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Law & The New Institutional Economics

Introduction

John N. Drobak*

The Articles in this symposium are examples of legal scholarship in the new institutional economics (“NIE”). The new institutional economics takes its name from institutions: the rules that structure the economic, political, and social interactions in a society. Institutions can be formal, such as law, or informal, such as social norms. The new institutionalists believe that economic performance cannot be understood without paying attention to institutions. Consequently, their scholarship examines a multitude of economic and political issues by focusing on institutions. Law in its various forms (constitutions, statutes, common law, contract terms, etc.) is the most important and prevalent type of formal institution, so the focus on institutions is often a focus on the law. To many new institutionalists legal issues are at the core of their scholarship, as this symposium will illustrate.

This symposium examines law in a wide variety of topics, ranging from economic theory, to the application of the techniques of NIE to discrete issues, and to broad questions of economic growth. The authors, all highly respected scholars, include a Nobel Laureate in Economics,¹ five former presidents of the International Society for

* George A. Madill Professor of Law, Professor of Economics, and Professor of Political Economy, Washington University. I would like to thank Doug North, Rolf Richter, Claude Ménard, Lee Benham, and Gerrit De Geest for their advice and suggestions about this Introduction. Any errors are mine, of course; not theirs.

1. Douglass C. North.

New Institutional Economics,² one of the pioneers of the new institutional economics in Europe,³ a Commissioner of the Securities and Exchange Commission,⁴ and numerous legal scholars and economics professors. Before introducing the symposium Articles, the Introduction will begin by explaining the new institutional economics and its relationship with law and economics.

NIE has existed as a specialty within economics for over a quarter century.⁵ Its prominence rose with the award of the Nobel Prize in Economics to two of the earliest scholars in the field, Ronald Coase in 1991 and Douglass C. North in 1993, and with the creation of the International Society for New Institutional Economics in 1997. Neoclassical price theory, the heart of contemporary economics, is an elegant, powerful model. Its quantitative aspects enabled mathematical economists to give the model ever expanding abstract applications over the past few decades. This quantification of the model often made the model less representative of the real economic world, however. Neoclassical price theory disregards the frictions inherent in making an economy work. The model does this in a number of ways. For example, it assumes away “transaction costs,” which are the costs of measuring the multiple dimensions of the goods and legal rights being exchanged in an economic transaction and the costs of enforcing these rights.⁶ The model also assumes away the political aspects of the economic world, even though

2. Lee Alston, Benito Arruñada, Gary Libecap, Claude Ménard, and Douglass C. North.

3. Rudolf Richter.

4. Troy Paredes.

5. Oliver Williamson introduced the term “new institutional economics” in his 1975 book *Markets and Hierarchy: Analysis and Antitrust Implications*, at 1, 7. However, the term lay dormant until Rudolf Richter began to draw together economists working in related areas under the banner of the new institutional economics. In 1978, Richter became the editor of a venerable German journal on general economics and changed its focus to the new institutional economics. Rudolf Richter, *The New Institutional Economics: Its Start, its Meaning, its Prospects*, 6 EUROPEAN BUS. ORG. L. REV. 161, 164–65 (2005). In addition, Richter and his colleague Eric Furubotn began to organize annual conferences on NIE topics beginning in 1983 and to publish the conference papers in the *Journal of Institutional and Theoretical Economics*, which was the new English name of Richter’s journal. Independent of Richter’s efforts, others were also organizing conferences on the new institutional economics. As Richter says, “The term NIE seems to have soon been sufficiently salient to become a ‘self propelling’ expression.” Rudolf Richter, *The New Institutional Economics—Its Start, Its Meaning, Its Prospects* (Nov. 24, 2003) (copy on file with author).

6. DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 27 (1990).

economic actors often try to use government for their own betterment.⁷

The unrealistic assumptions underlying neoclassical price theory led to the mismatch between the model and reality. As Richard Posner has explained:

In order to facilitate mathematical formulation and exposition, neoclassical price theory routinely adopts what appears to be, and often are, from both a physical and psychological standpoint, highly unrealistic assumptions: that individuals and firms are rational maximizers, that information is costless, that demand curves facing firms are infinitely elastic, that inputs and outputs are infinitely divisible, that cost and revenue schedules are mathematically regular, and so forth.⁸

Concerned about the mismatch between the model and reality, some economists tried to modify the model to make it more useful for understanding the real world. It was from this reaction against “blackboard” economics that the new institutional economics was born.⁹

It is important to emphasize that the new institutionalists do not reject neoclassical price theory. They recognize that the model successfully explains and predicts many real world markets and transactions.¹⁰ This acceptance of neoclassical price theory distinguishes the new institutionalists from the original institutional economists, whose ranks included Thorstein Veblen, John R.

7. See generally DOUGLASS C. NORTH, JOHN JOSEPH WALLIS & BARRY R. WEINGAST, *VIOLENCE AND SOCIAL ORDERS: A CONCEPTUAL FRAMEWORK FOR INTERPRETING RECORDED HISTORY* (forthcoming in 2008).

8. RICHARD A. POSNER, *OVERCOMING LAW* 428 (1995).

9. Ronald H. Coase, *The New Institutional Economics*, 140 J. INT'L & THEORETICAL ECON., 229, 229 (1984).

10. Sometimes the constraints of the real world make the assumptions of neoclassical price theory a close enough approximation of what really happens. To take one example, business firms do not try to maximize economic profit. In fact, most firms do not even try to maximize accounting profit. At the top end, firms try to maximize market share. That is an easier variable to observe, and it shows how a firm is doing relative to its competitors. At the bottom end, firms try to avoid insolvency. Both those objectives constrain firms to act very much as they would if they were attempting to maximize economic profit. In his essay for this symposium, “The Role of Law in the New Institutional Economics,” Rudolf Richter quotes Milton Friedman for the proposition that we should not ask whether assumptions are “descriptively ‘realistic,’ for they never are, but whether they are sufficiently good approximations for the purpose at hand.” *Id.* (quoting Milton Friedman, *The Methodology of Positive Economics*, in *ESSAYS IN POSITIVE ECONOMICS* 15 (1953)).

Commons, John Kenneth Galbraith, and Willard Hurst.¹¹ The original institutionalists did not just disregard economic theory, they affirmatively rejected it. As Ronald Coase puts it with his characteristic wit, the original institutionalists were “anti-theoretical, particularly where classical economic theory was concerned. Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire.”¹² In order to distance themselves from the original institutionalists, the current scholars embrace the adjective “new” in the description of their field.

Not only do the new institutionalists recognize that the neoclassical model suffices for many purposes, they retain the model as part of their search for a better understanding of the problems for which the unaltered model is insufficient. They do this by relaxing the assumptions of neoclassical price theory and by augmenting the model in many different ways. Some try to identify the transaction costs and incorporate them into their theories.¹³ Others focus on property rights or contract theory. Some are concerned with the political aspects of economic decisions and so work in the fields of political economy and public choice. A group of new institutionalists modifies one of the central assumption of neoclassical price theory, the rationality of human action, by using cognitive science, behavioral psychology, and experimental economics. Much scholarship in NIE uses case studies or cross-country comparisons, probably an influence of the economic historians who were some of the earliest NIE scholars. Likewise, the focus on economic growth by economic historians has remained a central question for many new institutionalists.¹⁴ Within all these different research programs, there are many scholars who focus on the various forms of the law.

11. POSNER, *supra* note 8, at 427.

12. Coase, *supra* note 9, at 230.

13. Transaction cost economics has its roots in the work of Ronald Coase, primarily from his two famous articles, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), and *The Nature of the Firm*, 4 ECONOMICA 386 (1937). Oliver Williamson was a pioneer in using transaction costs to explain contractual relations in a variety of circumstances, including business transactions and anticompetitive issues.

14. For more comprehensive descriptions of the wide scope of the new institutional economics, see JOHN N. DROBAK & JOHN V.C. NYE, *THE FRONTIERS OF THE NEW INSTITUTIONAL ECONOMICS* xv–xx (1997); Rudolf Richter, *The New Institutional Economics: Its Start, its Meaning, its Prospects*, 6 EUROPEAN BUS. ORG. L. REV. 161 (2005). Two excellent sources for the concepts and scholarship in NIE are ERIC FURUBOTN & RUDOLF RICHTER, *INSTITUTIONS AND ECONOMIC THEORY: THE CONTRIBUTION OF THE NEW INSTITUTIONAL ECONOMICS* (1997), and *THE INTERNATIONAL LIBRARY OF THE NEW INSTITUTIONAL ECONOMICS* (Claude Ménard ed.) (2005). The variety in research topics and methodology stems, in part, from the wide range of academic disciplines attracted to NIE. Scholars in the

With this focus on law, it is not surprising that there is considerable overlap in the scholarship by the new institutionalists and by scholars in law and economics. A number of shared attributes make the two disciplines very similar. Decades ago economics was easily divided into different schools, each with their own approach, so, for example, Harvard School economists were very different from Chicago School economists. In contrast today, the divide is between theoretical (sophisticated mathematical) economics and applied economics.¹⁵ Both NIE and law and economics are forms of applied economics. They also share a common heritage in the work of Ronald Coase. Much of modern law and economics is built on Coase's ideas, just as is much of the new institutional scholarship.¹⁶ In comparing the two movements, Richard Posner has emphasized the similar topics that interest scholars in both fields, such as contracts, corporate governance, vertical integration, transaction costs, and property rights, and the common analytical techniques, such as case studies, historical analysis, and informal theories.¹⁷ Posner views NIE and law and economics as so similar that he concludes they are "two sides of the same coin."¹⁸ Although Posner's overall assessment of the similarities of the two disciplines is accurate, there are relevant differences.

The two movements have different objectives: scholars in law and economics study the legal system while the new institutionalists study the economy. Of course, in studying the legal system some law and economic scholars examine the economic consequences of various legal rules, which is identical to what some new institutionalists do.¹⁹ However, the different objectives of the two disciplines affect the topics scholars find important enough to

field come from not only economics, but also political science, business, sociology, anthropology, and, of course, law.

15. POSNER, *supra* note 8, at 437.

16. As Richard Posner has written, Coase "can be said to stand at the intersection of these two movements making it natural to suppose that there is considerable overlap between them. . . ." *Id.* at 426.

17. *Id.* at 430, 439.

18. *Id.* at 440.

19. For example, while many new institutionalists would view transaction cost economics as a subdiscipline of NIE, the same can be said for law and economics. "Many of the law's doctrines, procedures, and institutions can usefully be viewed as responses to the problem of transactions costs, being designed either to reduce those costs or, if they are incorrigibly prohibitive, to bring about the allocation of resources that would exist if they were zero. The law tries to make the market work and, failing that, tries to mimic the market." POSNER, *supra* note 8, at 416.

research and the approaches they take in analyzing the topics.²⁰ The Articles in this symposium illustrate the range of legal issues that interest NIE scholars. There are also topics that interest the new institutional economists but not most law and economics scholars, such as economic development, the theory of the state, and hybrid organizations.²¹ In addition, there are sometimes differences in the analytical techniques used in the two disciplines. Price theory, for example, is a tool much more frequently used in the economic analysis of the law than in NIE.²²

Part of the differences between the two movements stems from their origins in different academic fields. Modern law and economics is a product of American law schools. Economists have always been important to the economic analysis of law, but it was law professors who made law and economics an established part of the law curriculum and legal scholarship in the United States.²³ In contrast, NIE is mostly a product of economists. With the focus on institutions, it was to be expected that some new institutionalists would concentrate on the law. The impetus for economists to study the law was even greater in Europe, where the tradition among law faculty discouraged the use of economics (and other social services, for that matter) for legal analysis.²⁴ Thus, European economists filled the role that law professors played in America. Most of these European economists who analyzed the law were part of the new institutional economics. Even today, many new institutionalists would view law and economics as a subspecialty within NIE. With legal scholars studying the law in the law and economics movement and economists doing the same in NIE, it would be expected that the two disciplines would begin by focusing on different problems with different perspectives. However, scholars do not work in isolation. Each

20. As Posner explains, the difference between the two approaches is “not in theory but in theoretical emphasis.” *Id.* at 439.

21. See Claude Ménard, *Challenges in New Institutional Economics*, in INSTITUTIONS IN PERSPECTIVE 21, 23–24 (Ulrich Bindseil, Justus Haucap and Christian Wey eds., 2006) (theory of hybrid arrangements).

22. POSNER, *supra* note 8, at 439.

23. See POSNER, note 8, at 437–39.

24. See Gerrit De Geest, *European Association of Law and Economics*, in 1 ENCYCLOPEDIA OF LAW & SOCIETY 509 (David S. Clark ed., 2007) (“law and economics met more resistance from traditional legal scholars in Europe”). Benito Arruñada and Veneta Andonova in their Article in this symposium, *Common Law and Civil Law as Pro-Market Adaptations*, note that law and economics was an American academic discipline. *Infra* at 81.

movement has influenced the other over the years, bringing the two closer and closer together.

The differences between the new institutional economics and law and economics were much greater at their inception than they are today. In the first Article in this symposium, “The Role of Law in the New Institutional Economics,” Rudolf Richter compares the different approaches to contract issues in the two movements that existed thirty years ago. At that time, law and economics theory assumed perfect law enforcement with a world of only two states: With low transaction costs, parties could write complete contracts that would be enforced by courts. If the transaction costs of reaching agreement on all contractual terms were prohibitively high, the court would fill in the gaps. There was no intermediate position. In contrast to this analysis, transaction cost economists, following the lead of Oliver Williamson, assumed that legal enforcement was impeded or impossible. This assumption led them to concentrate on the contracting parties’ actions and on the way they could protect their interests short of litigation. In situations in which transaction costs were high, they were more concerned with the ways the parties could plan for private dispute resolution through hierarchical governance structures or hybrid forms of organization. Richter ends his paper by showing how the research of law and economic scholars has evolved to deal with the concerns of transaction costs economists, by studying such issues as contract renegotiation under duress and contract design that anticipates renegotiations in specific circumstances. This leads him to conclude that NIE and law and economics have converged to a similar approach on contract law issues.

Frank Stephan and Stefan Van Hemmen give their perspective on the relationship between the new institutional economics and law and economics in the second Article in the symposium, “Laws, Enforcement, Legality, and Economic Development.” They emphasize the importance of distinguishing between the law on the books and the law as enforced, a distinction undervalued in early law and economic scholarship. They also rely on a model developed by Oliver Williamson to show how law fits into the wide range of issues included with NIE. Finally, they survey the various economic studies that connect economic growth to the legal environment, including well-known models created by La Porta, Lopez-de-Silanes, Shleifer and Vishy (LLSV models) and the World Bank’s “Doing Business” Project.

The third Article, “Can We Rank Legal Systems According to Their Economic Efficiency?” by Claude Ménard and Bertrand du Marais, is critical of these Rule of Law studies. After explaining the LLSV studies and the Doing Business project, the authors show the deficiencies in the methodologies and hence the conclusions that can be drawn from the studies. They end by applauding the attempts to understand the linkage between legal systems and economic growth, but they caution that this type of research, which needs more conceptual refinement and better methodologies, has “a long way to go in order to find the right direction.”

Benito Arruñada and Veneta Andonova are just as critical of the LLSV studies and the Doing Business project in their Article “Common Law and Civil Law as Pro-Market Adaptations.” They point out that legal systems are imbedded in a complex network of political structures and social preferences and therefore cannot be studied in isolation. This holistic approach influences the authors’ reexamination of the claim that common law legal systems are superior to civil law regimes for purposes of economic performance. They point out that both systems were instrumental in protecting freedom of contract and in developing market economies. The judicial systems were different because they each adapted to different environments and circumstances. Arruñada and Andonova hypothesize that common law judges, for a number of reasons, were supportive of the development of a modern market system and so were allowed greater discretion than civil law judges, who were constrained legislatively out of a belief that they were anti-market. In finding cognitive differences between common and civil law judges, the authors rely on studies from cognitive science and behavioral economics.

In the next Article in the symposium, “Understanding Judicial Decision-Making: The Importance of Constraints on Non-Rational Deliberations,” Douglass C. North and I also use cognitive science to examine how judges make decisions. We point out that the Legal Realists were correct in their claim that a judge’s opinion provides only a partial explanation of the reasons for a judicial decision. Although we know that judges’ belief systems, intuitions, and other hidden factors affect their decisions, cognitive science is still too primitive to help us understand how these non-doctrinal factors operate. We end by emphasizing the constraints built into both common and civil law legal systems that greatly limit the influence of

non-doctrinal factors on judicial decisions, just as constraints in the rest of the world often channel human decision-making to make it appear to be rational action.

The next Article in the symposium, “Argentina’s Abandonment of the Rule of Law and Its Aftermath,” by Andrés Gallo and Lee Alston, is an example of NIE scholarship from the economic history tradition. The authors show how the impeachment of Supreme Court justices for political reasons shortly after Peron assumed the Presidency in 1946 began a cycle of continuous change in the judiciary that lasted throughout the twentieth century. Beginning with the Peron government, the Supreme Court lost legitimacy as an independent body and became too weak and too politicized to provide any check to the Executive branch. Gallo and Alston also show that judicial instability has been closely related to political instability, which in turn created an uncertain environment for investment in Argentina.

The next two Articles in this symposium are examples of the NIE research that focuses on property rights. In “Law and the New Institutional Economics: Water Markets and Legal Change in California, 1987–2005,” the five authors (Jedidiah Brewer, Michael Fleishman, Robert Glennon, Alan Ker, and Gary Libecap) examine the interaction among regulation, property rights, and water markets in California. With the growing public pressure to reallocate fresh water from historical uses in agriculture to meet greater demands for use in urban areas, recreation, and environmental needs, the authors emphasize the importance of water markets for the voluntary exchange of water rights through leases of water and the sale of water rights. By studying the existing water markets in California over a 20-year period in the context of changing laws and property rights, the authors have identified crucial factors important to successful water markets.

In “On the importance to Economic Success of Property Rights in Finance and Innovation,” Stephen Haber, F. Scott Kieff, and Troy Paredes also investigate the relationships among property rights, regulation and economic performance. Their goal is to identify when property rights are “at their best” and most useful economically. To do this, the authors investigate property rights and regulation in various contexts, including the banking industry, the intellectual property system in biotechnology, the venture capital business, post-Enron securities regulatory changes, and patent law reform. The

authors conclude by emphasizing the need to understand how both market and government actors will react in the face of various possible legal regimes and to develop policies flexible enough to adjust to the inevitable unexpected consequences of regulatory change.

The last three Articles in the symposium examine different aspects of the legal regime in China as it is changing to accommodate rapid economic growth and to attract foreign investment. These papers are typical examples of NIE research about law and economic growth in developing countries. Sonja Opper and Sylvia Schwaag-Serger, in “Institutional Analysis of Legal Change: The Case of Corporate Governance in China,” examine the legal reforms in China’s formal corporate governance system and note that they fail in many ways to accomplish the goal of protecting shareholders. This leads the authors to conclude that informal norms and enforcement characteristics of a society are just as important as formal law to effecting legal change. Given the little research that exists on how formal rules and informal norms combine to shape the performance of organizations and economies, Opper and Schwaag-Serger suggest that transition economies provide opportunities for the useful study of this interrelationship.

David Gerber’s Article, “Economics, Law & Institutions: The Shaping of Chinese Competition Law,” examines the factors that are influencing the content of a competition (antitrust) law being promulgated in China and that will influence implementation of the law. Gerber groups the factors into three sets: the domestic incentive structure, the cognitive limitations in the knowledge of foreign laws and their enforcement, and the foreign pressures intended to push China into certain actions. The author suggests that this approach will aid the analysis of any situation in which a local law is or may be influenced by foreign legal developments, especially in the context of globalization. Consequently, even though Gerber’s essay is an examination of legal developments in China, it establishes a methodology that has much broader application.

Chenglin Liu anchors the symposium with his Article “The Chinese Takings Law from a Comparative Perspective,” in which he investigates the tension between private property rights and public development goals. Liu traces the history of urban home ownership in China since 1949 and then describes the massive demolitions that began in the 1990s to facilitate urban economic development. After

comparing the Chinese eminent domain law with similar laws in the United States and Singapore, the author returns to a conclusion reached by earlier authors in this symposium: what matters is not the written law, but the law as enforced by the government. With the current Chinese government embracing a new ideology of “GDPism,” economic growth takes precedence over the rights of property owners.