The new institutional economics of markets

Based on

E. G. Furubotn and R. Richter (2010)

(Available at http://www.uni-saarland.de/fak1/fr12/richter/publ/IntroductionFinal5.pdf)

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Understanding of markets in traditional economics

- Traditional economics
  - dealt with the determination of equilibrium (market) prices
    - based on demand and supply of goods and services in the market
    - but what is **market**?
      - place where buyers and sellers meet, exchange commodities and establish prices
  - consistent with *neoclassical model* of a capitalist economy
  - based on many unrealistic assumptions

Assumptions of neoclassical school

- perfectly rational traders
- full information
- well-defined and stable preferences
- homogeneous goods and services
- self-interested actors
- zero transaction costs (transaction hurdles)
  - information search, inspection, negotiation and bargaining, decision making and cost of making wrong decisions, monitoring and enforcement
- “Pareto efficient” exchange equilibrium

- *Pareto efficiency*: welfare of one actor couldn’t be improved without reducing welfare of someone else

Traditional/neoclassical model cont…

- As long as transaction is costless, future is perfectly predicted, and individuals are perfectly rational, **no need for a specific market organization**
  - it doesn’t matter whether individuals trade frequently or only occasionally
  - it doesn’t' matter whether trade takes place between specific individuals or through a trading network of complex relationships
  - institutions assumed to be exogenous and non-evolving

Conditions for neoclassical markets to function

- Well functioning constitutional rules
  - well-defined private property rights
    - all goods and services be privately owned and secured
  - contractual obligations
    - well functioning contractual laws and legal system that help enforce signed contracts and control wrong doings
  - obligations from tortuous acts
    - avoiding intentional and strategic acts that affect a trading partner
- Supreme authority guarantying the rules

❖ Thus, who to trade with, nature of product, time and place of trade, time and mode of payment, etc. doesn't matter

New Institutional Economics (NIE)

- Real markets involve frictions,
  - positive transaction costs
  - heterogeneous goods and services
  - information and power asymmetries between market actors
  - imperfect foresight
  - boundedly rational economic actors:
    - intention to make rational decisions but substantively not so because of limited information and/or limited cognitive capacity
    - hence room for opportunism (self-interest seeking with guile)
- Differences among actors with respect to their abilities, initial resource positions, information endowments, risk preferences, and a great variety of constraints in markets that limit options

Markets as Institutions

- Two interrelated institutional choice problems
  1. choosing a specific market organization within which to undertake trade
     - problem of coordinating individual plans among many traders
  2. selecting, within that market organization, a specific contract to utilize in conducting exchange with a trading partner
     - problem of coordinating individual plans between two parties
- Hence, importance of transaction costs and institutional arrangements in determining market outcomes
- But, no systematic and complete theory in NIE yet

Transaction costs and institutional arrangements

- Central objective of NIE:
  - identifying implications of given institutional arrangements for economic behavior
    - real life markets are imperfect
    - lowering transaction costs as the common goal

- Important to understand characteristics and organization of specific markets
- Transaction costs incurred both *ex-ante* and *ex-post*, in addition to those during the period of making exchange decision

1. Pre-contractual: Search and Inspection

- A milk processing company may have to
  - look for fresh milk producing dairy farms
  - search for information on the list of prices
  - identify potential buyers of processed dairy products
  - check the qualities of milk from different producers
  - check their sustainable supply potential and integrity
  - identify the legal status of potential trading partners, etc.

2. Contracting: agreeing on prices and other stipulations

- fresh milk seller and a processing company may have to negotiate and reach agreement on the terms:
  - the price for a specific quality of milk
  - the duration to stay in the trade relationship
  - time and frequency of delivery
  - mode and frequency of payment
  - level of compensation in case either party fails to obey the terms of the agreement, etc.

3. Post-contractual: execution, control, and enforcement

- a milk processing firm may need to employ a lawyer to take legal action against a milk supplier if
  - the milk is adulterated or not fresh
  - of lower quality than the agreed upon one
  - supply declines or abruptly stops, etc.
- the milk producer may also incur transaction costs if the milk processer
  - suddenly stops accepting milk or
  - fails to make payments as per the agreement, etc.

- Contracts in NIE world don't fully define future performances and don't incorporate all risks
  - traders rather enter into adaptable cooperative exchange relationships

Institutional arrangements: definition

- Institutional arrangement or governance structure
  - the ways in which transactions are organized
  - the mechanisms of delegation, distribution, or sharing of power related to management, decision-making and implementation authority
- Type of governance structure in place
  - defines the processes and traditions that determine how power is exercised, how traders behave and make decisions, etc.
  - is determined by the level of transaction costs and attributes of transactions

Types of institutional arrangements

1. Spot markets

- automatic forms; no customer relationships and identities required for entering into a transaction
- *examples*: market for processed milk, daily open market for vegetables, Safaricom SIM card from shops in Nairobi

2. Hierarchies: also called firms or vertical integration

- unified forms: transactions take place under the same administrative system
- *examples*: when a milk processing firm starts producing fresh milk by itself or fully integrates with another dairy farm and make joint decisions

Types of inst. arrangements cont…

3. Hybrids or relational governance

- intermediate forms whose attributes lie in between those of markets and hierarchies
- traders have some level of freedom of action and some level of control from contracting partners

examples:

- ✓ (milk) cooperatives
- ✓ whole seller-retailer agreements
- ✓ network arrangements
- ✓ strategic alliances
- ✓ partnerships
- ✓ "innovation platforms"

Transaction attributes

Why do marketers choose one or the other type of governance structure?

- **Asset specificity**
  - assets which have no value outside a particular transaction

  example: transaction agreement between XYZ bakery and University of Nairobi for *particular sized and shaped* bread for its student canteen involves specific asset
- **Uncertainity**
  - inability to foresee eventualities
- **Frequency of transactions**

Summary

- Justifications for the use of conventional maximizing models
  - they are good predictors
  - basis for other derivatives of economics
- In many real life situations, such models fail to produce the good results claimed by neoclassical economics
- NIE
  - identified these failures and emphasized the roles played by transaction costs and bounded rationality
  - stressed the need for greater understanding of real–world markets through studying transaction costs in specific market organizations

Summary cont…

- real world economies aren't free of frictions
  - exchange involves transaction costs and bounded rationality that could lead to opportunism
- market is considered not just "supply and demand determines the price"
  - set of rules and regulations, besides the price mechanism
- Institutional issues and transaction costs are important as they affect coordination and shape incentives
- Institutions and relationships are dynamic (evolving)

Implications for VC-IPs in Volta2 project

- Application of NIE to analyze the impacts of VC-IPs on market performance
- IPs as hybrid structures with formal and informal rules and contracts
- Need to understand how VC-IPs in Volta2 project are organized, operate, and interact in the process of attaining local development objectives and institutional innovation

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