# A Multiplicity of Approaches to Institutional Analysis. Applications to the Government and the Arts

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## Abstract

Four types of "economics" relevant for institutional analysis are distinguished: *Standard Neoclassical Economics*; *Socio-Economics* or *Social Economics*; *New Institutional Economics*; and *Psychological Economics* (often misleadingly called *Behavioural Economics*). The paper argues that an *extension* of Neoclassical Economics with elements from other social sciences (including political science, sociology, psychology, law and anthropology) is fruitful to explain institutions because it allows us to maintain the strength of that approach. Social Economics can play an important role helping to overcome the limitations of Neoclassics. However, it should become more concrete, integrate what is useful in Neoclassics, and should seriously engage in empirical research.

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## I. What „Economics“ for Institutional Research?

There are many different types of “economics” today. For the purpose at hand[1] it is useful to distinguish four versions:

- *Standard Neoclassical Economics* which the world over is the dominant paradigm. It assumes a *homo oeconomicus* selfishly and rationally maximizing utility under given exogenous and unchanging preferences with an unlimited calculating facility and no emotions (see Kirchgässner 2008);
- *Socio-Economics* or *Social Economics* whose crucial elements (as described by Davis and Dolfsma 2008) are an emphasis on *social values* (in particular ethics, equity, power, human dignity) and social relationships (in particular embeddedness);
- *New Institutional Economics* represented by agency, transaction costs, and property rights theory; and
- *Psychological Economics* (often called *Behavioural Economics*[2]) which widens the neoclassical *homo oeconomicus* by considering insights gained from psychology (and sometimes sociology).

The present author considers himself a (benevolent) outsider to Social Economics. Actually, he is one of the “New Social Economists” (Davis and Dolfsma 2008:4-5) or, less nicely, “Economic Imperialists” who finds it fruitful to apply (neoclassical) economic thinking to the environment, politics, history, the arts, terrorism and happiness. At the same time he strongly believes that the standard *homo oeconomicus* needs to be improved by considering institutions and psychological and sociological insights.

This paper advances two arguments:

- An *extension* of Neoclassical Economics with elements from other social sciences (including political science, sociology, psychology, law and anthropology) is fruitful to explain institutions because it allows us to maintain the strength of that approach:

[1] The guest editors specifically requested me (and probably other contributors) to analyze the question „Is economics adequate to explain institutions?“ on the background of the *Elgar Companion in Social Economics* (Davis and Dolfsma 2008).

[2] E.g. in Maital, ed. (2007). This is a misnomer, as economics (including Neoclassics) has always dealt with human behaviour, and the term “behavioural” reminds of “behaviouristic” (a la Skinner 1974) which is certainly not what is meant when scholars refer to behavioural economics. See also Simon (1985) for similar misgivings about the unfortunate term.

Neoclassics is based on clear concepts, strives to be as simple as possible, and makes an effort to derive theoretical hypotheses and to test them with empirical data from the field, natural and laboratory experiments. I find the assumption of exogenous and unchanging preferences to be good to discipline one's thinking – as long as one is prepared to deviate from it when needed.

- Social Economics can play an important role helping to overcome the limitations of Neoclassics when dealing with institutions. However, I wish to argue that Social Economics should change in order to be able to fulfil this role: it should become more concrete, integrate what is useful in Neoclassics, and should seriously engage in empirical research.

These arguments make clear that my position differs from Social Economics (as represented by most authors in the *Compendium*) which endeavours to go far beyond what is argued above. In particular, most Social Economists take Neoclassics to be a basically wrong view of the world, therefore want to discard it completely and endeavour to start from a radically "social" position[3].

## II. Explaining Institution

There are many different meanings of what an "institution" is. Not surprisingly, due to their very broad outlook, there are many different understandings among Social Economists (see e.g. Mayhew 2008, Bush 2008, Altman 2008, Hodgson 2008 in the *Compendium*). In standard economics institutions normally refer to the *rules of the game* reflected in specific agency relationships, transaction costs, and property rights. In order to be as concrete as possible (and therewith expose myself to criticism) I choose two quite different institutions in the form of organizations: the government (section III) and art venues (section IV). Due to the strict word limit imposed by the guest editors, it is of course impossible to provide an extensive account of how I think Neoclassical and Social Economics could help us to better understand these particular institutions. I can only sketch what aspects I consider well analyzed by Neoclassics, where the major shortcomings are, and where Social Economics has much to contribute.

## III. Government

[3] In the *Compendium,* writers such as Mayhew 2008, Altman 2008, Carvalho and Rodrigues 2008 or Bardhan and Ray 2008 might be associated with this view.

Public Choice, or the New Political Economy, is firmly grounded in Neoclassics[4]. Most importantly, the assumption that politicians are benevolent individuals is rejected. Instead they are taken to have the same selfish motives as all other individuals. The most important goal of all politicians is to stay in, or to come into, power which in a democracy means to be (re-)elected. The same selfish motives are taken to apply to public officials, in that literature normally called bureaucrats (e.g. Niskanen 1971, Wintrobe 1996). This approach allowed Public Choice scholars to reach original and relevant results. I want to illustrate this claim by discussing Politico-Economic Models and an extension of federalism by the creation of new kinds of governmental units.

***Politico-Economic Models***

Politico-economic models[5] seek to theoretically and empirically capture the interdependence between the economy and the polity for the institution of *representative democracy*. The state of the economy, represented by per capita income, the rate of unemployment and the rate of inflation, systematically affects the popularity of the government as well as re-election. The politicians in power are well aware of this influence and in turn use the policy instruments at their disposal, in particular government expenditures and regulations, to affect the state of the economy. This interaction *produces* regular economic fluctuations within election periods, in most countries four years. This is noteworthy, as traditionally economics scholars assumed that governments want to *reduce* business cycles. Economists rooted in Keynesian thinking took it as evident that once politicians know how to effectively combat business fluctuations, they will indeed do it.

The business cycles produced in *dictatorships* are different. The persons or groups in power are little or not at all constrained by elections; the main danger of being toppled comes from the military and possibly other organized groups whose interests have therefore to be taken into account. Only rarely an uprising of the population is able to remove a dictator – as long as it is not supported by the military. A successful dictator therefore does not need to react much to the grievances of the population but has to make sure that the military keep supporting him. This is best done by a policy making it clear to the military that they run a

[4] This is clearly visible in the authoritative surveys by Mueller 1997, 2003. As always, there are exceptions, such as Olson (1969), and most clearly Hirschman (1970, 1993). Recently, political economists such as Persson and Tabellini (2003) have, if anything, moved the field even more towards strict Neoclassics.

[5] See e.g. the collection of articles in Frey 1997

great and deadly risk if they oppose the dictator. At the same time the dictator must offer them benefits making it attractive for them to keep supporting the dictator.
Politico-economic models have also been applied to the institution of *direct democracy*. In such a democracy (of which Switzerland is a living example) the politicians in power are almost always re-elected – but they nevertheless have little power because the important political issues are decided by referendum. The politicians' main task is to win such referenda by arguing with the population about the merits of a proposition, and also to keep the voters satisfied with the economic conditions.

The sketch of the politico-economic interactions in the three different governmental institutions shows the strength of a neoclassical analysis focused on the effects of incentives provided by different institutional settings. Clear and empirically testable propositions are advanced helping us to understand how institutions function. But Neoclassical Public Choice certainly does not provide a full account of how political institutions work. The personality of politicians (such as their "leadership" quality), the social relationships between them and other decision-makers (such as in an "old boys network", and more generally their embeddedness), cultural differences, and their ethical standards also matter. Social Economics rightly points out that such aspects are crucial to explain how politicians behave, in particular for politicians with a great "aura" such as Gandhi, Kennedy, Thatcher, Mandela or Obama. It may well be argued that such politicians do not enter politics to enjoy power but rather because they want to put their ideas into reality. But it is also clear that even such extraordinary politicians are bound by the need to be elected and re-elected. It would greatly add to our knowledge of political institutions if Social Economists not only stated the importance of such aspects but would also advance theoretical propositions open to empirical tests.

***Reorganizing the State by New Federal Units***

The question to what extent "economics is adequate to explain institutions" can also be discussed with respect to *normative proposals* of how to organize government (rather than the positive analysis as in the case of politico-economic models). An important topic is how centralized and decentralized a state should be. Neoclassical public finance ("Public Economics") has extensively discussed the advantages and disadvantages of decentralization; the arguments need not be repeated here (see e.g. Inman and Rubinfeld 1997). But it has made an important, and often only implicit, assumption, namely that each level of government (i.e.

the central state, the provinces and the communes) have exclusive authority over particular governmental functions.

A new approach[6] proposes quite different federal units having four essential characteristics. The new federal units are called *FOCJ* in accordance to the four constituting elements:

*Functional (F)*, i.e. the new political units extend over areas defined by the tasks to be fulfilled; *Overlapping (O)*, i.e. in line with the many different tasks (functions) there are corresponding governmental units extending over different geographical areas; *Competing (C)*, i.e. individuals and/or communities may choose to which governmental unit they want to belong, and they have political rights to express their preferences directly via initiatives and referenda; *Jurisdictions (J)*, i.e. the units established are governmental, they have enforcement power and can, in particular, levy taxes.

The neoclassical economic theory of federalism analyzes the behaviour of given political units at the different levels of government. It takes in this sense the governmental institutions to be *given*. In contrast, FOCJ *emerge* in response to the '*geography of problems*'. The size of the jurisdictions is adapted to the problems existing and the governmental institutions become *endogenous*.

The four elements of FOCJ are now discussed in some more detail.

*Functions*

A particular public service benefiting people living in a certain geographical area should also be financed by them, i.e. there should be no spill-overs. The various governmental units providing for different functions can cater for regional differences in the populations' preferences or, more precisely, to its demands. To minimize cost, these units have to exploit economies of scale in production. As the latter may strongly differ between functions (e.g., between schools, police, hospitals, power plants and defence), there is an additional reason for uni-functional (or few-functional) governmental units of different sizes, i.e. for *"fiscal equivalence"* (Olson 1969, Oates 1972). That the size of governmental units is endogenous constitutes an essential part of FOCJ.

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[6] Similar ideas can already be found in Montesquieu (1749) and much later in Burnheim (1985). Tullock (1994) pioneered a similar concept. Casella and Frey (1992), Frey and Eichenberger (1999). Vanberg (2000), and Kyriacou (2006) discuss and apply the concept and refer to further literature.

*Overlaps*

FOCJ may overlap in two respects: (a) FOCJ catering to different functions may overlap; (b) two or more FOCJ catering even for the same function may geographically intersect (e.g., a multitude of school FOCJ may exist in the same geographical area). An individual or a political community normally belongs to various FOCJ at the same time. FOCJ need not be physically contiguous, and they need not have a monopoly over a certain area of land. This concept completely differs from archaic nationalism with its fighting over pieces of land. It also breaks with the notion of neoclassical public finance that units at the same level should not overlap.

*Competition*

The heads of FOCJ are induced to conform closely to their members' preferences by two mechanisms: (a) individuals' and communities' can *exit* imitating market competition (Hirschman 1970). Migration is only one means of exit; often, membership in a particular FOCUS (as the singular of FOCJ might be called) can be discontinued without changing one's location. (b) Individuals have *voting* rights establishing political competition.

For FOCJ to establish competition between governments, exit should be as unrestrained as possible. In contrast, entry need not necessarily be free. Jurisdictions and individuals may be asked to pay a price if they want to join a particular FOCUS and benefit from its public goods. The existing members of the particular FOCUS have to democratically decide whether a new member pays an adequate entry price and is thus welcome.

*Jurisdictions*

A FOCUS is a democratic governmental unit with authority over its citizens, including the power to tax. According to the two types of overlap distinguished above, there are two forms of membership: (i) The individuals living in a community become citizens of the FOCJ to which their community belongs. In that case, an individual can only exit via mobility. (ii) Individuals may choose freely whether they want to belong to a particular FOCUS, but then are subject to its authority and must pay the corresponding taxes. Some FOCJ may be non-voluntary in the sense that the central government may regulate that everyone must belong to some FOCUS providing for a certain function, e.g., to a school-FOCUS, and must pay the corresponding taxes (an analogy here is health insurance, which in many countries is obligatory but where individuals are allowed to choose an insurance company).

FOCJ compare favourably with traditional forms of federalism. The governments have stronger incentives and possibilities to satisfy the heterogeneous preferences of individuals. Due to the concentration on one functional area, the citizens of a particular FOCUS are better informed about its activity, and are in a better position to compare its performance to other governments. As many benefits and costs extend over a quite limited geographic area, FOCJ are often small. The exit option opened by the existence of overlapping jurisdictions is also an important means to make one's preferences known to governmental suppliers.

FOCJ are able to provide public services at low cost because they are formed in order to minimize inter-jurisdictional spill-overs and to exploit economies of scale. When the benefits of a specific activity indivisibly extend over large areas, and there are decreasing costs, the corresponding optimal FOCUS may cover many communities, several nations, or even continents. The threat of dissatisfied citizens or communities to exit a FOCUS provides governments with an incentive to take individual preferences into account and to provide the public services efficiently. FOCJ undermine the politicians' cartel (the formation of a self-serving “classe politique”) to competent outsiders. While all-purpose jurisdictions attract persons with broad and non-specialized knowledge to become politicians, in FOCJ, persons with a well-grounded knowledge in a particular functional area (say education or water provision) are successful.

A federal web composed of FOCJ affects the role of the nation states. They lose functions they presently do not fulfil according to the population's preferences, or which they produce at higher cost than FOCJ. On the other hand, the scheme does not purport to do away with nations but allows for multi-national as well as small-scale alternatives where citizens desire them. Nation states subsist in so far as they provide functions efficiently according to the voters' preferences.

Up to this point the advantages of FOCJ have been emphasized. The proposal may also have major disadvantages relating to issues of major concern to Social Economics.

- *Citizens may be physically and cognitively overburdened.* In a federal system of FOCJ, each individual is a citizen of various jurisdictions. As a consequence, individuals may be overburdened by voting in elections and referenda taking place in each FOCUS. At the same time, each individual is confronted with a multitude of suppliers of public services making life difficult. This may create ethical issues and may be incompatible with *human dignity*.

- *Income distribution may become more unequal.* All forms of federalism - including FOCJ – tend to undermine the possibility to establish a fairer distribution of income. Moreover, FOCJ may provide an opportunity of people sorting according to social classes strengthening *differences in income* and *power* and leading to *inequity*.

- *Citizens may loose their sense of belonging.* In traditional federalism an individual belongs to one particular unit at each level: one is a citizen of commune X, in province Y, in state Z. In contrast, with FOCJ, a citizen belongs at the same time to many different political units which moreover are overlapping. This raises the question whether FOCJ sufficiently care for people's desire for *embeddedness*.

The idea of FOCJ may be attractive to Social Economists because this new type of federalism overcomes nationalism and allows a dynamic adaptation to new problems. On the other hand, it needs to be seriously analyzed to what extent *social values* such as ethics, equity, power and human dignity, and *social relationships* such as embeddedness may flourish under this new concept of federalism, and whether it constitutes an advance over traditional federalism. There is thus a wide scope for a fruitful application of Social Economics.

## IV. Cultural Venues

The second institution to be discussed has quite different features from the governmental institutions discussed in the previous section. Cultural venues are *institutions* catering to *people's preferences for artistic experiences.* In order to discuss again as concretely as possible how the various types of economics may deal with institutions, a particular topic is chosen: how *various institutional types of museums* affect the supply of artistic activities. It will again be apparent where the limits of Neoclassics are and where Social Economics may play an important part.

There is an extensive neoclassical analysis applied to culture and the arts, called "Economics of the Arts" or "Cultural Economics"[7]. The managers of museums are assumed to be primarily concerned with their own interests. The directors' utility depends on their own income and the prestige they receive within their reference group, which consists mainly of art lovers and the international museum community. A second source of utility is derived from agreeable working conditions and job security. But museum

[7] A survey article is provided by Throsby (1994). Books are Baumol and Bowen (1966), Peacock (1993), Benhamou (2000), Throsby (2001), Frey and Pommerehne (1989), Frey (2004) and the collection of articles in Peacock (1998), Rizzo and Towse (2002), Towse (2003), Ginsburgh and Throsby (2006) and Hutter and Throsby (2008).

managers are not free to simply pursue their own goals, because they face constraints on their actions. Differences in these institutionally determined restrictions explain the museum management's behaviour. The finances available are the most important constraint on the museum's management. Other constraints, such as limited space or legal and administrative burdens imposed by the bureaucracy or labour unions, can also weigh heavily.

The source of income differs considerably between museums. Some depend mostly on public grants, others rely exclusively on private money (donations and sponsorship, or income generated from entrance fees, shops and restaurants). In the following, three types of museums are distinguished: *public, private* and museums dependent on *donations*.

*Public Museums*

Directors of *public museums* rely on public grants. The government allocates them sufficient funds to cover the expenses considered necessary for fulfilling their tasks. While they are expected to keep within the budget, if a deficit occurs, it will be covered by the public purse. This institutional setting provides little incentive to generate additional income and to keep costs at a minimum. The directorate will not allocate energy and resources generating additional income, because any additional money goes back to the national treasury acting like an implicit tax of 100 percent on profits.

The museum managers therefore are free to emphasise non-commercial aspects. It can legitimise its activities by referring to intrinsic 'artistic', "cultural", or 'scientific' values. This helps the museum directors to achieve their goals of gaining prestige in the museum world, enables highly rated exhibitions, and allows for pleasant working conditions.

From this institutional point of view, one would expect that:

- Public museums do not sell any paintings from their art collection because the income generated would be lost for them as it has to go to the treasury. Moreover, the museum activities become measurable in monetary units, which opens the museum managers to criticism from the outside (be it by politicians or public administrators).
- Exhibitions tend to be designed to please an insider group of art connoisseurs, including in particular other museum directors.
- Visitors' amenities in public museums are poorly developed. Little attention is paid to museum shops, restaurants and cafeterias.

*Private Museums*

Directors of *private museums* have a strong incentive to increase the income of the museum. Their survival depends on sources of money like entrance fees, the restaurant, shop surpluses and additional money from sponsors and donors. If private museums generate a surplus, they are able to use it for future undertakings. As a result, it is to be expected that:

- The museum managers rely on the market for their collection. Museums actively sell paintings that no longer fit into the collection and use the money to buy new works of art.
- Private museums are much concerned with attracting visitors. 'Blockbuster' exhibitions enable museums to earn revenue, as the preferences of a broad group of people are taken into account. The exhibitions are better arranged from a didactic point of view and are appealingly presented.
- Private museums emphasise visitors' amenities. The museum shop and the restaurants take up considerable space and are attractive.

*Museum dependent on donations*

In many countries, contributions to non-profit museums are deductible under the income tax rules for individuals and corporations. A lower marginal tax rate reduces the willingness to donate because the implicit cost of doing so rises. The tax-deductible status strongly affects the behaviour of museum managers. In particular, they have an incentive to avoid profits by charging low or 'social' prices which strengthens the legitimacy of tax-deductible status.

The directors devote much effort and skilled resources to make their museum attractive to prospective donors. As a result, donors directly and indirectly exercise some measure of control over the activities of museums:

- Donors directly influence museum policy in two ways: they can either interfere in the programming or they can set legally binding limitations on the collections they donate. These limitations can much constrain the management. Most donors want to highlight their own artistic visions. Many of them are pleased when museums publicise their contribution, thus enhancing their prestige in the museum world. Museums have developed an elaborated system of honours ranging from appropriate attributes ('benefactor', 'patron', 'contributor', etc.), to naming rooms, wings and even whole buildings after their donors.
- The indirect influence of donors works through impression management. The

museums directors must show that donations are well used. Donors want to feel that they contribute to a worthwhile cause. A good reputation of the art institution with the public and the media is crucial for the flow of donations.

This discussion shows that an analysis of museums inspired by Neoclassics is able to derive testable hypotheses and empirically relevant results. Nevertheless, there is much scope for analyses taking into account the concerns for *social values* and *social relationships* emphasized by Social Economist. I see three areas in which they may be directly relevant:

(1) Few museum directors are mainly or even exclusively interested in their own utility. The cultural world is characterized by persons with a strong *intrinsic motivation*, i.e. with individuals who are fascinated by the work of collecting, saving and exhibiting artefacts and works of art. This intrinsic motivation may lead them to act at least partly in a pro-social way.

(2) People engaged in the arts often have strong political ideologies and see cultural policy affected by the distribution of *power*. They see it as one of their tasks to fight against what they see to be "the bourgeoisie". They therefore oppose many suggestions to raise efficiency made by Neoclassics because they (rightly or wrongly) believe that they violate the principles of equity. A case in point is raising entry prices often proposed by Neoclassics[8]. Such a policy may raise revenue as the price elasticity of demand has generally been estimated to be below one. But higher entry prices may conflict with *equity* and *ethical* principles, and may even affect *human dignity*, as the population's possibilities to partake in culture is affected.

(3) People working in the cultural sector are strongly *embedded* in a community. The Neoclassical analysis of museums acknowledges that the reference group is important for museum directors but they are ill equipped to go any deeper. It is left open who the reference group exactly is and how quickly the identification with the reference group changes when a person moves upward in his or her career.

## V. Conclusion

I have argued that economics understood as Neoclassics has much to contribute to our understanding of institutions. I have tried to demonstrate such contributions for political

[8] See Lampi and Orth (2009).

economics (politico-economic models and a new type of federalism) and for the economics of art (for the case of museums). The adherence to clearly defined individual utility functions (selfishness and rationality) and clearly defined constraints allows researchers to derive propositions often successfully empirically tested. The strength of the Neoclassical analysis becomes most clearly apparent when it comes to the comparison of institutions. Differences in behaviour can be explained when different types of institutions are set against each other. Such an approach does not only provide interesting insights but also has immediate relevance for policy.

But Neoclassics has considerable shortcomings. My contribution endeavours to point out concretely what fruitful contributions Social Economics can make for the case of government behaviour, new types of federalism, and museums. I thus argue for a multiplicity of approaches where both Neoclassics and Social Economics, as well as the New Institutional and Psychological Economics have their particular roles. I am aware that such a multiplicity of approaches is unpopular and therefore has little chance of being of substantial importance in the future. Neoclassics is the clearly dominant paradigm today[9] - and accordingly its believers tend to disregard, and sometimes arrogantly reject, all other approaches. The situation of Social Economics is much different: its adherents consider themselves to be a minority and tend to isolate themselves leading to an unfortunate tendency to not seriously consider contributions by Neoclassics. In my view, Social Economists sometimes reject Neoclassical analyses too early and in a too general way[10]. While this is understandable, it robs Social Economics the chance to influence Neoclassical analysis – something I think is highly desirable.

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[9] An empirical analysis of the members of the professional organisation of German-speaking economists revealed that in 2006 80% percent of them considered themselves to be Neoclassics. This is a considerably larger share than 46% in 1981. See Frey, Humbert and Schneider (2007). This tendency has been intensified by the emphasis on publications and citations in orthodox journals (see Frey 2009).

[10] There are many examples in the *Compendium*. It must suffice to cite just one example: "..to date the work has not been done to show the power of NIE (New Institutional Economics, BSF) to explain institutional choice" (Mayhew 2008:37-8). I disagree with this statement.

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