

6 ORDERS AND ORGANIZATIONS: TOWARD AN AUSTRIAN THEORY OF SOCIAL INSTITUTIONS

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Introduction

That the Austrian school of economics is and has been fundamentally concerned with the theory of social institutions is a proposition gaining wide acceptance today — by critics of this school as well as by its adherents. This is a rather striking development. Not too many years ago, the prevailing wisdom was that the American Institutional school (of Thorstein Veblen, John R. Commons, and Wesley C. Mitchell) was the sole repository of thinking about social institutions and that, moreover, Institutional approaches and beliefs were strongly at odds with everything Austrian.¹ But a recent spate of articles, including a couple of symposia in the journals, has highlighted the Austrian approach to institutions and brought it into contact — albeit sometimes violent contact — with the Institutional school (Boettke, 1989; Hodgson, 1989; Langlois, 1989; Perlman, 1986; Rutherford, 1989a, 1989b; Samuels, 1989; Vanberg, 1989).

One result of this flurry of interest in Austrian institutionalism² is that the methodological issues and controversies have been well aired. This in turn leaves me free to engage in synthesis and extension without too much attention to the doctrinal niceties.

This essay proceeds in three parts. The first part looks into the concept of an institution itself. What exactly *is* an institution? How do we think about institutions in general and within the framework of Austrian economics as broadly understood? One of the important distinctions to emerge from this enquiry is F. A. Hayek's dichotomy between (spontaneous)

orders and organizations. The remaining two sections will examine in turn the theory of these two classes of institutions. The discussion of spontaneous orders will be largely a matter of synthesis and exposition, but the discussion of organizations will, I hope, point to new directions. Indeed, the analysis of organizations—notably the business firm—is a much-neglected area in Austrian economics. It is also an area in which there is a good deal of exciting theoretical work today that draws on many of the Austrian's favorite insights.

What are Social Institutions?

At the base of virtually all formulations of the concept of a social institution lies the notion of rule-following behavior. Institutions reflect behavior that is highly organized, in the sense that the behavior represents a relatively predictable or non-random pattern.³ And such patterns emerge as the result of the following of rules; they are, as Hayek (1967) puts it, systems of rules of conduct.

Sometimes the rules seem to be a property of the human agents themselves. Agents follow rules unconsciously as if, in effect, programmed to do so. Writers who take an evolutionary perspective on social institutions often incline to this interpretation, even though most are aware that rules have other meanings as well (Hayek, 1967, 1973; Nelson and Winter, 1982). These writers stress the skill-like nature of behavior, which implies that the rules guiding behavior are often necessarily inexplicit or tacit (Polanyi, 1958). Sometimes, however, social institutions seem to consist of rules external to individuals. Such rules are more in the nature of side-constraints (Nozick, 1974) that channel the behavior of individuals whose operating principles may not be the following of rules in the first sense. For example, the agents may be consciously maximizing their utility within a framework (like private property rights) that constrains their choices. In both cases, the rules generate an orderly pattern of behavior.⁴

There is not necessarily a conflict between these two meanings of rule following, and one can imagine both types to be operating, to varying degrees, in a system of social institutions. For example, consider what is probably the canonical example of a social institution in the modern literature: the convention that one drive on the right-hand side of the road in North America and Continental Europe. This institution is an explicit rule of law that one can be punished for violating; but it is also an unconscious predisposition of native drivers. Indeed, as Hayek and others would point out, the following of unconscious rules obviates attention to

many of the details of behavior, which frees up attention and thus actually facilitates conscious action (constrained or otherwise).

Another important aspect of social institutions, one closely related to their order-producing and rule-like aspects, is their capacity to economize on knowledge or information. The late Ludwig Lachmann put it this way:

An institution provides a means of orientation to a large number of actors. It enables them to coordinate their actions by means of orientation to a common signpost. . . . The existence of such institutions is fundamental to civilized society. They enable each of 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, 1971, 49–50)

Thus, by making the behavior of others more predictable, institutions reduce the amount of information we need to behave effectively in society. To make this point clearer, consider again our canonical example. Because of the convention that everyone drive on the right, I do not need information about the lane preference of each driver who confronts me head on. This is related to the point I made above. Institutions—viewed as rules, customs, routines, habits, or conventions⁵—contain or embody knowledge about effective behavior. This economizes on the explicit knowledge one must have to behave effectively. Knowledge and the following of rules are strongly intertwined.

Another important aspect of institutions is their hierarchical nature. This is an aspect that has received too little attention in the literature. Again, institutions are *systems* of rules of conduct. Theory here is not well developed; but it is probably not too much of an oversimplification to say that institutions—systems of rules—operate at many different levels, each level affecting the operation of the rules at the level below. For example, Lachmann distinguishes between external and internal institutions.

[I]t might be said that the undesigned institutions which evolve gradually as the unintended or unforeseeable result of the pursuit of individual interests accumulate in the *interstices* of the legal order. . . . In a society of this type we might then distinguish between the *external* institutions which constitute, as it were, the outer framework of society, the legal order, and the *internal* institutions which gradually evolve as a result of market processes and other forms of spontaneous individual action. (Lachmann, 1971, 81; emphasis original.)

This captures some flavor of the hierarchical structure of institutions.⁶

It may be helpful here to reassert a distinction that cuts across the one Lachmann suggests. Carl Menger long ago distinguished between institutions that are of *pragmatic* origin and those that are of *organic* origin. The former are the result of “socially teleological causes,” that is, they arise because of a common will directed toward their creation. By contrast, organic institutions are “the unintended result of innumerable efforts of economic subjects pursuing individual interests” (Menger, 1963, 158). Menger was primarily concerned with the *origin* of institutions. And, as Viktor Vanberg (1889, 338) reminds us, the question of the origin of an institution is logically distinct from the question of its social functionality, that is, of its principles of operation once created. Hayek makes a distinction about rules of operation that is analogous to Menger’s distinction about origins. We can divide institutions into *orders*⁷ and *organizations*. Although Hayek is not always clear on this point, what distinguishes the two classes is not so much their origins as the nature of the rules they comprise. The rules of an order are abstract and independent of purpose, whereas the rules of an organization are concrete and directed toward a common purpose or purposes (Hayek, 1973, 38).

These distinctions leave us with a matrix of intersecting possibilities. (See figure 6–1.) One class of institutions comprises systems of rules that are independent of purpose and are of organic origin. These are what Hayek calls *spontaneous orders*. Examples include: various kinds of social

	ORDERS	ORGANIZATIONS
ORGANIC	<p>Common Law</p> <p>Social conventions (Spontaneous Orders)</p>	<p>Public Choice view of government</p> <p>Evolutionary view of the firm</p>
PRAGMATIC	<p>Constitutional design</p>	<p>GM/Toyota joint venture</p> <p>NASA manned space-flight program</p>

Figure 6–1. Matrix of explanatory possibilities. Modified from Vanberg (1989).

conventions; the common law, language, money. At least in principle, however, not all orders need be organic. Writers of a constitutionalist bent (Buchanan, 1990) would insist that systems of rules can be both independent of purpose and pragmatic, at least in the sense that one can consciously design a constitutional framework. The proper domain of the spontaneous and the planned is a matter of running controversy between the followers of Hayek and the constitutionalists.

What has been less often noticed is that organizations can also be of organic origin. It is tempting to assume that, since organizations comprise rules directed toward specific ends, and since attention to goals is a feature of human rationality, all such institutions must have been consciously created. In fact, however, one finds the same sorts of unintended consequences and unplanned outcomes in the realm of organizations that one finds in spontaneous orders. The goals framing the rules of operation of, say, a government regulatory commission may be quite different from the goals envisaged by those who set the commission up (Edelman, 1964). Indeed, one might easily portray the entire Public Choice theory of politics as undermining a conception of government as a pragmatic institution. As I will suggest later, one can also see the evolution of another type of organization—the firm—as organic in character.

Conscious intention certainly does play a role in the formation of organizations; but it is a role fully analogous to the one it plays in the formation of a spontaneous order. That is to say, the explanation for the existence of an organization as we observe it today is not the conscious intention of any single individual or unified group but rather the diverse intentions of many individuals and groups interacting with one another and with external circumstance over time. For an organization to be genuinely of pragmatic origin, then, unintended consequences must not intrude to alter the intentions of the founders. This may occur when the organization is not very complex. It may also happen when we examine a short-lived organization or limit our time perspective to a short period. Examples of such pragmatic organizations might include a joint venture between GM and Toyota to produce cars in California, or perhaps the American manned spaceflight program of the 1960s.

How do these distinctions square with Lachmann's distinction between external and internal institutions? Not perfectly, I think. All external institutions are orders rather than organizations. They are general and abstract rules, facilitating many different concrete purposes. But some internal institutions may also be abstract. A constitution establishing the rights of property is internal to the institutions of language; the common law of contracts is internal to the system of property rights, and so on. In

some ways, of course, the distinction between an order and an organization is also a matter of degree, with orders shading off into organizations as the rules become more particular and concrete. And, in the end, it may well be that the externalness of an institution is tied up with the generality and abstractness of its rules. But I'm not sure how to prove this.

In the remainder of this chapter I will put aside pragmatic orders in the strict sense and consider in turn spontaneous orders and—if the reader will forgive the expression—organic organizations.

The Theory of Institutional Evolution

Following Menger's lead, a modern Austrian theory of social institutions would necessarily be a causal-genetic or process theory. By that I mean a theory in which explanation involves tracing out a sequence of events rather than merely constructing the conditions for an equilibrium. The exemplar of this approach is Carl Menger's theory of the institution of money (O'Driscoll, 1986).

To put it another way, Austrian theories of social institutions rely on Invisible Hand explanations. Such explanations describe the development of institutions as a sequence of the actions of individuals aggregated by some compositional principle (Langlois, 1986c). The compositional principle need not be merely "adding up" the behavior of the individuals (whatever that means), but would typically involve filtering or selection mechanisms. There is in my view no fundamental distinction between Invisible Hand explanations and evolutionary explanations, except to the extent that one takes the biological analogy to restrict the latter to particular types of selection principles. Indeed, it is now well understood that Menger's approach to social institutions and Darwin's theory of biological evolution have a common ancestor in the writings of the Scottish Enlightenment (Schweber, 1977; Jones, 1986).

With this said, it may seem paradoxical for me now to suggest that a useful place to begin a theory of institutions is with the theory of games. In its pure form, game theory is an equilibrium theory and certainly not a process theory. But there is ultimately no paradox. I will argue that game theory in its simpler manifestations can be a valuable complement to a causal-genetic or evolutionary theory of social institutions. Building on the work of philosophers David Lewis (1969) and Edna Ullmann-Margalit (1977), economists like Andrew Schotter (1981, 1986), Jack Hirshleifer (1982), Robert Sugden (1986), and Nicholas Rowe (1989) have looked at social institutions instructively from within the framework of game theory.

I particularly recommend Sugden's book as a starting place for those interested in this area.

In order to simplify the exposition, let me restrict myself to the two most important canonical games that appear in this work. The first of these is the *coordination game*, of which the automobile example is an instance. (See figure 6-2.) If I choose to drive on the left-hand side of the road and an oncoming motorist chooses the right (or vice-versa), the "payoffs" to both of us will likely be negative. If, however, we both choose the same side of the road—either side—we will not incur these penalties. With repeated play of this game, one would expect drivers to keep to one particular side as a matter of *convention*. Notice that such a convention is self-enforcing: anyone who consistently drives on the left in the United States will be punished by negative payoffs quite apart from any penalties invoked by the courts. Notice also that, while far superior to discoordination, a convention solution need not be optimal. In figure 6-2, driving on the right has a higher payoff than driving on the left, perhaps, we might imagine, because automobiles are cheaper when one conforms to the standard that is more popular around the world. But historical accident may lead a region to the opposite standard. Such conventions are path-dependent processes of the sort Paul David (1985) has popularized. It is typically costly to alter a convention once established, and it may take some kind of centralized coordination to do so—as when Sweden and Okinawa changed their side-of-the-road driving conventions.

In a coordination game, the incentives of both players are aligned; their common objective is facilitated by the reduction in information costs

		Player 1	
		Right	Left
Player 2	Right	2	-10
	Left	-10	0

Figure 6-2. A coordination game.

a convention achieves. By contrast, what characterizes a *prisoners' dilemma* is a divergence of incentives. The parable commonly attached to the game is as follows. Two suspects are hauled in by the police for a bank robbery. Without a confession, the authorities have insufficient evidence to convict the two, although they could convict them of a lesser crime. The police interrogate the criminals in separate rooms and propose a deal to each: if you turn state's evidence and testify against your cohort, you go free, and we throw the book at him. The resulting matrix looks like figure 6-3. In this case, each prisoner has a private incentive to confess, whereas the "social optimum" is for both to hold firm, in the sense that such steadfastness minimizes the total number of years in prison. Because of the private incentive to confess—both to lower one's own sentence and to insure against confession by one's compatriot—the solution of such a game played once is for both to confess,⁸ a result that maximizes total years in prison. If, however, the game is played repeatedly, and neither of the players knows when the game will end, there may emerge a *norm* of reciprocity, according to which the players refrain from confessing despite the private incentive to do so.

Like a convention, a prisoners' dilemma norm is an institution with an information function. It substitutes for the costly direct communication and negotiation between the players that might otherwise facilitate agreement on the joint-miximizing solution. Unlike a coordination convention, however, a norm of this sort is not completely self-enforcing. Whenever the players face an end-game, the discipline of repeated play evaporates, and the private incentives loom large.

		Player 1	
		Hold firm	Confess
Player 2	Hold firm	-2	0
	Confess	-10	-7
		-2	-10
		0	-7

Figure 6-3. A prisoners' dilemma game.

