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Introduction to *The Economics of Social Institutions*

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Introduction

John B. Davis and Asimina Christoforou

This volume includes thirty-six important contributions to the economics of social institutions by leading figures in the history of the field. Its nine Parts are: Early Contributions, Methodological and Conceptual Issues, Old Institutionalism, New Institutionalism, Social Costs, Growth and Development, Institutions and Change, Institutions and Organizations, and The Third Sphere of the Economy and Institutions. This set of topics provides a comprehensive review of the origins and development of the economics of social institutions. It addresses the main theoretical and policy concerns that have occupied contributors to the approach. The economics of social institutions has been a well-established research program for over a century, and continues to evolve and develop new areas of investigation. This collection provides researchers, scholars, and interested students an extensive review of the leading contributions to the subject. It can be used to advance future thinking about the economics of social institutions and as a key resource for university teaching and education.

Part I: Early Contributions

The first important contributions to the economics of social institutions announced a new approach to economics and advanced important criticisms of existing economic thinking. The articles collected in this Part of the book represent five influential statements of what an institutional economic approach involves. The first three are well-known classics; the latter two take stock of early thinking. Together they lay out the main boundaries and commitments of the economics of social institutions.

Thorstein Veblen's famous article (Chapter 1) defined many of the themes of institutionalism, and has since stood as a defining document for subsequent authors. His charge is straightforward and perhaps still applies to current economics: despite an already long history, economics at the beginning of the twentieth century was 'helplessly behind the times' (1898: 373), and was not up to the standards of modern science because it had failed to become an evolutionary science.

The classical economists saw the laws and principles governing the economy as normal and natural, and accordingly allowed ideals of conduct to serve as their measure of truth. Their taxonomic approach lacked an understanding of the economic process as continuous cumulative change. The Historical school was a modest advance, but was still pre-Darwinian and barely economic theory. The Austrian marginal utility and subjective value school had a 'faulty conception of human nature,' and its 'hedonistic conception of man' as 'a lightning calculator of pleasures and pains' (389) is incompatible with understanding how the 'economic life history of the individual is a cumulative process of adaptation of means to ends that cumulatively change as the process goes on' (391).

For Veblen the economic life of any community is constantly shaped and re-shaped by our changing material interests amidst a succession of changing economic institutions. Economics as an evolutionary science traces this cumulative process. It sees the habits and propensities of human beings as a reflection of their hereditary and cultural antecedents. Knowledge in economics needs to be formulated in terms of causal sequence. This is the case in other sciences, but economics has persisted with its theorems about 'normal' cases. This may serve some ceremonial or aesthetic effect, but it neglects the realities of modern industrial life and technological change. Veblen believed this state of affairs to be unsustainable.

Walton H. Hamilton's early influential statement of the 'institutional approach' (Chapter 2) was also instrumental in heralding a new approach to economics. He saw a divide between 'value' economics with its focus on utility and the origins and manifestations of value and institutional economics with its emphasis on the customs and conventions of the economic system. The former, he charges, fails to recognize 'the complexity of the relations which bind human welfare to industry' (1919: 311) – a complexity which only increases with time. Modern industrial society requires an economic theory which is able to explain it. Hamilton gives five tests for such a theory, and defends institutional economics as passing all these tests.

First, economic theory needs to be able to unify economic science. Economics appears to be a collection of at best overlapping inquiries, and value economics does not bring them together. An institutional economics focus on economic organization can unify economic science. Secondly, economics needs to address the modern problem of control. The change in the nature of the modern economy makes it important to recognize that institutions are social arrangements that can be changed rather than natural phenomena. Thirdly, the subject matter of economics is institutions. The price system, credit, forms of business, contracts, property, and so on are all institutions of modern industrial society. Fourthly, economics is concerned with process. In contrast, value theory approaches phenomena as if they were unchanging physical substances. It cannot deal with a genetic and historical 'economic dynamics' and only offers an 'economic statics' of mechanical formulas and equilibrium ideas. Fifthly, economics needs to be based on an acceptable theory of human behavior. But neoclassical economics is tied to individualism, rationality, and utilitarianism, and thus ignores what modern psychology has taught us about human behavior.

For all these reasons, then, institutional economics offers a way forward for economic science. Yet, for Hamilton, the future of institutional theory was uncertain. The issue, he believed, was whether institutional theory would fit in with the thought of the time.

John R. Commons (Chapter 3) was an influential leader of the Wisconsin school of institutionalism. He saw that there were competing accounts of what institutions are, and so defined them as being concerned with collective action that aimed at the control, liberation, and expansion of individual action. He believed this conception brought economics, jurisprudence, and ethics together, and determined the overall domain of institutional economics. This then meant that the ultimate unit of economic investigation was not individual behavior or the exchange of commodities, which had been the concern of the classical and 'hedonic' economists, but rather transactions between individuals and the working rules that underlie them.

Transactions are reducible to three economic activities: bargaining transactions, managerial transactions, and rationing transactions. Institutional economics studies these transactions in terms of the behavior of individuals who participate in them. The psychology which institutional

economics thus employs is a behavioristic psychology which Commons interpreted as negotiational psychology. Its subject matter is how every choice is at one and the same time a matter of performance, avoidance, and forbearance, and how the social relations of conflict, dependence, and order are implicit in every transaction.

Commons' multidimensional view made it possible for institutional economics to explain all types of economic systems. All exhibited conflicts of interest which were manifested in the different working rules that governed transactions between people. Further, an economic system's working rules necessarily evolved as conflicts of interest were worked out between people, and this then transformed the character of transactions between them. This did not mean that one could predict how economic systems might change over time, despite popular social philosophies predicting one inevitable historical outcome or another. But Commons saw his approach to institutional economics as capable of explaining all such systems because transactions were fundamental in them all.

Veblen, Hamilton, and Commons are all part of the American institutionalist tradition, but Karl Polanyi's contribution to institutionalist thinking has different origins. Polanyi was an influential Hungarian economic historian, anthropologist, and social philosopher whose famous *The Great Transformation* (1944) described the social development of capitalism. His article here (Chapter 4) reviews the foundations of his approach known as substantivism and his interpretation of the different meanings of 'economic.' The main argument he advances is that 'economic' has two meanings – the substantive and the formal – which have nothing in common. The formal meaning derives from the scarcity concept and the means–end relationship involved in explaining choice behavior in rational action terms as in standard economics. The substantive meaning concerns the historical nature of the market system and its embeddedness in social institutions, culture, and history.

Polanyi's principal goal was to understand the substantive meaning of 'economic.' This involves explaining those processes which sustain broad patterns of social economic integration over time. Foremost among these are reciprocity, redistribution, and exchange. Societies can then be differentiated and compared according to how they prioritize and determine the nature of these three processes. Polanyi characterized human economies generally as an 'instituted process' of interaction between human beings and their environment that took on many historical forms.

But Polanyi was also keen to demonstrate that the formal meaning of 'economic' had little value outside its close association with exchange and markets dominated by prices. A formal economics by nature ignores the great variety of institutions, economic and non-economic, in which life is enmeshed and embedded, and accordingly it can only offer an abstract and partial representation of how economies function. This produces an exaggeration of the role that scarcity or an insufficiency of means plays in explaining choice. Indeed it leads us to overlook the changing place occupied by the economy itself in society at different historical times and places.

Finally the article by Anne Mayhew (Chapter 5) closes this section by taking stock of the beginnings of institutionalism in relation to its American origins. The country's experience at the end of the nineteenth and beginning of the twentieth centuries of rapid industrialization and social economic transformation provided strong impetus to evolutionary thinking and demonstrated to many the inadequacy of much of existing economics. It also showed the need for drawing on social science knowledge from anthropology and sociology, particularly to

understand the role that culture played in economic change. Culture was thus an umbrella concept that brought together many aspects of social economic evolution.

Veblen and Commons were quite different thinkers, but they both saw economic life as a cumulative process that constantly built upon itself without any teleology or final destination. What gave continuity to this process was the apparatus of economic institutions which determined the space in which economic activity occurred and yet which evolved and transformed that activity at the same time.

Mayhew argues that thinking in this way was a product of the period from the 1880s through the 1930s, when many economists were 'unorthodox.' This made for a variety of connections between the institutionalist thinking, populist social reformers, Marxists, and socialists. But neither Veblen nor Commons was a social radical. Neither saw the growth of big business and economic concentration that concerned many at the time as reversible or believed that a return to a pre-industrial, competitive *laissez-faire* economy was a realistic proposition. Rather, they were Darwinian thinkers who saw change in culture, society's institutions, and the economy as interrelated and always on-going. This distinguished their thinking from other approaches in economics, and continues to distinguish the economics of social institutions from other types of economics.

Part II: Methodological and Conceptual Issues

Any theoretical and empirical analysis of institutions must address the crucial questions of what institutions are and how they work. Economists have failed to give full merit to an analysis of institutions and their role in the economy, often because of complexities in determining their nature and effects and deriving universal concepts and mechanisms. We should not abandon our efforts and engage in institutional analysis by adopting an inter-disciplinary approach to shed light on the historical and cultural dimensions of this phenomenon. In this Part, we focus on contemporary articles that offer an overview of the makings and workings of institutions.

In Geoffrey M. Hodgson's 2006 article (Chapter 6), we come across his widely cited – and highly criticized – phrase: '[institutions] make up the stuff of social life' (2006: 2). Nonetheless, the author engages in a systematic analysis of what institutions are and what they do. First, institutions – such as language, money, law, table manners, and firms – are systems of established social rules that structure social relations by means of socially transmitted and potentially codifiable, evidently or immanently, normative rules, which constrain, enable, and change thought and behavior. Generally, they fall in between the two extremes of (instinctive or automatic) genetically encoded behavioral regularities (like blinking and breathing) and pure or full, conscious deliberation and intentionality.

Secondly, habituation is the key mechanism by which individuals acquire dispositions to engage in previously adopted or acquired rule-like behavior, so that rules become embedded in social life and institutions are sustained. The author stresses that habits are not genetically transmitted; they are acquired in the social context, in a more or less unintended or customary manner, because individuals are born into a pre-existing institutional world which confronts them with its rules and norms. At the same time, habits do not negate deliberation, because institutions depend for their existence on individuals, their interactions, their shared customs

and thoughts. One of the author's major concerns is to combat the over-estimation of self-organization and spontaneous order that are characteristic of standard assumptions of rational choice theory.

Hodgson builds an alternative ontology of institutions in which behavioral habit and institutional structure are mutually entwined and reinforcing by combining both objective structures 'out there' and subjective events of human agency 'in the head.' These ideas are very similar to notions of structuration, introduced by authors such as Anthony Giddens and Pierre Bourdieu, whereby human behavior is shaped by the interplay of structure and agency.

To define institutions, John R. Searle (2005) (Chapter 7) decides to go a different way by delineating the characteristics of institutional facts, such as money, government, property, social clubs, and marriage. He begins by making certain assumptions about individuals as conscious human beings with intentional, subjective states, who are capable of developing an objective canonical universe for the conduct of social behavior. He then argues that institutional facts typically require structures in the form of constitutive rules and exist only in virtue of collective acceptance of a certain status that carries and performs a set of functions. Thus their main features are collective intentionality, assignment of status functions, and recognition of deontic powers. This is the glue that holds society together, as the author repeatedly claims in the article.

A general point reached here is that desire-based reasons for action (or deliberation) presuppose the acceptance of a system of desire-independent reasons for action. For Searle, the latter is identified with a relatively more conscious and intentional process of collective acceptance and collaboration among the members of a social group. This is consistent with a kind of methodological individualism that the author proposes whereby the individual component of collective action plays the role of *means* to ends. There is an interesting twist, which allows us to avoid the extremes of traditional perceptions of collectivism and individualism (see also Searle 1990: 410–11).

However, it is likely that the author underestimates the determinative power of institutional facts. He fails to see individuals as 'instituted' entities, whose subjective attitudes and feelings are determined by external, institutional factors, which incorporate a historically and culturally cumulative collection of individual and collective intentionalities, even if members of the group do not come together to form a pact to follow certain rules, assign functions, and achieve collective goals.

Mark Granovetter speaks of a kind of instituted individual in his analysis of embeddedness. In his infamous 1985 article (Chapter 8), he purports that individuals do not act as atoms outside a social context, nor do they adhere slavishly to the social categories ascribed to them. Rather, their attempts to purposive action are embedded in systems of social relations. In particular he stresses the role of concrete personal relations and relational structures (or 'networks') that generate trust between members and discourage malfeasance in order to tackle uncertainty and opportunism in the market.

Granovetter suggests an idea of embeddedness that does not comply with either of the two extremes of formalism and substantivism. For him, the formalist position, adopted by standard neoclassical analysis, as well as the 'new institutional economics,' argues that behavior results from the pursuit of self-interest by more or less atomized individuals, and thus offers an under-socialized conception of economic man. On the other hand, the substantivist position, with roots in anthropology, Polanyi's analysis, the idea of the moral economy and Marxist theory, holds that economic life is submerged in social relations by imposing a generalized morality

that deterministically strains human deliberation, so it adheres to an over-socialized conception of economic behavior.

The author makes the qualification that even when embeddedness, understood as networks of personal relations, out-performs authority relations or universal principles, it does not necessarily produce efficient solutions or social harmony, on account of the coordination problems and conflict that might emerge in network relations. Still, he purports that we should accept non-economic goals of sociability, approval, and status as part of individuals' rational choice decision-making.

More importantly, as Fikret Adaman and Yahya M. Madra (2002) (Chapter 9) argue, Granovetter tends to adhere to an ontologically structuralist perception of substantivism that overlooks the Polanyian notion of the 'double movement,' whereby the process of dis-embeddedness of economic behavior that is provoked by modernization is accompanied by a kind of re-embeddedness. That is, markets are re-embedded in new social relations and structures such as the so-called third sphere of the economy – charity, voluntary associations, gifts, and intra-community networks – where associative, egalitarian, and solidaristic modes of thought and action flourish to shield against the negative consequences of the market.

In the final Part of the book, we offer a more detailed analysis of third-sphere activities and organizations, considered as a special kind of institution. Here we focus on the work of Adaman and Madra, who examine the third sphere from a methodologically substantivist and ontologically institutionalist point of view, whereby social structures shape and are shaped by individuals.

One of the most intriguing sections of the article is the authors' comprehensive taxonomy of economic models used to explain third-sphere activities. Generally they observe that theory tends to revolve around the so-called economistic fallacy, whereby all economic and non-economic activities are analyzed through a formal-choice theoretic framework built upon the postulate of rational individual calculative behavior. Their analysis reveals that in economic models third-sphere activities are seen either as a means to rectify market imperfections (*qua supplement*) or to exacerbate them (*qua pathology*). More interestingly, the authors detect models in which institutions emerge and evolve as a result of the self-interested logic of rational choice, so they are conceptualized as a variant of the market (*qua exchange*).

The authors conclude that such reductionism overlooks the heterogeneity of the economy and the endogeneity of the economic subject. Only when we take heed of these aspects of human action can we design and implement alternative organizational and institutional forms that enhance social welfare.

To investigate the non-economic dimensions of human behavior and institutional analysis, Elinor Ostrom (2007) (Chapter 10), a political scientist with a Nobel Prize in economics, suggests that we encourage the exchange between different social science disciplines.

After documenting the contribution of different strands of study in the fields of economics and political science, Ostrom sets the foundations for an inter-disciplinary institutional analysis. First she determines the analytical unit, the so-called action arena, that is identified with the area in which participants – individuals, families, firms, voluntary associations and governmental units – interact in a structure of incentives generated by: (i) the characteristics of the goods involved (that share features of non-excludability and non-subtractability); (ii) the rules-in-use (that are enforced to resolve collective action problems and must be known, understood, and legitimate); and (iii) the attributes of the community (that achieves and maintains a shared understanding of rules, mutual responsibilities, and obligations).

Ostrom then suggests alternative arrangements that go beyond the typical market–state dichotomy and recognize the role of third-sphere activities discussed above within what she terms 'polycentric-linked systems.' Here public economies are studied not as a single, isolated government, but as multiple levels of organization, ranging from small neighborhoods to international regimes. System-level outcomes depend on multilateral linkages between the public and private realms of activity, and generate both upward and downward causal processes. The conception of polycentric-linked systems is based on the idea that both markets and centralized governments cannot exist without a set of institutions that will ensure their effectiveness and accountability to public welfare objectives.

In conclusion, the author argues that there are many questions to be tackled, especially with regard to the micro foundations of institutional analysis and the emergence of cooperation and trust among individuals. So, she proposes, 'let the potlatch continue' (2007: 258).

Part III: Old Institutionalism

Institutionalism divided into 'old' institutionalism and 'new' institutionalism after World War II, when early institutionalist thinking declined in influence in the economics profession and a new approach to explaining institutions arose in conjunction with neoclassical economics. On the one hand, this cast into sharp relief what the two different approaches to institutions involved. On the other hand, that there were different approaches demonstrated the fundamental importance of institutions in the economy. The articles collected in this Part of the volume provide clear statements of what the early approach involved. The articles in the fourth Part do the same for 'new' institutionalism.

Warren J. Samuels was an especially influential second-generation institutionalist who trained at the University of Wisconsin under followers of Commons. His article (Chapter 11) is a critical survey written at the end of the twentieth century when institutionalist economics had been displaced in the profession by a resurgent postwar neoclassical economics. Samuels' article both takes stock of the institutionalist paradigm and identifies a variety of reasons for looking forward with optimism to its future development.

First and foremost among the defining characteristics of the institutionalist paradigm, and its main difference from neoclassical economics, is the principle that the market is not the only means by which resources are allocated across different uses. Institutionalists focus on the organization and control of the economy as a system more encompassing than the market. Thus they reject methodological individualism and the idea that market equilibria explain the economy. This implies that *laissez-faire* economic policy is both naïve and misguided. Economic policy needs to address institutional evolution and to do this it is necessary to recognize the role of social values in the operation of the economy.

Samuels argues that institutionalism is by nature multidisciplinary and pluralistic, and this is shown through its many links to other approaches. Thus institutionalists have close connections to post-Keynesians, social economists, radical economists, and Marxists, while the 'new' institutional economics, the public choice school, and the new law and economics all combine institutional thinking with neoclassical concepts. That these different and often disparate approaches share a conviction that the institutional nature of the economy is fundamentally important demonstrates the future potential of the paradigm. What unites them

is a view of the economy as an evolutionary process operating on many social and economic levels. Thus institutionalism is fundamentally a holistic approach.

The article by Geoffrey M. Hodgson (Chapter 12) appeared in the authoritative *Journal of Economic Literature* and thus signaled recognition by the economics profession of the importance of institutionalism as a distinct approach in economics. In part this reflected the evolution of institutionalist economics into two distinct versions: the institutionalist economics of Veblen and Commons now referred to as the 'old' institutionalist economics and a 'new' institutionalist economics with close ties to neoclassical economics. Hodgson has two important goals in his article. He seeks to answer implied criticisms of the 'old' institutionalist economics, that it was descriptive and anti-theoretical, and seeks to clearly distinguish 'old' institutionalism and 'new' institutionalism. The key claim he makes is that 'old' institutionalism employs a distinct conception of human agency that emphasizes habit rather than individual rationality, and that this underlies our understanding of institutions.

Hodgson answers the criticisms of 'old' institutionalism by saying that the institutionalists, like evolutionary biologists, have not attempted to build a single general institutionalist model, but have relied on the ideas of habits, rules, and their evolution to facilitate multiple historically specific investigations. Institutionalism thus moves from the abstract to the concrete, allowing it to enrich its explanations with psychological, anthropological, and sociological evidence. This frees it of the need for neoclassical micro foundations and methodological individualism. Yet this does not mean 'old' institutionalism is methodological collectivist.

Regarding the 'new' institutionalist economics, its main characteristic is that it seeks to explain the emergence of institutions from rational individual behavior, or move from individuals to institutions taking individuals as given. This makes tastes and preferences the ultimate explananda of economics, whereas for the 'old' institutionalists tastes and preferences are molded by the institutional environment. One can understand this molding in terms of habit-driven behavior, and then investigate how the evolution of institutions influences habits. Thus what distinguishes 'old' institutionalism is how habits and institutions are mutually influencing and intertwined.

Malcolm Rutherford's article (Chapter 13) reviews the twentieth-century history of 'old' institutionalism in order to explain its rise, appeal, and post-1945 experience. He then looks at how 'new' institutionalism has defined itself relative to 'old' institutionalism in terms of shared themes and departures. He concludes that there have been and are likely to continue to be many 'institutionalisms' over time in economics and the social sciences. Their shared theme is that institutions matter a great deal, and economists need to think hard about how institutions shape economic behavior and are shaped by economic, political, and ideological factors.

Veblen, Hamilton, Wesley Mitchell, Walter Stewart, John M. Clark, and Commons were the original founders of institutionalism. In the years after the end of World War I the institutionalist program was perceived as modern and scientific. In his 1927 Presidential Address to the American Economics Association Mitchell emphasized that institutionalism was empirical and quantitative. Neoclassical economics was thought to be based on outmoded psychology. Thus institutionalism attracted many adherents in the interwar period. Major university programs were established at Columbia, Wisconsin, and Texas. Institutionalists were active in economic research and policy formation, for example in the development of unemployment insurance, workmen's compensation, Social Security, labor legislation, public utility regulation, agricultural price supports, and promotion of planning for high levels of output.

Rutherford identifies several reasons for institutionalism's loss of power and prestige after 1945. It did not develop psychological foundations for economics persuasive to economists. It failed to further develop its theories of social norms, technological change, legislative and judicial decision-making, transactions, and forms of business enterprise beyond the initial ideas of its founders. The rise of Keynesian thinking displaced its theory of business cycles. It was not part of the econometric revolution. And much of its reform agenda was adopted. Despite this, 'new' institutionalism drew on many of the ideas of 'old' institutionalism. Where it differed was in its effort to combine them with neoclassical concepts and methodology.

Tony Lawson's article (Chapter 14) takes up an important issue in 'old' institutionalism, namely its dichotomous treatment of institutions, understood in terms of their ceremonial aspect, and technology, understood as a driver of change – a dichotomy sometimes traced to Veblen. Lawson sees the dichotomy as a weakness of some interpretations of 'old' institutionalism, and traces it to problems involved in explaining the mutual dependence of human subjects and social structures. The issue is central because a truly evolutionary view needs to explain an overall process of cumulative change in both institutions and technology, not as a one-sided materialist account.

In Lawson's view, the problem is that, for some, institutions are seen as static and resistant to change whereas technology is seen as dynamic and the impetus for change. But this misrepresents the nature of institutions, which as part of social structure are systems of social interaction between people and constantly undergo change. In virtue of this they must be said to possess emergent powers in the sense of continually exhibiting new phenomena. Lawson terms this agency–structure relationship between social structures and people the transformational model of social activity. The principal idea is that human agency and social structures are irreducible to one another and so are mutually influencing.

However, one strand of 'old' institutionalism tends to see social structures as fully determinative of human activity (the opposite of how mainstream economics fully reduces social structures to individual behavior). Lawson cites passages from Clarence Ayres and Hamilton that indicate this, and also argues that it is not easy to see precisely what Veblen's position was because he avoided ontological argument. Many recent contributors to 'old' institutionalism, he allows, are more nuanced in their views. This suggests that 'old' institutionalism continues to have considerable vitality and potential to explain social reality, and gives further understanding to the idea of evolution as cumulative change.

Part IV: New Institutionalism

The 'new' institutionalists adopted an approach to institutions that departs from the tradition of institutionalist thinking inaugurated by Veblen, Hamilton, Commons, and Polanyi. For the latter, institutions shape and guide individual behavior. In contrast, the 'new' institutionalists see institutions as the products of individual behavior. Institutions also create incentives for individuals, and evolve according to the ways and extent to which they facilitate people's wealth-maximizing goals. In addition, the 'new' institutionalists differ from the 'old' institutionalists in emphasizing the market as a centrally important institution. Societies are then compared in terms of how development of markets influences economic development.

Douglass C. North, a co-recipient of the Nobel Prize in economics in 1993, is one of the originators of the 'new' institutionalist approach, and his article here (Chapter 15) gives an

important summary of this thinking. He sees institutions as humanly devised structures of rules that can be informal and formal. In both cases institutions function to create order and reduce uncertainty in markets, and this promotes economic growth. One important way in which this has occurred historically is through extension of the institution of private property. Clearly defined property rights reduce market transaction costs. When transaction costs are low, there are gains from trade and increased specialization, and markets are extended. But the extension of markets is often accompanied by national conflict. Whether such conflict can be overcome and growth maintained has consequently depended historically on whether property rights can be extended across national boundaries.

One dimension to this history concerns how path dependence plays a role in institutional development. Path dependence is the idea of how yesterday's institutional framework promotes or limits economic evolution and change in the future. Thus an existing matrix of interdependent institutions can lock in conditions which constrain or sustain growth. The latter situation is one where political institutions have a key role in promoting productivity-raising economic activities and increasing returns, while the former situation is one dominated by monopolies that tend to redistribute income rather than increase it. North uses the historical experience of England and Spain in colonizing the New World as an illustration. English political (and religious) institutions favored decentralized economic development in North America, and this strengthened wealth-maximizing entrepreneurial activity. Spain transferred highly centralized, bureaucratic political institutions to Latin America, and this rather limited local economic development and generated instability. In both cases the history of institutional development in Europe was carried over to the New World and determined the nature of development there. Thus for North, world economic development has been uneven because countries have very different kinds of political and economic institutions.

Mancur Olson's work focused on the economics of political institutions and the logic of interest groups and collective action. He was particularly concerned with how interest groups accumulated power and influenced economic growth. In his article here (Chapter 16) he compares dictatorship and democracy in terms of their implications for economic development. Olson's premise is that no society functions well unless it is peaceful and secures basic public goods. Small societies tend to achieve this unproblematically because individuals see the benefits of cooperation and collective action. Large, diverse societies find collective action difficult to achieve because the typical individual benefits very little from collective goods.

Large societies, then, have historically had the choice of roving bandits or stationary bandits, that is, dictators. People tend to prefer the dictator if theft takes the form of regular taxation and violence is minimized, particularly on the part of roving bandits. Dictators recognize that peace and prosperous populations increase what they can take in taxes and so take less than roving bandits. Olson calls this 'the first blessing of the invisible hand.'

Democracies, in contrast, operate by majority rule. Majorities that win elections have an interest in controlling tax collections, but since they also earn a significant share of market income, their optimal tax rate is lower than that of dictators. Democratic majorities express an 'encompassing interest,' but when majorities are slim and special interests are influential, that 'encompassing interest' can be narrow and redistribution from the population high – though rarely as high as dictatorships. For Olson, the answer to this is the security of individual rights, particularly property rights and contract rights, but also free speech and the rule of law generally. Democracy is more stable on this basis, but whether democracy emerges at all has

largely been an accident of history whereby those who overthrow dictatorships lack the power to establish their own. It is the balance of power, that is, which gives rise to constitutional protections of rights.

Oliver E. Williamson, a 2009 co-recipient of the Nobel Prize in economics, is one of the most highly cited of all economists. He is not only an important contributor to 'new' institutionalism, particularly in the emphasis he places on transaction costs, but has also done much to establish the scope and nature of that approach. The article included here (Chapter 17) is his comprehensive and influential statement of what 'new' institutionalism covers. Williamson's starting point in the article is social analysis and the four different levels on which it proceeds.

These four levels are differentiated according to abstractness versus concreteness, how long the institutions on each level tend to last, and their respective purposes. Higher, more abstract levels impose constraints on lower levels, though there are feedback effects from lower to higher levels. The first level is social embeddedness, and concerns norms, customs, mores, and traditions. Institutions on this level are taken as given by most institutional economists, and persist for long periods of time – centuries or millennia. The second level is the institutional environment, and is the domain of formal rules of the game, especially as relate to property rights and legal processes. Getting the rules 'right' is the first order of economizing. Such rules last decades and centuries. The third level is what Williamson labels 'governance' or explains in terms of the play of the game. This level addresses how formal rules operate in terms of their definition, management, and enforcement. Williamson emphasizes that what is fundamental here is aligning governance structures and transactions. The time span is shorter, and at issue is second-order economizing. Finally, the fourth level of social analysis and institutions pertains to resource allocation and employment. This is the third order of economizing, and is regarded as operating continuously.

In addition, Williamson lists and explains a set of 'good ideas' he sees as the achievement of 'new' institutionalism: an emphasis on human actors, attention to feasibility and caution over ideals, improved thinking about the internal structure of firms, concern with operationalization, the goal of theory development, and a commitment to prediction.

The last paper in this section, by Daron Acemoglu and Simon Johnson (Chapter 18), provides an empirical evaluation of the historical success in achieving long-run economic growth of two fundamental types of institutions: property rights institutions and contracting institutions. Contracting institutions are defined as the rules and regulations governing contracts between ordinary citizens. Property rights institutions are the rules and regulations protecting citizens against political elites.

The premise of the paper is that while institutional research has demonstrated the importance of institutions, it has not adequately distinguished the differential impact of these two types of institutions to establish their relative importance. Yet distinguishing these institutions empirically depends on finding valid proxies for them. This paper thus sets out these measures of each, and then uses a multiple instrumental variables approach to explain their respective effects on growth by the history of European colonization. Their estimation procedures show a large effect of property rights institutions on economic outcomes. Where there are significant constraints on political elites and genuine protections against expropriation there has been substantially higher income per capita. Contracting institutions, however, have had a more limited effect, and appear to have no effect on income per capita, investment as a share of GDP, or private credit as a share of GDP.

Acemoglu and Johnson conjecture that a key difference between the two types of institutions concerns the recourse individuals have when these institutions are weak. Weak contracting institutions allow a variety of adjustments that alleviate their effects. However, when property rights institutions are weak and checks on political power are lacking, there are few ways individuals can adjust. Nonetheless, the authors allow that the historical experience on which the study is based may not apply to other historical experiences, and so contracting institutions could have stronger effects on growth in other circumstances.

Part V: Social Costs

Social costs are distinguished from private costs. In traditional Pigovian welfare economics, social costs are private costs plus externalities. Externalities are then defined as costs and benefits which 'spill over onto' or fall on individuals and groups not party to the production and market transactions where they are generated. Costs are negative externalities (such as pollution) and benefits are positive externalities (such as education). Alternatively, social costs are seen as systemic effects of private production rooted in the profit-maximizing behavior of business. Social costs have been investigated in connection with social institutions in terms of the rules that govern those who bear them.

Ronald H. Coase was the recipient of the Nobel Prize in economics in 1991. His 'The Problem of Social Cost' (Chapter 19) is one of the mostly highly cited papers in economics, and is widely agreed to have laid the foundation for the modern field of law and economics. The paper addressed the problem of market externalities as set out in Pigovian welfare economics. Coase called for a change in approach replacing the case-by-case method that was dominant with a more systematic one based on economic theory. Its principal achievement was what came to be known as the 'Coase theorem,' or that in the absence of transaction costs externalities are internalized, private and social costs coincide, and from a resource allocation perspective legal rules do not matter. Thus Coase offers a strong argument for the efficiency of the market mechanism and reasoning about law in terms of costs and benefits.

There has been much debate over the realism of the 'Coase theorem,' but the transaction cost concept has been influential. To lay out his argument, Coase set out a case that assumed that there are no market transaction costs, though he was fully aware that this was unrealistic. He reasoned that in such circumstances people would bargain in such a way as to produce the most efficient distribution of resources whatever had been their initial allocation. The question that then arises is whether policymakers should aim to produce measures that would reduce transaction costs to increase the economy's efficiency. This would presumably be superior to a resource allocation process that was carried out through legal proceedings and passing laws regulating markets. For example, if we take factory smoke pollution as a representative case, the issue would not be whether to eliminate smoke pollution but rather to determine the optimal amount of smoke pollution defined in terms of maximizing the value of production.

K. William Kapp's paper (Chapter 20) calls for a wider rather than narrower understanding of social costs and benefits – one that he argues entails a re-orientation of economic theory and the development of an alternative theory of social value. Formal economic theory, particularly neoclassical economics, employs the method of logico-mathematical deduction from abstract assumptions about economic rationality and the equilibrium nature of markets. This method

is not helpful in explaining the causal processes which determine social costs and benefits, particularly in modern industrial societies which are highly interdependent and increasingly complex. Causal processes in such societies have a cumulative character which moves economies away from balance and equilibrium.

Alfred Marshall developed the neoclassical theory of social costs. Markets are seen to be generally efficient, but there is occasional market failure associated with the external economies or diseconomies of the firm. Kapp argues that social costs are not exceptional but are business costs systematically transferred to third parties or the community as a whole. The search for profit leads firms to minimize the private costs of production, and do so by transforming private costs wherever possible into social costs. Thus social costs are the norm and an intrinsic feature of economies dominated by firms that seek to maximize profit. Consequently, while firms and industries may exhibit a formal rationality in a Marshallian sense, this can coincide with an overall irrationality of the social system of which they are a part.

Kapp thus recommends economists need an alternative theory of social value and operate with a theory of social rationality. This is an elusive idea, but it takes the perspective of the social system as a whole in which social costs are explained in terms of how modern industrial society and modern technologies impose physical and psychological effects on health, and social benefits are explained with respect to essential human needs.

Part VI: Growth and Development

Neoclassical development theory (that stems from growth models developed by Solow [1956], Swan [1956], and Tobin [1955]) and new economic institutionalism (see Part IV) predict that institutions, particularly property rights and formal rules, will enhance economic growth by reducing transaction costs. Thus economic problems in developing countries can be resolved by building better institutions, which improve governance and achieve the maximization of market freedom and the protection of property rights. These views have received stark criticism. In this Part, we investigate the debate that has emerged. Due to limited space, we refer the reader to alternative sources in the development literature concerning the role of social institutions (e.g., Adelman and Morris 1967; Sen 1999).

We begin with R. C. O. Matthews' 1986 presidential address (Chapter 21), in which he tries to discover the sources of growth by appealing to an economics of institutions. He argues that in the first half of the twentieth century economists gave undue weight to the Marshallian conception of utility-maximizing individuals in a *given* institutional structure, in spite of opposition from the Veblenian institutionalist school. Only recently have economists focused on the role of institutions and analyzed their determinants by the tools of economic theory.

Matthews adopts a general definition of institutions, which he believes transcends the main approaches that appear in economics, namely property rights, conventions and norms, types of contract, and authority: institutions are seen as sets of rights and obligations affecting people in their economic lives. Nonetheless, he maintains a transaction costs approach, similar to new economics institutionalism.

In relation to the growth question, his main caveat is that the movement toward Pareto-superior institutions is not achieved at once, as an instant response by maximizing, self-interested individuals to a changing environment of technologies and taste. Rather, we are

looking at a very long run, possibly permanent process of transition, where institutional change depends less on conscious optimization and more on events of historical accident and processes of competitive selection. This is due to complexities and forces of inertia that arise from non-voluntary interactions and power structures. This, for example, explains why state policies for redistribution might produce less efficiency and growth, and serve to favor the interest of people with the most political influence, who may not coincide with the disadvantaged target-population, or with the priorities of the median voter. Therefore, Matthews purports, it is difficult to know whether institutional arrangements are important to growth, either as a source or as an explanation of cross-country differences.

He closes his address with a plea for more empirical studies to substantiate the relationship between institutions and economic growth. Nearly two decades later, Dani Rodrik, Arvind Subramanian, and Francesco Trebbi (Chapter 22) offered their own response in their well-known 2004 article.

They begin with the premise that traditional growth factors such as physical and human capital accumulation, as well as technological progress, are at best proximate causes of economic growth, since they fail to answer the question why some societies managed to accumulate and innovate more rapidly than others. For the authors, it is important to delve into the deeper determinants of growth, which are potentially captured by three strands of thought: geography/climate, international trade, and institutional change. They test their hypotheses empirically by conducting regression analyses and various robustness tests to conclude that the quality of institutions, measured by the existence of property rights and the rule of law, trumps integration and geography and outperforms these variables once it enters the growth equation. Indeed, they use various statistical and econometric procedures that confirm what is implied in their title, that institutions rule!

However, these procedures pose problems, most of which derive from violations of exogeneity and homogeneity assumptions needed to establish universal measures and produce sound econometric results. Of course, quantitative methods can provide the economist with an important tool-kit for empirical evaluation. But caution is required when we try to substantiate the robustness of our results by appealing to readymade rules such as the *American Economic Review* test (AER-test), which is contrived by the authors in the article and has not stood against mathematical proof.

Richard G. Lipsey (2009) (Chapter 23) is also rather critical of such estimation procedures and their underlying rationale. He argues that the absence of a clear causal link between growth and any one set of institutions, such as well-developed property rights, makes it extremely difficult to measure the importance of institutions empirically by means of correlating the existence of these institutions with various national growth performances.

The author prefers an evolutionary view of the growth process and thus applies a methodology that relies on the historical documentation of economic growth and institutional change as they took place in the West from Medieval times. The main idea developed here is that growth cannot be sustained without technological advancement, which is brought about by institutions that promote invention and innovation. By means of a 'flower metaphor' the author argues that the two industrial revolutions that took place in the West and led to self-sustaining growth can be attributed to institutional developments associated with the rise of science and universities that failed to emerge in non-Western regions, such as China and Islamic countries.

Beyond the author's technological determinism, there is one point that deserves further merit: the commodification of knowledge. From the beginning of the paper the author identifies

innovation with the commercialization of an invention, that is, of a new product, process, or form of organization. He thus focuses on what he calls elsewhere general purpose technologies (that, for example, produce steam and electricity) (Lipsey *et al.* 2005), or inventions and innovations based on technological knowledge that create economic value in the form of monopoly profits. However, this perception of innovation rules out the non-economic motives, which drive scientists and innovators and produce breakthrough products, such as medicines for rare diseases, which might not produce profits but enhance development by improving the quality of life.

Ha-Joon Chang (2011) (Chapter 24) applies a comparative historical analysis to explore countries' growth patterns and institutional settings. He objects to the dominant view that so-called Global Standard Institutions (GSI), which take the form of market liberalization and the protection of private property, are more effective for economic development. For instance, he argues that developed countries, particularly in the Anglo-American world, consider 'free' markets and 'private' ownership as their source of success and advocate for further liberalization and privatization in less developed countries. Nonetheless, history shows that they have most likely implemented a high level of protectionism in opposition to the free-market ideal, while combining various forms of property rights, including state and communal ownerships.

More importantly, Chang stresses that the dominant discourse is not equipped to construct the proper policies that will bring about change, precisely because it does not have a theory for institutional change and oscillates between extreme voluntarism and extreme fatalism. Voluntarism, on the one hand, overstates the impact of rational self-interest to provoke conscious deliberation and instantaneous change toward more efficient institutions. Fatalism, on the other hand, cultivates the determinist view that a lack of GSIs supports an 'anti-development culture,' and thus overlooks the existence of competing values and ideologies that could overrule this stereotype and enforce a gradual move toward a diverse set of institutions that favor development and welfare in the economic and ethical context of a particular region. Therefore, in less developed countries the dominant discourse encourages change in institutions, rather than in policies, even when deregulation and privatization policies fail.

The author concludes that there is need to go beyond this idea of alleged institutional deficiency, for 'institutions are politically too important to be left to those who believe in these simplistic and extremist views' (2011: 495).

Part VII: Institutions and Change

In this part of the volume, we center on the issue of institutional change. Institutional change is often studied in the context of evolutionary economics, which focuses on why and how knowledge, preferences, technology, and institutions – factors typically assumed to be exogenous in economic models – change in the historical process, and what impact these changes have on the state of the economy. Some authors define evolution in relation to the Darwinian theory of natural selection (i.e., determined by the innate dispositions and adaptation mechanisms – institutional regulations, habits, and preferences – transmitted through social learning); others prefer a Schumpeterian synthesis of innovation (i.e., implemented by pioneering entrepreneurs with unique capabilities and motivation and diffuses throughout the economy in competitive imitation processes) (Witt 2006: 2–3, 14–16).

An article written by Viktor Vanberg and Wolfgang Kerber (Chapter 25) and published in 1994 combines these two approaches via the economic notion of competition. Their principal interest is not how the process of competition affects various equilibrium states, but how it influences the distribution of characteristics in a population over time (population thinking). Hence institutional evolution is understood as competition-induced change in a framework of 'variation–selection–retention': the generation of innovation by certain agents might produce profits that offer them the lead in performance and enhance competition with others, who wish to secure their survival via imitation or new variation, giving new impetus to the evolutionary process.

Vanberg and Kerber apply their approach to the competition among polities or jurisdictions. Here the feedback mechanisms that determine institutional competition at a certain level of jurisdiction, be it local administration or state government, are of two kinds: political selection (collective decision procedures and legislation) and market-type selection (individuals' or firms' decision to migrate – or, in market terms, exit). Thus regional administrators may choose to lower taxes or state governments may liberalize their domestic markets in order to invite consumers and investors and become more competitive globally. To rectify state and market failures, the authors suggest a kind of constitutionally constrained competition (as a logical extension of the research program of the Freiberg school), whereby innovativeness is channeled toward efficiency or any other normative criterion that the population considers desirable. For jurisdictions the normative criterion suggested is 'citizen-sovereignty,' analogous to the individualist-liberal criterion of consumer-sovereignty in markets.

However, in this framework firms and jurisdictions alike are subject to consumers' or citizens' preferences that are represented in the constitutional rules or the rules-of-the-game and are thus taken to be exogenous and, more importantly, based on free will. How preferences are formed is a question left unanswered.

Samuel Bowles (1998) (Chapter 26) offers a study of the formation of preferences and the influence exerted by markets and economic institutions in general on the evolution of values, tastes, and personalities. He explores the hypothesis that preferences are endogenous, contrary to the assumption of exogenous preferences that economists usually adopt in their models despite its unrealistic connotations.

Bowles distinguishes between a number of effects of markets and other economic institutions on preferences that have been documented in the theoretical and empirical literature. He makes the qualification that few are supported by uncontroversial, empirical evidence, but most are plausible and consistent with considerable evidence.

The general idea across these groups of effects is that market-oriented allocation mechanisms can generate a novel set of values and objectives that might reduce the salience of non-market concerns (social, moral, political) and spill over to other facets of life (e.g., paid labor induces us to think of subjects as commodities). At the same time, markets still rely on social norms and personal relationships of trustworthiness and credibility, particularly in imperfectly competitive settings and incomplete contractual relations, to confront uncertainty and opportunism. In this sense, the effectiveness of policies and their political viability depend on how markets and other economic institutions affect preferences. However, in this paper Bowles implicitly assumes that institutions are exogenous determinants of individual preferences and behavior, and thus offers less attention to the process of institutional evolution.

In his 2007 paper (Chapter 27), Masahiko Aoki claims that institutions are endogenously shaped and sustained in repeated operational plays of a game, where players are conceived as

rationally bounded agents that hold common perceptions about the way the game is played. According to the author, aspects of agents' bounded rationality, which presupposes limitations to their abilities to have knowledge of all the relevant parameters, causal mechanisms and probabilities, play a significant role in mechanisms of institutional change.

In particular, change depends on so-called institutions-induced individual game models, which are simplified, personal versions of the objective game structure and provide sufficient information for individual choices in a currently prevailing situation. Thus a change in the objective game-form explicit – due to accumulation of knowledge and skills, new policies, or variations in technological and environmental conditions – may start to generate internal inconsistencies or endanger the sustained compatibility with environments. After a certain threshold, hitherto held individual perceptions about the ways in which the game is played become problematic and crisis emerges in the economic-, social-, and political-exchange domain. The transitional process converges when and only when: (i) a new pattern of plays of the game emerges and becomes collectively recognized as the way the game is now being played; and (ii) agents' new action choices generate satisfactory pay-offs to them.

Despite the advantages of a game-theoretic framework, as discussed by the author earlier in his analysis, there are certain drawbacks. Basically, the formalism applied leads to an approach whereby the method defines the concept, so that institutions, the fruit of human mind, heart and soul, are eventually equated with a 'game,' or 'common knowledge,' or 'equilibrium' states, or even 'prices' as an aggregation and summary of individuals' evaluations.

Avner Greif and David D. Laitin (2004) (Chapter 28) try to take distance themselves from the self-enforcing aspects of game-theoretic explanations of institutional change. They propose a unified framework by bridging game theory (where institutions are simply states of equilibrium) and historical institutionalism (where the formation of institutions is perceived as a historical process, induced by complex human motivations and feedback processes). In this manner, they aim to balance game theory's bias toward institutional stability and historical institutionalism's tendency to over-predict institutional change. The authors illustrate this dynamic approach through two paired comparisons of institutions – political regime in Venice and Genoa and cleavage structure in Nigeria and Estonia.

Their framework relies on two related concepts: quasi-parameters and institutional reinforcement. The end result is that change constitutes a kind of evolutionary refinement of institutions, without considerable departures from the past, since the direction of change is path-dependent. This is similar to Aoki's observation that transition revolves around a 'focal point' determined by past equilibria and the level of dissonance. Nonetheless, there is room for deliberation: if quasi-parameters are observable, then policymakers might actually realize that past behavior is no longer self-enforcing, and decide to provide for an alternative set of behaviors by specifying new rules and organizations. For example, in response to rising inter-clan conflict and political instability in Genoa, the authorities decided to change the structures of governance by hiring a non-Genoese to be military leader, judge, and administrator, and thus foster the clans' ability to cooperate by creating a military balance between them.

However, a closer inspection of the authors' analysis reveals aspects of standard game theory that contradict a deeper historical analysis, when, for instance, they accept conceptions of equilibrium states and prices. Ultimately, instead of explaining institutional change, the authors focus on reinforcing processes.

In his paper (Chapter 29), Paul A. David tries to see why history matters in the formation and functioning of human organizations and institutions. For the author, the roots of path dependence in economic phenomena lie in three factors, namely structures of mutually consistent expectations, transmission mechanisms to new members, and complementarities and interdependencies across various organizations and institutions.

What this discussion implies, according to the author, is that extraneous features of initial conditions that characterize the historical context within which institutions and organizations are formed, can become enduring constraints to the degree that they combine to favor 'stasis' and 'incremental' or 'conservative' change, rather than crises and revolutions. It is pointed out that such a process resembles those of technological or biological evolution, in that 'machines' or 'genes' constitute sources of accumulated technical information or natural mutations respectively, and change by means of developments and variations that are founded upon and adapted to pre-existing aspects of these objects.

Generally, institutions are seen as what the author terms 'precedent-based rule structures,' whose obvious functional limitations stem from their remote accidental origins, even though institutional forms may initially have been established to serve a social purpose, which has since been forgotten or rendered irrelevant. Consequently, human agency and deliberation appear to have a limited role. Even though the author distinguishes institutional forms from technological systems in that machines are not composed of sensate, volitional actors, he does not hesitate to claim that institutional forms are self-perpetuating and thus require less human direction to be reproduced compared with technological systems. If human intervention is gradually eliminated, then it comes to no wonder why we continuously fail to explain how institutions *change*.

Part VIII: Institutions and Organizations

What are organizations, and what different kinds of organizations are there? What relationships do organizations have to social institutions? Much research on social institutions explains them in terms of their relation to markets. Organizations, for example business firms, are also often explained in terms of their relation to markets. This suggests that the relationship between organizations and social institutions can be explained in terms of how they differently relate to the market. Alternatively, organizations can be seen as intermediate between social institutions and markets. The three papers in this Part give different answers to these questions.

Paul J. DiMaggio and Walter W. Powell, in a highly cited paper (Chapter 30), begin by addressing a fundamental issue in organization theory, namely that different kinds of organizations are remarkably homogeneous and similar in form. Max Weber associated this with the principle of bureaucracy as an expression of rationality – what DiMaggio and Powell label the 'iron cage view.' Weber associated bureaucratization with the needs of the capitalist market economy. As firms became larger and larger, the rationalizing impulse of the market demanded their strict bureaucratic organization. But DiMaggio and Powell argue that the principle of homogeneity has itself become a cause of bureaucratization and rationality, irrespective of whether it is associated with demands for efficiency. The state and the professions have been the great drivers of this rationalization in the second half of the twentieth century.

What, then, are the forces behind this self-propelling process of homogenization? The key concept advanced here is isomorphism, a process of change that constrains one unit in a population to resemble other units in similar environmental circumstances. If we then distinguish competitive and institutional types of isomorphism, modern organizations can be understood in terms of the concept of institutional isomorphism. DiMaggio and Powell then describe three mechanisms of institutional isomorphic change: coercive (stemming from political influence), mimetic (resulting from responses to uncertainty), and normative (associated with professionalization). These mechanisms function as predictors for organizational change, allowing for a variety of hypotheses concerning such matters as resource allocation, organization goal ambiguity, technology adoption, and so on.

The framework generates a number of paradoxical results. Societies as a whole are driven by rationality or are 'smart' but the homogenization of organizations makes them 'dumb' by comparison. DiMaggio and Powell recommend greater study of how organizations evolve and greater attention to pluralism as a guiding value in public policy deliberations.

In his paper in this Part (Chapter 31), Claude Ménard addresses the different relationships between institutions, markets, and organizations. The goal of the paper is to clarify the terminological ambiguities surrounding these key concepts that have operated in the institutionalist literature in order to deepen our understanding of them. Ménard's view is that institutions overarch and subsume markets and organizations; that is, markets and organizations are always embedded in an institutional environment. Further, while markets and organizations overlap in many ways and give rise to hybrid forms, they also have their respective distinct features. This precludes saying that markets and organizations lie along a single continuum of forms.

Why do institutions operate at a higher level of generalization than markets and organizations? Institutions determine the general rules of the game and function as a framework establishing the social acceptability of different possible actions. Markets are a specific type of institutional arrangement that concerns the conditions under which goods and services are produced and exchanged. Organizations, especially business firms, are a specific type of institutional arrangement with identifiable boundaries which coordinate activities and specific assets through implicit and explicit rules and agreements. Institutions, markets, and organizations can thus be explained in terms of their foundations, or principles of consistency working within each, according to their different modes of coordination, and with respect to their 'raisons d'être.'

Ménard argues that understanding institutions, markets, and organizations first as 'pure concepts' allows us then to better understand their intersections in hybrid forms in the real world. This generally promotes the institutions research program, and in particular makes it possible to establish how institutions emerge and are stabilized.

Richard A. Posner (Chapter 32) also argues for the importance of organizations to the study of institutions, and identifies organization economics as a key development. Organization economics is concerned with the relation between organizational structure and compensation and with the relation between organizational structure and innovation, management of information flows, agency costs, and efficiency in general. Posner discusses the two types of organizations that have exhibited significant organizational inefficiency problems: the publicly held private business firm and public organizations such as major government agencies. He then discusses two types of public organizations which have been relatively successful in organizational efficiency terms: judiciaries in common law nations and judiciaries in civil law nations.

As his cases demonstrate, Posner is particularly interested in what organizational economics can contribute to the field of law and economics. Thus he examines economic problems organizations encounter with an eye to how organizations operate in legal environments. For example, in the case of the private business firm, the issue of excessive executive compensation raises issues not only concerning agency costs but also concerning the legal rights of a firm's shareholders. In the case of the two public organizations Posner discusses, US intelligence agencies and the Federal Bureau of Investigation, competition and lack of communication between bureaucracies create inefficiencies in achieving agency goals while creating questions about the protection of citizen rights. In contrast, while common law and civil law organizations can have efficiency problems as well, they tend to be well adapted to the legal systems in which they operate.

Organization economics thus develops the understanding of institutions and formalizes many of its insights. It does so by first looking within the organization and by investigating the relationship between an organization's goals and culture, and secondly by judging this combination relative to the broader institutional environment, which is dynamic and changing.

Part IX: The Third Sphere of the Economy and Institutions

We close this volume by focusing on a special type of institution that we encounter in the so-called third sphere or third sector of the economy, which generally includes non-profit organizations, charities, voluntary associations, mutuals, cooperatives, and social enterprises. Despite interest in the social sciences, this field has received relatively little attention in economics.

Evers and Laville (2004: 13, 20–21) stress the context-specific characteristic of the third sector across countries, where social organizations interact with public legislation and welfare state policies, the values and practices of private business, contributions of informal family and community life, and initiatives by popular movements. Specifically, they distinguish between the US and European tradition: the former is highly influenced by the rational choice principle and relies on the 'market and government failure thesis' to explain the emergence of the non-profit sector; the latter reflects the 'social origins theory,' which highlights the historical and socio-political aspects of the third sector in pursing social welfare objectives against self-regulating markets.

We begin with Richard Steinberg's article (Chapter 33), published in 1997 in the journal *Voluntas*, one of the most prominent in this line of research. He evaluates the capacity of economic theories to analyze the emergence and evolution of non-profit organizations. A general conclusion that arises from the author's exposition is that economic theories are useful, but still have a long way to go in determining the character, the origin, and effects of non-profit organizations.

Specifically, Steinberg argues that more work needs to be done in terms of the various ways that the legal framework of tax and regulatory authorities have operationalized the non-distribution constraint, or have introduced alternative arrangements for the distribution of profits. This is a core feature of these organizations, which brings to the fore some of the central problems that are unique to the non-profit sector, compared with for-profit organizations, and are associated with governance structures (stakeholder versus stockholder obligations and rights, particularly in

decision-making) and entrepreneurial and staff motivation (social/ethical values versus financial incentive systems). He further stresses the need to develop useful distinctions between voluntary action and market exchange, and more comprehensive explanations of the co-existence of the various for-profit, non-profit, and governmental organizations.

The author argues that transaction costs and public goods theories could provide an economic foundation for the analysis of non-profits. Nonetheless, he encourages cross-fertilization between economics and the other social sciences in order to capture the influence of endogenous preferences, stigma, and power in economic models and conduct field experiments to detect the characteristics of managers, volunteers, and recipient agencies. However, Steinberg presents the voluntary sector more as a service provider and less as an agent of advocacy and change in the pursuit of social welfare.

We now turn to studies that focus on alternative types of not-for-profit organizations, which engage in production and commercial operations, based on interest objectives and structures that differ from for-profit organizations and the non-profit organizations examined by Steinberg.

We begin with an early article by Frederic L. Pryor (Chapter 34), published in 1983. Pryor conducts a review of the literature on production cooperatives, covering a wide range of structures and developments that were also characteristic of former communist regimes. According to Pryor's institutional definition, a production cooperative is an organization where: production is collectivized; the net income is divided among its members according to some formula; there exist various ownership arrangements over the means of production; and members choose their leader and take active part in the decision-making process.

Generally, the author observes that the growing literature on cooperatives reflects an interest in an alternative form of production that diverges from both extremes of heartless capitalism and soulless socialism. However, he feels that further theoretical and empirical studies need to be done in economics to investigate the formation of production cooperatives and their impact on economic performance at the micro and macro level.

One point worth mentioning is Pryor's comparison between production cooperatives and profit-maximizing firms, that is, between a labor-managed economy and a traditional capitalist economy. Case studies reveal that some producer cooperatives might fail to achieve some of their collective objectives, because of internal or external constraints, such as intra-group dissension, limited financial resources, and political opposition. The author then speculates that production cooperatives might need to achieve some kind of 'critical mass' before they can establish and maintain production in a competitive, profit-driven economy, and this depends on the social, economic, and legal environment that they face.

We proceed to recent studies that focus on a more general type of third-sector organization, which includes cooperatives, namely the social enterprise. According to Chris Mason, James Kirkbride, and David Bryde (2007) (Chapter 35), social enterprises are distinguished from other third-sector organizations, such as non-profits and charities that rely on donations and grants, by virtue of the trading of products and services as a means to raise capital and finance their primary social objectives. For Giulia Galera and Carlo Borzaga (2009) (Chapter 36), social enterprises combine entrepreneurial operations with the cooperative movement and stress the idea of collective entrepreneurship, which focuses on the needs of the most fragile segments of the population and the adoption of participatory governance structures.

Both of these papers address questions posed in our two previous articles concerning the role played by the institutional environment of the third sector. In particular Mason *et al.* argue

that there is a need to adopt a broader theoretical context that focuses on the institutional embeddedness of governance, in order to balance inherent tensions between having a business focus and supporting general-interest objectives. Drawing from existing governance theories, Mason *et al.* suggest that social enterprises can be most effectively informed by the stakeholder approach (which emphasizes the enterprise's ultimate goal to serve the needs of a group or community and deliver a social benefit, based on democratic and ethical values) and the stewardship approach (which stresses the trustworthiness and pro-organization orientations of the enterprise's managers). The two are then combined within the context of a neo-institutional theory that is developed by the authors.

Nonetheless, Mason *et al.* give limited attention to the different aspects of the institutional context that could influence social enterprises, by referring generally to cultural values as elements of the informal system. A more extensive discussion is provided by Galera and Borzaga, who focus on the impact of the legal framework of social enterprises, which often reflects the historical, political, and ethical conditions that determine the mission and operations of these organizations in society.

After a very comprehensive exposition of the conceptualizations of social entrepreneurship and social enterprise, Galera and Borzaga conduct a case study of the legal frameworks applied in different European countries, including Italy, Portugal, Spain, France, Belgium, Finland and the UK, and examine how social enterprises shape and are shaped by the legal forms established across national settings. They highlight the variety of conceptions, due to cultural and historical specificities, in relation to the mix of governance structures and goals recognized for social enterprises, so that even at the level of the European Union they discover no common definition. In their attempt to devise a more general definition across European regions, they observe a social and legal system that sees the social enterprise in its new role as service provider and worker-integration organization, and determines key aspects of its function, such as general-interest objectives, the adaptation of a non-distribution constraint, the participation of stakeholders, and public–private synergy.

For the authors, the key aspect of the social enterprise is the opportunity for social change by questioning the very concept of enterprise as an organization that typically promotes the exclusive interests of its owners and profit maximization objectives.

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