INDIVIDUALS, INSTITUTIONS, AND MARKETS

Individuals, Institutions, and Markets offers a theory of how the institutional framework of a society emerges and how markets within institutions work. The book shows that both social institutions, defined as the rules of the game, and exchange processes can be analyzed along a common theoretical structure. Mantzavinos's proposal is that a problem-solving model of individual behavior inspired by the cognitive sciences provides such a unifying theoretical structure. Integrating the latest scholarship in economics, sociology, political science, law, and anthropology, Mantzavinos offers a genuine political economy showing how social institutions affect economic outcomes.

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To the memory of
Alfred E. Ott
my teacher in Tübingen

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Preface

This book offers what may with reservations be described as a theory of how the institutional framework of a society emerges and how the exchange processes within this framework take place. We already possess a wealth of theoretical knowledge concerning the emergence and functioning of social institutions, as well as numerous fully developed theories explaining how markets work. The main purpose of this book is to show that both social institutions, defined as the rules of the game, and exchange processes can be analyzed in terms of a common theoretical structure. We propose that a problem-solving model of individual behavior inspired by evolutionary epistemology and cognitive psychology may provide such a unifying theoretical structure. A problem-solving model based on solid experimental findings from the cognitive sciences provides a synthesis of the two basic models currently employed in the social sciences: those of *Homo oeconomicus* and *Homo sociologicus*. This model, in turn, is the key to incorporating issues relating to institutions and institutional change and issues relating to the functioning of the markets in a genuine political economy.

Such a political economy can be understood as a transformation of neoclassical economic theory into a discipline that seriously considers the issue of institutions. In fact, the thrust of our argument is that any serious student of economic phenomena must pay attention to the institutions framing these phenomena. Although economists often pay lip service to the importance of institutions for economic and social life, they construct theories as if institutions were somehow given or even optimal. Instead, a theory of political economy must integrate systematically the study of the institutional framework and show how it affects economic outcomes.

Obviously, such a theoretical enterprise can be accomplished in different ways. Since sociology, political science, and anthropology have pro-

vided important insights in explaining institutions, a theory of political economy can be successful only if it can consistently integrate the different disciplines of social science into the general project of the study of institutions. In such a project, neoclassical economics must change and take institutions seriously. Neoclassical economics can be transformed into political economy only if one seriously reconsiders the behavioral foundations of the discipline. The fascinating developments in cognitive science provide rich empirical material one can draw from in order to revise the predominant behavioral assumption of utility maximization. Our view is that such a richer psychological model can provide the basis for a successful integration of institutions in the economic theory.

This revision of the behavioral assumptions of economics goes hand in hand with a shift of theorizing toward evolutionary arguments. Cognitive psychology teaches us that individuals actively interpret their environment and always act pragmatically, that is, in relation to a problem. This cognitive activity is responsible for the generation of novel behaviors and therefore for indeterminacy as well. The possibility of novelty implies the historicity of the evolutionary process and greatly complicates the theoretical attempt to come to grips with socioeconomic change. Despite the fact that the open-endedness of the evolutionary process dramatically reduces the possibility of predicting the exact forms of institutions that will be created in a society, the given institutions, once created, will act as the selection environment for the market processes that unfold within them. This means that institutions decisively channel the behaviors tried out in the given market arena.

Institutions, thus, matter for economic outcomes. This conclusion is common in every theory of political economy. What we want to state in addition in this book is that institutions come first. When theorizing about markets, one must first examine the prevailing institutional framework and then draw conclusions concerning market patterns and economic outcomes. This is not a methodological postulate. And though empirical evidence (for example, the failure of socialist economies) verifies this simple contention, it does not provide a substitute for a theoretical explanation. Such an explanation can, in our view, be provided only by consistently employing the cognitive-evolutionary model of individual behavior. Institutions are, from an internal point of view, nothing more than shared problem solutions that individuals have acquired while interacting with their environment. People proceed in exchange acts in markets on the basis of their existing knowledge of how to solve problems of social conflict. Institutions come first because they are already anchored in the

minds of the people before they start exchanging in markets. The channeling of market processes by institutions exists and is effective only insofar as it has its counterpart in the minds of the interacting individuals.

Because this causal relationship linking institutions and market outcomes is founded on cognitive path dependence, the feedback mechanism concerning entrepreneurs or organizations that try to change the institutional framework motivated solely by the effects of the distribution of wealth that the institutions have caused in the first place must be relativized. The distributional effects of market processes (i.e., the economic gains and losses that individuals or groups of individuals realize while participating in the market game under the given institutional constraints) do not automatically lead them to modify the rules in order to improve their competitive position. Whether such a step will be undertaken and who will undertake it depend on how the agents subjectively interpret and perceive their own position in their social setting; since their choices depend on their learning histories, the feedback mechanism is extremely difficult to explain and sometimes even to describe ex post. Therefore, our more modest claim in this book is to show that the direct causation linking institutions and market outcomes is valid.

Finally, we should remark that the focus of this study is positive rather than normative. Considerations of optimality and efficiency are systematically avoided so that the discussion of the issues can remain positive and therefore open to critical appraisal.

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