

# Institutions and the Economy

CARL GERSHENSON and FRANK DOBBIN

## Abstract

Sociology, political science, and economics have undergone parallel revolutions since the late 1970s, following on the heels of the behavioral revolution of the 1950s and 1960s. Four distinct institutional paradigms have emerged: sociological institutionalism, rational choice institutionalism in political science, historical institutionalism in the same discipline, and new institutional economics. Sociologists argue that economic institutions—which encompass paradigms, conventions, rules, and regulations—shape modern behavior. National institutional differences produce stable patterns of economic behavior within countries, but institutions themselves change over time. Four recent trends in sociology are reviewed: studies of the global spread of regulatory institutions; studies of the use of economic theories to support policy design and economic conventions; studies of market actors as social movements promoting economic change; and studies of the moral and cultural underpinnings of the economy.

## INTRODUCTION

Sociologists, political scientists, and economists have devoted a great deal of attention to the role of institutions—which encompass paradigms, conventions, rules, and regulations—in shaping economic activity, and have moved away from treating the individual as the central determinant of social, political, and economic outcomes. Institutionalists explain continuity and change in economic life as a consequence of the structure of institutions. They also study how institutions shape preferences, cognition, and behavior, which in turn influence new political, economic, and social patterns.

The first wave of sociological institutionalism focused on how policies and practices *within* firms gained a life of their own, becoming “institutionalized.” Zald and Denton (1963), Selznick (1949), and Clark (1960) showed that individuals become cognitively attached to certain policies and practices, seeing them as vital to organizational success. They also build up interests around existing institutions, such that they defend those institutions against challenge.

The second wave of sociological institutionalism used social constructionism to explore how new organizational institutions (policies, paradigms, structures) arise among organizational fields comprising firms, regulators, and professional groups (DiMaggio & Powell, 1983; Meyer & Rowan, 1977). The optimal means for achieving efficiency and equity are socially negotiated, although those means become objectified in the minds of modern actors, who come to believe them to be determined by transcendental economic and managerial laws and precepts. That paradigm has expanded its purview to national markets and political institutions (Dobbin, 1994; Fligstein, 1990).

In political science, two versions of institutional theory have taken hold. In the rational choice version, institutions shape the preferences of individuals in the political system. Broadly speaking, institutions conceived as regulatory and political rules are developed and persist to reduce political and economic uncertainty (Shepsle, 2005). At the national level, decision-making institutions in the political realm influence the economic preferences of different groups in society, and they determine the policy outcomes of negotiations and of parliamentary and congressional votes. For example, systems containing veto points may prevent groups from compromising (Tsebelis, 2002), while other institutional arrangements promote compromise. Rational choice institutionalists conceive of institutions as rules of the market, making markets predictable and giving them structure. They also conceive of institutions as rules of political exchange, making policy decisions predictable and facilitating strategic action.

In the historical version of political science institutionalism, national political institutions gain inertia and become resistant to change (Moore, 1966; Skocpol, 1979). Inertia comes not only from the stability of formal rules but also from the effects of rules and structures on how people conceive of society, polity, and the market (Campbell, 1998; Hall & Taylor, 1996; Steinmo, Thelen, & Longstreth, 1992). Broad policy institutions, according to Krasner (1984), tend to persist in equilibrium until a shock leads to the creation of new institutions. Thelen (2004), by contrast, describes institutions as changing incrementally, so that a revolution can come about through small steps. Political systems are path-dependent, such that an early policy choice determines the policy options available at a later date (Pierson, 1994).

Institutionalist economists, who predate the dominance of the neoclassical model of economic behavior (Yonay, 1998), argue that economic action is shaped by social institutions and evolves over time (Veblen, 1904). Commons (1924) viewed institutions as offering collective control over individual behavior and thought careful design of public policy could steer individual behavior. After the rise of the individualistic, neoclassical model, Williamson (1985) and North (1990) articulated a more rationalist approach

to institutions. Williamson (1985) presents the corporation as an institution that reduces transaction costs by “internalizing” them, rather than leaving all transactions to the market. He later extended this approach to economic institutions more broadly, emphasizing that institutions allow economic actors to minimize transaction costs.

### INSTITUTIONS AND ECONOMIC SOCIOLOGY

For sociologists, institutions play a fundamental role in the economy. For economists, institutions allow market actors to reduce transaction costs, whereas for economic sociologists, this puts the cart before the horse. Without social and regulatory institutions, there would be no market activity, and thus no transaction costs to speak of. Institutions are constitutive of the economy (Block & Evans, 2005). All economic activity is embedded in social institutions (Krippner & Alvarez, 2007).

Because institutions, or social conventions, create the framework within which economic activity is undertaken (Scott 2001), sociologists do not see the regularities that seem to shape economic life as either invariant or exogenous to economic, political, and social processes. Rather, while it may seem that the economic world is governed by eternal law-like verities, economic laws themselves are social products that demand explanation. Institutional explanations of economic life therefore cannot rely on universal covering laws, but rather must point to social factors such as culture, socially generated cognition, and power.

In culturally oriented theories, regularities in economic life are only mistaken for laws, perhaps because they are formalized and diffused through expert knowledge networks comprising economists (Fourcade, 2010), top executives (Fligstein, 1990), consultants (Strang & Meyer, 1993), and public policymakers (Roy, 1997). Regularities in ways of thinking, acting, and seeing the world become part of the taken-for-granted cultural inheritance of a nation, and solutions to new problems are found in the solutions to old problems (Dobbin, 1994). Just as early organizational institutionalists argued that organizational practices become imbued with meaning by participants, and come to be seen as singular means for achieving particular goals (Selznick, 1957); and just as organizational sociologists argue that existing corporate policies constrain the solutions managers can envision to new problems (March & Simon, 1958); institutionalists studying the wider economy and polity argue that existing policies and practices constrain the range of imaginable policy options for the future (Hall & Soskice, 2001; Whitley, 1992).

Power theorists argue that regularities prevail in economic life because the powerful shape economic institutions to their liking—for example, favoring

large limited-liability corporations to networks of smaller partnerships (Perrow, 2002). Power and institutions play supporting roles at different points in the process of institutionalization, as Roy (1997) illustrates in his work on the history of the firm. For Roy, power explains the creation of legal institutions that favor certain interests, but when these institutions become taken for granted they remain influential after those who promoted them are gone. They persist because people come to see them as natural and rational.

Economic sociologists use cross-national research to highlight the importance of institutions (Kristensen, 1996; Whitley, 1992). By showing that countries with widely different institutions can achieve similar levels of growth, economic sociologists and “Varieties of Capitalism” scholars contend that there is no single optimal set of institutions that all countries are destined to converge toward (e.g., Hall & Soskice, 2001; Hamilton & Biggart, 1988). Guillén (2001) argues that institutions confer comparative advantages that determine which industries can prosper in a given nation. More generally, institutions that allow states to remain autonomous from business interests without losing touch with those interests’ legitimate needs tend to facilitate economic development (Evans 1995).

Where are institutional studies in economic sociology headed? Early studies often focused on ways in which institutions reinforced existing social, political, and economic patterns, whereas the recent trend has been to examine temporal changes in institutions and their implications for economic systems. We discuss four trends in institutional analysis: studies of (i) the global diffusion of regulatory institutions, (ii) the use of economic theory to support institutional choices, (iii) market actors as social movement organizations, and (iv) how moral and cultural institutions shape the economy.

#### THE GLOBAL DIFFUSION OF REGULATORY INSTITUTIONS

Studies documenting the diffusion of regulatory institutions across borders often describe the effects of the world polity and of neighboring countries on national institutional arrangements. Thus, Lee and Strang (2006) chart the diffusion of British-style public-sector downsizing, following Thatcher’s experiments. Over time, many countries cut the size of government. Learning from the experiences of others was mediated by neoliberal theory, which defined downsizing as an effective means of promoting growth and balancing budgets. Countries only took the lesson from previous downsizers when those lessons lined up with theory. In periods when previous downsizings failed, they ignored evidence inconsistent with theory.

Yet other studies document that in the process of diffusion, regulatory institutions can be significantly altered, or “translated” (Czarniawska & Sevón, 1996). Djelic (1998) examines the diffusion of the US corporate form

to Europe in the years after World War II, finding that local institutions and traditions determined whether that model would be imported, rebuffed, or significantly altered to fit local traditions. Halliday and Carruthers (2009) show that a global consensus on the appropriate corporate bankruptcy institutions emerged following recent crises and then diffused widely to countries at different levels of development. But many countries so altered the international conventions in the process of implementation that their policies were unrecognizable, while others adopted the policies *in toto* only to disable them in the process of implementation.

#### THE USE OF ECONOMIC THEORY TO SUPPORT INSTITUTIONAL CHOICES

In recent decades, economic theory has played an increasingly important role in justifying institutional choices of all sorts, from welfare policy (Steensland, 2008) and labor market policy (Martin & Swank, 2004; Thelen, 2004) to financial policy (Krippner, 2012). Particularly striking is the application of market logics in arenas that were thought to be subject to alternate logics, as in the case of social welfare (Pierson, 1994). Unemployment insurance has been rebranded as a part of “active labor market” policies, and the logic of provision for the needy has been displaced by a logic of incentivizing the unemployed to seek work. Clinton’s 1996 welfare reform legislation was framed as an effort to reinforce market mechanisms, with a view to unleashing economic forces to trim the welfare rolls.

Studies of public policies have shown that policymakers use economic theory strategically and opportunistically to justify their favored policy choices. For instance, Jabko (2006) shows that European Union regulators use the rhetoric of economic theory to support a wide range of policies that depend on very different regulatory logics. “Marketization” can mean just about anything. Krippner (2012) shows, by contrast, that the “deregulation” of US financial markets resulted not from a master economic plan but from a series of decisions made for political expediency. Designed to soften the blow of recessions by controlling interest rates, these decisions were later rationalized with the rhetoric of deregulation.

Prasad (2012) shows that *laissez faire* rhetoric, as applied to the deregulation of US mortgage markets, conceals a more complicated reality. Despite the story that the United States had a weak welfare state, since the 1940s a system of mortgage supports has subsidized the middle class and produced countercyclical Keynesian mortgage spending.

## MARKET ACTORS AS SOCIAL MOVEMENT ORGANIZATIONS

A number of scholars treat markets as instances of the more general concept of social fields (Fligstein & McAdam, 2012), showing that professions and social movements can alter economic institutions and activity. Thus, economic change may be precipitated by social movements as well as by market forces.

Fligstein (1990) explores how groups of management professionals led a social movement to change the structure and strategy of corporations. After World War II, finance professionals gained control of most leading corporations, and turned firms into diversified conglomerates that operated internal capital markets. Since then, a new model of shareholder value management, promoted by managers, institutional investors, and securities analysts, has led firms to turn away from conglomeration, creating large single-industry firms intent on maximizing stock performance (Davis, Diekmann, & Tinsley, 1994; Dobbin & Zorn, 2005; Fligstein & Markowitz, 1993). These corporate-level organizational changes were promoted by professional groups using the tools of social movements.

Another contingent of scholars studies how activist groups affect the social and environmental policies of corporations. Soule (2009) calls the targeting of corporations by social movements “private politics,” to distinguish it from politics targeting the state. There are several explanations for the rise of “private politics” at the end of the twentieth century. Economic concentration creates industry behemoths that are tempting targets, for leading firms can influence the well-being of entire states and communities. Meanwhile, political trends since the 1970s have resulted in weaker labor unions and national regulatory agencies, making them less attractive targets for activists (Prasad, 2006). In a political environment where state intervention appears to be declining, activists may view the state as a less attractive political target than the corporation (King & Pearce, 2010).

While social activism by corporate outsiders can negatively affect stock valuation and financial performance (King & Soule, 2007), activism by corporate insiders with formal contractual relationships to the firm can be even more effective. For example, Vasi and King (2012) show that environmental activism by shareholders can increase the perceived environmental risks associated with corporate policies and thus negatively affect corporate financial performance. Activism by outsiders, on the other hand, relies on appeals to consumers. Consumer movements have resulted in the creation of markets for new products such as grass-fed beef (Weber, Heinze, & DeSoucey, 2008) and of new market niches for socially responsible corporations (Vogel, 2005).

While some shareholder activism is directed toward ethics, the lion’s share aims to maximize financial results (Davis & Thompson, 1994; Dobbin & Jung,

2010). As institutional investors unafraid to challenge management come to control an increasing concentration of shares, the costs of public ownership have grown from the perspective of management (cf. Goldstein, 2012). Executives have responded by cutting ties to investors: in 2009, the United States had half as many publicly traded domestic corporations as it did in 1997 (Davis, 2011). Meanwhile, executives of publicly held firms have become preoccupied with financial markets and share price. Davis (2009) heralds the death of the corporation as a social institution, for the firm is no longer viewed as a permanent entity offering a stable local economy to its community and lifelong benefits to employees. And again, these trends have been accelerated by the arguments of financial economists and law-and-economy scholars, who theorize the corporation as a “nexus of contracts” between owners, managers, customers, workers, and suppliers, with each group trying to maximize its claim to the firm’s revenue streams (Davis, 2005). A central challenge for economic sociologists is to understand how the corporate form, social movement, and state adapt to one another as “financial capitalism” evolves.

#### MORAL AND CULTURAL INSTITUTIONS AND THE ECONOMY

Early work on culture and the economy focused on the values necessary to “commoditize” objects as a precondition to the emergence of markets. For example, changes in cultural attitudes toward life and death themselves allowed for the emergence of a market for life insurance (Zelizer 1983). More recent changes in attitudes toward financial speculation have contributed to the emergence of secondary markets in life insurance, wherein the terminally ill sell their policies to third-party investors (Quinn, 2008).

Scholars have also investigated cultural underpinnings of economic life at the organizational and individual levels. This movement represents a cultural complement to Granovetter’s (1985) structurally oriented concept of embeddedness. The foundational tenet is that intimate relationships are neither incompatible with exchange relationships nor reducible to them. Rather, Zelizer (2005, p. 288) asks “what sorts of economic transactions match which intimate relations?” This question set the stage for studies of “relational work” investigating the social processes behind forging and maintaining exchange relationships (Zelizer, 2012). Healy (2006) examines how organizations manage organ donors’ understandings of their donations—as altruistic gifts or self-interested exchanges—while Almeling (2011) shows that gender norms affect the relationship between sperm and egg donors and organizational intermediaries. Both works show that the fit between exchange transactions and intimate relations pattern the exchange of goods.

While this literature has an obvious affinity with the sordid and the sacred as objects of research, nothing limits relational work to dealing with human byproducts. For example, Bandelj (2009) shows that post-socialist Europe used relational work to signal demand for foreign direct investment (FDI). Establishing FDI as a legitimate form of economic activity was more successful than simply passing regulations favorable to FDI. Bandelj's (2009, p. 128) work elucidates the "social foundations of macroeconomic trends beyond the instrumental considerations of risk and return."

Whitford (2005) uses relational work to investigate the weakening of firm boundaries and the move toward network modes of production (Powell, 1990). Many classics in the embeddedness literature (e.g., Uzzi, 1996) work from the assumption that interorganizational relationships are defined either by "logics of embeddedness" or "logics of the market." Whitford shows that interfirm relationships are often a confusing mix of these logics: they may embody fine-grained exchange of information *and* mutual distrust. Maintaining these relationships depends on the ability of partners to define the relationship as mutually beneficial, or better yet, as irreplaceable. The character of interorganizational relationships, then, is not simply a function of the uncertainty inherent in markets, where "embedded" relationships are valued as hedges against opportunism. Rather, the character of economic exchange is subject to negotiation through "relational work."

Research attentive to the quality of economic relationships is timely, both because of the criticism that has been leveled at overly structural interpretations of embeddedness (Krippner, 2002; Krippner & Alvarez, 2007) and because of the move away from the massive, hierarchical corporation and toward network modes of production, as discussed earlier (Davis, 2009).

## CONCLUSION AND FUTURE DIRECTIONS

Research in sociology, political science, and economics has established that institutions matter to the operation of the economy. Further, economic sociologists have shown that universal economic laws do not push national economies and corporate systems toward any one model, but rather permit a multitude of economic arrangements. Unable to rely on deterministic theories of convergence, economic sociologists face the challenge of explaining the causes and patterns of change in economic systems over time. We have shown that the recent trend in economic sociology is to address this challenge.

One group of scholars treats institutional change as a product of the diffusion of regulatory institutions across national boundaries. While this perspective may seem to privilege international networks as the locus of institutional change, studies point to the roles of power and coercion,

cognition and learning in diffusion (Simmons, Dobbin, & Garrett, 2008). Furthermore, this perspective may seem to predict convergence of economic forms. However, because regulatory regimes are necessarily translated as they become enmeshed in national cultures and politics, convergence may be superficial at best (Halliday & Carruthers, 2009).

Another group treats economic change as a product of the increasing preeminence of the discipline of economics among policy makers and corporate leaders. At first glance, this perspective too might seem to predict cross-national convergence of economies, but institutional scholars have shown otherwise. Economic theory manifests itself differently as it encounters divergent institutional arrangements (Weir & Skocpol, 1985) and it must be translated as it encounters different cultures (Fourcade, 2010). It is not surprising, then, that economic theory is used to justify a range of different, often contradictory, policies (Jabko, 2006).

A third group of researchers treat changes in economic and institutional fields as the result of activism by entrepreneurs and social movement organizations. They explore how powerful actors shape institutions in order to achieve their goals, but power alone does not explain outcomes. Rather, cognitive processes determine both the goals of actors and the success of strategies, while networks are important sources of resources and innovations. The “markets as politics” perspective treats markets as one instance of the larger category of “social action fields,” and pays special attention to the interactions of multiple strategic actors (Fligstein & McAdam, 2012).

A final line of research sees economic life as enabled and constrained by the values and understandings that emerge from interpersonal and interorganizational relationships. Researchers from this perspective have documented that patterns of economic behavior rise and fall in tandem with cultural values. Nonetheless, this perspective is not limited to cognitive explanations. Researchers have shown that actors can influence the relative salience of values (Healy, 2006; Quinn, 2008), while others have focused on how cultural work determines the character of exchange relationships (Almeling, 2011; Whitford, 2005).

These perspectives do not exhaust the types of institutional change. Future research will identify new mechanisms behind institutional change and strengthen our understanding of how institutional change affects economic life.

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#### CARL GERSHENSON SHORT BIOGRAPHY

**Carl Gershenson** is a doctoral student and National Science Foundation Graduate Research Fellow in the Sociology Department at Harvard University. His research focuses on the origins of the American business corporation.

#### FRANK DOBBIN SHORT BIOGRAPHY

**Frank Dobbin** is Professor of Sociology at Harvard. His *Forging Industrial Policy: The United States, Britain, and France in the Railway Age* (Cambridge, 1994) traces the roots of contemporary industrial policy approaches to the institutional logics of political order in different countries. *The New Economic Sociology: An Anthology* (Princeton, 2004), ties modern economic sociology to classical sociological theory. *The Sociology of the Economy* (Russell Sage Foundation 2004) showcases the range of the new economic sociology. *Inventing Equal Opportunity* (Princeton, 2009) explores how corporate human resources professionals defined what discrimination meant under the Civil Rights Act.

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