



A New View of Economics: Comparative Analysis of Institutions*

1. — *Introduction*

Over the past dozen years a perspective has been developed within economics which differs so markedly from traditional economics that it seems adequate to speak of a *new paradigm*. This development has been noticed and actively pursued by an increasing number of economists, but there is still a considerable share among them which is devoted to the 'old style' of thinking and does not seem to be aware of an alternative approach to economics. Among other social scientists the new paradigm is only partly known, economics often being identified with a highly formalistic but largely irrelevant subject.

This paper outlines the main features of this new paradigm in order to make this kind of thinking more accessible to traditional economists as well as to other social scientists. It will be argued that this approach is able to provide most useful insights into economics and social reality, and that due to its institutional and empirical orientation it is able to bridge the gap existing between economic analysis and what is commonly taken to be 'real life'. It is, in particular, useful for the study of the service sector.

The name of this new approach, «the comparative analysis of institutions» is rather clumsy, but identifies well the three main elements of which it is composed. They will be discussed in reverse order: the «institutions»-aspect is discussed in the following section; the «analysis»-aspect is dealt with in section 3, and the «comparative»-aspect in section 4. Section 5 summarizes the new aspects of this approach, and section 6 sketches

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the paradigm's relevance for the analysis of the service economy. The paper ends with concluding remarks (section 7).

The emphasis of the paper is on the new perspective provided; individual contributions are of secondary importance. It therefore seems to be more useful to provide a short survey of some of the main literature instead of burdening the paper with a host of citations.

2. — *The «institutions» aspect*

«Institutions» may be understood in various different ways: as decision-making mechanisms, as organisations, or as laws and rules.

2.1. — Decision-making mechanisms

Economics as traditionally conceived is largely a science of the market or of the price system. It is restricted to one single social decision-making mechanism. In this sense it focuses on *one* institution only, as disregards all other institutional possibilities for deriving collective decisions. It is, however, easy to see that there are many other institutional set ups within which such decisions are arrived at. A dichotomous classification may distinguish between market and non-market decisions. This distinction has not proved to be very fruitful because nothing is known about what constitutes «non-market» decisions. The dichotomy between *exit* and *voice* on the other hand is able to provide most interesting insights. When the individuals are dissatisfied with a particular supply of a product or service, they may either react by switching to another supplier (in the case of a public supplier, for example, by moving to another country), i.e. to exit, or by raising resistance within the given institution, i.e. to make voice. Another useful dichotomy is between *market* and *hierarchy* as it is again possible to identify the characteristics of each of the two decision-making systems. A threefold classification distinguishes between the ethically neutral *price* system, the *integrative* system based on love, and the *threat* system based on bad feelings. While this distinction may be useful for analyzing certain aspects of international relations it has not proved to be analytically very helpful for understanding economic problems better.

A fourfold classification of decision-making systems distinguishes between the market, democracy, hierarchy (or bureaucracy) and bargaining. This distinction is particularly useful because it identifies decision procedures whose characteristics are well-known, but keeps their number restricted so as to still allow an overall view.

2.2. — Organisations

The comparative analysis of institutions is not restricted to decision-making mechanisms; one of its important contributions is to include organiza-

tions as hierarchical entities. To non-economists, it must come as a surprise to hear that traditional economics which deals with the price system does not even include any theory of the firm as an organization! The theory of perfect competition which forms the core of traditional economics does not offer any theory of how the total output of an industry is divided between the individual (price-taking) suppliers.

There types of organizations are in the centre of the comparative analysis of institutions:

a) *Economic organizations.* — The combination of owners of inputs, labour and capital, into an organization called a *firm* is explained by the fact that this set-up is more efficient than markets, since transaction costs are reduced. Once specific types of costs such as those of information or monitoring can be identified, it is possible to predict under what conditions firms will arise and what their size will be.

Another form of economic organization which has received considerable attention within the comparative analysis of institutions are *interest groups*. While common interests of the individuals concerned are certainly a necessary condition for their formation, they are certainly not sufficient: there are a great many economic interests that find it difficult or impossible to organize an effective pressure group. Examples are in particular the consumers and the taxpayers. The reason for the inability of some interests to organize is that they to a large extent provide «public goods». Such goods (and services) are, by definition, available to all, so that there is no reason to carry the cost of joining and financing a pressure group. Interest groups are able to form when there are only few (potential) members, so that a free rider not joining the group is ostracized or sanctioned by the members, or if the members get a private good available only to themselves, or if the group is formed by legal force. This theory of pressure group formation has been successfully tested in many empirical applications. Once a group has formed, the power it can exert depends on its strategic location in the production process (which determines the possibility to impose costs on others), and on its ability to use money and votes to further its goals.

An analysis of institutions in the form of organized economic decision-makers is of obvious importance for modern economics. Not taking their activity into account would give a strongly distorted view of economic life, and would make it impossible to devise successful policy measures.

b) *Political organizations.* — Economic and political activity is closely interrelated; it is therefore also important to study the behaviour of organizations in the political sphere. The most prominent is *government* which nowadays has an enormous impact on economic life, as measured, for example, by its share in GNP. The comparative analysis of institutions takes government as an endogenous part of a politico-economic system. Often it is assumed that government, or rather the politicians forming it,

seek to maximize votes. A more realistic assumption is that government politicians pursue ideologically motivated goals subject to a number of political, administrative, and economic constraints. The crucial restriction in a democracy is to be re-elected by the voters; but no government can afford to alienate the public bureaucracy (administrative constraint). The economic restrictions are composed of the budget and balance of payments constraints as well as, of course, of the economic structure within which it must act, and of the economic policy instruments available. Within the framework of «politico-economic models» this approach to government behaviour has been empirically tested for many different countries, with considerable success. Macro-econometric models which include such a politico-economic model of government yield clearly superior predictions that those based on purely economic concepts (e.g. that government expenditure simply depends on the level of GNP and on lagged government expenditure).

Endogenizing government is not only important for a better understanding of reality and to improve forecasting. It also leads to a fundamentally different view in the theory of economic policy. According to the traditional approach, (optimal) economic policy is devised by maximizing a social welfare function, subject to the constraints imposed by the economic system. This approach of the theory of quantitative economic policy, which has been further extended in the theory of optimal taxation and of optimal public pricing, is no longer viable once it is acknowledged that government is endogenous. The consequences have been spelled out in the recently developed «theory of democratic economic policy». One of the most important conclusions is that the politico-economic process can be influenced mainly by establishing adequate *rules* which govern the way this process evolves. These rules cannot be imposed from outside (at least not in a democracy) but have to be accepted 'behind the veil of ignorance' by the individuals by consensus. Once the 'rules of the game' are set, there are only limited possibilities to influence the course of the politico-economic process. Endogenizing government, as well as other political organizations, thus has far-reaching consequences for the way economic policy is viewed.

c) *Administrative organizations.* — An increasing position of economic and social activity is heavily influenced by public and quasi-public bureaucracies. These entities function in a way quite different from other organizations. Public bureaucracies tend to enlarge the budget at their disposal (budget maximization) and to secure for themselves a terrain in which they can act at their own discretion. Members of the public administration have little incentive to act efficiently in the economist's sense; it is more important to them to observe the formal rules. To take the specific behaviour of this organization into account is again an important step towards a better understanding and prediction of the course of economic and social events.

2.3. — Laws and norms

A third type of institution which is studied in the comparative analysis of institutions is the various types of laws formally set by political and administrative decision-makers, as well as the informal norms which are socially accepted and sanctioned. While the specific process in which they emerge may be quite different, their consequences are often quite similar because they influence individuals by changing the system of rewards and punishment guiding behaviour.

3. — *The «analysis» aspect*

The comparative *analysis* of institutions places great weight on deriving theoretical propositions which are (at least in principle) amenable to empirical (econometric) testing. Indeed, many of the propositions brought forward within the context of this approach have been subject to extensive empirical tests. This procedure strongly differentiates the comparative analysis of institutions from much traditional theorizing concerned with logical, not empirically referable, relationships. (An example is the theory of competitive general equilibrium which is far from deriving, or actually testing, referable propositions).

3.1. — The model of human behaviour

The analysis used is based on the economic model of human behaviour. It is notable that an analysis designed to deal with *institutions* used *behaviour* as a foundation. This intimate connection between institutions and behaviour is perhaps the overriding strong point of the comparative analysis of institutions. Most other social science theories *either* look at institutions *or* at behaviour, but do not combine the two.

The economic view of man follows methodological individualism and has the following characteristics:

- individual preferences (goals) and constraints are strictly distinguished;
- changes in behaviour are explained by changes in constraints (particularly by changes in relative prices), and not by (unexplained) changes in preferences;
- marginal changes are considered and the possibilities to substitute between alternative courses of action are stressed;
- individuals are assumed to behave in a consistent (or 'rational') manner;
- individuals are usually assumed to act selfishly.

The *homo oeconomicus* is thus considered to be

- resourceful, because he searches for and finds solutions, learns and invents;
- expectant, because he attaches subjective probabilities to future events;
- evaluating, because he has ordered and consistent preferences; and
- maximizing, because he searches for the highest utility level attainable.

This model of man deviates quite strongly from the one found in traditional textbooks on micro-economics, where it is assumed that economic actors are fully informed and where the problem of uncertainty is disposed of by using the 'trick' of postulating certainty equivalents. The economic model of man is also quite different from the behavioural theory used in sociology (and in large parts of political science). The specific features of the economic view of man stand out well when they are compared to the sociological view. There is, however, not one '*homo sociologicus*' but two. The sociological model of man used in *structural functionalism* is socialized (he internalizes norms and values), role-playing (he acts according to situational role expectations) and sanctioned (if socialization is not perfect, norm deviance is punished by the other members of society). The second *homo sociologicus* is used in *sociological empiricism*. He is opinionated (he has attitudes about everything), sensitive (he is easily influenced by others) and active (he acts directly on the basis of his opinions and attitudes). Both types of sociological man lack resourcefulness and restrictions play a minor role or are totally absent (as in sociological empiricism). Preferences and constraints are not separated, changes in behaviour tend to be attributed to changes in norms and/or preferences. According to the sociological view, man has not really a choice between alternatives at all; he is propelled by the specific norms and values. The economic view of man is completely different: individuals are attracted by differentials in rewards of alternative actions, and man has the capability of taking advantage of those opportunities which provide the (relatively) highest reward according to the individual's personal evaluation. The amount of information searched for and used is determined by the same principle; it is therefore explained by the model and is not exogenously given.

The model of behaviour used as a backbone in the comparative analysis of institutions is increasingly used in other social sciences, in particular in political science and sociology. The 'rational choice' view, as it is sometimes called, has become a serious contender to the orthodox views of man described above. It has been subjected to extensive empirical tests and has proved to be a most useful tool of analysis. While it fares well compared with competing models of human behaviour it is not yet fully developed. Recently, new major avenues have been explored with the goal of making the economic model of man more realistic and capable of explaining additional types of behaviour. It may be used to sketch some of the major approaches in order to indicate the present limits of research. One may distinguish

efforts to enrich the concept of individual preferences (section 2), and those concerned with the deliberate choice of preferences (section 3) and constraints by the individuals (section 4).

3.2. — Enrichment of human preferences

The *first* direction in which human preferences have been enriched is to strengthen the *motivational basis* of individual preferences. Most such approaches have been disappointing, however, partly because they are unable to profitably transfer psychological theories of motivation into the economic framework, and partly because the introduction of 'psychological' elements proved to be unnecessary for explaining human behaviour. One of the most interesting psychological elements introduced is arousal theory which suggests that a moderate amount of stimulation is liked by individuals. Too much excitement *or* boredom is disliked. This may explain why individuals find it difficult (or impossible) to become happier in an industrial society geared to mass-production.

Another approach strongly relying on motivation is *satisficing* or *bounded rationality* which takes reference points and aspiration level effects into account. Another well known approach is *prospect theory* which considers the fact that risk attitudes are quite different above than below reference points: individual utility is convex for losses and concave for gains.

The *second* direction in which the concept of human preferences has been enriched is to acknowledge that *processes* and associated *procedural rules* may be valued by individuals. This view differs from consequentialist utilitarianism of economist's welfare theory which maintains that only outcomes or end-states matter. Individuals may well feel satisfied when they have followed accepted rules, even if they do not like the outcome. On the other hand, they may well feel dissatisfied if they have not followed generally accepted rules, even if the outcome is favourable for them. The change in view from outcome to process is of great importance for the economic policy problem of influencing individuals when their contributions to the outcome are difficult or impossible to measure. This problem is particularly prevalent in the service sector. In that case it may be necessary to examine how well the individual fulfills the *rules* established to guide the process. The system of rewards and punishments inducing people to observe rules may well differ substantially from those inducing them to produce the best outcome. It may in particular turn out that prices (which are designed to evaluate outputs) are no longer the most efficient reward system, but that administrative procedures are superior. It has been hypothesized that while prices are the most efficient decision-making mechanism when output is measurable, the public sector with its long tradition and expertise for devising rules and procedures for processes may be superior when output is difficult or impossible to measure. So far, this proposition has been empirically tested only partly.

A *third* direction in which the concept of human preferences has been enriched is by introducing *moral* aspects, in particular *altruism*. The traditional approach in economics is to include the consumption or utility of other persons in an individual's utility function. This procedure is problematic because it practically always «explains» observed individual behaviour by attributing an appropriate dose of altruism, making the model immune against falsification.

Another approach recently receiving some attention is to attribute to the individual *two* preference functions, one expressing his selfish desires, the other ethical (social) desires. These preference functions are ranked by a *meta-preference function*. This ability for reflective self-evaluation can be considered a peculiar characteristic of *human* beings. The more traditional economic model of behaviour restricted to egoism is applicable to *both* humans and animals, as has been shown in careful laboratory experiments. According to this view, a model of *human* behaviour requires the ethical dimension and the possibility to think about one's preferences. In some of the literature the two preference functions are associated with (fictitious) *persons* within an individual (say, within Smith): S-Smith is selfish and E-Smith is ethical and values social interests the way he perceives them. An allocation rule for that hypothetical two-person society determines 'ultimate preference'. Up to now, the two-persons approach is purely theoretical and it is not yet clear how much it adds to knowledge and whether it is fruitful for empirical research.

The *fourth* direction in which human preferences have been enriched is to allow them to be *endogenously* determined. There is a large theoretical literature which is, however, of little relevance for the comparative analysis of institutions because it is mainly concerned with the traditional problems of how competitive equilibrium and social welfare is affected. More pertinent is another line of research which is econometrically oriented. The *individual welfare function* approach measures the satisfaction of individuals with their income by carefully designed surveys. A two-parameter welfare function is estimated for each individual. The crucial parameter referring to wants can be explained by *habit formation* (i.e. the consumption of the individual concerned in the past) and by *preference interdependence* (i.e. the consumption of other individuals). The empirical results based on extensive surveys in various European countries suggest that an increase of income over a few years does not increase individual satisfaction. Within three years, the individual welfare function shifts downwards by thirty percent of the initial increase in satisfaction, due to the habit effect. If everyone in the individual's reference group experiences the same rise in income as the individual concerned, the initial increase in satisfaction is reduced by another seventy percent, i.e. the individual is reduced to the same level of satisfaction as before his income increase. The individual welfare function approach has been extended in various direction, e.g. by taking the joint satisfaction derived from personal monetary income and amenities such as natural environment into account.

The various directions in which the concept of human preferences has been extended suggest that the economic model of behaviour is capable of including many different aspects of human action without leaving the general framework of the model.

3.3. — Deliberate choice of preferences

Preferences may be actively chosen by individuals *first* by adjusting to the feasible consumption set. This adjustment may go in two divergent directions: The *sour grape* reaction obtains if an individual recognizes that he is not able to attain a good or service, and therefore reduces his preference for it. The *forbidden fruit is sweet* reaction obtains when an individual raises his preference for a good or service which he cannot reach. Little is known so far about the conditions in which there is adaptive preference formation.

A *second* possibility for an individual to actively choose preferences is *character planning*. Actions are chosen in terms of their effect on future preferences. Individuals engage in an activity (e.g. in a sport such as tennis) because they know that once they have mastered it, they will like the activity.

A *third* possibility for deliberately choosing preferences is to adopt beliefs in order to *reduce cognitive dissonance*. An example are workers in dangerous jobs who often refuse to use the protective devices required by law and offered free by the firm. They prefer to believe that their place of work is (reasonably) safe. This choice of beliefs may be interpreted to be the result of a rational decision: believing that the job is safe yields a *benefit* because the individual is not continually confronted with the unpleasant feelings of fear and doubts about his activity. The *cost* consists in the possibility that an accident may happen because the job is believed to be safer than is really true.

3.4. — Deliberate choice of constraints

The economic model of man has also been extended by explicitly accepting that an individual is *no* superman but that he is 'human' in the sense that he is prone to *weakness of will*. The recognition that man is fallible constitutes an important step towards constructing a more realistic model of man. To acknowledge human weakness is, however, not sufficient: it is equally important to recognize that *man is able to fight against his own weakness*. It is thus accepted that man is irrational in certain respects, but that he is rational enough to act so as to minimize the damage done to himself by that irrationality. For this purpose, individuals may deliberately impose constraints on their own behaviour. *Constraints* are deliberately and actively

chosen by individuals in the case of *strategic precommitment*. The situation is well known from Ulysses who ordered his companions to bind him to the mast in order not to fall prey to the Sirens. He also told them they must tighten the bonds when he begs them to release him as a consequence of his enchantment by the Sirens. In everyday life there are a great number of tricks one plays on oneself to achieve things one should, or to prevent things one should not do. The strategic setting of self-imposed constraints or *egonomics* has become particularly important in the health area, for example when one enters a slimming clinic, paying a (considerable) fee just to be assured that one gets little food. Precommitment is also well known among scholars. Many find it difficult to write or complete a paper if they are not forced by a deadline. They voluntarily choose to be subjected to a deadline by agreeing to contribute a paper to a conference.

The idea of strategic precommitment has been combined with the idea of two sets of preferences belonging to two different «persons» within the individual. The intertemporal conflict between the short-term preference for gaining immediate utility and the long-term preference for the future has been analyzed in these terms. The first person is a *planner* who is concerned with the life-time utility of the individual. The second person is a *doer* who exists only for one period and who is interested in current consumption only. The planner uses psychological instruments in order to influence the doer's behaviour. One such instrument is the imposition of internal rules which the doer is supposed to observe. Strategic precommitment alters the opportunity set (or relative prices) of the doer and therefore gives him an incentive to change his behaviour. The approach has been applied to analyze savings behaviour. Not to consume is difficult. Many individuals know that they do not have the will-power to save; they therefore resort to the planner in themselves to establish firm rules to make them save, for example by automatically having part of the salary transferred to an account over which they cannot currently dispose.

It has been shown in this section that the economic model of behaviour is capable of being extended in various directions, making it more realistic. Improving the *homo. oeconomicus* model strengthens the analytic foundations of the comparative theory of institutions.

4. — *The «comparative» aspect*

Nothing is perfect, everything is deficient: this is the basic attitude of the *comparative* analysis of institutions. There is little point in comparing institutions to an unattainable ideal, as this ideal cannot be reached anyway. The only realistic procedure is to compare existing institutions to other institutions which exist or which can be created. The comparison of realistic alternatives leads to a change in the question posed. One asks no longer: «What is absolutely best?», but rather: «What is relatively better?».

Traditional economics has a completely different orientation. The outcome of the workings of a decision-making mechanism, in particular of the market, is evaluated using an optimality criterion, Pareto-optimality. On this basis it is found that there is «market failure» in the presence of externalities, public goods and imperfect markets (monopolies), and it is often concluded that the government must step in to compensate for the deficiency. However, *every* other decision-making mechanism or other institution is also deficient; there is «government failure», «administrative failure», and «bargaining failure». The substitution of another decision-making system in the presence of «market failure» does not necessarily lead to an improvement since the alternative may be even more deficient. The so-called «Nirvana approach» ingrained in traditional economics is of little help, and may even direct attention in a wrong direction. The comparative view of the modern theory of institutions provides a more relevant view, which is of direct help for practical policy-making.

5. — *What is new?*

The comparative analysis of institutions is a novel approach combining for the first time the study of *institutions* (in the broad sense) based on a well developed theory of *human behaviour* in a *comparative* framework. The constitutive elements are, of course, not new but draw on various traditions in economics and related social sciences. The American *institutionalists* with the leading figures Veblen, Commons and Mitchell stressed the importance of economic institutions such as industrial, labour or monetary organizations. Veblen used the broadest concept of 'institution' by including social rules as habits and customs. The major difference to modern institutionalism is that they consider collective or group institutions, rather than individuals, as the main economic actors. They did not profit from the individualistic economic model of man, nor were they very interested in a strictly comparative approach. This also holds for the German Historical School which clearly preceded American institutionalism. Economists such as Roscher or Schmoller (the leader of the younger German Historical School) clearly saw the importance of institutions in the broadest sense. They sought to understand them by studying their historical development. Present day adherents to the institutionalist school such as Myrdal or Knapp proceed in the same way. Their approach radically differs from the comparative analysis of institutions because they do not amalgamate institutions and individual behaviour.

The comparative theory of institutions has its roots in the *theory of property rights* and in *public choice* or *modern political economy*. These fields share the analytical foundation of neo-classical micro-theory; the theory of property rights being more concerned with legal institutions, public choice more with political institutions. Part of public choice has, however, little to

do with institutions and human behaviour because it deals with the logical problems arising from the aggregation of individual preferences to a social welfare or decision function. (Well-known examples are the paradox of voting and preference revealing processes). Another difference, especially of public choice to the comparative theory of institutions is that the latter is more concerned with policy applications. It stresses that it is not sufficient to devise an «optimal» solution to economic and social problems but that it is necessary to carefully study the *incentives* of decision-makers which are created or destroyed by a particular institutional arrangement. The approach takes it as a matter of course that individuals make an effort to block changes in institutions which they fear are disadvantageous to them (even if they are in the «public interest»). Such resistance is nothing but natural; it has to be taken into account when an institutional change is proposed, for example by suggesting appropriate compensation.

6. — *Relevance for the service economy*

The service sector of an economy is an ideal field for the application of comparative institutional analysis, since it is subject to a great many different institutional arrangements. Unlike many areas of the production and supply of private commodities, the price system is not the dominating decision-making mechanism in Western service economies. A considerable part of services is provided and/or produced by other decision systems: the largest role is played by the democratic mechanism through vote-dependent governments, and by the administrative mechanism through public bureaucracy. Of great importance in many industrial and developing countries are intermediate forms of organization which are neither purely public nor purely private. It is obvious that a comparative view based on a realistic theory of human behaviour is of great help for the study of such new forms of institutions.

7. — *Concluding remarks*

The comparative theory of institutions provides a new perspective radically differing from traditional economics and from social sciences. It has been shown that its distinguishing feature is the combination of institutions, human behaviour and comparison of realistic alternatives. It uses 'hard' analysis without being overwhelmed by mathematics (as large parts of modern economics are), and is strongly empirically oriented.

Research in this new field has so far mainly been concerned with the incentives and consequences of existing institutions. The question of how institutions emerge has received less emphasis, and the respective studies have not been very successful. The general answer provided to the question

of why institutions emerge, the one that they are «efficient», is of limited use as it is not couched in terms of falsifiable propositions. These propositions would have to state under which specific conditions some institutions emerge, some do not emerge, and others are counterproductive. Research has barely started in this direction. This is just one instance indicating that while the comparative analysis of institutions has been able to provide a fruitful approach to social problem, it is a wide-open area capable of being developed further.

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