IESE Business School

University of Navarra

Working Paper

WP No 302

January, 1996

ECONOMIC ETHICS AND INSTITUTIONAL CHANGE

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Published by the Chair of Economics and Ehtics

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Abstract

Our economic system, the market economy, is part of a broader system or “society”. We frequently study the operation of the market economy as if it were autonomous, even though there are many complex and mutual relationships between society, the economic system and the other systems –political, cultural, religious, legal, etc.– that form part of society.

In a market economy we can identify several components: a frame or background in which economic activity takes place, a set of ideas and theories, the values shared by society, the set of institutions, norms and rules that control the economic behaviour of individuals, and the incentives or motivations of the economic agents. The interplay of these elements defines the operation of a market economy.

Is ethics an institution, or does it belong to the set of values and ideas? In this paper I will discuss the role of institutions, norms and rules in society, with special reference to the economic system, in order to gain insight into the relationship between institutions and ethics. I study, first, the concept and features of social institutions and norms; second, institutional change; and third, the relationship between ethics and institutions.

Keywords: institutional efficiency, institutional change, ethics, invisible hand

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Institutions in economic systems

Our economic system, the market economy, is part of a broader system or “society”. We frequently study the operation of the market economy as if it were autonomous, even though there are many complex and mutual relationships between society, the economic system, and the other systems –political, cultural, religious, legal, etc.– that form part of society.

In a market economy we can identify several components:

1. The historical, geographical, sociological, political, religious, cultural, etc. frame or background in which economic activity takes place.

2. The set of ideas belonging to this society. These include descriptions, interpretations and representations of the world, the person and society, as well as various theories, doctrines, ideologies and opinions.

3. A special subset of these ideas is the set of theories about the operation of the economic system, i.e., the explanations (scientific or not, usually incomplete, and not always mutually compatible) of the relationships between economic (and also non-economic) variables. These may also be considered a part of the ideas mentioned above.

4. The values shared by the society in question. These include basic and derived principles, precepts and imperatives that people give themselves, or that they receive and accept, as a way of governing their behaviour. Both values and ideas may be a part of the previously mentioned frame, but they deserve a specific mention.

5. The set of institutions, norms and rules that control the economic behaviour of people. Many of these institutions are also common to other systems –political, cultural, etc.–, which have their own specific sets of norms and institutions.

6. The incentives or motivations of the economic agents. I hesitate to label them as a specific element of the economic system because they are so interrelated with values and ideas that, in a sense, they form a whole; and moreover, because there are no specific economic incentives.

The interplay of these elements defines the operation of a market economy. In short, the incentives of the economic agents meet the restrictions and limits imposed firstly by the general frame and history –the endowment of resources, for example– and secondly by the institutions, norms and rules. The result is a division of functions in society in order to attain the goal of the system, i.e., economic efficiency.

What is the role of ethics in an economic system? Is ethics a part of the institutions, norms and rules, or does it belong to the set of values and ideas? These are relevant questions. If ethical norms belong to the realm of institutions,

1. they will be purpose-oriented, contingent, and relativistic;

2. the other institutions and social norms will be independent of the ethical ones, or at least they will have contingent relationships with them; and

3. the set of values and ideas will not be subordinate to ethics, since institutions are the result of those values, and not the other way round; or alternatively.

4. there should be a set of superior ethical norms that rule the realm of values and ideas, and another set of second-level ethical norms that govern institutions –but then the question of the coherence of the two sets of ethical rules arises.

In this paper I will discuss the role of institutions, norms and rules in society, with special reference to the economic system, in order to gain insight into the relationship between institutions and ethics. We discuss, first, the concept and features of social institutions and norms; second, institutional change; and third, the relationship between ethics and institutions. The article ends with the conclusions.

Institutions

The aggregate behaviour of a society is not simply the sum of the behaviour of the men and women that make up that society. There are intermediate structures that limit and guide the actions of people towards some social ends. We will label these intermediate structures institutions in a generic sense.

Different authors have varying opinions as to what an institution is. Their definitions can be grouped under two headings, according to Schotter's terminology (1989):

Type I: A set of rules that constrain the behaviour of economic agents and determine the results of their actions in terms of the choices that they make (Hurwicz 1973, Reiter 1977). "Rules" should not be understood here as if they were laws or decrees promulgated by a formally constituted authority, but as constraints accepted by the agents. According to a definition taken from the field of sociology, institutions would be "the complex of socially learned and shared values, norms, beliefs, meanings, symbols, customs, and standards that delineate the range of expected and accepted behavior in a particular context" (Nelson 1995, 80; cfr. also Powell and DiMaggio 1991).

Type II: Regularities in the agents' behaviour which enable them to solve recurrent problems. According to this view, a social institution is "a regularity in social behaviour that is agreed to by all members of society, specifies behaviour in recurrent situations, and is either self-policed or policed by some external authority" (Schotter 1981, 11). In short, we are talking about explanations of the "rules of the economic game" (North 1990, Eggertsson 1990b), given the agents' motivations, technology, and the other constraints; they define "how the game is played" (Schotter 1981, Sugden 1989) by including not only the rules but also the game's expected patterns, which define the players' restrictions and expectations.

Thus, we can find regularities of behaviour –spontaneous or otherwise– that give rise to social norms or rules (the norm itself is the institution, or forms part of it) that are based on conventions (and, when appropriate, legal norms) and generate a social order (which includes stable, predictable patterns of behaviour, and also cooperative behaviours). All of these concepts are interrelated. Institutions are defined by their organizational structure (a structure aimed at aggregating or guiding behaviours), if they have one, or, if applicable, by a pattern of stable, regular social behaviour, plus the formal rules (if any) and the social norms that determine their compulsoriness.

Institutions in this broad sense may be sets of rules that limit individual behaviour and define the social outcomes that result from those individual actions. They may also be unplanned and unlooked-for regularities that emerge organically in social behaviour. As regularities, they are types of human behaviour (even though spontaneous), and not passive elements of the historical, political and physical frame. And they are social, not individual norms (not enforced by social approval or external authority, and frequently not shared by others), individual habits (private, not compulsory), neurosis, psychological states, etc. (Elster 1989b).

Unlike rational action, institutions are non-conditional (of the type "do A") or, if they are conditional ("if B, do A"), they are not result-driven (Elster 1989a,b), although, obviously, they influence the result.

Institutions refer to repetitive situations. This is why many experts treat institutions as the solution to repeated games (for example: Lewis 1969, Nozick 1974, Hammond 1975, Kurz 1977, Ullman-Margalit 1977, Schotter 1981, Sugden 1986, Eggertsson 1990b). An institution seeks to anticipate social behaviour in specific cases; if these cases contain significant novelties, an attempt will be made to apply the previous norm, but it is also likely that a process of institutional change will be begun.

They receive social acceptance, inasmuch as all or at least a majority of the members of the society share them and support them. The approval or disapproval of a behaviour (including external shame, guilt, anxiety, punishment, etc.) means the social acceptance (total or partial) of the institution; there may also be private reasons for this acceptance (internalization), other than the social ones. Acceptance does not mean liking or enjoyment. And it may be less than a hundred per cent: the relevant condition is regularity of behaviour, not the percentage of approval. And obviously, they leave room for exceptions (for example, cannibalism in case of hunger, or nationalization of private property in case of public need).

However, although legal norms are excluded from the area of social norms (because their compulsory nature is not due to social acceptance but to the action of specialised agents: police, magistrates, etc.), there is a close connection between institutions and legal norms so that the former often become the latter (and, in turn, modify them). One could talk of a continuum, from self-enforcement of the social norm to enforcement by an external authority (law) and including norms that are enforced by social acceptance (Knight 1992).

In the definition of institutions we include several kinds of norms and conventions, and exclude others. Social customs are included, as well as self-policing social conventions, social norms (that reinforce the patterns of behaviour, making them specially desirable or obligatory), shared understandings (that may be nonsense for people of other societies or other epochs), and social standards (that lack the idea of a duty that is inherent in social norms) (Pettit 1990). We are not interested in the precise definition of each one of them, as they frequently overlap.

In any case, institutions include spontaneous orders that are the result of human action, but not of human design (the classic reference is Hayek 1960, 1967, 1973, 1983, 1988; see also Nozick 1974, Buchanan 1975, Ullman-Margalit 1978). But they also include legal norms created by a conscious act of men and enforced by an external authority, and even organisations (like "the" university or "the" firm, and even the United Nations or the General Agreement on Tariffs and Trade, but not General Motors or the University of Michigan: some collective actors –organizations– are institutions and others are not), although they are the result of the design of men. All of them, evolutionary or not, are social institutions that rule the social behaviour of persons, either through formal arrangements or through informal norms, and this is why we are interested in studying them. Moreover, these consciously designed institutions or organisations are frequently specifications of undesigned and evolutionary ones (as, for example, Nestlé or Asean Brown Boveri are specific cases of the legal institution called company and of the economic institution called firm, and the French civil code specifies general institutions such as private property or inheritance for a particular place and time).

People interacting in repeated situations have a superior knowledge of the interests, attitudes and behaviours of other persons and of themselves, through a process of learning (obviously, agents and institutions interact, so that they mutually change and adapt). This is why institutions save decision and transaction costs by collecting and spreading information and social experience (they are "interpersonal stores of coordinative knowledge": Langlois 1986b, 237; cfr. also Frey 1990, Langlois 1986a). And by establishing regularities of behaviour, they provide information on the expected behaviour of other agents.

Traditionally, the role of institutions is derived from their functions in the economic system:

1. They aggregate individual choices and preferences in such a way that the outcome is not the mere addition of those actions and preferences –and this is due to the process of selection and admission or elimination of alternatives that the institution performs.

2. They limit, restrict, specify and guide human behaviour –or rather, to be precise, the structure of incentives that guide human behaviour. This task of socialisation may be performed from inside behaviour (i.e., making explicit its internal limits: psychological boundaries to knowledge, historical or traditional barriers, etc.) or from outside it (for example, through the law) (Jackson 1990). This may be done, first, through information, resources, incentives, rewards or punishments, explicit or not, that lead to a re-evaluation of the alternatives; second, through exhortations that exploit the interdependence of utilities or manipulate them; or, third, through the spread of information.

However, an analysis of institutions based solely on the study of their functions (which would be a variant of "Parsonian functionalism", as Granovetter 1985 points out) is necessarily limited. These functions are no more than a posteriori rationalizations, which will probably be incomplete, as institutions, even though they are brought into existence for the specific purpose of performing them, have their own structure, history and continuity. For example, this accounts for possible situations of dysfunctionality (and, of course, economic inefficiency), and the existence of possible intrinsic effects that are independent of the functions they perform. In fact, as we will see further on, the institutions' stability, their resistance to change and the fact that this change is path-dependent suggest that one must consider something more than a change in functions when considering change in institutions (Coleman 1988). And, finally, even if it could be shown that an institution generates a good for society, this would not be enough to account for its existence, unless one could show the feedback mechanism which leads to its continuity being determined precisely by the positive social consequences.

In recent decades, a large number of studies have been published on institutions, both in the area of economics and in sociology, political science, etc. Although the study of institutions is interdisciplinary by nature, there are obviously major differences between different viewpoints. Thus, economists normally use as their starting point the axiom of individual rationality (a rationality that is preceded and modelled by institutions, which inform the way the agents see the world), while sociologists emphasise the rationalization of actions by norms and beliefs. In the following pages, we will discuss a number of related subjects: how institutional change is implemented, whether this change leads to some form of economic efficiency and what is the role of ethics in this change.

Theories of institutional change

Institutions are stable, but not unchanging, and the analysis of their changes is useful to clarify their relationships with ethics. What we are interested in here is to analyse why and how the innovation or institutional change process is carried out. Knight (1992) synthesizes the classic and modern theories on this change. Briefly, both theories resort to two opposing hypotheses to account for institutional change: (1) institutions evolve by means of a process of interest coordination in order to obtain collective benefits, or (2) it is the conflict or competition between opposing interests that leads to an evolution based on discrimination in favour of certain groups.

1. The classic theories based on the social benefit hypothesis usually cite four mechanisms of institutional change based on cooperation:

   (i) The implicit contract between agents to establish a framework that avoids systematic confrontation (Hobbes 1963).

   (ii) Spontaneous emergence; that is, an interaction process between free agents that gives rise to conventions, social norms and institutions as an unsought product of a social process (Hume 1978).

   (iii) Market-coordinated exchange, similar to the spontaneous order but with internal (self-approval) and external (social approval) sanctions, plus the invisible hand (Smith 1976). This produces the benefits of market-coordinated specialization and exchange.

(iv) Social selection: social institutions come into existence and continue insofar as they help society to survive successfully in a competitive world (Spencer 1969).

2. There are primarily two traditional change theories based on the conflict hypothesis and the predominance of the interests of certain groups over others:

(i) The Marxist theory (Marx 1986), in which all the benefits are retained by the capitalist class. This gives rise to two mechanisms which lead to violent institutional change: historic materialism (when existing institutions, that is, production relationships, cannot satisfy the functional requirements for the continued growth of production forces) and the class struggle (in which the irreconcilable tension between the two classes' interests will lead to the final institutional change).

(ii) Weber's theory (1989) on the dissemination of capitalism, when a few entrepreneurs are able to initiate a change of behaviour in line with their interests (material or non-material), carrying others along with them until the institutional change is firmly consolidated.

As is logical, this discrepancy in starting hypotheses is also found in modern schools.

1. Among economists, the conception of institutions as solutions to collective action problems (attainment of agreements, solution of free-rider problems, etc.) seems to predominate, along the lines of the classic theories based on social benefits. Thus, they account for the emergence and change of institutions by means of a combination of spontaneous factors, market-coordinated exchange and social selection, and by means of intentional design by contracts (in private or political spheres) but always directed towards the obtainment of socially positive results (optimality, efficiency, stability, minimization of transaction costs, etc.).

The spontaneous emergence of institutions is, for example, one of the keystones of Hayek's theses (1960, 1967, 1973, 1983, 1988). This author seeks to account for this emergence through a combination of the invisible hand (absence, or rather, impossibility of intentional design) and social selection (mainly by imitation). This gives rise to a set of institutions that are arbitrary, insofar as their rationality cannot be proven (because their complexity is beyond the control of the human mind), although Hayek assumes (on the basis of the social selection assumption) that their benefits are directed at society as a whole and not just at a group. Market competition as a selection mechanism is used by Alchian (1950), while Coase (1937), Williamson (1975, 1985) and North (1981, 1990), among others, turn to the market to account for the creation of rights and organizations whose purpose is to reduce transaction costs.

Knight (1992) identifies two branches –naïve and sophisticated– in the social benefits school, as explanations for the existence and evolution of institutions: the former considers that the spontaneous evolution of social orders always generates efficient or optimal solutions, from the social viewpoint, while the latter acknowledges that these solutions may be suboptimal.

For its part, the intentional design branch (contracts) emphasizes the creation of political institutions either with a view to producing collective benefits, along the lines indicated above, or as a result of the competition between the State and the representatives of private interests. The question of the optimality of the resulting institutional framework is often the subject of considerable debate, in view of the frequent suboptimality and inefficiency of State intervention and the ambiguity of the institutions deriving from lobbying and negotiation processes.

2. The hypothesis of social benefits as an explanation for institutional design and evolution is contested by some authors, who consider that institutions always have distributive effects and therefore generate problems of power and conflict, which may give rise to a greater social good, but also a clearly suboptimal result. In any case, insofar as agents seek to further their own interest when trying to create or change institutions, such processes can no longer (or not only) be accounted for from the viewpoint of the collective good.

These authors try to explain the relationship between rational action-driven behaviours (consequentialists, seekers of private, material or non-material results) and norm-driven behaviours (which are followed for different –sometimes opposing– reasons to further personal interest). Individualistic, rationally based behaviours generate conflicts between agents, which forces them to adopt strategies adapted to the circumstances. The existence of institutions in situations of interdependence between agents (games) alters the strategies chosen and their outcome, providing information on the possible future actions of other actors and on the consequences of infringing the norms. From this viewpoint, “social institutions are conceived of as a product of the efforts of some to constrain the actions of others with whom they interact” (Knight 1992, 19), and not to obtain collective benefits. Institutional development, thus, is not a case of Pareto-optimal response to these potential general benefits but the by-product of a conflict concerning the distribution of benefits.

This is not the place to elaborate on the debate between schools of thought. There are currently many theoretical and empirical arguments in favour of one or the other school and it is difficult to elucidate the matter. In any case, the important point for us is that, whether we talk of social benefits or of conflicts, we need to explain why institutions are created, how and why they evolve and change, whether this corresponds automatically to an optimization and efficiency process, what this optimality means and, therefore, whether there is any role for ethics in guiding these processes.

The process of institutional change

We have already mentioned that many institutions act as “spontaneous orders”, that is, they are the fruit of people’s actions, but not of their conscious design, as is shown by the evidence of historical analysis and by their very nature and complexity, which is beyond the design capacity of any human mind. This means that, when faced with the same problem, two different societies will respond in different ways, creating different institutions, and that the same society will seek different solutions at different times. The creation and development of institutions is dependent on their own history and on external circumstances. However, this is equally applicable to institutions that are created or evolve as a result of collective decision-making processes (political processes, for example).

The fact that institutions generate stability can be verified from several viewpoints. For example, in the culture theory, Mary Douglas (1978, 1986; cfr. Hargreaves-Heap 1993) points out that people who perform an activity develop a series of practices that are based on (or generate) beliefs that depend specifically on the social interaction they commit themselves to (she does not use the term social institution but her alignment with what has been said above is clear). These beliefs lead the group to look for solutions to new problems that are consistent with those beliefs and with the practices that generated them, while the beliefs make the group's specific practices intelligible and "correct", so that the solutions chosen reproduce the features of pre-existing practices. In this manner, institutions and social practices reproduce themselves, within a framework of continuity and coherence that impedes institutional change, since it not only affects practices but also the body of beliefs that give meaning to them. Douglas points out, however, that (discontinuous) institutional change can occur, for example, because the models of social organization contain anomalies or weaknesses that make them unsuitable for the group's interests in the presence of changing circumstances, or because the agents belong to different groups who share different values, which leads to the use of behaviour patterns other than those used in the past to solve new situations.

The concept of social capital (Coleman 1988) also leads to institutional stability. This capital is composed of the social structures (institutions) that facilitate the actors' exchanges or actions within the social structure. The existence of more or less sizeable investments in this capital works against any change in it, thereby guaranteeing its continuity.

Within modern institutional analysis, the stability or permanence of institutions is usually accounted for in terms of the collective benefits (efficiency, optimality, minimization of transaction costs, stability, etc.) they generate, or, alternatively, the predominance of one group over another in the obtainment of benefits in the course of their mutual interaction. The question of stability is therefore closely related to that of the efficiency and optimality of institutional change.

In the following pages, we will review a number of alternative explanations of institutional change.

Innovation sponsored by organizations

North (1990) makes a distinction between institutions and organizations to account for the change process. Institutions –he says– create opportunities (incentives) for society (in the economic sphere, these will obviously be opportunities for profit), while organizations come into being to exploit those opportunities, in a world where there are transaction costs (Coase 1937). Therefore, there is an interaction between the two: the former give rise to the latter and these, in turn, modify the former, without the social outcome necessarily being positive.

Let us think, for example, about how a company operates. This is the basic organization in the analysis of economic development carried out by North. The company tries to maximize profit under a set of constraints (factors available, technology, preferences, etc.), chief of which are the institutional restraints. However, in the same way that the company accepts the constraints (institutions) as given, it may also consider the possibility of changing them (by incremental or revolutionary means), using its negotiating power (something like the transition from short to long term in Marshall's analysis). For example, the company may optimize its research and training policies in the light of institutional incentives and factors (patent policy, government aid, technology market, specificity of human capital, etc.), but it may also devote its resources to promoting greater collective investment in research or education as public goods which it will benefit from, utilising its political power, the action of lobbies, etc.

North states that in the first case, taking the institutions as given and under the conditions normally applied in neoclassic economic analysis, the company's behaviour will lead to assignative efficiency. But is institutional innovation also efficient in the second case? Can we talk of an adaptative or dynamic efficiency in changing the rules? Under what conditions will it take place?

Clearly, the way in which institutions adapt will be a key factor in assessing this efficiency. As we already indicated, the learning and knowledge obtainment processes, which are the keys to economic development (entrepreneurship, innovation and technology dissemination, risk-sharing institutions, joint ventures and alliances, ownership rights and, above all, the right to reap the benefits of one's own actions, etc.), are controlled by institutions. What new institutions, or what incremental changes in existing institutions, will enhance this function? Alchian's (1950) rule suggests that the more institutions there can be and the greater the amount of experimentation that can be done, the easier it is for optimal institutions to emerge. Ultimately, institutional variety is a value, at least as a reflection of the variety between people and as a means of putting into motion all of the potentiality that men and society bear within them (Hayek 1988). However, we have no evidence that this dynamic efficiency will ultimately be achieved.

The question of institutional stability is vital for understanding the process of change: without stability, institutions would lose their raison d'être and cease to fulfil their functions. According to North (1990, chap. 10), stability is achieved by means of a complex interplay of hierarchical constraints, in which the higher the level, the higher the obstacles to change. However, absolute stability would also imply the impossibility of exploiting opportunities for profit: a stable institution does not guarantee (dynamic) efficiency.

What does the process of institutional change consist of? North identifies its sources in the change in relative prices (in a broad sense, including prices of factors, technology, transaction costs, etc.). These changes move agents either to recontract within the constraints currently in force or to devote resources to changing the institutions. The latter will occur when the costs of attempting the change are less than the costs (or lost profits) of the present situation. For example, the opportunities for extraordinary income that demographic changes offered serfs in the Late Middle Ages provided an incentive to novate their contracts with their feudal lords. The problem was that these contracts formed part of a complex network of rules on different hierarchical levels, whose final result was to make them depend on the conception society had of itself. The peasants could only "invest" in institutional change when the profits were high enough, either by negotiating a change in the rules with their lord or by reaching an agreement with parties representing other interests (kings, cities, traders, etc.) to receive their help or simply by flouting the norm and forcing change.

This explanation thus allows for assumptions concerning individual rationality, even in a world mediated by institutions: agents discover opportunities for benefit both within existing institutions and when faced with the opportunity for an institutional change, and act accordingly. However, it is obvious that this process will be complex: changing informal rules (infringing a norm, for example, in the hope that the costs of enforcing it will be high enough for the announced reprisal not to happen) disrupts the equilibrium of formal rules on a higher hierarchical level and gives rise to a new equilibrium (for example, infringement of the norm will be punished severely to prevent loss of authority or the norm will be phased out). In any case, nothing in the process described above guarantees that the institutional change will lead to a situation of dynamic optimum.

This is related to the development patterns of new institutions. Why have different societies chosen different institutional paths? Why is there no institutional convergence, in spite of the reduction in transaction costs that would be obtained and the "evidence" that certain institutions are "better" than others? Probably because this "evidence" does not exist as such, or because they are not "better" in absolute terms. North (1990) explains that institutional change has certain features that prevent or severely hamper this convergence:

1. The existence of multiple equilibriums: a variety of possible solutions, all of them stable, so that whether one or the other is chosen depends on random or fortuitous factors.

2. The new institutions may indeed be more efficient than the old institutions but the costs of the change may be prohibitive (perhaps not in the long term, but agents act with finite time horizons –even governments, which are those that best fit the infinite life pattern).

3. The processes are locked-in by certain options, which considerably increase the costs of the change.

4. And processes depend on their own history (path-dependence). Thus, in a context of incomplete markets, limited and asymmetrically distributed information, significant transaction costs, etc., the path of incremental change is far from clear.

The spontaneous order

Is there any reason to expect that institutional change will tend towards a social optimum? The theoreticians of the spontaneous order (for example, Hayek 1988) maintain that, once a change in external factors occurs, cultural evolution will find and enforce the institution best fitted for the welfare of society. In short, we have institutions because we need them for economic and social development, we maintain them while we need them, and we also change them as dictated by needs, following throughout an evolutionary process that implies that institutions adapt to functions that nobody has outlined beforehand.

This evolutionary process includes the variation of major features of existing institutions, the inheritance of successful features and a method of selection (random, or related with decision-making processes, or with natural selection, etc.). In this analysis, the selecting unit is the group; selection is aimed towards ensuring survival and it is assumed that there is a unit of comparative measure (not specified) for determining the match between the institution and the social order in each case.

But this is an "act of faith" in the evolutionary order. There are norms that are clearly Pareto-inefficient (Elster 1989b). There is no evidence that the best institution will be discovered, unless we tautologically define any spontaneous institution as optimal (which Hayek definitely does not do). Moreover, the means society uses to introduce institutional innovations (trial and error, prestige of a minority, fashion, flashy behaviour, analogy,...) are far from being a guarantee of rationality (Sugden 1989). Furthermore, the optimum institution must win the approval of the majority, a process that is far from being obvious, in the short term (Feeny 1988). And the process will not be smooth and cost-free. The very change of an institution means that the whole set of social costs and benefits of related institutions will change, so that even the very notion of the “best” institution may lack sense (in fact, many scholars of institutional change agree that an optimum may not be obtained).

In the short term, then, the institutional change may be efficient or not, so that the criterion of social evolution is not appropriate for judging its efficiency. In the long term, we may even admit that social evolution will bring out an efficiency optimum, but only if two additional conditions are fulfilled: first, a very long span of time, so that experience can accumulate (and the opposition to the innovation can be defeated), and second, relatively low transaction and adaptation costs, so that the advantages of the new institution can prevail. So, in a free market economy with rational agents, the spontaneous institutional change may drive the economy towards a set of efficient institutions, but only as a tendency and in the long term.

Beyond the pure theory of the spontaneous order, the literature on institutions based on repeated games contributes a new argument to support the efficiency or optimality of the results attained (Lewis 1969, Schotter 1981, Sugden 1986, 1989). Repeated social interactions –which Sugden (1989) calls “stable evolutionary strategies“– constitute the necessary mechanism of selection. When, among several possible strategies, one finally prevails, it becomes a social convention, a self-enforced rule based on the acquiescence of all, because all win by adhering to it (as they receive information on the likely actions of the others and the expected outcome of such actions, and can thus coordinate their actions), thereby forcing dissidents to also adhere to it. Furthermore, through imitation mechanisms, it is likely that this solution ends up prevailing in other settings, although, in any case, its stability does not imply Paretian optimality.

Finally, the literature on contracts (Williamson 1975, 1985, Brennan and Buchanan 1985, Eggertsson 1990b) combines intentional design (the contract) with the spontaneous emergence of the social order. In this literature, competition, which leads to the best contract in each circumstance, is the mechanism that ensures optimality –although this cannot be guaranteed either.

The viewpoint of conflict

Knight (1992) offers an alternative explanation, which places the emphasis on negotiation. As in North’s model, the agents (people, groups or organizations) have an interest in maintaining or changing institutions and, again as in North’s model, they do so as indicated by their interests, so that they will not uphold an institution that is against their interests, even if it is socially optimal. The purpose of an institution, therefore, is not to achieve collective goals (stability, optimality, or efficiency), but to uphold the interests of the actors concerned. This does not prevent an institution from being created or modified for the benefit of society as a whole but, in any case, it will not happen if there are not sufficient incentives for the agents involved to allow or promote it (in accordance with their relative power).

Static institutional stability occurs when an “equilibrium” is attained between the currently existing institutions that no-one is interested in changing. From the dynamic viewpoint, stability occurs when departures from equilibrium are not supported by other agents, creating incentives to return to the previous situation.

How does institutional evolution take place? If institutions have distributive effects, they will generate conflicts of interest, because they will distribute the benefits irregularly among the various agents involved. The most we can hope for in such a model is the attainment, through negotiation, of an equilibrium of outcome that interests each actor, either because it benefits him more than other alternative outcomes, or because he does not have the necessary strength to impose another social order. Rules are accepted, therefore, not as optimal solutions but because of the impossibility of achieving better solutions.

Institutions will change, then, when changes take place in the actors’ circumstances or relative power, or when some actors change others’ social expectations with respect to the results that can be attained (within the negotiation). Knight (1992, chap. 6) points out the connection between this process and the formalization of rules or institutions. Let us assume that an agent considers it in his personal interest to change an established rule or cease to observe it: for example, he may wish to weaken a civil servant’s impartiality with a bribe. With this action, he puts into motion a process of institutional change, which may fail if other agents are not interested in this change, but which may also become generalized to the point of making the impartiality rule invalid to all effects and purposes. In such cases, it is likely that the others will be interested in turning this rule into a formal institution that gives it stability (or, if applicable, changes it for another) by adding an external coactivity.

When does a formal norm replace an informal one? Knight (1992) identifies two basic cases: First, when the agents try to maintain the status quo, which is threatened by changes in information (uncertainty about the norm) or in the incentives (which encourage non-compliance). And, second, when the agents are in favour of an intentional change of rule, if the status quo ceases to be attractive. This will be done informally, unless the transaction costs are high (Coase 1960).

Generally speaking, it is preferable to use formal norms in a broad, plural society, in which non-compliance with the informal norm is not detected or reprisals are more difficult to implement, or when non-compliance with the norm generates major distributive advantages (as in the above-mentioned case of the bribe), although one must not forget the transaction costs that implementation of the rule may involve.

In any case, State intervention in the form of laws (formal rules) changes the nature of the conflict that was at the heart of the institutional structure in question, so that the agreement leads to external coercion, and institutional change is transferred from the field of private negotiation to negotiation with the authority (interest groups). The enactment of a law also requires the intentional negotiation of new institutional constraints, and the process of law-making is in itself an institutionalized process (with formal as well as informal features). The problem is compounded when we consider that the State’s agents (politicians, rulers, civil servants) have their own personal interests, which also come into play in the process of institutional change, generally making it less efficient (although we cannot rule out the possibility of change generating more efficiency if, for example, the civil servants responsible for designing tax legislation oppose a new distorsionary tax that will affect them as citizens). It seems reasonable to conclude, therefore, that the nature of institutional change will be altered significantly as soon as the State enters this field.

Conclusions on institutional change

Feeny (1988) offers a simple conceptual framework for identifying institutional change, distinguishing between factors on the "demand" side and on the "supply" side. The former become opportunities for benefit, which may present themselves as such for society as a whole (in terms of efficiency) or for the agent (in terms of income distribution): demographic or technological changes, constitutional changes, variations in market size, change in relative prices, etc. The supply side factors primarily include the stock of knowledge (including knowledge of institutions), the constitutional order currently in force (how it favours experimentation with new institutions, entry costs into the political system, access to public authority, etc.) and the cost of institutional innovation (Ruttan 1978).

In both North's and Knight's theories, mentioned previously, the rational search for self-interest determines the commencement of the process of institutional change. What determines the type of institution proposed as an alternative, or the direction of change in an institution that is already consolidated? Our knowledge here is very limited, but Sugden (1989) suggests three principles that may help focus this search:

1. An institution's popularity: when I suspect that others have started to change their conventions and rules, I steer my change in the same direction as them.

2. Analogy, that is, the application of institutions or norms applied in other contexts.

3. Versatility: preferences are for an institution that can be made use of in a greater variety of circumstances.

We can add another one to these:

4. Imitation of institutions that are successful in another setting. However, here, as in the case of technological change, transferring institutions from one geographical and cultural context to another may be easy if they are standard, non-systemic institutions, but it can also be very difficult and complex, due to factors such as the need for institutional learning, or the difficulty in giving coherence to new institutions within the network of existing institutions (and their values and beliefs), or resistance to change (which may perhaps be more acute in the case of an imported institution), etc.

The case of the institutional transformation of the Central and East European countries in the 1990s may be paradigmatic of imitation problems. The old norms and institutions in force during the Communist period had become discredited and the existence of extraordinary opportunities (for material benefit but also for cultural, human, family, etc. improvement) induced innovation. As the origin of these opportunities was primarily the "demonstration effect" of the market economy countries, it seemed logical to also "import" institutions, ranging from private property and the free market to democracy, economic legislation, social security system, etc. The problem is that these institutions are inserted in a network of values, norms and ideas that may be in direct opposition to them. For example, the Communist system led to a deformation of communication, which ceased to be the honest transmission of thoughts, ideas, values or messages, and this must undoubtedly influence institutions such as the enactment of laws, advertising, economic information, etc. (Johnson and Lundvall 1993). It may also give rise to "superstitious learning" –the acceptance of an institution for mistaken reasons– which may be dangerous for social stability (Kogut 1991).

We have already pointed out repeatedly that institutional change does not guarantee either collective optimality (in Pareto's sense) or economic efficiency. However, we can at least identify a number of institutions that favour economic development (by generating and selecting opportunities) and others that impede it (Chandler 1977, 1990; Williamson 1985). The history of developed economies shows that they have been able to encourage the former and avoid the latter (including both institutions that initiate change by breaking the inertia and institutions aimed at compensating those who are adversely affected by the change, so that they will not boycott it). In any case, Nelson (1995) attributes this to good luck and political and cultural contingencies, not to a special wisdom or virtue on the part of these countries' citizens or rulers.

And yet, the issue of institutional efficiency continues to be vital for the efficiency of the economic system. As De Alessi (1988) indicates, the economic system's efficiency ultimately rests on the choice of suitable relative prices and this, in turn, becomes the choice of suitable institutions to gather, interpret and disseminate information and provide decision-makers with the necessary incentives.

It therefore seems preferable to focus the issue of institutional efficiency on procedures, not on outcomes (Schotter 1989). When we are dealing with spontaneous orders –but also with institutions created by intentional design, at least in a complex world such as the economy of an advanced nation– the important question is no longer whether an institution really is an economic optimum or whether it really is efficient, but whether or not the institutional implementation and change process favours the attainment of those orders, norms and rules that lead to optimal or efficient behaviours (or, at least, to behaviours that are more efficient than the previous ones). And, as we will see further on, ethics must have something to say about this.

Institutions and ethics

In the previous discussion we spoke of optimal or efficient institutions or results, from the point of view of economics. But are they ethical? Can social evolution guarantee the morality of the new institutions? If our answer was not conclusively affirmative in terms of efficiency, it will hardly be so in terms of morals. The goal of the market mechanism is efficiency, not morality; hence, institutional changes improving the ability of the market to attain its goal contribute to efficiency, but not necessarily to morality. Ethics has an independent role in judging and appraising institutional change.

If even spontaneous institutional changes cannot disregard ethical criteria, this is all the more true of authority-induced institutional changes. In this case we cannot claim that there is an invisible hand that turns any political decision into an ethical one (in fact, the invisible hand is a technical concept and only by extension has it been viewed as an ethical principle). Thus, policy-induced changes guarantee neither efficiency nor morality. Once more, there is a role for ethics in institutional change.

What are the relationships between ethics and social institutions and norms? Must institutions be ruled by ethics? Or are moral norms a part of institutions and social norms, so that there is no ethical check on these?

Institutions are always the result of human action, be it purposeful or not. And as there are no ethically indifferent human actions, by virtue of their origin institutions always have an ethical content.

Moreover, ethics is not a class of social institutions, norms or rules. First, identifying ethics with an institution would make it contingent and relative, and would also make the other institutions independent of ethics, in direct opposition to the conception of ethics as the science guiding people's behaviour. This excludes the consideration of ethics as a type II institution (regularities of behaviour).

There is a greater similarity between ethics and type I institutions (rules constraining behaviours). However, there are also a number of significant differences. Ethics is not a pattern of behaviour observed by everyone but a prescription that can be adhered to or not. Its strength does not come from social acceptance but rather imposes its weight even on societies or individuals that reject it. By virtue of its origin, it is not a mere convention (although there are conventions that become moral rules).

Ethical norms are not adhered to only out of personal interest (including social pressure). People behave in a moral way even if their private actions will not be known to others (because of the learning process that ethical behaviour consists of). Moreover, social norms are supposed to promote the social good, but this cannot always be proved (Elster 1989). Therefore, a superior criterion –ethics– is needed to make a judgement. Social institutions and norms appear in specific recurrent situations, but ethics applies also to non-recurrent situations, and also consists of general, non-specific principles.

Ethics has an individual, private dimension in addition to the social one, so that it cannot be reduced to a set of social norms or institutions. If ethics is a normative science, it cannot be reduced to a description of social institutions –and, as we showed before, the normative content of social evolutionary institutions is at least very limited.

Do we really need ethics to judge institutions and social norms from outside? The point of view of Hayek (1988) is against this notion: institutions must be judged from inside, because the agents' belief that they must obey them comes from social evolution, like the institutions themselves. But Hayek's assertion comes from an act of faith in social evolution, as we said before, because he cannot prove that evolution yields the best solution either from the economic or the ethical point of view.

Hayek is right in his attack on constructivism, the ideology that asserts that a single agent (or group of agents) is capable of grasping all the relevant information needed to rule the social and economic life of a modern community. Hayek argues that the experience accumulated in social institutions and norms will allow the creation, storing, processing and dissemination of the relevant knowledge better than any one person or group could do it –and specifically, that the market will perform better than any central planning agency. But this does not mean that human reason cannot identify the errors and flaws of the system –although it is not able to rebuild and improve the whole system.

But to carry out this task of valuation and judgement of the system as a whole and of its parts, human reason needs a guide. And this cannot be the social norms and institutions, because they are always evolving. As we said before, the criterion of the long-term survival of a society is a very debatable one, and not only in ethical terms.

Ethics is not a voluntarist construct about how we would like society to be. Like many institutions, it is an unplanned reality, which acts as the equilibrium condition for economic, social, political, etc. systems (Argandoña 1989). As such, it explains the constraints of institutions and behaviours, not in the name of a utopia or human-designed perfection, but of the acknowledgement of the very conditions that allow people and societies to develop –this is what ethics seeks to explain.

Let us go a step further and ask ourselves what we could do –as social scientists, as civil servants or simply as citizens– faced with an evolutionary social system other than free it from all government intervention. There is no alternative but to live within its norms and institutions. This means that from the scientific point of view, Hayek's theory is a kind of determinism –a logical consequence of his cultural evolutionism. Even freedom is not a human responsibility, as evolution takes care of it (Argandoña 1991b).

To escape from this intellectual trap, we need to find a better role for reason, and consequently a new function for ethics. Reason is the capacity of the human being to identify his or her end and to choose the means to achieve it. Hence, reason is able to judge the ethical contents not only of human actions and behaviours, but also of social institutions and norms. Reason is, in reality, limited, so that building a complete economic system lies beyond its scope: in this, Hayek is right. But reason is able to understand that some actions, behaviours and institutions are harmful for the agent himself, and perhaps also for others, because they destroy his or her humanity. This means that the rules that govern the attainment of the ends of persons –the rules of ethics– are superior to their actions and also to the institutions that they create, purposeful or not. In this sense, ethics is a meta-institution in relation to social institutions, and belongs to the realm of ideas and values.

Ethics has a particularly significant role to play in the event of institutional change. As we have already indicated, agents seek the introduction, maintenance or change of a social institution or norm when their own personal interest (or that of a group) so advises, and not necessarily on the basis of social efficiency or optimality criteria. In the absence of an "ethical invisible hand" that could obtain a positive (from the moral viewpoint) collective outcome from all the actions coordinated by the market, people's actions must be submitted to ethical scrutiny, particularly if we accept the social conflict approach, in which institutional change always implies an attempt to change distribution, thereby creating fairness problems that go beyond mere economic efficiency.

Therefore, there will be morally suitable institutional changes and others that are not. Ethical science will simply tell us which actions –including institutional changes– are compatible in the long term with human and social development, and which are not. It will not tell us which institutional changes should be encouraged –this would be constructivism– but it will tell us the limits of the attempted changes and the criteria that must be observed for institutional evolution to be compatible with personal and social development. In short, it does not offer so much a criterion for ascertaining the "best" institutions as a criterion for identifying what long-term effects may be particularly harmful for people and society.

When judging institutional development, we are able to call upon a series of technical and economic criteria, some of which we have already discussed: the desirability of favouring institutional experimentation (and the variety of institutional forms), the limitation of the role of the State, the promotion of institutions that favour development (in the broad sense of the term, as opposed to the mere growth of output), such as entrepreneurship, suitable distribution of risks, a stable and clearly demarcated property right, the creation, preservation and distribution of information, etc. However, above all these, we must recognise the existence of the constraints and guidance provided by ethical science.

Conclusion

The theoreticians of the invisible hand were usually optimistic about the capacity of society to change its institutions and norms in a direction that was always positive for mankind, without the intervention of any ethical norm or rule. But their optimism was based on the hypothesis that social evolution always changes institutions for the better. We do not share this deterministic view, either in the technical aspect –economic efficiency– or in the ethical one. The reasons given why social evolution should drive society towards an economic optimum without the guide of ethics are unconvincing. And there are no reasons for the spontaneous attainment of an ethical optimum.

But if ethics controls the process, we can keep the optimistic conclusion. A society of individuals with strong ethical criteria and behaviour will provide the framework for a correct evolution of institutions –with errors and failures, but with many more successes. A society of morally sick individuals will be ruled by egotism, greed and arrogance, and its institutions –the barriers that were intended to check and limit unethical behaviour– will be unable to prevent its failure in the long run.

This means that:

1. Ethics, inspiring the ideas and values of society, may help the social evolution process to produce a set of institutions and social norms that are both efficient and ethical.

2. Ethics provides criteria for judging the morality of social institutions and norms, as well as people’s behaviour and actions.

3. These ethical institutions will constrain the behaviour and actions of men and women, driving them to efficiency and social stability, but not necessarily to morality, because they are free agents.

4. Ethics also provides a framework for the development and change of institutions and norms, inasmuch as moral people with ethical ideas and values will direct institutional change, even if spontaneous, towards ethical ends: the good of each and the good of the others.

5. Ethics is also a criterion for judging institutional change: a change that breaks an ethical rule cannot be a way to attain a better society.

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