



An Austrian Dilemma: Necessity and Impossibility of a Theory of Institutions

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No doubt institutions represent a central theme of investigation for the Austrian tradition. Since Menger's analysis of the emergence of money, Austrians have been devoting a lot of attention to the nature and function of institutional phenomena. Such interest cannot be considered as the expression of mere scientific curiosity but rather, it will be argued, as an analytical necessity. However, it is difficult to identify a typical 'Austrian theory of institutions'. There is hardly any unity between the various developments, be it on the conceptual level, the methodological level or even on the normative level. Given this acknowledgment of the Austrian inadequacy to provide with a complete and unified analysis of institutions, the question faced in this paper is the following: is it possible to organize the various and quite eclectic elements in a coherent whole and to elaborate in this way a genuine Austrian theory of institutions? In other words, which elements should we keep in the framework and which should we get rid of in order to build a complete and relevant theory of institutions? What are the prerequisites that such a theory should respect so to be legitimately considered part of the Austrian approach?

To answer this question, it is first necessary to identify what the essential features of the Austrian tradition are, and then to check whether it is possible or not to elaborate an analysis of institutions along these lines. So, what are the main determinants of the Austrian essence? Even though there is not such a clear-cut answer as for the definition of the mainstream paradigm, we think a consensus exists among authors to define Austrian essence according to the following tenets: Austrian analysis aims at explaining the process of emergence and evolution of complex economic phenomena in terms of individual interaction, each economic agent carrying out his/her subjective plans of action in a world of uncertainty. Consequently, Austrian approach (tenet 1) focuses on the *process* rather than the result of individual interaction, (tenet 2) is built upon *strict methodological individualism*, (tenet 3) develops a *dynamic subjectivism* approach, and (tenet 4) deals with the consequences of *ignorance and uncertainty*.

An Austrian theory of institutions should therefore incorporate these fundamental features. In what follows, the consequences of each of these prerequisites on an eventual theory of institution are examined in order to specify, step by step, the nature of such an analysis.

In Section 1, we underline the diversity characterizing the Austrian theoretical developments on institutions. In Section 2, we argue that Lachmann's analysis of the market

process is perfectly representative of the Austrian originality as defined above, in particular as regards the radical subjectivist orientation (tenet 3 and 4). However, this orientation leads to unsatisfactory results which open the door to a criticism of theoretical nihilism (the market process is an indeterministic process). Such criticism, it is argued, might well be overcome by enhancing Lachmann's analysis with a specific theory of institutions. Once the *necessity* for an Austrian theory of institution is admitted, the further step consists in identifying more precisely which kind of theory would be acceptable for the Austrian tradition. In that connection, we examine in Section 3 the implications on an eventual Austrian theory of institutions of non-equilibrium analysis and in Section 4 the consequences of methodological individualism.

As a result, an Austrian theory of institution should

- provide with an endogenous analysis of institutions (consequence of tenet 1);
- be based on a specific method of investigation, such as invisible hand explanation (consequence of tenet 2);
- take into account the consequences of subjective expectations of individuals and analyze institutions through their influence in the process of plan formation in a world of radical uncertainty (consequence of tenet 3 and 4).

However, it will flow from our investigation that the resulting 'Austrian' analysis of institutions is not free from contradictions and far from being fully satisfactory. The *possibility* of building such a theory appears rather doubtful. The difficulties encountered give evidence of the inner limits of the Austrian research program.

1. Diversity and eclecticism

In this section, we point out the lack of unity of the Austrian thought as far as the following questions are addressed: *What* are institutions? *Why* are institutions analyzed? *How* are institutions analytically tackled? *Which* are the normative results that the analysis of institutions allows to come up with? First of all, it is difficult to define the concept of institution without ambiguities. When using the term 'institution', what are we exactly referring to? Market, firm, State, law, rules, conventions, norms, culture, family, habits, routines, power, order, etc.? The meaning Austrians ascribe to institutions barely meets accurate degrees of specification. Definitions are rather sketchy and general. In that way, Menger (1871) wholly grapples the theme of institutions through the celebrated distinction between organic and pragmatic phenomena. Organic institutions, like money or market or exchange prices, are the result of individual interactions but not of any human design whereas pragmatic institutions, such as firm, arise from an explicit agreement on the part of individuals or from legislative acts.

The definitions given by Hayek (1967, 1973) do not provide a more detailed account of what is to be considered an 'institution'. Institutions are sometimes assimilated to a model of spontaneous order (market as an institution), sometimes defined as the socio-cultural environment from which the nature of the corresponding market order depends (market is no more considered as an institution but as a typical spontaneous order which arises from

the specific institutions of private property and competition). Actually, Hayek's definitions attempt to do away with such ambiguities. Institutions are differentiated from social orders: an order is a relational structure which emerges from a specific institutional set-up. Confusion stems from the fact that in turn, institutions might flow from an unplanned evolutionary process. Hayek refers in that perspective to the twin ideas of evolution and spontaneous order.¹

Suppose Austrians reach a consensus about what they mean by the term institution. The second essential step consists in identifying the underlying problematic of a theory of institutions. What are the various Austrian analysis of institutions aiming at? Is it to analyze the process of emergence of some sort of social phenomena or its evolution, or furthermore its influence on the development of economic activity? Austrian thought does not offer a single answer to these questions: Menger (1883) focuses on the emergence of organic phenomena; Wieser (1914) introduces power conflicts to explain the dynamics of society; Hayek concentrates on the evolution of social rules and on the emergence of spontaneous orders; Lachmann (1970) is interested in the influence of social conventions on individual plans formation and revision; Langlois (1986, ed.) attempts to extend the scope of Austrian approach to the analysis of the firm and the State . . .

Different methods of investigation are used in order to cope with the various analytical questions identified above: genetic invisible hand explanations allow to study the process of emergence of organic phenomena;² functional invisible hand explanations aim at justifying the existence of given institutions;³ game theory is sometimes used in order to formalize processes of emergence and propagation of social rules.⁴ It would be, however, misleading to argue the incompatibility of these various approaches. In fact, diversity of methods stems directly from diversity of analytical objectives. Eclecticism is the rule.

Diversity is also encountered when confronting analytical results. Indeed, one has to question the unity of Austrian authors at the normative level too. Although liberalism and non-interventionism constitute the basic credo of traditional Austrian thought, substantial divergences appear, against all expectations, as far as the question of efficiency of spontaneous institutions is addressed. Notice first how cautiously Menger refuses to assimilate organic phenomena with efficiency. The author even warns against an excessive confidence over spontaneous phenomena.⁵ Consider also the odd position—odd with respect to the traditional Austrian defense of liberalism—developed by Wieser. Social order proceeds, according to the author, from the continuous power conflicts between leaders and masses. However, Wieser's admiration for the higher wisdom of the bureaucratic class progressively

¹ Hayek (1967, p. 77).

² Menger's (1892) celebrated analysis of the emergence of money represents the typical Austrian illustration of genetic invisible hand explanation.

³ Consider Hayek's theory of cultural evolution.

⁴ Cf. Schotter (1994).

⁵ “[A] statesman who would hesitate to change the law with regard to the common good just because it is really or supposedly of “organic origin” would be comparable to a farmer, a technologist, or a physician who would avoid any interference in the course of natural organic processes out of the veneration for the high wisdom which is manifest in nature. And are there not even noxious organisms?” (Menger (1883, 1963, p. 233)).

leads him to shift from a paternalist position to a sharp defense of dictatorship.⁶ No doubt this position is the main cause of the current neglect of Wieser's theory of social evolution. Finally, the strength of Hayek's or Kirzner's conclusions concerning the efficiency of market institutions to coordinate individual plans is undoubtedly weakened by Lachmann's contrasting results. According to Lachmann (1976a), the institution of competition is not sufficient to insure inter-individual coordination, market forces having both *equilibrating* and *disequilibrating* effects.

2. Dynamic subjectivism and radical uncertainty: The need for an Austrian theory of institutions

One fundamental question we have to face is the following: what role should a theory of institutions fulfill in the Austrian logic? Or, to put it differently, why do Austrians need a theory of institutions? In order to identify the nature of a satisfactory Austrian theory of social phenomena, it is necessary, in our view, to position such analysis in the bosom of the Austrian logic and to capture exactly the part it should play in it.

From our point of view, the need for an analysis of institutions in the Austrian framework flows from the hypothesis of dynamic subjectivism and radical uncertainty. The point we want to develop is the following: if the full implications of dynamic subjectivism and radical uncertainty are accepted, Austrians come up with a specific theory of the market process which cannot be properly developed unless completed by a determined theory of institutions. Such a theory should focus on the *influence of institutions on the process of individual plans formation and revision* rather than the process of emergence and evolution of institutions.

Let's first identify what are the full implications of dynamic subjectivism and radical uncertainty upon the Austrian analysis of market process.

Mises' axiom of *human action* clarifies the distinction between Austrian and Neo-classical definitions of subjectivism. The principle of human action means that individuals act purposefully:

Action is will put into operation and transformed into an agency, is aiming at ends and goals, is the ego's meaningful response to stimuli and to the conditions of its environment, is a person's conscious adjustment to the state of the universe that determines its life. (Mises (1949, p. 11))

Action is distinguished from *reaction*. It refers to conscious choice and is oriented toward subjective ends. The Austrian concept is richer than the traditional one: Neo-classical *Homo Economicus* perpetually follows the same objective consisting in maximizing his/her utility function, given the means at disposal. The Austrian agent is free to choose his/her objectives

⁶Streissler (1986, p. 86) sums up in two sentences the ideological position of Wieser: "Building upon a strong catholic conservative foundation he was an interventionist liberal of a heavily nationalist cast with quite an admixture of racist sentiment, who still found it possible to admire Marx and deal in muck-raking rhetoric. Above all, he was an admirer of the state as guided by the supreme wisdom of his own bureaucratic class."

and the means he/she thinks are relevant to these ends. The means-ends framework is no more an exogenous information to which agent has to react in an optimal way but becomes itself the result of a previous subjective choice.

The axiom of human action involves three direct consequences: the introduction of (1) causality, (2) real time and (3) uncertainty:

1. for an individual to act, a condition is needed: present action must be thought to have a positive influence on his well-being, that is action will cause a modification of the future state of affairs which is supposed to be preferred. Agents act according to their knowledge of causal relationships between economic elements of the system.⁷ Without any knowledge of causal relationships and regularities, there is no room for action.
2. action is oriented toward improvement of individual well-being, that is toward change. Action thus takes place in time; Mises follows Menger in his adoption of a specific view of time, i.e., a Bergsonian one, a subjective view of temporality, by contrast with a mechanical conception. In this perspective, time is synonymous of change and human action is the propeller of change.⁸
3. uncertainty is introduced along the same logic: action, defined as real choice, can only take place in an uncertain environment as regards future, otherwise it is replaced by mere reaction. Indeed, according to Mises (1949, p. 106), “[...] every action refers to an unknown future. It is in this sense always a risky speculation”.

In the Austrian tradition, Lachmann and his followers are, in our interpretation, the only authors who analytically cope with those aspects of human action and especially with its speculative character. Radical Austrians, as their designation is, incorporate speculation (or rather ‘imagination’) in the concept of individual plan. More precisely, Lachmann (1969) defines individual plans of action as the outcome of two elements: (1) *knowledge*, as Hayek puts it, i.e., a diagnostic of the economic situation understood as interpretation of experience (the arbitragist dimension of human action) and (2) *expectations*, i.e., an interpretation of future situation, understood as imagination (the speculative dimension of human action).⁹

The introduction of expectations in the definition of plan does nothing more than making explicit Mises’ assertion of the speculative dimension inherent to every human action. Paraphrasing Hayek (1952, p. 31), we can consider Lachmann’s introduction of expectations in the definition of individual plan as “[...] an important advance in [Austrian] economic theory”, for it undoubtedly represents “[...] a further step in the consistent application of subjectivism.”¹⁰

⁷“In a world without causality and regularity of phenomena there would be no field for human reasoning and human action. [...] Where man does not see any causal relations, he cannot act.” (Mises (1949, p. 20))

⁸“Action aims at change and is therefore in the temporal order. Human reason is even incapable of conceiving the ideas of timeless existence and of timeless action.” (Mises (1949, p. 99))

⁹“[...] plans are products of mental activity which is oriented no less to an imagined future than to an experienced past.” (Lachmann (1969, p. 95))

¹⁰“It is probably no exaggeration to say that every important advance in economic theory during the last hundred years was a further step in the consistent application of subjectivism.” (Hayek (1952, p. 31))

The enlargement of subjectivism to expectations has got overwhelming consequences on the analysis of the market process. From Lachmann's point of view, market is described as a continuous process, characterized by unexpected change and inconsistency of plans.

The market process consists of a sequence of individual interactions, each denoting the encounter (and sometimes collision) of a number of plans, which, while coherent individually and reflecting the individual equilibrium, are incoherent as a group. The process would not go otherwise. (Lachmann (1976b, p. 131))

Inconsistency of plans is the direct consequence of the introduction of subjective expectations. Plans are divergent because subjective expectations are based on the image that agents form about an "unknown though not unimaginable" future (Lachmann (1976a, p. 59)). Competition may lead to diffusion of new knowledge, but appropriate expectations cannot be diffused by any ways, for once they revealed themselves relevant they already are obsolete and need to be revised; no *ex ante* criterion of success exists. Inconsistency of plans challenges the traditional view of a tendency toward equilibrium. Market is an undetermined process governed by the interaction of balancing *and* disturbing forces. The economic configuration emerging from the interaction of individual plans is definitely one of disequilibrium. In that perspective, there is no more reason to emphasize the equilibrating function of the market. Divergence of plans is the consequence of the extension of subjectivism to expectations and represents, within the Lachmannian view, the propeller of change.

However, the indeterministic result of radical Austrians might indeed legitimately leave the theorist of market unsatisfied. More precisely, the criticism usually addressed to Lachmann's developments is one of theoretical nihilism.¹¹

Institutions enter in the analysis precisely at this stage. It is only in introducing a relevant theory of institutions that Austrians might go beyond the mere indeterministic conclusion reached by Lachmann, while conserving the assumption of radical uncertainty. The idea is that between the pure determinism of an analysis of market in a perfect information context and the pure indeterminism of an analysis ruled by radical uncertainty, there is room for a positive investigation of market interactions which allows to make more precise the evolution of the degree of coordination between individual plans.

Individual choices which direct the market process are the result of neither purely reactive behaviors as regards a given environment, nor purely arbitrary actions stemming from the uncertainty attached to future and to other agents' actions. Modern Austrians such as Rizzo (1992, p. 249), seem to be perfectly aware of the challenge they are facing and which consists in finding a consistent compromise between "[...] complete mechanical predictability and totally unbounded freedom of choice". The theoretical element that could permit to develop a midway approach between these two extreme visions refers precisely to the *influence of institutional phenomena upon individual behaviors*.

¹¹ Such criticism may seem a priori totally justified by the kind of sentences punctuating Lachmann's argumentation, such as the following: "Any force from anywhere may at any time affect our process, and forces that impinged on it yesterday may suddenly vanish from the scene." (Lachmann (1976a, p. 131))

The orientation is given by Lachmann himself, aware of the limits of the theory he develops. The strict indeterminacy of market process is the evidence of the limits of pure abstraction. However, the task of the theorist does not finish at this point. The radical theory of market process cannot overcome the relatively general assertion of indeterminacy, *unless the decisional environment be specified*. According to Lachmann, economists should provide different theories of *market processes* rather than an abstract and general theory of *the market process*.¹² The author refers to an ideal-typical method of analysis as it is advocated in the works of Max Weber. More precisely, the general theory of market should be enriched by the specification of the institutional set-up that characterizes the typical process under analysis. Lachmann's theory of institutions (1970) is an attempt of appraising the role of institutions in the formation and revision of individual plans.

In a complex society such as our own, in which the success of our plans indirectly depends on the actions of millions of other people, how can our orientation scheme provide us with firm guidance? The answer has to be sought in the existence, nature, and functions of institutions. (Lachmann (1970, p. 49))

Institutions, described as reference points in a world of radical uncertainty, serve as benchmarks, guides to the elaboration of plans.

An institution provides means of orientation to a large number of actors. It enables them to co-ordinate their actions by means of orientation to a common signpost. [...] [Institutions] enable us to rely on the actions of thousands of anonymous others about whose individual purposes and plans we can know nothing. They are nodal points of society, co-ordinating the actions of millions whom they relieve of the need to acquire and digest detailed knowledge about others and form detailed expectations about their future action. (Lachmann (1970, pp. 49–50))

Unfortunately, Lachmann never provides an explicit and complete articulation of his theory of market process with his view on institutions. This seems to be the task for another generation of authors, whose work has already begun; O'Driscoll and Rizzo (1985) propose the concept of pattern coordination as an alternative to equilibrium; it allows to identify different levels of coordination according to the kind of institutions—unique or typical—that reduces the genuine uncertainty in which agents take their decisions; Langlois (1986a) studies the influence of organizations upon market mechanism and clarifies, through the use of game theory, Lachmann's definition of internal and external institutions (1986b).

Our analysis suggests that in order to overcome the criticism of nihilism addressed to Lachmann's stream, it is necessary to enhance the Austrian theory of market process with a specific theory of institutions. Such theory should deal with a precise argument: what are the influences of institutional socio-economic phenomena upon the process of individual plan formation and modification? That kind of inquiry contrasts with the traditional Austrian interrogations about the origin and evolution of institutions. The question now consists

¹²Cf. Lachmann (1986, chap. 6).

in examining whether such orientation is compatible with the basic tenets of the Austrian approach, namely non-equilibrium analysis and methodological individualism.

3. A dynamic analysis of institutions

Austrian authors are often confronted with a tricky challenge which concerns their position in comparison with Neo-classical logic. Austrian originality, in that respect, stems from the adoption of the so-called causal-genetic approach of economic phenomena which is antithetical with the Neo-classical method of equilibrium. The causal-genetic approach was first defined by Mayer, in an article dedicated to Wieser and more generally to the specificity of the Austrian tradition initiated by Menger. Although Mayer's distinction between *causal-genetic* and *functional* methods concerns precisely the realm of price theory, the demarcation might well be extended to all economic object of analysis. According to Mayer, causal-genetic theories aim at providing an *understanding* of economic phenomena through knowledge of the laws of their genesis, whereas functional theories aim at *describing* phenomena through a precise determination of equilibrium conditions.¹³ Causal-genetic approaches emphasize the research of primary causes which originate an economic phenomenon. Understanding an economic event means identifying the forces which set in motion the temporal process the outcome of which is the phenomenon under analysis.¹⁴ Causal-genetic thinking is undoubtedly part of the Mengerian legacy. Remember how the author presents his method of investigation:

[It is] to reduce the complex phenomena of human economic activity to the simplest elements that can still be subjected to accurate observation, to apply to these elements the measure corresponding to their nature, and constantly adhering to this measure, to investigate the manner in which more complex phenomena evolve from their elements according to definite principles. (Menger (1871, 1950, pp. 46–47))

Menger applies with great accuracy, throughout his 1871 and 1883 books, this method of causal decomposition of phenomena into their essential causes. The economic phenomena of value, of exchange, of prices are analyzed in that way. According to Menger, this method of investigation is universally valid: “[all] things are subject to the law of cause and effect. This great principle knows no exceptions, and we would search in vain in the realm of experience for an example to the contrary.”¹⁵ It is thus not surprising that, when dealing with economic institutions, Menger turns once again to a causal-genetic approach: an institution is a complex phenomenon, which, in order to be analyzed in a scientific way, should be reduced to its simplest causal elements. Obviously, only organic institutions are concerned, i.e., spontaneous institutions that come about as the unintended result of individual interaction and not of any human design. To investigate the process of emergence of pragmatic institutions is not a relevant question for economics, since these social

¹³Mayer (1932, 1994, p. 57).

¹⁴For an analysis of the genetic-causal thinking in economics, see Cowan and Rizzo (1996).

¹⁵Menger (1871, 1950, p. 51).

phenomena are merely and explicitly the product of human will or legislative acts. The question faced by the theoretician is thus as follows: "How can it be that institutions which serve the common welfare and are extremely significant for its development come into being without a common will directed toward establishing them?"¹⁶ The issue at stake is thus to provide a rigorous analysis of the *process of emergence of (organic) institutions*.

If effectively Austrian originality is in part captured through the resort to causal-genetic way of thinking, then in our view, institutions like all other complex economic phenomena, should be, in an Austrian framework, analyzed according to such a method. In other words, an Austrian theory of institution might rest upon an analysis of the process of emergence of social phenomena. Institutions, in an Austrian framework, cannot be taken for granted. It is necessary to develop an analysis of their genesis, in the same way as the Mengerian analysis of monetary institutions. An Austrian theory of institution should therefore be endogenous, in the sense that theory should explain the coming into being of social rules and behaviors.

Notice however that although the question of emergence of institutions has to be dealt with, it does not constitute the main analytical object of an eventual Austrian theory of institutions. An Austrian theory of institutions should consider institutions in the process of their genesis, so that to fit in the causal-genetic orientation of the Mengerian tradition, but the main question remains that of the influence of institutions on the process of plans formation and revision, as a consequence of the radical subjectivist orientation.

4. Methodological individualism and institutions

The objective of this section is to show that one of the main obstacles to the elaboration of a coherent and complete Austrian theory of institutions stems from the adhesion to a strictly individualistic view of society.¹⁷

Let's first clarify the terminology. We rely on the definition given by Elster (1982, p. 453), according to who methodological individualism is "[...] the doctrine that *all* social phenomena (their structure and their change) are in principle explicable *only* in terms of individuals—their properties, goals and beliefs." Only individuals are granted with the power to act and to make decision, collective entities being denied such power.

Now, what are the implications of methodological individualism on the character of an Austrian theory of institutions? This methodological position has a rather direct and elementary consequence on the analytical direction that such a theory should take: it implies indeed that institutional phenomena have to be explained in the last resort exclusively in terms of individual plans interaction. Individuals, 'their properties, goals and beliefs', are the primary cause of explanation of social phenomena. Methodological individualism allows in this way to render more precise the nature of the causal-genetic approach that Austrians have to rely on: institutions should be grasped through decomposition into their

¹⁶Ibid. p. 146.

¹⁷Cf. Clark (1993) who argues that the Austrian view of institutions (only as effects and not as causes of individual actions) is a consequence of the conception of society upon which this tradition is built, namely a conception of *society as a multiplicity*, "[...] a mental fiction, reality being a collection of individuals, with only the individual having any real existence," (Clark (1993, p. 374)).

elementary causes and, in an Austrian framework, human action represents *the essential element* which stands at the beginning of the causal chain of explanation. In other words, individual interactions initiate a process the outcome of which are institutions.

Fully aware of the implications of their strict adhesion to methodological individualism, Austrians develop *invisible hand explanations* (IHE). An IHE is a specific method of analysis of socio-economic phenomena, which involves causal-genetic way of thinking and individualism. Ullmann-Margalit (1978) provides the philosophical basements of IHE. The author distinguishes between genetic and functional IHE.

A *genetic explanation* is dedicated to the analysis of emergence of institutions. It aims at providing a convincing explanation of the process through which a complex social structure comes about. The realm of application of this kind of explanation is thus clearly delimited; it concerns social phenomena which, although presenting an obvious degree of organization in their structure, do not result from the conscious will of men, that is from planning. More precisely a genetic IHE should proceed according to the following steps:

- the environmental set-up of the earlier economic system should be analyzed in order to identify the imperfections of this opening state; the earlier system refers to the existing system before the institution under analysis emerged. Imperfections might consist in un-exploited profit opportunities (Kirzner's point of view) or more generally to coordination failures between individual plans;
- the next step is dedicated to the explanation of the process itself, through which social regularities emerge. Individual actions are the dynamic forces of this process. The challenge is to examine how individual actors adapt themselves to the previously identified imperfections they are facing. The punctual and efficient answer of a group of individuals to these imperfections is diffused among the rest of the population (consider for instance the leader and masse interaction in Wieser's analysis).
- finally, this process must be proved to be independent from any human design and the analysis ends with the evaluation of the efficiency of the newly established institutional order.

Functional IHE focus on the *raison d'être* of established institutions. Institutions, their existence and diffusion, are justified on the basis of the socio-economic functions they fulfill in the system which they are embedded in.¹⁸ Ullmann-Margalit refers as an illustration to the Hayekian theory of cultural evolution. Hayek is not concerned with origins of institutions but rather with the reasons that explain their upholding and stability. The existence of an institution is analytically justified by the function it performs within the group from which it emerges. The argument is rather simple: whatever its origin, the success of a social phenomena—in terms of its diffusion among individuals—depends on the efficiency of the function the institution carries out for the group of agents having adopted such common rule or convention—in terms of survival or enlargement of the group. According to Hayek (1979, p. 9), the present order of society has largely emerged not by design, but through the predominance of the most efficient institutions in a process of selection.

¹⁸Cf. for instance Langlois (1986b).

However, the above analysis opens the door to two types of criticism that will later on allow us to highlight the inevitable tension between an individualist position and the attempt to develop a complete and consistent Austrian theory of social institutions.

(1) There are situations in which individual interaction is not sufficient to explain the emergence and diffusion of institutions (we are referring here to prisoner's dilemma situations), casting doubts on the relevance of IHE. This difficulty may be well illustrated by Hayek's appeal to the holist argument of group selection in the theory of cultural evolution:

[...] new rules would spread not because men understood that they were more effective, or could calculate that they would lead to expansion, but simply because they enabled those groups practicing them to procreate more successfully and to include outsiders. (Hayek (1988, p. 16))

The existence of a rule is thus justified by its contribution to the continued existence of the group. More exactly, the group selection mechanism can only come into play if there is a particular property of the group acting on all its members (fashion, culture, behavioral habits) and that this feature reveals itself to be a powerful driving force for the expansion or the extinction of the group. Vanberg (1986) and Hodgson (1991) clash at this point on the question of the relevance of resorting to the concept of group selection in the Hayekian logic.

According to Vanberg, the tension characterizing Hayek's cultural evolution theory between the group selection mechanism and methodological individualism has to be solved by dropping the former concept in favor of an explanation of rule diffusion in terms of direct selection by the individuals concerned. The hypothesis of frequency-dependence developed by Witt (1989) is an attempt to answer the problem defined by Vanberg and consists in offering an alternative diffusion mechanism on a strictly individualist basis. The aim of Witt is to give—via the hypothesis of frequency-dependence—a strictly individualistic foundation to Hayek's approach to the diffusion of institutions and especially to enable the author's considerations in terms of group selection to be abandoned. The problem is presented in probabilistic terms: each individual has the choice between adopting a new rule or not, according to the advantage he/she believes he/she will get out of it. However, Witt introduces a dimension of inter-dependence between decision-makers: the extent to which an individual is able to improve his/her position by adopting a new social rule is a function of the relative frequency by which the other members of the population have themselves adopted the same rule. Witt's hypothesis of frequency-dependence enables the process of transmission and diffusion of institutions to be gone into in depth, beyond the simple mechanism of imitation. However, the field to which this theory may be applied to is limited to coordination game situations where the rule represents the efficient answer to a problem shared by all the agents. In the case of prisoner's dilemma situations where free-rider behavior may appear, the diffusion process cannot be explained on the strictly individualistic basis proposed by the author and group phenomena need again to come into play to ensure cooperation.¹⁹ Ultimately, Witt acknowledges that this type of explanation

¹⁹ Consider for instance Vanberg (1986, pp. 95–96) who explains that it is necessary in such a case to introduce a mechanism of reciprocity, which is defined as “[a] reciprocal reinforcement by mutually exchanging rewards and punishments in social interaction”, which prompts individuals “[...] to take into account the future consequences

which is based on the individual recognizing the advantage of adopting the rule, does not enable an explanation to be given regarding the situations where there is a prevalent rule, beneficial for the group as a whole but not for the individuals taken separately.

(2) IHE are perfectly consistent with Austrian methodological tenets and allow, despite the limit underlined above, to deal with the question of emergence genetic IHE and evolution functional IHE of institutions in terms of plans interaction. However, such method of analysis is not concerned at all with the dual question of the influence of institutions on individual plans; yet, as discussed in Section 2, the latter preoccupation represents the fundamental question an Austrian theory of institutions should focus on.

To recap, we have stressed the limits of pure individualistic explanations of the emergence and evolution of institutions (prisoner's dilemma situations). The next question we have to face and which is even more crucial for the survival of Austrian economics is related to the compatibility between individualism and a theory of institutional change. More precisely, the question is to examine whether it is possible or not to develop within the Austrian logic a theory of *the influence of institutions on individual behavior*.

Accepting the idea that the institutional environment affects individual's aims and constrains individual's choices amounts to grant collective entities with a proper existence and somewhat questions the statute of the individual as the primary building block of economic phenomena. As noticed by Rizzo (1992, p. 250), Austrians have not been very enthusiastic in developing such an analysis because "[...] they have feared the ghost of the Old Institutionalism". It is indeed hardly workable to develop an analysis of institutional change in a theoretical framework of *strict* methodological individualism in which (1) only individuals are granted with specific aims and interests, (2) social entities have no practical meaning and are described as merely collections of individuals, (3) the individual is the unique primary social entity.

In its strictly individualist version, the Austrian analysis takes no heed of the feed-backs of institutions concerning individuals. Institutions are *effects* and not *causes*. Introducing the role of collective entities obviously clashes with the pre-eminence of the concept of human action. However, do Austrians stick to such a radical methodological stance? This question is open to controversy to the extent that, as underlined in Section one, Austrian economics can hardly be defined as a monolithic block of thought. Of course, if we consider the methodological position of Mises and his followers, the answer is unambiguous and individualism bears up to reductionism: the axiom of human action is given the unquestionable primacy and Misesian authors cannot accept the existence of whatever supra-individual structure which could challenge the freedom of individual choice.²⁰ The only acceptable economic analyses are those reducible to theories of individual action, the only exogenous variables (preferences in particular) coming from outside the realm of praxeology.

of their present choices. Immediate gains from non-cooperation may well be overcompensated by the future losses from unfavourable responses one elicits."

²⁰According to Mises (1949, p. 273), the market is not a thing, a place, nor a collective entity. Market is a process, realized through the combined game of actions of the various individuals who cooperate within the realm of the division of labor. There is no phenomenon that does not come from men interactions. More generally, holist view of phenomena is considered as the philosophy which characterized the beliefs of primitive tribes (*ibid.*, p. 154), and those who pretend to begin the study of human action starting with collective units meet an insuperable obstacle (*ibid.*, p. 48).

According to Boettke (1989, pp. 76–77), it is an error to associate the whole Austrian tradition with an atomistic view of man which the author labels ‘naive individualism’. Boettke prefers to speak of ‘sophisticated individualism’ to characterize the position of a current of thought whose objective is to render the world intelligible in terms of individual behaviors. Boettke’s interpretation is not without reminding Agassi’s (1975) ‘institutional individualism’ which may appear as an acceptable compromise allowing Austrians to preserve their individualistic presupposition while taking account of the institutional involvement of individuals. More precisely, Agassi attempts to show that incompatibilities between holism and individualism are not insuperable: individualists can recognize the existence of collective entities provided that such entities are not granted with their own aims and interests but follow the aims and interests people have given to them; such entities, through their mere existence, shape individual means-ends frameworks and in turn individuals mold the institutional environment they are acting in so that both the individual and institutions are given the primacy. It is acceptable for sophisticated individualists to adopt a ‘regression theorem’, recognizing that present decisions are shaped by the prevailing institutions, the latter being the result of past decisions and past institutions.

The remaining question is whether Austrians are ready to weaken their methodological position towards such a direction, somewhat betraying the legacy of their founders. Consider indeed the position of Hayek. The author admits that preferences are the result of an individual undergoing a socialization process, but no analytical consequences are further derived from this. According to Hayek (1948, p. 67), it remains the task of sociology and of psychology to analyze how preferences are formed in the socialization process and economics on the contrary must take them as given. The individual is thus represented as an atomistic entity who in return is not influenced (given preferences) by the changes in the institutional context.²¹ This is precisely what impedes an Austrian theory of economic change to be developed since individual internal changes are disconnected from changes taking place in the environment in which the individual is acting.

During the last decade, Austrian thought has been experiencing acute progress through the enlargement of subjectivism to expectations and this progression has to be supported by an appropriate analysis of institutional phenomena. This means to shift from the question of emergence and evolution towards the question of the role of institutions. However, Austrians are committing themselves in that direction rather gingerly. While emergence and evolution of institutions can be legitimately grasped through IHE (genetic and functional explanations are indeed fully compatible with strict methodological individualism), the analysis of the influence of institutions upon individuals calls for a substantial softening of the Austrian individualist position. Ultimately, it seems difficult in the Austrian framework to elaborate an analysis of institutions that takes into account all the following requirements: an acceptable theory of institutions should provide an analysis of both organic and pragmatic phenomena. This means going beyond the superficial Darwinian argument according to which only efficient institutions survive in the long term; such a theory should allow sources of efficiency and inefficiency of existing institutions to be identified (both spontaneous and planned) regarding their capacity to coordinate economic activities; an acceptable theory of

²¹Cf. for instance the interpretation given by Hodgson (1994) who emphasizes the strict compartmentalization between social sciences as a characteristic of Hayek’s thought.

institutions should consider institutions as molding individual preferences and individuals as shaping institutions. This has the aim of developing an endogenous theory of evolution which is placed between holism and individualism. Identifying such an approach to institutional phenomena should enable us to complete Lachmann's ideal-type representation of the market process. This is, according to us, the direction that a modern Austrian approach to the economic process should take.

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