

Course:

*New Institutional Economics and
Economic Organisation theory*

Transactions (1)

- Focus is on New Institutional Economy (NIE) and Economic Organisation Theory (EOT)
- Fundamental unit of analysis is **transaction**.
 - Transaction is synonymous with economic concept of exchange → performance \Leftrightarrow counter performance
 - It is a two-sided mechanism.
 - Transactions can be organized by markets, organisations or by so-called hybrid forms.
 - To carry out a transaction, you have to make cost
 - i.e. how to organise transactions → for that reason we also can speak of EOT.
 - Markets and hierarchies are just two extreme forms of coordination mechanisms

Transactions (2)

- Transaction focuses on:
 - Co-ordination.
 - Incentives and motivation.
- Both demonstrate that organisation matter → how to organise
- The economic organisation theory is
 - particularly suitable for analyzing contractual relationships.
- The contracting approach to organizational theory emphasizes
 - the **voluntary** nature of people's involvement in (most) organisations
 - people will only give their loyalty to an organisation that serves their interests.

Firms

- In modern economic theory, a firm is an organisation that transforms input to output.
- In 1937 Coase:
 - markets do not regulate the whole of economic life.
 - In a firm, the co-ordination mechanism is not the price mechanism, but the firm itself.
- Important question within the EOT is why firms or organisations exist.
- The adjective New to NIE was added to distinguish it from early Institutionalists.

New Institutional Economics

- NIE tries to provide an economics with both “**theory**” and “**institutions**” (a complement to traditional neo-classical micro-economics).
- NIE looks at types and levels of institutions:
 - Institutional environment (= the rules of the game)
 - Informal and formal rules
 - Institutions of governance/institutional arrangements (= the play of the game)
- One important difference between these two is
 - the rules mainly **defines the environment of the governance structure**
- A governance structure is a way of implementing and operationalizing the “rules of the game”.

Institutional environment IA and institutional arrangement IA (1)

- NIE distinguishes between IA and IA
- The institutional environment
 - is the man-made constraints that structure political, economic, and social interactions.
 - delineates the **rules of the game within which the institutional arrangements (= governance structures)** actually operate, and
 - also prescribes the rules of conduct within which human actions take place.

IE and IAs (2)

- **Institutional environment (IE)**
 - consists of the basic formal and informal rules in a society.
 - differs between countries and even within countries the basic rules are not always the same.
 - rules are not always bound to borders
 - some parts of **IE** are more dynamic and change rather quickly, while other parts change more slowly.
 - Property rights belong to the IE
 - they determine
 - who has the power to control within an institutional arrangement and
 - consequently who has the right over the residual income.

IE and IA (3)

- Institutional arrangements or governance structures comprise the whole spectrum of co-ordination mechanisms,
 - with markets as one polar case situated at the **one end**, and
 - centralized organizations as another situated at the **other end** of the spectrum.
- Between these two polar cases we see all sorts of third way of co-ordination or **hybrid forms**, such as
 - Contracts
 - Associations
 - Clubs
 - Mutual adjustment
 - Standardization of norms

Co-ordination of activities

- Within organizations activities are often co-ordinated without the use of the market.
- Within a firm co-ordination of activities can take place
 - in a hierarchical way, based on authority or
 - mutual adjustment and standardization of norms
- Hierarchies can be seen as vertical co-ordination mechanism, and
- Markets as horizontal co-ordination mechanism.
- Co-ordination based on common values and norms, mutual adjustment and commitment can be found in
 - peer groups and partnerships
 - clubs
 - environmental co-operatives,
 - which can be characterized as a network organization in which people interact in a non-hierarchical way.

Co-ordination mechanisms

- Markets and organizations can be seen as the two polar cases of co-ordination mechanisms
 - The market makes use of market incentives (= prices).
 - Within an organizations coordination can, in the most extreme case, take place through “planning, command and control”.
- Hybrid forms work
 - with both market incentives and modalities of co-ordination
 - which can contain certain forms of hierarchical relationships.
- Examples of hybrid forms are
 - Contracts
 - clubs
 - co-operatives.
- Markets, organizations and hybrid forms like contracts are
 - **media** (i.e. **institutional arrangements** or **governance structures**)
 - or supporting structures for carrying out transactions.

NIE and EOT

- New Institutional Economy (NIE) is also called Economic Organisation Theory (EOT)
- They overlap completely in general economics and business economics.
- Differences:
 - NIE can be seen as a supplement to general economics theory based on the neo-classical theory,
 - while the EOT can be seen as a supplement to business economics.
 - EOT focuses mainly on institutional arrangements: markets, organisations (including firms) and hybrid forms like contracts
 - also known as governance structures or supporting structures for carrying out transactions.
 - The field of study of NIE goes beyond that of EOT (including e.g. IE on a micro level as well as on a macro-level)

Formal and informal rules of society

- Institutional environment consists of
 - the formal rules and
 - informal rules of society
 - Social capital
- Formal rules of the game
 - include laws and rules of society,
 - the way these are enforced, and monitored, and sanctions and conflict-resolving mechanisms are applied.
- Informal rules
 - consist of sanctions, taboos, customs, traditions, norms, values and beliefs and common codes of behaviour
- Social capital (see next sheet)

Social Capital

- Social capital is
 - shared knowledge, understandings, norms, rules, and
 - expectations about patterns of interactions that groups of individuals bring to a recurrent activity
 - Trust is perhaps the most important component of social capital.

- A small amount of social capital in society will lead to higher transactions costs.

The four levels of institutions (Williamson)

Level 1	Frequency (years)	Core elements	Purpose
Level 1 Social theory	100 to 1000	Embeddedness: informal institutions, customs traditions, norms, religion	Often non-calculative; spontaneous
Level 2 Economics of property	10 to 100	Institutional environment: formal rules of the game - especially property (polity, judiciary, bureaucracy)	Get the institutional environment right; 1 st order economising
Level 3 Transaction Costs Economics	1 to 10	Governance: play of the game - especially contract (aligning governance with transactions)	Get the governance structures right; 2 nd order economising
Level 4 Neo-classical Economics / Agency theory	continuous	Resource allocation and employment (prices and quantities; incentive alignment)	Get the marginal conditions right; 3 rd order economising

Levels of institutions

- Social embeddedness level
 - ❑ common values and norms, informal rules
- Institutional environment level
 - ❑ formal rules
- Governance structures level
 - ❑ markets, organisations and hybrid forms
- Resource allocation and income distribution level
 - ❑ prices, incentives, etc.

Fields of study (1)

NIE and EOT look at the following fields of study:

1. **Transaction cost economics (TCE)**

→ *Tries to explain which institutional arrangement has a comparative advantage in carrying out transaction.*

- Environmental characteristics important for the level of transaction costs are:
 - asset specificity,
 - uncertainty and
 - frequency of the transaction.
- The empirical object of TCE is formed by governance structures in which transactions are co-ordinated:
 - markets,
 - organizations and
 - Hybrids forms: institutional arrangements which lie in between these polar cases.

Fields of study (2) Transaction and transition cost

- **Transaction cost economics**
 - transaction is basic unit of analysis
 - assumes that the IE is unchanging, **at least for the moment of analysis**
 - is an comparative static analysis
 - changes in the IE elicit shift in comparative costs of governance
- **Transaction costs**
 - cost of running a system
 - cost of gathering information, co-ordination and motivation

Fields of study (3) Transaction and transition cost

- **Transaction cost** should be distinguished from **transition cost**
- **Transition cost** are
 - the cost of creating, building up or changing a **system** or **institutional structure**
 - or the cost of institutional provision that will change the IE
 - e.g. the cost of developing a land cadastre
 - it is an institutional provision that belongs to the IE
- **Stretching out transaction costs to transition costs**
 - it is not more in line with TCE as comparative static analysis
 - it will miss a sound theoretical basis

Fields of study (4)

- Results of transactions are strongly influenced by IE
 - Lack of property rights or the corrosion of property rights had a negative incentive on revealing productive activities or investing → society has a hold up problem.
 - The environment in the western part of the world had developed
 - from a situation where monarchs had the monopoly of violence
 - to a situation of a constitutional state and parliamentary democracy.
- In a modern constitutional state and parliamentary democracy
 - law and rules form important a part of the formal rules of the game of the institutional environment.
- Together with the informal rules and level of social capital
 - they form the behavioural framework in which individuals act.

Fields of study (5)

2. Information economics

Information economics is branch of economic theory, in which economics study the characteristics and implications of the phenomenon of information.

- Lack of information:
 - essential adequate information is missing.
- Information asymmetry:
 - information is available but unevenly distributed.
- Individuals will try to eliminate their lack of information
 - by collecting information before they make their final decision
 - The acquisition of information involves transaction costs.
- To reduce uncertainty in the economy all sorts of (formal) rules have been implemented over the time.
 - Building and preserving social capital can also reduce uncertainty.

Fields of study (6)

3. Agency Theory (principal-agent theory)

The principal/agent framework can be used in situations in which a person, the principal, has a certain relationship with another person, the agent.

- Central problem:
 - how should a contract be designed to motivate the agent optimally to act in a way that serves the interests of the principal.
- The agency theory is characterized by:
 1. Conflict of interests
 2. Information asymmetry and uncertainty
 3. Entering into agreements and concluding contracts
 4. Questions like how contracts influence the behaviour of the participants.

Fields of study (7)

4. Complete contract theory

The basic model of a perfect competitive market relies on a number of assumptions.

- In the same way we can speak about contracts
- A complete contract
 - specifies what each party has **to do in every possible situation** and
 - arranges the distribution of realized costs and benefits in each contingency so that
 - each party individually finds it optimal to follow the contract's terms.

Fields of study (8)

5 The incomplete contract theory

- *Factors which lead to incomplete contracts:*
 1. Complexity and highly unpredictable world
 2. Difficulties in negotiating because of
 - uncommon language to describe the states of the world and actions
 - where prior experience may not provide much of a guide.
 3. Difficulties in writing plans down in such a way that
 - in the event of a dispute,
 - an outside authority can figure out and decide what these plans mean and
 - enforce them.

Fields of study (9)

6. The role of the institutional environment

The institutional environment consists of the basic rules, as established in formal and informal rules in the society.

- The institutional environment differs between countries, and even within countries the basic rules can vary.
 - Some parts of the institutional environment are more dynamic and change rather quickly than others.
 - Under favourable conditions,
 - the institutional environment enables to take place transactions by institutional arrangements
 - that lead to a decrease of transactions costs.

Fields of study (10)

7. The role of social capital

Social capital

- includes elements of institutional environment
- belongs to social embeddedness
- glue that holds society together
- facilitates co-operation between people
- reduces transaction costs
- important key elements
 - Trust (most important component of social capital)
 - Common values and norms/rules
 - reciprocity (and reputation)
 - commitment
 - connectedness
- A small amount of social capital within a group, organisation or society leads to higher transaction costs.

Fields of study (11)

- Social capital can improve co-ordination and motivation and can therefore reduce transaction costs.
- **Trust** plays important role outside, but also between and within the organisation:
 - Lowers cost of search and monitoring.
 - Reduces cost of contracting and control.
- 3 different notions of trust
 - Trust in people (behavioral trust).
 - Trust in the institutional environment (confidence).
 - Trust in organisations (and government)
- Sources of trust are related to the institutional environment and to institutional arrangements.
 - Process trust

Fields of study (12)

8. The property rights theory

- Property rights belong to the institutional environment

Two important approaches:

Approach 1:

1. property as a bundle of rights
2. property rights regimes

Approach 2: What does it mean to own an asset?

- Who has the residual control rights and who is able to capture the residual income
- Is particularly important for incomplete contracts

Fields of study (13)

9. Takings

We have to balance the economic costs and the benefits of the provided public goods. For that reason an economic analysis of takings have to take place.

- Types of takings:
 1. Titular takings
 2. Regulatory takings
- Compensated and uncompensated takings have different incentive effects
→ uncompensated restrictions result in inefficient use.