THE EMERGENCE AND EVOLUTION OF INSTITUTIONS. CONNECTIONS BETWEEN INSTITUTIONAL ECONOMICS AND THE AUSTRIAN SCHOOL

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Abstract

This article aims at analyzing the similar viewpoints between the Austrian approaches of institutions and what we call today (new)institutional economics. We assume the hypothesis that when it comes to the emergence and evolution of institutions, the Austrian School has inspired, explicitly or not, the recent contributions in this area. We focus mostly on the contributions of Carl Menger and Friedrich von Hayek, considered to have achieved the most advanced level in the evolutionary perspective of the Austrian tradition.

Key words: human action, spontaneous order, Austrian School, Institutional economics, institutional evolution.

1 Introduction

Institutions, their emergence, existence and evolution, have become a central theme of investigation in explaining and enhancing socio-economic development.

Although the analysis of institutions is not new, going back to the American institutionalists and the German historical school, what we call today New Institutional Economics is somehow distinctive.

We call for two reasons to support this statement, first of all, it incorporates influences from different moments in the history of ideas and, secondly, it brings as a novelty the theme of institutional evolution. At the same, there are several common viewpoints Institutional economics shares with the Austrian School.

In this article, we proceed at a short overview of institutional economics, pointing out the most important moments that have influenced this area. The second part of the paper presents the main Austrian approaches to institutions, in an attempt to create a framework for analyzing the similarities between the Austrians' and the institutionalists' approaches. The last section of this article is a synthesis of the common viewpoints, focusing on institutional evolution which we consider to be the major similarity between the two conceptions.

2 The Path to Contemporary Institutional Economics

The role of institutions in economic development has been a topic of great interest to economists.

Starting from the tradition of American Institutionalism (Thorstein Veblen, John Commons, Westley Mitchell), the modern history of economic thought abounds in writings

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which explain the strong relationship between economic performance, wealth and the rules and laws which govern economic and social life.

An overview of the evolution of what we call today Institutional Economics requires *sine qua non* a return to the Scottish philosophers and economists of the eighteen century, such as David Hume, Adam Smith and Adam Ferguson. The famous "invisible hand" is nothing else but an institution. Besides advocating a minimum state and the self-reliance of the individual citizen, they explored "what basic institutions a functioning capitalist economy needs, namely the rule of law, private property and the freedom to contract" [Kasper & Streit, 1998, 35].

The analysis of institutions also received the very important contributions of the Austrian School, particularly of Carl Menger, Ludwig von Mises, Friedrich von Hayek and their disciples. It is its methodology and realism that had a strong impact on the development of Institutional Economics.

Another tradition in institutional analysis is elated to the Freiburg School, also known as the German ordo-liberal school. Its main representatives, Walter Euken and Franz Böhm, "adapted the basic institutions described by the Scottish philosophers to modern industrial society, with political parties, self-seeking bureaucracies and organized interest groups" [Kasper & Streit, 1998, 36].

Some ideas have also been taken up from Public Choice economics. James Buchanan developed a study of political institutions, starting from the idea of Constitution [Buchanan, 1990, 1-18]. Mancur Olson is one of the classics of organizational and institutional analysis of the century, being concerned with the issue of the emergence of groups and organizations, the idea of democracy as an institution and of state as a special type of organization [Solcan, 2005, 3].

The recent economic analyses of institutions, incorporating all the influences mentioned above, are included, generally, within Institutional Economics. This area studies the impact of alternative institutional arrangements, as sets of rules, upon the way people achieve their goals and upon economic performance. The institutional approach also designates the feed-back analyses referring to the way institutions develop, that is issues related to the process of institutional change [Marinescu, 2003].

Another step forward leads to New institutional economics. Ronald Coase, Douglas North and Oliver Williamson are considered to be its founder by integrating the economic analysis of institutions in the field of property rights and transaction costs.

Lately, within this research area, the methodological hypotheses and the analytical techniques have achieved a growing heterogeneity reflected in the components of New institutional economics: transaction costs, property rights and contracts, imperfect information, agency problems, as well as relevant aspects of game theory.

3 Austrian Approaches to Institutions

The Austrian approach focuses on the process rather than the result of individual interaction, is built upon strict methodological individualism, develops a dynamic subjectivism approach and deals with the consequences of ignorance and uncertainty [Gloria-Palermo, 1999, 31].

Although we cannot speak about a unified theory of institutions, they play a central role in Austrian tradition. The nature and function of institutional phenomena have received attentions since Carl Menger's analysis of the emergence of money. Menger showed how the organic institutions emerge, in other words, institutions that are not the result of one individual's will, nor the realization of a collective objective, contrary to pragmatic institutions that are the result of an individual or groups of individuals realizing an intentional goal [Garrouste, 2007, 4].

According to Austrian economic tradition, institutions represent the social crystallization of human behaviour according to the rules. It derives from here the necessity of making an essential distinction between *planned institutions* (*pragmatic,* in Menger's terms) which are created and implemented by official actors (for example, governments) and *unplanned institutions* (*organic*). These last ones arise spontaneously and they "develop in time as a result of human action, not of human design" [Hayek, 1967, 96-105].

In Austrian economics institutions emerge because people back perfect knowledge and try to cope with this uncertainty. People struggle to find institutional arrangements which can make life more predictable. Hayek argues that there is no way for bureaucrats to make intelligent decisions to deliberately plan or design an economy because it is impossible for them to gain and possess sufficient knowledge. Furthermore, he explains that the arguments against a designed order consist of a combination between "man's fallibility and the limits of reason" [Younkins, 2005, 1-2].

It is this conviction that makes Hayek a strong defender of spontaneous order. In his opinion, this type of order originates from "the discovery that there exist orderly structures which are the product of the action of many men, but are not the result of human design" [Hayek, 1973].

However, Hayek does not fully reject the normative element whose correspondent is the government. But the proper role of the state is to create general rules which facilitate mutually beneficial interactions rather than prescribing specific outcomes.

It is the rule of law that underpins the idea of spontaneous order. It requires "simple, transparent, non-discriminatory and negative rules of conduct, telling actors what not to do, but otherwise leaving them free to do as they wish. In other words, such rules are proscriptive, not prescriptive" [Sally, 2002, 16]. The rule of law is, thus, about general rules of conduct, applying equal to all players.

Hayek's spontaneous order comes with the idea of evolution. He views the world *as continually changing and realizes that institutions are forever evolving* [Boettke, 1989, 75].

Austrians share this emphasis on change in economic analysis in general and in institutional analysis in particular. However, there is no consensus on what the institutional analysis in Austrian tradition aims at. Different authors have been concerned with different research directions. If Carl Menger's focus is on the emergence of organic institutions, Hayek is more preoccupied with the evolution of social rules and the emergence of spontaneous order. More recently, Langlois, for example, extends the Austrian approach to the analysis of the firm and the State [Langlois, 1986].

4 Some common points of view

A first common point of view between Austrians and the representatives of Institutional economics consists in the common conception of the role of economics in social sciences, that is the definition of economics as "the theory of how individual economic agents pursuing their own selfish ends evolve institutions as a means to satisfy them" [Schotter, 1981, 5]. Institutions are seen as "regularities of behaviour that are accepted by all the members of a society and that specify the behaviours in specific recurring situations" [Schotter, 1981, 9].

Institutions reduce uncertainty by providing a stable structure for everyday life. They have a *guiding role in human interaction* [North, 2003, 11], approach which is convergent with the Austrian view of institutions as means of orientation for individuals' coordination and the improvement of the cognitive limits of human nature. The institutions emerge and evolve as a result of human action and the theory which explains this process should be grounded on the Austrian principle of methodological individualism.

Another common approach is related to the conception of rationality. Contemporary analyses of institutions are based on the idea of *bounded rationality*. That is "human agents are subject to bounded rationality, whence behaviour is intendedly rational, but only limitedly so" [Williamson, 1985, 45]. Originally proposed by Simon, the concept of "bounded rationality", a very important behavioural hypothesis in Transaction Costs Theory, stands for the following principle: "The capacity of the human mind for formulating and solving complex problems is very small compared with the size of the problems whose solution is required for objectively rational behaviour in the real world – or even for a reasonable approximation to such objective rationality" [Simon, 1957, 198].

This conception of rationality is similar to the Austrian viewpoint which agrees hat we live in a world of uncertainty and imperfect knowledge.

Perhaps the most obvious common point of view between the two schools consists in applying the evolutionary perspective n their analyses.

As pointed out by Boettke, "institutional economics is distinctive not because of the focus on institutions per se, but rather because of the insistent theme of change in the economic process" [Boettke, 1989, 74]. Indeed, institutions are not static; they change and develop over time. It is institutional evolution which best explains the processes of social interaction and human coordination and the obtaining of economic performance. On the other hand, Austrian economists seek to understand the ongoing evolutionary processes in which institutions change. Hayek asserted that "economic problems arise always and only in consequence of change" [Hayek, 1980, 82]. He has tried to understand the evolution of institutions, such as the market, law, rules of conduct. In Austrian economics the study of evolving institutions is recognized as being indispensable to the understanding of the processes of social interaction. From this perspective, "the theorists in the Austrian tradition envisions the economic world as an emergent, evolving process" [Samuels, 1989].

5 Conclusions

Institutions incorporate and structure the incentives of human interactions, be them political, social or economic.

With no doubt the analysis of institutions was strongly impelled by the methodology and the realism of the Austrian School of economics, essentially by Carl Menger, Ludwig von Mises, Friedrich von Hayek and their disciples. The similarities envisage mostly the question of emergence and evolution of institutions. The connections between Austrian economics and new institutionalism enrich the understanding of institutional dynamics and of the manner institutions reduce uncertainty.

But the question of the role of institutions in Austrian thought is a research direction that still needs to be explored at the same time with the analysis of both organic and pragmatic rules.

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