A NEW INSTITUTIONAL ECONOMIC APPROACH- A FORM OF GOVERNANCE

Dr. Mousumi Das, *Lecturer in Economics, Rama Devi University, Bhubaneswar*

Received: 17/01/2018	Edited: 24/01/2018	Accepted: 07/02/2018

Abstract: *"Governance" is different from 'government' which primarily refers to rules and actions that are produced, sustained and regulated. Good governance is developed by 'institutions' and its standard is compared with governing bodies of Europe and USA. The "New Institutional Economic Approach" is an inter-disciplinary study combining economics with other disciplines like law which attempts to explain what should be the characteristics of efficient institutions which are mainly established to reduce 'uncertainty' in human exchange and thereby reduce 'transaction costs'. In a sense-the concept of 'economics of perfect governance' may now be seen as development of 'institutions' which require establishment of secure contract laws, property rights etc. as enforcement mechanism for its service.*

Keywords: *Governance, Institutions, New Institutional Economic Approach.*

An Introduction:-What is Governance?

Governance refers to all "processes of governing, whether undertaken by a government, market or network, whether over a family, tribe, formal or informal organization and whether through laws, norms, power or language". (Bever, 2013)

In short, "governance" differs from the word "government", which is a concrete activity that reproduces a formal and informal organization.

If the organization is a formal one, "government" is what the relevant "governing body" does .If the organization is an informal one (such as a market) it is primarily the rules and norms that guide the relevant activity. Whether it is a geo-political activity (state) or corporate entity (business), a social political entity (chiefdom, tribe, family etc.), its governance is the rules and actions that are produced, sustained and regulated.

What is "Good Governance"?

The term "good governance" is again a relative term often used in international literature to describe how public institutions conduct public affairs and public resources. In other words, it is a model to compare "ineffective economies and political bodies with viable economies and political bodies." (2) In this sense generally the governments and governing bodies of Europe and America set the standards by which we compare other states institutions while talking of good governance.

What promotes /conducts "Good Governance'?

It is the institutions. The notion of the institutions embodies several elements like formal and informal rules of behaviour, ways and means of enforcing these rules, procedures for mediation of conflicts, sanctions in case of breach of rules etc. institutions are more or less developed depending on how well they perform or operate.

What is then "new institutional economic approach"?

The New Institutional Economic Approach (NIE) is an approach explaining the relevance of institutions in our economy. This is an interdisciplinary enterprise combining economics, law, organization theory, political science, sociology and anthropology to understand the institutions of social, political and commercial life. It borrows literally from various social science disciplines, but its primary language is economics and Williamson and Elinor Ostrom bagged Nobel prize in economics in 2009 for their contribution in this field. Its goal is to explain what institutions are, how they arise, what purposes they serve, how they change and how if at all they should be reformed.

How the concept of "institutions" was incorporated into "economics"?

In theoretical economics, we consider the "perfect competition" as the ideal model where there are a large no. of buyers and sellers, perfect knowledge, single price etc. Let us drop the assumption of "perfect knowledge' assuming "imperfection" arising out of "incomplete information" and 'limited mental capacity" that humans possess to transact between them, given that human knowledge is partly 'culturally derived' and partly derived by "individual perception".

This incomplete information and limited mental capacity results in "transaction cost" because information is costly and asymmetrically held by parties to exchange (North, 1992). To reduce this transaction cost, we establish "institutions" which are nothing but formal/informal rules and enforcement mechanisms to reduce uncertainty in human exchange.

What are institutions?

Institutions are "rules of the game" or more precisely human derived constraints which may be formal rules (statutes, laws, legal restrictions) or informal constraints (conventions, norms of behaviour, self-imposed codes of conduct) or enforcement mechanisms.

Formal rules change overnight but informal rules change gradually. Even if we adopt the formal rules of a developed country, our performance may be quite different given that enforcement characteristics and informal norms are different. It is due to that reason that western market economies has not been always successful when imitated without change.

No more the static concept of "allocative efficiency" is important now, but today's economy is a flexible institutional arrangement that adjusts itself to technological and demographic changes as well as has the capacity to absorb shocks to the system. In the short run paying attention to only allocative efficiency may yield economic growth but long run growth entails development of the rules of the law and protection of civil and political freedoms which we can define as "adaptive efficiency".

Two terms require attention in this connection:-

A) Institutional Environment

B) Institutional Arrangement

What is Institutional Environment?

In the words of North (1990, P-3), "Institutional constraints include both what individuals are prohibited from doing and sometimes under what conditions some individuals are permitted to undertake certain activities. They are perfectly analogous to the rules of the game in a competitive team sport."

The only difference between sport and these guidelines are that very often they arise because of "individual choices rather than through deliberate collective action."(Hayek, 1967, 1973).

In a sense therefore economics of perfect governance is now seen as a development of institutions which require establishment of secure contract laws, property rights etc.

What is Institutional arrangement?

Institutional arrangement refers to the different government structures that are various systems of enforcement mechanisms. At one extreme lie the market structure providing opportunity for profit maximisation and revealing information through prices and in the other extreme lies the hierarchies with completely with centralized system with weaker incentives to profit but incurring additional bureaucratic costs. Between these two extremes lies varieties of "hybrid modes" having elements of market and hierarchies in different degrees.

What is institutional economic approach (transaction cost economics)?

This approach holds that even the simplest of transaction requires some kind of mechanism (governance structure) to protect the transacting parties from various hazards associated with exchange. However, the appropriate governance structure depends on the characteristics of the exchange. (Williamson, 1985)

Now, with two extreme governance structures (i.e market and hierarchies) there are 'n' dimensional spaces of possible governance structures? How to choose an efficient governance structure?

Every government structure has its own enforcement mechanism. There are two extreme enforcement mechanisms imaginable.

1) Rules that can be enforced by a third party (COURT ORDERINGS);
2) Rules that are self-enforcing (i.e Private ordering):

Which enforcement mechanism is to be chosen depends on the type of monitoring and verifying cost, that is bureaucratic or transaction cost. But one thing is certain without any kind of enforcement mechanism either directly or indirectly none of the institutions can last long or be stable. So, enforcement mechanism is a vital property of institutions.

What is the problem then?

The problem is that some transactions yield harmful effects.

Case-1: When transaction cost is zero and property rights are well-defined the problem of harmful effect will be directly solved by contracting procedures. (Coase Theorem).

Case-2: In the real world when transaction cost is not zero, they are influenced by a no of determinants;-

A) Behavioural attributes of actors (Bounded rationality, Opportunism);-
B) Attributes of transaction (Uncertainties, frequency, asset specificity);-
C) Types of governance structure (market, hybrid or hierarchy);-
D) Institutional environment (Property and contract law):-

It is because of the bounded rationality and opportunistic behaviour that corruption arises. It is because of specific attributes of a transaction like uncertainties, frequency and asset specificity that transactions command higher costs.

Similarly, the difference in governance structures. In one extreme we have the capitalist form where the harmful effect is settled through bargaining or at best they rely on courts to settle the disputes through compensation. At the other extreme we have the hierarchical governance structure where the potential harmful transaction is controlled through administrative controls beforehand. But a hybrid mode of governance is characterized by ex- ante co-ordination (a long term contract) to mediate the conflict and ex post uses instruments with administrative controls.

Always the government structures are not infallible, since it operates without checks and competitions and hence not always necessary that it increases the efficiency of the system! Economists need to patiently study how markets, firms and government handle the problem of harmful effects i.e. where the boundary lines of all parties are to be drawn! Ronald Coase in his "the problem of social cost" depicts about a candle making factory in the town and writes, "the world must have factories, smelters, oil refineries, noisy machines and blasting at the expense of some inconvenience to those in the vicinity and the plaintiff may be required to accept some not unreasonable discomfort for the general good."

But how to define "unreasonable comfort"? It is where the concept of property right arises.

Ambiguous property rights can lead to disastrous growth patterns:

David Li (1996) in his "A theory of ambiguous property rights in transition economy: The case of Chinese non-farm sector" develops a model of how ambiguous property rights of the Chinese non-farm sector had led to enormous growth. Out of the total non-state sectors China has only 13% of purely private enterprises and collective enterprises 74% (Jefferson and Rawski, 1994).

Collective enterprises means joint control of firms with local governments. By choosing this form of organization the entrepreneurs intentionally invite the government to share the control rights hence the division of control becomes blurred. Chinese 'market environment" can be characterized as "grey market" where transactions can be blocked due to government regulation but a government agency or bureaucrat can work around to make the transaction possible. In the presence of "grey market" the entrepreneur would like to involve government as an ambiguous owner, so that when the state of nature is black (difficult), the farm can easily get help from the bureaucrats to make it white.

However, intervention of a third party (government) is not costless. If the benefit derived is better protection of the enterprise, the cost is diversion of resources by the local bureaucrats to their own pockets. Now it is for the entrepreneur to balance the cost and benefits in choosing the optimal property rights arrangements.

Such an institutional arrangements with ambiguous property rights, may in the short run may bring tremendous growth but in the long run, be subjected to conflict, tensions and social unrest in the country. Therefore "role of government interventions" may not be always healthy.

India's government structure is not absolutely but to a large extent hierarchical, property rights of the state and the central government being rather secure. Sometimes these ambiguous rights of the Government and highly secured nature has helped in generating a no. of scams and scrupulous individuals like Vijay Mallya, Nirav Modi etc But the difference between autocratic countries like China and democratic countries like India are that there are enough checks and balances, sometimes so high and rigid that it may block a Government and may lead it lose its power in the next election. In other words the transaction cost may be too high for the protection of the well-defined property rights.

Thus, establishment of well-defined property rights and thereby suitable institutions are now the demand of matured and informed democracy.

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