Introduction

CLAUDE MENARD and MARY M. SHIRLEY

1. What is New Institutional Economics?

New institutional economics (NIE) studies institutions and how institutions interact with organizational arrangements. Institutions are the written and unwritten rules, norms and constraints that humans devise to reduce uncertainty and control their environment. These include (i) written rules and agreements that govern contractual relations and corporate governance, (ii) constitutions, laws and rules that govern politics, government, finance, and society more broadly, and (iii) unwritten codes of conduct, norms of behavior, and beliefs. Organizational arrangements are the different modes of governance that agents implement to support production and exchange. These include (i) markets, firms, and the various combinations of forms that economic actors develop to facilitate transactions and (ii) contractual agreements that provide a framework for organizing activities, as well as (iii) the behavioral traits that underlie the arrangements chosen. In studying institutions and their interaction with specific arrangements, new institutionalists have become increasingly concerned with mental models and other aspects of cognition that determine how humans interpret reality, which in turn shape the institutional environment they build (North 1990, p. 3–6; Williamson 2000).

New institutional economics abandons the standard neoclassical assumptions that individuals have perfect information and unbounded rationality and that transactions are costless and instantaneous. NIE assumes instead that individuals have incomplete information and limited mental capacity and because of this they face uncertainty about unforeseen events and outcomes and incur transaction costs to acquire information. To reduce risk and transaction costs humans create institutions, writing and enforcing constitutions, laws, contracts and regulations—so-called formal institutions—and structuring and inculcating norms of conduct, beliefs and habits of thought and behavior—or informal institutions. They develop modes of organization embedded in these settings that provide different incentives that vary in their capacity to motivate agents. For new institutionalists the performance of a market economy depends upon the formal and informal institutions and modes of organization that facilitate private transactions and cooperative behavior. NIE focuses on how such institutions

C. Ménard and M. M. Shirley (eds.), Handbook of New Institutional Economics, 1–18.

emerge, operate, and evolve, how they shape the different arrangements that support production and exchange, as well as how these arrangements act in turn to change the rules of the game.

Because NIE considers choices to be embedded in institutions, it has a much broader reach than neoclassical economics, which has been largely concerned with prices and outcomes. But unlike old institutional economics, NIE does not abandon neoclassical economic theory. While new institutionalists reject the neoclassical assumption of perfect information and instrumental rationality, they accept orthodox assumptions of scarcity and competition. Both Arrow and Williamson have attributed the rising influence of NIE to its acceptance of the successful core of neoclassical economics. As Kenneth Arrow observed, unlike the older institutionalist school, New Institutional Economics does "... not consist of giving new answers to the traditional questions of economics—resource allocation and the degree of utilization. Rather it consists of answering new questions, why economic institutions emerged the way they did and not otherwise ... " (1987, p. 734).

NIE tries to answer questions that neoclassical economics does not address and this has given NIE a distinct identity and a strong following. As North has pointed out (North 2004, forthcoming) neoclassical economics was not created to explain the process of economic change, much less political or social change. Institutionalists in contrast aim to understand change by understanding human incentives and intentions and the beliefs, norms and rules that they create in pursuit of their goals (see North 2004, forthcoming).

Answering new questions requires institutionalists to devise new methodologies. Elinor Ostrom points out that unlike much of social science institutional analysis cannot simply hold constant other institutions because "the impact on incentives and behavior of one type of rule is not independent of other rules" (Ostrom, chapter 30). There are numerous examples of these interaction effects throughout this Handbook. For instance, the section on state institutions illustrates how electoral procedures, political party norms and constitutional laws and structures interact with one another to shape the incentives of politicians and voters and, ultimately, to influence policy decisions and organizational choices.

NIE's breadth and innovation have fostered a multi-disciplinary approach. Institutional analysts adapt useful concepts and methodology from political science, sociology, law, anthropology, cognitive science, evolutionary biology, and any other discipline that sheds light on the rules, norms and beliefs that govern human interactions in the process of production and exchange. A number of the authors in this Handbook are not economists, but all are social scientists who share an interest in the scientific analysis of institutions.

2. Why a Handbook on New Institutional Economics?

New institutional economics (NIE) has grown rapidly over the last three decades. Since the term was first coined by Oliver Williamson in 1975 (1975) the subject