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The Frontiers of New Institutional Economics

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Economists spent much of the 20th century perfecting models based on nontrivial simplifications (complete markets, symmetric information, homogenous agents, the initial-conditions-do-not-matter assumption, rational expectations, and so on), only to see their theories fail empirical tests and directed experiments. Perhaps the major unfulfilled challenge to the economic literature has been the search for "sufficient" conditions for long-term growth. Accumulation of capital, the "right" macroeconomic policies, privatization, all of these arguably positive and "necessary" elements failed to ensure growth in some of the countries where they were successfully implemented. Which sufficient conditions are missing from our textbooks that may explain these failures?

Douglass C. North received the 1993 Nobel Prize in Economics for highlighting the role of institutions for economic processes. His work and that of his followers is commonly known as the New Institutional Economics.[1] The importance of institutions is two-fold: First, institutions provide structure on which civilizations are built. Second, institutions provide incentives to agents through formal and informal rules and their enforcement. While informal rules stem from religion and complex historic developments, formal rules are the work of polities that aggregate choices in societies. The institutions-rules nexus provides surprisingly rich context for studying economic and social processes. In addition, new institutionalists offer relatively rare ground for debates between economists and historians.

One example of the institutions-rules nexus is the emergence of trade, or so-called *impersonal* exchange, which could not properly develop before effective third-party enforcement (courts, police) became available. Another example is the prevalence of low US-dollar wage rates in less-developed countries. Professor North and others link the low level of income in these countries to comparatively high transaction costs that make these countries much less favorable destinations of foreign investment. This fact has been well known, but the new institutionalists explained why there are no quick fixes to these problems. For example, the favorite fix of transplanting the US or French constitution does not work, primarily because newly imposed formal rules conflict with informal rules.

[1] New Institutional Economics does not constitute a separate branch of economics because, in part, it is deeply rooted in neoclassical price theory. Moreover, new "institutionalists" have little in common with the older institutionalists, whose research goes back to the work of Commons and Veblen. Chapter I and II of this book provide a fairly good overview of new institutionalists contribution to economic analysis.

This book, edited by John N. Drobak and John V. C. Nye, contains 12 papers by an assortment of well-known new institutionalists. The papers were originally presented in 1995 at a Washington University conference to celebrate the Nobel Prize award to Professor North. The topics covered in the book show the range of interests of new institutionalists: failed land privatization in Kenya, several economic history case studies; the role of institutions in explaining violence in the Brazilian Amazon region; or the testing of rational expectations in computerized experiments.

I will not discuss every paper in this review, some of which deal with fairly esoteric topics; the focus will be instead on a few papers addressing some of the issues that I found relevant for the new millenium.

Philip T. Hoffman and Jean-Laurent Rosenthal, in "The Political Economy of Warfare and Taxation in Early Modern Europe: Historical Lessons for Economic Development," neatly integrate warfare, fiscal regimes, property rights, and economic growth. Economists have known, of course, that parliamentary regimes taxed less than absolute monarchies and that the former established more stable property rights. According to Hoffman and Rosenthal, the motivation for fiscal policies – which were to a large extent determined by the distribution of taxpayers – was warfare. Military spending typically accounted for almost one-half of total government spending during peacetime, rising to around three-quarters thereof during wartime. The authors built a model to explain the costs and benefits of going to war for different forms of ruling classes.

Hoffman and Rosenthal find three rather optimistic implications concerning political regimes and wars. First, the willingness to engage in warfare declines with a move from autocracy to absolutism and further so with parliamentary regimes. Second, although taxes will on average be lower under absolutism than under an autocracy or parliament, because absolute monarchs control only a part of the economy, distortions caused by marginal tax rates are highest under absolutist systems. Finally, the net returns of war will be highest under parliamentary regimes, which tend to commit all needed resources only to wars they consider economically justifiable. Hence, the model results suggest that representative governments of the western type can survive and prosper when surrounded by warlike neighbors, both for economic and military reasons. This is certainly encouraging for some of the new democracies in the Third World.

Avner Greif, in "On the Interrelations and Economic Implications of Economic, Social, Political, and Normative Factors: Reflections from Two Late Medieval Societies", compares developments in two trading societies, in that of Jewish Maghribi traders who operated in the Muslim Mediterranean during the 11th century,[2] and among the Genoese traders of the 12th and 13th century, who were a part of the Latin world. The Maghribis, despite having access to both the Muslim legal system and the Jewish legal system of the Fatimid Caliphate, entered contracts and attempted to resolve disputes informally. The Maghribis created a "collectivist" society with economic, self-enforcing collective punishment and with a weak government. In contrast, Genoa was incorporated as an independent city-state where society was "individualistic" with a strong, coercive government. The Genoese relied on second-party enforcement institutions, especially courts and city authorities.

The paper finds that the collectivist system is more efficient in supporting *intraeconomy* agency relations and requires less costly formal organizations, yet it restricts efficient *intereconomy* agency relations and limits individual initiative. In contrast, the individualistic system does not restrict *intereconomy* agency relations and does promote anonymous exchange; however, the system is costly and is less likely to have effective social enforcement mechanisms.

[2] By the end of the 12th century the Maghribis were forced by the ruler of Egypt to cease trading and eventually vanished as a distinct social group.

John V. C. Nye, in “Thinking about the State: Property Rights, Trade, and Changing Contractual Arrangements in a World with Coercion”, debates some cases of the rational-actor theory of state. First, slavery can exist only in a society with incomplete markets (otherwise the slave would buy his freedom by paying more than he can produce as a slave) and high costs of monitoring, control, and rent extraction (otherwise the slave would end up producing the same output as a free man but without the cost of slavery). Second, Nye provides a positive explanation of why the form of government in Britain and France diverged so sharply between 1600 and 1800. It appears that the French paid for greater short-run control both by higher dead-weight costs of restrictions and regulations but surrendered long-term control and flexibility in their administrative apparatus.

Jean Ensminger, in “Changing Property Rights: Reconciling Formal and Informal Rights to Land in Africa”, confronts an intriguing puzzle: even though many African societies are becoming more individualistic, an increasing number of them are backing away from a government-sponsored formal system of freehold land tenure (Kenya, Tanzania, Ghana). Interestingly, the absence of individual title to land has been widely recognized among Africans and aid agencies alike as one of the main roadblocks to food security and credit availability (in western societies, “immovable” land traditionally served as the safest credit collateral). Jean Ensminger identifies many pitfalls of land privatization in Africa: creation of new property rights that conflict with informal (and indeed sometimes formal) rules; high cost of re-titling; the conflict between land consolidation and split holdings as a form of insurance; and so on.

The remaining and equally interesting chapters are written by Stanley L. Engerman (“Cultural Values, Ideological Beliefs, and Changing Labor Institutions: Notes on Their Interactions”); Lee J. Alston, Gary D. Libecap, and Bernardo Mueller (“Violence and the Development of Property Rights to Land in the Brazilian Amazon”); Robert H. Bates and Kenneth A. Shepsle (“Intertemporal Institutions”); Barry R. Weingast (“The Political Foundations of Limited Government: Parliament and Sovereign Debt in the 17th- and 18th-Century England”); John N. Drobak (“Credible Commitment in the United States: Substantive and Structural Limits on the Avoidance of Public Debt”); Andy Clark (“Economic Reason: The Interplay of Individual Learning and External Structure”); W. Brian Arthur (“Beyond Rational Expectations: Indeterminacy in Economic and Financial Markets”); and Paul A. David and Warren C. Sanderson (“Making Use of Treacherous Advice: Cognitive Process, Bayesian Adaptation, and the Tenacity of Unreliable Knowledge”).

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In summary, the book’s editors, J. N. Drobak and V. C. Nye, have collected 12 fascinating papers covering issues ranging from economic history to computerized experiments with “rationality”. Most of the papers are inter-connected through the inspiration provided by Professor North, whose writings are heavily cited. This is a book for both economists and historians, and indeed will be enjoyed by all those who appreciate the historical, social, and political dimensions of economic processes.

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