UNIVERSITY OF MACEDONIA
DEPARTMENT OF ECONOMIC STUDIES

EXAMINING EFFICIENCY UNDER THE CONSTRAINTS OF TRANSACTION COSTS AND PROPERTY RIGHTS

THE EMERGENCE OF OLD AND NEW INSTITUTIONAL ECONOMICS

Main Thesis for Acquiring the Master Degree in Economics

by THOMAE TSIAKIRI

THESSALONIKI 1999

CONTENTS

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INTRODUCTION

Most economists examine and accept efficiency which is defined in terms of standard neoclassical theory. It is interesting though for someone to consider and other concepts of efficiency, especially when lately neoclassical economics are criticised. That was the reason for choosing this theme . To read, study and write about something new which can influence economic thought. It was also a challenge to present some, not so widely known , concepts. Hopefully, the aim of this essay it to accomplish the above.

In section I we present the innovation of Coase who introduced the assumptions of positive transaction costs and property rights in the terms that specify efficiency and in section II we consider in more details how transaction costs and property rights affect efficiency. The relationship between property rights and institutions is examined in section III and then in section IV we present Old and New Institutional Economics which emerge from the above concepts and section V is the conclusion.

CHAPTER 1

THE INNOVATION OF COASE

In the last decades, neoclassical theory has been under strong criticism, merely because of its incapability of dealing effectively with problems of market failure, such as externalities. The problem arises for there are some assumptions of neoclassical theory that do not always hold. The basic conditions of zero transaction costs which assumes full information and fully defined and unchanged property rights, do not describe the real world. Consequently the solution imposed by neoclassical theory cannot be valid and does not lead to optimal allocation of resources.

Since the 1960's, many economists were concerned with broadening the assumption of neoclassical economics by introducing positive transaction and information costs and the constraint of property rights. Coase (1960) was one of the firsts who tried to give another solution to problems of market failure based on these new conditions described above. In a fundamental article of his (1960)[1], he introduces a different approach to the problem of externality from that of the mainstream economics. At the same time, he shows the weakness in Pigou's treatment to the problem of harmful effects (negative externalities) which is caused from the actions of a business firm. Pigou's conclusion, at that time, was that, since in the presence of externalities, markets could not achieve a Pareto optimum and therefore a government action (usually a tax imposition) was required in order to restrain the harmful effects[2]. However, Coase did not believe that an optimal outcome could be achieved by defining the liability for damage and by imposing a tax to the damaging business. What he showed was that when there are zero transaction costs, there can be negotiations between the parties that could lead to a rearrangement of property rights which would maximize the wealth, given that rights are fully defined[3]. As a result, externalities would be eliminated.

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[1] Coase, R.H. (1960), "The Problem of Social Cost", Journal of Law and Economics, 3, pp. 1 – 44.
[2] That was generally the conclusion of standard neoclassical theory about the problem of externalities.
[3] This is the famous Coase Theorem.

Another, probably the most important, contribution of Coase is that he considers the case of positive transaction costs[4]. In the presence of positive costs the initial delimitation of rights is crucial and can influence the efficiency of a system. The problem then is to choose the appropriate social arrangement for eliminating the externalities. The market, the firm and the government are three possible solutions but they all have operating costs. Although the government is regarded as the most possible solution because it can impose regulations or establish a legal system at a less cost, Coase believes that the advantages of government solution are overestimated[5]. The basic conclusion is that in the presence of transaction costs, an efficient outcome cannot be reached. It is the determination and the assignment of rights what really matters then, if we want to achieve an attainable optimum. Clearly then the legal system as well as the courts may have a profound effect in the economy and Coase recognizes this[6]. The innovation of Coase's article is that it adds in the constraints that specify an optimal allocation of resources, the constraint of positive transaction costs (which are the costs of the real world) and the constraint of property rights. The idea is that since there are costs of transacting which lead to externalities, the focus should be on creation and distribution of defined property rights in order to internalize these harmful effects.

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[4] According to Coase himself, the Coase Theorem was a stepping stone to analysis of an economy with positive transaction costs. He illustrates the importance of positive transaction costs, when he says in his Nobel lecture (1991): " Let us study the world of positive transaction costs", Coase, R.H.(1995), "The Institutional Structure of Production"

[5] Coase (1960) [op.cit. note 1] p. 18.

[6] Coase (1960) [op.cit. note 1] p. 27.

CHAPTER 2

TRANSACTION COSTS, PROPERTY RIGHTS AND EFFICIENCY

a. Transaction Costs

The concept of transaction costs is very important, for in the absence of these costs many problems that arise today in economic theory would just not exist. One of the firsts who gave an elaborate definition of transaction costs was Coase. He says:

"In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up a contract, to undertake the inspection needed to make sure that the terms of the contract are being observed and so on"[7].

Dahlman (1979)[8] adopted this definition and he describes the three types of cost that constitute transaction costs. These are the search and information costs, bargaining and decision costs and policing and information costs. Nevertheless, the most interesting argument he makes is that he attributes these costs to the lack of information. He argues that:

"...Both search and information costs are their existence to imperfect information about the existence and location of trading opportunities or about the quality or other characteristics or items available for trade. The case is the same for bargaining and decision costs: they represent resources spent in finding out the desire of economic agents to participate in trading at certain prices and conditions... Policing and enforcement costs are incurred because there is lack of knowledge as to whether one (or both) of the parties involved in the arrangement will violate his part of the bargain... Therefore it is necessary to talk only about one type of transaction costs: resource losses due to imperfect

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[7] Coase (1960) [op.cit. note 1] p. 15
[8] Dahlman, C.J. (1979), "The problem of externality", Journal of Law and Economics, 22, 141 – 162.

information"[9].   However, some writers do not agree completely with this equation of transaction costs with information costs, although they accept the initial definition of transaction costs. Papandreou (1994)[10] accepts that the first two costs (search and information costs and bargaining and decision cost) represent costs due to lack of information, however he believes that policing and enforcement costs cannot be attributed to imperfect information. He argues there are costs that should be included in the enforcement costs that Dahlman sets aside. These are the costs of creating and enforcing property rights and they cannot be connected with the lack of information. E. Furuborn and R. Richter (1995)[11] also have an objection to this equation who support that Dahlman should just stay to his initial definition of transaction costs.

Nevertheless, I believe that Dahlman's definition is quite elaborate and complete, although it should probably include costs of creating and enforcing property rights. In cases where rights have not been enforced there are high transaction costs that prevent the exchange. Pejovich (1995) gives another definition where he includes the cost that we have just mentioned above:

"Transaction costs are the costs of all resources acquired to transfer property rights from one economic agent to another. They include the costs of making an exchange (e.g. discovering exchange opportunities, negotiating exchange, monitoring and enforcement), and the costs of maintaining and protecting the institutional structure (e.g. judiciary, police, armed forces)"[12].   This description of transaction costs is not so general but it concentrates on the costs incurred when property rights are transferred from one person to another, and it could probably feel the gap in Dahlman's transaction cost. The final question in the Dahlman's definition is whether transaction costs can be associated with imperfect information. It is my opinion that they can, however the concepts of transaction costs and imperfect information are not identical.

Another type of transaction costs arises from the theory of the agency[13]. According to this theory in an agency relationship there is a principal who delegates some rights to an agent who is obligated to represent the principals interests in return for payment of some kind. The

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[9] Dahlman (1979) [op.cit. note 8], p. 148.
[10] Papandreou, A.A. (1994), "Externality and Institutions", Oxford University Press, pp. 144 – 145.
[11] Furuborn, E. and Richter, R. (1995), "The New Institutional; Economics: An Assessment", in Williamson, O. and Masten S. (eds.) Transaction Cost Economics, vol. I, The International Library of Critical Writings in Economics
[12] Pejovich, S. (1995), "Economic Analysis of Institutions and Systems", Klumer Academic Publishers, p. 84.
[13] Eggertsson, T. (1990), " Economic Behaviour and Institutions", Cambridge University Press, pp. 40 – 45. The rest of this section is based on this book.

problem in this relation is that the agent usually has more information about his abilities or preferences, which could lead to a shirking or opportunistic behaviour, because information is distributed asymmetrically between the agent and the principal. The asymmetrical information can give rise to moral hazard and adverse selection. In the moral hazard case, the principal cannot observe the agent's performance whereas the adverse selection arises when an individual's decision depends on his privately held information in a manner that affects the other participants. A good example of the case of adverse selection is the used–car market or the case of employers who hire workers by examining only their college diploma[14]. In both cases of moral hazard and adverse selection there is transaction cost which is generated from asymmetrically distributed information.

b. Transaction Costs and Efficiency

In mainstream economics, economic efficiency is defined in terms of Pareto efficiency (or optimality). This means that an allocation of resources is Pareto optimal if society's initial resources and technology possibilities are used efficiently in away that there is no other organization of production and distribution of goods that will make someone better off without leaving at the same time someone worse off. However, a market is not Pareto efficient under some conditions. These are the presence of externalities, public goods and of course imperfect (or asymmetric) information[15]. The existence of asymmetric information (which as we have seen above could be considered as another type of transaction cost) often results in an equilibrium that is not Pareto optimal. In this case, a central authority (e.g. the government) that knows all agents' information could achieve a Pareto improvement. In practice, however, in most of the cases, a central authority will not be able to have this kind of information and this prevents the achievement of Pareto improvement outcome. Consequently, an allocation that cannot be Pareto improved by an authority which does not know all agents' private

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[14] Eggertson (1990) [op.cit. note 13] p. 44.
[15] Asymmetric information is a case of imperfect information where some individuals are better informed than others

information is called a constrained (or second – best) Pareto optimum. Because a Pareto improvement cannot be achieved, the constrained Pareto optimal allocation is not (fully) Pareto optimal. Usually the cases where a constrained Pareto optimal allocation is observed are connected with asymmetrical information. The existence of moral hazard and adverse selection lead to constrained Pareto optimality where there can be no intervention to improve the outcome. In recent literature we find examples where moral hazard and adverse selection or generally imperfect information lead to an equilibrium that is constrained Pareto optimum (Chambers, 1992; Fernadez, 1992; Kocherlacota, 1998)[16]. However, there are different opinions supported by scholars who argue that even when there is imperfect information the market is not constrained Pareto optimal. According to them, there are interventions by the government that can improve the outcome (Foldvary, 1996)[17]. B.C. Greenwald and I.E. Stiglitz (1986)[18] support that economies with imperfect information and incomplete markets are not necessarily constrained Pareto optimal (or efficient). The government can intervene by setting taxes and subsidies that can make everyone better off and result in a Pareto improvement. In this way many problems that arise from incomplete markets and imperfect information, such as adverse selection, moral hazard, quean rationing etc., can be solved because there is a tax that is Pareto improving.

It is clear that the notion of constrained Pareto optimality was created by standard economics theory in order to be a solution to the problem of imperfect information. Though, constrained Pareto optimality is not really a solution since it does not suggest any ways of acting by market or government in order to achieve optimality. What could probably be is an effort to cover the weakness of standard economic theory to face the problem of incomplete information and inefficiency. Next, we show there are economists following the work of Coase who considers the concept of efficiency differently, considering of course imperfect information.

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[16] Chambers, R.G. (1992),"Insurability and Moral Hazard in Agricultural Insurance Markets", American Journal of Agricultural Economics, 71 (2), p. 604ff. Fernadez, R. (1992), "Terms of Trade Uncertainty, Incomplete Markets and Unemployment", International Economic Review, 33 (4), p. 881ff. Kocherlakota, N.R. (1998), "The Effects of Moral Hazard on Asset Prices When Financial Markets Are Complete", Journal of Monetary Economics, 41, p. 39ff.

[17] Foldvary, I. (1996), Beyond Neoclassical Economics. Heterodox Approaches to Economic Theory", Edward Elgar, pp. 72 – 73.

[18] Greenwald, B.C. and Stiglitz, I.E. (1986), "Externalities in Economies With Imperfect Information and Incomplete Markets", Quarterly Journal of Economics, 101, p. 229ff.

Demsetz (1969), Dahlman (1979) and De Alesi (1983) examine the notion of efficiency under the presence of transaction costs and the constraint of property rights.

Demsetz (1969)[19] advocates the concept of efficiency that incorporates transaction costs. He argues modern welfare analysis cannot describe the characteristics of efficient long run equilibrium, because the assumption of complete information, absence of indivisibility etc., cannot be attained in a real world. Consequently, an equilibrium cannot be described as inefficient when its assumptions can only be accomplished in an ideal world. He calls this approach *"the Nirvana Approach"* because it describes the relevant choice between an ideal nom and an existing imperfect "institutional arrangement". In other words, what Demsetz rejects is the fact that it is inappropriate to judge the efficiency of real world institutions[20] by comparing them to an ideal norm. Since we know there are constraints in real world that prevent the economy from reaching an optimal allocation, then we must as well know that every solution reached in real world is suboptimal or inefficient. According to Demsetz, efficiency should be examined under the constraint of transaction costs, because knowledge is costly (there is imperfect information), there is moral hazard, people are risk – averse etc., and most of all they are all part of human behaviour and real world. Demsetz calls this approach *"Comparative Institution Approach"* and here the choice is between alternative real institutional arrangements. In this case, the question is to find the appropriate institutional arrangement that can improve the economic organization. The basic difference between the "nirvana" approach and the "comparative institution" one is that the first describes the Ideal, rejecting at the same time any possibility of improving in the economic outcome, while the latter describes the Actual. From this last characterization, I think we could say that the notion of constrained Pareto optimality is a part of the "nirvana" approach.

The "comparative institution" approach as well as Buchanan and Tullock's argument that not all externalities are Pareto relevant have influenced Dahlman (1979)[21] who argues that transaction costs should be included in the constraints that specify the Pareto optimal solution. According to Dahlman, this is a world of transaction costs, which generate externalities, and they are the one cause of market failure. Provided that we include these costs in the constraints, then we are in position to describe an attainable optimum (comparative institution approach) and not an unattainable and an irrelevant optimum of zero

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[19] Demsetz, H.J. (1969), "Information and Efficiency: Another Viewpoint", Journal of Law and Economics, 12 (1), p. 1ff.

[20] With the term institutions, at this time, we mean market, firms, and government.

[21] Dahlman, C.J. (1979), "The Problem of Externality", Journal of Law and Economics, 22, p. 141ff.

transaction costs. He firmly believes that the notion of Pareto optimality under costless transaction costs does not exist. A very interesting argument in Dahlman's article is that externalities are not the cause of market failure, as it was traditionally thought. If externalities cannot be internalized, this is because of the presence of transaction costs and these costs should be regarded as the reasons for market failure. Dahlman supports the presence of positive transaction costs and imperfect information prevents the economy from reaching a Pareto optimal. He accepts the "comparative institution" approach and thus he argues that in order to achieve efficiency, analysis should be focused to the fact that institutions can reduce transaction costs and organize the allocation of resources.

Finally, L. De Alesi (1983) supports the same ideas about efficiency (or optimality)[22]. He recognizes that neoclassical theory is limited and its failure to take into account the limitations of positive transaction costs and property rights will have some implications. In order to avoid these implications, neoclassical theory could be generalized in two steps[23]. First by extending the utility maximization hypothesis to all individual choices including those made by business managers and government employees , and second by including the constraints of transaction costs and property rights in the conditions that specify efficiency. Once the above constraints are satisfied then the solution is always efficient . According to De Alessi :

"... efficiency is being defined as constrained maximization ... a system's solutions era always efficient if they meet the constraints that characterize it"[24].

Nevertheless, Furubotn, E. and Richter,R. (1995)[25] in their article support that De Alessi's definition of efficiency is open to criticism , even though they agree that standard conditions[26] of optimality cannot be accomplished in real world because there are "unavoidable" constraints (as they call them) that prevent the economy from reaching an attainable optimum. They establish their claim by saying that constraints cannot be easily classified as avoidable or unavoidable, especially when these

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[22] De Alesi, L. (1983), 'Property Rights, Transaction Costs and X – Efficiency: An Essay in Economic Theory", American Economic Review, 73 (1), p. 64ff.

[23] In this article, De Alesi presents another approach to the problem of limited neoclassical theory. It is the X-Efficiency construct first proposed by Leibenstein in 1966, but this theory does not consider the constraints of transaction costs and property rights. De Alesi rejects this approach and follows that of generalization of neoclassical theory.

[24] De Alessi (1983) [op.cit. note 22] p.69

[25] Furubotn ,E. and Richter, R. (1995), " The New Institutional Economics: An Assessment ", in Williamson ,O. and Masten ,S. (eds) , Transaction Costs Economics, Volume I, Aldershot: Edward Elgar , 611-641.

[26] With standard conditions we mean the conditions of neoclassical theory for reaching optimality, such as zero transaction costs , fully defined and unchanged property rights.

constraints relate to personal qualities and tastes. Consequently if we are not able to specify which constraints affect all decision makers the it becomes possible to accept every outcome as efficient. The last is the conclusion that De Alessi reaches. That efficiency always holds and when it doesn't it is because some constraints were neglected at the first place. After they are included then an attainable optimum will be reached. However, Furubotn, E. and Richter,R. believe that this constrained maximization approach does not lead to an optimal allocation of resources. The same aspect is also advocated by Eggertsson (1990)[27] who in his article argues that it is impossible to obtain inefficient solutions from microeconomic models which use the postulate of constrained maximization. In this case the equilibrium outcome is Pareto efficient by definition.

Apart from this criticism the fact remains that De Alessi adopts a constrained transaction cost concept of efficiency as Dahlman and Demsetz do. All these economists , including of course Coase who introduced the new ideas , reject the conventional notion of efficiency and they support the term of efficiency that includes real life constraints which limit individual choices[28].Between an efficiency with relevance to an ideal (nirvana state) and that which is accomplished with given constraints , they believe that comparative institutional analysis should be concentrated upon the latter. The introduction of transaction costs and property rights into the conditions that specify efficiency is the fundamental characteristic of **New Institutional Economics** which we present later.

c. Property Rights and Efficiency

As it has been shown by Coase (1960)[29] it is the presence of positive transaction costs which makes the assignment of property rights necessary. In the real world where transaction costs are grater than zero it becomes clear the crucial importance of rights in economic life. The

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[27] Eggertsson, T.(1990) [op.cit. note 13] pp.22-23. Eggertsson presents the argument of Staten and Umbeck about efficiency using the constrained maximization postulate

[28] Papandreou ,A.(1994) [op.cit. note 10] p.253

[29] Coase (1960) [op.cit. note 1] p.16

system of property rights can be described as *" the set of economic and social relations defining the position of each individual with respect to utilization of scarce resources"[30].*   A very important issue is that the assignment of property rights can affect the allocation of resources in an economy and even change the income distribution as Dragun argues(1988)[31]. According to Furubotn, E. and Pejovich , S. (1972)[32]the means through which the determination of rights affects the allocation of resources is exchange. Then the volume of goods that are exchanged depends on the bundle of property rights that can be transferred. A very good example of this is given by Furubotn, E. and Pejovich , S. who say: *"... the worth of a house to an individual will be relatively greater if the bundle of property rights acquired contains the to exclude gasoline stations , chemical plans etc"[33].*

The most known category of property rights is the right of ownership. Demsetz (1967)[34] examines the forms of ownership which are the communal ownership, the private ownership and the state ownership. In communal ownership a right can be exercised by all members of a community whereas in state ownership the state can exclude anyone from the use of a right. Finally, in private ownership, rights are held by individuals and the community recognizes the right of the owner to exclude others from exercising the owner's private rights. The communal ownership is distinguished for high negotiating and transaction costs which result in externalities. The only way of dealing with this problem , according to Demsetz, is the development of private rights through which externalities will be internalized. Besides these forms that a right can take, there are also three basic elements that define the right of ownership in an asset. These are the right to an asset , the right to earn income from an asset and contract over the terms with other individuals, and the right to transfer all rights (through sale) or some rights (through rental)[35]. It is my opinion that the right to transfer is the most important element because without this there cannot be any exchange and consequently the assignment of property rights cannot affect the allocation of resources in an efficient way. At this point the significance of **contracts** must be illustrated. Contracts are important because they allow property rights to be transferred by through contractual agreements. Property rights are

[30] Furubotn, E. and Pejovich,S. (1972) , " Property Rights and Economic Theory: A survey of recent literature" , Journal of Economic Literature , 10(2), 1137-1158, p.1139

[31] Dragun , A.K (1988), " Externalities , Property Rights and Power ", in Samuels, W.J (ed.) Institutional Economics , Volume II, Aldershot: Edward Elgar, 667-682

[32] Furubotn, E. and Pejovich, S. (1972) [op.cit. note 30]

[33] Furubotn, E. and Pejovich, S. (1972) [op.cit. note 30] p.1139

[34] Demsetz , H.J. (1967), " Towards a theory of property rights ", American Economic Review, 57,347-359

[35] Furubotn ,E. and Pejovich, S. (1972) [op.cit. note 30] p.1140

transferred from one person to another and a contractual agreement is the effective mean by which rights are exchanged. As a result of this procedure, new property rights are created and the existing ones are changed because it may be profitable for certain individuals to restructure the system. In this process the state plays a central role since it has the power to influence the structure of rights which can affect the contractual agreements and probably the wealth of people because some will be benefited and others harmed.

The **property rights approach** is concentrated on the fact that subtle changes in the assignment of rights affect the economic system and the wealth of people when the state redefines the property rights. Demsetz (1967)[36]who in his article tries to give a theory of rights , argues that property rights emerge in order to internalize externalities. Specifically, the determination of new property rights is triggered by changes in technology and productivity of resources. In this case the distribution of rights promotes efficient allocation of resources. He presents an example of the development of rights in land among American Indians, where the beginning of the fur trade made necessary the assignment of rights of ownership in order to internalize external effects[37].According to Furubotn ,E. and Pejovich ,S.(1972)[38] the property rights approach was developed as a reaction to the standard economic theory , even though the modifications it makes are within the neoclassical framework. There are important changes that are introduced. First of all, individulas are assumed to maximize utility subject to constraints established by the existing organizational structure, second there is an interrelation between the institutional arrangements and economic behaviour because they take into account the effects of the assignment of property rights on the penalty- reward system , and third transaction costs are considered greater than zero. Under these new conditions the next step is to formulate an optimization model that reflects these institutional features. For the optimization model there are two important assumptions, i) the utility function is associated with the individual decision maker and as a result it becomes possible to consider the behaviour of a decision maker within a firm , a government etc. In other words individuals try to maximize utility functions not only as consumers but also as a firm , a government bureau etc and ii) different property rights assignment leads to different penalty-reward system. By introducing these new assumptions the aim of the property rights approach is to show that a certain structure of rights can influence the allocation of resources in a specific way. Changes in the

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[36] Demsetz (1967) [op.cit. note 34] pp. 354-359
[37] Demsetz (1967) [op.cit. note 34] pp.352-353
[38] Furubotn, E. and Pejovich, S. (1972) [op.cit. note 30] p.1137

content of property rights will have an effect on the allocation of resources or income distribution. As far as efficiency is concerned a complete specification of rights will lead to an efficient allocation and use of resources. Furthermore, knowledge of the institutional environment and the conditions under which transactions take place is required in order to study efficiency.

Dragun (1988)[39] argues also that efficiency depends on the structure of rights. Once rights are determined in a specific way then efficiency can be achieved. However he supports that since there is no unique structure of rights there cannot be a unique efficient solution. Finally, changes in the property rights structure not only have impacts on efficiency but they can also change the wealth of people through the distribution of income. Thus the role of the state is significant since it create and assign new rights. The distribution of rights involves a choice between the interests of individuals because some will be harmed and other benefited. This is called by Dragun the **"duality"** in rights assignment and I believe it is the key idea that justifies and explains the change in the distribution of income and of course the wealth of people.

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[39] Dragun , A.K (1988) [op.cit.note 31]

CHAPTER 3

INSTITUTIONS AND PROPERTY RIGHTS THEIR RELATIONSHIP AND THEIR EFFICIENCY

The aim of this section is to examine the relationship between property rights and institutions. As it has been argued the property rights assignment specifies the behaviour among people and the way they interact with each other. Especially when transaction costs are positive the redetermination of property rights will influence the allocation of resources and the wealth of people. A very crucial role in the determination and enforcement of property rights have the political and legal systems. Furthermore, it seems that the political and legal systems are nothing else but established institutions. Consequently institutions are the ones that finally determine property rights.

Institutions are defined as the constraints[40] that people impose on themselves (North 1990)[41] and these constraints can be formal or informal. They have an important role in an economy because they provide a stable structure through which people interact with each other. This stability , however, does not imply that institutions never change because they do and this is part of social and economic evolution. Institutions can also reduce the costs of enforcing property rights , which are a part of transaction costs. Coase as well concludes in his article *"The Problem of Social Cost"* that when there are transaction costs then institutions truly matter. Especially if we accept that production costs are the sum of transformation and transaction costs , then institutions can affect the costs of production and thus we understand their importance in economic performance[42].

Previously when we defined institutions we said that they consisted of informal and formal constraints. By informal constraints we mean the taboos , the unwritten codes of behaviour and conduct which guide our interaction with others whether this interaction is social or economic. The difference between informal and formal constraints is that in the latter there are written laws which is a characteristic of a more complex society.

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[40] New Institutional Economists accept the definition of institutions as constraints. As we will see later the Old Institutional Economists reject the definition of institution as merely constraints. See , Hodgson, G.M. (1999) , " Economics and Utopia", New York: Routledge, p.145.

[41] North, D.C (1990) , " Institutions , Institutional Change and Economic Performance", Cambridge: Cambridge University Press. North is one of the most Known exponents of New Institutional Economics.

[42] North , D.C. (1990) [op.cit. note 41] pp.27-28.

Formal rules are a part of formal constraints (e.g. legal system) and they involve political rules , economic rules and contracts. According to North (1990) political rules *"define the hierarchical structure of the polity, its basic decision structure and the explicit characteristics of agenda control"* and economic rules *" define property rights , that is the bundle of rights over the use and the income to be derived from property rights and the ability to alienate an asset or a resource"[43]*. Furthermore, economic rules are influenced by political rules because the polity specifies and enforces property rights.

The question that emerges is how efficient property the rights and hence institutions are . According to North the efficiency of property rights depends on the the efficiency of the political market. If there are high political transaction costs then we cannot have efficient property rights which would lead to economic growth. High political transaction costs are also recognised from Vira (1997)[44] as the reason for the existence of undesirable and inefficient institutions. Vira is concerned with examining institutional change and how this is affected from political factors. The importance of political market in the achievement of efficiency is demonstrated by the Political Coase Theorem . According to Vira: *" given an initial distribution of political entitlements such as voting rights , lobbying rights , etc. within a given constitutional framework , the optimal institutional outcome will be achieved if there are no political transaction costs, and this outcome does not depend on the initial allocation of political entitlements"[45]*. It is an effort from Vira to apply the Coase Theorem of the economic market to the political market. Nevertheless, it is very difficult to achieve zero political transaction costs and efficient political markets. It is more difficult than achieving zero transaction costs in economic markets which is impossible. Nevertheless, it is argued that some times transaction costs may be desirable. Especially in cases where individuals do not have political power to defend their rights , high transaction costs can prevent institutional change which would otherwise worsen the individuals' position. It is obvious then that change can be prohibited from those who will probably lose.

Finally, the basic conclusion is that institutions and property rights can influence the efficiency of an economy. Since the costs of exchange (or transaction costs) depend on institutions (e.g. political system, legal system, education, culture) it is the institutions that control the economic performance.

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[43] North , D.C. (1990) [op.cit. note 41] p.47.

[44] Vira, B. (1997) , " The Political Coase Theorem: Identifying Differences between Neoclassical and Critical Institutionalism", Journal of Economic Issues, 31 (3), 762-779.

[45] Vira, B. (1997) [op.cit. note 44] p.770

CHAPTER 4

NEW AND OLD INSTITUTIONAL ECONOMICS

New Institutional Economics

The introduction of positive transaction costs and constraint of property rights in the conditions that specify efficiency, as well as the acknowledgment of the major role of institutions in economic performance are the main features of New Institutional Economics. It is generally accepted[46] that New Institutional Economics originated from contributions of Coase and his article " The Nature of the Firm" (1937), Williamson, North etc. Though as Coase argues[47] the name " new institutional economics" was created by Oliver Williamson in his effort to differentiate the subject from that of " old institutional economics" which we examine later.

New Institutional Economics (or NIE) recognises that standard neoclassical analysis is incapable of dealing effectively with problems that arise from positive transaction costs. Its aim is to extend the applicability of neoclassical analysis by bringing in institutions into the economic models[48]. In other words it does not reject neoclassical economics but it enlarges it. Moreover, NIE as well as neoclassical economics define the problem of the economy as the on eof allocation of scarce resources . The difference in NIE is that it adopts more realistic assumptions and it recognises the significance of institutions.

It is apparent that everything we have examined so far about how transaction costs and property rights affect efficiency and how institutions reduce transaction costs and obtain efficiency are the basic features of New Institutional Economics which seem to have a great impact on economic thought.

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[46] Palermo ,G. (1999), " The Governance of Austrian Economics and New Institutional Economics . Methodological Inconsistency and Political Motivations", Journal of Economic Issues, 33 (2) , 277-286, p.277, Eggertsson ,T. (1996) [op.cit. note 13] p.6 , Coase ,R.H (1998) , " The New Institutional Economics", American Economic Review, 88 (2), 72-74, p.72, Vira , B. (1997) [op.cit. note 44] p.774.
[47] Coase ,R.H (1998) [op.cit. note 46] p.72
[48] This is probably why Vira refers to New Institutional Economics as Neoclassical Institutionalism.

Old Institutional Economics

Old Institutional Economics (OIE) , although they proceeded in time from New Institutional Economics (NIE), they were not broadly accepted and in fact they were rejected by NIE because they did not provide a systematic theory[49]. The lack of theory and the concentration on data gathering are the two things that Old Institutionalism is accused for from NIE. Clearly , even though Old and New Institutional Economics recognise the importance of institutions and they build their theory on that , there are certain quite significant differences between them which we present later on this section.

Thorstein Veblen in the beginning of the century was the first who developed a theory of economic and institutional evolution , following the Darwinian approach[50]. Along with John Commons and Wesley Mitchell they established Old Institutionalism and its theory. The basic characteristic of this theory is that it examines the individual and its behaviour from the concept of **habit**. The founders of the Old Institutional Economics reject the idea of an agent acting as utility maximiser and they promote another conception of an agent based on habit. Habits affect the behaviour and belief of a person. Hodgson (1998) decribes habit " as a largely non-deliberative and self-actuating propensity to engage in a previously adopted pattern of behaviour. A habit is a form of self-sustaining , nonreflective behaviour that arises in repetitive situations"[51]. This is a quite different approximation of the notion of habit from that of conventional economics . In standard economic theory habit is explained in terms of rational choice and it is regarded as a result of this choice. However, the Old Institutionalists support the opposite ; that rational choice is explained in terms of the habit. They believe that habit is connected with knowledge , preferences and beliefs. Since they accept that preferences and knowledge determine the habits of individuals which in their turn affect individuals' behaviour , they consequently reject the utility maximisation model. In the latter the agent is assumed to have fixed preferences but these are ruled out by the Old Institutionalists , because these economists represent a more dynamic

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[49] Hodgson, G.M (1998), "The Approach of Institutional Economics", Journal of Economic Literature, 36 (1), 166-192, p.166.

[50] Hodgson, G.M (1998) [op.cit. note 49] pp.166-167. Many scientists of that time were influenced from the Darwinian process as well as evolutionary psychology .Especially in the USA the American Social Darwinism was created to justify the wealth of people , see Canterbery, E.R. (1999) , " Thorstein Veblen and The Great Gatsby", Journal of Economic Literature, 33(2), 297-304, pp.297-298

[51] Hodgson, G.M (1998) [op.cit. note 49] p.178

approach to economic life . They do not regard agents as robots who will act in a specific way and this results from the major role of habits in human behaviour.

Although Old and New Institutional Economics share basically the same broad definition of institutions (university, bank, market , firm, language, law etc) , the former includes also the notion of habit. For the Old Institutional Economics habit is important for the development of institutions because habits gradually become customs which finally form institutions. Furthermore , even though institutions are regarded as relatively stable and invariant Old Institutionalism accepts institutional change and evolution along with the New Institutional economics. However it disagrees with NIE in certain other issues such as it rejects the rational choice model whereas NIE accepts it. As we have said before NIE is an enlargement of neoclassical economics but Old Institutional Economics separates completely from neoclassical economics. NIE defines institutions as constraints while on the other hand Old Institutionalism supports that institutions are not merely constraints[52].

Old Institutional Economics introduces social change , power and culture into the analysis because there is emphasis on institutional and cultural factors. Furthermore, it is open to influences from anthropology, psychology, politics and other sciences. The method that they use to test hypothesis is different from the neoclassical economics for they do not use extensively the econometric models. OIE tends to rely more on qualitative information rather than on quantitative [53]. Accordingly, it does not apply mathematical tools in its theory and probably this was the reason for its failure. After 1930 , neoclassical economics appeared with a mathematical style which was quickly accepted. As a result OIE without any mathematical style was inferior and less challenging .

Probably there can be some objections for OIE and its theory needs to be further developed as Hodgson argues[54] . However ,besides any criticism fair or not , it is my opinion OIE should be appreciated for two things. First , it emphasises the importance of learning and knowledge not only as a process of gathering information but mainly as a development of a new behaviour and an adoption to new circumstances. Clearly , knowledge and learning ,which are stored in institutions ,are very powerful concepts because they can lead to socio-economic change. Second, it introduces a more dynamic efficiency which is not based on the allocation of scarce resources as neoclassical economics does .

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[52] Hodgson , G.M (1999) [op.cit. note 40] p.145
[53] Stanfield, J.R (1999), "The Scope , Method and Significance of Original Institutional Economics", journal of Economic Issues, 33 (2), 231-254,p.236
[54] Hodgson , G.M (1999) [op.cit. note 40]p.146

CONCLUSION

Many economists today accept the fact that standard neoclassical economics are not able to explain and solve the problems which arise in many cases and need to be enlarged. New and Old Institutional Economics in their attempt to present another concept of efficiency brought in institutions into the analysis and I believe that institutions could fill the gap in standard theory and explain many problems. However , it is true that New Institutional Economics are more easily adopted mainly because it does not abolish neoclassical economics and therefore it is more acceptable. On the other hand Old Institutional Economics does not have yet a complete theory and it is more innovator. Nevertheless , lately it is applied in cases such as the one of the failure Structural Adjustment Programs in Africa[55]. In order to deal with this problem , the World Bank adopted a more institutional approach based on New Institutional Economics of stable property rights and monetary incentives. Surprisingly, people did not respond to the new policy because it was not consistent with their culture and habits. Thus, it was accepted that a new approach was required which would take into account the political, the cultural and institutional environment of each region. It is obvious that the World Bank moved toward the approach of Old Institutionalism.

What I want to show from the above case is that since the World Bank considers a case like that, it means there is a need for revision in standard economic theory. I believe that generally Institutional Economics have to offer a lot because it introduces the significance of institutions in economic life. Whether New or Old Institutional Economics prevail is something which certainly cannot be predicted. It needs time and application of these theories to examine how they handle in practice economic problems.

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[55] Schneider, G.E (1999), " An Institutional Assessment of Structural Adjustments Programs in Africa", Journal of Economic Issues, 33 (2), 325-334.

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