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THE NEW INSTITUTIONAL ECONOMICS - MAIN THEORIES

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Abstract

The aim of this article is to show that the New Institutional Economics is an interdisciplinary stream combining economics, law, organization theory, political sciences, sociology, and anthropology. The main theories which are part of the New Institutional Economics are: Agency Theory, Property Rights Theory and Transaction Costs Theory. The basic assumptions of these theories are mentioned in this paper. This article is an introduction to the New Institutional Economics and its main theories. For this purpose, it presents a brief guide for those who are interested in the New Institutional Economics. Finally, the article is accompanied by a short review of examples of empirical studies connected with these theories.

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Introduction

The New Institutional Economics is a rapidly growing interdisciplinary field combing economics, law, organization theory, political sciences, sociology, and anthropology. It is helpful to "understand the institutions of social, political and commercial life" (Klein, 1999, p. 456). The founding father of the New Institutional Economics is Ronald Coase, who, in 1937, wrote an article entitled "The nature of the firm". The term was coined by Olivier Williamson, who wanted to highlight the differences between the new economic ideas and the "old" institutional economics (Landreth & Colander, 2005).

The "old" institutional economics is connected with Thorstein Veblen, Wesley Mitchell and John Commons. As Coase wrote (1998), they were of great intellectual stature but they were also anti-theoretical. Without a theory which bound together their ideas, they could not have succeeded (Coase, 1998, p. 72). The Institutional Economics' style of presenting their ideas was very informal and rhetorical (Parada, 2002, p. 44). The second reason why that theory is not very common is that "the old institutionalism was partially disabled by both profound shifts in social sciences in the 1910–1940 period and of the rise of a mathematical style of neoclassical economics in the depression stricken 1930s" (Hodgson, 1998, p. 167).

There are many essential differences between the "new" and the "old" institutionalism. The New Institutional Economics evades the holism of the older school (Klein, 1999, p. 457). Institutional Economics' analysis is based mostly on formal institutions and the role of society in defining values (Parada, 2002, p. 45), while the approach of the New Institutional Economics is more individualistic- the point of departure is the individual itself. Institutions in this theory are originated from individual behaviour, through interaction among individuals (Parada, 2002, p. 45). According to North, they are "the humanly devised constraints that shape human action" (North, 1990, p. 3). Institutions are constrained by the informal conditions like culture and custom, as well as formal conditions: law, property rights. "Institutions are the rules of the game in the economy, and 'organizations' ('the players of the game') arise in response to the institutional structure" (Ankarloo, 2006, p. 6). The next difference is the role of rationality. According to Institutional Economics, habits, norms and institutions play a significant role in directing human behaviour without rejecting some rationality in individual behaviour that is, however, constrained by economic and social environment (Parada, 2002, p. 45). The New Institutional Economics introduces the idea of an individual not being a utility-maximizer but being subjected to bounded rationality. According to Herbert Simon (1961), the individuals are "intendedly rational, but only limitedly so".

A significant influence in the development of the New Institutional Economics has come from the following Nobel Laureates: Ronald Coase – the Nobel Prize in 1991, Herbert Simon – 1978, Olivier Williamson – 2009, Douglass North – 1993 and James Buchanan – 1986.

James Buchanan made a significant contribution to the development of the theory of public choice, whereas Herbert Simon focused on rationality. The rest of the above-mentioned Nobel Laureates are discussed below.

This paper is to emphasize that the stream of the New Institutional Economics is not homogeneous. There are a few complementary theories being part of it: Agency Theory, Transaction Costs Theory and Property Rights Theory. The other aim of this article is to present basic assumptions of the main theories in the New Institutional Economics such as: Transaction Costs Theory, Property Rights Theory and Agency Theory. Because of so many great economists who are interested in this economics stream, it is worth knowing the main building blocks. The third purpose of this paper is to present a short review of empirical studies connected with these theories.

As a review article, it is organized as follows. First, there are presented Transaction Costs with their basic assumptions. Next is Property Rights Theory and Agency Theory which are also presented with the most important assumptions. Then, a number of examples of empirical studies of these theories is presented. This part is a short review of research which brings theory into practice. The paper ends with conclusions.

Transaction Costs

The founding father of this theory is Ronald Coase, who, in 1937, wrote an article entitled "The nature of the Firm". Transaction costs have become a very significant category in Coasean economics. "Without them, many aspects of the functioning of the economic system remain unexplained, including the emergence of the firm itself"

(Parada, 2002, p. 50).

Transaction costs are the costs stemming from applying the price mechanism. In other words, these are the costs of negotiating contracts, monitoring performance and getting to know trading partners (Parada, 2002, p. 50). According to Kenneth Arrow (1969), "transaction costs are the costs of running the economic system". The Glossary of Industrial Organisation Economics and Competition Law states that these are the costs which are involved in market exchange-so these are the costs of "discovering market prices and the costs of drawing up and enforcing contracts" (Organisation for Economic Co-operation and Development [OECD], 1993).

The sources of transaction costs are: searching for information, analyzing options, selecting a product, drawing up the contract and realizing it as well as the costs resulting from bounded knowledge and the tendency towards making mistakes (Chotkowski, 2010, p. 106).

According to Coase, "without taking into account transaction costs it is impossible to understand properly the working of the economic system and have a sound basis for establishing economic policy" (Watkins). Coase observed that the relationships between companies are governed by the market prices while within the firms themselves, it is different, that is, decisions are made on thorough entrepreneurial coordination, which is "a basis different from maximizing profit subject market prices" (Watkins).

If the transactions are not managed by the price system, it must be done by the organisations themselves. The purpose of a business organisation is to recreate the conditions of a competitive market for production factors. Within the firm, this process should be run at a lower cost than the actual market (Watkins). The entrepreneur can reduce transaction costs by coordinating activities related to contractual commitments by themselves. It is worth remembering that it is also part of another costs, coming from within, for example "problems of information flows, incentives, monitoring and performance evaluation" (Klein, 1999, p. 464).

In "The nature of the Firm" Coase raised the question of why there are any market transactions if the organisations can reduce the costs (Coase, 1937, p. 394). He also mentioned the reasons why it is so. First of all, there is a connection between a firm's size and the costs of managing additional transactions. In larger organizations, the costs of managing additional transactions can be higher and "equated with the costs of additional market transactions" (Watkins). The second reason mentioned by Coase (Coase, 1937, p. 394-395) is that "as the transactions which are organised increased, the entrepreneur fails to place the factors of production in the uses where their value is greatest, that is, fails to make the best use of the factors of production".

The Coasean framework was developed and expanded by Olivier Williamson. It was Oliver Williamson who coined the term of "transaction costs". According to him, transaction costs appear when a service or goods are transferred through a technologically separate interface (Kowalska, 2005, p. 52). The analysis of transaction costs replaces the concentration of technology and production (or distribution) costs by relying on the study of comparative costs of planning, adapting and supervising. These costs concern task accomplishment at different structures of management (Kowalska, 2005, p. 52).

Williamson defines a transaction as a process in which goods or a service are transferred through a technologically separate interface. That definition shows that the transaction is not only a market exchange, but it covers all the exchange procedures within the organization (Kowalska 2005, p. 53).

Williamson has been also the first to have paid attention to a transaction's dimensions which determine its specification and process. Those dimensions are: assets' specification, frequency and uncertainty (Kowalska 2005, p. 59). It is worth mentioning that those dimensions have an influence on the level of transaction costs: the increase in transactions' frequency decreases transaction costs (Zbroińska, 2013, p. 165); the more asset specification, the higher transaction costs (Kowalska, 2005, p. 59).

Property Rights

Property rights entitle the owner of an asset to a number of "privileges", including the rights of use, benefit and exclusion of others from them (Segal & Whinston, 2010). It gives the owner of those rights a freedom to transfer them to others.

As far as an asset is concerned, property rights are "defined as a bundle of decision rights involving the asset (also called entitlements in legal terms), which provide rights to take certain actions ("rights of access") and to prevent others from taking certain actions ("rights of exclusion"), including the right to take the profit generated by use of the asset and to prevent others from doing so, often called "profit rights" or "cash flow rights" in the literature" (Segal & Whinston, 2010).

For Demsetz (1967), "property rights convey the right to benefit or harm oneself or others"., which means that it is prohibited to use firearms against a competitor, but harming them by the production of a superior product is not; it may be permitted to benefit by using firearms against an intruder but it is prohibited to benefit by selling below a floor price (Demsetz, 1967, p. 347). Therefore, the property rights show how one can benefit or harm and who should pay to whom to alter the actions taken by an individual.

They are four characteristics of property rights (http://cmbc.ucsd.edu/content/1/docs/PROPERTY%20RIGHTS.ppt):

1) universality: property rights can be held by individuals, state, groups; the entitlements should be completely specified and enforced,

2) exclusivity: all benefits and costs are for the owner; this characteristic is concerned with durability, which is a duration of these rights (a length of the entitlement),

3) transferability: all property rights can be transferred from one owner to another in a voluntary exchange; transferability is connected with divisibility,

4) security: property rights should be secured from a seizure.

Property rights can be held by individuals, groups and state. Property rights held by individuals are private property rights; by groups are collective property rights; by state-it is an extended form of collective rights (Libecap, 1986, p. 235).

There is a close relation between property rights and externalities. One of the property rights' function is achieving greater internalization of externalities by guiding the incentives. A potential externality can be every cost and benefit which is associated with social interdependencies (Demsetz, 1967, p. 348). It is necessary that "the cost of a transaction in the rights between the parties (internalization) must exceed the gains from internalization" (Demsetz, 1967, p. 348). It means that the transaction costs can be large because of difficulties in trading and legal reasons (Demsetz, 1967, p. 348).

Property rights theory assumes that the production or consumption of a service or goods impacts market participants, that is, there are externalities in each economy. According to this theory, owing to the internalization of externalities, the range of unexchangeable relations can be reduced. The main task of the government should be ensuring the accurate division of property rights. Internalization is connected with transaction costs because, for example, securing of property rights has a price (Gorynia, 1999, p. 783).

Douglas North observed that the effectiveness of informal rules can be complemented and increased by formal rules. Within the formal rules themselves there are distinguished the following: political and judicial rules, economic rules and contracts. "Formal rules also may be enacted to modify, revise, or replace informal constraints" (Mahoney, 2005, p. 125).

Property rights are defined by economic rules. Political decision making specifies and enforces property rights. The political structure is influenced by the structure of economic interests. Property rights theory, as a simple function of changes in economic costs and economic benefits, is not widely popularised in the economic literature. According to North, this theory needs to be modified "to account for the obvious persistence of inefficient property rights" (Mahoney, 2005, p. 125).

Agency Theory

Agency Theory is very helpful in understanding the relation between employers and employees, owners and managers or buyers and suppliers (Eisenhardt, 1989, p. 60). The most important idea this theory is premised on is the agency relationship that involves two parties: the principal and the agent. The principal delegates work to the agent whose role is to perform it (Eisenhardt, 1989, p. 58). Jensen and Meckling (1976) define the agency relationship as a contract under which the principal engages the agent to perform some services on their behalf. This leads the principal to delegate some decision making authority to the agent (Jensen & Meckling, 1976). The agent receives gratification for their performance as long as it is consistent with the principal's interest. On the other hand, there is opportunism in the agency relationship, that is both parties of this relationship have different aims and risk preferences (Gorynia, 1999, p. 779).

If the principal and the agent are utility maximizers, there is every reason to assume that the agent won't always act in the principal's best interest (Jensen & Meckling, 1976), which has to do with two problems that exist in that theory. The first of these is the agency problem. It occurs when there is a conflict between the agent's goals and the principal's desires and it's difficult or expensive for the principal to verify the agent's mode of operation. The main principal's problem is to check if the agent acts in the principal's best interest (Eisenhardt, 1989, p. 58).

The second one is the problem of risk sharing. It occurs when the both parties perceive taking risks differently. The problem here is that both the principal and the agent can act in a different way depending on their risk preferences and that is where Agency Theory is concerned with solving these problems (Eisenhardt, 1989, p. 58).

The way of solving the first problem can be establishing appropriate incentives for the agent. If the agent has an opportunity to have a valuable gain, they do not want to act against the principal's interest, because it will not produce the expected profit. The principal often resorts to incurring monitoring costs. The monitoring of the agent's acting should limit the aberrant activities of the agent (Jensen & Meckling, 1976). Causing the agent to act on behalf of the principal is a very common problem. It exists in all organizations and cooperative-efforts at each level of the management process (Jensen & Meckling, 1976).

These are agency costs which result from the first problem of Agency Theory. There are three sorts of agency costs: the principal's costs, the agent's costs and the alternative costs. The principal's costs involve monitoring the agent's acting. The second sort of the agency costs concern the agent's expenditures made to gain the principal's trust, e.g. insurance costs. These are also bonding costs which ensure that the principal will receive a compensation if the agent does not act on the principal's behalf (Jensen & Meckling, 1976). The third sort of agency costs are residual losses. These are the costs of the reduction in welfare experienced by the principal as a result of the divergence between the agent's decisions and actions and the principal's interest (Gorynia, 1999; Jensen & Meckling, 1976).

The principal and the agent have different attitudes towards risk. The risk aversion of the agent is understandable-the main agent's asset is their position: employment, contract or agreement. The agent is unable to diversify their position. The principal, who usually owns many assets, often represents an attitude of risk-seeking (Urbanek, 2005, p. 100). That problem can be observed in big organizations, where shareholders hire managers to manage their assets. The manager's behaviour is strictly connected with their job contract. If they have been employed to manage the company, they will not have to be focused on company profit, because no matter what, they will receive their gratification. However, if their contract is accompanied with a clause linking their gratification with the company's profit, their behaviour will be completely different.

Moral hazard, adverse selection and information asymmetry exist in Agency Theory.

Information asymmetry defined in this theory can be illustrated in the fact that the agent knows more than the principal about their own behaviour. The principal must bear the cost of monitoring and controlling to make sure that the agent acts on their behalf.

"Moral hazard refers to lack of effort on the part of the agent" (Eisenhardt, 1989, p. 61). This problem occurs when the agent is shirking. It means that one part of the relationship (the agent) does not behave according the contract or agreement, so the agent acts in their own interest. For example, when a research scientist works on a personal research project during their work time, but the project is so complicated that the principal (it may be a manager) cannot detect what a researcher is actually doing, then it is a moral hazard (Eisenhardt, 1989, p. 61).

Adverse selection relates to the misrepresentation of the agent's abilities. The main problem in that case is the principal's inability to verify the agent's claims. The agent can state that they have the skills or abilities required to fulfil the contract or agreement. Adverse selection arises because the principal cannot completely verify it (Eisenhardt, 1989, p. 61). This problem is common in how new employees are hired. During a job interview, an employer cannot verify all the skills and abilities, which, according to the CV submitted by the candidate, they are equipped with.

Examples of empirical studies

This section offers six examples of empirical studies of Transaction Costs, Property Rights Theory and Agency Theory. This part is a short review of practical studies which confirm theoretical assumptions.

Transaction Costs-vertical integration (Monteverde & Teece 1982; Masten 1984)

Vertical integration (a make or buy decision), is regarded as a very important problem. According to Transaction Costs Theory "the explanation as to whether economic agents procure critical inputs and services through internal production or via market transactions is the role of asset specificity" (Macher & Richman, 2008, p. 13).

Monteverde and Teece studied 133 automobile components. For each of them they ascertained the extent of vertical integration by Ford and General Motors for American production in 1976 (Monteverde & Teece, 1982, p. 207). They found that as component engineering development efforts rose, so did the probability of in-house production. Engineering development effort is understood as human capital, which creates lock-in. "Transactions cost considerations surrounding the development and deepening of human skills appear to have important ramifications for vertical integration in the automobile

industry, thereby supporting the transactions cost paradigm advanced by Williamson" (Monteverde & Teece, 1982, p. 212). The studies confirmed that vertical integration in General Motors and Ford is based at least in part on efficiency assumption. This structure appears to take advantage of the ability of internal organization-reduction of an automakers' exposure for a risk of suppliers' opportunism; and the coordinating properties of hierarchies (Monteverde & Teece, 1982, p. 212).

Masten studied the aerospace industry, "constructing measures of specificity and complexity for each input and finding that the combination of these two measures is especially important in explaining which inputs are produced in-house (Gibbons, 2010, p. 12). He found that an asset specificity has a significant influence on the decision: make their own input or buy it from another producer. The characteristic of components used in this industry gives an answer to the question of whether to make or buy. The more complex and specialized components are, the higher the probability of producing them internally.

Property Rights Theory-building of a welfare state (De Soto, 2001)

De Soto focused in his studies on underdeveloped countries. He shows that in many of those countries property rights are not regulated. He pointed out that, for example, in Haiti 68% of city-dwellers and 97% of people in the countryside live in houses "to which nobody has clear legal title" (De Soto, 2001, p. 30). In this country the value of untitled rural and urban real-estate holdings is worth 5.2 billion dollars. He also mentioned examples of Peru or the Philippines. De Soto pointed out that unregulated property rights in less developed countries obstructed the way houses were administrated. Lack of legal titles of ownership and problems with legalization of informal property rights has caused the bargaining power of citizens to grow very weak, especially to banks. Because of the country's problem related to property rights, a lot of enterprising citizens couldn't mortgage their houses to take a loan. It caused problems with development of the whole country (Zalesko, 2013, p. 98).

Property Rights Theory-economic development (Acemoglu, Johnson & Robinson, 2001)

Acemoglu, Johnson and Robinson also studied property rights and they pointed out that they are very important for economic development. As they wrote "countries with better "institutions," more secure property rights, and less distortionary policies will invest more in physical and human capital, and will use these factors more efficiently to achieve a greater level of income" (Acemoglu, Johnson & Robinson, 2001, p. 1369). They studied different types of European colonization policies. Acemoglu, Johnson and Robinson pointed out that European colonizers implemented different policies in Africa, Latin America and Australia or the United States. This created different sets of institutions in those new countries. Belgian colonization of the Congo is an example of an extractive one-the main purpose of the colonization was about as much transfer of resources from the colony to the colonizer as it was possible. It caused colonizers to lose their interest in protection of property rights or prevention of government expropriation. A completely different policy was followed in Australia or the United States." The settlers tried to replicate European institutions, with strong emphasis on private property and checks against government power" (Acemoglu, Johnson

& Robinson, 2001, p. 1370).

Agency Theory-takeover bid resistance (Walkling & Long, 1984)

Walkling and Long studied the resistance of managers to takeover bids. Data for their research "were sought on all cash tender offers filed with the Securities and Exchange Commission during the 1972-1977 period" (Walkling & Long, 1984). Resistance to takeover bids may be in the interest of managers. Because of a takeover they can lose their jobs. The situation is unlike the one stockholders would expect-in general, resistance to a takeover bid isn't in their interest. This research confirmed that if the managers have a lot of company equity (an outcome-based contract), they will not resist takeover bids. These results are consistent with Agency Theory: outcome-based contracts such as executive stock holdings are the mitigation of agency problems which exist between shareholders and top executives in the situation of different interests.

Agency Theory-commission and salary compensation of salespeople in retailing (Eisenhardt, 1995, 1988)

Eisenhardt focused her research on the choice between commission and salary compensation of sellers in 54 retail stores. A commission compensation is an outcome-based contract and a salary compensation is a behaviour-based contract. The research from 1985 included only agency variables but a later one was widened by "additional agency variables and institutional theory predictions" (Eisenhardt, 1989, p. 69). According to the results of that research, task programmability and outcome measurability significantly predict the choice between the salary and commission compensation. Agency Theory predictions assume that task programmability is negatively connected with outcome-based contracts and positively related to behaviour-based contracts. It is easier to observe a seller who is engaged in more programmed work than an entrepreneur in very programmed jobs to reveal behaviour of the employees. Outcome measurability is negatively connected with behaviour-based contracts and positively related to outcome-based contracts. So the outcome-based contracts are more attractive when outcome is easy to measure. It is not always a simple task, because some tasks require team effort or time for preparing and executing them.

Conclusions

The New Institutional Economics is, as it has been illustrated, a highly diverse field. It has many branches, which are rich in theoretical insight. Those branches have an influence on policy-making and they are also empirically useful. This article covers the fundamentals of Agency Theory, Transaction Costs Theory and Property Rights Theory.

The literature concerns the New Institutional Economics and its main theories that are rapidly expanding. These theories are gaining more adherents. Agency Theory, Transaction Costs Theory and Property Rights Theory are applied to many fields of our life, such as: economics, political science, law, strategy, sociology, growth and development, and history, which is why it is worth knowing their main assumptions.

The second part of this article points out some selected examples of studies which concerns Agency Theory, Transaction Costs Theory and Property Rights Theory. As it was shown, the New Institutional Economics and its main theories aren't only theoretical assumptions. The conclusions which can be drawn are of great practical significance.

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