A Nobel for Practical Economics

One winner helped us understand the social benefits of mergers, the other how to take care of common resources.

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Yesterday's award of the Nobel Prize in economics to Elinor Ostrom and Oliver Williamson at first struck me as a good choice. Now I think it's a great choice. The reason is that mainstream economics has become highly mathematical and increasingly independent from reality. Many economists sit in their offices and derive proofs. Few go out and do the time-consuming work of examining the institutional structures that humans build to solve their own real-world problems. Among those few are Ms. Ostrom and Mr. Williamson.

Both draw on rich data from outside the field of economics. Ms. Ostrom draws much of hers from case studies of common-property resources and Mr. Williamson from business historians such as the late Alfred Chandler. Some have summarized their work by saying that institutions other than free markets often work well. But that statement can mislead you to conclude that government solutions are the answer. Free markets are only a subset of free institutions. A better way to sum up their work is that what Ms. Ostrom and Mr. Willamson really show is that voluntary associations work.

Consider Mr. Williamson's work. Drawing on 1991 Nobel laureate Ronald Coase's work on why firms exist, Mr. Williamson showed that these voluntary institutions exist to solve problems that arms-length market transactions have trouble solving.

Take, for example, a coal mine that depends on a railroad line to ship its coal. Before the mine owner develops the mine, he wants to be assured that the railroad owner won't charge him a monopoly price. Before the potential railroad owner builds the spur, he wants to be sure that the coal mine owner, his only customer, won't try to skin him by paying a price below the amount that would compensate him for the high fixed cost of the railroad. Solution: vertically integrate. Have the railroad owner also be the mine owner and you solve the problem.

Prior to Mr. Williamson's work, many legal scholars and economists had seen vertical integration as a way to acquire market power. This argument made little sense, as antitrust scholars Robert Bork and the late Ward Bowman pointed out, because it's hard to multiply market power using vertical integration. As the Nobel committee noted, Mr. Williamson's work led to less concern that vertical integration enhances market power and this has caused judges and antitrust officials to be less hostile to vertical integration.

Although the Nobel committee did not highlight Mr. Williamson's classic 1968 article, "Economies as an Antitrust Defense," I will. Mr. Williamson showed that horizontal mergers of companies in the same industry—even those that increase market power and even those where the increase in market power leads to a higher price—can create efficiency. The reason is that if mergers reduce costs, the reduction in costs can create more gains for the economy than the losses to consumers from the higher price.

How about Ms. Ostrom's work? Most economists are familiar with the late Garrett Hardin's classic article, "The Tragedy of the Commons." His idea was that when no one owns a resource, it is overused because no one can control its usage and each person has an incentive to use it before others do. This insight has helped us understand much human behavior and has led people to advocate either having the resource privately owned or having it controlled by government.

Not so fast, said Ms. Ostrom. Examining dozens of case studies, she found cases of communal ownership that worked—that is, that didn't lead to the tragic outcomes envisioned by Hardin—as well as ones that didn't. Were there systematic differences? Yes, and interestingly the ones that worked did have a kind of property rights system, just not private ownership.

Based on her work, Ms. Ostrom proposed several rules for managing common-pool resources, which the Nobel committee highlights. Among them are that rules should clearly define who gets what, good conflict resolution methods should be in place, people's duty to maintain the resource should be proportional to their benefits, monitoring and punishing is done by the users or someone accountable to the users, and users are allowed to participate in setting and modifying the rules. Notice the absence of top-down government solutions. In her work on development economics, Ms. Ostrom concludes that top-down solutions don't help poor countries. Are you listening, World Bank?

In a 2006 article with Harini Nagendra, Ms. Ostrom wrote: "We conclude that simple formulas focusing on formal ownership, particularly one based solely on public [government] ownership of forest lands, will not solve the problem of resource use." Garth Owen-Smith, who helped solve the common-resource problem of elephants in Namibia by ensuring that local residents shared in the financial benefits from tourism and trophy hunting, drew explicitly on Ms. Ostrom's work. If locals benefit from having a resident population of elephants, they are much less likely to poach and more likely to stop other poachers.

Economists talking about real humans and not mathematical abstractions and winning the Nobel prize for it? Good on ya, Nobel committee.

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