

Introduction to Institutional Analysis

Purpose of the lecture: to determine the subject, and areas of study of institutional economics

Original (Old) Institutional Economics (OIE)

Institutionalism arose in the USA in the late 19th - early 20th centuries and is associated with the names of T. Veblen, W. Mitchell, John R. Commons.

A broad network of OIE-scholars formed an influential movement in American economics in the period 1918–1947.

Their approach is characterized by:

- 1) underlining the role of institutions as constraining and enabling behavior, and highlighting the institutional role in shaping values, beliefs and preferences;
- 2) incorporating a social psychology which is consistent with recognizing that institutions influence values, beliefs and preferences, and a related rejection of the idea of utility maximizing;
- 3) an open empirical and critical investigation of social phenomena;
- 4) critically examining the functioning of prevailing institutions, and;
- 5) adhering a pragmatic and humanistic approach to social value;
- 6) *criticism of the orthodox neoclassical theory* (equilibrium theory, the concept of *homo economicus*, formalism)

New Institutional Economics (NIE)

The term 'new institutional economics' was originated by Williamson (1975). NIE, which began to develop as a self-conscious movement in the 1970s, traces its origins to Coase's analysis of the firm (Coase, 1937), Hayek's writings on knowledge (Hayek, 1937, 1945) and Chandler's history of industrial enterprise (Chandler, 1962), along with contributions by Simon (1947), Arrow (1963), Davis and North (1971), Williamson (1971, 1975, 1985), Alchian and Demsetz (1972), Macneil (1978), Holmström (1979) and others. Its best-known representatives are Coase, Williamson and North.

OIE and NIE

Both schools of thought OIE and NIE recognize the role of institutions and agree that institutions are matter. And this is the most important thing that combines two schools.

OIE and NIE

Table I.1.2 Radical distinctions between the ‘old’ institutionalism and neoinstitutionalism

Indications	Old institutionalism	Neoinstitutionalism
Movement	From the law and politics to economics	From economics to politics and law
Methodology	Other social sciences (law, politology, sociology, etc.)	Neoclassical economics (methods of microeconomics and game theory)
Method	Inductive	Deductive
Focal point of attention	Collective action	Independent individual
Assumptions	Holism	Methodological individualism

OIE and NIE

Moreover NIE-scholars focus on efficiency, while OIE-scholars focus on social reform.

First, the 'old' institutionalists approach economics from the point of view of law and politics, in an effort to try to study the problems of modern economic theory by methods used by other sciences. Neoinstitutionalists use a completely different way: they study political and legal problems using the methods of neoclassical economics and using modern microeconomics and game theory.

Second, traditional institutionalism essentially relied on the inductive methods and intended to move from particular cases to generalizations. Therefore, no common institutional theory has been developed. Neoinstitutionalism uses a deductive method: from the general principles of neoclassical economics to the explanation of the particular phenomena of social life.

Third, the 'old' institutionalism as the current of a radical economic thought focused on the actions of groups (mainly, trade unions and government groups) dealing with the protection of the interests of the individual. Neoinstitutionalism focuses on the independent individual who chooses which organisation is more expedient to him.

NIE

- The new institutional theory in the field of methodology has common roots with the neoclassical concept.
- Modern institutional economics apply the analytical apparatus of neoclassical theory to explain the workings and evolution of institutional arrangements.

NIE and Neoclassical economics

Neoclassical economics	New Institutional Economics
information	
perfect, symmetric	neoclassical theory imperfect, asymmetric
rationality	
full	bounded (Herbert Simon)
How market economy functions	
without costs	transaction costs
Property rights	
full specification (property rights are well defined)	incomplete specification
actors	
individuals, firms, state	individuals
product properties	
price, quantity	price, quantity, quality
preferences	
Exogenous	Endogenous
Opportunism	
impossible	available

The Main Directions of Institutional Theory

Williamson's Framework for Institutional Analysis

Oliver Williamson characterizes four levels of social analysis. The first concerns itself with social theory, specifically the level of embeddedness and informal rules. *The second* is focused on the institutional environment and formal rules. It uses the economics of property rights and positive political theory. *The third* focuses on governance and the interactions of actors within transaction cost economics, "the play of the game." Williamson gives the example of contracts between groups to explain it. Finally, the fourth is governed by neoclassical economics, it is the allocation of resources and employment. *New Institutional Economics is focused on levels two and three.*

The Main Directions of Institutional Theory

- *“Economic imperialism”*
- This direction of institutionalism has expanded the subject area of traditional economic theory and uses the economic tools to study such non-market phenomena as racial discrimination, education, marriage, crime, parliamentary elections, etc.
- A prominent representative of this trend is **Gary S. Becker**. Becker extended the domain of economic theory to aspects of human behavior which had previously been dealt with by other social science disciplines such as sociology, demography and criminology. He argued that many different types of human behavior can be seen as rational and utility maximizing. Becker showed that people act rationally not only when they buy goods or save, but also when they study, get married, have children, follow fashion, attend church, and even when they commit crimes or use drugs. That is why, the economic approach provides the most fruitful framework for the theoretical understanding of any form of human behavior.

The Main Directions of Institutional Theory

- ***Public Choice Theory (James Buchanan)***. Public choice theory focuses on people's decision making process within the political realm. Buchanan used both the fields of economics and political science to help develop Public Choice. The same principles used to interpret people's decisions in a market setting are applied to voting, lobbying, campaigning, and even candidates. Buchanan maintains that a person's first instinct is to make their decisions based upon their own self-interest, which varied from previous models where government officials acted in constituents' best interest. Buchanan explains public choice theory as "politics without romance" because, he says, many of the promises made in politics are intended to appear concerned with the interest of others, but in reality are the products of selfish ulterior motives. According to this view, political decisions, on both sides of the voting booth, are rarely made with the intention of helping anyone but the one making the decision. Buchanan argues that by analyzing the behaviors of voters and politicians that their actions could become easily predicted

Additional Reading:

Eggertson Thr. Neoinstitutional Economics. // Newman P. The New Palgrave Dictionary of Economics and the Law. Macmillan Reference, 1998, Vol. 2, pp. 665-670.