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# Institutional Economics

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## Abstract

Institutional economics is interested in the interactions between institutions and the economy: how institutions influence the functioning, performance, and development of the economy and, in turn, how changes in the economy influence the institutions. Institutional economics studies the impact of institutions on economy, how institutions evolve, and how they could be improved. In furthering institutional economics, more extensive exchanges between the communities of institutional economics and law and economics would be fruitful. Those interested in institutional economics should certainly be more aware of developments in law and economics and utilize these insights in their further research – and vice versa.

## Definition

Institutional economics is interested in the interactions between institutions and the economy: how institutions influence the functioning, performance, and development of the economy and, in turn, how changes in the economy influence the institutions. Institutional economics studies the impact of institutions on economy, how institutions evolve, and how they could be improved.

## Introduction

For readers from outside the discipline of economics, the adjective "institutional" in front of "economics" in the title of this entry may appear somewhat redundant. It would seem obvious that in order to understand what is going on in the economy, it is necessary to examine the institutions that the economy is embedded in. Thus, one could ask: why it is necessary to emphasize the term "institutions" in "institutional economics" given that "economics" should, logically, already include the analysis of "institutions"?

The reason for including the term "institutional" in front of "economics" is that neoclassical economics, which has constituted the economic mainstream since the mid-twentieth century, has paid only very limited attention to institutions. This has, at least partly, been due to the fact that economics came to be defined by its *method* (i.e., formalistic analysis of rational choice), rather than its *object* of analysis (i.e., the economy).

Fortunately, despite the lure of the mainstream economics in which the method was given prominence over the subject matter, a sufficient number of economists have been interested in real-life economies. In studying the *economy* as a subject matter, however, institutions cannot be

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ignored for too long before the analysis becomes stalled. Thus, in recent decades, institutions have returned to economic analysis, with an increasing number of economists paying attention to the role of institutions when explaining what is going on in the economy.

The law and economics movement has certainly played an important role in bringing "institutions" (like law) back into economics. Indeed, institutional economics and law and economics are closely related: they have similar intellectual roots, common pioneers, and overlapping research agenda. Law is, obviously, one of the most important "institutions" that are studied in institutional economics. Some would even say that "law and economics" could be viewed as one of the subfields or "building blocks" of institutional economics.

## What Is Institutional Economics?

Most broadly speaking, institutional economics is interested in the interactions between institutions and the economy: how institutions influence the functioning, performance, and development of the economy and, in turn, how changes in the economy influence institutions. Institutional economics studies the impact of institutions on the economy, how institutions evolve, and how they could be improved.

When studying the economic system, institutional economics assumes that "institutions matter" since institutions are the key element of any economy and should hence be placed at the center of analysis. Various definitions of the term "institution" have been offered by different authors. Broadly speaking, institutions can be defined as formal and informal rules, including their enforcement mechanisms. Douglass North, who can be considered as one of the "bridge-builders" between the old and new institutional economics, has defined institutions as "the rules of the game in a society" (1990, p. 3) or, more specifically, "humanly devised constraints that structure political, economic and social interaction" (1991, p. 97). According to North, institutions consist of both "informal constraints" (e.g., customs, traditions, and codes of conduct) and "formal rules" (e.g., constitutions and laws).

Some analysts (especially in the new institutionalist camp) have considered it useful to distinguish between different levels of analysis in examining institutions (see, e.g., Williamson 2000; North 1990): (1) the "highest" or so-called "social embeddedness" level entails norms, customs, and traditions; (2) the next level – the "institutional environment" – comprises of constitutions, laws, and political institutions; and (3) the lowest level of analysis looks at "institutional arrangements" or "governance arrangements" (e.g., vertical integration, franchising) and "organizations" (e.g., political parties, firms, and trade unions). Institutional economics considers all these different levels of analysis as worthy pursuits (including interactions between the different levels), though admittedly, a lot more progress has been made on the third level of analysis than on the first two, where a lot of research still remains to be done.

### Roots of Institutional Economics

The roots of institutional economics go back (at least) to the German historical school (represented, e.g., by Gustav von Schmoller, Wilhelm Roscher, Werner Sombart, and Max Weber) and the American institutionalist school (represented, e.g., by John Commons, Thorstein Veblen, and Wesley Mitchell) (for more detailed discussions, see, e.g., Medema et al. 1999; Rutherford 1994). The historical school dominated the discipline of economics in Germany from 1840s to 1940s, whereas the American institutionalist school had its peak during the interwar period. While there were important differences between these two schools and also between the individual thinkers

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within them, what they had in common was the focus on the role of institutions in shaping economic outcomes and their critique of the neoclassical approach to economic analysis (especially the formalistic aspects of it). The German historical school underscored the importance of sensitivity to specific cultural and historical circumstances in economic analysis (resulting in their emphasis on using empirical data to ground economic theories). The American institutionalist school emphasized the relevance of institutions (including the role of the laws and the state) in analyzing the economy. Commons (1924), for example, examined the legal underpinnings of the capitalist economic system; he demonstrated how evolutionary changes in the economic domain (e.g., with regard to what types of activities were deemed reasonable) facilitated specific changes in laws (e.g., the transformation of how the concept of property was legally defined) and how these changes, in turn, facilitated specific forms of economic activity. The American institutionalist school was also skeptical of the notion of the fixed preferences of individuals and emphasized that individual preferences can be shaped by the institutions that surround them (e.g., via forming habits, as argued by Thorstein Veblen). In addition, the institutionalists criticized the static approach of the neoclassical economics and emphasized the evolutionary nature of economy (and hence the focus on change, technology, and innovation in economic analysis) (see, e.g., Veblen 1898).

In the postwar period, the popularity of the institutionalist approaches waned and economics became dominated by neoclassical economics. However, the institutionalist traditions were carried on by economists like Clarence Ayres, Karl Polanyi, John Kenneth Galbraith, Allan Gruchy, Simon Kuznets, Gunnar Myrdal, Ragnar Nurkse, Joseph Schumpeter, and others. In law and economics, the institutionalist traditions have been carried on by Allan Schmid, Warren Samuels, Nicolas Mercuro, and Steven Medema.

## Different Approaches Within the "Modern" Institutional Economics

Until a decade or so ago, authors writing about "institutional economics" considered it necessary to distinguish between "old" and "new" institutional economics (for a more detailed discussion of the differences between these two camps, see, e.g., Rutherford 1994). "Old" institutionalism referred to researchers (e.g., Wendell Gordon, Allan Gruchy, Philip Klein, Marc Tool, Warren Samuels, Allan Schmid) following the traditions of John Commons, Thorstein Veblen, Wesley Mitchell, and others. The "new" institutional economics referred to the developments in economics that started in 1960s (led by Ronald Coase, Douglass North, and Oliver Williamson) when institutions were (at least to some extent) "brought back in" to the economic mainstream. Many authors in the emerging new institutional economics camp (e.g., Robert Sugden, Andrew Schotter, Mancur Olson, and Richard Posner) attempted to use the analytical tools of neoclassical theory to explain the emergence and impacts of institutions, with a specific attention to transaction costs, property rights, and contractual relations. In more recent years, however, the academics in the new institutionalist camp have increasingly moved away from the assumptions of neoclassical economics.

While one can still observe differences between the "old" and "new" camps, one can also talk more generally about (modern) institutional economics. In the light of the recent convergences between the camps (see, e.g., Dequech 2002), it would be helpful to offer a more *synthesized* view of what institutional economics is about. Thus, this entry tries to delineate the "common" ground of different institutional approaches by focusing on issues that many (if not most) researchers involved in doing research in institutional economics would agree are important.

Still, it is worth keeping in mind that institutional economics entails a rather diverse (and to some extent also conflicting) set of approaches. These different research streams vary with regard to the substantive questions studied and the methodology applied. Thus, institutional economics is not a single, unified, all-embracing, and well-integrated theory, proceeding from a set of common

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assumptions and hypotheses. Instead, it consists of different "building blocks," coming from different traditions. Furthermore, it is worth emphasizing that institutional economics is an openly interdisciplinary endeavor, which draws on other disciplines (like sociology, psychology, anthropology, history, political science, public administration, and law) in order to understand and explain the role of institutions in economic life.

## Differences Between Institutional Economics and Neoclassical Economics

Although at least some of the topics that used to be the playground of institutional economics have gradually found their way into the economic mainstream and there is a growing consensus about the importance of institutions in influencing economic growth (see, e.g., Acemoglu et al. 2005), it is still too early to say that "we are all institutionalists now." Hence, a few remarks on how the *institutional* approach in economics differs from the *neoclassical* approach are still necessary. It is worth keeping in mind, though, that the different institutionalist camps differ somewhat with regard to their "distance" from the orthodox neoclassical economics: those who are closer to the "old" institutionalist traditions are further removed from the neoclassical assumptions than those in the "new" institutionalist camp.

In sum, the differences between the (mainstream) neoclassical economics and institutional economics are the following (for a more systematic comparison, see, e.g., Hodgson 1988; Medema et al. 1999):

First, while neoclassical economics proceeds from the assumption of "rational" individuals who maximize their utility (*homo oeconomicus*), the institutionalist approach takes a more realistic view of individual behavior: it regards individuals as being purposeful but only *boundedly rational*. Unlike orthodox economics, institutional economics emphasizes the importance of severe information problems (including uncertainty about the future) and the costs involved in obtaining necessary information. Proponents of institutional economics have hence criticized the orthodox approaches for simply "assuming away" the information problems and "assuming" perfect knowledge.

Second, in contrast to the neoclassical approach of treating the tastes and preferences of individuals as "given" or "fixed" (at least for the purposes of analysis), most institutional economists view the individuals as "social beings" and hence consider it necessary to proceed from the assumption that preferences are *malleable* and that *changes* in preferences should be analyzed as well, including the role of institutions in molding individual preferences and purposes (via changes in habits, as argued by Hodgson 1988, 1998).

Third, while neoclassical economics is concerned with states of *equilibria* and equilibrium-oriented theorizing (focusing on "mechanistic" optimization under static constraints), most institutional economists prefer to take a more evolutionary view of economic phenomena and also institutions. They emphasize that economic development has an *evolutionary* nature and hence prefer dynamic modes of theorizing, with a focus on longer-run processes of continuity and change, entailing path dependencies, transformations, and learning over time. Institutional economics is also interested in the evolutionary nature of the interactions between institutions and the economy. Further, while the neoclassical economics treats technology as "given" (or exogenous), institutional economics emphasizes the importance of examining the role of technological changes (and their interactions with institutions) in economic development.

Fourth, while neoclassical economics tends to treat the use of *power* as given (and accept the power structure as it is), at least some institutional economists (especially those with closer ties to the "old" institutional economics) are concerned with how power is actually deployed in the economic, political, and societal settings. Power is deemed important because power relations influence who gets to shape the institutions (including legal rules), whose values dominate, and whose "interests"

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are to be regarded as "rights." The allocation of rights, in turn, would influence the distribution of power in society (see, e.g., Acemoglu et al. 2005; Furubotn and Richter 1997; Medema et al. 1999).

## Why and How Do Institutions Matter?

Most generally speaking, institutions "matter" for the economy because the structures entailed in the institutions influence the behavior of the economic actors, which in turn influences the functioning and performance of the economy. The influence from the "institutions" to the "economy," however, is not unidirectional: changes in the economy can bring about changes in institutions as well and, hence, it would be more accurate to talk about mutual interactions between institutions and the economy (see, e.g., Medema et al. 1999). In other words, we should not take a deterministic view of institutions according to which institutions always *determine* the actions of individuals: the causal arrow can go in the other direction as well. "Actors and structure, although distinct, are thus connected in a circle of mutual interaction and interdependence" (Hodgson 1998, p. 181).

How do institutions influence the behavior of economic actors? There are different ways to answer the question. The answer closest to mainstream economics is that institutions shape the "choice set" available to the economic actors and "structure the incentives" of the actors (hence making a certain course of action more attractive than other courses) and thus steer individual behavior via affecting the costs and benefits associated with different types of actions (including engaging in different types of economic activities) (see, e.g., Acemoglu et al. 2005; Eggertsson 1990; Furubotn and Richter 1997; North 1991). Other answers point to the more "sociological" and deeper "psychological" mechanisms and emphasize role of institutions in shaping the habits and, through that, also the preferences of individuals, which, in turn, would influence their choices and actions (see, e.g., Hodgson 1988, 1998).

At the most basic level – and this is something that all institutionalists agree with – institutions influence the interactions of economic actors by providing "order" and reducing uncertainty in exchange. Given that institutions outline the "rules of the game" (which provide boundaries, constraints, and patterns for behavior), they provide economic actors with information about the potential behavior of *other* actors and hence help to establish baseline conditions for interactions between economic agents. Hence, institutions allow individuals to make reliable predictions about what *other* economic agents are likely to do in any given circumstance, which allows them to proceed with decision-making, negotiations, and exchange with at least some level of certainty (see, e.g., Hodgson 1988; Kasper and Streit 1998; Nelson and Sampat 2001; North 1991). Thus, institutions can both *constrain* and *enable* individual actions, e.g., by providing information about the behavior of others, defining pathways for doing things, allowing coordinated actions, and limiting opportunistic and arbitrary behavior.

Many institutional economists have emphasized that institutions influence the size of *transactions costs* associated with exchange relations (see, e.g., Furubotn and Richter 1997; Kasper and Streit 1998; North 1991). Transaction costs involve different cost associated with exchange processes, including search and information costs (e.g., discovering what one wants to buy, who the sellers are, and what the prices are), bargaining and decision costs (e.g., associated with drawing up a contract), and policing and enforcement costs (see, e.g., Coase 1960; Furubotn and Richter 1997; North 1991). For example, provisions of contract law can help to lower the costs of concluding and enforcing contracts (e.g., the possibility to turn to courts in case of a breach reduces the need undertake "private" safeguarding measures by the parties themselves) and to hence facilitate impersonal contracting between strangers.

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It has to be emphasized, however, that the institutions that have evolved in any given country do not necessarily *guarantee* a well-functioning economy and fast economic development. The institutions that have emerged can also be highly inefficient and entail elements that clearly hinder technological advances and economic development and growth (Freeman and Perez 1988; North 1990, 1991; Nelson and Sampat 2001).

## Some Examples of How Institutions Influence Economic Performance

While lot of research still needs to be undertaken in order to achieve fuller understanding of the role of institutions in economic development, a number of insightful studies have been conducted so far. A complete overview of these achievements is certainly beyond the scope of this entry. Thus, the examples below constitute only a small portion of the body of research in institutional economics and should be viewed as indicative rather than exhaustive.

### Markets as Institutions

Mainstream economics tends to treat the market as some sort of a "natural" feature of a social domain, an aggregate of individual bargains, resulting from free exchange between economic agents – almost as "an ether in which individual and subjective preferences relate to each other, leading to the physical exchange of goods and services," independent of institutions (Hodgson 1988, p. 178). In contrast, for most institutional economists, the market should be conceived of as an institution (or a set of institutions), involving "social norms, customs, instituted exchange relations and – sometimes consciously organized – information networks" (Hodgson 1998, p. 181). Institutional economics emphasizes that market institutions (and the institutions the market is embedded in) can play an important role in lowering transaction costs and hence facilitate more exchange relations.

Institutionalist research has also examined the role of the state in creating (what mainstream economists call) "free markets." Karl Polanyi (1944), for example, shows, in his study of the Industrial Revolution in Great Britain, that the development of free markets in the eighteenth and nineteenth centuries actually involved a significant increase in the activities of the government: more legislation was called for and more administrators needed to monitor and safeguard the free working of the market system. In other words, the creation of "free markets" implied an increase in the control, regulations, and intervention by the state. The same applies today: "every successful market economy is overseen by a panoply of regulatory institutions, regulating conduct in goods, services, labor, assets, and financial markets" (Rodrik 2000, p. 7). The "freer" the markets, the greater the vigilance that may be required from the regulatory institutions (e.g., in the field of antitrust, financial regulation, securities legislation, etc.) (ibid).

In the light of these findings, some institutionalists emphasize that the dichotomy between regulation vs deregulation (or intervention vs nonintervention or "more" vs "less government") is false. Instead, one should ask which *type* of regulation and intervention the state is engaged in (and for what ends) and whose "interests" are protected as "rights" by the state (Hodgson 1988; Medema et al. 1999). For example, if the government relaxes regulations pertaining to workplace safety, it expands the set of rights of employers and narrows the set of rights of employees – and vice versa when these regulations are toughened. In either case, the government is "present" – via the legal framework and the mechanisms of enforcement (Medema et al. 1999).

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## Property Rights

An important set of institutions that has captured the attention of many institutional economists – both in the "old" and "new" camps, from Commons (1924) to North (1990) – involves *property rights*. Again, while neoclassical economics takes property rights as "given" (i.e., perfectly defined), institutional economists take a much closer look at the actual definition, delineation, allocation, and enforcement of property rights and how these influence exchange relations and other economic activities. Institutionalists from different traditions agree that the specific content of property rights (e.g., control rights over assets or resources) and the way they are enforced influence the allocation and use of resources. As Rodrik (2000, p. 6) puts it, "an entrepreneur would not have an incentive to accumulate and innovate unless s/he has adequate control over the return of the assets that are thereby produced or improved." Thus, for example, when property rights are not credibly secured (e.g., when there is a threat of expropriation by the government or unilateral seizure by another private actor), entrepreneurs are less likely to adjust (efficiently) to changes in technology, to invest (e.g., in research and development, which facilitates technological change), and to innovate. In contrast, secure property rights encourage firms to make higher value-added investments with longer-term time horizons (Keefer and Knack 1997).

Institutional economists have also examined the role of the *state* in protecting property rights. On the one hand, it is emphasized that protection of individual property entails legal structures for recognizing, adjudicating, and enforcing these rights, which can be provided by the state (e.g., Sened 1997). On the other hand, it is argued (especially by the new institutionalists) that the state can also pose a danger to private property through expropriation (Furubotn and Richter 1997). Bringing these two arguments together, Douglass North (e.g., 1990, 1991) has argued that economic development is fostered by an institutional environment in which the state is sufficiently strong to protect the private parties from seizing each others' property but can at the same time make a credible commitment not to expropriate the very same property it is defending and securing. As Hodgson (2004) puts it, "For private property to be relatively secure, a particular form of state had to emerge, countered by powerful and multiple interest groups in civil society. This meant a pluralistic state with some separation of powers, backed up by a plurality of group interests in the community at large." In his empirical studies, Douglass North has argued that the establishment of clear and secure property rights played a major role in the economic development and rise of the "West." Establishing secure property rights (with a credible commitment by the state to respect and secure them) allowed, for example, the emergence of capital markets and the employment of technology necessary for industrial production (see, e.g., North 1990, 1991). Many other studies (e.g., Acemoglu et al. 2005; Keefer and Knack 1997) have confirmed that finding.

Another discussion concerning property rights pertains to the question of whether the policy instrument of more extensive allocation of property rights implies "more" state or "less" state. Some economists in the new institutionalist camp (e.g., Demsetz, Alchian) regard clearer definition and allocation of property rights (especially the extension of private property) as "solutions" to different types of market failures, hence allowing the "lessening" of the need for government intervention. Hodgson (1988, p. 152), in contrast, has pointed out that by expanding the domain of formal property rights, the state still remains engaged, but in a different way – through the extension of litigational activity. Chang (2007), among others, has also warned us of the dangers of using the institutional prescription of "private property rights" as the main "solution" for guaranteeing economic development (see also Rodrik 2000). Indeed, a whole stream of research examines the conditions under which different types of ownership – private property, common property, state property, and various hybrid forms (like the township and village enterprises in China) – lead to optimal use of resources. Elinor Ostrom (e.g., 1990), for example, has shown that in the case of

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common-pool resources, common property can (when combined with suitable institutional arrangements) lead to a better use of natural resources (e.g., fish stock, forests, water) than either privatization or nationalization.

### Political Institutions and Bureaucracy

One of the building blocks in the institutionalist literature looks at the impacts of specific features of *political institutions* (including constitutions) on economic performance. The starting point for many of these studies is that the balance and separation of powers and the number and power of veto players are likely to influence the general character of policy action (including the levels of decisiveness and credibility) and also specific features of policies and laws the governments adopt, which, in turn, can influence economic performance. For example, it has been examined how the level of democracy (and the level of inclusiveness in governance) but also specific constitutional features – like government type (presidential vs parliamentary), electoral rules (e.g., plurality vs proportional), the organization of the judiciary, and vertical separation of powers – influence economic performance (see, e.g., Acemoglu et al. 2005; Persson and Tabellini 2003; Rodrik 2000).

Yet another stream examines the role of administrative structure, public administration, and the characteristics of bureaucracy in the economic growth and development. Evans and Rauch (1999) show that economic growth is higher in those developing countries where the bureaucracies entail more Weberian elements (e.g., recruitment based on merit and predictable long-term career paths). They argue (drawing, e.g., on Weber [1904–1911] 1968 and also Polanyi 1944) that merit-based recruitment and long-term careers facilitate higher competence of public administrators, lower levels of corruption, and long-term orientation. These factors, in turn, facilitate the design and implementation of policies that can help to promote growth, e.g., the provision of long-term (public) investments that complement those made in the private sector and helping private sector actors to overcome coordination and information problems (see also Rodrik 2000; Wade 1990).

## Concluding Remarks

Despite an increasing number of studies examining the links between institutional setting and economic performance, we are only at the beginning of the journey to understand the interrelations involved and which institutions constitute a “good fit” in different countries and contexts. As Chang (2007, p. 3) puts it: “We are still some way away from knowing exactly which institutions in exactly which norms are necessary, or least useful, for economic development in which contexts.”

As the experience of transition, emerging, and developing economies has demonstrated, in further studies it would be necessary to explore the effects of different *configurations* of (complementary) institutions rather than examining the effects of specific institutions (e.g., the establishment of private property rights or the adoption of a new contract law) in isolation.

Also, the relationships between informal and formal institutions still need to be examined further. It is clear that the effectiveness of “formal” institutions (e.g., laws and regulations) depends on whether they fit sufficiently well with the “informal” institutions (like norms and customs), which in turn influences, for example, how well institutional transplants (from one country to another or implementing the “best practice” blueprints) can work. However, we are still far from completely understanding how informal forms emerge and persist, how such informal norms interact with formal norms, and how that, in turn, influences specific economic activities in a given country.

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Finally, we still have only limited knowledge of how institutions conducive to economic development in specific contexts can be "built." These are all important arguments for undertaking more in-depth qualitative and comparative studies in the field.

In furthering institutional economics, more extensive exchanges between the communities of institutional economics and law and economics would be fruitful. Those interested in institutional economics should certainly be more aware of developments in law and economics and utilize these insights in their further research – and vice versa.

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