# Rational Choice and the Problem of Institutions

## A Discussion of Rational Choice Institutionalism and its Application by Robert Bates

Lise Rakner

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**Summary:**

The paper discusses and reviews various directions within *new institutional economics*. A central question of concern is whether theories of institutionalism based within rational choice reasoning provide a theoretical basis for understanding institutional formation and change. The paper presents what is perceived as core elements of rational choice theory, and focus is on new institutionalism in particular. General perspectives are compared to the works of Robert Bates. By way of concluding, the paper questions whether rational choice theory, as it evolves to include an increasing number of factors such as institutions, ideology, norms and culture, may lose its parsimony and strength.

## Contents

## Introduction

Rational choice theory has over the last two decades acquired a central place within political sciences and economics. However, as a theory aiming to predict social outcome, rational choice has produced some unconvincing results when subjected to empirical testing. While the theoretical advancements within the school of rational choice have been impressive, successful empirical applications of rational choice models have been scarce (Green and Shapiro 1994). In attempts to increase the explanatory powers of the theory, a number of rational choice proponents have sought to extend the theoretical agenda and modify the original presumptions of rational choice theory. The developments within rational choice theory and the extension of the theory's agenda in the last decade is in particular related to the way *institutions* are perceived. In the original neoclassical rational choice theory, institutions were taken as given and studies of institutional origin and change were perceived to be exogenous to the theory. Over the last two decades, however, a new school within economics and economic history has evolved which has sought to endogenise institutions to rational choice analyses. Although diverse, these new theoretical developments have been identified as *new institutional economics*. Originating in economics, these theories have also acquired a central position within political science where the new theoretical developments within a rational choice framework have been identified as *new institutionalism*.

A central question of concern here is whether theories of institutionalism based within rational choice reasoning provide a theoretical basis for understanding institutional formation and change. My research project (Dr. Polit dissertation) concerns the interconnections between economic and political liberalisation in Southern Africa (Zambia). A main task when confronting development issues in general and the question of political and economic reforms in particular is to explain why in some cases efficient institutions are established under the authority of development oriented governments whereas in other cases government intervention produce inefficient institutions hampering economic growth and resource allocation. An indirect aim of this presentation is therefore to consider the advantages of rational choice institutionalism as a methodological approach for my own dissertation project. Based on these considerations it may be appropriate to designate this presentation a review essay. The aim is to discuss the evolvement and expansion of the rational choice research paradigm to include the study of institutions, institutional origins and change.

It can be argued that whenever a concept is packaged as new, social scientists should be cautious! (Koelble 1995: 231). Concerning the concept of new institutionalism, further clarification is necessary as a number of seemingly opposing theoretical directions are making claims to the term. In this presentation I shall focus on a direction *within* rational choice theory emphasising the role institutions play in structuring individual choices. Focusing on the issue of transaction costs, limited information and collective action, institutions are perceived as both expanding individual choice by influencing the availability of information and choices (Ostrom, Feeny & Picht 1993) and as constraining individual actors scope of choice (Moe 1990, North 1981, Bates 1989). What is important to note here is that contrary to historical institutionalism, organisational institutionalism and sociological institutionalism, *rational choice institutionalism* insists that individuals and their strategic calculations ought to be the central concern of social science and thus the basic unit of analyses[1]. To rational choice institutionalists, institutions thus constitute an intervening variable capable of affecting an individual's choices and actions but not determining them (Koelble 1995: 232). Contrary to other theoretical schools emphasising the significance of institutions, rational choice institutionalists are not rejecting the core elements of the neoclassical rational choice logic. Rather, its proponents are attempting to include institutions and the question of institutional change and origins into the explanatory models of rational choice.

According to Lakatos, a research programme may be divided into the programme's hard core and its variable protective belt (Lakatos 1970). A modification of a research programme takes the form of readjusting the protective belt, whereas an alteration of elements in the core represents a shift to a new research programme. The theoreticians under focus in this presentation all claim to adhere to the core principles of rational choice. Sometimes referred to as positive political economy (Alt and Shepsle 1990, Bates 1988, 1990), new institutional economics (North and Thomas 1973, North 1989, Ruttan 1989) or just new institutionalism, the school has already acquired a central position within schools of economics and political

[1] Sociological institutionalism holds that individual decisions are "embedded" in cultural and institutional "sectors" which determine the very concept of self-interest and utility (Granovetter and Swedberg 1992). March and Olsen, however, claim the title "new institutionalism" in their monograph *Rediscovering Institutions* (1989) arguing that both the behaviourial approach and the rational choice school has eliminated the role of institutions in policy-making. Basing their work on Herbert Simon's (1947, 1957) concepts of bounded rationality and satisficing, the organisational institutionalism of March and Olsen should be distinguished from rational choice institutionalism as they deny the concept of utility maximation. Historical institutionalism has imprecisely been labelled political science institutionalism. These works borrows from the notion of bounded rationality explored by March and Olsen (See Steinmo et al. 1992). While there is an on-going debate within social sciences regarding "who owns the institutional flag" this question will not figure centrally in this presentation.

science (Cook and Levi 1990; Moe 1984,1989; Ostrom 1986; Shepsle 1989) and is gaining ground within development studies (Nabli and Nugent 1989; Ruttan 1989; Bates 1988, 1989). Nevertheless, while seeking to modify the original premises of rational choice theory by extending the agenda to encompass the role of institutions and the issues of institutional change and origin, the question is whether the new institutionalists are transgressing the boundaries of rational choice theory in their efforts to increase its explanatory power.

The significance of this question is highlighted when discussing the works of Robert Bates. Bates is one of the leading proponents of the rational choice approach within political economy and development studies. Furthermore, he is perhaps the most cited social scientist working on Africa in general. Bates scholarly work over the past two decades is both voluminous and exceedingly varied in terms of topics addressed. When studying Bates' scholarship it is possible to detect an evolutionary trend which is closely associated with some of the main theoretical debates within political science and economics. Like many political scientists working within a rational choice framework, Bates has moved from a narrow economic concept of rational choice to include issues such a the independent role of politics and institutions to the theoretical agenda. A focus on his applications of rational choice and new institutionalism to African studies therefore promises to illuminate the strengths and weaknesses of the paradigm. Moreover, it enables an evaluation of the applicability of these theoretical tools to a non-western political and economic setting.

The presentation is divided into three parts. Starting with a brief presentation of what I perceive as the core elements of rational choice theory, the discussion moves to the new institutionalism within rational choice theory which has emerged within economics and political science over the last decade. In part two the general perspectives of part one is sought clarified and discussed in more detail when compared to the works of Robert Bates. By way of concluding, part three questions whether rational choice theory, as it evolves to include an increasing number of factors such as institutions, ideology, norms and culture may lose its parsimony and predictive strengths. More concretely; when Bates localises his rational actors in specific historical contexts and focuses on the role of cultural specific topics such as norms and symbols, has his research then exceeded the limits of rational choice theory and come full circle back to interpretive cultural analyses?

## Rational choice theory and the role of institutions

### *The core elements of rational choice theory*

Rational choice cannot be presented as one single theory as most practitioners of rational choice agree to some, but not all, features present in a definition of rational choice theory. However, some theoretical features are generally shared by all rational choice theorists and may therefore be described as *the core* elements of rational choice theory. The proponents of new institutionalism within rational choice all claim to adhere to the core principles of rational choice. A discussion of this scholarly direction should therefore commence with a characterisation of these core elements.

The main identifying character of rational choice theory is its adherence to the *individual as the unit of analysis*, in other words, methodological individualism. Based on an abstract description of goals in terms of interests, utilities and preferences, rational choice theorists aim to explain a variety of human behaviours. Collective outcomes are explained by references to the maximising actions of individual agents. To illustrate this point, Buchanan and Tullock argue that collective action is nothing more than the actions of individuals when they choose to accomplish purposes collectively rather than individually (1962:13). Social patterns are thus explained as aggregative consequences of the rational actions of a relatively large number of participants given the circumstances of the natural and social environment within which they deliberate (Green and Shapiro 1994:16).

Rational choice theory further require a certain *consistency* of choice as part of the definition of rational action. In other words, as a theoretical requirement it must be possible to rank order the available options of an agent (Green and Shapiro 1994:14). This preference ordering within rational choice theory is further supposed to be transitive which again implies that if A is preferred to B, and B is preferred to C then A must be preferred to C. There is further widespread agreement among rational choice theorists that rational action involves *utility maximation*. In other words, when confronted with a range of options, an individual actor will choose the one she finds will serve her objectives best (Green and Shapiro 1994, 14). The concept of utility is used as a basis for comparing heterogenous benefits and costs and to provide a common measure of a variety of goods (Little 1991: 45). However, while individuals are guided by self-interest when making choices, self-interest need not imply selfishness. If an individual finds fulfilment in helping the poor, charity may be the best way for that person to pursue self-interest. Adhering to a "thick" concept of motivations, altruism need therefore not be excluded from a definition of self interest (Riker 1990, Little 1991). Maximation assumption only requires that some schedule of preferences is maximised, it does not specify any particular goals.

Based on the core principles of the individual as the unit of analysis, utility maximation, consistency and rank ordering, rational choice theory constitutes a relatively simple model of explanation. Given a social phenomenon, what is needed in order to explain its origin are the strategies that rational prudent persons would pursue in those circumstances, and the aggregate effects of those strategies (Green and Shapiro 1994, Little 1991, Bates 1983). Social phenomena are thereby the result, often unintended, of the purposive actions of a large number of rational agents. Rational choice theorists finally seem to agree that their theories apply equally to all persons under study and that decisions and rules are stable over time. This assumption of homogeneity is usually justified on grounds of theoretical parsimony (Przeworski and Teune 1970: 17-21). From these basic assumptions the school of rational choice takes a number of directions based on the position of the various theoritisians within the school on subject such as the robustness of assumptions of human goals, the amount of relevant information agents can be assumed to posses and act on, and the universality of the explanatory enterprise of rational choice theory[2].

While it can be argued that the basic premises of rational choice theory have been present within the field of economics from the very beginning, rational choice theorising and market analogies saw its way to contemporary political science in the late 1950s. As such, studies of politics based on the actions of large numbers of utility maximising individuals is a relatively new field. However, the flaws of the rational choice theory when applied to 'real life' politics and economics soon became apparent[3]. One of the most significant weaknesses of rational choice theory when applied to empirical data and testing, relates to the problem of aggregating from micro-level observations to macro-level social output.

2 For a useful review of the debates and conflicting views on these subjects within the school rational choice, see Green and Shapiro (1994 ch.2) and Little (1991 ch. 2 and 6).

3 One of the most debated aspect with respect to the fallacies of rational choice theorising in politics relates to the paradox of voting. Starting with Anthony Downs (1957) rational choice theorists have characterised voter turnout as a collective action problem in which individuals are asked to sacrifice time and transport costs on behalf of a public good, the election of a party or candidate. Many scholars view voter turnout as a case in which rational choice theory has failed empirically. See Brennan and Buchanan (1984) and Green and Shapiro (1994) for an excellent review of the paradox of explaining voter turn out within a rational choice paradigm. For a further discussion of the limits of the neoclassical rational choice paradigm in terms of understanding social outcome, see James Scott (1976) and Samuel Popkin's (1979) critique of Scott relating to the problem of aggregating from micro levels of analysis to macro level social outcomes.

Researchers working within a narrowly defined rational choice paradigm have sought to account for collective behaviour by showing that it is consistent with the rational behaviour of the individual preferences of a large number of people. As a result, the problem of aggregation lying between individual preferences and social outcome was largely left unresolved by rational choice analysts. The lack of attention to the issue of aggregation may be the main reason why the theory did not prove robust in empirical tests of political action[4]. In an attempt to solve the problem of aggregation and to increase the explanatory powers of rational choice theory a number of scholars turned to the study of institutions.

## *The new institutionalism within rational choice theory*

The focus on institutions within the framework of rational choice theory emerged in the late 1970s as a critique of the narrowly economic rational choice approach which many proponents came to believe did not provide an adequate predictive theory of action as it failed to answer the question of how preferences come about and why they vary from person to person (Cook and Levi 1990, Koelble 1995). According to Shepsle (1989) the rational choice notion of economic man as a purposive proactive agent maximising privately held values came to be regarded as an unnecessary impoverished concept. Perceived as an atom unconnected to the social structure, Shepsle finds that the narrow economic concept of rationality lacked a notion of a"glue" holding the atoms of society together (Shepsle 1989: 134). Finding that the neoclassical rational choice paradigm failed to account for the fact that politics takes place in context, a number of proponents of rational choice theory came to the conclusion that the question of institutions could not be considered as exogenous to social theories.

The school within economics which have attempted to bridge the gap between economic theory and the `real' world in which institutions play a decisive role, has loosely been labelled new institutional economics (NIE). The NIE method can briefly be described as one which integrates institutions into the analysis of economic change from the very beginning. Institutions are supposed to interact with other forces and to be part of processes of economic change. According to one of its main proponents, Douglass North:

> "It is institutions that provide the key constraints and therefore shape incentives, and it is the interaction between institutional framework and the organisations that are a

[4] The issue of aggregation from individual-level processes to social causation is naturally also related to a broader debate within social science theory, namely the issue of methodological individualism. Rational choice theory is based on the concept of methodological individualism as one of its core premises is that social explanations must be grounded in facts about individuals. For a discussion of the controversy surronding the issue of methodological individualism, consult Alexander et. al (eds.) 1987, Little 1991 and Elster 1985.

response to that framework that shape the evolution of economics" (North, quoted in Gunnarson 1991: 49).

Within the framework of new institutional economics, institutions are the outcome of repeated interactions between utility-maximising individuals. Furthermore, institutions are perceived to reconcile rationality on the part of individuals with rationality on part of society. Institutions may therefore be considered as means to solve problems of aggregation and collective dilemmas arising when choices are made by rational individual that no one prefers (Bates 1988b, Koelble 1995).

New institutional economics or new institutionalism as its parallel within political science has been labelled, is new in the sense that these scholars attempt to *combine* the study of institutions with neoclassical economic analyses. Rather than abandoning the concept of rationality, the new institutionalists seek to *modify* the rational choice approach. Contrary to the `old' institutionalism associated with Torstein Veblen, historical and sociological institutionalism, the new research programme within economics and political science aims to generalise micro economy while retaining the core elements of rational choice theory[5]. As equilibrium theories, the new institutionalism within rational choice theory aims to describe the strategic context in which optimising behaviour takes places by laying down the rules from which, players are identified, prospective outcomes and alternative modes of deliberations are determined (Shepsle 1989: 135). The equilibrium theories of new institutional economics thus attempt to explain characteristics of social outcome on the basis of agent preferences and institutional features (Shepsle 1989: 135). Individual agents maximise an objective function albeit subject to constraints. The constraining `variable' is institutions. However, rather than determining choice, institutions within the rational choice paradigm are regarded to provide certainty under conditions of uncertainty and thereby help to foster cooperative an habitual behaviour (Koelble 1995: 241).

The consensus among economists and political scientists which have emerged over the last decade concerning the centrality of institutions in order to understand the degree of stability in competitive political and economic settings, economic growth and development have not been matched by one on its definition. The large variety of definitions applied vary according to the degree to which institutions and organisations coincide and whether to include both formal and informal aspects of institutions. As a result of these deviations, the common

[5] Torstein Veblen's (1898) attack on conventional economics became a central source of a school of institutionalism which developed within economics at the beginning of this century. The institutional school associated with Veblen is usually referred to as "old institutionalism". However, as institutional economics came to be regarded as a empiristic and anti-theoretical, it did not pose a challenge to the neoclassical hegemony within economics. See Gunnarson (1991) for a good review of the old-institutionalists.

understanding of what the term institution entail is rather wide and all-encompassing. The definition of Ruttan and Hayami is illustrative as according to these scholars (1984: 204) institutions are...

> "the rules of society or organisations that facilitate coordination among people by helping them form expectations which each person can reasonably hold in dealing with others".

Similarly, North defines institutions as rules and the enforcement characteristic of rules, norms and behaviour that structure repeated human behaviour (North 1989: 1321). Despite the variety of definitions, however, the main characteristic of institutions figuring in most analyses stress their effect as *constraining and limiting* the individual choice-set, thus *governing* the behaviourial relations among individual or groups and as a result institutions become a major *stabilising*, or equilibrium, force in society (Nabli and Nugent 1989).

The focus on institutions within rational choice theory has evolved over the last decade and as a new research programme it is in constant development. To present new institutionalism as a homogenous body of knowledge is therefore neither feasible nor correct. Nevertheless, two broad approaches within the study of new institutional economics can be identified, namely the theory of collective action and transaction-cost economics. While these two directions have developed separately, they are also related and dependent upon each other in many ways. Both the collective action and transaction cost approaches are based on the notion of rational utility maximising individuals constituting the basic unit of analysis. However, the two approaches differ on the extent to which the issue of institutional change and formation is sought endogenised to the theory[6].

## *Collective Action Theories of New Institutionalism*

As argued above, the neoclassical rational choice paradigm did not address the issue of aggregation as in the original models social outcome was simply perceived to be the result of the choices of a large number of self-interested utility maximising individuals. However, following Mancur Olsons seminal work *The Logic of Collective Action* (1965) and Buchanan and Tullock's equally path

[6] While emphasising the scholarly directions of transaction costs and collective action theory when aiming to describe the evolvement of the new institutionalist research programme, some may argue that important developments within game theory is left out of the discussion. The theoretical developments wit8hin game theory which attempts to endogenise important structures such as institutions, preferences, norms and culture have been significant. (For an elaboration of these subjects, see Sen 1979, 1987, Margolis 1982 and Regan 1980). I will nevertheless argue that game theory should be considered theoretical tools applicable to a number of theoretical directions within rational choice, rather than a particular scholarly direction of new institutionalism in and of itself.

breaking work the *Calculus of Consent* (1962), the notion that there is no reason to expect social outcome to be systematically related to individual preferences was made evident. Focusing on the dilemma of public goods and free riding, attention was put to the problem of aggregation. The key concern in the works of Olson, Buchanan and Tullock was to explain the likelihood of the success or failure of a set of self-interested individuals in undertaking actions that may benefit them collectively. The collective action theory evolving from these pioneering works focused on the issue of public goods. Arguing that the self-interested individual may find it preferable not to participate in the provision of a public good due to its non-exclusionary character once established, the theory of collective action not only identified non-cooperation, but also how cooperation could be achieved. The role of interest groups, issues related to the nature of the group and the role of selective incentives are main concerns in Olsons work (1965, 1982). The large and influential school of public choice analysing non-market decisions and institutional interaction, should be regarded as descending from these theoretical perspectives (Mueller 1979).

Focusing on interest groups and the behaviour of special interests, the collective action theory is essentially a bottom-up approach in the sense that emphasis is placed on how groups affect the behaviour of the state and governing institutions. The state is in turn perceived as a passive agent merely responding to interest group demand. Thus, the view of the state within collective action reasoning is largely negative as the state is seen as an exogenous redistributionary force employed in the benefit of special (group) interests. This lack of consideration of a potential independent role of the state has been one of the main criticisms of the collective action approach. By focusing on interest groups and conceiving the state and state institutions as largely responding to demands of interest groups, the collective action approach has been criticised for "modelling government as nothing more than a gigantic form of theft and redistribution (North 1989: 1323). The collective action approach and the school of public choice descending from it have not made any real attempt to endogenise institutions to their models of explanation (Gunnarson 1991). The question of how institutions come about and which factors cause institutional change further seems to be regarded as exogenous to the theoretical approach and thus taken for given.

The theoretical insights deriving from the school of public choice have greatly influenced the debate within developing economics in the last two decades. Emphasising the negative impact of government involvement in the economy, the call for "less government" and the need to "get the prices right" have been brought to the fore both by development scholars and the international financial institutions (World Bank 1981, 1989; Lal 1984; Nelson 1990). However, while it may be argued that these theoretical contributions have been able to portray interest group behaviour, they have failed to account for the fact that in developing societies, government actions as often as not *precede* interest group behaviour which often evolves in *response* to state activities (Bates 1990). It may therefore be argued that the independent role of politics has been largely ignored in collective action approaches.

### *Transaction-costs theories of New Institutionalism*

Transaction theory can to a certain extent be regarded as a response to the collective action approach and its lack of explicit theorising on the role of the state. A concern of the transaction-cost approach is to explain why some states produce and enforce institutions which lower the transaction costs while others fail to do so. Contrary to the collective action theories, the transaction-cost theories explicitly aim to endogenise institutions into economic theory as the state is regarded as an actor in the market (Gunnarson 1991). The general hypothesis is that institutions are transaction cost-minimizing arrangements which may change and evolve in concert with changes in the nature of transaction costs (Nabli and Nugent 1989).

Ronald Coase's work on firms and the problem of social costs (1960) may be considered the main pioneering work within this direction of new institutionalism. Posing the question of why economic agents in real economic contexts tended to arrange themselves hierarchically, Coase criticised the neoclassical economic model for not taking account of transaction costs. Coase argued that exchange by no means is costless as institutions became a significant factor in terms of lowering the costs of transaction. He thus found that rational individuals would willingly let go of some of their freedom of choice in order to reduce the costs of information and transactions. The new institutionalism descending from the pioneering works of Coase has focused on the contractual nature of organisations and institutions, costs of transactions, individual explanations and rationality. Within this perspective institutions are designed to stabilise exchange relationships, induce cooperative behaviour among self-interested individuals and to minimise transaction costs between the parties (Koelble 1995: 239)[7].

[7] The theoretical direction focusing on transaction costs contains several interrelated fields: The role of transaction costs in economic organisations as described above, the property rights approach associated with the law and economics literature and the issue of incomplete and asymmetrical information here under the problems of "moral hazard" and "adverse selection". For a useful debate of these issues, see Nabli and Nugent (1989).

As one of the main proponents within transaction-cost theory, North aims to explore the role of institutions in promoting economic growth (North and Thomas 1973; North 1981, 1989, 1990). According to North, institutions origin in the efforts of economic agents to promote exchanges unattainable in markets. The interaction of individuals involves transaction costs, which are the key to the performance of economies (North 1989). Risks and costs of information are two important elements explaining why individual agents would see it in their best interest to create institutions to regulate market transactions rather than to leave it to the market. According to North, institutions arise and evolve because of rising specialisation and division of labour in society. Institutional change in this perspective is therefore regarded as a result of changing prices which provide an incentive for those within institutions to renegotiate terms of participation. Changes in relative prices result from population change, technological change and changes in cost of information (1989: 1324). It may therefore be argued that the transaction-cost approach within new institutionalism seeks an economic theory of institutions to account for the origins of institutions which again enable individuals to transcend the limits of decentralised decision making and instead behave in a way that enhance collective welfare (Bates 1988).

### *Institutional change and origin within new institutionalist theory*

Regarding the theoretical developments within rational choice institutionalism, it is evident that, so far, the questions of institutional formation and change are relatively underdeveloped in explicit theorising. The reason why such important questions have received so little attention may lie in the fact that as equilibrium-theories, the school of new institutionalism has emphasised the notion of institutions as stabilising forces (Steinmo and Thelen 1992: 15). When focusing on institutions as mainly constraining individual choices and thus expecting continuity rather than change, the issue of institutional change has remained outside the scope of much theorising within new institutionalism of rational choice.

It is only within the direction of transaction-costs that the issue of institutional change and origin is explicitly sought endogenised to the theory. As evident in the above, the concept of institutional origins and change within transaction cost theorising is perceived in terms of market analogies. From markets, rational behaviour leads to various forms of contractual arrangements because, due to costs of transaction and information, rational actors find these institutional arrangements more efficient than markets (Moe 1984: 759). To the extent that the theories of rational choice institutionalism have attempted to endogenise the issues of institutional formation and change, the theorising adheres to a *contractarian* concept of institutional origin and change. References are made to a state of nature comprised of autonomous decision-makers, and questions concern the kinds of social agreements individuals would voluntarily agree upon (Moe 1984: 759).

How well does this contractarian paradigm of institutional origin and change transform to the study of political processes? Although a lot of promising work has been carried out, Moe finds it problematic that politics is sought understood as if it were an extension of economics. Moe adheres to the view that political institutions *mitigate collective action problems*, particularly commitment and enforcement problems and thus allow various political actors to cooperate in the realization of gains from trade. However, contrary to the market, not all decisions arrived upon within the realm of politics are based on voluntary actors, as institutions may also be weapons of coercion (Moe 1984). Echoing Moe, Shepsle (1989) argues that politics is afflicted by special problems that lend distinctive features to structural choice and political institutions. Politics is distinguished by what they vote about, namely the determining of how public authority will be exercised.

To a certain extent it can be argued that the notion of coercion and the non-voluntary character found in political exchange-relationships is incorporated in the collective action approach. Yet, it may also be held that institutions are not sought endogenised in collective action theory. Lacking an explicit theory of the state and state institutions, the collective action approach is therefore not very constructive in it self in terms of explaining institutional origins and change. As the brief discussion of the transaction cost approach above has indicated, a mainstream direction within this approach perceive institutions in market and contractarian terms. The emphasis on institutions as inducers of efficiency, however, fails to explain the formation and sustainability of *inefficient* and dysfunctional institutions. Based on a notion of transaction costs, the contractarian theories of institutional change and formation is able only to account for efficiency, hypothesising that the economically efficient institutions survives and supplants inadequate exchange relationships.

It may therefore be argued that the most convincing answers to these theoretical puzzles so far are found in approaches which seek to *combine* the perspectives of collective action and transaction cost reasoning. Founded on an extensive empirical material, North finds that contrary to theoretical hypotheses, inefficiency has been the rule rather than the exception through history. North attempts to solve this theoretical dilemma by combining the perspectives of the collective action approach with transaction-cost theorising by introducing the notion of an agent, or third party to make change possible (North and Thomas 1973). In the framework of North, the main supplier of institutions is the monarch who in his own desire to maximise revenue works for institutional change. However, North finds a tension to exist between social efficiency and the rulers desire to maximise revenue (1981). Arguing that the state (monarch) will favour influential interest groups which pose a potential threat to the regime in power, North echoes Olson finding economic inefficiency to be the rule through history (North 1981, 1989).

By introducing a third party agent as the initiator of change and emphasising the tension between social efficiency and the individual rulers desire to maximise his own fortune, North seeks to account for the existence of economically inefficient institutions. However, while the introduction of third party agents goes some way to solve the dilemma of institutional variance in terms of efficiency, it does not provide a satisfactory answer to the question of why some agents act benevolently and are willing to pay the cost of organising socially sound economic institutions while others may not. Questions regarding why some agents set aside their private incentives to maximise revenue in order to produce a social good, while other rules chose to behave in kleptocratic manners and why some rulers are better able to isolate themselves from the demands of special interests are not accounted for in this approach. It may therefore be argued that the third party agent perspective do not provide an inclusive and satisfactory answer to the question of variation among nations and institutional efficiency. As evident in the discussion above, most proponents of new institutional economics understand institutional change, or demand for such, to be induced by technological change which affect resource endowments (Ruttan 1989: 1375). By referring to technological change, institutional change is given an exogenous determinant. North, however, in an attempt to solve the dilemma of variation, emphasises an additional source of disequilibrium and institutional change, namely changes in decision rules of society. By arguing that changes in norms influenced by the evolution of ideas and ideology may bring about institutional change, North brings in an extra-rational factor of change (North 1989: 1323). Emphasising cost benefit calculations, North argues that institutional change may be initiated by a ruler who wishes to pursue policies of change with no direct relation to demands from specific groups or existing relations of production. This factor is referred to as ideology (North 1981). However, North does not develop any clear ideas of how and why ideology evolve or how variance in the preferences of a ruler or agent can be accounted for. At one point he asserts that ideology matters when it is relatively costless. In other words, the lower the cost entailed by ideology determined choices the more ideology will matter (North 1989: 1323 and Gunnarson 1991: 62). It is interesting to note, however, that so far North has not developed this perspective any further, despite of repeated claims to the need for a better understanding of ideology