Journal of Business and Economics, ISSN 2155-7950, USA
March 2013, Volume 4, No. 3, pp. 269-274

http://www.academicstar.us

Ion Pohoață, Landmarks in Institutional Economics: Book Review*

Oana-Ramona Socoliuc
(Doctoral School of Economics and Business Administration, Alexandru Ioan Cuza University of Iaşi, Romania)

Abstract: Institutional Economics is becoming the gravity center of all economic analyses promoted in order to explain development gaps between worldwide nations. Even so, in Romania, the interest in this field was not sufficiently explored, even though the past experiences of the country require a profound analysis and clear answers to which standard economic theories of growth and development failed. In such circumstances the profound analysis of Ion Pohoata, professor in economics and economic doctrines had the mission to clarify the major role of institutions in the society and furthermore, their impact on economic development. The book illustrates an interesting ingression in the impressive world of institutions, highlighting the fundamental contributions of the greatest economists to the *rules of the game* universe.

Key words: institutions; institutional change; genetic heritage; development gaps
JEL codes: O43, P14, B25, D23

Leaving behind the classical and neoclassical perspectives on economic growth and the determinants of wealth, a new current is requested to explain the development gaps between states, The Institutional Economics, especially The New Institutional Economics (NIE). Its specific features and the particular manner of converting the economic theory in a more earthly version are emphasized with an exceptional accuracy in the book of Ion Pohoață. The paper *Landmarks in institutional economics* published in 2009 and awarded in 2011 by the Romanian Academy, come to define the shape of more than three years of individual hard work, a considerable effort dedicated to an intimate study of The New Institutional paradigm with all its valences. Undoubtedly, the author proposes an interesting integrative approach designed to provide consistency and structure to institutional vision. In fact, this paper was preceded by many articles written on this topic that highlighted the particular propensity of the author for the study of institutionalism. We can remember: *Transaction costs, institutionalism and neoclassical paradigm (2005), Arguments for the study of institutionalism and institutional reform in Romania (2006), To the springs of a modern economic theory: Institutionalism (2007), An institutionalist outlook on the origins of property from the perspective of transaction costs (2008),* or *The institutional dimension of Hayek's work (2008).*

The book offers a multidimensional approach starting with the most representative figures of the *institutional family,* like T. Veblen, J. R. Commons, W. Hamilton, even some remarkable names representing the binder of the Old and the New Institutionalism, as: J. A. Schumpeter, J. K Galbraith, G. Myrdal, Fr. Perroux, M. Weber, or K. Polanyi and others. Taking into consideration the variety of analyses and ideas that the NIE is based on, Pohoață

* Some preliminary ideas of this paper were published in REBS.

Oana-Ramona Socoliuc, Ph.D. candidate, Alexandru Ioan Cuza University; research areas: economics, institutional economics. E-mail: oanasocoliuc@gmail.com.

emphasizes from the very beginning that the neo-institutional paradigm it is in fact *a unity in diversity* (p. 52). First of all, NIE might be resembled with a mixture of currents because there are too many different positions under the same umbrella, but on the same time, in this entire „ocean" of studies we can capture a common trend line, the *reaction to the neoclassical school.* It is certain that NIE consists of a response and not a complete break from neoclassical school. In other words, the author explains that the NIE does not deny neoclassicism and its values: natural order, private property, the free market, or the competition, but contrary, it tries to provide solutions to some unanswered questions through critique. D. North had a defining contribution in this respect, with his attempt to explain why ineffective institutions survive and persist when individuals are perfectly rational? Even though this contradiction came from a neoclassical register, only New Institutional paradigm was able to provide the necessary instruments for a relevant answer. It is what Ion Pohoață calls *the hard core* of NIE, which consists of: *transaction and transaction costs, institutions, property rights, governance structures, economic evolutionism or path dependence* (p. 54).

Secondly, NIE promotes a *dynamic analysis* of economics generally; its representatives are focused on *economic evolutionism*, a different perspective that brings together biology and economics in order to explain the development processes. As an example, Pohoață indicate the article *Uncertainty, Evolution and Economic Theory* (1950) of Armen Alchian, where he emphasized that market (an institutional environment) could be assimilated with a selection tool that is able to choose only those profitable firms that survived the competition. Furthermore, the author makes a masterly association between the genetic component and the economic one, with the purpose of a better understanding. The economic correspondent of genetic heritage is the good management practice; in other words, only the firms based on profitable management skills will be chosen as patterns of behavior, worthy of imitation (p. 303).

All these attributes that come to shape the new paradigm have their origin in the works of Ronald Coase, Douglas North and Oliver Williamson, *the three pillars* of the theoretical scaffolding of NIE. Institutions are placed in the center of analysis even if free market remains a key element. As author observed, everything might be explained through *institutions* without using mathematics or other calculations. This assumes the eminently social character of the new institutional paradigm.

Thirdly, the NIE admit the *principle of bounded rationality*, which brings theory closer to the real world. The author generally agrees with Herbert Simon in order to offer an explanation: humans are not computers, or perfectly informed robots and information they get in contact with is incomplete (p. 58). The fact that people perceive the present and anticipate future through some clichés based on past experiences, as North stated is also an explanation (p. 60). In neo-institutional world everything might be defined as a sequence of circumstances, nothing is precise. *Incomplete contracts* defined through uncertainty and adaptability reveals another differentiation from the neoclassical model (p. 62).

Finally, the brilliant minds of Hayek and Mises inspired institutional economists with their *methodological individualism*. However, from NIE perspective institution is "*the first violin*", and then comes the individual. As author highlighted, the NIE shapes a new kind of individualism, *the institutionalized individualism*, totally different of the possessive individualism of Smith or Hayek (p. 64). Institutions are a human construction and once produced they have the role to monitor human activity. Moreover, rules are always improved and innovated from a generation to another, which means institutional change. As we can notice, there is a permanent circularity relationship that explains the specific individualism of NIE.

In order to provide a definition for *institutions,* the author highlighted the perspective of D. North according to whom institutions may be defined as *rules of the game or constraints created by people in order to shape human interaction* (p. 76). There are *formal* and *informal* institutions. In the former category we can include political and legal rules, economic rules as property rights, even contracts, while the latter consists of codes of conduct, conventions, traditions, and customs. While official rules are created to increase the efficiency of informal constraints, these should provide consistency for social changes. Furthermore, as author maintains, these informal institutions that are very hard to change have a major role in influencing future orientation, since it consist of a synthesis of the past. If we have a game with strict rules represented by institutions, then it is important to state that organizations are the players. The same North emphasized the distinction between these two elements by saying that *institutions are the rules of the game and organizations are the agents of institutional change* (p. 83). There is a symbiotic relation between these two parts; organizations appear and are developing within the institutional background, but on the same time institutional change cannot be made without organizations.

The book illustrates various ways of explaining the existence of institutions. These abstract and impersonal rules must configure human cooperation in order to make life easier and to reduce the uncertainty. In this respect we cannot omit the example that the author uses to explain the origins of institutions. He refers to "Mending Wall" poem of Robert Frost and compares institutions with fences. In fact, people need fences because it offer safety and intimacy, but on the same time a cold wall will isolate and restrict freedom. So, we feel very comfortable when we are protected by rules, but there is something in human construction that is fallible and here comes the need for institutions to prevent the propensity for selfishness or exacerbated individualism. Institutions are necessary to reduce market imperfections, informational asymmetry, to minimize risks and transaction costs. All these deficiencies come from the imperfect world we live in, so institutions are the instruments that make living possible in such conditions.

D. North had a remarkable phrase: *In the process of economic growth, institutions matter* (p. 247). As a completion, the author proposes the technological change; innovation is also an engine of growth. In translation, there is a strong connection between institutions and economic dynamics. Institutions appear as a rule generated by economic evolution, but on the same time these institutions are able to support economic growth or moreover, to induce an economic contraction. As book reveals, *time* is a variable included in the analyses, taking into account that our world is non-ergodic, nothing is repeatable. The changes that will come will create new situations that request new institutions and the old institutional system will be restructured. In other words, institutional change is a permanent process where not all institutions disappear; some of them are just reproduced. Unfortunately, there is no institutional model that might be adopted, so institutional change is *incremental;* the past is connected with the present and future. This incremental changing is from the inside to outside, things are totally reformed; it is a sort of "creative destruction" where the disintegration is made by transformation and construction, not through annihilation.

The author further argues that economic activity is in fact a human activity, which bears the mark of *intentionality*. Economic and social changes take place under the rule of consciousness and they pass through cultural filter. At D. North this incremental evolutionary process to order and balance remains under the mark of intentionality. Enlarging the perspective, a society needs a minimum state intervention in order to guide the game and its rules. Democracy is essential in this case, only here formal and informal institutions are able to reduce uncertainty and establish the balance. From this point of view, NIE provides a totally different vision from Hayek or Mises. They do not admit state intervention; at them the spontaneous evolutionary process to order and balance is guided by the invisible hand. *Learning* remains the only solution; its origins are in the genetic heritage of every nation. Through learning uncertainty is limited and nations are able to take from the past only those elements that promote progress, adaption to rules and good practices. We must learn from the past experiences in order to prevent other similar disasters in the future. When the institutional level is able to fit economic changes it is created a strong connection between economic and institutional dynamic, which is called *adapted efficiency.* This should be the guarantee of success, but it might be achieved only on long-term. This connection between past and future allows institutional economists to argue development gaps between states using *the path dependence*. Countries that were conducted by good rules in the past have encouraging perspectives to achieve development in the future; healthy institutions from the past serve as solid basis for new ones. For example, the efficient institutional structure of the American economic system is a consequence of path dependence, of political and economic institutions inherited from the British Empire. Basically, the future is closely related to the cultural heritage of every nation; in the institutional specific language it is called *artefactual structure*.

In his attempt to investigate institutional economics, the author converges on the idea that Ronald Coase, the parent of the NIE had a great contribution to the creation process of the new paradigm with his article *The Nature of the Firm* (1937). As Pohoață indicates, this article was the starting point for new research scopes related to firm, transaction costs, or governance structures, elements that together create a solid part of the *hard core* of the NIE. Coase generally agreed that economy is based on two alternative mechanisms of coordination: the prices mechanism, which is responsible for market allocation resources and the hierarchy, which ensure resources allocation within the firm through authority and planning. As a result of his investigation Coase focused on some reasons that might argue the emergence of the firms. First, he emphasized the option of some individuals to work for other people for less money; the individual desire to be the leader, to control and to have the power on others, or customers preference for certain goods made by companies. Second, to reduce transaction costs, that consists of an information cost, omnipresent when the transaction takes place on the market and a cost of contracting. Finally, the public authority applies different regulations to firms and to the market. As an example, sales taxes are targeting only market transactions, not those transactions that take place within the firm.

So, in order to reduce transaction costs, Coase came with an innovative proposal: *the incomplete contract* that should be negotiated and signed for a longer period of time which reflects an antagonistic view towards rigorous neoclassical contract, with many clauses and terms of execution. It provides uncertainty, and it supports the opportunism. Another option would be *vertical integration*, the low specialization. For Coase the firm is *a small planned company* that operates alongside other firms within the market competitive system. In his perspective, an efficient economic system must be based on free market, but must include also some areas of planning, which are the firms. As author highlighted, the firm does not appear as a reaction to the free market, but to reproduce market conditions at the level of some smaller transaction costs. With other words, firms exist just because the transactions within firms are made with lower costs than the market. This subject was widely investigated by many authors and Harold Demsetz for example pointed out that the firm and the market cannot be the coordination alternatives of production. In Demsetz perspective authority has a minimal role in the process of resources coordination. Is what he called *"the perfect decentralization"*. The contract has almost the same value with the entrepreneur because the firm and the market belong to the same network of contractual relations. As the author of the book noted, Demsetz, Alchian and others have identified a *contractual nature of the firm*, according to which the firm is not replacing the market, it would be more proper to say that a certain type of contract is replacing an another type (p. 157).

However, transaction cost is a key element governing the economic reality and the theory related to this subject was also introduced in the extensive analysis of institutional economics. As author shows, the origins of transaction costs came from the origins of the emergence and nature of the firm. From the large variety of definitions the author retains the one provided by A. Iancu. He divided the production process into three components: pre-production, post-production and production and stated that the first two periods (pre and post-production) properly determine the transaction costs. Apart from these costs he mentioned the production costs which are related to organization and management of the firm. This approach is able to establish that transaction costs appear upstream and downstream of production.

As author emphasized, O. Williamson operates with other structure: ex ante and ex post transaction costs. According to him, in ex ante category there are the costs related to relevant prices identification, negotiation, or advertising; in terms of ex post transaction costs Williamson included costs of imposing and monitoring the behavior of partners, the one related to tracking and damage recovery, etc. In order to enumerate the determinants of transaction costs Williamson argues that uncertainty, bounded rationality and informational asymmetry have a great influence, because it supports opportunistic behavior. In such conditions of instability, risk, or incomplete contracts the transaction costs might become very high. The solution offered by O. Williamson would consist of *governance structures*. He defines it as contractual and non-contractual mechanisms that have the ability to reduce transaction costs (p. 189). Furthermore these governance structures do not replace the incomplete contract, but adjust it in order to reduce uncertainty and risks. Their role is to assure the proper conduct of transactions, to protect transactions against risks and opportunistic behavior, or to settle conflicts with minimal costs.

Between institutional environment and governance structures there is a dependence relationship. Property rights, contractual arrangements, reputation or uncertainty are elements that define the institutional environment, but also the governance structures. For example, well defined property rights and contractual guarantees are associated with low transaction costs, which means orientation to market and hybrid forms. On the same time these elements may be a signal of a developed economy or of a third world country.

The evolution of a society is highly determined by the hereditary mark, especially what comes from the cultural background. This component of institutional system is responsible for development gaps between states. In Romania for example, the path dependence is obvious. There is a hereditary mark of the ex-soviet regime that obstructs development. The socialist institutional performance which seized the moral values of individuals and their freedom of thinking is responsible for low institutional performance in our country. After more than two decades of freedom the values of a civilized society like: freedom, competition, property rights are incomplete. Even if Romania is at the moment a European Union member, it is formally adhered; it does not have all the attributes of a developed country. The change of political regime, the democracy or freedom was not able to create a new prosperous society. Romania is still suffering from the institutional crisis; private property and competitive market are not functioning well, and even if there is a democratic background there are no political initiatives in order to activate democratic institutions and to ensure their correct operation. As the author highlighted, Romania is not able to learn from its past, it does not even imitate a successful model from outside because the institutional structure does not allow this. In a world guided by bureaucracy and corruption institutional performance cannot be promoted, so until this path dependence will not be improved Romania has no chance to be inserted in the developed nations of Europe. Let's hope that our economic evolution will not follow the entropy law of N.G. Roegen and our potential will not be wasted until its complete disappearance.

There are still many things to say after reading a book developed on such a large scale that offers an integrative perspective of all valences of institutional economics. This impressive opera is the result of an enormous effort of understanding and explaining the evolution of the institutionalism in all his hypostases and it addresses not only to economist reader, but to every person or student that would like to enrich his knowledge with the purpose of a better understanding the economic theory, but also the economic reality. The book is able to provide some clear answers to sensitive questions that used to have no answer and furthermore, the necessary solution in order to achieve growth and development because *in the process of economic growth institutions matter*!