Staff Paper

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The answer to the question, "Is there any theory in institutional economics?" depends on what you expect of theory and where institutional economics starts and stops. Theory performs many roles and only welfare economics and an example of prediction and explanation can be discussed here (Samuels 1994).

Welfare Economics

If you demand deterministic conclusions about changes in aggregate welfare, then institutional economics will disappoint. John R. Commons did not have a welfare economics. For example, he did a lot of work on labor unions but did not try to prove that they were/or not efficient, increased total product, or whatever. He was content to explain their origin and growth and whose interests they served.

His concept of "reasonable value" was not something to be discovered, but to be worked out in private and public governance. He observed that different people had conflicting interests and thus to speak of aggregate welfare required a moral judgment among the conflicting parties to guide their compromises and achievement of order and peace. Commons had an up-front value judgment which drove his search for institutions benefiting the laboring class. If you believe that failure to assume the scientific high priest role of pronouncing on the desirability of one institution over another emasculates economics and cheapens our coin, then institutionalists have no theory.

Prediction and Explanation

Institutional economics, on the other hand, does have theory directed to prediction of the substantive impacts of institutional alternatives on different groups. A good theory should identify key instrumental variables and the relationships among them to predict and understand. Institutional economics can be applied to both individual and collective decision making, though its specialty is collective choice.

Individual Choice

The theory of advantage has been worked out in great detail. Institutional economics does not have or desire another theory of profit maximization. The effects of equating marginal cost and revenue is the same in both theories. But institutional economics being a behavioral science is interested in how individuals form subjective perceptions of marginal cost and revenue and particularly how institutions affect those perceptions under uncertainty.

Let me give just one example of individual choice. The theory of advantage tells us that sunk costs should be ignored. But simple observation tells us that people frequently do not ignore fixed costs. Behavioral economics suggests that people try to avoid regret and embarrassment. To research these matters means that we will have to talk to people to learn what cues they respond to. If you have an aversion to this and prefer what Herbert Simon calls "armchair economics," you will not like institutional theory. I know you can't fully trust what people say, but it is the only game in town if analysts are not to substitute their perception for that of the actual actors. There is new theory that shows that it may be rational to consider sunk costs where there is risk and imperfect contingency markets. It remains to be seen which theory will better explain behavior.

Collective Action

But institutional economics is much more than a better theory of individual attempts at profit maximization even if improved by including variables with respect to interacting individuals affecting each other's perceptions. Its main agenda is collective action. Smith's famous invisible hand celebrates the assertion that people need have no concern for each other and need not make any conscious collective decisions. The best aggregate result will emerge from individual isolated choices (well, most of the time). However, this is not an accurate picture of contemporary economics represented by Mancur Olson who asks when will individuals contribute to the provision of high exclusion cost goods. Olson even uses the example of contributions to agricultural lobbying as a case study.

But while Olson is an institutionalist in subject matter, he does not stray far from narrow rationalist assumptions. This "homogeneous individual globule of desire" (to use Veblen's derisive words) calculates how to get the most for the least. In cases where individuals know they can use any amount of the product that might exist regardless of their contribution to its cost of production, know that their individual contribution would not make a difference anyway, and are members of a large group where their share of benefit is smaller than the cost of providing any amount of the good, he predicts that people will not willingly contribute to the cost of providing these goods and little or no such goods will exist. The group will remain latent even though we can imagine that total benefit to all members is larger than the cost. Collective action will not occur. This is a powerful model that does explain a lot. It explains the fact that there are more well financed organizations of manufacturers than of consumers. If you are satisfied with this level of analysis, again you are not in the market for institutional theory.

Where does Olson's theory leave us? Does it give an extension specialist any basis for being helpful to such groups? Or do we just smugly say, if you are a member of a large group your cause is hopeless. If we dare look around, we can observe that in fact some people do contribute to the provision of high exclusion cost goods even when all of the above conditions hold. Environmentalists contribute to environmental lobbies and funds to save endangered species. Dare I note that gun enthusiasts contributed recently to the National Rifle Association? Even farmers have been noted to contribute voluntarily to such organizations as the National Soybean Association. Olson's variables leave him with only two bits of advice. One, try to sell some low exclusion cost good on the side (tie-in sales) and use the profits to provide the high exclusion cost good. He points to the American Farm Bureau as a case in point. They sell insurance and other inputs and require dues in the organization to get it. Never mind the question of why the buyer in a competitive market will pay extra to buy insurance from Farm Bureau. On the environmental side, he might point to the fact that the Sierra Club sells calendars, but this does not seem to explain why people pay dues since you can buy the calendar without being a member.

The second bit of advice derived from the narrow rational collective choice model is to establish a super-ordinate authority to make the contribution involuntary. We see many examples in agriculture such as commodity check-offs. The government establishes a requirement that a certain amount is collected on each commodity sale and made available to some organization which provides the high exclusion cost goods such as promotion of demand for a generic agricultural product. Never mind that this advice begs the question of how do you get the government to pass such legislation in the first place. Wouldn't you need a collective action to lobby for the legislation?

Perhaps the interesting thing about commodity check-offs is that most of them allow the farmer to request return of the money deducted at time of sale. Here Olson's theory does not explain the majority action which does not ask for the money. Surely there are a lot of people who do not ask for their money back whose return would exceed the transaction costs.

Cognition and Learning

So while there is utility in the advice deduced from the narrow rationalist model, it seems woefully limited and incomplete. Can the model be saved by positing preferences for community and collective action? Not unless we can empirically determine when these preferences are present. What can an institutional theorist add by giving attention to cognition and learning? Take for example the analysis of Albert Hirschman. One of the features of institutional theory is to include a role for learning. People's preference maps are not fixed for all time. People learn who they can trust to not be opportunistic free riders. People learn standards of behavior and form self images that they try to live up to. So empirically, Hirshman observes that any experience at collective action, even when unsuccessful, increases the probability of subsequent collective action (e.g. contributing time and money to causes). When we ask people why they contributed, they reply that they care about others in the group and that they would not feel right about themselves if they were to ride free (Dawes) .

This perspective and evidence suggest some additional advice that an extension agent might offer to latent groups. Take advantage of leaders willing to bear the costs of organization just because they think it is the right thing to do. Try to create some experiences in group action in perhaps quite innocent and apparently unrelated contexts. I remember a former colleague who returned from India and responded to my question of what he had done by saying, "I started some Rotary Clubs." I thought he had lost it, but now see the theory and empirical observation behind his program. If you are one of the leaders, try to take advantage of events which provide some emotional response in potential contributors. This is clearly what the National Rifle Association did when ex-President Bush canceled his membership, and it is what lots of farm and resource groups exploit. Many practitioners understand this and I suspect that many extension workers utilize this even if they have no systematic theory to organize their experience.

I can hear the econometricians saying that is all well and good, but we like large sample econometric tests and you are offering only anecdotes. Unfortunately, we don't have a lot of data on the learning experiences of those who don't ask for return of their commodity check-off dollars. Institutionalists have nothing against econometrics, but we don't have a lot of data on the relative success of extension agents who use some of the extended advisories noted above vs. those who rely on the Olsonian advice. My hypothesis, however, is that any agent who relies exclusively on saying that large groups are hopeless without tie-in sales and taxes has been eliminated by the ultimate market test and is no longer in business.

Nobel Prize Institutionalists

It is fine to mark 50 years since the passing of John R. Commons. There is much to learn from him, including an appreciation for many types of theory. But what about contemporary institutionalists? Where does one look for theory? We give the Nobel Prize to those who have made outstanding contributions to our discipline. So one could do a lot worse than to ask what institutionalists have won the prize. My list is as follows: Gunnar Myrdal, Herbert Simon, Maurice Allais, Kenneth Arrow, and Douglass North. Some others who I predict will win the prize (or should) are Albert Hirschmann, Robert Heilbronner, Amartya Sen, Joseph Stiglitz, and Warren Samuels. [2] And of course in agricultural economics there are people like Daniel Bromley, Larry Libby, Richard Norgaard, and Gene Wunderlich in resource economics, and James Shaffer, Willard Mueller, and Ron Cotterill in marketing, and many in this room. There is not time to detail the contribution to institutional theory by each of these.

I will choose Kenneth Arrow to illustrate where institutional theory can be found since his theories address welfare economics and include cognition and learning . He is widely respected for his general equilibrium theory. But we institutionalists admire his path breaking work in the economics of information and such fundamental conceptual formulations of mutual interdependence where people both shape institutions and are shaped by them. He insists that rationality is not a property of the individual alone. "Perceptions of others and, in particular, of their rationality become part of one's own rationality (S387)." We also admire his general impossibility theorem which if taken seriously guts a lot of the welfare theory that led us astray in spite of Commons' earlier lessons to the contrary.

I might have chosen Nobelist Robert M. Solow who recently observed that the marginal product of labor is not invariant with respect to wages. This theme has been taken up by some feminist economists because of its implications for gender wage and opportunity differentials (Ferber; Jennings). Just when we thought that one of the defining principles of economics was independence of supply and demand, Solow (and also Stiglitz) insist on a more evolutionary, path dependent, behavioral, and institutional set of variables and relationships. Sorry, I couldn't resist citing just one more institutionalist dimension in mainstream theorists. I could choose theories from any of the other Nobelists above to suggest models which utilize variables of cognition and learning as well as other institutional variables which can't be noted here.

Agricultural economists can be justly proud of their contributions to mainstream theory such as Ezekial's work in demand theory. We have been obsessed for many years now with the idea of being as theoretically well grounded as are general economists. But, it is my judgment that many agricultural economists are now behind the exploding curve of institutional theory. There are a lot more institutional economics articles in the American Economic Review and the Journal of Economic Literature than in the AJAE.[3] I expect that we shall be catching up soon. The assumptions of fixed preferences, rational choice, and equilibrium are at the core of neoclassical economics. These are increasingly selectively used and replaced by the best theorists in our business.

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Endnotes:

1. Paper presented at a symposium, A Half Century Memorial to John R. Commons: Contributions of Institutional Concepts to Contemporary Agricultural Economics, American Agricultural Economics Association annual meeting, August 8, 1995, Indianapolis. Thanks go to Warren Samuels, James Shaffer, Lindon Robison, and Michael Carter.

2. Ronald Coase might be included in the list of Nobelists who practice institutional economics. His claim to be included follows from his Nobel acceptance speech where he made it clear that the point of his work is to insist that institutions matter since transaction costs are ubiquitous (rather than the Bastardized Coase Rule which states that property rights do not matter if markets are allowed). Why he allowed this bastardized version to exemplify his work so long would itself be a good topic for institutional analysis (see Medema and Samuels).

3. Some examples of recent institutional articles in the AER include: Ayres and Siegelman, Borjas, Ferber, and McCloskey and Klamer.