

## The Demarcation between the “Old” and the “New” Institutional Economics: Recent Complications

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Proponents of the Veblen-Commons variety of institutionalism have distinguished this school from the so-called “new institutional economics” (NIE hereafter). Recent contributions to the *Journal of Economic Issues* have once again dealt with this issue. In a paper entitled “What Is the Essence of Institutional Economics?” Geoff Hodgson (2000a, 318) has listed five propositions that he considers as the core of what others have called the “old,” or original, institutional economics (OIE hereafter). There is no need to repeat all these propositions here, except for proposition 5: “The notion of individual agents as utility-maximising is regarded as erroneous. [Old] Institutionalism does not take the individual as given. Individuals are affected by their institutional and cultural situations. Hence individuals do not simply (intentionally or unintentionally) create institutions. Through ‘reconstitutive downward causation’ . . . institutions affect individuals in fundamental ways.” For Hodgson, this is “the single most important defining characteristic of the old institutionalism . . . Among other schools, the new is distinguished from the old institutional economics principally in these terms” (318). As Hodgson (325) noted, by saying this he is reaffirming what he argued in his survey of OIE and NIE (Hodgson 1993b).

In her comments on Hodgson, Anne Mayhew (2000, 331) agreed with his identification of that proposition as the defining feature of OIE. She approvingly interpreted Hodgson as “saying that what is distinctive and attractive about institutional economics is the emphasis on seeing people as cultural animals.” Like Hodgson, Mayhew was also

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restating a point made on previous occasions. The contrast between OIE and NIE is clear when, for example, Mayhew (1989) attributed to NIE the aim of making institutions endogenous by explaining them with the tools of neoclassical theory, so that institutions are chosen by individuals and not allowed to condition individual choice.

The present paper points out the need to qualify these and similar views, while recognizing that this way of contrasting OIE and NIE was very useful when first formulated by Hodgson, Mayhew, and others and continues to be so in most cases. The paper's intended contribution is not to criticize these authors but to show that there have been recent developments that make it more complicated to distinguish between these two varieties of institutional economics. In particular, some authors associated with NIE have put forward views that indicate an incorporation of, or at least an important move toward, the very point that Hodgson, Mayhew, and others see as most distinctive of OIE vis-à-vis NIE.

The remainder of the paper is organized as follows. The first section presents a taxonomy of different types of influence that institutions have on economic behavior. In the light of this taxonomy, the second section shows that some new institutionalists have recently pointed out what I call the deeper cognitive function of institutions. In doing so, they seem to have significantly embraced the old institutionalist notion of the "institutionalized individual" or "cultural animal." The third section then discusses some implications of this for the demarcation between OIE and NIE.

### ***Institutions and Their Influence on Economic Behavior***

I have suggested elsewhere (Dequech 1998) that, based on the work of several institutionalists, one can identify at least three types of influence that institutions have on economic behavior. The first, which may be called the *restrictive function* of institutions, consists in their role as constraints on economic behavior. The second refers to what Hodgson (1988) called the *cognitive function* of institutions. These two functions of institutions are not totally independent of one another, since restrictions themselves can under certain circumstances be seen as information providers. In particular, if they restrict the behavior of several people, they help each person to imagine the possible behavior of the others. The cognitive function refers, firstly, to the information that institutions provide to the individual, including the indication of the likely action of other people. I call this the *informational-cognitive function* of institutions. Secondly, the cognitive function of institutions includes also their influence on the very perception that people have of reality, that is, on the way people select, organize, and interpret information. I call this their *deeper cognitive function*. Institutions perform a third function through their influence on the ends that people pursue. For want of a better term, this can be called their *motivational or teleological function*.<sup>1</sup>

### ***The New Institutional Economics and the Influence of Institutions***

Standard neoclassical economics, whenever it discusses institutions, can be seen as emphasizing their role as constraints. According to Elias Khalil (1995, 452), NIE too still focuses on institutions as constraints, while, in contrast, "the main thrust of old institutional economics is the modelling of institutions as determinants of the agent's cognitive ability" (as paradigms, in Khalil's words). Similarly, Hodgson (1999, 34) has argued that "it is a defining characteristic of the 'new' institutional economics that institutions act primarily as constraints upon the behavior of given individuals."

To the extent that Khalil, Hodgson, and others are right in maintaining that NIE focuses on constraints, this is a serious limitation of NIE. Indeed, there have been extensions of neoclassical theory which endogenize institutional constraints by transforming them into rules accepted by mutual consent. Part of NIE might be seen as belonging to this line of research.<sup>2</sup> It is also true that, even when not simply extending the neoclassical approach, other segments of NIE still focus on institutional constraints. However, it can be argued that the traditional neoclassical focus on, and often negative view of, institutions as constraints is not characteristic of all NIE.

It is important to note that Hodgson has characterized NIE not only as focusing on constraints but also as taking individuals and their wants and preferences as given, at least "for the purposes of economic enquiry" (Hodgson 1993b, 5). I intend to show that this approach, too, seems to have been abandoned or rejected by some new institutionalists.

In my view, the characterization of NIE as focusing on institutions as constraints (that is, on their restrictive function) needs to be qualified. Authors that have been considered practitioners of NIE have pointed out the cognitive function of institutions, like their colleagues in the institutionalist tradition of Veblen and Commons. This is the case, for example, of Andrew Schotter (1981, 109), Richard Langlois (1986, 18), and Jack Knight (1997, 694–95) regarding the informational-cognitive function of institutions (see also Greif 1994, 915, on cultural beliefs). Manfred Streit, Uwe Mummert, and Daniel Kiwit (1997, 688) also must be noted for establishing, as I did above, a link between the restrictive and the cognitive-informational function of institutions. This idea is implicit in North 1990 (3, 25).

More importantly, as noted in Dequech 1999, even the deeper cognitive function of institutions is acknowledged and emphasized by a few scholars within or close to NIE, most of whom were already mentioned above. This is particularly relevant because it implies that individuals are not taken as given, in their relation to institutions. For some time I thought that the recognition of, and emphasis on, the deeper cognition function of institutions was the major theoretical difference between OIE and NIE. In this sense, I adopted a demarcation criterion quite similar to Hodgson's.<sup>3</sup> Reading the recent work of some authors associated with NIE, however, made me realize that things were or have become more complicated than that.

Knight, for example, turned to a non-individualistic approach in cultural anthropology to draw insights on cognition, particularly regarding two mechanisms by which

social institutions in particular and cultural context in general affect the process of individual cognition (Knight 1997, 694). Discussing the first mechanism led Knight to acknowledge, as already noted, that which has been termed here the informational-cognitive function of institutions. Recognition of their deeper cognitive function comes in his discussion of the second mechanism, which “entails a more pervasive role for institutions in the cognitive process” (Knight 1997, 695). Here Knight made many important points by approvingly quoting cultural anthropologist Edwin Hutchins (1995). Knight supported Hutchins’s (1995, 354) argument that “culture, context and history . . . are fundamental aspects of human cognition and cannot be comfortably integrated into a perspective that privileges abstract properties of isolated individual minds.” Knight also agreed with Hutchins (1995, xiv) that “human cognition is not just influenced by culture and society, but . . . it is in a very fundamental sense a cultural and social process.”<sup>4</sup> Knight (1997, 696) went on: “Institutional rules do more than give content to beliefs, they also structure the processes by which the particular substantive content is established.” For Knight, “cognitive processes *themselves* are shaped by interaction with the external world” (696). Understanding the genesis of social institutions and culture “is important not only for understanding incentive structures, but also . . . for understanding processes of cognition and rationality” (697). All this seems to amount to a rejection of an individualistic conception of cognition and of an atomistic conception of individuals. This rejection is reinforced in Knight’s longer discussion of these issues (2000). He explicitly praised Hutchins for significantly departing from the individualistic conception of cognition and rationality. Furthermore, he also criticized the individualistic approach of standard psychological research on cognition and decision making and argued that research on these issues “must move beyond the walls of experimentation and pay greater attention to the mechanisms of everyday cognition in social life” (Knight 2000, 16, 20–21).<sup>5</sup>

Other authors associated with NIE who emphasize the deeper cognitive function of institutions are, again, Streit, Mummert and Kiwit (1997). They maintain that institutions do not only facilitate cognitive processes. More than that, “being a part of the cultural environment they also influence the individual’s perception of information: It is assumed that the human mind creates cognitive models interpreting the environment. These cognitive models act like filters and influence the perception of information. . . . The cognitive models are assumed to be influenced by the process of socialization” (Streit, Mummert, and Kiwit 1997, 688–89).<sup>6</sup>

Somewhat less explicitly, Andy Clark (1997, 269) also allowed “the cultural artifacts of language and of social and economic institutions” to be part of the “external structures” that “act as filters” in the reasoning process, working as important “situated aspects” of the latter.

Another approach to consider is that of Arthur Denzau and Douglass North (1994). They highlight a specific aspect of the deeper cognitive function of culturally shared mental models by pointing out their importance to the process of learning: a culturally shared mental model expedites the process by which people learn directly from

experience; it also facilitates communication between people, which is crucial for them to learn from each other's experiences; in addition, the cultural heritage helps to transfer perceptions to other generations. Denzau and North call these models ideologies, used to interpret reality, and conceive of institutions just as rules of the game (constraints), used to structure and order the external environment. Even if under another name, they are discussing the deeper cognitive function of what others call institutions (see also North 1995).<sup>7</sup> Note, however, that Denzau and North (1994, 4) confusingly also have stated that both "ideologies and institutions can . . . be viewed as classes of shared mental models"—which would imply that institutions, even as the term is used by Denzau and North, do perform a deeper cognitive function. It is not clear to me how they reconcile this with their claim, on the same page, that "the institutions are the *external (to the mind)* mechanisms individuals create to structure and order the environment" (emphasis added).

Regarding North, Hodgson (1999, 34n) has acknowledged that this author has recently (although ambiguously, in Hodgson's view) begun to admit that institutions "may channel unchanging incentives or, more radically, that purposes or preferences are themselves changed by institutions." In addition, Hodgson briefly noted "North's widening discussion of the role of ideology in determining individual behavior" (see also Rutherford 1995, 446), but without explicitly acknowledging that North has, even if with a different terminology, started to emphasize the deeper cognitive function of institutions, since, as seen above, ideology is one of North's terms for those shared mental models. One may complain that North's definition of institution is too narrow, but, in the light of the preceding paragraphs, it seems more difficult to accuse him of ignoring the cultural or social character of cognition. Nor is it the case that North acknowledges this cultural or social character while still claiming that this is not the concern of economists. After stating that some mental models are intersubjectively shared, Denzau and North argued that an understanding of how mental models evolve and the relationship between them and institutions "is the single most important step that research in the social sciences can make to replace the black box of the 'rationality' assumption in economics and rational choice models" (5). In another recent work, North (1999, 1) has located the study of beliefs "at the heart of all theorizing in the social sciences."<sup>8</sup>

In sum, a few new institutionalist authors have been identified who discuss the deeper cognitive function of institutions and who seem to believe that it does concern economists. It is not the purpose of this paper to discuss whether these authors have approached the deeper cognitive function of institutions (or their motivational function, for that matter) in an adequate way. From the point of view of OIE, for example, it is necessary to investigate whether culture is conceived of in an individualistic fashion or not (Mayhew 1987; Hodgson 1993a, 156). This certainly is an important question for future examination, but it seems that what these authors say regarding these issues already has important implications.

### ***The Demarcation between the Two Institutionalisms***

One possible implication is to make the very definition of NIE in relation to other schools of thought a more complicated matter than it would seem—or than it already is. In particular, the acceptance or rejection of the view that individuals should be taken as given, in their relation to institutions, does not serve completely well as a criterion to separate NIE from OIE, at least if one continues to consider the authors mentioned above as new institutionalists, as they seem to be considered by many people working in this field.

To be sure, an emphatic acknowledgement of the informational-cognitive function of institutions and the consequent recognition that institutions are not just constraints may not necessarily imply the rejection of an atomistic conception of individuals, at least for scholars who remain unaware of, or somehow offer an answer to, the question of how atomistically conceived individuals would select, process, and interpret the information conveyed by institutions. However, an atomistic conception of individuals should be untenable for new institutionalists who acknowledge and emphasize the deeper informational function of institutions (or shared mental models, for Denzau and North 1994).

Of course, one can, as Hodgson (1999, 2000a) and others do, *define* NIE as characterized (perhaps among other things) by the view that individuals are given and that institutions basically work as constraints on these given individuals and as channeling incentives. How to deal, then, with the case of authors who are (or could previously be) considered new institutional economists and (at some point start to) emphasize the deeper cognitive function of institutions and the like? From Hodgson's standpoint, these authors would be seen as moving away from NIE. One consequence of this would be to exclude from new institutionalism authors that are usually (still) considered members of this school. If, however, we were to follow the usual practice and continue to refer to these authors as new institutionalists, the result would then be that NIE would be seen as evolving, so that its scope and its views on institutions would be widening. Hodgson's demarcation criterion, even if working well for most of NIE, would not apply to all of it.

On the other hand, this would raise the question: what should be the alternative demarcation criterion? This is a difficult question, and I do not claim to have a good answer to it. We should not content ourselves with simply considering as new institutionalists those who are usually considered or who consider themselves as such. We should look for theoretical and methodological criteria (and this is what Hodgson is doing). In other words, a definition like "new institutionalism is what new institutionalists do" is not totally satisfactory. Nevertheless, such a definition is not meaningless either, at least in the following sense: communication would be facilitated if those theoretical and methodological criteria led to a definition of new institutionalism that implied the inclusion under this umbrella of important authors

who are usually considered new institutionalists by others and/or by themselves.<sup>9</sup> The labeling of economists itself is an institutional process.

The discussion in this section indicates the need for further consideration of this conceptual issue. A demarcation criterion like Hodgson’s (based on whether individuals are taken as given) or like the one I used to adopt (based on whether the deeper cognitive function of institutions is recognized and emphasized) may still be the best we can adopt. Even if this is the case, we need to recognize that such a criterion no longer works as well as it used to, at least for communication purposes.

### **Notes**

1. The term “teleological” is used here in its general etymological sense of “related to (the study of) ends,” rather than as specifically referring to a characteristic of an argument or explanation.
2. Some new institutionalists, however, insist on separating NIE from an extended neoclassical approach (e.g., Furubotn and Richter 1998).
3. Hodgson’s criterion may be seen as broader than mine, in that it can also be related to the motivational or teleological function of institutions.
4. These points are conspicuous by their absence in Oliver Williamson’s (1998) discussion of Hutchins’s views.
5. In his comment on Knight, Kiwit (2000) adopted the language of cognitive psychology to argue that internal representations (mental models) of the environment, and particularly the more abstract representations called schemata, interact with the environment. Among other stimuli of the environment to mental representations Kiwit (2000, 35) identified the “cultural transmission of social norms.” Although one may be led to see this as an acknowledgement of the deeper cognitive function of institutions, Kiwit’s (2000, 33) explicit discussion of the cognitive function of institutions includes only their informational function, by which “they cognitively relieve the individual actor.”
6. Curiously, Streit, in his book with Wolfgang Kasper, did not resume this line of argument and was more ambivalent about the possible influence of the social context on individuals (Kasper and Streit 1998). This ambivalence was also noted by Hodgson (2000b).
7. It may be claimed that some of these ideas already appear in North 1990, 37, 42, in which he argued that institutions such as “informal constraints . . . are part of a heritage that we call culture. . . . Culture provides a language-based conceptual framework for encoding and interpreting the information that the senses are presenting to the brain). . . . In the short run, culture defines the way individuals process and utilize information.” On the other hand, in this earlier work North put much more emphasis on institutions as constraints and on the complementarity between his conception of institutions and the individualistic choice theoretic approach of neoclassical economics (5).
8. North (1999) has also highlighted the importance of the cultural heritage in the formation of beliefs and criticized evolutionary psychology for neglecting this.
9. To cite the most prominent example, North was very recently, from 1997 to 1999, the president of the International Society for New Institutional Economics (ISNIE). However, he might be excluded from NIE if one applied to him the demarcation criterion employed by Hodgson, Mayhew, and others.

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