

The Theory of the Firm in the Context of the New Institutional Economics

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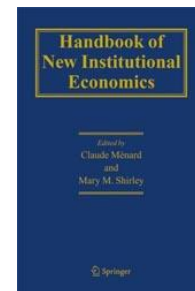
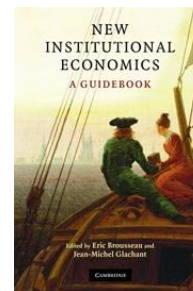
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The New Institutional Economics



► Nature and scope

- An interdisciplinary enterprise combining economics, law, organization theory, political science, sociology and anthropology
- Goal: understanding institutions of social, political, and commercial life (formal and informal rules, business practices, firms, contracts) — what institutions are, how they arise, what purposes they serve, how well they work

► History

- Term coined by Williamson (1975); gained widespread use in 1980s
- Annual conferences published in JITE in 1980s and early 1990s
- International Society for New Institutional Economics (1997–)

► Two views of the field

- Economic analysis of institutions and organizations
- An alternative approach to studying all economic phenomena



Readings for this afternoon

- ▶ Coase, Ronald H. 1992. “The Institutional Structure of Production,” *American Economic Review* 82: 713–19.
- ▶ Klein, Peter G. 2000. “New Institutional Economics,” in Boudewijn Bouckeart and Gerrit De Geest, eds., *Encyclopedia of Law and Economics* (Cheltenham, U.K.: Edward Elgar, 2000), pp. 456–89.
- ▶ Bjørnskov, Christian, and Nicolai J. Foss. 2008. “Economic Freedom and Entrepreneurial Activity: Some Cross-Country Evidence,” *Public Choice* 134: 307–28.

Institutions



▶ Definition

“[H]umanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights). . . . Together with the standard constraints of economics they define the choice set and therefore determine transaction and production costs and hence the profitability and feasibility of engaging in economic activity” (North, *JEP*, 1991, p. 97).

▶ Examples

- Exogenous: law, language, money, custom
- Endogenous: firms, contracts, business plans

The economic analysis of institutions (highly simplified)

- ▶ **Pre-classical economics:** eclectic mix of theory and institutional study
- ▶ **Classical economics** (c. 1776– 1871): gradual focus on production and exchange in hypothetical, idealized conditions; emphasis on equilibrium analysis over the causal-realist approach
- ▶ **Neoclassical economics** (1871–1970s?): further emphasis on static equilibrium under “perfect “ conditions; little interest in institutions (e.g., money)
- ▶ **Old institutional analysis** (German Historical School, American institutionalists [Veblen, Commons, Mitchell, Ayers]): institutions are important but not susceptible to economic analysis
 - Coase: “Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire.”
- ▶ **New institutional economics:** (1) institutions matter, and (2) institutions are susceptible to economic analysis, using “standard” tools
 - Some canonical problems: emergence of long-distance trade, design of constitutions and administrative rules, make-or-buy decision, contractual design, firm organization



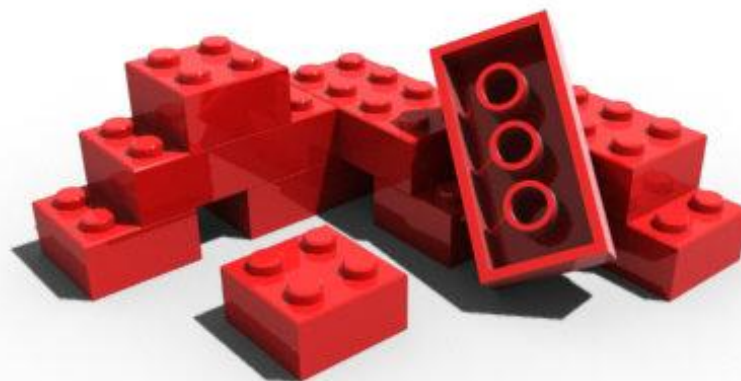
Foundations of the new institutional economics

▶ Method

- Methodological individualism
- Comparative institutional analysis
- Economics and sister disciplines

▶ Building blocks

- Property rights
- Transaction costs
- Agency costs
- Information costs



Basic strands of the new institutional economics

▶ The institutional environment

- The legal environment and property rights
- Norms, culture, and social conventions
- Economic history, growth, and development
- Political economy (“positive political theory”)



▶ Institutional arrangements (governance structures) – the theory of the firm

- Coase and the nature of the firm
- Moral hazard and agency
- Transaction cost economics
- The property-rights approach
- Resource-based theories
- Innovation and organizational change



Methodological individualism

▶ Methodological holism

- Veblen: “hallmark of scientific explanation is the elimination of consciousness as an explanatory element.”
- Parallels with evolutionary biology
- Keynesian macro models (neglect of heterogeneity)
- Data mining?

▶ Flavors of methodological individualism

- Weber (and the Austrian school of economics): primacy on the *action-theoretic* level of understanding (introspection, teleology, subjective understanding)
- Neoclassical economics: emphasis on identifying equilibria use of the experimental method
- Methodological individualism versus “atomism” (Hobbes)

Methodological individualism II

▶ Human action versus human design (Hayek)

- “Artificial” versus “natural” institutions (Greeks), “organizations” versus “orders” (Carl Menger), “human design” versus “human action” (Hayek)

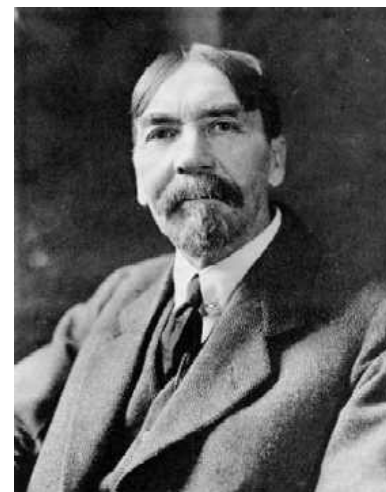
[Orders] as a rule are not the result of socially teleological causes, but the unintended result of innumerable efforts of economic subjects pursuing individual interests. The theoretical understanding of them, the theoretical understanding of their nature and movement can thus be attained in exact manner only . . . by reducing them to their elements, to the individual factors of their causation, and by investigating the laws by which the complicated phenomena of human economy under discussion here are built up from these elements (Menger, 1963, p. 158–59).



Methodological individualism III

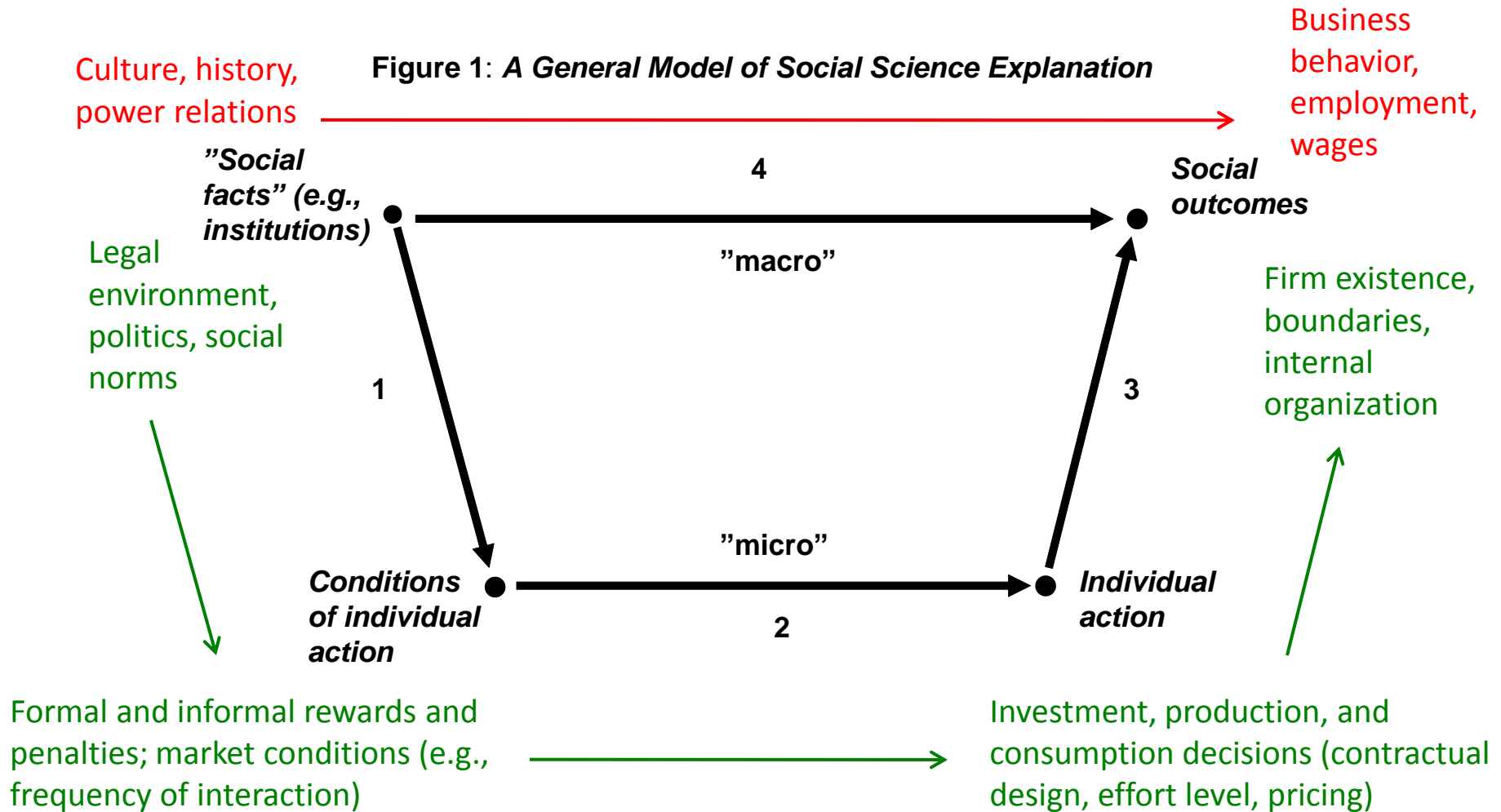
► Methodological individualism versus rational choice

The hedonistic conception of man is that of a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact. He has neither antecedent nor consequent. He is an isolated, definitive human datum, in stable equilibrium except for the buffets of the impinging forces that displace him in one direction or another. Self-imposed in elemental space, he spins symmetrically about his own spiritual axis until the parallelogram of forces bears down upon him, where upon he follows the line of the resultant. When the force of the impact is spent, he comes to rest, a self-contained globule of desire as before. Spiritually, the hedonistic man is not a prime mover (Veblen, 1919, p. 73).



Methodological individualism IV

Figure 1: A General Model of Social Science Explanation



Building blocks I: property rights

▶ Definition, importance, emergence

- Property rights as bundles of rights(use, alienability); can be shared
- Incentive effects
- Emergence (Demsetz, 1967)
 - ▶ Marginal benefits: internalizing externalities
 - ▶ Marginal costs: definition and enforcement

▶ Property rights and liability

- Pigouvian welfare economics
- The Coase Theorem (Coase, 1960)
 - ▶ *The initial allocation of legal entitlements does not matter from an efficiency perspective so long as they can be freely exchanged.*
 - ▶ *The initial allocation of legal entitlements does not matter from an efficiency perspective so long as the transaction costs of exchange are nil.*
 - ▶ *The initial allocation of legal entitlements does not matter from an efficiency perspective so long as they can be exchanged in a perfectly competitive market.*



Building blocks II: transaction costs

▶ Definitions (Allen, 2000)

- Costs resulting from the transfer of property rights (“neoclassical” approach – limited to market or “external” transaction costs)
- Costs of establishing and maintaining property rights (broader, “property rights” approach – includes external and “internal” transaction costs)

▶ Examples

- Searching for prices and quantities, trading partners, or other information needed for trade
- Bargaining
- Writing contracts, monitoring contractual partners, enforcing contracts (and collecting damages)

▶ Importance

- Without transaction costs, “inefficiency” makes no sense
- Coase: transaction costs explain both the existence of the firm (Coase, 1937) and the existence of the law (Coase, 1960).

Building blocks III: agency and information costs

- ▶ Economics of information
 - Pre-contractual issues: bargaining costs, adverse selection
 - Post-contractual issues: agency costs
- ▶ Extensions and applications to management theory
 - Tomorrow morning's lecture!



The institutional environment

- ▶ Efficiency of the common law (Posner, Rubin, Priest, 1970s)
- ▶ Emergence of long-distance trade (Greif)
- ▶ LLSV debate
 - Common law
 - Civil law
 - Issues and problems
- ▶ Role of the political environment
 - Policy constraints (Henisz, 2000)
 - Economic freedom (Bjørnskov and Foss, 2008)
- ▶ Data and methods
 - Analytical tractability (examples)
 - Classification problems



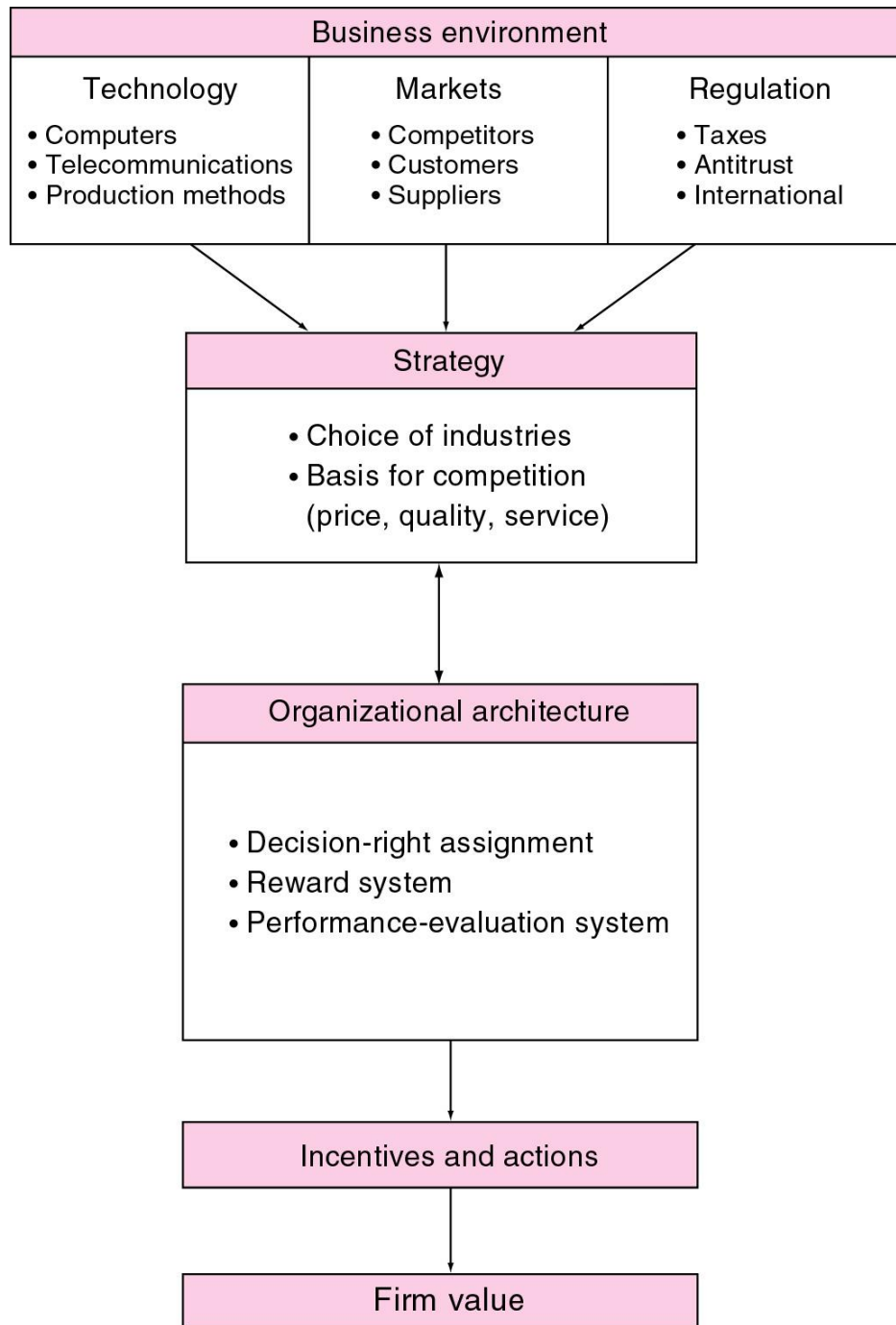
The institutional environment and the ToF

▶ Common themes

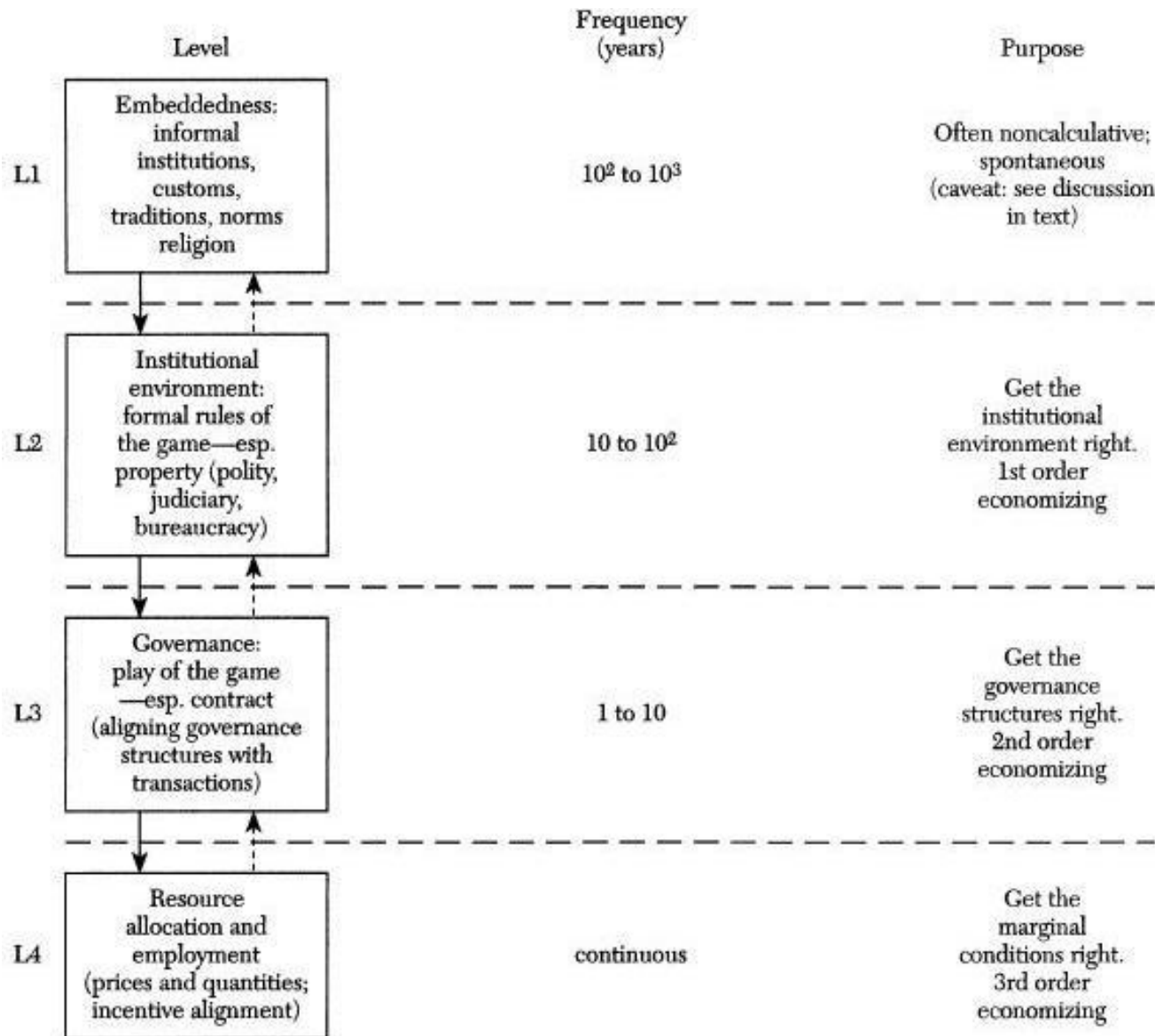
- Transaction costs
- Property rights
- Agency and information costs

▶ How the institutional environment affects institutional arrangements

- Exogenous constraints (“shift parameters”)
- Environment in which experimentation, learning, and selection takes place
- Endogeneity?



Institutional change



Takeaways

- ▶ Different views of the NIE
- ▶ Different views of ToF
 - “Mainstream economics” or heterodox economics?
 - Pure economics or an eclectic mix?
- ▶ Complex relationship between NIE and ToF
 - If NIE describes a set of phenomena to be explained (“economic analysis of institutions and organizations”), then ToF is part of NIE
 - If NIE is an interdisciplinary analysis of various phenomena, then maybe not. . .