

May 2022

A preliminary draft, only a few basic references

Suggestions and objections welcome!

How to bring D.C. North, O.E. Williamson, and D. Acemoglu et al. together, and start unifying Institutional Economics

For presentation at the 2022 Conference of the Society for Institutional and Organizational Economics in Toronto, June 23-25

Pavel Pelikan

Prague University of Economics and Business

Abstract: The main motive for this paper is the hypothesis that Institutional Economics (IE) has the potential to raise to the top of entire economics. A direct support is the growing evidence that the performance of economies depends more on their institutional features than on any other factor, including natural resources, technologies and education. An indirect support appears, when suitable conceptual correspondences are established, in the recent raise of genomics to the top of biology. This paper helps IE realize this potential by repairing its two actual flaws: terminological ambiguities and fragmentation into largely disconnected strands. The most embarrassing ambiguities concern the very term ‘institutions,’ used in many different and not always well-defined meanings. The fragmentation is exemplified by the three prominent strands of IE following the seminal contributions of O.E. Williamson, D.C. North, and D. Acemoglu with S. Johnson et J.A. Robinson, respectively. To repair these flaws, the paper proposes a logical model of an economy’s main institutional features, where each strand has a well-defined place. The model will disclose and bridge two deep gaps between them, with a suggestion for their fruitful division of labor on what the paper will define as the ultimate IE issue.

1. Introduction

The initial motivation for working on this paper is the hypothesis, recently occurred to the author, that Institutional Economics (IE) has the potential for raising to the top of entire economics. Its direct support is the growing evidence that the performance of economies depends more on their institutional features than on any other factor, including natural resources, technologies and education. An indirect support has been found – when precise logical correspondences between certain institutional features of economies and the genomes of organisms are established – in the recent raise of genomics to the top of biology.

Intuitively, why large financial aids cannot make a poor economy with bad institutional rules grow rich may be compared to why large quantities of food cannot make a mouse grow into an elephant.

But today's IE is not ready to realize this potential. This paper finds it to suffer from two major flaws: conceptual ambiguities, and fragmentation into largely disconnected strands. The most embarrassing ambiguities concern the very term 'institutions,' which continues to be used, by both economists and public at large, in many different and not always well-defined meanings. The fragmentation is here exemplified by the three chief strands of IE that follow the seminal works by O.E. Williamson, D.C. North, and D. Acemoglu et al. – denoted as W-strand, N-strand, and A-strand, respectively. Apparently, no one is fully clear on their possible interconnections. The aim of this paper is to help IE raise to the top by repairing both these flaws.

2. Definitions and clarifications of key terms

It is first necessary to find and define the terms that could clearly express the central ideas of all the three strands. A novel proposition is to drop the term 'institutions' altogether. This term is recognized as irremediably ambiguous due to its unstoppable uses in two analytically different meanings: *rules* as constraints on, or guides to, behaviors; and *organizations* as one kind of the actually behaving entities. While many prominent economists, including D.C. North, E. Ostrom, and M.M. Shirley, use this term only in the first meaning, others, including O.E. Williamson and G. Hodgson, use it in both meanings.

To express the meaning intended by North, this article uses the longer, but less ambiguous and more evocative term 'institutional rules' (IRs). It moreover corrects his

intuitively appealing, but logically imprecise comparison of institutions to the rules of a game and organizations to its players. It does so by also considering the internal IRs of organizations. The game may then be seen played by both individuals and organizations. The individuals who are members of organizations play then two games – of their organizations and of the entire economy – while organizations play the game of the economy by two kinds of choices – of their external input-output behaviors (e.g. as constrained by the competition law), and of their internal IRs (e.g. as constrained by the corporate law).

The set of all of an economy's institutional rules is denoted as its 'institutional framework' (IF). The rules are classified into four kinds according to two intersecting criteria: formal-informal, as done by North, and economic-political, as done by Acemoglu.

The IF is shaping (constraining, guiding) the behaviors of both individuals and organizations, both of which are the active entities that make the economy operate and develop. They are defined to form, together with their interrelationships, the economy's 'markets-organizations-network' (MON). While the notion of IF is closest to the N-strand, the one of MON is closest to the W-strand.

But the MON is more general than what Williamson probably had in mind. It also accommodates the polycentric governance studied by Ostrom by admitting organizations partly to overlap, and thus create possibly changing networks of action situations. The MON, however, connects these networks to the more stable network of their actors, so that the often-important distinctions between market and government, and between private and public, in contrast to same studies of the networks of action situations, may fully be preserved.

3. A simple logical model of an economy's institutional features

The term 'institutional features' refers here very broadly to both the IF and the MON of an economy, of both the economic and the political kinds. But the present point is not to mix these four features together, but on the contrary, clearly distinguish them from each other and comprehend their interrelationships.

To do all this, this paper starts with the scheme outlined by Acemoglu et al. (2005: 392), which it adjusts and elaborates by zooming in on individuals behaviors – the only link through which any IF may effectively influence any economic or political outcomes. The result is a simple logical model, consisting of two quasi-causal chains forming an infinitely

reiterating feedback loop. To avoid subscripts in the text, the neighboring time periods are denoted as ‘actual’ and ‘next.’

(E) ... the actual econ-IF → the economic behaviors of individuals → the forming, operating and developing of the econ-MON → production, consumption, investments, enterprising, innovating → the actual economic outcomes → the actual cultural-political behaviors within (P) ...

(P) ... the actual polit-IF → the cultural-political behaviors of individuals influenced by the actual economic outcomes → the forming, operating and developing of the polit-MON → formal and informal rule-making → the next IFs, both econ- and polit-, beginning the next round of both (E) and (P) ...

The arrows symbolize the quasi-causal relationships, meaning that the first term strongly influences, but not fully determines, the second – in other words, that the first term is only one of the possibly many causes of the second. Two points are important to realize: (i) that all of the influences that any IR might have on the economy’s outcomes must inevitably pass through individual behaviors; and (ii) that these behaviors also depend on the individuals’ preferences and their more or less bounded rationality.

An important, but not always fully realized difference between (E) and (P) is in what is for them the ultimate most controversial issue. For (E), this may roughly be described as ‘market vs. government,’ and for (P), as ‘political democracy vs. dictatorship.’ The model brings to light that, at least in the short run, the two issues may be combined in all the four ways – including political democracy giving extensive economic powers to government, and dictatorship imposing or defending an extensive market economy – which has not always been properly considered.

Another important difference between (E) and (P) is in the strength of their quasi-causality: the one of (E) appears much stronger than the one of (P). For example, if the actual economic IF hampers production or investment, it will quite certainly cause wastes and shortages, possibly even empty shelves in shops and long waiting lines of dissatisfied consumers – which can hardly be debated away. In contrast, how the actual political IF the actual economic outcomes may influence the political choices of the new IFs is much more debatable. Differences in preferences, rationality, eloquence, and the knowledge (or false beliefs) about the effects of different IRs, cause much uncertainty in who will actually win the political debates and what IFs will consequently be chosen. The frequent mistakes usually come to light only after many years.

4. Localizing the three strands of IE in the model

Each of the three strands deals with a more or less rich variety of issues which to some extent overlap, although the overlaps are not always properly noted. But each strand also has a central issue on which it concentrates most of its efforts. It is only these central issues that will be considered here. It is according to them that the strands will be localized in the model.

The central issues of both the N-strand and the W-strand have their places in chain (E). They both concentrate on the effects of economic IFs, and they both estimate these effects by means of the transaction costs theory following R.H. Coase. But with the exception of this theory, they have little to do with each other. The N-strand is about the IFs of entire economies, embracing the entire (E)-chain, while the W-strand is, in present terms, about the internal IFs of firms and other organizations within the economy, and thus only deals with a limited section of this chain. In contrast, the N-strand largely jumps over this section – the terms ‘firms’ and ‘enterprising’ are there conspicuous by their absence – while the W-strand cares little for the entire economy, with the exception of its static (Pareto) efficiency. Another difference is that the N-strand pays attention to adaptive efficiency (adopted by North 1990 from Pelikan 1986) and considers institutional change, which makes it dynamic and evolutionary, while Williamson was refusing evolutionary approaches and kept his institutional analysis largely static. His well-known transaction-costs defense of big M&A may indeed be criticized for being too static, ignoring the negative dynamic impact of too-big-to-fail firms on the future of market competition.

On the other hand, the central issue of the A-strand belongs to chain (P): its main interest is indeed in the effects of political IFs. But it has a problem. As it aims to follow these effects all the way to the economic outcomes, it is forced also to pass through the entire chain (E). So far, however, it has not done so very carefully: it has been skipping over most of the (E)’s issues, including the ‘market vs. government’ one. For instance, while many results of the A-strand claim political democracy to be economically superior to autocracy, little is said about the mixture of market competition and government policies imposed by the economic IF that a democratic political IF may cause to be chosen. Acemoglu et al. (2005:387) simply state that “Economic institutions ... are social decisions chosen for their consequences.” This implies that these consequences are assumed known. But if they were, people working in the N-strand and the W-strand would become jobless.

5. The two gaps between the three strands, and how to overbridge them

The places of the three strands in the model reveal two deep gaps between them: (1) between the N-strand and the W-strand within chain (E), and (2) between chain (E) with these two strands together and chain (P) with the A-strand. It is these two gaps that are the main causes of the fragmentation of today's IE, and it is by overbridging them that most of this fragmentation appear possible to repair.

The model rather straightforwardly indicates how to build the two bridges. While their details would require a rather long elaboration, here it is only possible to briefly and incompletely outline their main principles.

The building of bridge (1) demands the N-strand to include economic organizations with their internal IFs – including private firms, cooperation and government agencies – and state the necessary conditions that their performance would have to meet, to allow the economy's IF to attain the outcomes that the N-strand predicts it to attain. Clearly, even the apparently most efficient MON would grossly underperform if it contained many poorly performing firms.

In return, the W-strand is demanded to consider more effects of firms on the economy than those of their transaction costs on the economy's static efficiency. Particularly important appear to be the effects of their sizes and the forms of their corporate governance on the economy's adaptive efficiency. Another demand is more attention to the economy's IF, and to the distinction between the corporate governance good for a firm, and the corporate governance of firms good for the economy – with lessons on how the economy's IF, e.g., via the corporate law, may need to constrain the firms' choices of their internal IFs. Managerial abuses allowed by insufficient constraints of these choices are legion.

The building of bridge (2) demands that the N-strand and the W-strand pay more attention to the origins of economic IFs, in particular to the influences on these origins of different political IFs. Some attention to these influences may be found in the N-strand, but appear not to suffice to build a solid bridge to the A-strand. The essence of the demand on the A-strand is in the word 'believed' inserted into the above citation: "Economic institutions ... are social decisions chosen for their *believed* consequences." This word directly leads to the N-strand and the W-strand as the specialists in the consequences of different economic IFs. It is the task of these strands – even if they are still far from fulfilling it – to distinguish the right beliefs from the wrong ones, and thus help stop the IFs with disastrous consequences –

despite the possibly widespread false beliefs in their advantages – from being chosen.

6. The ultimate issue for IE and its division between the three strands

There are several important issues that such a unified IE may be expected fruitfully to handle. In this short article, only one issue, and only very roughly, may be considered. But, arguably, this is the ultimate issue of the highest social importance:

Which IFs, if any, could lastingly succeed in making human individuals – given their enormous but limited learning abilities, and the set of their hard to unlearn preferences and other instincts – form, operate and keep developing an evolutionarily successful economy?

While different parts of this issue have already been many times addressed, the merit of the above-proposed logical model is that it suggests how to effectively divide this issue among the three strands, and how these strands could smoothly cooperate. The main points of this division may roughly be summarized as follows.

The task of the N-strand may roughly be put as searching for the form of the overall economic IF, which could provide the economy with sufficient static and adaptive efficiency without causing unacceptable inequalities.

The task of the W-strand may roughly be put as searching for the segment of this IF concerning the internal IFs of the economy's organizations, that could protect the economy from the forming, or at least lasting, of wasteful firms.

The task of the A-strand may roughly be put as searching for the form of the political IF that could make the actual population support the choices of such successful economic IFs. The additional task of the united IE is to find and spread the knowledge on what these IFs are.

The research program of the united IE promises to be much richer, with connections to several existing results in each of the three strands, but a more extensive exploration of this program must be postponed to another occasion.

Three basic references

Acemoglu, D., S. Johnson and J.A. Robinson (2005), "Institutions as a fundamental cause of

long-run growth,” in P. Aghion and S.N. Durlauf, eds., *Handbook of Economic Growth*. Elsevier B.V.: Amsterdam.

North, D.C. (1990), *Institutions, Institutional Change, and Economic Performance*. Cambridge University Press: Cambridge and New York.

Williamson, O.E. (1985), *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting*. The Free Press: New York, and Collier Macmillan Publishers: London.

A sample of the precursory texts

Pelikan, P. (1986), *Institutions, Self-Organization, and Adaptive Efficiency: A Dynamic Assessment of Private Enterprise*, IUI Working Paper, No. 158, The Research Institute of Industrial Economics (IUI), Stockholm
https://www.researchgate.net/publication/335224744_Institutions_Self-Organization_and_Adaptive_Efficiency_A_Dynamic_Assessment_of_Private_Enterprise

Pelikan, P. (1995), *Competition of Socio-Economic Institutions: in Search of the Winners*, in L. Gerken, ed., *Competition among Institutions*, Macmillan Press: London, and St. Martin's Press: New York.

Pelikan, P. (2010), *The government economic agenda in a society of unequally rational individuals*, *Kyklos* 63: 231 – 255.