Chapter 2
New Institutional Economics and Economic Development:
A Smithian Critique

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ABSTRACT

In recent years, the concept of "institutions" has become central in scientific and political discourse. This reflects an increasing awareness of the role of institutions in the functioning of economies and in economic development more generally. Many of the catchphrases articulated within new institutional economics such as "institutions," "organisations," "transaction costs," "property rights," and "contracts" have become very common in orthodox economics discourse. This development is intellectually stimulating and interesting because it raises some fundamental issues with regard to the role and functioning of institutions. These concepts are seated on Smith's idea of the "harmony of interests." However, Smith sees power as dominant in the formation of institutional framework. This chapter aims to provide a Smithian critique based on the notion of power, arguing that the formation of institutions and institutional framework cannot be considered apart from the intrinsic power relations which are vested in society.

INTRODUCTION

In recent years the concept of "institutions" has become central in scientific and political discourse. This reflects an increasing awareness of the role of institutions in the functioning of (market and non-market) economies and in economic development more generally. For instance, the International Monetary Fund (IMF) puts great emphasis on reforming corporate governance and financial institutions as a response to

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economic crises. Accordingly, the poor economic performance of developing countries is conventionally explained in terms of the lack of a clearly defined and secure institutional framework. This is because, according to the mainstream idea, in the absence of an appropriate guarantee for the fruits of their sacrifices, people would not take the initiative to invest, whatever the policies regarding macroeconomic balances, trade and industrial regulations may be. This emphasis on institutions raises the need for a scientific theorisation of the issues involved, while also bringing to the fore some fundamental questions with regard to the origin and nature of different institutions, and to their desirability or otherwise, thus also raising the question of institutional change. Within economics, new institutional economics, the trend in economics that deals with the origin and evolution of (mainly capitalist) institutions within the mainstream tradition, has become well established. Many of the catchphrases articulated within new institutional economics such as “institutions”, “organisations”, “transaction costs”, “property rights” and “contracts”, have become very common in orthodox economics discourse. This development is intellectually stimulating and interesting because it raises some fundamental issues with regard to the role and functioning of institutions.

In November 2009, Oliver Williamson was awarded the Nobel prize in economics.1 This follows the award to Ronald Coase in 1991 and to Douglass North in 1993. Between them, Coase, Williamson and North, are the founders and most important representatives of new institutional economics. This third Nobel prize is symbolic of the continuing vitality of the new institutionalist research program within, and around the borders of, mainstream economics as well as the occasional idiosyncrasy of the Nobel awards.

New institutional economics conceives society as a network of voluntary contractual relations and analyses the economy in particular in terms of contractual agreements among atomised individuals. In particular, the emergence and evolution of institutions and institutional framework are elucidated on the grounds of the deliberate and voluntary personal decisions taken by individuals. Hence, institutional formation is explained in terms of voluntary contractual agreements based on the transaction costs minimisation principle. Subsequently, economic development and growth become an issue of individual’s action to choose these institutions that generates efficiency. Within New institutional Economics, economic development and growth depend on the choice made by individuals to implement the favourable institutional framework. Based on the neoclassical microfoundations, new institutionalists construct and erect their macro-institutional theory for analysing economic development and growth. However, in such a context where social institutions emerge as a result of a transaction cost minimisation process at the individual level, the question of power and conflict simply does not arise.

Under these theoretical givens, the underlying assumption is that society embodies a fundamental level of “harmony of interests” that always eventually leads to beneficial “mutual agreements” between the contracted parties leading to new institutional formations. Although the idea of “harmony of interests” can be traced back to Smith’s (1986 [1776]) work, and implies that if people understand their own individual interests correctly they will see that they are not incompatible with those of others, however Smith, himself, explicitly posits the notion of power as the main explanandum in the formation of institutions and institutional framework. Our aim is to provide a Smithian critique based on the notion of power, arguing that the formation of institutions and institutional framework cannot be considered apart from the intrinsic power relations which are vested in society. Thus, the issues of power and power relations must become sine qua non conditions for a comprehensive analysis of institutional arrangements.

Thus, in what follows we firstly attempt to offer a definitional context of the notions, concepts and ideas found in New Institutional Economics. Then, we pinpoint the neoclassical micro foundations whereas new institutionalists are mostly rested on. Based on these neoclassical micro foundations,

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