INSTITUTIONS, HUMAN ACTION AND TRANSACTION COSTS

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Abstract

Institutions and institutional arrangements cannot "work" by themselves, meaning without necessary efforts – considered costs in economics - for enforcement, preserving and improving them. Legal institutions and rule of law are based on systemic efforts needed to apply the ethical rule, actions that mean, in their turn, certain costs. These efforts - designed to facilitate social cooperation process - represent for many economists the costs of economic system functioning. In nowadays institutional economics, the costs of running the economic system are generally called "transaction costs". Such costs are to be distinguished from production costs, which is the cost category with which neoclassical analysis has been preoccupied. This paper aims to offer a critical point of view on significance of transaction costs in institutional economics.

Key words: institutions, transaction costs, efficiency

Institutional economics founds itself on recognizing the fact that human action and their results must be fundamentally analyzed in connection with economic, social and political *rules* that governs interpersonal relations in the society[1]. So, economic approach on institutions is focused on identifying the optimal institutional arrangement, being given obvious possibilities of normative analyze of alternative institutional arrangements. Nowadays, the economists consider that economic performance depends strongly on the institutional framework of the economy.

In the institutional approach of Douglass North, Nobel laureate in 1993, the theory of institutions "is constructed from a theory of human behavior combined with a theory of the costs of transacting" (North, 1990:27). By combining these theories, one can understand why institutions exist and what role they play in the functioning of the society. North also mentions that if you add the theory of production, one can analyze the institutions implication over the economic performance.

With no intention to underestimate the role of social institutions in the reduction of uncertainty, I will try to emphasize the *irrelevance of transaction costs criteria, as objective sources of valuation of the institutions efficiency*. Also, I will emphasize the implications of institutions utilitarian approach over the economic science and public debates on politics.

One may ask whether had ever been other two words in the economic literature that generates as much friction as "transaction costs"? *The economics of transaction costs* begin with "The Nature of Firm", the famous article of Ronald Coase from 1937. The Nobel laureate Ronald Coase explains the existence of the firm and the integration of the activities from this kind of organizational structure using the transaction cost concept - "the cost of using the price mechanism" in original terminology of Coase (1988:38). But, as Oliver Williamson shows (1991:8), "one could say that Coase's approach on the transaction costs did not face time as well as the theory [of firm], on the whole". Coase neither defined in "The Nature of the Firm" the empiric character of transaction costs, nor explained how these could be recognized. Despite of all contradictions regarding the transaction costs, this theory represents today the corn stone of efficiency analyses on comparative institutional arrangements. These analyses are focused on the role transaction costs play in determining the distribution of property rights, broadly defined as all laws, rules, social customs and organizations that generate incentives for human action.

The economic theory reveals the universal fact that any human action entails a cost, as human action means choice, and so sacrifices and opportunities forgone. Accordingly, doing a transaction has a cost; conceptual, the transaction cost phenomenon becomes easily to be accepted. The major difficulty refers to these costs becoming operational. So, it can be said that transaction costs represent more a way of giving arguments than an efficiency indicator, of empiric nature. The confusion derives from the fact that transaction costs are considered an indicator used in order to appreciate the efficiency of institutions and institutional arrangements.

For example, for Douglass North (1990:27), the information costly character represents the key of transaction costs:

„The costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements. These measurement and enforcement costs are the sources of social, political, and economic institutions".

[1] In Douglas North model (1990:3), *institutions are the rules of the game in the society*, meaning the constraints and incentives that shape social cooperation process. These rules – "pragmatic" designed or spontaneously emerged - are adopted by individuals depending on the way they succeed to solve the social cooperation problems. In fact, as Kasper and Streit (1998:28) shows, institutions refer to *the rules in the society (but not physical or natural limits) that constraint opportunistic behavior* that can be adopted within interpersonal relations.

On the whole, in transaction costs category the economists include information costs, negotiating costs and those of writing contracts, the costs of protecting property rights and those of enforcement rules and agreements from different contractual arrangements. The problem of "measuring valuable attributes of what is changing" reveals the objectivist perspective on which North (1990:27) built his theory. But the subjectivist paradigm, on which the entire modern theory of value is built on, excludes any possibility of objective valuation (external one) for costs involved by human action, as a choosing process.

Economic science learns us, too that valuations that determine human choices are, necessarily, *ex-ante* and subjective economic categories. These valuations represents the importance, utility or value that individual gives to goods and events taken into consideration. Today, despite many inconsistencies in *mainstream* economics, the theory of subjective value is the corn stone of economic science, as demonstrated over more than a century by economists of Austrian School[2]. For example, in one of the most cited paper dedicated to the cost economic theory, the Nobel laureate James Buchanan emphasize, too that *all costs that influence our decisions are always subjectivist valuations reported to potential opportunities*. The source of these conclusions derives from the economic way of thinking of the Austrians, Ludwig von Mises and Friedrich von Hayek, whom influence over researches of L.S.E. (London School of Economics) was a significant one.

Cost (including transactions costs) analyze has to start necessarily with emphasizing the distinction between the measurable *objective* cost (the accountancy cost) and the cost as subjective essential element for the choice process (the economic cost). Within the neoclassical theory, the cost has a material dimension, being not presented through the distinction *ex ante – ex post*. The formal theory of human action is based on the recognition of the fact that cost phenomenon (impossible to be separated from choice process) has a subjective dimension when speaking about utility. This perspective reveals insuperable difficulties when making transaction costs operational and when appreciating their influences. Murray Rothbard (1997:269) pointed out about the nature of the cost when he wrote the followings:

„But if costs, like utilities, are subjective, nonadditive, and noncomparable, then of course any concept of social costs, including transaction costs, becomes meaningless. And third, even within each individual, costs are not objective or observable by any external observer. For an individual's cost is subjective and ephemeral; it appears only *ex ante*, at the moment before the individual makes a decision. The cost of any individual's choice is his subjective estimate of the value ranking of the highest value foregone from making his choice".

Despite of these arguments against the possibility of making transaction costs operational, almost all approaches on institutional economics use transaction costs as criteria for efficiency of institutions. For example, inefficiency is explained by high transaction costs, assimilated to a presumed failure for the parts of an exchange when trying to obtain information over the exchange terms. The secret of obtaining efficiency could be decreasing of transaction costs – the Ronald Coase famous idea.

The conclusion could be that, if potential exchange parts can be better informed or more able to communicate one to another, then it won't be unconsumed exchanges and looses over the property rights value. But, this perspective involves difficulties impossible to be overcome. For the external observer, *the existence of unconsumed exchanges does not reveal, necessarily, lack of information and communication* or institutional inefficiency. The real problem consists in the difficulty to reveal the existence of transaction costs and also the impossibility of measuring these costs. On the other hand, the implications of the entrepreneurship over institutional change process must be taken into consideration. Let us presume that actual institutional arrangement does not reveal, through market process, the "relevant knowledge" form hayekian approach. So, initial institutional arrangements are appreciated to be "inefficient". But, in this conditions, the entrepreneurial process will generate institutional change over "*the human action, but not human designed*" model.

Let us consider the following example: there are two villages, Cosmin and Marinescu, which does not communicate one with another. Within first village two pheasants are exchanged on a beaver. Within the other village, two beavers are exchanged on a pheasant. On isolation conditions, allocation results can be considered efficient because there is free market within every village. But, on the condition the market specific to each village is isolated, obtaining maximum earnings, equivalent to the two markets' integration, is not allowed. So, the entrepreneurship activity (the speculative one) will try to collect the advantages of this inefficient arrangement, which will, sooner or later, generate the exchange between the villages.

Trying to anticipate price discrepancies for the same product, as in the previous example, indicates the existence of profit opportunities (incorporated in the price structure). These opportunities will enhance entrepreneurship, which will adjust the inefficiency of isolation. Profit opportunities stimulate the entrepreneurship, which can, thus, improve the efficiency of allocation process. As a consequence, the institutional constraints and incentives will be restructured and communication and informational environment improved.

[2] In his *magnum opus* "Human Action", Ludwig von Mises (1966:102) shows that "value is the importance that acting man attaches to ultimate ends. Only to ultimate ends is primary and original value assigned. Means are valued derivatively according to their serviceableness in contributing to the attainment of ultimate ends. Their valuation is derived from the valuation of the respective ends. They are important for man only as far as they make it possible for him to attain some ends. Value is not intrinsic, it is not in things. It is within us…".

On free market, entrepreneurship is not just the result of existing institutions, but it itself creates new institutional constraints and unblocks organizational inertia[3]. So, entrepreneurship can be considered the fundamental source of institutional change, not just its catalyst, as it appears in North approach. As Israel Kirzner (1963:304) argues, on free market, profit opportunities sustains competition: "*…if the greatest entrepreneurship talent is insufficient for removing all "misallocations", even giving the profit reason, then the rest of "misallocations" are simply undetectable (*the "misallocation" term is used by Kirzner referring to an allocation inefficiency, to a presumed lack of co-ordination of individual plans.

According to the above mentioned example, it is exaggerated and unfair in the mean time, to suggest that the initial institutional arrangement (isolation of the two villages markets) prevent efficient allocation because of the transaction costs' barrier. Free exchange means including entrepreneurship efforts of obtaining all possible exchange earnings, which means recognizing the existence of informational and communication constraints permanent restructuring. If present constraints are artificially imposed, politically or through administrative rules, entrepreneurship that may generate exchange barriers optimal restructuring, cannot be stimulated or can even been stopped. On these artificial constraints conditions, which do not allow volunteer agreement over property rights involved, the allocation frame can be labeled, shows Buchanan (1985:98), as "inefficient".

This kind of arguments reveals that the economic analysis *á la Coase* cannot establish a scientific criterion for economy of law or of private property rights; as well, it cannot create an adequate medium for the positive approach of the economic science. Furthermore, the impossibility of measuring the transaction costs reveals their irrelevance for evaluating the efficiency of the exchange, or for the efficiency of the alternative structures of property rights.

In a fundamental manner, it is argued the unrealistic character of the hypothesis used by Coase. The costs that we deal with in economic science — opportunity costs — are a real-world phenomenon. Real-world behavior results from choices and to choose means to do something and not to do other valuable things that could have been done instead. The costs of real-world behavior are the values of such real alternatives. But transaction costs, as Coase understands them, can only be defined in terms of "alternatives" that have never been open to human beings and which never will. To be a human being means to act under uncertainty. This fact permeates all aspects of human behavior. It is therefore meaningless to hold up perfect foresight as a standard in terms of which real-world human action appears to be costly.

Hülsmann (2004:50) pointed out about irrelevance of Coase's hypothesis:

"We do not wish to insinuate that it is useless to compare our real world with fictitious other worlds. The point is to be careful in defining and using fundamental concepts lest we invalidate analyzes of the real world. The cost concept underlying Coasian transaction costs has nothing to do with the opportunity costs that we use in economic analysis. Rather, transaction costs have affinities with what a distinguished follower of Coase has called "the nirvana approach" - identifying "inefficiencies" in our world through comparisons with a perfect-foresight nirvana. This is a deficiency that vitiates Coasian explanations of the emergence and transformation of social institutions".

So, it is misleading to say that those practices and institutions spring from a special type of "costs" – transaction costs. And it is wrong to conclude that one can explain the evolution of those practices and institutions in terms of transaction costs. Explanations that rely on the nirvana approach can be more or less exciting literature, but they add nothing to science. Valid explanations of human action and human institutions must stress real-world choices among real-world alternatives. This approach too has been known before 1937. It is called methodological individualism.

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[3] See, for this, the institutional reforms developed in China, generated by the entrepreneurship, which have became a factor of political pressure, directed toward the relaxation of formal legislation in business.

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