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To cite this article: Antoon Spithoven (2019) Similarities and Dissimilarities between Original Institutional Economics and New Institutional Economics, Journal of Economic Issues, 53:2, 440-447, DOI: [10.1080/00213624.2019.1594532](https://doi.org/10.1080/00213624.2019.1594532)

To link to this article: <https://doi.org/10.1080/00213624.2019.1594532>



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Published online: 13 May 2019.



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Similarities and Dissimilarities between Original Institutional Economics and New Institutional Economics

Antoon Spithoven

Abstract: Original Institutional Economics and New Institutional Economics display several similarities. However, differences in methodology and normative stance are too big to reconcile both approaches. Both approaches may keep each other sharp.

Keywords: contextual change, new institutional economics, original institutionalism

JEL Classification Codes: B15, B25, B41, B52

Original Institutional Economics (OIE) and New Institutional Economics (NIE) are far from monolithic. Malcolm Rutherford is one of the first who drew attention to the heterogeneity of both approaches. He (1996, 5) distinguishes five dichotomies to compare them.¹ According to him (1996, 174), OIE and NIE do not “line up on opposite sides of each of” the five dichotomies. Other scholars reconfirmed Rutherford’s analysis, while observing attempts at rapprochement. David Dequech (2002, 566) claims that developments in NIE outmoded Geoffrey Hodgson’s statement that reconstitutive downward effects distinguish OIE from NIE: “For Hodgson . . . [reconstitutive downward causation] is the single most important defining characteristic of the old institutionalism. . . . Among other schools, the new is distinguished from the old institutional economics principally in these terms.” John Groenewegen, Frans Kerstholt, and Ad Nagelkerke (1995, 472) conclude that the NIE-scholar “Douglass North has gradually moved away from a predominantly deductive explanatory strategy to one that is,” more empirically based. Peter von Staden and Kyle Bruce (2015, 113) argue that North provides “a ‘meta-theoretical framework for understanding economic change’ that is congruent with the OIE” approach. Gonzalo Caballero and David Soto-Oñate (2015, 971–972) point to “mutual institutional enrichment via inter-institutionalism cooperation” in the study of institutional change. Finally, some OIE-scholars make common

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¹ The dichotomies are: a) Formalism and anti-formalism; b) Individualism and holism; c) Atomistic rationality and rule-following; d) Evolution and design, and; e) Efficiency and reform. Social reform might include redistribution of (personal) incomes to smooth the business cycle or to fight poverty and unemployment.

cause with the NIE (Luz and Fernandez 2018, 597). For example, Hodgson (2007, 99) focuses on explanations in terms of individuals and structures, rejects holism, and approaches organizations as institutions and not as collective agents.

Displaying similarities between OIE and NIE does not imply that they are interchangeable. Jairo Parada (2002, 46) thinks that the deductive method of NIE-scholars is one of the main obstacles for reconciliation with OIE approaches. According to Milan Zafirovski (2003), NIE-scholars continue to embrace the focus on economic orthodoxy, contrary to OIE-scholars who state that institutions are not uniquely determined. Manuel Luz and Ramon Fernandez (2018, 597) elaborate some dissimilarities between North, who (2005, vii) very substantially extended NIE, and OIE-scholars, among which North's orientation on equilibrating dynamics and on technology that promotes growth through a process creative destruction and not through a process of institutional change.

In this article, I elaborate a limited comparison between NIE and OIE. Both comprise different strands, each with their own nuances. Some synthesis is inevitable to contrast both approaches. Content not only differs within and across the institutional disciplines but also across time: For example, Thorstein Veblen addresses other issues than John Commons, whereas both address other issues than modern OIE-scholars (Rutherford 1996, 2-4, 101; Jo 2018; Caballero and Soto-Oñate 2015, 949-958).

My contribution to the existing literature is a closer look at the NIE-scholars Daron Acemoglu and James Robinson, who follow in the footsteps of the "NIE-OIE-bridge-builder" North. Additionally, I elaborate a little on the contributions by the NIE-scholars Elinor Ostrom, Masahiko Aoki, and Avner Greif. All recognize in line with OIE-scholars that cognition, ideology and historical development are relevant for institutional analysis.

Original Institutional Economics

A broad network of OIE-scholars formed an influential movement in American economics in the period 1918-1947. Their approach is characterized by: 1) underlining the role of institutions as constraining and enabling behavior, and highlighting the institutional role in shaping values, beliefs and preferences; 2) incorporating a social psychology which is consistent with recognizing that institutions influence values, beliefs and preferences, and a related rejection of the idea of utility maximizing; 3) an open empirical and critical investigation of social phenomena; 4) critically examining the functioning of prevailing institutions, and; 5) adhering a pragmatic and humanistic approach to social value (Rutherford 2013, 347). In a nutshell, OIE-scholars reject the assumption that institutions generate mechanistically employment, production, distribution, and growth. They provide a real-world perspective by starting with history. "It is from experience, not a priori first principles that institutionalists try to" provide a rational evolutionary explanation of the development of economy and society (Dugger 1992, xvii). Along with Rutherford's analysis of the OIE-approach, he (2013, 42-53) convincingly debunks the criticism that OIE is anti-theoretical.

Despite sharing some general principles, OIE-scholars do not line up on the analysis of several phenomena. For example, OIE-scholars differ in their view to the relation technology and cultural/institutional change (Waller 1982, 757). According to Veblen, institutions influence economic and social behavior of actors, and the other way around (Hodgson 2003, 19). Vested interests may ceremonially obstruct cultural/institutional change, while habituation to new (material) circumstances (technology) is the driver of change (Waller

1982, 762–763). Commons contrasts this view. He (1990, 84–85, 365, 654) thinks that institutions (among which technology and science) and economy coevolve—that is, technology and economy “are jointly produced—not independently given, *not* merely interacting” (Samuels 1989, 1567). Alternatively, Wesley Mitchell argues that the perception of economic advantage rather than technological change affects change in social institutions (such as “the substitution of money payment for knight service”) (Rutherford 2013, 136). This view is differentiated by the sociologist William Ogburn, who contributed significantly to the institutionalist movement (Rutherford 2013). Ogburn introduces a hierarchy of changes: if technology changes faster than other social institutions, then changes occur in respectively the economy, system of communication, governance of society, family culture, socialization, and finally the belief system (de Boer, Spithoven, and Groenewegen 1975). Finally, Clarence Ayres presents technological change as an inherent dynamic process (Rutherford 1996, 40).

Similarities or Bridges between OIE and NIE

Oliver Williamson (2000, 603) uses Commons’s (1968, 108–121) remediableness criterion to allocate bureaucracies (government) in his contracting scheme, adopts Commons’s choice of transaction as the central unit of analysis, and substitutes governance structures (for example, markets) for Commons’s going concerns. Going concerns are “collective action in restraint, liberation, and expansion of individual action” (Commons 1990, 73). They are dynamic in character, whereas governance structures represent static equilibria. However, a comparison over time of efficient alignments of governance structures with transactions might generate a theory of change (Spithoven 2012).²

The NIE-scholars and joint Nobel Prize Laureates Williamson (2000) and Ostrom (1990, 1, 29, 61) seek how transactions can be efficiently governed. Ostrom (2005, 59, 99) deviates from Williamson’s approach by incorporating tenets of the OIE approach in the Institutional Analysis and Development (IAD) model. She (2005, 27, 112, 120–121, 127) recognizes that culture “affects the mental models that participants in a situation may share” and that preferences are influenced by institutions.

Ostrom’s (2005, 34–35) IAD framework is especially suitable for analyzing complex chains of action situations or for performing a carefully crafted case study. According to her (1990, 51), institutions “are used to determine who is eligible to make decisions . . . [concerning transactions], what actions are allowed or constrained, what aggregation rules will be used, what procedures must be followed, what information must or must not be provided and what payoffs will be assigned to individuals dependent on their actions.” Ostrom’s definition of institutions is compatible with the OIE claim that institutions determine “whose knowledge and which/whose interests will count and in what ways” (Samuels, Johnson, and Perry 2011, 211).

Williamson and Ostrom focus on institutional *arrangements* (governance structures), while North focuses on institutional *environments* (Richter 1996, 573; Aoki 2001, 397n25; Luz and Fernandez 2018), which “shape our present and influence our future” (North 2005, 6). North (2005, viii, 47) approaches economic change as artificial selection in a non-

² NIE-scholars measure efficiency in terms of pecuniary gains and interpret efficiency as production gains (Luz and Fernandez 2018).

ergodic world. He recognizes path-dependency, influence of institutions on preferences, and influence of cognition, ideology, and power relations on decision-making.

Acemoglu and Robinson (2006a, 80; 2012, 9; Groenewegen, Spithoven, and van den Berg, 2010, 88) resume North's question why inefficient institutions are not eliminated by competitive pressures. Acemoglu and Robinson (2006a; 2006b, 325–326; 2012, 73–83) provide a political-economic model wherein interaction between political and economic institutions is behind the development of societies. In line with North's (1990, 16) explanation, congruous with the OIE approach, they (Acemoglu and Robinson 2012, 82, 431) explain the persistence of inefficient or extractive institutions by vested interests of political elites who support political systems that benefits them.

Finally, Greif tries to endogenize institutions through their impact on quasi-parameters such as asymmetric information (Caballero and Soto-Oñate 2015, 965).³ He (Grief 2006, 30) approaches institutions as interrelated equilibria “of rules, beliefs, norms, and organizations that together generate a regularity of (social) behavior” (italics are in the original). He (2006, 47) complements the definition of transactions as transfers of rights by emphasizing the role of inter-transactional linkages or auxiliary transactions—that is, transactions that lead agents to internalize certain beliefs and norms. It results in the following definition: A transaction is “an action taken when an entity, such as a commodity, social attitude, emotion, opinion, or information, is transferred from one social unit to another” (Greif 2006, 45–46).

Essentially, NIE-scholars implicitly give their own turn to Commons's (1990, 73–74) idea of the institutionalized mind. As a matter of speaking, they approach the neoclassical *homo oeconomicus* as an institutionalized character (Zafirovski 2003, 807–808) or as a representation of Joseph Agassi's idea of “institutional individualism” (Rutherford 1996, 50). The institutionalized *homo oeconomicus* is an agent who is subject to conflicting interests and asymmetric information and who is redirected with the right institutions to meet the neo-classical assumptions (Williamson 2000, 597; North 1990, 16). Conflicting interests and asymmetric information result in adverse selection—that is, *ex ante* opportunism—or moral hazard—that is *ex-post* opportunism. According to Williamson (2000, 598), institutional change is rooted in aligning neoclassical inspired incentives with resource allocation and employment.

Dissimilarities between OIE and NIE

Differences between OIE and NIE are crystalized in the orientation on markets, the application of game theory, and the use of regression analysis.

Equilibrating Markets

Departing from an institutionalized *homo oeconomicus*, who sacrifices under imperfect and asymmetrical information, NIE-scholars deduce that markets foster efficiency best for transactions that are characterized by low risk, low frequency, and low asset specificity (Spithoven 2012), while OIE-scholars approach markets either as unfolding activities (Veblen), through which vested interests enhance their privileges, or as going concerns, through which societies use procedures to organize themselves to generate livelihoods. Neoclassical assumptions also underpin Acemoglu's and Robinson's approach to history,

³ Quasi-parameters are exogenously given but change endogenously (Greif and Laitin 2004).

while OIE-scholars criticize the assumption of the *homo oeconomicus* and associated equilibrating markets.

The NIE-assumption of a satisficing institutionalized *homo oeconomicus* does not imply that resources are assumed to become automatically optimally allocated. According to Acemoglu and Robinson, optimal allocation requires a system of inclusive institutions that diffuses market power and separates political and economic power. Inclusive *political* institutions include the rule of law and checks and balances, while inclusive *economic* institutions consist of remedial rights, private property rights, exchange and contract freedom, and freedom to enter or exit from business or vocation. They stimulate the exertion of efforts to become educated, to adopt new technologies at the cost of old technologies (creative destruction), and to increase productivity (efficiency). Conversely, extractive economic institutions—such as expropriations and forced labor—hamper innovation and productivity. Acemoglu, Robinson, and Verdier (2012) seem to approach also taxes and premiums as extractive institutions.⁴ Accordingly, they disfavor stakeholder economies. In contrast, OIE-scholars in the tradition of Commons support governmental intervention to establish equality, morality, or justice, while OIE-scholars in the tradition of Veblen think that social reform might become realized by scientists and countervailing powers.

Acemoglu and Robinson (2012, 431, 515) explain changes of inefficient institutional systems by the occurrence of critical junctures. They (2006b, 329; 2012, 83–87) define critical junctures as “major [exogenous] events that disrupt existing political and economic balance” which may be turning points to change institutional systems. A demerit is that they ignore or bagatelle that exogenous shocks, such as the Black Death, require specific circumstances to generate a (positive) turn. Yehojachin Brenner (1998, 14), who is, just like several OIE-scholars, totally aware of the power-economic nexus, explains the rise in wages in the fourteenth century not only by the Black Death but also by the observation that people were enabled to reinforce their fair share in the production by force because they had learned in the army to fight with the just-invented longbow. It is the coincidence of several factors that is relevant for explaining development.

The NIE approach to markets as driving forces of growth “clashes with the emphasis placed upon a wider understanding of the provisioning process as defended by the OIE tradition” (Luz and Fernandez 2018, 597). NIE-scholars recognize that cartels, monopolies, and government failures should be addressed by (discretionary) antitrust policies respective of separation of economics and politics, while OIE-scholars focus on predatory behaviors of vested interests or on unequal bargaining, managerial, and rationing powers. These behaviors and unequally distributed powers require progressive intervention to fight discrimination or to reduce inequality. Herewith, OIE-scholars recognize that also “personality, leadership, and ability to organize” (Commons 1990, 880) influence the degree of progressivity of institutional change (Caballero and Soto-Oñate 2015, 955). Equity and liberty “from

⁴ Extractive institutions concern institutions that benefit politicians in charge. Deducing from Acemoglu, Robinson and Verdier’s (2012) analysis of Scandinavian countries—which provides a technological frontiers and preferences model instead of the political-economic institutions nexus model,—extractive institutions might coincide with taxes and premiums in exchange for subsidies and social benefits. Redistributing income might benefit politicians themselves because it might favor their reelection (Acemoglu and Robinson 2006a, 6; 2012, 35). The overall impact of redistribution is lower innovation because subsidies only partly compensate the lower incentives to innovate due to higher taxes and premiums. This is in line with their finding that the relation between democracy and economic growth is weak.

coercion, duress, discrimination, or unfair competition” (Commons 1990, 73) are not self-validating or self-enforcing.

Game Theory

NIE-scholars use game theory as an analytical tool. North (1990) approaches institutions as rules of games. Acemoglu and Robinson (2006a, 177) differentiate between durable and reversible rules of games. Aoki (2001, 397n25) substitutes games for transactions as unit of analysis. Ostrom (2005, 34) analyzes complex chains of action situations as a game by focusing on their key parts. According to her (2005, 69), game experiments are “an excellent way to understand how the components of an action situation and changes in these components, even small changes, can make a difference.” Ostrom (2005, 103–104) does not change all the assumptions at the same time. She explores different assumptions concerning information acquisition, information distribution, information processing, valuation processes, and strategic processes. Methodological individualism and marginal analysis reign supreme in her “interdisciplinary” approach.

Game theory has several caveats. Game theory “cannot deal adequately with institutional *change* as it requires ‘three assumptions of constancy’: the constancy of the players, the constancy of the basic rules, and the stability of the objectives and the environment” (Rutherford 1996, 21). Game theorists focus on rational decision-making of atomistic players under complete information (Acemoglu and Robinson 2006a, xiv). In (prisoner’s dilemma) games one decides individually without face-to-face contact with other players. Consequently, the Commons (1990, xxviii, 720–725) inspired OIE-idea of consensual, reasonable decision-making is not captured. Consensual, reasonable decision-making is a social process guided by (internal) rules and procedures, and subject to ethical feelings, custom, subordination or exercise of coercion, arousals (sexual, religious, partisan), ignorance, fallibility, and changeable motives, purposes, or values.

NIE-scholars acknowledge limitations of game theory. Ostrom (1990, 6) warns “that the constraints that are assumed to be fixed for the purpose of analysis are taken on faith as being fixed in empirical settings.” Game theory applies limited and a-historic ideal types as mental models for analyzing the real world and assumes transaction costs, which are a problem if bargaining power doesn’t match, away (Ostrom 1990, 190–191). At least simulation games would be required to approach social procedural rationality processes.

Nowadays, most economists may recognize the importance of context dependency, but may have problems with how to deal with this. NIE-scholars try to make their models socially more relevant by modeling variants of information acquisition, information distribution, information processing, valuation processes, and strategic processes in prisoner’s dilemma games. In contrast, OIE-scholars provide a real-world perspective by observing that the coevolving social and economic history is “not determined by given and unchanging natural laws, but by social and legal norms and conventions that changed (and could be changed) over time”, and by approaching institutions as instrumental values which are relevant “for the solution of pressing social problems” (Rutherford 2013, 8, parentheses in original). OIE is relevant to the problem of social control consistent with the public interest.

Regression Analysis

Acemoglu, Johnson, and Robinson (2001, 1386–1387; for a critic see Albouy 2012) use a cross-national regression analysis to describe the unidirectional causal relation between

protection of property rights and income. The analysis contrasts the OIE-coevolutionary development of property rights and income. First, using an aggregated index of risk of expropriation bagatelles that the composition of protection of property rights differs in different countries. Second, underlying the isolated regression model is the assumption that private property rights are like Planck's constant. However, rights are human-made, differ between countries, and are unequally distributed within countries because, among other things, international conglomerates enjoy monopolistic property rights (e.g. patents, brands, franchises, copyright (Stone 2008, 7)) and make use of country differences in arbitrage, employment conditions, rulings, taxation, and legal irregularities (Scheuerman 1999, 3-6, 21).

Conclusion and Discussion

Though NIE-scholars pay lip-service to the main issues of the OIE approach, neither approach is interchangeable. The fundamental dissimilarities between North and OIE-scholars also apply for several other NIE-scholars, among whom are Acemoglu and Robinson who took up North's analysis but retrace steps to a neoclassical approach.

NIE-scholars differ in methodology and normative stance from OIE-scholars. Regarding the methodology, NIE-scholars analyze individual decision making which results in equilibria, whereas OIE-scholars apply a holistic approach to analyze unfolding activities or going concerns through which vested interests might enhance their privileges. Additionally, NIE-scholars ignore cultural influences by applying game theory or by using cross-national regression analysis. Regarding the normative stance, NIE-scholars focus on efficiency, while OIE-scholars focus on social reform.

The inquiry for dissimilarities helps OIE to stand in sharp relief. Instead of North's focusing on equilibrating dynamics, OIE-scholars focus on how societies regulate their provisioning within a three-pronged competition process between structures (culture), institutions, and agency which comprises individuals as well as collectivities or organizations.

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