METHODOLOGICAL POSITION(S) OF INSTITUTIONAL ECONOMICS

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Abstract. Institutional economics has made significant contributions to economic methodology. The goal of institutional economics is to enable more realistic comprehension of economic phenomena. Methodology of institutional economics is significantly different from the composition method of the mainstream, which tries to base macroeconomic phenomena on microeconomic foundations. Methodological orientation of institutionalism is much more broadly founded and incorporates insights of holistic, system and evolutionary epistemological approach.

Key Words: Methodological individualism, institutions, habits, evolution

INTRODUCTION

Institutional economics emerged at the end of the 19th and the beginning of the 20th century in the United States, and gained the greatest influence in the mid-thirties of that century. The founder of this doctrine, also known as "old institutional economics", is Thorstein Veblen. His famous critic of capitalism is based on sarcastic view of American business circles he called "leisure class". Influenced by some British historians, Veblen emphasized the need for wider historical approach and usage of inductive empirical generalizations in economic theory [Ekelund, Herbert 1997, p. 450]. This methodological shift was to contribute to transforming economics into modern science.

Due to several factors the influence of institutional economics on American economic thought significantly diminished in later decades [Stefanović 2009, p. 27-28]. Institutional thought developed at the margins of the dominant currents of economic theory. Among representatives of post-Veblenian economic thought in this period were Clarence Ayres, John Fegg Foster and Alan Gruchy. At the end of sixties, institutional approach re-emerged as an attractive mode of economic analysis. However, the new type of the insti-
tutional analysis generally does not refer to old institutional economics as its theoretical source. Moreover, while Veblen rejected mainstream economics, especially neoclassical analysis, protagonists of new institutional economics accept neoclassical theoretical framework. They define their research agenda as an attempt to modify some core assumptions of neoclassical economics, in order to make this theoretical approach more realistic. The reputation of new institutional economics in contemporary economic theory is increasing. Leaders of this school of thought were rewarded Nobel prize for economics – Ronald Coase in 1991, Douglass North in 1993 and Oliver Williamson in 2009. Another institutional doctrine exists, but of different orientation, and much less influential in modern economic analysis. This strand of institutional thinking represents continuation of original thought of founders of institutional economics - Thorstein Veblen, John Commons and Wesley Mitchel. Among most prominent protagonists of this outgrowth of old institutional economics are Geoffrey Hodgson, Warren Sammuels, Marc Tool and William Dugger.

METHODOLOGICAL PILLARS OF OLD INSTITUTIONAL ECONOMICS

The main difference of institutional approach in relation to mainstream is in cultural interpretation of economic agents. The critic of mainstream economics is directed to methodological individualism, the concepts of optimization and equilibrium. The complex nature of economic agents leads to their "imperfect" behavior, resulting in sub optimality, multiple equilibria or even unstable states of the system.¹

Another point of critic, present already in Veblenian period, relates to formalistic methods, immanent to neoclassical economics.² Formalism of the a priori rationalist type cannot be much helpful in revealing the nature of social reality. It is impossible to incorporate large set of heterogeneous variables and behavioral peculiarities in formal modeling.

According to Wilber and Harrison [Wilber, Harrison 1978, p. 71] the main characteristics of institutionalism are holism, systemic approach and evolutionism, combined with theoretical sensitivity for power and conflict and significance of irrational behavior. These methodological features substantially separate old institutional economics from the mainstream.

Institutional economics conceive socio-economic reality as something more than rigorously determined system of relations – it is a process that cannot be separated from societal institutions. Socio-economic change is not purely mechanic; it is the product of human action, but action definitely shaped and bounded by the society, from which it originates. Institutional economics is holistic, because it is focused on the causal relations be-

¹ Contrary to methodological individualism of the mainstream, old institutional economics claims that societal phenomena cannot be explained in terms of individuals (society is not simple sum of individuals). Furthermore, behavior of agents and states of economic system cannot be reduced to optimization and equilibrium.

² Formalistic methodological orientation tries to extract logical system of relations from some empirical content. It heavily relies on mathematics and develops axiomatic, deductive structures. For instance, in classical theory of firm, firm is involved in any sort of production process, with any sort of inputs and technologies, at any level of prices. The point of departure in this type of methodology is construction of models that refer to processes or systems. Postulates and definitions are derived from the empirical process, previously decomposed to its obvious parts, which is followed by determining necessary or possible connections between parts.
tween the whole and its parts. It is systemic in nature, because of the conviction that interaction of parts gives rise to the coherent structure, within which parts can only be understood. It is evolutionary, because it perceives change in the causal relations as the essence of socio-economic reality.

However, institutional economics avoids the danger of entering into another sort of reductionism, which overemphasizes societal impacts on individual economic behavior. Veblen wanted to transcend both methodological individualism (immanent to mainstream) and methodological holism (that he ascribed to Marxian economics). There is some entity through which individual actions and societal forces meet and interact. This entity Veblen called "habits of thought", or "institutions". Since Veblen's time, conceptualization of institution is the centerpiece of institutional economics. Individuals are the main actors, but their actions are not the product of their "naturally" given propensities, but of prevailing habits of thought in society, generated by the dominant technological paradigm [Kitanović, Petrović 2008, pp. 1-13].

THE NECESSITY OF RULES AND HABITS

Old institutional economics rejects the conception of individual maximization. Alternative behavioral conception is developed within institutionalism, based on then dominant instinctive psychology (propagated by pragmatist philosophy) and Darwinian theory of evolution.

This behavioral conception neglects "rationality" of behavior. Behavior is not "rational' in neoclassical sense but is governed by rules of socio-economic environment. This thesis can be found in early definitions of institution. Hamilton, for instance, claims that institutions are ways of thought, prevailing or permanent activities contained in habits and customs [Rutherford 2001, p. 174]. Veblen defined institutions as prevailing habits of thought, common to the generality of men [Veblen 1919, p. 23], while Commons conceived them as durable and integrated complexes of customs and habits [Commons 1961(1934), p. 46].

Considerable amount of empirical evidence confirms the influence of habits and customs on economic behavior. Nowadays deserted theory of James Duesenberry describes functional dependency of consumption [Duesenberry 1949]. The starting point of this theory is that the level of income, within the existing structure cultural and social norms, "directs" consumption decisions towards certain goods. In fact, the level of income and prevailing norms determine preferences of consumers. Consumer behavior reflects norms and habits within society. The study of aggregate demand in USA by Houthakker and Taylor, also finds that consumer behavior is strongly subjected to inertia [Houthakker, Taylor 1966].

DISPUTING PRIMARY ANALYTICAL UNIT AND EVOLUTIONARY APPROACH

Old institutionalism neglects the idea of pre-existing, "natural" state without institutions, as a theoretical point of departure [Petrović 2008, pp. 185-194]. An illustration of this methodological standing is the conceptualization of market by Oliver Williamson. His famous sentence "in the beginning there were markets", locates the beginning of the economic activity within "pre existing natural state" represented by the "proto-market" [Williamson 1975, p. 20].
Common theoretical line for all members of old institutional economics, Veblen, Commons, Mitchell, Myrdal and Galbraith is the idea that in economic analyses, individuals, their wants and preferences are not natural datum. Through their interaction, individuals spontaneously create the socio-economic environment and circumstances. Being established as the result of individual interaction, socio-economic environment becomes the framework for individual behavior, which exerts fundamental influence on agents' preferences and propensities [Hodgson 1998, p. 172]. Individuals are both producers and products of the socio-economic environment.

Thus, initial "natural state" also exhibits some institutional features, and contains certain rules. Individuals are born in the society with the well defined and operating institutional structure. However, this does not mean that individuals have no role in the socio economic process. Therefore, the theoretical relation between individual and institutions must be properly established. Action-information loop can be much helpful in explaining this relation. It shows that individual interaction generates conventions, which, at certain moment become institutions. When institutions are once established, the process of their reinforcement begins. Through imitation and usage, convention is being reinforced, acquires institutional features and begins to function as an institution [Schotter 1981, p. 160]. The well-known example of reinforcing character of institutions is Menger's theory of the origin of money [Menger 1892, pp. 239-255]. According to Mengers theory, money was the spontaneous result of individual endeavor to transcend exchange problems. When all the participants accepted money as the medium of exchange, it became an institution that reinforces itself through repeating transactions among the agents.

Fig. 1 The Institutionalist Action-Information Loop

In academic circles, institutional economics is often accused of cultural determinism [Granovetter 1991, pp. 481-510]. Veblen's theory of cumulative causation is used to support this thesis. The essence of this theory is that exogenous impacts and endogenous forces generate tension within the system and unleash infinite changes of the system. The main endogenous force of the process is "cumulative causation". The logic of cumulative causation suggests that acting in accordance with goals is endless, while during that time both agent and goals are being transformed [Veblen 1919, p. 70-77]. Thus established

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3 Process of institutional reinforcement is often explained on the example of traffic conventions. The necessity for security and efficiency in the long run motivated drivers to stick to same rules of traffic, until, at one moment, the whole area became subjected to legislation (one of typical traffic convention is driving the same side of the street) [Schotter 1981].
feedback can result in "inhibitory effects". The source of these effects is the aforementioned reinforcement of institutions.\footnote{Stability of system and institutions as a result of exogenous and endogenous factors is disturbed from time to time. While neoclassical economics insists on exogenous factors of institutional change, institutional economics directs attention to endogenous mechanisms of change, technology being the most important of them [Нестеренко 1997, p. 47].}

The process of institutional change is an incremental one, and belongs to the class of evolutionary phenomena. Veblen's intention was to interpret institutional evolution as the process of change analogous to biological evolution. Some recent followers of Veblen seek for evolutionary explanation of institutional phenomena, based on recent findings in evolutionary biology – among most prominent of these authors are certainly Geoffrey Hodgson [Hodgson 1993] and Richard Nelson and Sidney Winter [Nelson, Winter 1982]. Hodgson tries to delineate institutional features of society as a genotype of the socio-economic evolution, from phenotype (individuals, organizations, societies). Similar to genetic structure in biology, institutions define key features of society and its adaptive ability to changing circumstances. Institutions have key quasi-genetic quality – durability. Some sort of selection operates in institutional dynamics. The ultimate targets of selection in the long run are institutions and routines, while the immediate selection targets are phenotypical entities. Through time, some institutions prevail over others. Different societies have different institutions, as the result of the different environment challenges which these societies had to face, through history. Every society is a specific combination of institutions, and represents a different socio-economic model. This institutional diversity is an important feature of the contemporary economy. The process of institutional evolution is permanent, because changes in environment that impose selective pressure on institutional environment are always present. Thus, there is no "perfect" or "absolutely efficient" institutional structure. Efficient institutional structure in one environment can be extremely inefficient in another cultural setting [North 1994]. Sidney and Winter launched models of industrial dynamics, based on routines as genetic structures. If the firms with most efficient genetic structures become dominant on the market, than they will exert fundamental influence on the environment. Existing environment will change, inducing further change of routines, including those of the most efficient firms. Institutional economics is the main promoter of the new epistemological movement in economic science, that derives its inspiration not from classical and 19th century physics, like the mainstream, but from contemporary evolutionary biology. In some other schools of thought, like Austrian and Schumpeterian economics, similar references to evolutionary biology can also be found.

**DESCRIPTIVE REALISM AND INDUCTIVE METHOD**

Old institutional economics is strongly dependent on descriptive method. Commitment to practical questions imposed strong reliance on tremendous empirical material and detailed descriptions of existing institutional forms. Therefore, inductive method plays a crucial role within this school of thought.

The prevalence of inductive method was the source of another critic against institutional economics. Institutional economists were accused of being representatives of ex-
treme descriptive realism. There was a belief in academic public that institutional economics lacks systemic theoretical core [Coase 1998, p. 72]. Instead of comprehensive theory of complex socio-economic phenomena, institutional had few general concepts and specific theoretical instruments.

Hodgson criticized opinions that institutional economics fell into the trap of overemphasized empiricism [Hodgson 1998, p. 166]. Initial concepts like Veblen's cumulative causation and Common's transaction approach evolved into coherent and comprehensive theories of economic behavior, transaction costs, technological evolution etc.

**METHODOLOGICAL PRINCIPLES OF CONTEMPORARY INSTITUTIONAL ECONOMICS**

The recovery of the institutional economics in the second half of the twentieth century is not, as mentioned before, the result of the revival of old institutional economics, but some sort of supplement to neoclassical economics. Representatives of new institutional economics do not reject all of neoclassical fundamental assumptions. On the contrary, their intention is to transcend theoretical limitations of neoclassical analysis, through constructive critic and adding institutional element into its theoretical structure. It was also stressed earlier in the text that another, Veblenian and strongly anti neoclassical school of institutionalism, coexists with the new institutional economics. This complicates the identification of methodological foundations of contemporary institutional economics. We can speak of two different research agendas and respective methodological frameworks.

The agenda of new institutional economics was most clearly announced by Richard Langlois [Langlois 1986] and consists of these elements:

1. Situational analysis – agents are rational, they behave reasonably in the context of their individual situation. Their rationality is however limited, and need not be maximizing.
2. Institutions – existing social institutions of various sorts are not only limitations, but also definitions of agent's individual situation. This is known as the dual role of institutions in economic analysis.
3. Explanations in accordance with "invisible hand" principle – economic phenomena are conceived as unintended consequences of human interaction.
4. Composition principle – there are various selection mechanisms and processes, following from the principle of the invisible hand.

New institutional economics treats relevant economic environment as agent's individual situation, which should be included into economic analysis. The unintended effects of agent's interactions with other individuals that result in spontaneous emergence of institutions should also be part of the analysis. In this manner, institutions serve as some kind of the substitute for the knowledge of the agent's internal situation. Institutions define agents' situation and serve as approximation of their complex individual psychology. Institutions emerge from the result of individual action, but cannot be reduced to the sum of individuals, because they are independent entity. The mechanism of institutional genesis, mutation and demise mimics Smith's invisible hand that eventually leads to desirable social outcomes.

Key features of the Post-Veblenian institutional economics are the following [Hodgson 1998, p. 173]:
1. Emphasizing institutional and cultural factors not present in neoclassical economics
2. Analysis is open for interdisciplinary insights, especially those from political science, sociology, psychology
3. Neglecting the model of rational maximizing agents
4. Analysis does not start from mathematical models, but from stylized facts and theoretical constructions that involve causal mechanisms
5. Mathematical and statistical methods are treated as instruments, not as the essence of economic analysis
6. Extensive usage of historical and comparative empirical material that refers to socio-economic institutions.

The roots of human actions should be looked for in the existing institutional structure – preferences are not naturally given but are the result of cultural-historical milieu. Neoclassical economics begins with universalistic claims about individual behavior, and than, without any transmission mechanisms, applies this framework to the theories of consumption, production, prices etc. Institutional approach begins with general propositions about human behavior, institutions and evolutionary nature of economic processes. Afterwards, attention is directed to specific institutions and actual types of economy. Institutional economics is interested in making specific, historically located approaches to economic analysis. Research procedure should be based less on mathematics, and much more on empirical evidence. Indeed, there is a strong tendency of institutional economics to collecting empirical material that relates to social and economic institutions.

Some conclusions about relations between old and new institutional economics can be drawn [Stefanović 2009, p. 35]:

1. Old institutional economics exposes neoclassical economics to radical criticism. New institutional economics is much more moderate when criticizing mainstream economics. Moreover, new institutional economists conceive their research program as an extension of neoclassical analysis, through incorporation of the so far neglected concept of institutions into neoclassical theoretical core.
2. Conceptualizing institutions within these two schools is different. Old institutional economics explains institutions through complex socio-psychological analysis, and uses concepts of habits and routines extensively. New institutional economists avoid this conceptual framework. Representatives of new institutional economics claim that individual actions are highly context-dependent, and the best approximation for the agents' contextual surrounding are the institutions of society. Institutions are unintended results of individual interactions.
3. Within old institutional economics, the attitude towards institutions is not uniform. While Veblen and Ayres concluded that institutions inhibit technological progress and conserve existing social relations, neo-institutionalists observe some positive effects of institutions – assistance in assimilation to new technology, preventing some socially destructive effects of technologies and markets etc. New institutionalists explain emergence and dynamics of institutions through the benevolent mechanism of invisible hand. Therefore, although temporarily some institutions can be dysfunctional and obsolete, the ultimate influence of the institutional structure can be arranged to be socially desirable.
4. The common feature for both strands of institutional economics is insistence on institutions as the key objects of economic analysis.

5. Functional definition of institutions is similar in both schools of institutional economics - institutions are framework and constrains of human behavior.

Common feature of both strands of institutional economics is the remark of reductionism of neoclassical analytical framework. The concept of institutions significantly improves capacity of economic theory to comprehend real economic processes. Another theoretical device also contributes to more realistic economic analysis – the evolutionary view of institutional dynamics. As mentioned before, institutional evolution is a process that in a way mimics biological evolution; institutional structure is subjected to evolutionary principles of heredity, diversity and selection. However, similar to the biological world, evolution does not mean optimization. Neoclassical interpretation of evolution claims that only most efficient economic subjects, that survive severe laws of market selection, prevail. Institutional economics indicates that long-term evolution of the economic process can give rise to phenomena that are not conceivable within neoclassical framework. For instance, competition hypothesis in the long run must lead to equalizing of profit rates, as the consequence of capital mobility - its migration from less to more propulsive sectors. Therefore, not any of the monopolists can secure retaining his monopolist status (except state monopoly). According to mainstream, it is very difficult to retain monopolist power in the long run. However, in the process of the evolution on the market, the principle of survival of entities with atypical features often operates.\(^5\) For instance, local monopolist, despite lesser quality of his products in relation to competitors, retains his position and satisfactory level of profit, due to economics of transportation costs.

The outcome of the evolutionary approach is the belief that optimistic scenario of market-lead, socio-economic and technological development cannot be taken for granted. Chreodic development (from the Greek words chre – fatal, and odos - path) is one of possible scenarios of socio-economic evolution. Because of the impact of random factors, certain phenomena can develop in non-desirable, suboptimal and unexpected direction, and every further prolongation of this course makes it more difficult to return to the proper path of development. The development of the phenomenon is the result of the phenomenon itself, but also of some factors from the environment, that "channel" its movement in a direction that may not be optimal from the social point of view.\(^6\) Therefore, the mechanisms of the market selection in conditions of uncertainty and randomness, as basic features of every real socio-economic situation, do not always operate as "punishing" and "eliminating" those socio-economic phenomena that are unsustainable according to criteria of economic efficiency and optimality [Nelson 1995, p. 63].

\(^5\) North explains this phenomenon as the result of imperfect political market. Imperfect knowledge of voters, tendency of voters to be uninformed, prevailing ideological stereotypes is the basis of subjective model of reality that fundamentally affects choice. This may lead to preserving unproductive institutions and organizations within the market [Hopf 1997, c. 15].

\(^6\) For instance, car constructors were able to choose between fuel and electrical engines. They chose fuel engines, which was not a rational decision from today's point of view, when both technical and ecological dimension are taken into consideration. However, restructuring of the production to electric engines is almost impossible now, having in mind the number of vehicles with fuel engines and the infrastructure dependent on car industry: service companies, oil industry, gas stations etc.
Institutional economics avoids glorification of markets, present in the neoclassical economics. Moreover, institutional economics views both competition and cooperation as selection mechanisms of socio-economic evolution. If the thesis of limited human cognitive capacities is adopted\(^7\), than agents must be somehow referred to each other. This gives rise to various sorts of cooperation among agents. In the biological world, this type of selection operates within the process of co evolution, where biological potential of certain species is magnified by the changes within other species [Boulding 1981, p. 30]. In the economy, spirit of competition in certain situations may in fact produce cooperation between agents, because it is optimal economic solution at that moment. For instance, Schumpeter's creative destruction, as the symbol of the merciless market competition, does not always presuppose survival only of those that realize new combinations of production factors and methods, but leaves the room for survival of those subjects that follow and imitate most successful entrepreneurs.

**CONCLUSION**

In contemporary mainstream economics, there is a tendency to analyze reality through logically consistent and well formally interpreted theories, without preliminary consideration whether the basic hypotheses fit economic reality. All the features of economic actors are taken as naturally given. Market mechanism is conceived as undisputable natural datum that enables socio-economic coordination. Operation of the market process is comprehended as some kind of mechanical process, which produces ultimate equilibrium. Institutional economics tends to avoid this kind of epistemological orientation. Individuals have their inherited biological propensities, but they are also under the strong influence of the social heritage, that is transmitted intertemporarily through institutions of society. Institutions and their evolution have crucial influence on individual behavior. Therefore, individual behavior is not a universally determined natural category. Behavior of an economic agent can be properly understood within the socio-psychological, historical and cultural environment in which individuals are situated. All the influences of the environment are represented by the institutions of society. In order to explain institutions, both at the general theoretical level, and within some society, economic theory must cooperate with other social sciences.

Institutional economics tries to avoid the dangers of both individualistic and holistic reductionism. Methodological orientation must be well balanced. This is achieved by proclaiming both individual and collective features of the system as equally relevant. Some kind of synergetic usage of various methods must be achieved in order to comprehend complex, dynamic, multileveled socio-economic reality. Different versions of both individualist and holistic methodological orientations, combined with evolutionary view of institutional dynamics may significantly contribute to establishing realistic approach to economic phenomena.

\(^7\) Cosmides and Tooby research on capacity of human brain concludes that human cannot solve generalized and logical problems. However, if these problems are transformed into units of social interactions, our ability to solve problems is significantly improved, although, their logical structure remains unchanged [Cosmides, Tooby 1994a, pp. 41-77].
REFERENCES


METODOLOŠKE POZICIJE INSTITUCIONALIZMA

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Institucionalna ekonomija dala je značajan doprinos ekonomskoj metodologiji. Cilj institutionalista je stvaranje realističnijeg pristupa promišljanju ekonomskih fenomena. Metodologija institutionalne ekonomije razlikuje se od kompozitnog metoda ekonomske ortodoksije, koji nastoji da konceptualizuje makroekonomsko fenomena uz pomoć mikroekonomskih osnova. Metodološka orijentacija institucionalizma široko je postavljena i inkorporirana u vid holističkog, sistemskog i evolucionističkog pristupa.

Ključne reči: metodološki individualizam, institucije, navike, evolucija