The New Institutional Economics

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It is commonly said, and it may be true, that the new institutional economics started with my article, "The Nature of the Firm" (1937) with its explicit introduction of transaction costs into economic analysis. But it needs to be remembered that the source of a mighty river is a puny little stream and that it derives its strength from the tributaries that contribute to its bulk. So it is in this case. I am not thinking only of the contributions of other economists such as Oliver Williamson, Harold Demsetz, and Steven Cheung, important though they have been, but also of the work of our colleagues in law, anthropology, sociology, political science, sociobiology, and other disciplines.

The phrase, "the new institutional economics," was coined by Oliver Williamson. It was intended to differentiate the subject from the "old institutional economics." John R. Commons, Wesley Mitchell, and those associated with them were men of great intellectual stature, but they were anti-theoretical, and without a theory to bind together their collection of facts, they had very little that they were able to pass on. Certain it is that mainstream economics proceeded on its way without any significant change. And it continues to do so. I should explain that, when I speak of mainstream economics, I am referring to microeconomics. Whether my strictures apply also to macroeconomics I leave to others.

Mainstream economics, as one sees it in the journals and the textbooks and in the courses taught in economics departments has become more and more abstract over time, and although it purports otherwise, it is in fact little concerned with what happens in the real world. Demsetz has given an explanation of why this has happened: economists since Adam Smith have devoted themselves to formalizing his doctrine of the invisible hand, the coordination of the economic system by the pricing system. It has been an impressive achievement. But, as Demsetz has explained, it is the analysis of a system of extreme decentralization. However, it has other flaws. Adam Smith also pointed out that we should be concerned with the flow of real goods and services over time—and with what determines their variety and magnitude. As it is, economists study how supply and demand determine prices but not with the factors that determine what goods and services are traded on markets and therefore are priced. It is a view disdainful of what happens in the real world, but it is one to which economists have become accustomed, and they live in their world without discomfort. The success of mainstream economics in spite of its defects is a tribute to the staying power of a theoretical underpinning, since mainstream economics is certainly strong on theory if weak on facts. Thus, for example, in the *Handbook of Industrial Organization,* Bengt Holmstrom and Jean Tirole (1989 p. 126), writing on "The Theory of the Firm," remark that "the evidence/theory ratio ... is currently very low in this field."

This disregard for what happens concretely in the real world is strengthened by the way economists think of their subject. In my youth, a very popular definition of economics was that provided by Lionel Robbins (1935 p. 15) in his book *An Essay on the Nature and Significance of Economic Science*: "Economics is the science which studies human behaviour as a relationship between ends and scarce means that have alternative uses." It is the study of human behavior as a relationship. These days economists are more likely to refer

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to their subject as "the science of human choice" or they talk about "an economic approach." This is not a recent development. John Maynard Keynes said that the "Theory of Economics ... is a method rather than a doctrine, an apparatus of the mind, a technique of thinking, which helps the possessor to draw correct conclusions" (introduction in H. D. Henderson, 1922 p. v). Joan Robinson (1933 p. 1) says in the introduction to her book *The Economics of Imperfect Competition* that it "is presented to the analytical economist as a box of tools." What this comes down to is that economists think of themselves as having a box of tools but no subject matter. It reminds me of two lines from a modern poet (I forget the poem and the poet but the lines are indeed memorable):

> I see the bridle and the bit all right
> But where's the bloody horse?

I have expressed the same thought by saying that we study the circulation of the blood without a body.

In saying this I should not be thought to imply that these analytical tools are not extremely valuable. I am delighted when our colleagues in law use them to study the working of the legal system or when those in political science use them to study the working of the political system. My point is different. I think we should use these analytical tools to study the economic system. I think economists do have a subject matter: the study of the working of the economic system, a system in which we earn and spend our incomes. The welfare of a human society depends on the flow of goods and services, and this in turn depends on the productivity of the economic system. Adam Smith explained that the productivity of the economic system depends on specialization (he says the division of labor), but specialization is only possible if there is exchange—and the lower the costs of exchange (transaction costs if you will), the more specialization there will be and the greater the productivity of the system. But the costs of exchange depend on the institutions of a country: its legal system, its political system, its social system, its educational system, its culture, and so on. In effect it is the institutions that govern the performance of an economy, and it is this that gives the "new institutional economics" its importance for economists.

That such work is needed is made clear by another feature of economics. Apart from the formalization of the theory, the way we look at the working of the economic system has been extraordinarily static over the years. Economists often take pride in the fact that Charles Darwin came to his theory of evolution as a result of reading Thomas Malthus and Adam Smith. But contrast the developments in biology since Darwin with what has happened in economics since Adam Smith. Biology has been transformed. Biologists now have a detailed understanding of the complicated structures that govern the functioning of living organisms. I believe that one day we will have similar triumphs in economics. But it will not be easy. Even if we start with the relatively simple analysis of "The Nature of the Firm," discovering the factors that determine the relative costs of coordination by management within the firm or by transactions on the market is no simple task. However, this is not by any means the whole story. We cannot confine our analysis to what happens within a single firm. This is what I said in a lecture published in *Lives of the Laureates* (Coase, 1995 p. 245): "The costs of coordination within a firm and the level of transaction costs that it faces are affected by its ability to purchase inputs from other firms, and their ability to supply these inputs depends in part on their costs of coordination and the level of transaction costs that they face which are similarly affected by what these are in still other firms. What we are dealing with is a complex interrelated structure." Add to this the influence of the laws, of the social system, and of the culture, as well as the effects of technological changes such as the digital revolution with its dramatic fall in information costs (a major component of transaction costs), and you have a complicated set of interrelationships the nature of which will take much dedicated work over a long period to discover. But when this is done, all of economics will have become what we now call "the new institutional economics."

This change will not come about, in my view, as a result of a frontal assault on mainstream economics. It will come as a result of economists in branches or subsections of economics adopting a different approach, as indeed is already happening. When the majority of economists have changed, mainstream economists will acknowledge the importance of examining the economic system in this way and will claim that they knew it all along.

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