

## The market for the “old” and the “new” institutional economics

*O mercado na perspectiva da “velha”  
e da “nova” economia institucional*

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RESUMO: Este artigo concebe o mercado como uma instituição, contrastando duas abordagens teóricas: os institucionalistas com viés analítico evolucionário, cuja base teórica vem do “velho/original” institucionalismo, e a Nova Economia Institucional, com uma abordagem de viés analítico contratual, vinculada ao *mainstream economics*. Ambas as abordagens têm dado relevantes contribuições ao considerarem a importância das instituições para o desempenho econômico. Destaca-se um dos limites da abordagem da Nova Economia Institucional, cuja análise do funcionamento dos mercados está centrada na lógica da busca de economia dos custos de transação, como determinante do desempenho econômico. Por sua vez, o institucionalismo evolucionário compreende o mercado em um escopo mais amplo, em que as economias de custos explicam apenas parcialmente o desempenho econômico, não se constituindo, necessariamente, em um fator determinante. PALAVRAS-CHAVE: Economia institucional; mercado; custos de transação; institucionalismo evolucionário.

ABSTRACT: This paper conceives of the market as an institution, and contrasts two theoretical approaches: Institutionalism, with an evolutionary and analytical bias, whose theoretical basis comes from “Old/Original” Institutionalism, and New Institutional Economics, with an analytical, contractual approach, linked to *mainstream economics*. Both approaches have given relevant contributions, as they consider the importance of institutions for economic performance. The limits of New Institutional Economics are particularly relevant, whose analysis of the operation of markets is centered on the logic of transaction cost economics as a determinant of economic performance. Evolutionary Institutionalism, in turn, sees the

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market within a broader scope, in which cost economies only partially explains economic performance, but it is not necessarily seen as a determining factor.

KEYWORDS: Institutional economics; market; transaction costs; evolutionary institutionalism.

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“A principal theme of institutional economics has been that the economy is more than the market.” (Samuels, 1995, p. 580)

## INTRODUCTION

The perspective that capitalist economy must be understood through and beyond market mechanisms has long been absent in both theoretical and applied analyses of the dominant trend in Economics. The way in which the logic of efficiency of free-market mechanisms has been incorporated into neoclassical economic theory throughout the twentieth century has caused the market to become but a locus of exchanges, which would lead to the solution for the most relevant economic problems, including those related to growth.

In a capitalist economy, the conception of the market as a “dependent variable” would eventually demonstrate the lack of perception of neoclassical economic theory, as it does not accept that the market comes into being out of a historical process; it is not a matter of pre-established data (a set of fully known and accepted information), in face of which economic agents maximize their utility and production functions in accordance to a price system regulated by supply-and-demand laws. One of the consequences of this abstraction is that markets are conceived as efficient, which implies taking institutions for granted, exerting little or no influence over the behavior of agents and economic performance. On the other hand, conceiving the market<sup>1</sup> as a fundamental capitalist economic institution subverts the neoclassical logic of efficient markets; at the same time, it allows to broaden the scope of analysis of the influence of such markets over economic performance, as well as the influence of other market-related institutions, both based on and through these markets.

Therefore, it may be inferred that understanding capitalism as synonymous with market economy implies that the latter cannot be treated as an efficient mechanism, both in productive and distributive senses. On the other hand, the importance of the market in a historical context becomes clearer when it is considered as

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<sup>1</sup> This paper conceptually characterizes the word market (in the singular form) as an institution, e.g., the State or an enterprise. When the word is used in a more specific sense, it will be made explicit by means of qualifications, for example, financial market. When used in the plural form, it will refer to the “multiple markets” which are part of capitalist economics, according to Zysman (1994).

an institution in which economic agents have been expressed within markets in varying ways in time and space. Importantly, it should be noted that markets have been formed prior to capitalism itself.

The emergence and development of capitalism in various countries have shown that the market is an intrinsic part of the process of social formation. It does not represent only the locus of buyers and sellers, or, in a stricter sense which is typical of neoclassical economic theory, the locus where supply and demand issues are handled in accordance with a price system wherein the agents are fully rational.

The increasing number of studies in Economics based on institutional approaches since the late twentieth century demonstrates the need to consider the importance of institutions in economic development. This reinforces the relevance of understanding how the market functions as a fundamental capitalist institution: there are markets without capitalism, but there is no capitalism without markets. However, it does not mean that there is a consensus over the operation and importance of markets for economic performance. This is largely due to the lack of consensus, among the different institutionalist trends, on the meaning and importance of institutions for economic performance.

Institutionalism, which originates from the “Old” (*Original*) Institutionalism (Stanfield, 1999), assumes the existence of various markets (Zysman, 1994), with distinct and various modes of operation. It challenges the assumption of (perfect or imperfect) markets operating in accordance with a price system, therefore fully integrated (hence the idea of *market economy*, in the singular form). Also, it differs from the proposition that imperfections would be an exception to the rule (market failures), as viewed by mainstream economics<sup>2</sup> and by its institutional trend, New Institutional Economics (NIE).

In this sense, for the heirs to “Original” Institutionalism, markets are not efficient institutions, whose failures are corrigible; their imperfections, far from being sporadic and/or exceptional manifestations, have been constant, and they form a regular pattern in capitalist economy throughout history. There are no markets, whether perfect or imperfect, which allow the type of generalization that has been elaborated since neoclassical economic theory became predominant. Consequently, in this paper we hypothesize that markets exist and operate while conditioned by a complex process of interaction among individuals and institutions<sup>3</sup>. Therefore, as Zysman (1994) points out, capitalism is made of multiple markets, which may or may not be integrated, whose imperfections are inherent in their operation, because they are created by man, hence there is no tendency towards an equilibrium in their internal operations, whether they are short-term or long-term ones.

In fact, even though the market has been considered by economic theory as an

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<sup>2</sup> For further information on the meanings of neoclassical economic theory and *mainstream economics* adopted in this paper, see Dequesch (2007).

<sup>3</sup> A fuller account of the relation between individuals and institutions may be found in Hodgson (2007, 2010, 2011), based on a conception of *reconstitutive downward causation (effect)*.

institution, this does not imply that it should be uniformly viewed as such, as regards both its historical formation and its function in the performance of various different economies. This is evident, for example, when the concept of market adopted by NIE is contrasted with the concepts adopted by Institutional trends with an analytical and evolutionary bias. Thus, this is the main theme of this paper: to understand how the market is structured, and the functions ascribed to it by the aforementioned institutionalist trends. As stressed by North (2006), if economic performance is a function of institutions and their evolution, when the market is conceived as an institution, its evolution definitely has to be analyzed.

A better understanding of the theoretical perspective of how the market functions in an institutionalist analysis requires to address the behavior of economic agents – that is, the agent/institution interactions. In this sense, it is crucial to understand market not as an “abstract entity”, as an efficient allocator, but rather as an institution simultaneously affecting and being affected by the behavior of economic agents and other institutions. It should be noted that not all authors cited in this paper share this perspective, as will be shown in the next section, even though the market is understood as a fundamental institution for economic performance by Institutionalism as a whole.

Given the breadth of what is understood as Institutionalism, the analysis made in this paper is centered around some NIE<sup>4</sup> authors and in Evolutionary Institutionalism<sup>5</sup> (here viewed as “Old” Institutionalism, as it is based on fundamental theoretical elements found especially in Veblen). The second section points to their differences and possible complementarity as regards the meaning of market as an institution. The third section presents a synthesis of the main aspects approached in the second section, in a critical perspective to NIE’s view on the market. The last section presents the final remarks.

## INSTITUTIONAL ECONOMICS: MARKETS AND ECONOMIC PERFORMANCE

The idea that economy is more than the market (Samuels, 1995; Stanfield, 1999) shows that Institutionalism has sought to elaborate a “new” theory to explain the function of market within capitalism, or to restore the idea that capitalism should not simplistically be understood as market economy. In this sense, the mar-

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<sup>4</sup> Ronald Coase, Oliver Williamson and Douglass North are here viewed as the NIE “hardcore”.

<sup>5</sup> This phrase is here adopted in the sense proposed by Hodgson (1993). Besides Thorstein Veblen, John Commons e Wesley Mitchell compose the nucleus of United States “Old Institutionalism”; however, this paper tackles only the evolutionary perspective, the fundamental theoretical aspects of which are to be found particularly in Veblen. The term *evolutionary* originates from Charles Darwin’s theory of the evolution of species, and is markedly present in Veblen (1898, 1914, 1992), as a fundamental part of his theoretical background for the analysis of economic institutions. For further information on the use of Darwinian theory in institutionalist analysis, see Hodgson (1992, 2002, 2005).

ket began to be seen as a fundamental institution, as opposed to a “natural given”; based on this premise, economic agents would make the best possible decisions in face of current conditions (or restrictions).

Therefore, capitalism is not to be seen as market economy any longer, in which the solution for economic problems would lie exclusively in the price system, that is, based on the idea that “the greater the number of markets, the merrier”. However, it should be noted that, as institutionalist approaches resurface, some differences persist in terms of the meaning of market and its function in economic performance, as we will see below, as well as the understanding of the behavior of economic agents in face of the market. It is also worth of notice the fact that the importance of institutions, as a fundamental aspect to economic analysis, is new to mainstream economics only.

This section approaches Institutionalism in Economics from two analytical perspectives, which are based on different starting points; on the one hand, Evolutionary Institutionalism, influenced by Veblen’s “evolutionary” perspective, and, on the other hand, NIE, centered around transaction costs, originally developed by Coase, and disseminated as theory especially by Williamson.

### Evolutionary Institutionalism and the market

When Veblen (1898) wondered why Economics was not an evolutionary science, he emphasized the need to understand the transformation process instead of focusing on the method of approach. Above all, he stressed the need to understand the results of human actions. When he devoted to understanding the nature of human actions, Veblen believed it was crucial to understand the process of change (evolution). Veblen’s “method” is evolutionary, because its central goal is to understand transformative action; there is not a method *a priori*, partly because finding the results of analysis become less important than identifying and clarifying how the transformative process takes place – an idea which is, to a large extent, contained in the concept of *cumulative causation*. Veblen (1914, 1992) sees evolution, from the viewpoint of human action, as a transformative process, in which habits of thought are molded by instinct and institutions.

Material life (an idea linked to Karl Marx) puts instincts to the test, sometimes modifying but sometimes maintaining habits of thought which condition the behavior of individuals in their interaction environment. Therefore, institutions simultaneously result from and directly influence the transformative process by imposing restrictions to transformation at times – for example, when there occurs institutional inertia, or what Veblen coined as *conservatism*.

Veblen (1898) criticizes the main theoretic trends in Economics, especially the dominant trend (classical/neoclassical), because he believes that they dismiss aspects that are of paramount importance for understanding human behavior, especially

the construction of “habits of thought”, which are a sort of fundamental “genetic load” for understanding economics as an evolutionary science<sup>6</sup>.

In this sense, Veblen (1898) argues that an evolutionary theory should take into account both individuals and their (institutional) environment. “Habits of thought” are molded in an evolutionary process, because they combine instincts (individual nature) with conditioning elements which go beyond the individual as a rational agent. Material life conditions, in their turn, simultaneously result from and condition habits of thought, in so far as individuals are inserted in a social milieu which is productively organized to provide for subsistence, etc.

Broadly speaking, it may be said that Veblen’s approach is multidisciplinary; it acknowledges the importance of institutions while considering material life conditions as fundamental, as a result of the process of “cumulative causation”, considered as transformative action. Institutions mold the behavior of individuals while they are transformed (or maintained) by these individuals as well, as a way to guarantee current life conditions. As noted by Veblen (1992), institutions result from a selective and adaptive process which molds the prevailing or dominant types, their actions and modes of thought; they are, at the same time, special life methods and human relation methods, and they are efficient selection factors.

According to Evolutionary Institutionalism, under Veblen’s influence, institutions are made of a set of habits, practices, routines, forms of organization, etc., adopted in a given context, which affect the behavior of individuals; when individuals interact within institutions, they eventually produce a route of permanent transformation, in a process of “cumulative causation”.

Dugger (1990) understands that the meaning of Institutionalism, as well as the concepts and examples of institutions (currency, language, measuring systems, norms, etc.), adopted by Veblen’s followers, clearly show that this approach needs not only a holistic view but also an understanding of the nature of individual actions. Therefore, with this institutionalist trend in mind, one clearly needs to go beyond the logic of the economics-based approach to the meaning and the functions of capitalist institutions, especially as far as the market is concerned.

According to Atkinson and Oleson (1996, p. 711): “Since institutions are not the product of spontaneous generation, but are the accumulation of history, we must examine their evolution and understanding the fact that they are in process”. It should be noted that transformations or changes are not necessarily for the better; on the contrary, “imbecile institutions” (Veblen, 1992) may be as important and long-lasting (inertia) as the others.

For Veblen (1992), the search for the highest possible amount of profit on the part of businesspeople subordinates productive (industrial) interests to commercial

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<sup>6</sup> It should be remembered that neoclassical views economic agents as fully rational, and therefore as maximizers of their choices, and their behavior is independent on current institutions. Besides, according to Veblen (1898, p. 389), in the neoclassical tradition, “[t]he hedonistic conception of man is that of a lightning calculator of pleasures and pains [...]”.

ones. In this sense, the market is not characterized as a locus determinant of productive and distributive efficiency; on the contrary, it would represent the very capitalist antagonism (“predatory instinct” x “constructive instinct”), in which the desire for the highest possible amount of profit would, to some extent, “sabotage” productive efficiency. Idleness in productive structure, as well as working class unemployment, are proof that the market does not produce efficiency, nor is efficiency its *raison d’être*. Thus, the subordination of production to commerce is not a result of the sum of individualized attitudes, but that of a business “routine”. It becomes evident that conflict plays an important role in the formation/maintenance of institutions, because they are complex social formations which involve habits, norms, values, etc., and are constructed with a basis on individual relations under institutional influence.

Therefore, the market may be neither conceived as a “natural given”, nor as a result of the simple aggregation of a set of agents, as if the macro level resulted from the sum of its (micro) parts (Hodgson, 1994, 1998). Understanding the market under Evolutionary Institutionalism implies decentralizing it both as an “abstract entity” and as a “natural given”. Based on this premise, the agents would make the best possible (optimal) decisions. It is an institution, and as such it results from a historical process of interaction with individuals, but it does not necessarily have to be efficient. It is in this sense that the market must be understood as a fundamental institution for the capitalist system to function, from the perspective of Evolutionary Institutionalism.

Individual choice in face of the market is conditioned by a set of factors, from the meaning of information to the process of education and socialization, which results in the development of cognitive capacity, i.e., their behavior of individuals is socially conditioned and, in this sense, their choices depend of a set of factors which go beyond their capacity for isolated action (Hodgson, 2002). As noted by Samuels (1995, p. 571), Evolutionary Institutionalism rejects the idea that the market is a mechanism which guides and organizes economy, that is, “[...] markets are organized by and give effect to the institution which form them”.

Forms of economic control and organization encompass a much broader and more complex system than the market. When criticizing methodological individualism (a fundamental assumption for NIE), Samuels (1995) states that individuals are interdependent; their behavior is not determined by exogenous but rather by cultural factors; in this sense, market operation should be analyzed from collective behavior, unlike the idea of isolated decision-makers whose purpose is to maximize their usefulness, based on the current price system.

Dugger (1988, p. 13) complements this idea by stating that the market cannot be conceived as the agent which leads to equilibrium, because “[e]ven if the economy were an equilibrium rather than a process, it would never have time to get to equilibrium because a new ‘disturbance’ force would strike it before equilibrium were reached”. Thus, State intervention “is essential to turn the economic process toward the public purpose”. In brief, Dugger understands that the free market is not an efficient social and economic mechanism, because markets are not efficient

as a rule, either. Moreover, for Dugger, the State should not be limited to the correction of possible market failures; instead, it should seek public interest as a major goal, especially in the face of current economic institutions, which often favor private interests to the detriment of the common good.

There are formal and informal institutions that condition processes of exchange through the market. In this sense, far from being an impartial locus, market structure and conventions reveal their influence over the behavior of individuals, as well as their importance in business actions during their operation. The business company itself may be explained as a powerful institution, but not for its efficiency in production and transaction cost reduction (Hodgson, 1994)<sup>7</sup>.

Samuels (1995) explains that the market is one of the institutions which account for the operation of economy, which is permeated by so many others. It is the existence of institutions and especially of power structures, but not the free market, which is the uttermost determinant in the allocation of factors and, consequently, in the distribution of wealth. Thus, one needs to understand the multiplicity of markets (Zysman, 1994), as well as their forms of articulation with the remaining institutions, for the purpose of analysis of different economies.

The paths of economic growth of each particular country illustrate different modes and functions of markets throughout the history of capitalism. In this sense, in order to understand the performance of economies, one needs to understand the institutional process of formation of their respective markets. For Zysman (1994, p. 244), “[m]arkets do not exist or operate apart from the rules and institutions that establish them and that structure how buying, selling and the very organization of production take place”.

In Dugger’s view (1988, p. 8), the combination of power and status in the capitalist society is fundamental to explain market behavior, especially as regards the role of the state in the creation and maintenance of rules (laws, etc.). “The market is a result of class conflict, tradition, legislation, and adjudication. The market is not a cause, but an effect.” Therefore, markets must be conceived as a result of a historical process, i.e., they are in constant transformation (or inertia), following the example of the other institutions.

There are agents, such as governments and companies, which usually exert a strong influence over the operation of markets, and, therefore, over economy as a whole. Therefore, it is understood that markets are organized and institutionalized exchanges (Hodgson, 1994, p. 175).

According to Dugger (1988, p. 16), for “radical institutionalism” (based on Veblen) “[i]nstitutional analysis implies that we need to replace the market, not adjust it”. It is not about the existence of failures in the market; in a capitalist system, the market is controlled by “predatory values” to the detriment of “con-

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<sup>7</sup> Dugger highlights that NIE, following the example of neoclassical economic theory, confuses existence with efficiency, ignoring the reasons why inefficient companies are long-lasting. We shall return to this in the next section.



structive values”, as pointed by Veblen (1992). According to Dugger, the market does not promote well-being; planning and intervention need to exist, i.e., institutions are developed which enable better operation of markets, in the productive and, especially, in the distributive sense.

In this sense, it is important to highlight that market failures, externalities, imperfect competition and information asymmetry are not “residual” aspects of market operation, but constitutive parts of its evolution, i.e., there is no tendency towards short or long-term equilibrium, as advocated by the neoclassical economic theory. These are inherent aspects to the existence of markets, to the extent that they are conditioned both by current institutional arrangements and by economic policies adopted throughout history.

In synthesis, for Evolutionary Institutionalism with an analytic bias, the market results from a historical process, therefore, it is an institution built over time, in permanent transformation; like other institutions, it was always subject to positive or negative influences in economic performance. Its failures and imperfections are inherent in its existence, causing agents to adapt to them, while influencing them at the same time, thus producing various possible results over economic activity. “A greater amount of markets” does not mean more productive or distributive efficiency, and it is not synonymous with better economic performance.

### **New Institutional Economics: Transaction, Market and Economic Performance**

NIE has been gaining prominence regarding the development and application of transaction cost theory (TCT), whose analytical perspective is explicit especially in the work of Williamson, originating in the ideas of Coase (1937). Coase (1992) acknowledges Williamson’s importance for the dissemination and consolidation of TCT, as a fundamental reference to performance analysis, especially of companies and their mode of operation in face of the market.

Coase (1992) believes that it is necessary to advance from the neoclassical economic theory – which was limited to microeconomic analysis of how market conditions affected production by means of price mechanisms – towards the understanding that there were conditioning factors between production and market, reflected in transactions, which would eventually determine the behavior of economic agents, especially companies (Coase, 1937)<sup>8</sup>.

NIE’s interpretations of market operation as a capitalist institution depend on the understanding that there are operational costs, which involve both production and transaction, i.e., economic agents deem the institutional environment relevant for the purpose of decision-making. In this sense, before approaching the perspec-

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<sup>8</sup> The answer to Coase’s (1992) question about the reason why companies exist is based on the very concept of transaction costs. Companies exist because there are costs in the utilization of market (transaction costs), and the function of their form of operation is to reduce them.

tive of decision-making agents, it is fundamental to understand what institutions mean to NIE.

According to North (1991), institutions are restrictions, which create or set limits for the behavior of agents (individuals or organizations), reducing uncertainty in relations, serving as reference for human interaction; they are the “rules of the game”, whereas individuals and organizations are “players”. Also according to North (1990), the analysis of factors should always take into account the fact that institutional influence may give rise both to a favorable environment for cooperation and to social and distributive conflicts. North’s conclusions are based on the analytical perspective of “game theory”, which exerts strong influence over NIE as a whole.

For North (1994, pp. 359 and 360), “[i]nstitutions form the incentive structure of a society, and the political and economic institutions, in consequence, are the underlying determinants of economic performance”. However, it should be noted that “[i]nstitutions are not necessarily or even usually created to be socially efficient”. North, however, admits that existence is not synonymous with institutional efficiency, as he takes into account the dichotomy conflict-cooperation and its possible results.

Williamson (2000) understands that the institutional perspective may be understood from four analytical and seemingly interconnected levels, in some sort of hierarchy of change. His “model” shows the need of theorization allied to the measurement of economic variables, especially as regards the time required for changes to take place. This analytical perspective conditions NIE’s approach, while highlighting the importance of the neoclassical theory but, above all, highlighting TCT<sup>9</sup>.

Level one (L1) in Williamson’s “model” (2000) tackles norms, customs, tradition, whose institutions are informal (spontaneous) and change very slowly over time (it takes over a century, according to the author). Level two (L2) refers to “institutional environment”, in which informal rules are added to formal ones<sup>10</sup>, and the process of institutional change has a shorter time span compared with L1 (between a decade and a century); it is here that the importance of organizations (government, justice, bureaucracy, etc.) and power struggles may be felt, which require the use of formal rules to “keep order in place”, which, for Williamson (2000), essentially means reducing uncertainty by raising economic efficiency and ensuring property rights. In level three (L3), the time span for changes to set in would be of about ten years; here is where one finds “governance” (by means of organizations), whose central goal is to guarantee that contracts are fulfilled, in

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<sup>9</sup> Williamson’s (2000) “model” follows the logic of a “Lakatosian progressive research program”, and therefore there is no breach with neoclassical theory, which explains the fact that NIE, by conscious choice of its exponents, is part of mainstream economics, becoming its institutionalist trend.

<sup>10</sup> It is important to highlight that changes in formal rules do not necessarily imply changes in informal rules, given that the latter are based on embedded behavioral aspects, the process of change of which is usually very slow, as it is economic path-dependent (North, 1993).

addition to “keeping order in place”, with a view to transaction cost reduction; it implies organizational strategies, whose main goal is to minimize uncertainties and imperfections associated with market “use”. Therefore, their aim is to reduce transaction costs. Level four (L4) is related to neoclassical economy, in which resource allocation is aimed at maximization; this is where changes occur frequently<sup>11</sup>.

From Williamson’s perspective, NIE has been seeking to develop its analysis of the performance of different economies by centering its approach on the concept of transaction costs (L3). In brief, this concept expresses the idea that market operation generates costs, therefore, it is not enough to analyze production to understand why companies exist and how they are organized. Transactions are fundamental, especially when the market is used.

The understanding of the concept of transaction costs becomes fundamental, given that saving, in the sense of reducing costs, is viewed by NIE as the central problem in economic organization, both regarding intra and inter-company costs. Therefore, transactions affect the way companies are organized by exerting influence over their productive behavior (Williamson, 1985). It should be noted that, in capitalism, the use of the market by productive organization is inevitable, as pointed by Coase (1937); otherwise, the company would be able to solve all its productive problems internally (full vertical integration); nonetheless, transaction costs would not be completely eliminated.

Therefore, under NIE’s perspective, the occurrence of transaction costs makes it imperative that institutions be taken into account in economic analysis, given that incomplete and imperfect markets generate transaction costs, stemming to some extent from information asymmetry, which, in turn, generates higher opportunism (Williamson, 1993) on the part of agents, thus raising market-operational costs. Agent’s reputations have an important role in the process, but the need to fulfill contracts is the basis of relations in TCT (North, 2006). Therefore, admitting the existence and relevance of transaction costs is a central fact for the understanding that institutions matter, as they condition the actions of individuals and companies, based on the (not always efficient) use of market mechanisms.

The analysis of transaction costs has some specificities which need to be observed. It is a micro-analytical approach, which focuses on more specific issues than the traditional microeconomic (neoclassical) approach, although it takes into account the importance of the neoclassical economic theory for the analysis of the company’s short-term productive structure (Williamson’s L4, 2000). It develops a comparative institutional analysis; institutional efficiency is measured in terms of the results achieved, considering the business company as an organizational structure, unlike conventional (neoclassical) analysis, whose scope is limited to produc-

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<sup>11</sup> According to Williamson (2000), NIE’s analysis focuses on L2 and L3. However, North makes frequent use of L1. In other aspects, which are not approached here, especially regarding the role of the State in economy, North also diverges from Williamson’s contractual take; nevertheless, both remain as fundamental exponents of NIE.

tion costs. Moreover, it emphasizes the importance of contractual relations between agents; after they enter into a contract, therefore, it becomes fundamental to see an agent's behavior (and reputation) as relevant, as occurs in "game theory". In summary, it is about economy, right and organizations, and history is seen as necessary to convey an image of dynamic change, even though historical analyses, as proposed by Williamson (2000), are limited to specific time spans, which is shown by the emphasis on L2 and L3.

According to Williamson (1989), if, on the one hand, the market is more efficient in the production of incentives and in the restriction to bureaucratic hindrances, as well as in gains of scale and scope, on the other hand, internal organization is prominent in terms of control instruments. Still, reciprocity is comprised of one of the modes of mutual gain, in which the buyer-seller relation defines more than a buy-and-sell transaction; it establishes a contractual relation involving transaction costs, thus entailing a fundamental decision for the company: to use (*buy*) or not to use (*make*) the market to implement its productive strategy. It is for these reasons that the company is understood by NIE as a "governance structure" (Williamson, 1993), centered around organizational management, whose behavior is differentiated in face of the market. It is not, therefore, about the typically neoclassical "representative firm", but about the ability to react in accordance with current institutional arrangements, given that saving would be a fundamental strategy for different companies, i.e., in the case of TCT, it is the strategy that has "representative" character, with efficiency evaluation being dependent on the results achieved; the most efficient company is the one which is able to operate with lower transaction costs. Therefore, it is the one which adopts "better strategies". In this sense, it is understood that transactional considerations are decisive to determine the organizational form to be adopted. The market has, thus, a decisive role in the company's path, even if decisions are made internally. The central issue is to decide when to resort to the market, while considering production costs but, above all, transaction costs.

One of the fundamental aspects to understanding the existence of transaction costs consists in the notion of opportunism, used by Williamson (1989). It is understood as a mode of behavior subject to institutionally-imposed restrictions, even if it seems to be a maximizing behavior on the part of agents, in the sense that they would seek the highest possible gains, given the current conditions. Under this approach, market failures are not the product of uncertainty, but the result of opportunism and limited rationality (Simon, 1987), which, in turn, are also responsible for the existence of transaction costs. The more complete the contract, the more efficient the exchanges would be, the less relevant the market failures, and the lower the transaction costs. Therefore, market failures, associated with incomplete and asymmetrical information, externalities and imperfect markets, are "residual" aspects in the operation of markets, which affect transaction costs and lead a company to decide on the level of internalization of productive processes, i.e., the way to establish its "governance structure".

The combination of limited rationality with a search for self-interest (opportunism) in imperfect and informationally asymmetric markets reinforces the role

of institutions in relations between agents, in order to guarantee the fulfillment of contracts, that is, to seek higher governance efficiency (Williamson, 1998), with a view to lower transaction costs.

As we may see, Williamson's approach (1985, 1989, 1995) is centered around contractual aspects, which serve as basis for his account on the operation of economy, based on the consideration of transaction costs and governance strategies. Despite its multidisciplinary character, Williamson's approach (2000) is centered around decision-making in a previously established context. It is not about the interaction between individuals and institutions, but rather about agents' options to reduce costs in transactions, in search of productive efficiency; such efficiency, in turn, is given (L4), hence it is assumed that, when opting for the market, agents (maximizers) incur in transaction costs that favor organizations, thus reducing total costs. For this reason, saving (by reducing transaction costs) is the "representative" strategic behavior of agents/players (individuals and organizations), given the current "rules of the game".

In synthesis, Williamson's "model" (2000), whose analysis is centered around TCT, shows that NIE does not emphasize the formation paths of markets as institutions arising from historical conditions; it highlights contractual aspects and micro-organizational strategies as determinants of the behavior of economic agents in face of the market, and it infers economic performance therein.

## WHY NIE'S CONCEPTION OF MARKET IS NOT EVOLUTIONARY

If the concept of institution, in the generic sense, has a complementary character for both NIE and Evolutionary Institutionalism, the same may not easily apply to market in particular; its mode of organization and importance for economic activity have different meanings for these two trends of thought. It should be noted that North's (2005) interpretation, especially for the influence of the State over the market, is very similar to the evolutionary approach inherited from "Old" Institutionalism<sup>12</sup>, which detaches itself from NIE's general perspective, which is linked to the idea of knowledge of how agents operate in face of restrictions created by institutions, which affect the operation of markets. In this case, institutions are treated by NIE as "rules of the game", unlike the idea that institutions "mold and are molded by individual habits", which is central to Evolutionary Institutionalism.

For NIE, as a rule, the market is a given whereby agents make their decisions, hence demonstrating a lingering influence of neoclassical economic theory, which is still considered to be valid by Williamson (2000). Limited rationality and op-

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<sup>12</sup>The works of Douglass North brought considerable advance in abating the excessive emphasis given to formal rules in institutionalist analysis. By taking beliefs, mental models and learning process into account, North acknowledges that higher consistency in institutionalist analysis needs more studies on the nature of individuals. On this topic, we suggest North (2005) and North et al. (2004).

portunism, as they define transaction costs, eventually establish the extent to which the market may be considered productively and distributively effective; it is a “dependent variable”, essentially similar to the way in which it is conceived by neoclassical economic theory; the fundamental difference is that institutions began to be considered relevant for decision-making, a fundamental aspect to explain the existence of transaction costs. The understanding that there should be a maximizing behavior on the part of agents attests this assertion<sup>13</sup>. The option by the market, for NIE, suggests that it is an efficient institution, to the extent to which it is the best “saving” alternative, by means of total cost reduction (transaction and production), despite its failures (imperfections), which would be corrigible, as they are “residual”. Frequency of interaction among “players”, based on current rules, would contribute to minimizing imperfections.

Corroborating the above, Hodgson (1993; 1998) states that some NIE authors still adopt the neoclassical conception of the market as a “natural given”, an aggregate of individuals and companies, which at best has failures; still, as a fundamental institution, it would usually lead to higher efficiency and to long-term economic growth.

Considering Williamson’s statement (apud Hodgson, 1998, p. 182) that “in the beginning there were markets”, it is presumed that agents take a stance in face of the “market institution”, thus making decisions according to their limited rationality and opportunism, albeit with restrictions and uncertainty. The market would be the space for exercising the “rules of the game”; it is not set as a space of interaction between individuals and the market itself, which would have contributed through time to the formation of multiple markets, as noted by Zysman (1994). The very term *market*, in the singular, reveals the understanding by NIE that there is a “great market”, which comprises and, to some extent, manages all others<sup>14</sup>; that is, the idea that capitalism is synonymous with market economy is still valid, equilibrium being the rule and failures the exception, hence “residual”.

The need for prediction, present in the works of Coase and especially of Williamson (which were discussed here), is strongly influenced by Neoclassical Economics, and eventually conditions NIE’s theoretical formulation, as regards the importance of the choice for the market as a way to evidence agents’ maximizing behavior. Furthermore, for Williamson (1989, 1995), transformations are necessarily positive, in so far as agents, in a given institutional environment, can choose lower total costs, aiming at more efficient institutions, which positively influence the performance of economies. The strategy is “representative”.

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<sup>13</sup> For Williamson (1995, p. 23), “maximization is justified not because it is realistic but because it is tractable”. This may be why Williamson (2000) still considers neoclassical theory as valid in his model. According to Mathews (1986, p. 906), another NIE exponent, “[t]he objective of the economic agent is not to minimize transaction costs as such, but to minimize the sum of transaction costs and production costs”.

<sup>14</sup> In this aspect, there is a clear influence of the logic of “general equilibrium models” in NIE’s approach.

Admitting the maximization hypothesis implies assuming that the option for the market demonstrates that the market is more efficient, as it contributes to total cost reduction. However, it is only possible to admit market efficiency based on the assumption that there is one pre-established order, in which conflict, usually generated by the exercise of power (political and economic), is not relevant enough so as to affect the institutional environment, that is, it is liable to control by a current “governance structure”.

Furthermore, Chang (2010) also highlights that “global standard institutions”, disseminated in Anglo-Saxon countries, would be aimed at maximization, based on the free market, with strong protection to property rights, which would agree with NIE’s thought; it is a simplistic, linear and static conception, inappropriate to the understanding of how institutions evolve and modify through time, as Chang points out.

This shows that, despite NIE’s effort to demonstrate that mainstream economics no longer sees economy as stationary, in the sense that it takes the transformation process into account, the lingering reductionist perspective (methodological individualism) reveals that the causation of the process of change has a linear tendency, i.e., there is a high degree of predictability in behavior of individuals, who are major agents of change. Market is thus seen as a locus of action, rather than an institution per se, that is, the perspective of individual action is essentially reactive; as individuals are considered “game pieces” in the process of change, the results of their choices, when positive, are assumed to show current institutional efficiency (the rules of the game).

As noted by Villeval (1995), one of the functions of institutions according to NIE is to adjust market operation, so as to minimize transaction costs, thus ensuring higher economic system efficiency. This is why economic performance would be conditioned to “good” market operation. It is in this sense that the State would be in charge of correcting its failures, that is, act as system regulator, and price mechanisms would remain fundamental within the system. Under this perspective, the State would have a “residual” role in economic development. Cost reduction strategies would be effectively “representative” of economic agents’ behavior, and the State would be responsible for ensuring fundamental guarantees (by establishing and adhering to “rules”) for the realization of transactions.

For Coase (1992), for example, former East European Communist countries are an example that a market economy cannot be developed without “proper” institutions. However, Coase does not specify which institutions those would be (he only implies that they would be the ones in developed capitalist countries); furthermore, he does not define market itself as an institution which influences and is influenced by the other institutions, that is, as something that cannot be “transplanted” (Chang, 2007), as it is built on the singularity of national histories.

NIE deems it necessary to consider State influence over economy as an integrating party on transaction costs, whereas Evolutionary Institutionalism sees the State as a fundamental agent of transformation, with the transformation of markets included.



Williamson (1993)<sup>15</sup> conceives government as an instrument that should guarantee property rights; however, he does not identify the use of the State in order to establish property and control over economic activity, especially regarding market operation.

North (1999, p. 23) also notes the importance of State in economy; the influence of the former would directly affect the market, i.e., the role of the State “[...] is to structure the game so you force the players to compete by price and quality rather than compete in other ways”. The regulating State makes use of inherent enforcement mechanisms to correct failures and imperfections of the market, but it does not adopt development strategies, viewed as transformative actions (also for markets) by Evolutionary Institutionalism. As the theoretical and analytical approach of NIE is centered around L2 and L3 (Williamson, 2000), it analyzes institutional environment and governance institutions based on a given context; however, it largely neglects L1 (embedded), which corresponds to a series of historical processes, such as the formation of markets and property rights, especially concerning the use of State mechanisms – which, for NIE, would act only as an “arbitrator” in economic relations.

According to North (1990), despite the difficulty in accessing or measuring or institutions, they exist and are human constructions. They are fundamental to the operation of society. Inability to measure an institution should not be confused with the impossibility to evaluate its social impact. Something similar happens to power.

Contrary to Williamson’s interpretation (1995) that power is a diffused and vaguely defined concept, markets are seen as institutions which display power structures in a capitalist society, despite the occasional prevalence of competition. A broader understanding of State influence over economic activity throughout history, even when reduced, shows that power is the central concept for the analysis of the capitalist system, especially regarding markets, with capital markets included.

For Evolutionary Institutionalism (since “Old Institutionalism”), conflict is the central analytical element when it comes to politics – neither rationality, however limited it may be, nor the quest for efficiency, as expressed in the predominant view of NIE. Governance structures may be understood, to a large extent, as resulting from the exercise of economic power.

Institutionalism, “heir to Old Institutionalism”, sees the market as an institution fitting into an evolutionary perspective, whereas NIE (with partial exception of North) sees it as an institution for which agents would adopt an essentially reactive attitude, based on a “representative” saving strategy.

In summary, the effort to know how markets develop is more important than the effort to understand how markets operate – the original neoclassical approach,

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<sup>15</sup> According to Williamson, NIE’s approach is established with basis on two complementary elements: property rights (including contracts, norms, etc.) and “governance” mechanisms, necessary so the former be followed. Therefore, as previously mentioned, the role of the State is “residual”.



which exerts strong influence over NIE's theoretical background. Only then can one analyze their importance for economic performance.

## FINAL REMARKS

Institutionalist approaches to economy have contributed to a larger approximation between Economics and other applied social sciences, such as History, Politics, Sociology, Law and Management. To some extent, this represents a “return to the past”, as regards the analytical perspective of the role of the most relevant economic institutions. In other words, “political economy” was very much in vogue in the late nineteenth century, before it was dismissed by mainstream economics.

The inclusion of institutions into economic analysis represents a considerable advancement for the understanding of various economic phenomena, despite lack of consensus over their meaning, dimensions and importance for the development of economies.

In this sense, incorporating institutions to the economic analytical background has caused a number of interpretations, within and without the dominant trend, about their meaning, and, consequently, about the importance of understanding institutions as historical constructions, or as “rules of the game”. This has brought a broader and more complex vision of the operation of economies, as well as enlightened their singular paths.

In this sense, this paper has highlighted some similarities, but especially some differences between “Old” and “New” Institutionalism, as regards the meaning and importance of institutions, especially as far as markets are concerned. The main goal of the present paper was to seek an understanding of the logic of existence of markets, so as to identify how they affect and are affected by economic performance, in a theoretical and analytical perspective.

By centering its analytical approach on transaction costs, NIE evaluates the economy performance by the efficiency of their markets, that is, if the “rules of the game” are not working well, this is a sign that markets have imperfections that must be corrected, so as to reestablish their functions, or enable players to use the current “rules” more efficiently.

Although proponents of Evolutionary Institutionalism, since “Old Institutionalism”, do not form a “trend of thought”, they understand that markets, by following the example of other capitalist institutions, have singular paths, as they interact with individuals and institutions, sometimes also under direct influence from the State; the very establishment of rules, as well as adherence to them, results from this interaction; that is, there are no previous rules that define higher probability of market efficiency; it is even questioned whether any market is efficient whatsoever. Transaction costs also result from this permanent transformation process. Therefore, as the epigraph highlights, capitalist economy is more than the market; these are not synonymous words, as NIE suggests, according to the neoclassical tradition.

In brief, it is understood that multiplicity and multifunctionality of markets in capitalism, in which national paths behave in various singular ways, leads to a more appropriate understanding of the meaning and importance of institutions for economic performance. In this sense, old institutional economy has given a historical contribution, which approximates Economics to other applied social sciences, and which may represent one important institutional change, at least from the analytical viewpoint of Economics.

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