

# **The problem of embeddedness and the limits of the rational choice approach: some institutionalist notes on culture, social structure and cooperation.**

**David Soto-Oñate**

University of Vigo, [ERENEA](#), [ECOBAS](#)

E-mail address: [davidsoto@uvigo.es](mailto:davidsoto@uvigo.es)

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### **Abstract**

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This article shows some of the New Institutional Economics' (NIE) remarks on individual, structural, and cultural elements that are central to solving problems of collective action but are neglected by conventional economics. Beyond the old vision of the limited *homo oeconomicus*, driven by an instrumental and perfect rationality, the paper presents a human being whose behavior could also respond to value-based rationality, identity imperatives or habits. On the other hand, they have incomplete mental models with positive beliefs about how the world is and works, but also a system of normative considerations about how it should be. They contain aseptic beliefs about the consequences of concrete decisions but also a universe of meanings that is also composed of identities, feelings, notions of good and evil and deep human aspirations. These decisively affect the initial design, the change and the performance of institutions. A microeconomics that admits group generalities necessarily redirects us to certain degrees of holistic analysis and leads us to become interested in cultural systems, their reproduction and their evolution. The shaping process of beliefs and preferences is an entire new world that occurs in a pre-rational instance in the individual. This instance was treated as given by conventional economics but not by the rest of the social sciences. This is why economists would do well by rescuing classics from sociology and promote interdisciplinary communication. The NIE is in a privileged position to bridge the gap between economics and the rest of the social sciences.

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## **1. Introduction**

This article shows some of the New Institutional Economics' (NIE) remarks on individual, structural, and cultural elements that are central to solving problems of collective action but are neglected by conventional economics. Although these are often mentioned by institutional economics, they are still underdeveloped. It reveals the correctness of its remarks but also its still lack of preparation to treat them analytically. The article presents these challenges and provides some insights developed in other disciplines that could help the NIE to strengthen its approach.

Market failures—e.g. market power, information asymmetries or production externalities—may generate transaction costs that give meaning to the existence of governance structures. In the absence of these failures and transaction costs, we would obtain the first and second welfare theorems, but these are ubiquitous and, in their presence, governance structures emerge to elicit efficiency gains.

However, the same problems that justify the existence of these governance structures also affect the life within the organization; there exist horizontal—derived from group production externalities—as well as vertical—affecting the principal-agent relationship—organizational costs. The function of governance used to be seen as the merely management of the incentive system to promote efficiency, but now we increasingly are aware that this is only a part of the story. There are logical limits to the ability of a system of incentives to mitigate the problems of collective action and other usually neglected elements play a decisive role in fostering cooperation. And, as Miller (1992) argues, other social sciences, such as political science, anthropology, or sociology, have devoted much more effort to this issue than economics.

Cooperation can be briefly defined as “voluntary deviations from self-interested behavior” (Miller, 1992, p. 13) for a collective purpose. In the presence of these failures, it is necessary to solve the problem of the free rider or, in other words, to achieve cooperation for collective purposes even when the individual self-interest would lead to opportunistic decisions that result in socially suboptimal outcomes. Often, forcing cooperation only through a system of external incentives is too costly or directly impossible. For this reason, Miller (1992), and other classic authors such as Barnard (1938), understands that there are other important managerial functions such as leadership and motivation in the promotion of loyalty, trust, ethics, etc. to align

individual behaviors with the collective interests. Miller (1992) shows how organizations are able to create and follow their own social norms or even define their own corporate culture to solve problems of collective action. Moreover, for Meyer and Rowan (1977), DiMaggio and Powell (1983) and other authors of economic sociology, the culture of an entire society enters into the organizations themselves affecting their form and the procedures within it. The typology of the norms, values and beliefs that are widespread in a society can influence the cooperative capacity within the organizations it hosts.

But also markets are actually institutions subject to social norms, values, and beliefs that highly condition their functioning and outcome. For instance, they may affect the kind of things that are susceptible of being exchanged, the limits of ownership over objects or the morality involved in the transactions. This is what has come to be called *embeddedness* (Granovetter, 1985; Polanyi, 1957).

All competition in society takes place within a framework of cooperation that is embodied in a series of rules. Here cooperation takes the form of cooperation with such rules, compliance with the rules of the game. This compliance legitimizes the result and the distribution of rewards derived from it. Cooperation with norms depends on, on the one hand, a system of incentives —rewards, effective sanctions, etc.—, but also, on the other hand, factors such as the legitimacy of the rules themselves, the morality of the actors to comply with them, or expectations about the compliance of others. But where do these phenomena occur if it is not in the process of instrumental rationality, by which individuals maximize their utility function? These have to do with elements such as beliefs, values, ideology or identity and seem to be formed in a previous instance to that of instrumental rationality. Here we ask ourselves about the role of the community in the formation process of these elements and their capacity to conform and persist as a *culture*. Culture is regarded as a system of these elements extended in the generality of individuals in a community and with capacity to endure in the long term. We will therefore discuss the relationship between the beliefs and preferences of an embedded individual and the community in which he/she is situated. Recognizing the existence of these pre-rational elements pushes us to concern about how they operate, are constructed and are modified in that previous instance.

The article proceeds as follows. Next section is concerned with social and cultural embeddedness. Section 3 deals with human behavior and the formation of preferences, with special attention to values. The fourth section is concerned with beliefs, highlighting the different roles of positive mental models, identity and ideology. Section 5 closes the article with some conclusions about the importance of culture for the study of cooperation, institutional performance and economic development.

## **2. Social and cultural embeddedness**

The concept of *embeddedness* refers to the epistemological insertion of the individual and the economic action into an institutional, social or cultural context. From this approach, it is emphasized that economic actors are not atoms that act with independence of their context, but are embedded in concrete, institutional, social and cultural systems.

Conventional economic theory does not dip the individual in his/her cultural and social context. It conceives the subject as isolated and making decisions with independence of the social and cultural environment to which he/she belongs. The NIE has made efforts to place the individual within the incentive system that shapes the formal and informal institutional structure of a society. The neoinstitutional individual, endowed with instrumental rationality, makes utility-maximizing decisions within this incentive system, which promotes or prevents decisions on investment, entrepreneurship, rent-seeking, etc.

From network analysis approach, Mark Granovetter (2005) considers that social structure, especially in its form of social networks, affects the economic outcome for three main reasons: (a) social networks affect the flow and quality of information, (b) social networks are an important source of rewards and punishments, and (c) trust —i.e. the expectations that others will do the “right” thing despite the individual cost-benefit calculation—may emerge from social networks. It is interesting to review some of the empirical contributions under this approach to better understand what social embeddedness consists of:

- There is a flow of non-economic content through economic exchange relationships. Often the content that is exchanged in economic relations is broader than the mere

formal transaction. This is precisely because economic action is embedded in a broader social structure. The relations of economic exchange and personal relations are confused, and they distort the result of an impersonal market. As Dore (1983) argues, a long friendship between a buyer and a seller can prevent the buyer from leaving the seller simply for an item that is sold elsewhere at a cheaper price. In this respect, we can also find sociological studies on the network of friendship relations that the managers have and its positive impact on the firm success or its resistance to price wars (Granovetter, 2005; Ingram and Roberts, 2000). Economist George Akerlof (1982) acknowledges that economic exchanges—labor contracts, in this case—are only part of the content of a broader reciprocity relationship.

- Continuing with the previous point, this flow of contents not necessarily economic will have an impact on the performance of imperfect markets. Social networks will alleviate the costs of finding information and, especially, reliable information. Granovetter (1974) shows how labor market deficiencies can be alleviated by certain characteristics of individual social networks. Since “all social interaction unavoidably transmits information, details about employers, employees and jobs flow continuously through social networks that people maintain in large part for non-economic reasons” (Granovetter, 2005), thereby facilitating more efficient exchanges. Clifford Geertz (1978), from his study of the Bazaar of a Moroccan region, shows how social networks are a partial solution by means of “clientelization”—an individual’s tendency to establish a stable relationship with a particular provider instead of searching comprehensively every time he/she goes to the market—and haggling.
- Verticality-horizontality or concentration-dispersion in social structures and networks can have enormous implications for sectoral or regional economic outcome. Saxenian (1994) argues that the main cause for the rapid technological progress of Silicon Valley as opposed to Route 128—two well-known high technology industrial regions in the United States—was the opening of its social networks and a more horizontally organized structure, crossing the formal limits of the firms. Saxenian’s comparative account reveals the centrality of social networks and cultural particularities in the different performance of these two industrial regions. Locke (1995) analyzes the process of staff restructuring in the seventies and eighties of the two largest Italian car manufacturers: Fiat (in Turin) and Alfa-Romeo (in Milan). The process of restructuring Alfa-Romeo, although it was longer, had a

much more beneficial outcome for both the parties and the community at large. Locke explains how the way in which organizations were formed in the regions of Milan and Turin, and, in particular, the involved economic and political agents, determined the process and the result of the operation. The relative horizontality of the structure and the slight concentration of power in Milan contrasted with the structural polarity of Turin, where two powerful blocks were organized, with no mediating links of sufficient solidity and independence.

Paul DiMaggio (1990) and other more culturalist authors consider incomplete the structural embeddedness of Granovetter and see fundamental to incorporate the cultural contents. For instance, to the explanation economic action within markets, cultural embeddedness incorporates elements such as role relationships and normative scripts, which define what, with whom and how one should/can exchange. It is considered that there is a relationship of interdependence between social structure and culture: patterns of social relations lead and channel the acquisition and expression of culture, and patterns of cognition are deeply involved in the construction of social structure. Structural embeddedness, in the sense of network analysis, has important implications for cooperation since as the network gets more densified it is more likely to repeat the interaction, the reputation effect becomes more intense and it increases the capacity of second- and third-party enforcement within the community. Cultural embeddedness is broader and incorporates social norms, beliefs and concrete values. The individual is no longer taken as given and only reacting to external stimuli. In turn, the subject is also transformed in his/her beliefs and preferences. The construction of the subject is one of the most neglected implications of conventional theory and the NIE. Structural and cultural contextualization affects the preferences and beliefs of individuals.

What role plays embeddedness in cooperation? In the recurrent scenario that an individual can opt for opportunism, Dasgupta (2002) identifies four types of mechanisms that reinforce cooperative behavior:

1. *Mutual Enforcement*. The agreement is mutually reinforced through a system of sanctions for deviant behavior. The cooperative solution is favored by a balanced distribution of power and the existence of subsequent repetitions.

2. *External Enforcement.* There is a third party that is responsible for enforcing the agreement: a state, an arbitration body or a social network in which the reputation effect discourages opportunism.
3. *Pro-social disposition.* The parties are honorable. Their integrity leads them on their own initiative to fulfill the contract or the norm even in the absence of affection. It can operate in impersonal contexts and in the absence of subsequent repetitions.
4. *Mutual affection.* In the group they take care of each other and concern about their well-being.

The first two are accessible without any difficulty by the conventional economics, but the cooperation based on the other two is out of its radius of explanation. It has often been considered as residual behavior, nonexistent or even impossible.

The following sections will focus on individual's pre-rational aspects that are susceptible to being endogenous to his/her social and cultural environment and to being shared with his/her community or groups. This allows us analyzing the micro mechanisms that, in aggregate terms, give a sort of personality or idiosyncrasy to the economic, political and social phenomena of a community, thereby conditioning their performance and evolution.

Let us return to the concept of social capital. This has been understood by some as an individual resource (Glaeser et al., 2004), which one may be interested in accumulating for the own benefit, and by other authors as a resource that resides in the community, from which all its members benefit. In another dimension it has also been understood as a configuration of social networks (Lin, 1999) or as a cultural system. The broader version conceives it as a configuration of the community and integrates structural and cultural components: it draws a concept of social capital as a dense social structure whose topology is rather horizontal and where individuals share a series of cultural traits to civism, generalized trust and a cooperative and participatory spirit. This conception was formulated by Putnam et al. (1993). They argue in their study that communities with a greater share of social capital are better able to take advantage of the economic opportunities offered to them. In their concept of social capital, they attach considerable importance to networks of civic engagement and argue, like Granovetter, that the existence of these networks increases the costs of opportunism, fosters robust rules of reciprocity and facilitates the flow of information. However, they

also highlight the existence of a civic culture, democratic and organizational values, orientation towards public affairs and a high level of interest in politics<sup>1</sup>.

### **3. Preferences, values and habits**

For conventional economics, the action of individuals responds to rational decisions with accordance to their preferences. According to Samuel Bowles, preferences are “reasons for behavior, that is, attributes of individuals that (along with their beliefs and capacities) account for the actions they take in a given situation” (Bowles, 1998, p. 78). But, as he put it, “most economists have not asked how we come to want and value the things we do” (Bowles, 1998, p. 75). Conventional economics takes individual preferences as given, without concerning for their formation process, and pays attention exclusively to *instrumental* rationality, i.e. to the conscious calculation that connects means to ends.

For conventional theory, values are part of the concept of preferences and operate under the same logic of instrumental rationality. Not so for Max Weber, who developed the concept of *value-rational actions*. This type of actions follows a rationality other than the instrumental to guide social action: it can be carried out regardless of the outcome. In Weber’s words, value-rational actions are those “determined by a conscious belief in the value for its own sake of some ethical, aesthetic, religious, or other form of behavior, independently of its prospects of success” (Weber 1978[1922], p.24). These do not need further ends and are considered as ends in themselves. Not only are they ends to be achieved, but they can also affect instrumentally-rational actions in the management of the means, since the procedures may be socially or ethically proscribed and prescribed. This neglect is striking especially when it has a determining impact on behavior. For Weber, two other patterns can also guide social action: the *traditional* and the *affective*. The *traditional* consists of customs that the individual ceremonially follow and in which rationality plays an insignificant role. The *affective* refers to visceral and irrational behaviors, based on emotion without the mediation of reason. These three forms of social action—value-based, traditional and affective—are systematically neglected by conventional economics. The neglect of traditional and value-based actions can be seen particularly serious because they are substantially shared by the rest of a community or

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<sup>1</sup> For an introduction to the debate about the concept and role of social capital, see Paldam (2000).

social stratum, thereby contributing greatly to the explanation of individual and aggregate economic outcome. An example of this is the *habitus*, popularized by Pierre Bourdieu. The habitus is the disposition of an individual to behave in a similar way to its group of peers, adopting their tastes and beliefs, and is shaped by means of a constant process of socialization. They are schemes of perception, thought and action. This provides an explanation to why members of same social class tend to share tastes, aspirations, customs or ideologies.

A fundamental question for solving the puzzle of cooperation is why someone is able to cooperate when honesty, loyalty or altruism have a negative pay-off. North (1990b) poses two possible responses: a) the existence of group conventions that prescribe cooperative behavior and acquire moral force (Sugden, 1986) and b) the existence of a group identity that makes individuals assume the group interests as their own (Margolis, 1982). The first alternative is covered in this section and the second one in the next.

In *The Evolution of Cooperation*, Howard Axelrod (1984) presented the result of some computer tournaments that he himself organized, consisting of an iterated prisoner's dilemma. He discovered that there was a dominant strategy: tit-for-tat. Basically, what we usually call reciprocity. The player chooses to cooperate in the first place and then responds to every opponent's choice with the same movement. However, if both players play tit-for-tat and one mistakenly or purposely cheats, they cannot return to the cooperative equilibrium. An improved strategy is then *reciprocity* and *forgiveness*. Theoretically, with these strategies cooperation holds as long as the players expect the interaction to continue; once repetition is not expected the players have incentives to defect. So, what can ensure cooperation in non-repeated prisoner's dilemmas or when further interactions are not expected? Here ethical principles that prescribe cooperative behavior, which are assumed as values—ends in themselves—, play a fundamental role.

A determining factor to choose the cooperative solution is the expectation of cooperation by the other players. This expectation of cooperation is what has been called trust. This is a high-value feature for a society when it spreads across a community. Economic activity involves more confidence than is normally assumed. In words of Kenneth Arrow (1971, p.22), “[i]t is useful for individuals to have some trust in each other's word. In the absence of trust, it would be very costly to arrange for alternative sanctions and guarantees, and many opportunities for mutually beneficial co-

operation would have to be foregone”. He remarks the role of norms of social behavior, including ethical and moral codes, which serve “to compensate for market failures”.

In *Moral Markets*, Paul Zak (2008) argues that if the modern market economy works, it is because most people for most of the time are moral and decide to cooperate with the social norms and institutions in which the market is integrated. The property rights of the counterpart are respected, the fiscal and labor duties are fulfilled, and rules are observed even when individual instrumentally-based calculation prescribes opportunism. David Rose (2011) wonders in *The Moral Foundations of Economic Behavior* what kind of moral beliefs a society should have to ensure the overall maximization of prosperity and arrived to a similar conclusion.

Honesty and ethics become essential to sustain cooperation in the generality of cases, especially when there are gains from opportunism and there is no possibility of punishment. Therefore values can substantially condition economic life in society.

#### **4. Beliefs**

North (2005) proposes a complementary annex to the NIE to address “societal change and the way humans understand and act upon that understanding of societal change” (North, 2005, p. vii). This represents a "cognitive turn" in economics, not because beliefs were not hovering over the NIE from its inception, but because it places a much more intense focus on beliefs as explanatory factors of institutional design and change than hitherto.

According to North (2005, p.2), “[t]he ‘reality’ of a political-economic system is never known to anyone, but humans do construct elaborate beliefs about the nature of that ‘reality’—beliefs that are both a positive model of the way system works and a normative model of how it should work”. Following sections present three important elements contained in the beliefs: mental models, ideology and identity. These decisively affect recognized factors related to economic behavior and the development of societies such as legitimacy, values, moral behavior or trust.

#### **4.1. Shared mental models**

Mental models are aseptic considerations about how the world works. For North, any social science based on individual rational choice must include the “subjective models people possess to interpret information and of the information they receive” (North, 2005, p. 64). These mental models may be incomplete and wrong. Incomplete and wrong mental models can lead to unintended consequences in decision making—e.g., in institutional design—diverting again the reality from the outcome expected by conventional economics.

Uncertainty is a key element for the economy. It has a fundamental impact on the possibilities of economic development, affecting investment and consumption decisions. One way to reduce it is by designing institutions that constrain possibilities in human behavior. Reducing uncertainty is one of the most important functions of institutions. A recurring example for the NIE is the ability of institutions at the top of the State to generate credible commitments on the security of property rights. In this way, constitutional or parliamentary constraints on the executive or the independence of the judiciary were broadly analyzed as relevant institutions.

Mental models are often widely shared by a community. Societies construct mental models that connect causes and consequences and reinforce some decisions over others under uncertainty conditions. Culture, with all its myths, superstitions, taboos, stereotypes, local knowledge, historical experiences, etc., becomes a source of prescriptions that force aggregate choices over others. For instance, shared mental models may affect international trade flows. Beliefs about the reliability of others influence the tendency to exchange more with some countries than with others (Guiso et al., 2009). The effect is even stronger when it comes to goods that are more trust intensive.

Thráinn Eggertsson (2005) formulated what he called social models, “mental constructs that actors use to cope with uncertainty and complexity in their social environment” (Eggertsson, 2005, p. 26). They are a subset of the overall mental models and may also be incomplete. Social technologies are social models that describe how institutional arrangements create social outcomes. Unlike production technologies, which are more mobile across countries, social technologies do not travel well, thereby affecting the

capacity of a community to import institutional arrangements. Eggertsson (2005) points out social technology as a major issue for economic development.

#### **4.2. Ideology and legitimacy**

Here let us assume ideology as a normative system of ideas about how things should be. It is built upon beliefs about how the world is and works and based on very basic deep values, human aspirations and models on how they can be achieved. In ideology, there is an overlap of the terrains of beliefs and values. For instance, Alesina and La Ferrara (2005) show that those who consider that the social system is fair and success is determined on effort are less favorable to redistribution than those who believe that social mobility is a matter of luck and special social connections.

Ideology affects the legitimacy of institutions and organizations. Its legitimacy will depend on the extent to which they resemble the normative conceptions prescribed by ideologies. The contradiction can lead to problems of institutional observance and even festering and violent disobedience. One of the key conflicts is the one about “the legitimate ends of government and the rights of citizens. All rights accorded to citizens—whether personal, economic, religious, civil, or political—imply limits to the behavior of political officials” (North, 2005, p. 107). A good example is contained in Thompson (1971), which explains how the British population rebels against the crown after breaking a consensus broadly-perceived as legitimate. The foundations of the rebellion rely more on values and beliefs than on the material consequences of the reform. North (1981) had already recognized the fundamental importance of legitimacy for the social order and remarked that, in the absence of it, institutional enforcement could be too costly or even impossible.

Ideology also affects the legitimacy of organizations and their own internal configuration. Meyer and Rowan (1977) argue that organizations are forced to incorporate practices and procedures based on society’s institutionalized conceptions. These institutionalized conceptions refer to products, services, techniques, policies and programs that function as powerful rational myths and are adopted by corporations ceremonially. The coherence of the organization structure with the institutionalized rules improves its legitimacy and stability and increases its chances of survival. They introduce their concept of *isomorphism*, understood as the way in which a society

reproduces organizational structures—or incorporates structural elements—similar to those stored in their cognition in the form of rational myths. This isomorphism becomes, for various reasons, key for the survival of organizations and obliges them to incorporate these externally legitimized elements that can often be in conflict with efficiency criteria. As a result there will be a tendency to the homogeneity of organizational structures within a given environment.

A shift in beliefs or values can affect the perceived legitimacy of a community's institutions and force institutional change in the style of Roland (2004). In North's words, "I know of no way to explain the demise of slavery in the nineteenth century that does not take into account the changing perception of the legitimacy of one person owning another" (1990b, p.24). It can affect even preferences over what things should or should not be consumed or traded and under what terms. Zelizer (1994) chronicles the process of historical change from a time when children had an economic value—to work in the countryside, to assist them when they grow old, etc.—to a modern childhood where children are economically "useless" and emotionally "priceless". They went from being treated as an economic asset, with an instrumental value for other purposes, to be valuable in themselves.

This forces us to rethink power and how individuals and organizations can be willing to transform the ideologies of others. In this sense, it is revealing the case contained in Zelizer (1978) about the transformation during the nineteenth century of the social meaning of life insurance for Americans, from a sacrilege to a moral obligation for heads of families. To this end, the insurance industry made use of the religious language and even obtained the support of the clergy community, which persuaded the faithful to ensure an economically worthy life for their family in the event of their death. A similar case occurred with the derivatives market: through an intense work planned by "lobbies", the derivatives went from being considered a betting game to a serious and respected financial product (MacKenzie and Millo, 2003).

### **4.3. Social roles and identity**

Every formal or informal institution appeals to at least one subject, and entitles or forces him to do or receive something. That is, it involves at least a social role. When one plays a social role, he/she acquires obligations and rights associated with it. Social roles

refer to social functions and individuals often occupy a plurality of them—father, citizen, physician, member of a football team, etc. They “are defined by norms structured by the institutions and organizations of society. Their relative weight in influencing people’s behavior depends upon negotiations and arrangements between individuals and these institutions and organizations” (Castells, 1997, p. 6). While roles organize the function in the social organization, identity is about organizing the meaning. It answers to who I am, who mine are and who the others are, what distinguishes me or what my attributes and aspirations are. For Castells, identity is a process of endowment of meaning on the basis of a cultural attribute or set of them, which are given priority over other sources of meaning. They are "sources of meanings for the actors themselves, and by themselves, constructed through a process of individuation" (Castells, 1997, p. 6). By *meaning*, Castells refers to the “symbolic identification by a social actor of the purpose of her/his action” (Castells, 1997, p. 7). So, while roles are something external, localizing the individual in the functional structure of a society, identity refers to the very meanings and aspirations of the self.

While structural embeddedness could address this insertion of the individual into a system of roles, it is not enough for theorizing about the operations of identity. Its formation process is more complex and refers to the very formation of the individual: the conception of himself/herself, his aspirations or his/her communities of feeling. Identity is the construction of what is significant in oneself, what is similar in his/her peers and what is different from his/her opposites. Thus, the formulation of an alterity is always implicit or explicit. It is, therefore, essentially a social question: it is located and defined within and with respect to social groups.

It may have attached notions about legitimate rights, responsibilities, goals, aesthetic canons and behaviors. But, in another dimension, it implies the existence of intersubjective feelings, which makes the individual capable of assuming group utility functions or internalizing the happiness of others. This relaxation in the borders of the economic individual allows analyzing more precisely the overcoming of the free-rider problem, altruism and even cases of extreme cooperation and identity fusion. In cases of identity fusion, what might be called a personal identity and a person’s social identity become functionally equivalent (Swann et al., 2009) and can explain phenomena such as extreme heroism, soldiers at war or terrorist immolation. In addition, an individual can identify with several social groups assuming a plurality of identities. These

identities overlap—not necessarily concentrically—and may create internal conflicts if they pose contradictory constructions. The articulation of identities is also a complex and poorly understood process.

The possibility that an individual can be integrated into supra-individual identities, assuming group preferences as his/her own, is something denied to the individual formalized by conventional economics. All preferences associated to identity fall outside the analytical capabilities of neoclassical thought. There have been well-known attempts to address this identity-related behavior at microeconomic level, as in the case of Margolis (1982). This work posed the maximization of a utility function that integrated an individual function and a social function. In this manner, the individual has to manage to optimize his/her individual preferences and that of his/her group within the same rational operation.

More recently, Akerlof and Kranton (2000, 2010) dealt with the effect of acts of an individual on the utility of other individuals through identity-related mechanisms. For instance, a politician with a corrupt behavior affects the image of the collective thereby creating a deep unease in other politicians. The anxiety that is generated in the other members is formalized as a direct loss of utility—that is, not through any subsequent professional or personal damages that may arise. Individuals will attempt to create standards, specific penalties or systems of sanctions to prevent or respond to damages. According to Akerlof and Kranton (2000), the introduction of this particular concept of identity necessarily expands economic analysis because it involves a new type of externality and because it raises a new process by which the preferences of an individual can be transformed.

Indeed, the fact that an individual's actions directly affect another by means of identity operations has not minor implications for the economic outcome, but that is only part of the story. We must also study the formation process of intersubjectivities and supra-individual identities, the basis on which the identity-alterity binomial is built, the construction of identity-based meanings, aspirations and values and the implications that all this has for real behavior —consumption, investment, cooperation, etc.

Regarding the importance of identity over consumption we can recall what Hirsch defined as *positional goods* (Hirsch, 1976). These goods make implicit reference to social status and acquire their value precisely from their scarcity. Their consumption

produces direct utility by the fact that others are excluded from owning them. By extending this logic, we can identify a category that would be called *identity goods*, whose consumption involves identity-related utility that do not refer necessarily to a vertical status. It can be associated to group membership or a differentiation within a group. Status as an identity trait has indeed important implications for behavior in commodity consumption but also for design and institutional change. Part of the problem of transitions is the resistance of elites to losing their status. But, again, under the logic of identity goods, we can understand that non-status identity traits in general can also affect preferences toward forcing or resisting institutional change.

On the other hand, previous section pointed out that the internalization of social norms and prescriptions—such as honesty, reciprocity or forgiveness—were crucial for imposing and sustaining cooperation in the long term. But when we talk about the scope of cooperation in a community, identity becomes fundamental because it involves a “with whom” to cooperate. This could be revealing the idea of an underlying “us” in the beliefs and feelings of individuals. As stated above, identity always refers to some kind of otherness. This is context-dependent and an important element is the construction of the other and its characteristics and what can normatively be granted to and demanded from the other. Identity is thus key to the application of ethical norms and cooperative behavior. Banfield (1958) distinguished what he called “moral familism” and “generalized morality”. Amoral familism denotes moral schemes in which members of a community apply moral imperatives only when dealing with their own relatives. In turn, behavior with members outside the family circle is openly opportunistic. In the case of generalized morality, moral standards apply broadly to the entire community. At least for this case, the identity marks the application or not application of ethical standards within human interactions. This statement finds empirical support across countries (Alesina and Giuliano, 2011).

The difficulties to identifying with a larger group might explain why the level of ethnic fractionalization within a community may affect—though not necessarily—cooperative spirit (Alesina and La Ferrara, 2000), generalized trust (Alesina and La Ferrara, 2002) and the provision of public goods (Alesina et al., 1999). But not only diversity by ethnicity affects trust, inequality of wealth and income also does so (Alesina and La Ferrara, 2002; Uslander and Brown, 2005). Any element that serves as a pivot for the creation or consolidation of opposing identities can affect the capacity for cooperation

and trust levels within a group. This is why advanced communities invest resources in the extension of group identity, breaking down identity barriers, fostering tolerance for diversity and establishing emotional and identity bonds between groups.

Cooperation is necessary to enable a society to build new levels of organization. Thus morality and widespread trust—and not only limited to family or personal relationships—allow larger well-functioning organizations (La Porta et al., 1997) or more functional complex markets (Guiso et al., 2004).

Culture and the socialization process are therefore of crucial importance. Although largely stable over time, identity maintains a constant dialectical relationship with the social environment and is thus subject to continuous transformations (Berger and Luckmann, 1991). This process would involve a pre-rational operation of identity construction—partly deliberated, partly imposed, partly unconsciously assumed. It is the process by which an individual would assume or get rid of group identities or specific roles in an instance prior to the rational articulation of his/her maximization strategy.

Not only the socializers but also the institutions themselves play a fundamental role in the formation of identity. Dominant institutions can originate concrete identities based on the roles they define. It happens when “social actors internalized them, and construct their meaning around this internalization” (Castells, 1997, p. 7).

## **5. Conclusion**

This article delved into the conventional economics' conception of human behavior. Beyond the old vision of the limited *homo oeconomicus*, driven by an instrumental and perfect rationality, the paper presented a human being whose behavior could also respond to value-based rationality, identity imperatives or habits. On the other hand, they have incomplete mental models with positive beliefs about how the world is and works, but also a system of normative considerations about how it should be. They contain aseptic beliefs about the consequences of concrete decisions but also a universe of meanings that is also composed of identities, feelings, notions of good and evil and deep human aspirations. These decisively affect the initial design, the change and the performance of institutions (Eggertsson, 2015; Rodrik, 2014). Social orders or reforms

that defy ideologies may face a lack of legitimacy, leading to problems of enforcement—in the form of fiscal fraud, for example—, deliberate disobedience—strikes, boycotts—or violent confrontation—protests, revolutions.

Besides all the great advances promoted by the NIE, it is necessary to incorporate into the institutional study new logics different from those of instrumental rationality and to investigate the formation and evolution of the pre-rational traits, which in a substantial part are shared by a community or a group. A microeconomics that admits group generalities necessarily redirects us to certain degrees of holistic analysis and leads us to become interested in cultural systems, their reproduction and their evolution. The shaping process of beliefs and preferences is an entire new world that occurs in a pre-rational instance in the individual. This instance was treated as given by conventional economics but not by the rest of the social sciences. This is why economists would do well by rescuing classics from sociology and promote interdisciplinary communication. The NIE is in a privileged position to bridge the gap between economics and the rest of the social sciences.

The process of socialization becomes a mechanism for the intergenerational transmission of values and beliefs, making them highly persistent over time. The dialectical mechanisms that link the formal institutional environment with culture and those that allow the autonomous evolution and reproduction of culture in the long term are thus fundamental for institutional economics. North (1981) already was an enormous and honorable precedent when he spoke of the importance of the learning process for institutional change and pointed to the process of socialization as a mechanism for stability and persistence. Cultural persistence and the mechanisms of socialization that make it possible boosted a recent and active line of research in economics.

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