A CONCEPTUAL FRAMEWORK: THE NEW INSTITUTIONAL ECONOMICS

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1. INTRODUCTION

Following Hayami and Ruttan (1985), one can argue that the pace of economic development depends upon the interactions among institutions, patterns of resource endowments, technology, and cultural endowments. It is on the first two factors that the Ninth Conference on the Ethiopian economy focuses as its theme.

To analyze this theme, a theoretical framework is obviously required. As orthodox neo-classical economics (which assumes institutions as given) is incapable of adequately meeting this task, it is important to consider a relevant theoretical tool, for this purpose.

One such theory is the new institutional economics (NIE), a school of thought that was meant not to abandon but save neoclassical economics. The NIE, though yet at its formative stage, has gained wide currency in recent years. Its importance was underlined with the award of the Nobel Prize to two leading institutional economists, i.e. Ronald Coase in 1991 and Douglass North in 1993. Currently, an increasing number of economists have shown interest in the NIE, as can be suggested by the volume of publications that are coming out. Non-economists, too, are perhaps interested in the subject because economists have finally come out with a school of thought that would provide a forum for an interdisciplinary discourse on the problems of development.

However, to the extent that the majority of economists and non-economists are concerned, one can argue that the NIE is little understood. Very few professionals appreciate the subject matter and the basic assumptions of this theory. Even the meaning of "institutions" and why the adjective "new" is included in the nomenclature of the theory may not be clear to those who want to know more about the subject. Above all, the relevance and applicability of the NIE to problems of development are not yet well established as the literature has remained highly fragmented and incomplete.

The framework paper addresses the following questions: what do we mean by "institutions"? (section two); what are the limitations of mainstream economics? (section three) and what are the fundamentals of the NIE? (section four).

2. INSTITUTIONS: CONCEPTUAL PROBLEMS

The term "institution" has remained confusing since its emergence in development literatures in the 1950s and 1960s. Its definitions vary widely not only among disciplines but also within them (Blase 1973; Bienkowski 1981). That is why Blase (1973) noted that "while a single, all-purpose definition of institution would be convenient, it does not exist, and the literature is not mature enough for its formulation at this time". In a recent paper, a senior economist at the World Bank (in reference to her colleagues at the Bank), noted that " they are confused by the different definitions used by different scholars of institutions" (Shirley 1997). Nabli and Nugent (1989), who provided the most authoritative work on the applicability of the New Institutional Economics (NIE) note that:

> The consensus on the centrality of institutions to development has not been matched by one on its definition. Different authors have used quite different definitions each emphasizing quite different aspects or characteristics of the more general phenomenon.

In defining "institutions", different authors have emphasized aspects of the term as can be seen from the following definitions:

- "Institutions are more settled habits of thought common to the generality of man" (Veblen 1919).
- "An institution is a long-established law, custom, or practice" (Advanced Learners Dictionary).
- "Institutions are the rules of the game in a society or, more formally, are humanly devised constraints that shape human interactions" (North 1990).
- "We define institutions as the legal, administrative and customary arrangements for repeated human interactions" (Pejovich 1995).

Most authors belonging to the new institutionalist school accept the definition provided by Douglass North. This definition takes institutions as rules of the game or constraints that shape human interaction: For the purpose of this conference we adopted North's definition (i.e. rules of the game) as further elaborated by Pejovich above.

In further elaborating his definition of institutions North (1996:344) noted that "institutions are the humanly devised constraints that structure human interactions". He then classifies constraints into several categories, namely, formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics. Together, these define the incentive structure of societies and specifically economies.

Informal rules have their origins in the experiences, traditional values, ethos, religious beliefs, ethnicity and other factors that influence the subjective perceptions individuals form to interpret reality. They are part of the heritage or culture, which is transmitted from one generation to another through teaching and imitation (Pejovich 1995:31; Boyd and Richerson 1985). Formal and informal rules might operate side by side as in the case of marriage rules in Ethiopia, where customary rules are enforced along with the civil code.

Moreover, similar formal rules operating in different societies may produce different outcomes (Pejovich 1995:32). Collectivization of agriculture had different results in the former Soviet Union and Ethiopia, although the two countries adopted more or less similar blueprints. The Grameen Bank model has worked well in Bangladesh but has produced different outcomes in Ethiopia (Dejene 1998). It has also been observed that "informal rules have frequently outlived formal rules" (Pejovich 1995:32).

One definition problem is whether organization is part of institution or not. Two different, although related, meanings are given to the term " institution" in discussion of development (Arkadie 1989:153). The first is as rules of the game. The second is as organization.

North makes a clear distinction between institutions and organizations. He writes that "if institutions are rules of the game, organizations and their entrepreneurs are the players" (North 1996:345). Accordingly, organizations are made up of groups of individuals bound together by some common purpose to achieve certain objectives. Thus, organizations include political bodies (e.g. political parties, regulatory bodies, a city council), economic bodies (e.g. firms, family farms, cooperatives), social bodies (e.g. churches, clubs, associations), and educational bodies (e.g. schools, universities).

However, there are other renowned adherents of the NIE who take "organizations" as "institutions." For example, Nabli and Nugent (1989:8-9) clearly indicate that "organizations" are also "institutions":

> Formal organizations such as labor unions and employers organizations are institutions because they provide set of rules governing the relationship both among their members and between members and non-members.

Another definitional problem is the disagreement as to whether institutions can best be understood from a behavioral perspective or from rules perspective (Nabli and Nugent 1989). According to the former, institutions are complexes of norms of behavior that persist over time, by serving collectively valued purposes (Uphoff 1986). North and his followers, of course, propose the latter view.

Institutions can be also defined in terms of certain characteristics they possess (Nabli and Nugent 1989). The first of such characteristics is the rules and constraints nature of institutions. The second is their ability to govern the relations among individuals and groups. It was this definition that one authoritative paper emphasized: "institution is defined as a set of humanly devised rules that govern and shape the interactions of human beings in part by helping them to form expectation of what other peoples will do" (Lin and Nugent 1995:2306-2307). The third is their predictability. That is, agents should expect rules and constraints to have some degree of stability; otherwise, they would not have an institutional character. Accordingly, "institutions" may be reflected in the appearance of certain behavioral regularities or norms" (Lin and Nugent 1995:2307).

We also note that the NIE provides a framework not only to explain the determinants of institutions and their evolution over time but also to evaluate their economic efficiency and distributional implications (Nabli and Nugent 1989:9b).

Some authors (e.g. Clague 1998:18) distinguish between different categories of institutions. These are (1) the constitutional order (which is stable in industrialized and in surviving communist countries and very unstable in Africa), (2) the institutional arrangements (which is widely discussed in the literature including this one), and (3) the cultural endowments (which change very slowly and are little discussed in the institutionalist literature, except in economic anthropology).

From the above, we can conclude that the literature suggests that, at present, there is no universal definition of " institution"; it depends on the type of discipline to which an author belongs and on the purpose at hand. Accordingly, for this review, we adopt the definition provided by Nabli and Nugent (1989). The essence of this definition is that it takes "institution" as a "set of constraints which governs the behavioral relations among individuals or groups." Accordingly, both formal and informal organizations are institutions because they embody rules that govern the behavior of individuals or groups. Moreover, "cultural rules and codes of conduct are institutions" in so far as they can constrain the interactions between individuals and/or groups.

How important are institutions in the process of economic development? Institutions structure economic forces and play an important role in expanding human choice–a fundamental goal of economic development. Institutions affect choice by influencing availability of information and resource, by shaping incentives, and by establishing the basic rules of social transactions. Institutional innovations contribute to development by providing more efficient ways of organizing economic activity (Ostrom et al., 1989). In the words of Douglass North (1992), "Institutions and the way they evolve shape economic performance." According to Burki and Perry (1998:143), "Well-defined institutions reduce transaction costs by ameliorating information and enforcement problems. Thus, they make possible the existence, efficiency, and depth of markets and organizations."

According to the followers of the NIE, institutions play the following roles in economic activities (Harriss et al., 1995:3): (1) institutions are broadly conceived as a means for reducing information and transaction costs (for details see North 1992); (2) institutions are formed to reduce uncertainty in economic activities (e.g. see North 1995); (3) institutional analysis enables us to understand that individuals make choices on the basis of their "mental models", (for details see North 1990; 1995); and (4) institutions provide the mechanism whereby rational individuals can transcend social dilemmas, where "social dilemmas" refer to those kinds of problems which arise when choices made by rational individuals yield outcomes that are socially irrational (Bates 1995).

3. LIMITATIONS OF MAINSTREAM ECONOMICS

The *raison-de-etre* of institutional economics emanates from the shortcomings of neoclassical economics. In neoclassical economic theory, institutions are taken as given. Mainstream economists tend to leave the analysis of institutional constraints and opportunities to professionals in other disciplines like anthropology, sociology, history, etc. In this theory, the "institutional framework has almost invariably been taken as given, and in many cases has been even altogether omitted" (Nabli and Nugent 1989:9b). Because it largely neglects institutions, some authors argue that mainstream economics is largely inappropriate to the analysis of problems of development. For example, Douglass North (1996:342-43) notes that "neoclassical theory is simply an inappropriate tool to analyze and prescribe polices that will induce development".

A very recent critique of mainstream economics has been provided by Ronald Coase (1998) in the *American Economic Review*. Coase notes that mainstream economics has "become more and more abstract over time, and although it purports otherwise, it is in fact little concerned with what happens in the real world." He goes further and notes that economists "study how supply and demand determine prices but not with the factors that determine what goods and services are traded on markets". In short, he underlines that "economists think of themselves as having a box of tools (an economic approach or methodology) but no subject matter". Coase wonders whether we would be able to study the circulation of the blood without a body!

The shortcomings of mainstream economics are not limited to the neglect of institutional analysis. Time is another factor that is largely neglected by this theory. The implication of this point is that history is not a subject matter of neoclassical economics. But to appreciate the continuity of society's institutions and learn from the past, economists need the knowledge of history as noted by Douglass North (1990:7):

> History matters. It matters not just because we can learn from the past, but because the present and the future are connected to the past by the continuity of society's institutions. Today's and tomorrow's choices are shaped by the past. And the past can only be made intelligible as a story or institutional evolution. Integrating institutions into economic theory and economic history is an essential step in improving the theory and history.

The condition of pure competition is taken as the core and essence of economic reality, although the neoclassical approach admits certain variants like the theories of monopoly, oligopoly or imperfect or monopolistic competition. More modern textbooks do treat recent variants like modeling with incomplete information (e.g. see Kreps 1990; Pindyck and Rubinfeld 1994). In fact, some of the recent concepts of the mainstream theory are capable of explaining aspects of development. For example, Winiecki (1996) used the theory of agency (adverse selection and moral hazard) to explain the inability of rulers in the former Soviet states to radically reform their economies. Similarly, researchers have used the concept of contractual choice to investigate contract enforcement problems in developing economies (e.g. see Manard 1998; Matoussi and Nugent 1989).

However, in spite of recent developments in the theory, pure competition, a largely unrealistic assumption, remains at the heart of the neoclassical approach. One implication of the assumption of pure competition is that transaction costs of doing business are zero. But in the real world, transaction costs are often positive and significant thus implying inefficiencies in economic activities. This problem is compounded when information becomes incomplete, asymmetric, and costly.

Moreover, conventional economic analysis grossly underestimates the role of institutional uncertainty in determining economic decision making, in particular, in developing economies as demonstrated by the case of Latin America (Borner et al., 1992). Institutional uncertainty, defined as "risk arising from a highly volatile institutional environment" (Borner et al., 1992:17), means that there are no clear and irrevocable rules of the game. This reflects the permanent danger of expropriation or limitation of property rights. Insecure access to land provides a good example of institutional uncertainty. Other examples of such type of risks include unpredictable judiciary, discontinuities in the legal system, unstable tax systems, volatile macroeconomic variables (e.g. unpredictable exchange rates), insatiable administration, civil conflict, etc.

4. THE NEW INSTITUTIONAL ECONOMICS

The foregoing problems have necessitated the emergence of different schools of thought within the economic thinking. One such school is the New Institutional Economics (NIE), which dates its origin back to the turn of this century when Thorestein Veblen undertook pioneering studies of issues in relation to institutions.

Two major traditions of institutionalist economics can be identified. The first is the American institutionalist tradition that began at the turn of the century and has continued to this day. This tradition, termed as "old" institutional economics (by adherents of the "new" institutional economics), has included the works of Thorstein Veblen, Westley Mitchell, John R. Commons, Clarence Ayres, Allan Gruchy, Marc Tool, Warren Samuels, and many others.

The second strand of institutionalist thought in economics is of relatively recent origin. It is termed as the "new" institutional economics (by its followers). It is found in the works of writers like Ronald Coase, Douglass North, and Oliver Williamson. What is "new" about the NIE is that "there is an older school of institutionalism in economics" (Harriss et al., 1995:4).

The NIE started with Ronald Coase's (1937) article, "The Nature of the Firm" and the phrase "the new institutional economics" was coined by Oliver Williamson. It was intended to differentiate the subject from the "old" institutional economics.

The NIE is a line of investigation that departs from but does not abandon neoclassical economics. In the words of Douglass North (1978), "to abandon neoclassical theory is to abandon economics as a science." The NIE attempts to save neoclassical economics by incorporating institutions into its analysis. Its critique of mainstream economics is largely a positive one. Thus, according to North (1995:17):

> The new institutional economics is an attempt to incorporate a theory of institutions into economics. However, in contrast to the many earlier attempts to overturn or replace neoclassical theory, the new institutional economics builds on, modifies and extends neoclassical theory to permit it to come to grips and deal with an entire range of issues heretofore beyond its ken. What it retains and builds on is the fundamental assumption of scarcity and hence competition: the basis of the choice of theoretic approach that underlies microeconomics. What it abandons is instrumental rationality: the assumption of neoclassical economics that has made it an institution-free theory.

There are different strands (Clague 1997:18-22), themes or approaches in NIE. According to Lin and Nugent (1995), the NIE has two interdependent approaches, namely, the transaction costs approach (which analyses the demand for institutional innovations) and the collective action approach (which analyses the supply of institutional arrangements). The former contains different but interrelated themes. One such theme is concerned with the role of transaction costs (defined as costs of finding what the relevant prices are, of negotiating and concluding contracts, and of monitoring and enforcing them) in economic organization. The general hypotheses are that institutions are transaction cost-minimizing arrangements, which may change and evolve with changes in the nature and sources of transaction costs and the means for minimizing them. Thus, Lin and Nugent (1995) underline that the most basic function of institutions "is to economize".

Property rights (defined as an actor's rights, which are recognized and enforced by other members of society, to use and control valuable resources) (Libecap 1996:31), is a theme related to transaction costs theory. Well-defined and properly enforced property rights may reduce conflicts and facilitate co-operation thus resulting in a reduction in transaction costs. In this way, along with technology and other traditional constraints, institutional constraints enter into the decision process of individuals. In the presence of transaction costs, different systems of property rights yield solutions of differing efficiency. What is efficient in the presence of transaction costs may be quite different from that which is efficient in the traditional neoclassical economics without transaction costs.

Another theme, which is closely related to transaction costs, but originated outside the institutionalist tradition, is concerned with incomplete information and asymmetries of information in particular. The problems of "adverse selection" and "moral hazard", which were first identified in the context of insurance markets, have been found to be relevant for a large class of problems where asymmetries of information are present between the parties to a contract. These problems, moreover, may lead to "market failure" unless incentive mechanisms capable of overcoming them, such as appropriate forms of contract, are developed.

Collective action is defined as "the conditions under which groups of people with a common interest will perceive that interest and act to achieve it" (Clague 1997:21). It is also concerned with the elimination of "the free-rider problem." The key issue in the collective action literature is to "explain collective outcomes in terms of individual motivation", or, to put it differently, to explain the likelihood of success or failure of a given set of self-interested individuals in undertaking actions that may benefit them collectively. The theory of collective action has been concerned with public or collective goods or with common property resources (Nabli and Nugent 1989b).

The subject matter of the NIE is much wider than that of standard neoclassical economics (but narrower than that of "old" institutional economics). Politics is relevant to economic growth and development because transaction is not costless. The NIE incorporates ideologies, ideas and politics into economic analysis without rejecting some of the fundamental postulates of standard neoclassical economic theory. In the words of Douglass North (1995:19):

> (The NIE) extends economic theory by incorporating ideas and ideologies into the analysis, modeling the political process as a critical factor in the performance of economies, as the source of the diverse performance of economies, and as the explanation for 'inefficient' markets.

The basic assumptions of the NIE include the assumption of a situation of bounded rationality and the assumption that knowledge is very costly to obtain. Since decision-makers do not have perfect knowledge, opportunism (i.e. self-interest with guile) can exist and often exists (Acheson 1994:7).

Where does the importance of the NIE lie? According to Harris et al. (1995), the NIE is important for perhaps three reasons. First, it is an emerging body of theory, which starts out within the framework of neoclassical economics, "but offers answers to what have otherwise remained as puzzles in neoclassical theory." Second, it is important in the context of structural adjustment policies of the 1980s and 1990s because it "has challenged the dominant role ascribed to the market by the orthodoxy of these decades". Third, it attempts to offer "a grand theory of social and economic change" at the very time when grand theories in the social sciences have generally been on the retreat.

Moreover, the NIE is a school of thought that has the potential for bridging the gap between economics and neighboring subjects like political science, history, sociology and anthropology. This is because these disciplines share institutional analysis with reformed economics, i.e. institutional economics. According to Harriss et al. (1995:1) NIE is "a body of economic theory which ascribes an important role to ideas and ideologies, and one which is accessible to other social scientists, seeming to open up the terrain of genuinely inter-disciplinary inquiry."

The NIE does suffer from certain shortcomings. First, there has been no consensus regarding the meaning of "institutions", as explained above. Second, the NIE is at its formative stage and, so far, it has no full-fledged theory or body of thoughts of its own. Thus, Nabli and Nugent (1989a:1336) note that "the NIE is not... a homogenous body of knowledge". According to Acheson (1994:6), the NIE "is moving so rapidly that no commonly agreed on set of principles has emerged." Further, he argues, the NIE refers to "the work of a loose collection of economists and political scientists interested in the generation of institutions from the behavior of individuals, and the ways in which these institutions influence the level of productive activity and exchange." One observer noted that "the NIE is not yet capable of generating universal set of hypotheses concerning institutional changes...A theory in which anything is possible is a theory in which outcomes can't be predicted" (Herrick 1989:435). Similarly, Toye (1995:64) notes that, in some respects, "the NIE is another example of the unfortunate tendency of some theorists to inflate a useful low-level theory until it becomes an unsuccessful global-historical generalization." Toye goes further and asserts that "the main weakness of the NIE as a grand theory of socio-economic development is that it is empty." Anthropologists and sociologists, who argue that the assumptions of the NIE are often unrealistic, provide further critiques of the NIE (e.g. see Acheson 1994:23-26).

But, does that mean the NIE should be rejected with respect to problems of development? No. Even Toye himself admits that "the NIE represents an important breakthrough for development theory." This is so not only because "the NIE has brought about a major shift in the terms of the discourse about development" (that is, what Toye calls the "linguistic argument"), but also the NIE makes a substantive contribution to the development discourse by providing "exploration of opportunism" (rationally self-interested behavior in conditions of strategic interaction of decision-making, deficiency of information and uncertainty). According to Toye, the exploration of opportunism will have far-reaching consequences beyond the realm of game theory to which it has been traditionally confined. But to successfully go beyond the realm of game theory and elegant models and understand the real causes and nature of economic crises in Africa, economists need to learn more about related disciplines like history, anthropology, sociology, political science, etc.

The NIE framework has been successfully applied to the investigation of a wide range of development issues, including problems of ownership and management of natural resources, undefined roles of the state in economic development, international economic issues, the underground economy contractual choice and law enforcement, etc.

5. CONCLUDING REMARKS

This paper has attempted to discuss conceptual issues related to institutions and the NIE. It has also reviewed the importance of the NIE for economic development. The relevance and limitations of the NIE can be partly investigated using findings of papers presented in these proceedings.

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