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On Integrating New and Old Institutionalism: Douglass North Building Bridges

John Groenewegen,
Frans Kerstholt,
and
Ad Nagelkerke

In institutional economics, the explanandum is the institution. Definitions of institution refer to a framework of behavior: institutions direct, channel, or guide behavior. We prefer to distinguish values as the underlying systems of belief about right and wrong from the more concrete institutional structure of norms, rules, and structures. In economics, it is important to study the influence of the institutional structure on behavior in order to understand better the performance of firms, markets, and economies in different settings. For instance: with respect to take-overs, norms in Japan differ from the American ones; legal rules of competition differ in the United States from those in France, and the structure of market and firms differ between sectors, which influences behavior of management with respect to diversification, networking, and the like.

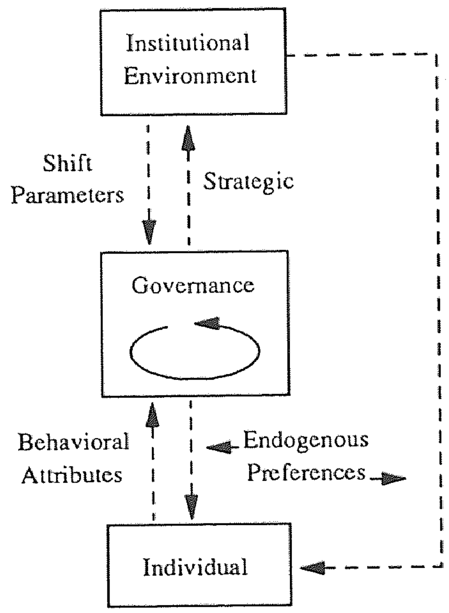
Central questions in institutional economics are why institutions come into existence, why they develop in specific ways, and what can be said about their efficiency? In economics, these questions are approached from different perspectives within the schools of new and old institutionalism. These schools differ in respect to their problem definition (explanandum), to their explanatory variables (explanantia), and to their methodology of

The authors are Associate Professor of Economics, Erasmus University Rotterdam; Associate Professor of Sociology, Tilburg University; and Associate Professor of Sociology, Tilburg University, respectively. This paper was presented at the joint session of the Association for Evolutionary Economics and the American Economic Association, Washington, D.C., January 6-8, 1995.

inquiry. The differences can be illustrated with the three-layer schema of Williamson [1993] (see Figure 1).

In Figure 1, the explanandum is the governance structure, and the explanantia (solid arrows) are the institutional environment, the individual, and the "life of the governance structure on its own."

Figure 1. A Layer Schema



The Old Institutionalism (OIE)

Institutionalism[1] has had institutional change as its paramount object of study for a century. The central problem has not been the influence of a given set of institutions on economic behavior, but understanding the process of institutional change itself. With respect to the explanantia, it is important to stress the use of a collectivistic point of view. The structure of social and economic reality is seen as complex, functional, and interdependent while the dynamics of this structure are described in evolutionary terms. However, a serious problem of coherence is apparent. In fact, there are two general approaches, one based on Veblen and the other on Commons. The differences between them are remarkably broad. For instance, whereas in Veblenian thinking the individual is carrying out the exigencies of big cultural forces placed in a Darwinian perspective, Commons pictures a voluntaristic world of collective rules. In contrast to the materialistic and collective institutionalism of Veblen, the regulative and collective institutionalism of Commons assumes a man-made social order with a high degree of constructivism. In the development of old institutionalism to modern neo-institutionalism (see note 1), there has been a shift from Veblenian thinking to that of Commons.

Among the explanantia, the predominant factor in shaping institutions has been technology. As technology evolves, new configurations of social structure are bound to emerge, always accompanied, however, by conflicts. In solving conflicts between societal values (higher efficiency) and individual values (lower efficiency), we have witnessed a development from irreconciliable forces (Veblen) to appeasing rule-making by means of democratic procedure (Commons). In Commons's point of view, conflicts of interest render certain institutions socially inefficient; institutionalization then is an (artificial) process of selection of (increasing) efficient and reasonable rules. As a consequence, the strict Veblenian interpretation of institutions as inherently conservative, or even hostile, to community life has been largely abandoned. Institutions can be efficient for tasks at hand [for a discussion on ceremonial and instrumental institutions, see Bush 1987].

The actors in the process of institutional change are collective in character. The individual as an "individual entity" is an uneasy subject for OIE. At every level of aggregation, economic behavior is interdependent and, above all, non-univocal. Every transaction–Commons's smallest unit of analysis–reflects more than efficiency alone. It also incorporates a stable social order–a kind of higher order efficiency. Transactions must meet the requirements for equity and trustful behavior. Therefore, notions of property and freedom are incorporated in rights and are legally protected. Most transactions, however, are repetitive and habitual, not subject to judicial controversy. Relevant, however, are the strategic transactions bringing in "limiting factors" for the parties concerned. These limiting factors give rise to conflicts out of which new "working rules" will emerge, which in turn become habitual after some time. Thus, strategic transactions are crucial for institutional change as they exceed the scope of a single company or a single logic or action.

Thus, in terms of the layer schema, the old and neo-institutionalists claim to explain the institutional environment (giving central attention to technology and "working rules" resulting from solving conflicts and habituation), while recognizing at the same time an important influence of the institutional environment on the process of institutional change. In other words, institutions are constraints as well as instruments.

With respect to the method of inquiry, the old and neo-institutionalists favor a multidisciplinary approach in which different techniques are applied. Wilber and Harrison [1978] explain that their methodology certainly is neither deductive nor based on methodological individualism. Institutionalism is holistic, systematic, and evolutionary and proceeds by what Wilber and Harrison call "pattern modelling." The fact that the approach is open-ended and multidisciplinary makes it simultaneously rich in content and relatively low in rigor [see Caldwell 1982].

New Institutional Economics

In New Institutional Economics, the focus is on the explanation of institutions by use of the well-known basics of economic theorizing: the utility maximizing individual placed in well-specified environments produces efficient outcomes. Methodological individualism makes the individual with given preferences the fundamental building block of the theory. These economists believe that preferences in reality are influenced by the institutional environment, but for the purpose of economic inquiry it is considered legitimate to start the analysis with the abstract maximizing individual. The new institutionalists explain economic, legal, and historical institutions in terms of individual behavior.

We illustrate the fundamentals of New Institutional Economics with the transaction cost economics of Oliver Williamson. The institution to be explained is the "governance structure": the institutional matrix within which transactions are negotiated and executed. With respect to the individual, Williamson considers bounded rationality and opportunism crucial. The individual is farsighted and calculates the risk of opportunism that arises from asset specificity. It is recognized that preferences are not exogenously given (represented by dotted arrows in the layer schema), but the process of preference formation is of secondary importance. The institutional environment is considered important by Williamson: changes in the governance alternatives influence comparative costs of markets, hybrids, and hierarchies. The institutional environment is a "shift parameter"–a datum for the actors. It is recognized that, for instance, firms try to influence their environment of legal rules (dotted arrow in Figure 1), but these strategic actions are not considered the crucial issue (in the end the best strategy is economizing).

Williamson recognizes that the governance structure has a life of its own and makes the point that "such effects demonstrate the need for deep knowledge about organizations, but it does not imply that the economic approach to organization (which easily misses such effects) is fatally flawed" [Williamson 1994, 11-12]. Williamson certainly realizes the importance of the different layers (represented in Figure 1 with the solid arrows) and the relevance of feedbacks (represented with the dotted arrows), but he considers "economizing" as the main avenue to understanding economic organization. He asks critics to develop rival explanations.

With respect to the method of inquiry, we conclude that the NIE is of an individualistic, deductive nature. After having characterized the transaction, different potential governance structures are discussed in terms of their transaction cost minimization. Then hypotheses are confirmed using historical examples.

Douglass North: Building Bridges

Three stages in the development of the work of Douglass North are apparent. Douglass North initially explained historical economic growth in the institutional context of developed capitalist institutions and recognized the limited historical scope implied by this [North 1955, 243-244]. Then his subject shifted to the relationships between efficient institutionalization and economic growth. However, inefficient institutions are not completely overlooked [North and Thomas 1973, 127-131]. The restriction to a developed capitalist environment was lifted. Recently, problems of inefficient institutional change and economic performance have advanced to center stage.

The early Douglass North employed a neoclassical model. Institutions figure as data. Fully informed actors maximize their utilities. Economic processes oscillate to optimal equilibria. During middle period, the significance of institutions (property, state) for economic performance is given special emphasis. The explanatory model remains neoclassical; his hypothesis about the efficient institutions was central to the theory of institutional change.

This hypothesis explains change as a transition from one efficient institutional form to another one. Changing relative prices (scarcity) together with changes in transaction costs generate the transformation. The changing medieval manor provides an example.

Two explanations for inefficient institutions are suggested. "Free riding" as a cause of inefficient institutions tallies well with the neoclassical approach.

The other explanation is explicitly based on conflicting interests and differences in relative bargaining strengths. The examples center on the relations between governments and their subjects: ". . . a prince may find short-run advantage in selling exclusive monopoly rights which may thwart . . . growth because he can obtain more revenue from such a sale than from any other source" [North and Thomas 1973, 7]. The efficient institution hypothesis lingers on in the emphasis on the short run. As the short-term sometimes simply lasted too long, Douglass North turned to a theory capable of explaining long-term inefficient institutions.

Subsequently, Douglass North has drastically changed his explanatory model. The efficient institution hypothesis is dropped; power relations are seen to systematically influence institutional arrangements; the fact that information is not costless and often incomplete is the basis for a thorough critique of neoclassical theory as well as for a turn to theories of motivation and information processing and to theories of the formation and significance of ideology.

The efficient institution hypothesis is replaced by a bargaining theory. Differential bargaining strengths (power), e.g., between rulers and subjects, may now lead to inefficient outcomes in the long run as well [North 1981, 23, 27]. The institutional framework appears as a mixed bag: efficiency is contingent on many conditions [North 1990, 64].

Neoclassical theory should be superseded, North argues, by a theory in which transaction costs may prevent potential partners from reaping the gains from trade. The problems of human coordination and cooperation cannot be solved in the absence of institutions. The inevitability of subjective and incomplete processing of information "accounts for ideology . . . playing a major part in human beings' choices." Douglass North here discerns an additional source of inefficient institutions. Institutions are constraints as well as endogenous factors, which are investigated in the theory of institutional dynamics. North combines the emphasis on choice, a characteristic of mainstream economics, with the emphasis on institutions typical for old institutional economics. North endorses some criticisms of the received behavioral theory. Yet, the resulting proposal to include nonwealth maximizing motivations conforms to much current rational choice theory.

According to him, ". . . institutions alter the price paid for one's convictions and hence play a critical role in the extent to which nonwealth-maximizing motivations influence choices" [North 1990, 26]. Cost/benefit factors are crucial.

Douglass North has gradually moved away from a predominantly deductive explanatory strategy to one that is more clearly characterized by a back and forth between empirically established relationships and explanatory models carefully designed to do the job of explaining.

Toward a Pluralistic Institutional Approach

Douglass North is not simply interested in the influence of institutions as data, but also in the process of institutional change itself. For understanding that process, the individual using cost/benefit analysis is the basic building block. This individualism can be best characterized as structural individualism (or "institutional individualism"): on the one hand, the individual is constrained by the existing institutional structure, whereas on the other hand, he or she is capable of changing that structure according to his or her own preferences. The aggregate outcome of the individual actions can be an efficient but also an inefficient structure. For a deeper understanding of that process of institutional change and its influence on economic performance, understanding ideology (culture), historical specificity (path dependency), power, strategy, and most of all processes of learning, are necessary [North 1994]. We conclude that with respect to explananda, explanantia, and methodology, the later Douglass North works in a line consistent with the old and neo-institutionalists, especially with the ideas of John R. Commons.

All this suggests that the recent developments in new institutional economics certainly have been promising, but that the discussion should now focus on problem definitions and under what set of conditions the "economizing lens is a good starting point" [Williamson 1995] and for what kind of explanandum and conditions a more neo-institutional approach is warranted. For understanding the influence of institutions and the process of institutionalization, a broad framework of concepts from different disciplines should be available. In that framework, both concepts of old, neo-, and new institutionalism should have a place. The work of Douglass North shows the importance of both approaches.

New institutionalists, such as Oliver Williamson, are making attempts in the same direction. Williamson [1994], for instance, formulates conditions under which predictions of TCE (transaction cost economics) will hold better than in other situations: With respect to the explanatory power of the concept of power, he remarks: "Power has less to contribute to the study of intermediate product markets and capital markets than it has to contribute to labor and final goods markets and the study of politics" [Williamson 1994, 18]. The example of the De Beers monopoly in the diamond market is used to show the importance of reputation (an important TCE concept) related to knowledgeable dealers and a very good communication between them. With respect to consumers and labor markets: "(. . .) transactions are characterized by (comparatively) shallow knowledge, confusion, inability to craft a specialized governance structure, weak reputation effects, and costly legal processes" [Williamson 1994, 25].

For assessing the competitive pressures of the market, other disciplining mechanisms, such as the role of protecting structures (market as well as socio-political structures) and availability of information (with consequences for the role of reputation effects and credible committments), are important. It is neccesary to start the analysis with the institutional environment in which the actors are embedded. Only then the pressures toward efficient governance structures can be made visible and only then the set of alternative governance structures of which actors can choose become known to the researcher.

Notes

1. The terminology can be confusing. We refer to the work of Thorstein B. Veblen, John R. Commons, and Wesley C. Mitchell as the old institutionalists. Following Gruchy [1972] we call the later institutionalists who work in the tradition of the old ones (among others John K. Galbraith, Gunnar Myrdal, Marc R. Tool, Paul D. Bush, and Warren J. Samuels) the neo-institutionalists.

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