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To: Economic Sociology Discussion List <economic_sociology@listserv.asanet.org>
Subject: ECONSOC Editorial: How Institutional Economics is Killing
Micro-Economics

It is my pleasure to present the fifth guest editorial of the 2000-2001 school-year. This editorial is contributed by Professor Frank Dobbin, Professor of Sociology at Princeton University. Professor Dobbin is the author of Forging Industrial Policy: The United States, Britain and France in the Railway Age (1994). Recent articles by Professor Dobbin chart the effects of antitrust policy on business strategy and the effects of equal opportunity law on personnel management.

I encourage everyone on the list to respond to Professor Dobbin's editorial.

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How Institutional Economics is Killing Micro-economics

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Over the last decade, sociological and economic institutionalists have begun to converge on a view of how institutions shape individual behavior. The two broad kinds of institutionalism -- economic and rational choice institutionalism, on the one hand, and historical and sociological institutionalism, on the other had begun with very different theories of action (Hall and Taylor 1996; Thelen and Steinmo 1992; Campbell 1998; Scott 2001). Economists such as Oliver Williamson (1985) and Douglass North (1981) were building a theory on the foundation of micro-economics -- that dismal science that makes greed the motive behind all human behavior. Historical and sociological institutionalists not only depicted individual behavior as driven by other forces than self-interest; they rejected methodological individualism altogether, challenging the idea that society emerges from the hard-wired behavioral patterns of

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individuals that society is the individual mind writ large. Historical and sociological institutionalists (Meyer and Rowan 1977) described the individual mind as society writ small (Douglas 1986). In their view, the observable behaviors we associate with the idea of self-interest come from nurture, not nature. Sociologists saw social institutions as producing the psyche; whereas economists saw the psyche as producing social institutions.

There have been dramatic changes afoot, however, among economic and rational choice institutionalists. Leaders in both camps, such as Douglass North (1990) and Avner Greiff (1993) in institutional economics and Victor Nee (1998) and Jon Elster (1989) in rational choice theory, have begun to describe institutions more broadly. Whereas early works in institutional economics focused on how property rights regimes can orient the rational behavior of individuals (North 1981) or how market characteristics can shape the rational decisions of corporate managers (Williamson 1985), later works expanded the definition of institutions to include political patterns, state policies, organizing norms, and culture. Institutions still constrain individual choices (choice-within-constraints remains the buzzphrase) (Ingram and Clay 2000), but the institutions include broad characteristics of the environments that shape not only what is rational, but whether people are oriented to rationality in the first place.

In effect, economic and rational choice institutionalists are moving toward a position that makes the central tenets of micro-economics untenable. Under cultural institutions that do not prescribe behavior oriented to rationality or self-interest in Weber's view, this condition included all of the world's major religions but Protestantism -- a choice framework that presumes individuals who by nature are first and foremost calculative actors makes no sense.

The emergent view seems to be that macro institutions determine general actor orientations to economic self-interest or salvation for instance and that macro institutions themselves do not follow a prescribed teleological course of development (North 1990). If you follow these ideas to their natural conclusions at the micro level, you do not end up with a micro-economic view of behavior. Economic and rational choice institutionalists appear to be dismantling micro-economic theory from above. Douglass North seems to recognize this when he calls for the importation of ideas from cognitive science, which holds the view that individual behavior is shaped by patterns of cognition and decision-making that have been identified by psychologists, linguists, neuro-scientists, and others (Thagard 1996). Sociological institutionalists have embraced a theory of action that is broadly compatible with cognitive science and cognitive psychology, in which behavior is learned and scripted rather than purely calculative (DiMaggio 1997).

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Economic and rational-choice institutionalists have made "choice-within-constraints" their rallying cry. They view micro-economic, rational choices as constrained by institutional context. Yet North, Greif, and Nee now argue that those constraints are not limited to state and firm structure, but include even informal institutions of culture and norms. If one defines institutions broadly enough to encompass culture and norms, one ends up with the social constructionist vision of individual behavior, in which rational scripts of behavior vary widely across setting and are really norms themselves. This leaves nothing for micro-economic models to explain those models themselves are scripts or norms.

Micro-economists thus serve as modern philosopher/witch-doctors, in that they prescribe behavior and explain those prescriptions not in terms of human-made norms, but in terms of the way nature made the universe. The formal theories they develop are prescriptive, such that observed individual conformity with those norms has the same social-scientific status as observed conformity with the Christian norm of piety. In other words, micro-economic theory is itself a cultural constraint within which choices are made by individuals. From the perspective of sociological institutionalism, in fact, this cult and its rituals and beliefs are among the most important characteristics of modernity to understand, precisely because economists are among our most prominent witch-doctor/philosophers.

In the modern world we are -- all of us -- rational actors. Rationality and science are the cognitive frames with which we make sense of the world. We think of human behavior as shaped by goals and means and rational calculation, and see the world through the lens of physical and social laws like the laws of thermodynamics and the laws of the market. We do not think of human behavior as shaped by an omnipotent deity, or believe that what happens to us is a product of his will. We do not think of human behavior as shaped by a dense universe of spirits that inhabit the flora and fauna, or perceive a cacophony of battling spirits around us. Religion still plays a role in the lives of many, but for all but a few it is integrated with a rational and scientific worldview. We tend to perceive something amiss in those with a truly encompassing religious or mystical worldview, and prescribe Lithium or deprogramming or, in the case of Islam, representative democracy in tandem with Coca-Cola.

The two broad camps of institutionalists concur on the point that modern actors are mostly rational actors, meaning simply that they orient behavior to the rational pursuit of goals given the physical and social laws they perceive to govern the universe.

Where sociology and neoclassical economics have differed is in their micro theory, their theory of individual behavior. Mid-century American economics began with methodological individualism, explaining all behavior

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by the individual trait of greed and sketching the implications of that trait by observing behavior. Actors were perceived to be systematically calculating, even conniving. The idea was that in observing actors, you could divine a small set of mathematical formulas that represent, and thus predict, how people behave. Those formulas were written by nature, and economists acted as mere scribes. Sociologists are, of course, wont to argue that it was not so long ago that you could, likewise, divine the will of God by observing his actions on earth.

Sociology began with what Victor Nee (1998) calls methodological holism -- the observation that our behavior is determined by circumstances. Sociology has been more theoretically diverse than economics, but most approaches see humans as creatures of habit, driven by customs and routines that arose themselves by chance or by force. For sociologists (Berger and Luckmann 1966; Meyer, Boli, and Thomas 1987) and anthropologists (Douglas 1986; Geertz 1983), this is just as true in rationalized social systems as it is in mystified or religious social systems. We collectively seek to rationalize human life no doubt with substantial success -- but the individual still chooses based on habit and custom just as she did when it was frog totems, and not mathematical formulas, that ruled the world.

Some economic and rational-choice institutionalists have challenged methodological individualism from within, bringing typically sociological insights about institutions to bear on rational behavior. Perhaps most importantly, they have championed the path dependence model of institutional evolution, which suggests that institutions arise by happenstance (rather than by nature's design) and then persist to shape the future. This is vastly more sociological than is the neoclassical view, which formally neglected institutions but which carried an implicit and teleological model of natural selection among social institutions. Adam Smith argued, in effect, that only social institutions that reinforced the economic laws of nature could survive, because natural selection would destroy anything else. Mid-century American economists bought this argument, such that they thought they did not need to pay heed even to economic institutions because those institutions transparently reinforced the economic laws of nature.

Recent work in economic institutionalism represents a huge challenge to the micro-foundations of economic theory, because it is fast moving toward defining institutions not narrowly, in terms of rules of behavior imposed by states and corporations, but broadly to include culture and norms. My point is simple. If you expand the definition of institutions to include culture and norms, and you subscribe to a path-dependent view of institutions, you end up with a micro theory that is not compatible with the micro-economic view. You end up with a theory that is based in

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cognitive science, constructionist sociology or symbolic anthropology. In short, if choices like "what to do with excess capital" in a large corporation are normative and if norms are path-dependent, then there is little choice left in rational choice.

The path that institutional economists are marching down has already been trodden by sociologists, and their work clearly suggests that we often do not need micro-economic theory to understand even profit-oriented behavior. They show that the means to the pursuit of self-interest are learned, not innate, and that those means vary across rational societies just as the means to the pursuit of salvation vary across religious societies. We learn that to maximize corporate profits, we should diversify to spread risk and create an internal capital market. Or that we should spin off unrelated businesses and focus on our "core competence." Neil Fligstein (1996) charted the first process, whereby the Celer-Kefauver act changed the parameters of antitrust law, spurring a minority group of managers trained in finance to promote conglomeration in place of vertical integration, which the law now rendered suspect. They championed a new economic theory portfolio theory and popularized the conglomerate well beyond corporations that had any real use for it. Everyone jumped on this bandwagon, whether it made sense for them or not. Gerald Davis and colleagues (Davis, Diekmann, and Tinsley 1994) have since charted the counter trend, stimulated in part by lax antitrust enforcement and spearheaded by a new group of managers advocating a "back to basics" approach in which management teams made the best of their competitive advantages and stayed out of areas they didn't know anything about. They spun off unrelated businesses left and right, and the trend spread from firms that had trouble managing diverse enterprises to those that were doing perfectly well. William Roy (1997) describes a similar series of events at the turn of the century, when antitrust law first brought about a new business strategy horizontal consolidation that, likewise, spread to sectors where it made no sense as well as to those where it made sense.

In these stories we see actors doing their best to behave rationally, but we don't really see rational calculation in the micro-economic sense. Just as frog worshippers may switch allegiances to lizards after a couple of seasons of drought, these poor executives are nervously scanning the horizon for new lessons that will help them to make it through the next season.

Fligstein and Davis and Roy have made superb use of classical ideas in sociology to describe how institutional context shapes rational behavior. What is striking in these studies is that classical micro-economic theory doesn't seem to play a role. What we have at the micro level is really a sort of learning theory. Institutionalists in

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sociology haven't worked this out well, because they begin their explanations with institutions rather than with individuals, but it seems clear that if economic institutionalists continue on the path they have taken, they'll end up where sociologists have long been, arguing not about how people make choices, but about how they don't have any choices to make.

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