

Institutional individualism and institutional change: the search for a *middle way* mode of explanation.

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ABSTRACT

After noting the lack of enthusiasm of several well-known scholars concerning the adoption of both methodological holism and methodological individualism in its several versions, the present article shows that *institutional individualism* is a different mode of explanation from both of these and also that it is not the same thing as the so-called Popperian program of situational analysis. Institutional individualism is a mode of explanation that yields non-systemic and non-reductionist explanations at the same time as it allows for the incorporation into economic theories and models of the many formal and informal institutional aspects surrounding all human interactions, whether these interactions take place within stable structures of legal rules and social norms or whether they attempt to change the said rules and norms. Finally, the paper shows that it is possible for old institutionalists to make institutional individualist analyses of institutional changes while retaining the remaining methodological assumptions of the *school*. The same is true for new institutionalists. Some examples are offered from both camps.

JEL Classifications: B41, D23, D72

1. INTRODUCTION

In the final section of a previously published article (Toboso, 1995) I left the following question open: to analyse the institutional changes taking place everywhere in democratic societies, is there any mode of explanation that provides a *middle way* between methodological holism (MH) and methodological individualism (MI)? My purpose here is to offer a preliminary answer to this question.

Since the article mentioned above emphasises the methodological differences that usually exist between *most* old (or *original*) institutionalist contributions and *most* transaction cost/new institutionalist ones concerning the analysis of institutional changes, in section 2 I merely point out these differences in order to provide the reader with a useful global starting point. Whereas *most* old institutionalist contributions are *usually* based on a holist mode of explanation, *most* new ones are based on a methodological individualist one. Of course, within each camp we can also find several analyses that are not so based, as well as many debates concerning both the explanatory relevance of the analyses thus elaborated and the adequacy of the methodological

choices made, including the mode of explanation choice and the issue of versions. In order to show that more research is needed on the issue, in section 2 I also briefly mention the positions held by some well-known scholars who are not satisfied with systemic and reductionist analyses of social affairs and are looking for a mode of explanation that provides a kind of *middle way*. Though they are necessarily interwoven, the present article places special emphasis on separating this issue from the many other methodological issues at stake, such as those concerning the rationality assumption, the mode of interaction assumed, the intended/designed versus unintended/evolutionary conceptualisation, the assumption concerning the level of uncertainty, etc.

In section 3, I go on to explain what institutional individualism consists of. I argue that this mode of explanation is different from those considered in section 2 and that it is not the same thing as the so-called Popperian *programme* of situational analysis. In order to present it, I go back to the contributions of J. Agassi in order to show that institutional individualism allows for a *middle way* type of explanatory analysis, compared to the analyses that stem from MH and MI in their most often employed versions. The three methodological rules that form institutional individualism are compatible with many other methodological assumptions or principles. These rules allow scholars to give non-systemic and non-reductionist explanations in which the formal and informal institutional aspects surrounding all human interactions may be incorporated as explanatory variables.

Lastly, in sections 4 and 5, I point to some analyses of institutional changes that may be deemed to be reasonably good institutional individualist analyses. Some of them may be placed in the old institutionalist camp while others may be ascribed to the transaction cost/new institutionalist one, all depending on the remaining methodological foundations or *hard core* assumptions made by the scholars. This, of course, means that it is possible to maintain the sharp differences in approach that exist between old and new institutionalist contributions even when the authors adopt a similar mode of explanation. Institutional individualism does not preclude the possibility of accounting for power influences, distributional conflicts, inequalities, etc., as old institutionalists frequently do when attempting to explain institutional changes. Nor does it prevent new institutionalists from adopting a voluntary conceptualization of economic transactions, using transaction cost concepts, accounting for efficient or inefficient institutional

changes, etc., as they usually do. Sharing institutional individualism, then, does not necessarily lead to any kind of convergence between old institutional economics (OIE) and new institutional economics (NIE). No statement in favour of such a convergence is made in the present article.

In accordance with the dictates of methodological pluralism, the purpose of the present paper is not to argue against any of the methodological holism and methodological individualism versions.

2. THE SEARCH FOR A MIDDLE WAY MODE OF EXPLANATION BETWEEN HOLISM AND METHODOLOGICAL INDIVIDUALISM.

In Toboso (1995), among several other methodological differences, I showed that old institutionalist contributions and new institutionalist ones are *usually* based on two different modes of explanation and on two different sets of *hard core* assumptions concerning the mode of human interaction.¹ Methodological holism, in its different versions, and the so-called power conceptualization are two *hard core* methodological principles of many old institutionalist analyses of institutional/organisational changes. By contrast, many new institutionalist analyses are based on the so-called voluntary conceptualization or perspective and on the requirements of methodological individualism, though they also present different degrees of reductionism. Whereas old institutionalists usually look for inequalities and distribution impacts, new institutionalists are usually concerned with the quantity of the transaction costs that stem from alternative institutional frameworks. Institutions are more efficient if transaction costs are lower, all other things being equal.

Although the purpose of the paper is to deal with institutional individualism, not to argue in favour or against methodological holism or methodological individualism, as a way of briefly summarising the position on methodological holism that is most accepted among old institutionalists, though this is a controversial issue², we could say according to the classic and much cited contribution by Wilber and Harrison (1978), and also according to Rutherford

¹ A list of representative contributions from both the Old and New institutional economics may be found in Toboso (1995). See also Hodgson (1998), Alston and others (1996) and Kasper and Streit (1999).

² Rutherford (1994, pp. 27) even says that "A great deal of confusion surrounds the debate over methodological individualism and holism". Gruchy (1947) is considered the pioneer among the old institutionalists in introducing the term *holism*. Differences exist, however, among the current old institutionalists concerning the characteristics that a holist explanation should have. In fact, several versions of methodological holism are being used. See for example, Klein (1993), Bush (1993), Hodgson (1993a) and (1998). Some connections between OIE holist approach and Durkhemian positive economics are shown in Gislain and

(1994), that adopting this mode of explanation implies the presupposition that individual actions can only be understood and explained properly if individuals are considered as elements or components of some other *entity*, the position they occupy being a basic factor that determines the values, ideas, knowledge, preferences, purposes, and constraints they face. Therefore, in order to analyse human actions and interactions and the events generated, special attention must be paid to the *entities* (*groups, associations, corporations, political parties, churches, states, etc.*) to which most individuals mostly belong as passive members who assume (we do not now specify how) the purposes, values, norms, etc. which have usually been established long before as distinguishing marks of the said *entities*. It is because of the aforesaid presupposition that these collective or social *entities* assume such a central position in *most* old institutionalist contributions. In these holist analyses it is also frequently assumed, explicitly or implicitly, that these *entities* possess a kind of systemic force or logic which drives events in such a way that it is difficult for the analyst to discover personal responsibility for what is going on. Events such as continuous changes in prices, increasing unemployment, technological changes, etc. and, indeed, institutional reforms, all tend to be explained mainly by way of revealing which systemic and impersonal forces are in place and how they operate. Of course, not all old institutionalist contributions are systemic to a similar degree. Not all of them attribute such an insignificant role to human action. Some analyses incorporate functionalist explanations in order to show the presence of a stabilising force without referring to any causal mechanism, but others do not. Whatever the variety of MH adopted, old institutionalist contributions seem to be built on a presumption that gives primary importance to the social whole. According to Rutherford (1994, chapter 3): "This social whole is seen as influencing and conditioning individual behaviour. However, the strength with which the social is seen as conditioning or determining behavior of the individuals varies substantially between holists.... In some cases, holists do seem to imply that macro or social entities have some sort of agential power of their own, but this is by no means an universal characteristic of the genre".³

In contrast, *most* transaction cost-new institutionalist contributions are built on a methodological individualist mode of explanation, on a voluntary conceptualization, on the

Steiner (1999).

³ See also Hodgson (1998).

closely related bounded⁴ rational choice principle, and on a efficiency criterion based on transaction cost, besides other assumptions and criteria.

Although not all new institutionalist contributions present the same degree of reductionism⁵, we can find many that are built on the requirements of the strict and frequently used interpretation of methodological individualism that is sometimes associated with Elster's contribution on the issue. According to that, this mode of explanation requires that social events (inflation, increasing unemployment, organisational changes, evolution of cultural norms, etc.) be explained in terms of individual actions, assuming fixed preferences and incorporating nothing other than material constraints (natural, technological, and monetary) into the analyses. "Social/institutional" factors must be reduced or broken down into the individual actions (with fixed preferences and material constraints) that generate them if an acceptable individualist explanatory analysis is to be constructed. This is why many new institutionalist scholars who are interested in investigating the changes that are taking place in social conventions, legal rules, forms of organisation among private companies, etc. are making explanatory analyses in which we only see abstract individuals (boundedly rational, etc.) who attempt to obtain income-favourable (usually efficient) legal rules/social norms in stylised situations that the analyst presents as being characterised almost exclusively by the rule of competition and the existence of transaction costs.⁶ Of course, not all new institutionalists analyses are so built as we shall see in section 5.

The existence of both holist and methodological individualist analyses of institutional/organisational changes has been paralleled by an interesting debate concerning both the explanatory relevance of these analyses and the adequacy of the methodological choices that are made.⁷ The debate may be introduced by reference to the representative papers of Langlois (1989) and Rutherford (1989). R. Langlois does not like the holist explanations that, as we said, are so abundant among old institutionalist contributions. M. Rutherford, in contrast, does not like the reductionist or psychologistic requirement that a strict interpretation of methodological

⁴ On the bounded rationality assumption, see Simon (1979) and Kahneman (1994).

⁵ On this issue, see Johnson (1999), as well as Eggertsson (1990, pp. 7) and Furubotn (1993, pp. 8).

⁶ See, for example, Sudgen (1989), Axelrod (1984), Schooter (1981), Furubotn (1989), or the classics Coase (1937) and North & Thomas (1973). I do not pay attention here to the "it happens because it is efficient in reducing transaction costs" argument that is also offered on many occasions.

⁷ Bush (1980a), (1981b), and Seckler (1980), (1981) contain an interesting debates on the virtues of different modes of explanation. Coase (1984: 230) and Dugger (1990) contain more radical statements.

individualism imposes upon many new institutionalist analyses. Of course, a similar dissatisfaction was not only emphasised by several social scientists in the sixties and seventies⁸; other economists before and after Langlois and Rutherford's brilliant articles have also partially dealt with the topic and reached similar conclusions.⁹ Among these authors, however, apart from their shared dissatisfaction and their pronouncements in favour of a *middle way* mode of explanation, it is not easy to find any other consensus concerning the rest of the methodological assumptions they endorse and use. The consensus even breaks down when this alternative *middle way* mode of explanation has to be defined and named.¹⁰

At this point, I propose to go a step further and offer a synthetic but innovative presentation of a mode of explanation that most of the said authors seem to have in mind to some extent and to which some even refer explicitly. To the best of my knowledge, it was Agassi (1975) who named it *institutional individualism* and who offered a pioneering systematic presentation of such a *middle way* mode of explanation. I shall also argue that it is not the same thing as the so-called Popperian programme of situational analysis, even if there is a common ground between the two.

3. WHAT DOES INSTITUTIONAL INDIVIDUALISM CONSIST OF?

The above comments clearly show that more research and academic dialogue are needed¹¹. In this section, I want firstly to argue that the program of situational analysis and institutional individualism as a mode of explanation are not the same thing. Situational analyses require the researcher to adopt not only an institutional individualist mode of explanation but also some other complementary assumptions such as the rationality assumption or principle. In contrast, it is possible to give institutional individualist explanations of different types of non-calculated behaviour, that is, of rule-following behaviour, norm-guided behaviour, etc. Situational analysis may be best understood as a program of analysis in which several *hard core* methodological principles or assumptions are established. Institutional individualism is only one of these

⁸See, as an example, the collection of papers contained in O'Neill (1973).

⁹See Lawson(1987), Gunnarsson (1991) or Field (1979, 1981, 1984).

¹⁰See for example Mäki (1993: 17), Boland (1982: 36), Caldwell (1991: 13), Langlois & Csontos (1996: 122-25) or Rutherford (1994:37).

¹¹Hodgson (1993b) has edited a selection of articles on *The Economics of Institutions*, from the reductionist methodological individualist contribution by Axelrod (1986) to the methodological holist one by Bush (1987). He also includes several articles on methodological issues and debates.

methodological principles. However, institutional individualism, as a mode of explanation, may be used in combination with many alternative *hard core* methodological assumptions, not only with that which is selected in the program of situational analysis.¹²

Secondly, this section is intended to offer a definition and presentation of institutional individualism that covers the essentials and avoids many complementary aspects and much unnecessary sophistication.

Since Popper's written ideas about situational analysis are not very precise, as mentioned in the previous section, it is N. Koertge's (1975, 1979) interpretation of that program¹³ that is being used as a substitute. Although I have deliberately altered the order of elements and made the role played by institutional individualism explicit, the ultimate elemental components and structure of a situational analysis, following Koertge's interpretation as closely as possible, should resemble the following:

1. *Rationality assumption:*
Agents always act appropriately (rationally) in their situation.
2. *Description of the situation:*
Agent A is in type C situation
3. *Institutional individualist analysis under the rationality assumption:*
In a type C situation, the appropriate (rational) thing to do is X.
4. *Explanandum:*
Therefore, A does X.

Using Lakatos' concepts to characterise scientific research programs, we could say that this rationality assumption or principle represents something close to a *hard core* methodological foundation that is not subject to discussion among those who accept the program. The type of rationality to be assumed is a different question. What we all know as *standard rational choice theories* should be considered only as the most popular and extended way of defining rationality. The rationality principle need not be defined as it usually is, that is, as a full rationality assumption. It may also be defined as a bounded rationality assumption that incorporates a cognitive limitation in human processing abilities¹⁴. Of course, although the above elemental schema contains no indication in this respect, such a program also enables strategic interactions among agents or groups of agents to be accounted for. Some characteristics of the situation,

¹² U. Mäki's critical comments at the 1995 EAEPE meeting, as well as those of an anonymous referee, have led me to refine this aspect. See Oakley (1999).

¹³ B. Caldwell (1991), Hands (1992) and U. Mäki (1993) are examples of such a presentation.

when present, might induce agents to act strategically when dealing with others, through individual or team/collective strategic actions.

However, what is important here is that the aspects of the situation (proposition 2) which this program of situational analysis makes it possible to incorporate as explanatory variables include not only the preferences, aims and interests of the relevant agents and the relevant material conditions (natural, technological and monetary), *but also all other relevant institutional or social aspects* that might characterise the situation in which agents interact. This means that situational analyses, so constructed, are not of a reductionist or psychologistic nature¹⁵. In this respect, Blaug (1980) offers the following quotation from Popper (1976: 117):

"this program consists of building a model of the social situation, particularly incorporating the institutional situation the agent confronts when acting, so that the rationality of his action may be accounted for".

In contrast, J. Agassi's (1975) presentation of institutional individualism makes no reference to the rationality principle¹⁶. Agassi's main task is to find out which role should be attributed to "social" or "institutional" factors when analysing human interactions and their consequences, rather than which type of mental processing should be assumed. For Agassi, both are interwoven aspects that every social researcher should consider and take a position on, but they may be conceptually demarcated. Neither was he interested in adopting a position on the many other methodological assumptions that social researchers necessarily have to make in order to construct their analyses. Institutional individualism is just a mode of explanation that may be incorporated into different programs.

What, then, characterises institutional individualism? Although Agassi (1975) defines it from a comparative point of view, I shall define it autonomously from the beginning. I shall, however, follow a similar schema to that employed by Agassi, and also by Rutherford (1994), to define methodological holism and methodological individualism¹⁷.

In order to characterise institutional individualism, a central question is whether

¹⁴ See Langlois (1990).

¹⁵ See the coincident position held on the issue by such diverse authors as Blaug (1980: 71), Caldwell (1991: 14) and Langlois (1989: 278), Langlois and Csontos (1993: 122) and Rutherford (1989: 304).

¹⁶ However, in a much earlier article, Aggassi (1960) gave a preliminary, more ambiguous, presentation of institutional individualism that I shall not consider here.

¹⁷ Though Rutherford (1994: 28-35) makes a similar characterisation to that of Agassi (1975), he uses the definitions of methodological holism and methodological individualism contained in Agassi (1960) and others which are less precise than

"social/institutional" elements may be incorporated into the analyses/models as explanatory variables regardless of the remaining methodological assumptions adopted. A complementary question is whether "social/institutional" conditions affect the behaviour or even the preferences of participants. A third question is whether particular institutional/organisational changes always take place under the umbrella of broader formal and informal institutional frameworks. The rules of institutional individualism provide for a straightforward answer to these three questions.

Institutional individualist explanations require that three rules be obeyed. These rules establish the way in which institutional aspects may be incorporated into the theory as explanatory variables. The rules also specify the way in which institutional conditions may be assumed to affect human interactions. However, in any analysis of a social event, several other methodological principles are needed in order to establish additional rules and procedures. Which type of rationality and preferences should be attributed to participants? Which mode of human interaction should be assumed? What of intended/designed versus unintended/evolutionary conceptualisations? What of the level of uncertainty agents are supposed to experience? And so on. Institutional individualism, as a mode of explanation, does not determine the answers to these other questions because it is compatible with most, if not all, of the possible alternatives.

Though Agassi (1975) does not explicitly adopt the following schematic presentation, I believe that it incorporates all his basic ideas and arguments about institutional individualism.

In accordance with this schema, institutional individualism may be defined as containing the following three propositions or rules:

1. *Only persons can pursue aims and promote interests.*

(They can act individually or in groups of individuals; the aims may be perceived as their own or as those of others; the aims may or may not be set out in written documents; the aims may be stable or subject to changes when preferences and mental models change or when the situational circumstances change, for whatever cause; etc.)

2. *Formal and informal sets of institutional rules affecting interactions among persons must be part of the explanatory variables.*

(These formal and informal institutional structures may be part of the exogenous situational conditions that influence the opportunities faced by participants but not their fixed preferences, or they may affect the preferences of those who spontaneously try to conform or adapt themselves to the prevailing social and legal institutional environment created by others; or the

those of Agassi (1975).

institutional rules may also affect the preferences of some because others deliberately persuade them to conform and adapt to the said institutional environment; etc.)

3. *Marginal institutional changes always result from the independent or collective actions of some persons and always take place within wider institutional frameworks.*

(These independent or collective actions may be guided by unbounded rational and strategic calculations of self-interest on the part of all relevant participants (case by case strategic maximisation), or by bounded rational and strategic ones, or by bounded rational but not strategic ones (rational rule-following, satisfying, adaptation by imitation, etc.), or by other considerations of morality, solidarity, etc. In these processes of independent or collective action some persons may attempt to persuade others to internalise certain social norms or conventions, to vote sincerely in favour of certain legal reforms they believe to be fair, etc. Such independent or collective actions may result in intended or unintended consequences, etc. When any institutional framework is changed or reformed, not only human agency but also the other legal rule structures and social norms that are not being changed must be taken as explanatory variables if they influence the process of reform)

The comments below each proposition or rule must be considered as examples of the potential and flexibility of institutional individualism. They do not exhaust all the possibilities. Institutional individualism is a methodological principle that may pertain to the *hard core* of different programs of analysis. Proposition or rule 1 makes this a different mode of explanation from that of methodological holism, particularly in its most frequently used versions that were mentioned in section 2. Constructing models and analyses according to this rule means that *no impersonal active entity with apparent aims, interests and driving forces of its own is included in the discourse as an explanatory variable, nor is any other impersonal systemic factor that possesses its own dynamics for which the responsibility may not, even indirectly, be attributed to any person.* Social norms and legal rules structures exist nevertheless, and they usually form informal and formal institutional structures that may be included in the model or discourse, but only according to the dictates of these three propositions or rules. These rules forbid nothing concerning the many complementary assumptions that researchers also have to make in order to construct their analyses, as the examples depicted below each of the said rules show.

Proposition or rule 2 makes this a different mode of explanation from that of methodological individualism, particularly in its standard or strict version also mentioned in section 2. The construction of analyses according to this rule means that the purpose of eliminating all "social/institutional" explanatory terminology from the discourse is left to other scholars. If there are always legal rule structures and social norms that frame and affect interactions among

persons or groups of persons, then accounting for those actions requires that attention be paid to the existing relevant rule structures.

Proposition or rule 3 requires not only that concrete institutional changes be explained as resulting from the independent or collective actions of some persons but also that those other legal rules and social norms that (not being changed) are influencing the said process of change be incorporated into the analysis as explanatory variables. If this is so, apart from the institutional rule or set of rules the change of which is being explained, many other institutional variables, as well as preferences, mental models and material conditions (natural, technological, and monetary), may be incorporated into the analysis or model as exogenous or endogenous explanatory variables. The way in which they are incorporated must be in accordance with the three rules of institutional individualism.

Only a few options are not allowed by the rules of institutional individualism. Those conducting institutional individualist analyses are not allowed *to assume that only preferences and material conditions (natural, technological, and monetary) are sufficient exogenous explanatory variables for the construction of economic analyses*. Among the many other alternatives, as indicated in the comments below the said rules, it is permissible, for example, to account for a change in preferences or mental models and to use this change as an explanatory variable of another event or phenomenon in what, therefore, becomes a dynamic theory or a theory of a process of change¹⁸.

Compared to methodological holism and methodological individualism, at least to their most frequently used versions, there is no doubt that institutional individualism is a *middle way* mode of explanation that yields non-systemic and non-reductionist explanations at the same time as it allows for the incorporation into economic theories and models of the many formal and informal institutional aspects surrounding all human interactions, whether these interactions take place within stable structures of legal rules and social norms or whether they attempt to change the said rules and norms.

¹⁸ In Hodgson (1998), as well as in other papers, this author emphasises that one of the most important limitations of the rational choice analyses that are based on the principles of psychologistic methodological individualism is to assume fixed/exogenous preferences for the analysis. When explaining the process of change taking place in legal rule structures, a place in the model, as explanatory variables, must be reserved for political debate, mutual persuasion and, consequently, for changes in the preferences and mental models of some participants.

4. SOME EXAMPLES OF INSTITUTIONAL INDIVIDUALIST ANALYSES FROM THE OLD INSTITUTIONAL ECONOMICS.

At this point, a new question arises: are there any examples of institutional individualist analyses of institutional changes?

As regards economic analyses, I believe that it is not difficult to agree that this type of explanation/analysis is more frequently found in applied economics papers, reports and books than in pure theoretical or general ones. Institutional individualist explanations are also frequently found among the contributions of non-economists such as historians, political scientists, legal scholars, anthropologists, etc. They are, of course, predominant in the stories of human affairs recounted by journalists or movie makers and they are also predominant among practical people, as we all are, when we reason or think about the strategic choice problem situations we confront day after day.

However, as regards most general/theoretical economic analyses of institutions and institutional changes, we can affirm that these institutional individualist contributions are far more scarce. Why this is so is a very stimulating question that goes beyond the scope of this paper.

In section two of this article I said that *most* old institutional analyses are formed by holist explanations of several types, but, of course, not all are so constructed. We can find some contributions that are not so extreme in the mode of explanation they adopt.

A.A. Schmid (1987) is an outstanding example. Of course, the reference to this classic book in no way implies that all Schmid's contributions are so constructed. Among many other institutional individualist analyses, he shows how people in feudal Europe had a traditional right to use certain land for cultivation and had common access to certain pastureland. If someone could not make use of his entitlement, the land was simply absorbed by others. There was no way for a person to transfer rights explicitly to some specific other person. There was a right of use but no right to exchange or grant. The transformation from use rights to markets in most resources may be considered one of the most painful and misery-producing periods of history if we pay attention not to the total wealth created but to the huge number of people whose living conditions became extremely poor during those years as a result. This transformation severely altered the prevailing institutional framework. The right to transfer meant that it became

possible to gain assets by withholding what you own from others even when you cannot make use of it yourself. This is a proprietary scarcity. The right to withhold from others what they need but do not own is the potential substance of market income. Coupled with the right to transfer, it is the engine by which it is possible for some people to accumulate great wealth and, in effect, to have other people work for them. In a non-transfer economy, some people are more energetic and skilled than others and many have access to the use of rights to natural resources that are more productive than the resources of others. Differential access to resources means that some people still have more wealth than others, but differences are limited. In an exchange economy, the differences can be and are extreme. In a non-transfer economy with given use rights, the only cleverness that counts is that which competes with nature, but in an exchange economy, cleverness against other people redistributes assets even where the total wealth remains unchanged. If one party can be kept in ignorance, the other may make a more advantageous bargain. In a modern market economy, a good deal of talent and energy goes into manipulation of paper assets and tax avoidance, which have little to do with the production of wealth. Much effort also goes into creating scarcity to increase prices.

Schmid also shows, for example, how there is a set of property-rights issues that can best be understood as boundary questions if an institutional individualist analysis is to be made. In one way or another they all involve the issue of how a person, in his capacity as consumer or voter, is grouped with other people. For example, in a number of situations the scale of product Y has some influence on the profitability of making product X because both products are segments of a larger product sought by certain consumers. An example may be seen in the different links that exist in a transport network, such as main lines and feeder lines. A problem of interdependence arises when not all people have the same interest in each segment of the product. Some people ride a long distance over many segments and others only use a portion. When the segments are provided by different firms, the existence of a feeder line may affect the number of customers and the profitability of the company that owns or operates the main line. This interdependence may be accounted for in several ways. The main line firm may offer the feeder firm a payment to help it to stay in business. The external effect is internalised by market bargaining. Another possibility is an expansion of the size of the firm to include both segments of its interconnected route. It is possible that the integrated firm will suffer losses on certain portions of its system,

but the existence of the feeder routes may still contribute to overall profitability. If the contractual costs or internal information costs are not too high, the selection of either alternative will cover the entire route. But there is an interdependence between customers that raises the distributive issues that old institutionalists seek to reveal. Schmid clearly makes an institutional individualist analysis. He says that if a person rides the whole route he will pay for its total cost regardless of how the portions are priced. But some riders may only ride the feeder route and some only the main route. The feeder-route riders get a reduced-cost ride compared with the marginal cost of that portion of the route. The integrated firm might charge a flat price per mile regardless of the portion of the route used. Customers would be treated as one large group, to the advantage of those riding the higher-cost feeder routes exclusively. The firm, in arriving at its profit-maximising pricing scheme, does not care about someone getting a reduced-cost ride. It might not profit the firm to try to charge more for the feeder route and lose customers on the whole system. The possibility of contracting or creating a single firm may make the maintenance of the whole system possible, but it does not address the question of how different portions of the system are of interest to different groups. If each separate product “should stand on its own feet”, that is, each portion should cover its own marginal cost, then the person who rides only the main line would have his fare reduced if he did not have to help pay for the feeder line. What Schmid’s institutional individualist analysis shows is that there are several options which all affect different groups of people in different ways. The institutional structure of the market affects its profitability and affects who gets what. Besides individual action (rule 1 of institutional individualism), this institutional structure must be taken into account if a relevant institutional individualist analysis is to be made (rule 2 of institutional individualism).

What is true for market boundaries is also true for political boundaries, as the famous Lake Michigan national park case shows. According to rule 2 of institutional individualism, constructing institutional individualist analyses of political behaviour means considering the relevant formal rules and informal norms that affect the participants in every collective decision making process as explanatory variables. That is what Schmid does in order to explain why a political representative acted differently on the same political issue depending on which group of constituents he was representing. The issue arose in connection with a proposal to create a type of national park on a peninsula in Lake Michigan. Most of the local people near the proposed

park opposed it because they feared congestion and loss of private ownership of individual cottage sites. The U.S. Congress representative from this district reflected this dominant interest and opposed the park. Later, when he became a U.S. senator for Michigan, he supported the park. The dominant interest in a state-wide vote was the people of Detroit, who wanted a public recreation area away from the busy city. It is also interesting to note that the park was originally proposed by a senator from the neighbouring state of Illinois, where the largest city was within easy driving distance of the park. The Michigan Congressman and, later, Senator was democratically elected, but he changed his mind when the electoral boundary changed the character of the majority. It seems that power to the people does not acquire its full meaning until we inquire: which people? If the people in the vicinity of the park had the right to make the decision, they would have furthered their interests at the expense of lost opportunities for more distant people. The reverse is also true. The establishment of the federal park created costs for the local people for which they received no compensation. If the right to decide had been assigned to the local people, a compensation payment could have been designed or a market for negotiation could have been established, with representatives from both parties, in order to reach an agreement on such a compensation payment. Schmid makes an institutional individualist analysis in which distribution conflicts and power influences are also taken into account, as is usual in old institutional economics.

Is there any example from the old institutional economics that deals with institutional reform? An excellent one is the classic article by W.J. Samuels (1981) that contains an analysis of the Miller and Shoene Virginia Court case. Of course, what have been said of Schmid's book must be mentioned again: taking the said paper as an example does not imply that all Samuels' works are built on the requirements of institutional individualism. In fact, they are not.

Briefly, the Miller and Shoene' Virginia Court case was a court case which involved red cedar and apple trees and their respective owners. There is a plant disease that develops in two different phases. In the first one the fungus lives on the ornamental red cedar tree without any adverse effect on it. During the second phase it severely damages the apple trees that are sufficiently near, causing complete destruction of the fruit and leaves. In 1914, the legislature of the state of Virginia passed a statute which empowered the state entomologist to investigate and, if necessary, condemn and destroy without compensation any cedar tree that has the fungus

within a two-mile radius of an apple orchard. This was an institutional reform that changed the legal rules governing the red cedar and apple trees conflict. Warren Samuels gives an institutional individualist explanation of the consequences of these two different institutional frameworks for the income and wealth of conflicting parties. He also makes an institutional individualist analysis of the process leading to such a change, as well as of the reaction by cedar tree owners who, unsuccessfully, first brought a suit in the state courts and then sued to reverse the unfavourable decision of the Supreme Court of Appeal of Virginia. The thrust of the cedar tree owners' argument as a whole was that the statute was an unconstitutional exercise of police power by virtue of its violation of the due process clause of the Fourteenth Amendment. However, the Supreme Court affirmed the judgement of the lower state courts, denying the challenge to the statute on the grounds of unconstitutionality. The Legislature was under the necessity of making a choice between the preservation of one class of property and that of the other wherever both existed in dangerous proximity. It would have been none the less a choice if, instead of enacting the new statute, the legislature, by doing nothing, had permitted serious injury to the apple orchards within its borders to go unchecked. When forced to such a choice the legislature does not exceed its constitutional powers by deciding upon the destruction of one class of property in order to save another. The new statute altered the effective assignment of rights upon which market transaction might be made. It was of course possible to allow for private agreement among conflicting parties but the result of such a negotiation process would have been different depending on the legal framework in place. Without the new statute, only by paying the red cedar owners for cutting down the affected trees might the apple owners avoid damage if the fungus were to reach them. With the new statute in place, it is the red cedar owners who are forced to offer a compensation payment to the apple trees owners if they want to avoid cutting down their red cedar trees when the fungus appears. Market forces emerge and take on shape and direction only within legal frameworks. Since relatively effective rights are a partial function of law, the bargaining strength or power, the distribution of the relative risk, the level of business costs, resource allocation, income distribution, etc., are law dependent variables. The apple and cedar trees court case also shows how the relevant issue is not whether the government has to intervene or not but who will influence government decisions. Apple orchards were a major *industry* in Virginia. Red cedar trees were of primarily ornamental use,

with some little use and value as lumber. The apple owners were organised and influential whereas the red cedar owners were not. The case also shows how marginal institutional changes, that is, changes in specific legal rules and social norms, always result from processes of human interaction that take place in specific situations in which certain other legal rules and social norms remain unchanged (rule 3 of institutional individualism).

Of course, several other examples could have been mentioned. M. Rutherford (1983, 1984, 1987, 1989), for example, has persistently searched the old institutionalist pioneers' contributions, by Commons, Veblen, Mitchell, etc., to find these institutional individualist explanations wherever they might be found and whatever the significance or weight that is attributed to them in those contributions. V. Vanberg (1989) has given a presentation of some central ideas contained in Commons' *Economics of Collective Action* where the arguments and explanations are of a non-psychologicistic individualist type rather than holist. Biddle (1990) and Ramstad (1987, 1989, 1991) also emphasise the analyses by Commons in which human action appears to function as an explanatory variable, whatever the degree of discretion attributed to it. Finally, the book by R. Bartlett (1989) is another excellent example in which the concept of *mutual power influences* among persons and groups of persons is included in his institutional individualist models.

It must be clear by now that it is possible to conduct analyses that retain most of the traditional assumptions and criteria of the old institutional economics but are built upon institutional individualism rather than methodological holism.

5. SOME EXAMPLES OF INSTITUTIONAL INDIVIDUALIST ANALYSES FROM THE NEW INSTITUTIONAL ECONOMICS.

Turning now to the new institutionalist camp, we may also mention some examples of analyses that come close to fulfilling the aforesaid three rules of institutional individualism. This fact does not mean that a kind of explanatory or prescriptive convergence between the OIE and NIE approaches is being reached. No statement in favour of such a convergence is made in this paper¹⁹. The contributions I shall mention next still retain all the basic assumptions and criteria that characterise the NIE approach, as shown in section 2 of the present article, except for the

¹⁹Some authors such as Rutherford (1995) and Groenewegen & others (1995) attempt to discover whether the later works

mode of explanation.

Some of the later works by the Nobel prize-winner Douglas C. North may be taken as examples. His previous works may not. In North (1990, 1988, 1991a, 1991b, 1993, 1995), for example, he abandons the *efficiency view* that characterises *some* of his previous works. He also abandons his previous purpose of explaining all institutional changes in terms of self-interested human actions responding to changes in prizes, technologies and natural conditions alone. Furthermore, he also provides preliminary answers to the question of what explanatory role mental models and ideologies may play in explaining the changes taking place in some formal institutions. His concern with cultural inertia and path-dependence should not be surprising given that North is an economic historian.

Particularly in North (1990), he dedicates a full chapter to emphasising a number of basic behavioural assumptions by which his theory departs from traditional neoclassical theory. According to North, the sources of contrasting economic performance between societies lie within the institutional structures that define incentives for saving, investment, production and trade and that also influence production and transaction costs. Since standard neoclassical theory usually assumes zero transaction costs and most if not all institutional factors are removed, this theory is of little help to North in the task of explaining the source of contrasting economic performance. Although North's analysis is an institutional one, in the sense that he pays attention to the formal and informal institutional structures (set of legal rules and social-behavioural norms) that influence the situation under investigation, his analysis is nonetheless an individualist one in the sense that individual action remains essential for his explanations. Individuals may act alone or in groups through what North calls "organisations". Organisations always try both to profit from the existing institutional situation and to modify the said institutional structure in order to obtain a more favourable one. Individual perceptions, much influenced by their mental models and ideologies, are also an essential part of North's analysis. Formal institutions such as constitutions and other legal rules must be reformed through political decisions, while efficient changes in those institutions are not guaranteed by political competition. Efficient changes are sometimes promoted and sometimes blocked in the political arena. Sometimes they are blocked for centuries, as the case of the medieval manor institution

by North might build bridges between the OIE and NIE. See also Standfiel (1999).

shows. In North's own words:

“Institutions are not necessarily or even usually created to be socially efficient, rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to devise new rules.” (North 1990, p. 16)

Though he is basically concerned with the degree of efficiency of alternative institutional frameworks and usually disregards the distributional impacts that those frameworks produce, in these contributions North does not conduct a methodological individualist analysis in which only preferences and material conditions (natural, technological and monetary) are taken into account as explanatory variables. On the contrary, he adopts an institutional individualist mode of argument similar to that outlined in section three of the present article.

Some other examples of analyses in which many of the standard NIE assumptions and criteria are combined with an institutional individualist mode of explanation are North and Weingast (1989), Weingast and Marshall (1988), and Kiewiet and McCubbins (1989).

In Weingast (1989), for example, the author analyses the workings of the legislative committee system of the USA Congress. He attempts to show that this system is significantly less plagued by problems of ex-post facto enforceability than a pure vote-trading system (logrolling or market for votes system). In so doing he performs an institutional individualist analysis that follows the three rules given in section three of the present article but, at the same time, retains the rest of traditional assumptions and criteria that were also mentioned in section two.

Of course, he is basically concerned with efficiency, as new institutionalists usually are. ¿Is this system more efficient than the logrolling system in the sense that it generates lower transaction costs for legislators in their tasks of reaching agreements on the policy actions that are being implemented day after day? If the answer is yes, Weingast says, legislators who are seeking reelection from their constituents would have an interest in creating and maintaining the legislative committee system if they were faced with a choice between this and the traditional logrolling system. This seems to be an example of the comparative static type of analysis so often adopted by new institutional economists. The mechanism that links this reasonable outcome (more efficient rules in which legislators have an interest) to the process of human

interaction that is necessary to achieve this outcome collectively must be indicated to avoid charges of non-intended but actual functionalism. Weingast assumes that political competition for votes in legislators' constituencies is that mechanism. Legislators from different constituencies have considerable incentives to exchange support so as to provide benefits to their supporters. Because the value of today's legislative bargains depends on actions taken in future legislative sessions, legislators have incentives to devise institutions that provide today's bargainings with durability. According to Weingast, repeat play among legislators is insufficient to prevent the breakdown of co-operation under certain circumstances. Legislative rules must not be considered, however, as substitutes for the reputation building and the trigger strategies commonly used in repeat play. Rather, rules complement the use of these strategies and, in particular, prevent the breakdown of co-operation in precisely those circumstances under which these other strategies fail. It is obvious that this argument parallels that of vertical integration, in which reputation effects are also insufficient to police co-operation between firms. In both cases, potential contractual problems lead to the design of institutions that substitute for market exchange (vote trading in the legislative arena). In so doing they improve ex-post facto enforceability of agreements.

According to Weingast, the diversity of interests among legislators creates gains from exchange within the legislature. But under a logrolling system, votes are usually *sold* and *bought* for a *price*, with the equilibrium prices determining vote trades and hence the set of bills passed. Legislators are better off by giving away votes on issues that have lower marginal impact on their districts (and therefore on their electoral fortunes) in exchange for votes on issues having larger marginal impact. But what if bills that are going to come are not known in advance? Or what if future events modify the payoffs of bills already exchanged? Or what if a legislator changes his mind and his perceptions of an issue that was previously subject to exchange? In a pure exchange system or simple logrolling the time dimension cannot be fully taken into account, consequently the enforcement of agreements remains exogenous. It is unlikely that agreements will cover more than one legislative session. A variety of exchange problems arises because the value of today's legislation significantly depends on next year's legislative events. Even if no change in seats has occurred, members of future sessions may face different incentives from those faced when the trade occurred and may seek, for example, to amend,

abolish, or simply ignore previous agreements. Moreover, these settings inhibit the ability of reputation to serve as the sole enforcement tool.

Weingast first depicts a model of an idealised legislative committee system and then argues that evidence found in the USA Congress is consistent with that model.²⁰ In his model, legislative committees are composed of a number of seats, each held by an individual member who has a property right over his seat, based on the so-called “seniority system”, that allows him to remain on the committee for as long as he chooses. Associated with each committee is a specific subset of policy issues over which it has jurisdiction, and therefore the monopoly right to bring alternatives to the status quo up for a vote before the legislature. Whenever a member leaves a committee his seat becomes vacant and is assigned to other congressmen through a bidding mechanism based on the preferences previously revealed by legislators and on the “seniority system” of those who placed it as first choice. The control over the agenda within its jurisdiction implies that a committee has veto power over the proposals of others. Agenda power allows committees to bias the outcome in favour of the alternatives they prefer most. The agreements made among members of a committee or between members of different committees are simply enforced by the property rights over seats system already mentioned. A legislator on committee i gives up influence over the selection of proposals in the area of committee j in exchange for members of committee j 's giving up their rights to influence proposals in the area i . Institutionalising control over the design and selection of those proposals that will come to a vote substitutes for purchasing the votes of others in an explicit market. Since committees afford their members a disproportionate influence over the policy choice within their jurisdiction, representatives from farm districts, for example, are much more likely to bid for seats on agriculture committees than they are for seats on urban, housing, or merchant marine committees. The more competition for seats, the less likely the bid will be successful, however.

All these are the reasons why, in the USA Congress, representatives from farming districts dominate the agriculture committees and oversee programs that benefit farmers. Members from urban districts usually sit on the banking, housing, and welfare committees that provide benefits to an incredible array of urban constituents. Etc. USA representatives opt for committees that are

²⁰In fact, as pluralist methodologists know, it might be better to say that the said *theory-lead* evidence does not seem to refute the model when a Lakatosian sophisticated refutation of both the logrolling system and the committee system is attempted.

relevant to their constituents' interests and their doing so leads to committees composed of legislators with considerable support for policies within their jurisdictions. Weingast offers some figures showing how this support by committee members is indeed significantly above the mean for the entire Congress. Finally, the pattern of campaign donations by firms, according to Weingast, provides additional evidence on the accuracy of his model in representing the basic working of the USA committee system. Because of their influential position, the probability that a committee member will receive a donation from a firm is .34 higher than that of a non-member, according to the figures provided by Munger (1984).

As is usual among new institutionalists, here Weingast has attempted to demonstrate that efficiency considerations are the central aspects to take into account in any explanation of the institutional changes in which the relevant participants are pushed by competition pressures. The legislative committee system of the USA Congress seems more efficient than a pure vote-trading system (standard logrolling) in the sense that it generates fewer transaction costs for participants since it is significantly less plagued by problems of ex-post facto enforceability. For the purpose of the present article, it is not relevant whether this is true or not. What must be clear now is that Weingast and North, as well as others, have conducted analyses of institutions and institutional change that are in accordance with the rules of institutional individualism, as a mode of explanation and are also based on the rest of the assumptions, conceptualisations and criteria usually adopted by new institutional economists. The above examples are analyses that do not follow the reductionist claim of methodological individualism.

Therefore, institutional individualism, as a *middle way* mode of explanation, does not preclude the possibility of accounting for power influences, distributional conflicts, inequalities, etc., as old institutionalists frequently do. It does not prevent new institutionalists from adopting a voluntary conceptualization of economic transactions, using transaction cost concepts or accounting for efficient or inefficient changes, etc., as they usually do²¹. It is simply a *middle way* mode of explanation that yields non-systemic and non-reductionist explanations at the same time as it allows for the incorporation into economic theories and models of the many formal and informal institutional aspects surrounding all human interactions, whether these interactions take place under stable structures of legal rules and social norms or whether they attempt to

²¹ It is obvious that sometimes old institutionalists comment on efficiency aspects, in the same way as new institutionalists

change the said rules and norms.

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