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New institutional Economics and Economic History

A Case of 'Economics Imperialism'

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Abstract

This paper analyses the contributions of New Institutional Economics (NIE) as regards economic history. It is argued that although NIE's theoretical innovations try to solve the problems of the non-realistic, asocial and ahistorical foundations of neoclassical economics – moving it in a more realistic, social and historical direction, the project rests on unsolvable contradictions. Since NIE retains the basic analytical apparatus of static equilibrium theory as its 'economics', the problem arises that where there is economics in NIE, there is no history – and where there is history in NIE, there is no economics. This dilemma is then met by NIE proponents in a twofold manner. Either the economics is reintroduced through the backdoor by adapting history to theoretical preconceptions and known historical falsehoods such as 'in the beginning were markets', what I call 'as-if economic history', or, faced with the problem that the economics is rendered more and more superfluous for explanations of economic history, NIE proponents apply a specific form or 'economics imperialism'. The analytical apparatus that initially, and admittedly, called for revision in explaining economic development is reinvoked to explain almost all other aspect of social life, such as 'culture', ideology, 'belief systems', the state and even the 'selection' of the whole institutional structure of capitalism. In this light, I suggest that NIE does not provide scientifically grounded explanations of the 'institutions of capitalism'. Instead, NIE is itself best viewed as an 'institution of capitalism'.

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> *All this is actually the case with the bourgeois. For him only* one *relation is valid on its own account – the relation of exploitation; all other relations have validity for him only insofar as he can include them under this one relation, and even where he encounters relations which cannot be directly subordinated to the relation of exploitation, he does at least subordinate them to it in his imagination.* (Karl Marx and Friedrich Engels)[2]

Introduction

'Institutions' has become a keyword within political and scientific discussion. It reflects the ever more widespread realisation that a well-functioning market economy presupposes an effective institutional framework to work its wonders. In the light of global turbulence, financial unrest, the development in the former Eastern Bloc, continued underdevelopment in the 'Third World', staggering income inequalities etc., businessmen, economists and politicians (from neo-conservatives to the New Left) alike are converging on the idea that economic development without 'good institutions' and an effective state is impossible.

This focus on institutions presents us with interesting questions. First it pinpoints that a 'market economy' is not a 'spontaneous' phenomenon on which society automatically rests, but a problematic system in need of good 'governance'. A 'well-functioning' market rests on society. From right to left the scope and aims of 'governance' differs somewhat, but the underlying premise that markets need institutional support and an effective state is becoming common ground.[3] Secondly, it has put focus on the *history* of capitalism.

However, there are also other issues that present themselves, which are seldom spelled out: For instance, if the market is not an integrating institution of society but rather one in need of institutional integration, what good is the market? If the market does not support society, but is in need of support from the institutions of society, why should institutions support exactly market capitalism, rather than, say, community or provision based on need? Willy-nilly, institutional analyses may very well lead us to question the very basics of capitalism. However, within economics and economic history, there has flourished a New Institutional Economics (NIE), which has risen to somewhat of a new 'orthodoxy' (notwithstanding the fact that its exponents wish to describe themselves as 'non-mainstream'). NIE, far from questioning the economic and social bases of market capitalism, becomes rather a theoretical defence of market capitalism – more concerned with the question of how to 'get the institutions of capitalism right'.

To simplify complicated issues somewhat, the basic assumption of this paper is that the development of the theoretical apparatus of NIE rests on two grounds: (i) The current (uneven) development of global capitalism – which calls for explanation. As more and more 'orthodox' economists recognize, the predictions of 'convergence', equalisation of wages, prices etc. entailed in the gospel of free trade have not materialised. In short, the actual development of global capitalism is not consistent with the preconceptions and predictions of neoclassical price and market theory. (ii) The theoretical impetus of making the ahistorical, asocial and non-realistic assumptions of neoclassical economics historical, social and more realistic. This second point is from a theoretical point of view, I argue, a defining characteristic of NIE.

Both these 'movements' are in current social, political and theoretical arenas somewhat paradoxical. But since the problems associated with current economic and social trends in global capitalism raises political issues far beyond the scope of this analysis, I refrain here from making any comments on these admittedly decisive issues. Below I limit myself to the problematic of economic theory.

It is the aim of this paper to argue that NIE does not provide solutions to the acknowledged problems associated with neoclassical (static equilibrium) theory. The rise of NIE is not a healthy development of (or rather: away from) neoclassical theory. NIE is instead best viewed as a demonstration of the degeneration of the neoclassical conceptual tool-kit for explaining economic evolution. Furthermore I wish to indicate how this fact has led to the paradoxical result that rather than abandoning neoclassical preconceptions, NIE exponents (being 'good economists') have instead resorted to a specific form of 'economics imperalism', by extending the concepts of neoclassical economics beyond traditionally conceived 'economic' spheres. As I hope to show below, the results of this intellectual development within economic history have hitherto not been very impressive. Indeed, I find it rather telling that a whole economic paradigm of NIE is developing around the acknowledgement that we (i.e. NIE theorists) do not really know very much of what we are trying to explain (institutional change and the direction of economic development) and that for the most part 'everything is uncertain'. Yet, many do not seem to care to see this as a weakness of theory. And very few eye-brows have been raised in this light.[4] Douglass North succinctly describes the economist's attitude:

> Although I know of very few economists who really believe that the behavioural assumptions of economics accurately reflect human behaviour, they do (mostly) believe that such assumptions are useful for building models of market behaviour in economics... (North 1990: 17)

As will be shown in this paper, in NIE, not only are the behavioural assumptions of microeconomics perceived as being 'useful for building models for market behaviour in economics' but also for building models of 'voting behaviour', of the state, of ideology, of 'culture' – even of 'choosing' whole institutional structures, for instance market capitalism.

The basics of New Institutional Economics

NIE as a school of thought has a historical basis, which can be traced back to the tradition of classical liberal political economy. Evolutionary arguments, the ideas of selection, of 'survival of the fittest', of 'the invisible hand' etc. are in various ways inherited and elaborated upon by NIE.[5] On the other hand the concepts of markets, supply and demand, marginalism, factors of production etc. are inherited from neoclassical orthodoxy. As two new institutionalists claim:

> ... [T]he exponents of modern institutional economics apply the analytical apparatus of neoclassical theory (and newer techniques) to explain the workings and evolution of institutional arrangements and thus to expand the scope and predictive power of microeconomics. (Furubotn and Richter 1997: 2)

Although this is true (as well as an indication of 'economics imperialism' – 'expanding the scope … of microeconomics') the conceptual framework of NIE does in some important aspects deviate from neoclassical economics. Let us turn to these concepts.

Bounded rationality

Firstly, more and more new institutionalists reject the assumptions of perfect information and hence the concept of full rationality in favour of the concept of 'bounded rationality'. This concept – originating from Herbert Simon – is a disputed one.[6] In the hands of NIE it is taken to include the point that in the presence of uncertainty, information problems and 'transaction costs', economic agents cannot gather all the information necessary to calculate, case-by-case, the optimal solution on the market. Individuals are therefore: 'intendedly rational but only limitedly so' (Williamson 1985: 45). Neoclassical 'equilibrium' is as a rule not attainable.

To minimise the problem of uncertainty, economic agents devise rules of thought and action to base their decisions on. They become 'rule followers' (Vanberg 1994). These rules are rather fixed and do not change by the case-by-case calculation. As one observer puts it: 'A boundedly rational individual intends to maximise, but finds it costly to do so.'[7]

Transaction costs

The main theoretical achievement of NIE is the transaction cost concept. It originated from Ronald Coase's 1937 article on the firm, where Coase posed the question in this vein:

> But in view of the fact that it is usually argued that co-ordination will be done by the price mechanism, why is ... organisation necessary? Why are there these 'island of conscious power'? ... Yet, having regard to the fact that if production is regulated by price movements, production could be carried on without any organisation at all, well might we ask, why is there any organisation? (Coase 1993: 19)

His historic answer was that 'the main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism' (Coase 1993: 21).

This 'cost of using the price mechanism' is a transaction cost. The concept is far from easily understood, and it remains rather dubious, since definitions vary a lot. Some examples from the literature could show this. North (1990: 28) defines transaction costs as 'the costs of defining, protecting and enforcing property rights'. Williamson (1985: 18-19) quotes Kenneth Arrow who talks of 'the costs of running the system', as 'the analogy to friction in physics'. Cheung (1983: 14) writes 'The determination of the piece-rate – a price – illustrates the costs of "discovering" prices'. Eggertsson (1990: 14) claims that: 'transaction costs are opportunity costs just like any other costs in economic theory...' A workable conception, in summary, is:

> These then, represent the first approximation to a workable concept of transaction costs: search and information costs, bargaining and decision costs, policing and enforcement costs. (Dahlman 1979: 147-148)[8]

A first theoretical linkage can now be seen. In the presence of transaction costs, markets and prices are not sufficient to create equilibrium. And new institutionalists argue, transaction costs are pervasive in every economic system. The development of transaction costs is the key to the institutional structure of a society and economy, according to NIE. One cannot over-stress the importance of the concept in NIE. As two proponents explain:

> The concept of transaction costs is crucial to any acceptable interpretation of how a capitalist market economy actually functions. To see the truth of this judgement it is only necessary to consider a world where transaction costs are zero. In such a 'frictionless' world even basic institutions as e.g. money, the firm, public regulation become *irrelavant*. (Furubotn and Richter 1991: 11)

The efficiency of the market economy is in NIE based on a third condition, the distribution and protection of property rights.

Property rights

The focus on property rights with regard to capitalism is very welcome. In General Equilibrium, property rights distribution is immaterial to the equilibrium solution of the market, but in the light of bounded rationality and transaction costs, the original property rights distribution is decisive for economic efficiency.[9] With the property rights theory of NIE, things have changed for economic orthodoxy.[10]

NIE's definition of property rights is much wider than the one of political economy. For instance Barzel (1989: 2) contends that human rights 'are simply a part of people's property rights'. In such a definition everything from buying a tomato to committing suicide or driving a car too fast concerns 'property rights'. But sticking to the economics of it, we can settle for the following definition:

> There are various categories of property rights; the right of ownership, however, is the best known. By general agreement, the right of ownership in an asset consists of three elements: (a.) the right to use the asset (usus), (b.) the right to appropriate the returns from an asset (usus fructus), and (c.) the right to change its form, substance and location (abusus). (Furubotn and Richter 1991: 6)[11]

The economic problem for property rights theorists now becomes how and when property rights are exchanged in the economy. This is not a simple affair. The property rights over assets have to be specified in a *contract*, and hence by law. Questions arise: What rights are bought and sold? Under what conditions? What happens if some party breaks a contract? What constitutes a breach of contract? Etc. Depending upon such questions and the exclusiveness of the property right (is it only mine, or can someone else use it too?) the value of the asset for particular owners will vary. In order to assure the exclusiveness of private property rights, they must be well delineated and enforced (by the state). If property rights are easily delineated, well protected, and enforced by the state, then the transaction costs will be low and the gains from trade inherent in the neoclassical market argument will be realised. If not, exchange will not occur and the market will not work. Here is a noteworthy twist to the argument. North summarises:

> A theory of the state is essential because it is the state that specifies the property rights structure. Ultimately it is the state that is responsible for the efficiency of the property rights structure, which causes growth or stagnation and economic decline. (North 1981: 17)

Trade on the market remains the cause of growth in NIE, but this is now made dependent upon the workings of the state and the way, in which property rights and institutions work to lower transaction costs. Having put such great emphasis on the state, North concludes that the state is both the precondition for economic development, yet at the same time '… the source of man-made economic decline' (North 1981: 20).

Institutions

Institutions are 'the humanly devised constraints that shape human action' (North 1990: 3). With this concept NIE can arguably become more social and realistic in its approach. In the words of the founding father: 'Modern institutional economics should study man as he is, acting within the constraints imposed by real institutions' (Coase 1984: 231).

Institutions are both 'informal constraints' (custom, culture, incentives, 'belief systems' etc.) and 'formal constraints' (law, property rights etc.). Institutions are the rules of the game in the economy, and 'organisations' ('the players of the game') arise in response to the institutional structure. North (1993: 7) explains: 'It is the interaction between institutions and organisations which shapes the institutional evolution of the economy'. Conceded the fact that equilibrium does not come about in the real world, and conceded that the property rights structure, the state and the institutional evolution of society determine economic performance, North comes to the following conclusion:

> History matters. It matters not just because we can learn from the past, but because the present and future are connected to the past by the continuity of a society's institutions.

> Today's and tomorrow's choices are shaped by the past. And the past can only be made intelligible as a story of institutional evolution. (North 1990: vii)

The distinctiveness of NIE

NIE can be described as the attempt to make neoclassical economics more *realistic*. This is achieved primarily by mellowing the concepts of a fully rational 'economic man', acting with full knowledge and certainty into a concept of a 'boundedly rational' individual, acting with limited knowledge in a world of almost ubiquitous uncertainty. With the concepts of property rights and transaction costs, NIE moves its economic theory in a more *social* direction, pointing to the fact that markets are in need of institutional (often translated into 'state') support to work its wonders, as well as conceiving the market as preconditioned by society, rather than the other way around. On this basis, with the aid of the institution concept, NIE has opened up avenues for *historical* explanation of different paths of economic development. 'Institutions' has, thus, become the key concept in indicating the more realistic, social and historical approach to economics in NIE.

Theoretical problems in NIE

The overriding question, however, is: Do the concepts of NIE help as far as making a realistic contribution to economic history? What are the realisation 'history matters' and the focus on institutions – a social aspect of life – really worth?

Theoretical problems with 'transaction costs'

The key issue in NIE is the concept of transaction costs. What can we make of it, and how does it help us explain historical evolution and economic performance? First I emphasise that the initial assumption of the Coesean procedure is the idea that production and exchange at least in principle could be carried out solely by use of the price mechanism. The question on this basis then becomes: if the distribution of resources in principle could be conducted through the price mechanism on the market, why does the 'non-market' of the firm arise and allocate resources through internal planning and co-ordination by 'entrepreneurs'? Pervasive in this line of reasoning is the question 'why are there not markets?' Note, therefore, that transaction costs *cannot explain* markets (in a sense it would be more accurate to say that in theory markets and prices are the causes of transaction costs). In NIE – most strikingly formulated in Williamson's dictum 'in the beginning there were markets – markets are assumed and from this assumption all other institutions and organisations are explained. In some versions of NIE the choice of institutions is explained by their relative 'efficiency'.[12]

I wish to point out two problems in this section: (i) the concept of transaction costs is problematic in relation to the very basics of the neoclassical theory, which it was supposed to complement, (ii) the concept is not a very helpful tool in explaining the origins and evolution of the institutions of capitalism.

(i) Transaction costs and neoclassical economics

The first issue relates to the 'cost' or 'price' of 'using the price mechanism'. Such a formulation of transaction costs runs into an infinite regress of markets and prices. If there is a price of knowing the price (and if all prices entail transaction costs), then there has to be a price of knowing the price of knowing the price as well etc., etc. So every market must have a meta-market in which the price of the transaction costs to the price at the lower market level is determined. We get a hierarchy of markets, which all have transaction costs.[13]

A possible solution to this problem would be to say that transaction costs are costs, which are not reflected or seen as prices on the market. They are the 'underlying costs of exchange' (North 1989: 661). But they are not *bona fide* prices. Hence the regress stops. It could be argued that this is not *per se* an implausible line of reasoning. But it entails a deeply problematic view in relation to the neoclassical price theory which the transaction cost concept was supposed to supplement.

Consider for instance the idea that prices carry all the information needed for economising. This is in effect undermined, because these most important costs – those that ultimately determine the evolution and structure of institutions and organisations – would then not be reflected as prices at all. The allegedly integrating capacities of the price mechanism and the market – as argued by above all Hayekian free marketeers – are put into question. In Coase's formulation, it is indeed the very fact that prices in themselves *do not* reveal all the information necessary for market integration and efficient resource allocation that brings about the transaction costs, which the institutions, organisations and 'non-markets' try to cope with. So contrary to the orthodox argument, prices do not convey all the information necessary for the individual to make rational economic calculations.

Also, the notion that prices and costs are determined through choice and adaptations of the individuals on the market is seriously weakened. Mainly because these transaction costs – being invisible as prices – cannot in this vein be determined by the subjective, calculated choices of economic actors. In turn, therefore, it seems problematic to maintain that economic actors can build and revise their choices regarding institutions in a correct way, solely on the information of the price mechanism, since transaction costs are not visible as prices.[14] And if this argument is sound, it applies regardless of rationality assumption: full or 'bounded'.

The limits of the price mechanism are in effect recognised by the transaction cost theorists of NIE. But if we choose to go along this line, we confront another major challenge to the orthodox theory of market and individual choice. The only way to escape the problem of the limits of the price mechanism seems to be to argue that the economic actors indeed can make these cost-benefit calculations without knowing the prices, yes, even in the absence of prices. This route, however, presents somewhat of a no-win-situation for the transaction cost theory notion of just widening or complementing orthodox price theory. It runs like this.

Initially transaction cost theorists have acknowledged that prices are not a *sufficient* condition for conveying all the information needed for economic actors to make rational calculation – nor are they sufficient to create co-ordination (the case of positive transaction costs). But then to save the idea that economic actors can, and do, make rational choices on the cost and benefits of institutional arrangements and property rights structures, exponents of transaction cost theory depict these individuals as making these choices without the use of the price mechanism (for instance via a 'selection mechanism').[15] This, however, entails the idea that the price mechanism is not a *necessary* condition for rational economic calculation. So, *if prices are neither a sufficient nor a necessary condition for economic calculation and institutional choice, what is left for them to do? And what is their explanatory value*?[16] We could argue that there is some other integrating mechanism to the economy, but it would not be prices, if we follow the transaction cost argument.[17] So the following contradictions arise. *If transaction costs are visible as prices on the market, then they too must have a transaction cost. If they are not visible as prices on the market, then the individual economic actors can gain no information of them and base their choices and resource allocation on them – at least not the standard way of calculation on price information.*

This realisation has some further consequences. It seems we would have to admit that there are costs, which are not solely subjective and dependent upon the choice of individual actors, but are ruled by some other underlying non-subjective logic. In short, this calls for a theory of 'objective cost', which is neither decided on nor reflected on the market.[18] Accordingly, the whole methodological underpinning of 'consumer's choice' and methodological individualism is in danger. If we follow the definition of transaction costs to this logical conclusion, they must be conceived of as being costs and underlying mechanisms and institutional structures, which are governed by other forces than the calculations of individual economic actors. Yes, actually, it seems that property rights theory itself acknowledges that it is these underlying costs and structures that determine – or at least influence – choices on the market rather than the other way around. In short – given transaction costs – institutions influence choice.

So the question arises, should we not then investigate the structure of these costs and institutions instead, rather than starting from consumer's choice, and economic calculation or prices on the market?[19] If so, any conception of rationality and choice outside the given institutional setting seems unwarranted. In an institutional analysis we cannot, then, start from the given individual of the neoclassical model in order to explain institutions, we must start from the individuals, as they appear *within* the institutional frameworks at hand.

The basic problem for any theory that poses the question on the efficiency of institutions and organisation based on the neoclassical assumptions of choice and calculation – given transaction costs – can be summed up in the following question: How could the economic actors interact to create an efficient outcome, when they either do not have the information to do so (granted that transaction costs are invisible), or they are acting in the sphere where this information is not to be had (granted that transaction costs are not *on* the market)?

(ii) Transaction costs and historical change

NIE builds upon the realisation of that the world is full of transaction costs, information problems, non-equilibria etc. Yet the explanation of these phenomena starts from orthodox equilibrium: a 'zero transaction cost world', where institutions do not exist. But how can transaction costs arise from an institution free and frictionless framework? How do institutions arise and change from a state of no institutions? And how do actual individuals act and create institutions from a state of no institutions?

We could relax these strict conditions for the interpretation of the 'zero transaction cost world' of NIE and say that it is indeed a world where institutions exist. But then the following problem arises, *if we conceptualise a world without transaction costs as one encompassing institutions, then we have to admit that transaction costs cannot in general be the cause of institutions*.[20] It may then, at best, be true that in a 'zero transaction cost world' the question of *which* institutions that exist is irrelevant *from an efficiency point of view* (the so-called

Coase Theorem) but the structure of these institutions cannot be irrelevant if we want to explain – from this 'zero transaction cost world' – the direction of change of institutions.[21] And, in general, this was the challenge NIE set before itself: to explain the direction of institutional change and its effect on economic growth, decline and efficiency.

Transaction costs were supposed to help explain institutions in history, but instead we arrive at the conclusion that transaction costs are dependent upon institutions. The concept therefore seems ill-equipped to explain institutional change in history.

Why not markets?

In general, the method and concepts of NIE cannot explain the origins of the market. Rather the market is assumed, and from the pre-existence of markets the question is why other institutions and organisations exist. This procedure is most clearly shown in Oliver Williamson's treatment of the institutions of capitalism (Williamson 1975, 1985) which simply starts from the assumption 'in the beginning there were markets'. The ideological content of this assumption is apparent. From such an assertion all other allocation systems are to be explained (away) as inefficient, as deviations or 'constraints' to the market, or at best only introduced where the market 'fails'.[22] But property rights theorists at the face of it are different. For instance Dahlman (1980), McCloskey (1972, 1975, 1976), Fenoaltea (1976, 1991) and North and Thomas (1973) provide analyses, which show that communal property rights, the manor system, the open-field system etc., under given 'constraints', can be viewed as rational and efficient, for instance in avoiding and spreading risk (McCloskey 1976). The problem is that the argument assumes cost-benefit calculation on property rights structures. The underlying premise is that the market is always a possible property rights structure to choose, and if economic actors have not chosen it, it is because of the given 'constraints' and transaction costs.

But it is difficult to see that there was a historically independent choice available of different property rights structures for economic agents, the way property rights theorists describe it. In theory, we could at best choose to buy different amounts of commodities on the market, but not choose to 'buy' more or less market organisation itself.[23] It is not as though feudal lords and peasants initially made a calculation on whether to 'choose' serfdom over a labour market and feudalism over capitalism. But it is exactly this analytical leap property rights theorists make when they explain the efficiency of the one over the other, and why they change and transform. In short, in NIE markets have to be described as present, even in their absence. I will use the example of North's institutional economic history further down to illustrate this.

Furthermore, if we admit that institutions and property rights determine choice, then these institutions and property rights can hardly be explained by that very same calculation and choice. If the same rationality and efficiency argument is evoked to explain both the persistence of an institution, for instance serfdom, as well as its change of this institution into another (wage labour) then it is difficult to specify the explanatory capacities of the property rights argument. It boils down to this simple truism: 'If the market is there, it is because it is efficient, and if it is not there it is because that is efficient too'.

For NIE the preconceptions of neoclassical economics remain an ideological blockage. The underlying premise of 'why not markets?' effectively dismisses the very question economic history puts on the agenda: 'why markets?' Markets are, after all, results of historical evolution, not its primordial condition.

'The disappearance of the economic'

NIE is wide-ranging. And particularly North (1990, 1993, 2005) has in recent years tried to widen the institutionalism of his model to incorporate everything from ideology, culture to law and the state. Following his own logic North has come to see the determining effects of economic growth or decline in the 'informal constraints' and the state – not in the traditionally conceived economic sphere of production, exchange and market. The further NIE goes along this road, however, the more this economic sphere disappears in the model. The economic logic of a system is no longer the *cause* of development and growth, it is rather the *consequence* of non-economic 'constraints'.[24] The simple fact is that the economic sphere is becoming increasingly sterile as an explanatory variable. It is all other relations – culture, ideology, 'mental models', and the state – that explain different economic systems and their performance. North, as well as NIE in general, can only succeed in saving the core of neoclassical economics by making it almost superfluous to the explanations in the model. The economic has disappeared. Mysteriously, the economic wisdom that once started with the omniscient calculator guided by 'the invisible hand' of the 'spontaneous market order' as explanatory key, has ended up in 'uncertainty' and in the 'belief systems' of 'entrepreneurs' (North 2005). A trip from the world market to the individual's brain!

However the mystery dissolves, once it is granted that equilibrium economics is not suitable for explaining how economies develop.[25] Because if this neoclassical economics is the only conception of the economic sphere NIE has, then the economic sphere will ultimately have little value in NIE's explanations. Once it is granted that neoclassical economics is a static and technical framework, the dynamic for social change must come from somewhere else. And this is, I argue, the main theoretical function of the institution concept of NIE.

This pressing dilemma is becoming clear to NIE and North in particular. And although North repeats throughout his work that transaction cost theory is only a complement, and that it is an explanatory variable alongside the traditional concepts of neoclassical economics, these traditional variables: prices, markets, technology and production, are more and more pushed aside. In come instead 'culture', 'custom', 'ideology', 'belief systems', law and the state as the main explanatory variables.[26]

Yet, rather than seeing this pressing dilemma as a problem – even the ultimate limit of NIE, most new institutionalists at this juncture resort to 'economics imperialism'. So, the problem of explaining the economy with institutions is now reversed into the one of giving these institutions a microeconomic explanation. The economic apparatus which called for complements and revision is now invoked to explain the revision itself! Therefore, new institutionalists try to talk of the state and policy in terms of standard economic modelling. They talk of the state as 'political markets', of 'political entrepreneurs', of voting and ideology as 'the cost of expressing your conviction'.[27]

But such an escape of bringing the 'economic' back in again is illusory. Even if one would agree to conceptualise politics, state, culture and ideology as 'markets', one would at least have to concede that these sorts of 'markets' have a very different logic than the economic ones. There is in general no 'voluntary contracting', no exchange of property rights (not to mention the absence of commodity production), no economic calculation on price information etc. in 'political markets'. If there is any 'exchange' here it is of a very different kind than market exchange. By extending the market exchange concept to these other spheres NIE runs the risk of emptying the explanatory value of exchange and market full scale. Indeed, it is difficult to see how a theory of economics, which, as new institutionalists at the starting point of analysis readily admit, on its own is incapable of explaining money, distribution, markets and efficiency suddenly (the second time around) could explain 'belief systems', culture and the state.

Such 'economics imperialism' of trying to explain other spheres of social reality than those traditionally conceived as 'the economy', in actuality does not provide salvation for NIE, it is rather its dying breath. Even North, perhaps the must unorthodox new institutionalist to date, cannot do away fully with the barren burden of his original economic paradigm. The result is that where he has taken it, this theory becomes increasingly empty in content.[28] NIE is caught in the middle: paying the double price of both abandoning and clinging on to concepts of neoclassical economics at the same time.

The 'as-if economic history' of NIE

Examples of ahistorical history – ultimately leading to 'economics imperialism' – within NIE abound. Except, possibly, for the case of economic historian Douglass North, historical investigation is not the driving force of the arguments of NIE. History is rather evoked to illustrate theoretical preconceptions. Take for instance this example from a classic article within the tradition from Harold Demsetz:

> For example it might be thought that a firm which uses slave labour will not recognise all the costs of its activities, since it can have its slave labour by paying subsistence wages only. This will not be true if negotiations are permitted, for the slaves can offer to the firm a payment for their freedom based on the expected return to them of being free men. The cost of slavery can thus be internalised in the calculations of the firm. The transition from serf to free man in feudal Europe is an example of this process. (Demsetz 1967: 348)

Such historical 'explanations' do raise more questions than they solve. What kind of economic system exists on the premise that 'firms buy slave labour'? Well, the closest thing in actual history, I guess, would probably be the ante-bellum US – a form of industrial slavery. But how does this economic system relate to feudal Europe – and the transition from feudalism to capitalism there? Slaves, furthermore, do not get wages, by definition, and even if for some reason they did, they would be subsistence wages, so how could the slaves 'offer to the firm a payment'?

I for one find it difficult to resist the temptation of making fun of some of the major NIE exponents in relation to historical explanation, since similar examples to the one cited above abound in their writings.[29] But I will not here indulge, so I leave it with supplying (without further comments) two more quotes, which relate to explanations of hierarchical capitalist firm relations, to illustrate the ubiquity of this ahistorical method of NIE.[30]

> Workers voluntarily undertake to be supervised ... They submit to being compelled to work harder than direct incentives provide for, because the consequence is a higher expected utility. (Stiglitz 1975: 571)

> My favourite example is riverboat pulling before the communist regime, when a large group of workers marched along the shore, towing a good sized wooden boat. The unique interest of this example is that the collaborators agreed to the hiring of a monitor to whip them. (Cheung 1983: 8)[31]

If this were all NIE had to offer, it would be difficult to account for its growing influence within economic history. So, I argue, it is through the consistent application of the tools of NIE from economic historian Douglass North that NIE has gained its influence on economic history. Yet, as I hope to illuminate in what follows, the method, examples and the analyses in North's writings, remain similar to the basics of NIE in general.[32] This is evident in North's analyses of economic transformation and the transition from feudalism to capitalism. North contends that the manor system was 'efficient' and therefore chosen by the economic agents:

> Against this background, the contractual arrangement of the manor can now be seen as an efficient arrangement for its day. The obligation of the serf to provide labour services to his lord and protector, an input-sharing arrangement, was chosen because given the constraint of high transaction costs involved in trading goods, it was the most efficient. The almost total absence of a market for goods, plus the existence of a rudimentary market for labour, ensured that inputs could be shared with lower transaction costs than would be involved in other contractual arrangements … The 'quaint' organisation of the classic manor is therefore understandable as an appropriate response in the general absence of a market economy. (North and Thomas 1973: 32)[33]

The transformation of the manor system and feudalism is explained by population growth and decline which changes the market and the land-to-labour ratio in the economy. Thereby both prices and the transaction costs of serfdom vs. wage labour eventually changed.[34]

> From handicraft to putting out system to the factory system spans more than three centuries: the key to explaining the transformation is growth in the size of the market and problems of quality control (that is, measurement of the characteristics of the good). In the course of the transformation in economic organisation wage labour developed… (North 1981: 167-168)

The disturbing problem of economic history in North's fashion is that the decisive institutions and human characteristics that are specific to capitalism have to be assumed to exist even when capitalism is not at hand. Otherwise the explanation does not work. But, if we acknowledge that markets and the institutions of capitalism originate from somewhere, and evolve, we cannot assume them from the start.

North does not *explicitly* do this, but in order for the explanation to work *the economic logic* of the market has to be described as ubiquitously present, anyway. This is due to the fact that in the model institutions evolve as rational responses to relative price changes, by, albeit 'constrained', capitalist micro-rational economic men. But the market cannot be explained by this method since it is presupposed in the argument. Calculating what to buy only makes sense when there are commodities on the market to buy. These calculations cannot at the same time be the cause of the market for these commodities.[35] This is especially true of the labour market. If wage labour 'develops' and there is 'an absence of a market economy', as North concedes, then the price of labour cannot be assumed from the start of the explanation.

North fails to take fully into account the fact that it is the 'free' individual – the micro-calculating consumer – that is the result of capitalism, rather than the other way around. This individual in North's theory has no history, and that is a critical limit for his program of 'history matters'. The problem of neoclassical theory is not solved at all. It is inherited.

There are examples of this analytical procedure in North's writings, even to the prehistory of man. Here is a most telling one:

> Prehistoric man employed his labour in conjunction with natural resources to produce his living. The natural resources whether animals to be hunted or vegetation to be gathered, were initially held as common property. This type of property right implies free access by all to the resource. Economists are familiar with the proposition that unconstrained access to a resource base will lead to its inefficient utilisation. This inefficiency as the demand for the resource increases eventually leads to the depletion of the resource … This instance is an example of incentive failure caused by cultural or institutional (property rights) inadequacies. (North 1981: 80)[36]

Well, back to the land-to-labour ratio explanation in the description of the transition from feudalism to capitalism. We do not need to doubt that population change and a changing land-to-labour ratio will have effects on the economic system and its underlying logic. The decisive counter-argument is that these changes cannot be *mediated* as price changes and microeconomic choice, the way North and Thomas describe it, unless land and labour (or rather labour power) already are commodities. But they were not. This remains valid both as a historical remark, in relation to the historical development of proletarianisation and marketisation, but more importantly as an *analytical* remark, since feudal work relations are not wage labour relations. North and Thomas do acknowledge that in the *definition* of feudalism labour and land are not commodities. Although, of course, wage-labour did exist, it did so only to a limited degree.[37]

We cannot have it both ways: either capitalism came from some different economic system, or else it is ubiquitous. In the first case, we have to describe the economic logic of the preceding system in its own right – i.e. as non-capitalist. In the second case economic history does not explain capitalism. Rather it assumes it from the start. If this second case is true, then economic history must be totally revised from being the history that leads *to* capitalism, into a history *of* capitalism.[38] The transition from feudalism to capitalism is not solved but *dissolved.*

North and Thomas (1970, 1973) try to solve this dilemma by using concepts such as 'implicit contracts' or 'implicit prices'. But North then encounters the theoretical challenge of 'transaction costs', I have previously pinpointed: how could the people of the feudal era, who supposedly chose the most efficient property rights, make these calculations on implicit information? If there was no market, how could they visualise it and economise on it? And even further, considering the persistence of serfdom, even if individuals could calculate on a non-existent market, how could they act upon this knowledge? Labour mobility was heavily restricted by the serf's bondage to his or her lord, which means that even if market opportunities somehow were present, individuals could not take advantage of them.

The ahistorical assumptions and explanations constitute a consistent luminous thread in NIE at large as well as in North's work. North ends up, willy-nilly, in maintaining that all institutional frameworks work 'as if' these capitalist micro-rational principles are in place, although he knows they are not.[39] North paints himself in a corner, because what he knows as a historian to be falsehoods, as a neoclassical economist he is compelled to allow himself in order for his economic explanations to work. Conversely, what he 'knows' as a neoclassical economist, he feels compelled not to allow himself as a historian.[40] In short, in NIE history and economics go in opposite directions. Where there is economics in NIE – there is no history; and where there is history in NIE – there is no economics. North and NIE at large try to deal with this dilemma by adopting theoretical preconceptions into a framework of 'as-if economic history'.[41] History is adapted to support preconceptions of handed-down economic theory – and in this process history is not a source of knowledge, but is transformed into a 'narrative', where actual history is said to work 'as if' the neoclassical principles of 'market behaviour' are in ubiquitous operation – explaining not only 'the economy', but also close on all other aspects of social life.

Concluding remarks

There is an underlying contradiction in NIE, as it attempts to make its economic theory more realistic, more social and more historical in its approach. The concepts of 'transaction costs', property rights, 'institutions' etc. are invoked in recognition of the limits of the tools of neoclassical static equilibrium theory. However, from this analysis of NIE there emerges a picture, where, inasmuch NIE tries to retain the basic elements of neoclassical theory, the acknowledged unrealistic, asocial and ahistorical foundations re-emerge as major obstacles to the success of NIE's projects within economic history. When, in turn, NIE seriously tries to move beyond its economic preconceptions – making them more realistic, social and historical – the economics of its theory is rendered more and more superfluous, or even contradicted. This dilemma is then 'solved' in a twofold move from NIE proponents.

On the one hand historically known falsehoods and logical storytelling such as 'in the beginning there were markets' are introduced (through the backdoor) as the basis of explanation for economic evolution. History is invoked to support neoclassical economic preconceptions, not in an attempt to build the theory on historical knowledge of the past, but to reinvent history 'as if' it were consistent with neoclassical theory. The present is not seen in the light of history – history is seen merely in the light of the present. In NIE economic theory and history go in opposite directions – as the writings of North clearly indicate.

On the other hand, having made the economic foundations of neoclassical market theory more and more superfluous in explanations of the economy, NIE resorts to 'economics imperalism' the second time around – providing 'economic' explanations of the development of all other aspects of social life such as the state, culture, 'ideology', 'belief systems' etc.

Whatever partial insights the advent of NIE entails in relation to 'orthodoxy', I conlude that NIE is ultimately grounded on unsolvable contradictions. NIE's 'economics imperialism' is an indication, not of the success but the limits of NIE as science. As ideology production NIE may perform important functions, many of which go beyond the scope of this paper. But let me all the same finish by pinpointing what to me is the most striking feature of NIE in this relation. Once NIE proponents in actuality ended up in a position where the economist could only refer to the psychologist, the anthropologist, the sociologist, or even the priest…, for counselling on the problems of economic development (and the lack of it) they have tried to re-establish economics as 'the crown-jewel' of social science by explaining exactly the subject-areas of the psychologist, the anthropologist, the sociologist and the priest… The 'use-value' of this economist is from the viewpoint of science indeed questionable.

NIE is not the solution to the problems of orthodox economics. NIE is rather testament to fact that the problems remain unsolved. NIE does not explain 'the institutions of capitalism' – NIE is itself best explained as 'an institution of capitalism'.

Notes

1 This paper is a revised version, for presentation at the *Historical Materialism* conference 2006 in London, of Ankarloo (2002a) which in turn was a condensed summary of some of the major conclusions of my doctorate thesis Ankarloo (1999). Those works of mine were at the time authored independently (in truth without my knowledge) of the critical works on NIE by Ben Fine and Dimitris Milonakis. I now fully acknowledge the importance of their contributions to the formulation of a Marxist critique of NIE, even though their important contributions are not integrated in this paper. However, as far as I can see, there are numerous points of convergence in our respective critical analyses of NIE. As always remaining flaws in this paper are mine.

2 Marx and Engels [1845-46] (1982: 110).

3 The intellectual developments of former Hayekian John Gray and former Marxist Geoffrey Hodgson are interesting examples of this fact. All other disagreements aside, they both now converge on this idea that markets need support of institutions to work. See Gray (1997), Hodgson (1999)

4 The works of Fine and Milonakis (2003), Milonakis and Fine (2007) being important exceptions to this rule.

5 On this matter see Hodgson (1993a) and Vromen (1995).

6 See Langlois (1990), Hodgson (1993b).

7 Kreps, quoted from Furubotn and Richter (1991: 4). For critical expositions of the rationality assumptions of NIE, see Hodgson (1988 chapters 3-5), Mäki, Gustavsson and Knudsen (1993).

8 In the light of the widespread usage of transaction cost concepts today, it seems appropriate to stress that in Coase's theory *prices are the cause of transaction costs*. His original idea was that the only plausible economy *without transaction costs* would be a fully planned economy, with no direction of the price mechanism. He says: 'If I were asked to imagine an economic system in which transaction costs did not exist, it would be a completely communist society' (Coase 1992: 73). In subsequent theoretical developments of the transaction cost approach, these limits set by Coase have been abandoned, so that transaction costs are conceived of as arising in all economic systems and organisations – not only the market. See Barzel (1989), Williamson (1985), North and Wallis (1994).

9 See Coase (1960).

10 The property rights theory has its origin in NIE in Coase (1960) and has subsequently been developed by Demsetz (1964, 1967), Furuboth and Pejovich (1972, 1974), Alchain and Demsetz (1972), De Alessi (1980), Barzel (1989), North and Thomas (1970, 1973) to name a few.

11 See also Eggertsson (1990: 34-35).

12 Most notably this is the case in Alchain (1950), Williamson (1975). North (1990, 2005) however does not subscribe to this view.

13 Mirowski (1988: 71) in a different vein points to the problem of 'meta-markets'. He says: '... what structures organise this "meta-market", to allow us to buy more or less market organisation...? Who sets the price of the market? Who sets the price of the price of the market?'

14 The fact that transaction costs are not visible or measurable to the economic actors is mentioned in Magnusson and Ottosson (1996: 355-356), Samuels and Medema (1998: 172-176).

15 This idea that economic actors economise on transaction costs and rationally choose among institutional arrangements is pervasive in NIE. The most prominent example is Williamson's theory of the choice of 'governance structures' (Williamson 1975, 1985).

16 A possible solution is to measure transaction costs in the economy in an indirect way. Attempts to measure the value of transaction costs on various bases include North and Wallis (1986), Demsetz (1968), Williamson (1979) and Furubotn and Richter (1997: 54-62). For all their merits and limitations, such measurement techniques by researchers to determine costs which do not exist as prices, cannot answer what I argue to be

the most fundamental question facing NIE: how can the actual economic actors determine the level of transaction costs without access to a price measure?

17 The fact that prices do not give sufficient information for co-ordination of 'plans', nor is such information all that is necessary for such co-ordination, is adequately pinpointed in O'Niell (1998: 132-142).

18 'Objective cost' here is used only in contrast to the cost and price formation of the market that production function analysis and market analysis of orthodoxy account for. Relating transaction costs to the subjective cost theory of neoclassical economics does not entail that one should accept it. A forceful critique against this subjective cost and price theory is the argument that it is not possible for individuals to form and revise their utility functions and relative demand without *first* knowing the relative prices of the goods and services which they can choose from. Hence costs and prices are presupposed in the argument and not explained by utility functions and cost-benefit calculation. Carchedi (1996: 168) succinctly summarises the point: 'Neoclassical theory has at most a theory of price selection, not a theory of price formation'. An illustration of what Marx called 'the illusion of competition' (Marx 1981 chapter 50). We could of course say 'value' instead to solve the problem.

19 This is indeed North's definition of what economic history should do, when describing the theories of Karl Marx and Joseph Schumpeter: 'if economics is a theory of choice subject to specific constraints, a task of economic history was to theorise about those evolving conditions.' (North 1978: 963)

20 A fact acknowledged in North and Wallis (1994: 662): 'institutions do not exist to minimise transaction costs'.

21 The 'Coase Theorem' of a 'zero transaction cost world' was initially intended as a weapon against Arthur Pigou's 'welfare economics', but for explanatory purposes on the origins and evolution of institutions it is a non-starting point and a meaningless reference.

22 A Marxian critique of Williamson's transaction cost economics on these grounds is pursued in Ankarloo and Palermo (2004). Ideological residues of viewing the market as a primordial condition also abound in North's earlier writings of economic history, where he consistently conceives of other economic systems than market capitalism, not in their own right, but as 'the *absence* of markets'. Why not say 'the *presence* of serfdom…'?

23 Of course individuals may choose to act in order to change and transform given property rights structures. But not by cost-benefit calculation of having more or less of them, as NIE would have it, but through (revolutionary) social praxis, in relation to already pre-given social structures which these individuals did not choose in the first place, as Marx would have it.

24 This analytical turn is clearly exposed in Rosenberg and Bridzell (1986) which starts with an account of some of the major economic explanations of economic growth presented in the history of economic thought. Once these have been pushed aside as non-satisfactory by the authors, all that remains to discuss is politics, law and culture.

25 North readily concedes this in North (1986) and North (1993: 2).

26 The relationship between institutional economics and cultural explanations is becoming very clear. I for one reject this analytical move and in Ankarloo (1999) I suggest that the problem – and analytical need for an institution concept to make the economy social – arises solely because the economic sphere of society at the outset is defined in a non-social manner. In Marxism the problem does not arise, since the economy is already defined as social relations. Thereby 'institutions' as a concept is superfluous within Marxism, at least for these explanatory purposes.

27 See North (1981: 20-32), North (1989: 661-668).

28 See North and Wallis (1994), Ankarloo (1999: 148-153).

29 A good laugh is Silver (1995), which is a transaction cost analysis of the economic system of Antiquity. The first chapter analyses 'the lowering of transaction costs by the collective investment in gods'! In Ankarloo (2002b) I provide some criticisms of Silver's approach in relation to the works of Karl Polanyi.

30 For criticisms of theories of the firm within NIE, see for instance Lazonick (1991), Pitelis (ed.) (1993), Palermo (2000), Ankarloo and Palermo (2004).

31 Lazonick (1991) effectively rebuts a famous argumentation of Alchain and Demsetz (1972). He states: 'The key empirical point in the Alchian and Demsetz story is that with the rise of centralised power sources, "the measurement of marginal productivity ... became more difficult". It will be of no help to us to examine the empirical sources that Alchain and Demsetz used to support this contention – they did not cite any... Nor is it likely that they would have found any support if they had bothered to look. The assertion concerning the monitoring problems of a centralised power source is simply wrong – as are most of Alchain and Demsetz's other statements...' (Lazonick 1991: 185-186). As for Cheung's example it forgets that it is not the slaves, who hire monitors to whip them, but the slave owners, who do so. Indeed, it is a general feature of NIE to view the 'problems' of (team) work not from the viewpoint of the workers who perform the work, but from the viewpoint of the 'monitors' who watch.

[32] Below I do not fully integrate a critique of North's latest book (North 2005). For a deeper critique of North's theories of economic history, see Fine and Milonakis (2003), Milonakis and Fine (2007).

[33] North has later conceded that this view is over-simplified, because: '… carrying over the modern-day notion of contract to the serf-lord relationship is imposing a modern-day concept which is misleading. The serf was bound by his lord and his actions and movements were severely constrained by his status; no voluntary agreement was involved. Nevertheless, it is crucial to re-emphasise a key point of our analysis; namely, that it was the changing opportunity cost of lords and serfs at the margin which changed manorialism and eventually led to its demise.' (North 1981: 131)

However, North's correction is only half-hearted and misses the important point, In general, each individual lord only protected the serf from other lords or bandits etc. not from other serfs. So lord protection is not a general explanation of the lord-serf relation as such.

[34] See above all North and Thomas (1970, 1973).

[35] There are numerous critics of these conceptions in North's work. See Mirowski (1988: 70-72), Field (1981) and Brenner (1977), which even today remains one of the most revealing critiques of the 'Smithian legacy' to economics – and which, although not specifically addressed to North, applies to him as well.

[36] See also: 'Let us examine the situation where several bands compete for the same commonly held migratory animals…The band then has the incentive to exploit the resource to the point where the value of the last animal killed is equal to the private costs of killing it. The collection will continue until all of the income the scarce resource would have earned under private property is dissipated. That is, in a competitive situation no band has any incentive to conserve the resource, since the animals left to reproduce probably would be taken by the rivals. The stock of animals thus could be placed in danger of extinction. The crucial element causing this inefficiency is the lack of any barrier to the exploitation of the commonly owned resource base… The result is too many hunters' (North 1981: 81).

[37] On the rate of proletarianisation see Tilly (1984) which estimates that the proletariat between 1550 to 1843 grew eightfold, by 131 million people, almost equivalent to the total population growth of Europe at the time.

[38] On this matter see Wood (1999).

[39] See Brenner (1977), Mirowski (1988: 70-72).

[40] As is indicated for instance in this concession from North (1981: 40): 'All the modern neoclassical literature discusses the firm as a substitute for the market. [This] ignores a crucial fact of history: hierarchical organisation forms … predate the price-making market'.

[41] I first used the concept 'as-if economic history' in Ankarloo (1999). It is also used in Ankarloo (2002a), Ankarloo and Palermo (2004: 419-420). The concept relates to the (in-)famous 'instrumentalist' defence of 'positive economics' in Friedman (1953). As I have argued in the above-mentioned works, what is sometimes forgotten in the discussion is that Friedman's home-made instrumentalism is based on the idea that the aim of economic theory is *prediction* and that therefore the 'realism' of theoretical assumptions is immaterial to the validity of economic modelling. However, the aim of history - and *a fortiori* economic history – cannot be prediction, so the argument simply does not apply. This said, leaving all other serious misconceptions in Friedman's 1953 article aside.

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