

Toward a Teaching of Pluralistic Economics in the Netherland Some experience from the Erasmus University Rotterdam

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Résumé

Economics as a social science is heavily debated nowadays. This is not new: ever since economics pretends to be a 'hard' science a number of difficulties have arisen: economics adapts the methods of physics, which is inappropriate for a social science, economics neglects human behaviour which is central to social science, economics makes universal claims, which no partial analysis can, economics has been conquered by mathematicians, which has eliminated the process analysis from the discipline, and many other types of criticism. In Part I of this paper I will briefly discuss those familiar problems, then raise the question how economics could be developed into a real social science, what the consequences for the curriculum would be and how those changes could be implemented. I will add in the second part some remarks about three schools in economics that should be part of a pluralistic approach: Neoclassical economics (NCE), New Institutional Economics (NIE) and Original Institutional Economics (OIE).

I. What is Wrong with Economics and how to Restore it ?

Economics is about the production, distribution and consumption of scarce goods and services. Economics is about how human beings take decisions concerning the allocation of scarce resources. Economics is about the understanding, explanation and prediction of those issues: what is the optimal scale of production, what is the efficient mode of organisation of the transaction of labour, what is the necessary role of government in market economies, what...etc. Economics develops theories in order to structure complex realities so we can better understand the complexities around us; economics also develops theories for explanation which is more pretentious and in the end economists would like to predict. Understanding, explanation and prediction are related, but not necessarily always part of science. Economics could also be satisfied with understanding alone. The point is that for realising for example predictions about firm's choices, or outcomes at sectoral level, or macro variables, the theoretical constructs have to be extremely abstract (so-called single exit situations, see below); for the purpose of understanding the theoretical model can be more realistic and can allow for 'multi-exits'. In other words: for different purposes, issues, and problem definitions one should make use of different type of theories. Example: for issues of a comparative static nature, transaction cost economics is appropriate, whereas for dynamic issues like the change of the structure of the firm, evolutionary economics is needed. What is wrong with economics is that the mainstream claims to be relevant for all economic issues.

Another problem concerns the claim of relevancy of economics under all possible conditions: the law of diminishing returns holds in Japan, France and the US, it holds now and 2000 years before Christ. Specific institutional conditions of time and place are irrelevant. What is wrong with mainstream economics is that specific institutional contexts do not matter.

If it is recognised that different issues demand for different theories and that different conditions demand for different theories, then 'pluralism in economics' is at stake. What is wrong in economics is the lack of pluralism.

Below I first discuss how pluralism can be introduced into the curriculum.

Towards a pluralistic economics.

When classical economics was succeeded by neoclassical economics the scope of analysis was narrowed down to marginal analysis. Followed by models of monopolistic competition and oligopoly, economics was further narrowed down to so-called single exit situations (Latsis 1976). The movement of American institutionalism had never been strong and faded away after WWII. Both at the level of micro economics and macro economics neoclassical economics have dominated ever since. Keynesian economics was reduced to mechanical relationships. All this seemed to change in the mid seventies with the arrival of new institutional economics: game theory, agency theory and certainly transaction cost economics allowed for uncertainty, different type of agents and process analysis. Below it will be explained that now we have to conclude that the new institutional economics is an important development in economics, but that it belongs to the same paradigm as neoclassical economics. The other paradigm that is needed for understanding, explaining and probably predicting economics is the one of the so-called original institutional economics (OIE).

The bachelor-master programmes at the Rotterdam School of Economics (RSE)

As off September 2002 the RSE will offer a bachelor programme 'Economics and Business', indicating that both general economics and business economics are part of the programme. The bachelor is trained in such way, that she controls both mainstream economics at intermediate level and the modern schools of new and original institutional economics as well. The basics are taught in the first two and a half years, which are mainly taught in Dutch and students have no choice. The second part of the third bachelor year students can choose out of a wide variety of economic, but also non-economic topics offered in national or international programmes. After the bachelor the student can follow master programmes, which specialise in a specific domain (marketing, finance, organisation, etc.), or combine economics with another discipline like law, political science (social economics), or opt for a more general programmes in which the students select a combination of their own interest to be subject to approval of the curriculum committee.

Below it is discussed how the implementation of pluralism in economics is attempted for. This has an aspect of administration and of content.

The introduction of pluralism from an administrative point of view.

New administration of the department.

To implement major changes in the curriculum a decision making structure is needed which allows for consultation, but which also offers the dean the possibility to take decisions. That sounds obvious, but in the Dutch context it is not. What was the situation a couple of years ago? Like in most countries the sixties of the last century had resulted in all kind of democratic councils responsible for the administration of the department. The professors, being the experts in a specific domain of their appointment and by law being extremely autonomous, had gradually eliminated the democratic institutions at decentralised level (vakgroepen en vakgroepsraden), whereas at central level the faculty council had blocked most of the decision making power of the board. The faculty council was, because of changing coalitions, not able to develop a clear policy, whereas the board could not do much more then ratify the weak compromises of the council. The result was a faculty of islands of expertise, which were not to be coordinated in terms of research programmes and curricula. Those autonomous kingdoms developed in highly respected expertise centres, but the university, faculty and department as a whole was not a coherent institution. With respect to the curriculum of economics this resulted into a programme with good and sometimes excellent courses, but in general characterised by a lack of consistency. The programme was also dominated

by mainstream economics, which is to be explained in the same way as Thomas Kuhn explained the maintenance of paradigms in his 'structure of scientific revolution'. The paradigm of neoclassical economics dominated the committees that appointed new staff, that discussed the programmes, etc.

With respect to the decision making structure of the faculty important changes took place recently: in the Netherlands the so-called MUB (Modernisation of University Administration) has created the following structure:

- the dean is the only one responsible like a CEO
- the council is only advisory
- the dean appoints two vice deans: one for research, one for the programme (director of studies), who operate under the dean's responsibility.
- the director of studies decides about and determines the 'demand side of the market'. He is responsible for the consistency and quality of the programmes.
- the supply side of the market is in the hands of the so-called 'capacity groups', who organise the supply in a specific domain.
- that internal market is an organised markets with 'relational contracts', which are embedded in carefully constructed consultation structures (Dutch Poldermodel)

In this new administrative structure it is formally possible to intervene in the programme from a central point of view, but this will be only materialise after broad consultation (also the university is a learning organisation subject to path dependent developments and small room to manoeuvre).

The content of a pluralistic bachelor in economics

The growing criticism on economics has driven the debate at the RSE into the direction of pluralism: next to the basics of mainstream economics, the student should be well trained in institutional economics as well. The programme ought to include well the foundations of economics: the Philosophy of Science in general and of economics in particular, the History of economic thought, the Economic history and the Methods and Technics. Then the programme should include the intermediate level of mainstream economics, including new institutional economics, also the programme should include the other paradigm of heterodox, institutional, or social-political, evolutionary economics to be subsumed under the label Original Institutional Economics (OIE) and finally the programme in the bachelor should touch upon issues of multi-disciplinarity.

The implementation of the changes

To implement a fundamental change into an existing programme is a difficult thing to do. Although the formal decision procedure is installed, it is necessary that the proposed changes are accepted broadly in the faculty community. So a lot of attention should be paid to communication and consultation. At the same time one should organise the programme in such a way that during the trimesters moments are available to integrate subjects and to have students work on cases in a pluralistic setting. For that reason the RSE have reduced the number of courses available for individual subjects like micro, finance, etc. to reserve short periods for the integration of the theories and to apply these jointly to a case. Automatically the relevancy of economic theory for specific issues and under specific conditions will be shown, which stimulates pluralistic thinking. Gradually the relevancy of the different schools in economics can be made more explicit jointly with historical, methodological and instrumental aspects. So far about the administrative and content sides of the issue of pluralism in economics.

Personally I consider NIE and specifically Transaction Cost Economics (TCE) as an appropriate vehicle to demonstrate the essentials of the different streams of thought in economics and to

demonstrate with empirical cases the idea of 'different theories for different issues' and 'different theories for different conditions'. Below I deal in more detail what to my opinion NCE, NIE and OIE are about.

II. The styles of NCE, NIE and OIE

1. *The style of neoclassical economics*

Values and objectives

What is the purpose of the neoclassical style? The heart of NCE is General Equilibrium Theory with the Arrow-Debreu model as the symbol. The objective of NCE is not positive, but normative: to predict optimal outcomes of processes that result in equilibrium. The theory is designed to predict optimal end states (Blaug 1998).

Technique

The technique used for realising the objective can be summarised as 'create single exit situations' (Latsis 1976). For that purpose actors are substantive rational and able to calculate ex ante optimal positions. The actors are positioned in a crystal clear environment (market structure) that leaves only one option open to the actors: the optimal one. Otherwise the actor will not survive (cost too high, price too high, no survival of the fittest). In other words: a specifically constructed actor, with a specific motive (maximise utility/profit), placed in a specific environment cannot do anything else than calculate the one and only optimal position.

Principal-agency theory belongs to this same, normative methodological individualistic approach¹. The only difference is information asymmetry and opportunistic behaviour, but because of substantive rationality the problem of "hidden action" can be solved by complete contracting.

Limitations

Because the assumptions are very abstract the explanatory power of the theory is limited. Conventionalists like Friedman and Machlup do not bother: the taste of the pudding lies not in the ingredients, but in the predictive power of the theory. As long as the predictions are not falsified, the theory works. Latsis (1976) demonstrates how questionable testing in economics is (in case of falsification the reaction mostly is that such a situation is 'bad for the facts'). The famous 'ceteris paribus clause' offers too many possibilities to ignore 'non confirmations'. Often correlations are shown, but what does a theory explain when the assumption about behaviour and information is totally different from reality and the hypothesis is not falsified? Correlations do not show causalities. The question of the 'realisticness' of assumptions can also be formulated in terms of relevancy of the theory (Groenewegen and Vromen 1996): when is a specific theory relevant given the empirical conditions at hand? Neoclassical economics claims universal relevancy, but we will see that 'modern' micro-theory, like new institutional economics, accepts the fact that 'all purpose' theory cannot exist and that the relevancy of the theoretical building depends of the correspondence with the conditions at hand. We will see below how Williamson wrestles with that problem.

Development

The conclusion of Latsis (1976) that mainstream neoclassical economics is degenerating has been supported recently by many authors (see Blaug 1996 for a summary). In short: too much mathematical rigour and too few causalities are explained. 'Autistic economics', which concentrates on the control of the technique has become a perfect example of *'l'art pour l'art'*: "there is much

economic theory that is pursued for no better reason than its intellectual attraction; it is a good game"(Hicks 1979, VIII)

ⁱ Two streams of thought are distinguished in agency theory: the normative one which deals with optimal contracting and the positive one which focuses on explaining contracts in real markets. The latter version does not belong to the neoclassical school, but is more part of institutional economics.

2. *The style of new institutional economics*

Values, objectives

The objective of NIE is to explain the institution that coordinates transactions, like in our case the supply of an intermediate good. Why are firms coordinating the transaction internally and not via a market contract with a supplier? The production function (NCE) and normative contractual approach (agency theory) do not open the box of the firm as an organisation; NIE does. At least the question is raised why transaction are organised by different institutional arrangements like contracts, hierarchies, or hybrids.

Two streams can be distinguished (Rutherford 1994): the formalist (game theory) and literary (transaction cost economics) style.

Game theory

In the case of game theory the technique works as follows (Schotter 1994):

- "game theory allows us to describe and analyze social and economic situations as if they were games of strategy
- a game of strategy is an abstract set of rules that constrains the behaviour of players and defines outcomes on the basis of actions taken by the players
- the rules specify: who the players are, the order in which the players will make their moves and the choices that will be available to the players, as well as the information the players will have when making their moves. Finally the rules specify how much utility each player will receive depending on the choices of all players in the game".

Following among others Hodgson (1988) and Blaug (1998), we conclude from the work of game theorists that it belongs undoubtedly to the neoclassical school (methodological individualism, deductivism) and that general equilibrium theorising has been replaced by a modern version of 'single-exit-theorising'. When the game is played as a one-shot cooperative game in which the pay-offs are expressed in an one-dimensional variable, game theory 'predicts' the optimal equilibrium solution. In non-cooperative repeated games with multiple equilibriums, game theory is not able to predict one optimal outcome anymore and is in need of additional information in order to reason what type of equilibrium is to be expected. Institutional conditions and historical paths of development then become necessary complements to game theory. Aoki (2000) is a good example of an economist, who applies the fundamentals of game theory to actual issues like the question about the convergence of economic systems and who is very well aware of the complementary information of especially historical nature one needs in order to explain why out of the multiple potential equilibria a specific one has or will come about. In the words of Rutherford (1994,21):

"It is, however, important to realize that institutional detail is often required in order to obtain a deterministic solution to a game".

Without doubt game theory has contributed to the understanding of the underlying mechanisms, but without complementary information about institutional conditions game theory leaves many questions unanswered.

Transaction cost economics

The *purpose* is to explain governance structures that match specific types of transactions. Why are specific transactions coordinated inside hierarchies and others via market contracts? Why do internal labour markets exist and why are for some financial transactions external markets used?

The *technique* of TCE can be summarised as follows:

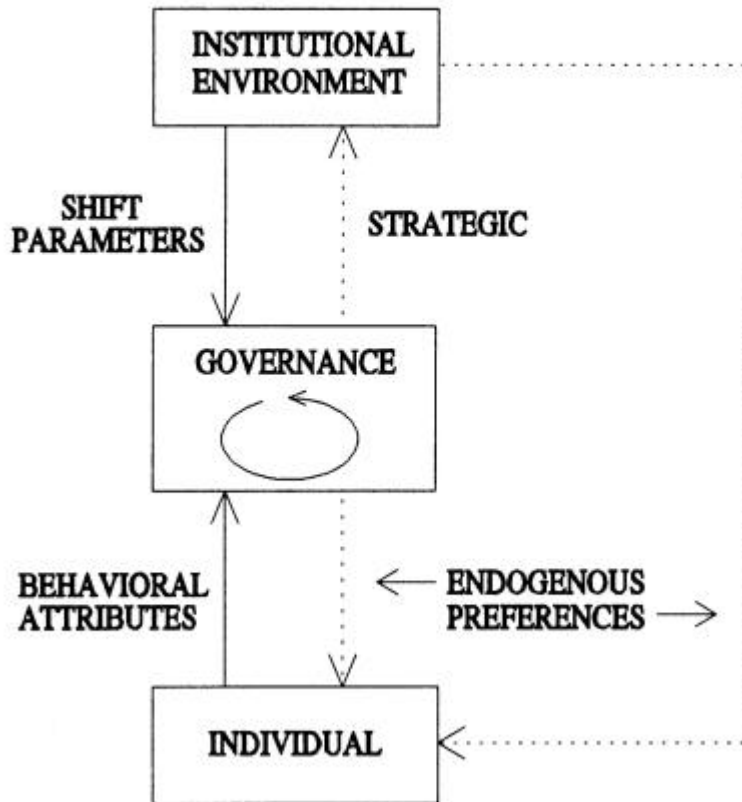
- the basic unit of analysis is the transaction
- identify potential governance structures, like vertical integration, a classical market contract or a hybrid like a subcontracting relation
- make plausible matches of types of transactions with governance structures using theoretical insights from TCE concerning asset specificity, opportunism, safeguards, farsightedness, and the like. Transaction ‘A’ will be matched with governance structure ‘X’ because of cost economizing reasons
- test by means of confirmation, assuming that a selection mechanism selects ex post the most efficient governance structure
-

How has TCE *developed* since the mid –1970s?

Because of the introduction of bounded rationality next to opportunism, complete contracting is not possible anymore. The big change compared to neoclassical economics concerns this incomplete contracting. Then safeguards, higher prices or refusing transactions, become understandable (compare Maston 1996). Although TCE has proven to be useful for understanding organisation of economic transactions from an economic perspective, two important limitations have become clear over the years.

The first limitation of TCE concerned the impossibility to explain different governance structures in case of identical transactions. Why is the transaction of an intermediate good with identical characteristics in terms of asset specificity, frequency and uncertainty in Japan coordinated by means of a subcontracting relation and in the US inside a hierarchy? There should then be an extra explanatory variable, which was first put aside by Williamson (1975) in the ‘atmosphere’, but later explicitly taken on board as the ‘institutional environment’ (Williamson 1996) . In figure 2 the solid arrows indicate the relationships that are part of TCE explanations; the dotted arrows indicate relationships that certainly exist in reality, but which are no part of TCE analysis. I will come back to these relationships when OIE is characterised.

Figure 2.1 A Layer Schema



Source: Williamson 1996

The second limitation of TCE concerns its static nature: TCE is only appropriate for comparative static analysis. Economic issues of dynamics, processes, analysis of adaptation, are not within the reach of TCE. Williamson (1996 and 1998) extended the model in such a way, that he claims nowadays that TCE is capable to handle economic issues of dynamics, strategy and processes (Williamson 1998). Four concepts (farsightedness, selective intervention, remediableness, and system analysis) illustrate his position and also make clear that stretching the model in that way in order to serve new purposes can cause serious flaws in the theory itself.

Farsightedness

Central to TCE is the governance structure of the contract and organisation. Anticipating, farsighted actors foresee future opportunism and create safeguards. So time, the future, is incorporated. Lindenberg (1996) pointed to a conceptual inconsistency here: how far can actors look ahead? Not far enough for complete contracts, but far enough to select the most efficient ('fitter') governance structure? Without further knowledge about the actors, their perceptions, the complexity around them, etc, it is not possible to decide what to assume about the nature of farsightedness in specific cases. In other words: in some cases farsightedness is a realistic assumption, but in other situations is definitely not; institutional, historical and cognitive conditions matter and should be incorporated in the analysis.

Remediableness

Although the concept of farsightedness might suggest otherwise, Williamson did not develop his theory into the direction of 'ex ante selection of the fitter'. Ex post selection of the fitter is central to his approach, but as he noticed himself in 1985 'a theory of selection is missing'. That is still the situation of today; when one concludes that actors are able to 'remedy' inefficient governance structures and are able to replace them by more efficient ones (due to bounded rationality these are 'fitter' and not the 'fittest'), then such an explanation of existing governance structures demands an insight into the selection process. Additional information about the conditions in order to be able to conclude about the possibilities of actors to select the fitter. Or the Test of Time is accepted: because a specific governance structure exist for a considerable period it has to be the 'fitter' (What is, is best).

Selective intervention

Every governance structure is efficient for specific transactions and less efficient for others. However, selective intervention in the sense that for every transaction a specific governance structure can be selected, is in reality hardly possible. Mostly discrete choices have to be made resulting in, for instance, hierarchies, that have to coordinate a variety of transactions. For some of these transactions the hierarchy will be less suitable, because for instance it misses high powered market incentives. However, once decided to have a hierarchy also that specific transaction has to be coordinated inside that hierarchy. Selective intervention in the sense of selecting the optimal governance structure for every specific transaction simply is not possible.

System analysis

Governance structures like firms are systems in which different elements are related. Changing one element because of transaction cost arguments, can be inefficient from a system perspective, because in systems different elements are 'institutionally interlocked' (Dore 2000, Aoki 2000).

According to Williamson TCE has demonstrated a progressive *development* over the years. It started as a comparative static analysis explaining the dichotomy of markets and hierarchies and nowadays it is able to accommodate strategic decision making and the process of institutional development.

"What I should like to emphasize are that 1) theories of organization that feature adaptations should not be described as 'static' and 2) theories that rely on administration to accomplish cooperative adaptation (sometimes by fiat) are very definitely concerned with 'management'. The upshot is that transaction costs economics is very much an intertemporal, adaptive, managerial exercise- although this is not to say that more dynamic theories or more prominent provisions for management are unneeded" (Williamson (1998,33).

In 1975 TCE was presented as an universal theory applicable to all places and times; in 1993 the role of the institutional context was explicitly recognised and from that moment on the relevancy of TCE was (also by Williamson himself although mostly in a rather implicit way) made conditional of the conditions at hand.

In recent publications Williamson indicates when TCE is more relevant for understanding economic issues than other approaches.

Referring to issues of make or buy Williamson (1998,30) states:

"As compared with other interesting contracting issues – for labor, with consumers, as for capital- contracts between firms in intermediate product markets have the advantage that the two parties can be presumed to be risk-neutral and roughly, to be dealing with each other on parity. Each has extensive business experience and has or can hire specialized legal, technical, managerial, and financial expertise. Attention can therefore be focused on the attributes of the transaction and the properties of the alternative modes of governance- rather than be deflected by differential risk aversion or by competence disparities between the parties (as might arise, for example, with contracts between firms and inexperienced consumers)".

In other words: TCE is more relevant for understanding transactions of intermediary goods in situations where farsighted, well informed actors negotiate contracts in competitive situations. Actors are then equal, of the same nature and have a similar perception of the world and have also access to the same objective information. This fits well in a positivistic (knowledge is objectively available) and methodological individualistic (independent actors) framework. For situations in which these conditions are not fulfilled TEC is a less relevant approach.

3.The Style of Original Institutional Economics (OIE)

Objective

The purpose of the framework of OIE is to understand processes of change, of institutional development (Bush 1991). Not the prediction of an optimal end state is the objective, but the understanding of complex processes of institutional dynamics.

According to the OIE the relations to be investigated are depicted in figure 2, but then the dotted arrows have to be considered as solid ones too. Another way of presenting the complexity at which OIE is focused, is the four layer schema of Williamson 1998. In figure 4 the 'economics of institutions ' is presented showing that the governance structures at level 1.3 (where the make or buy relations in the *keiretsu* is located) are connected with the broader institutional context. Williamson (1998, 26) on the interdependences between the levels:

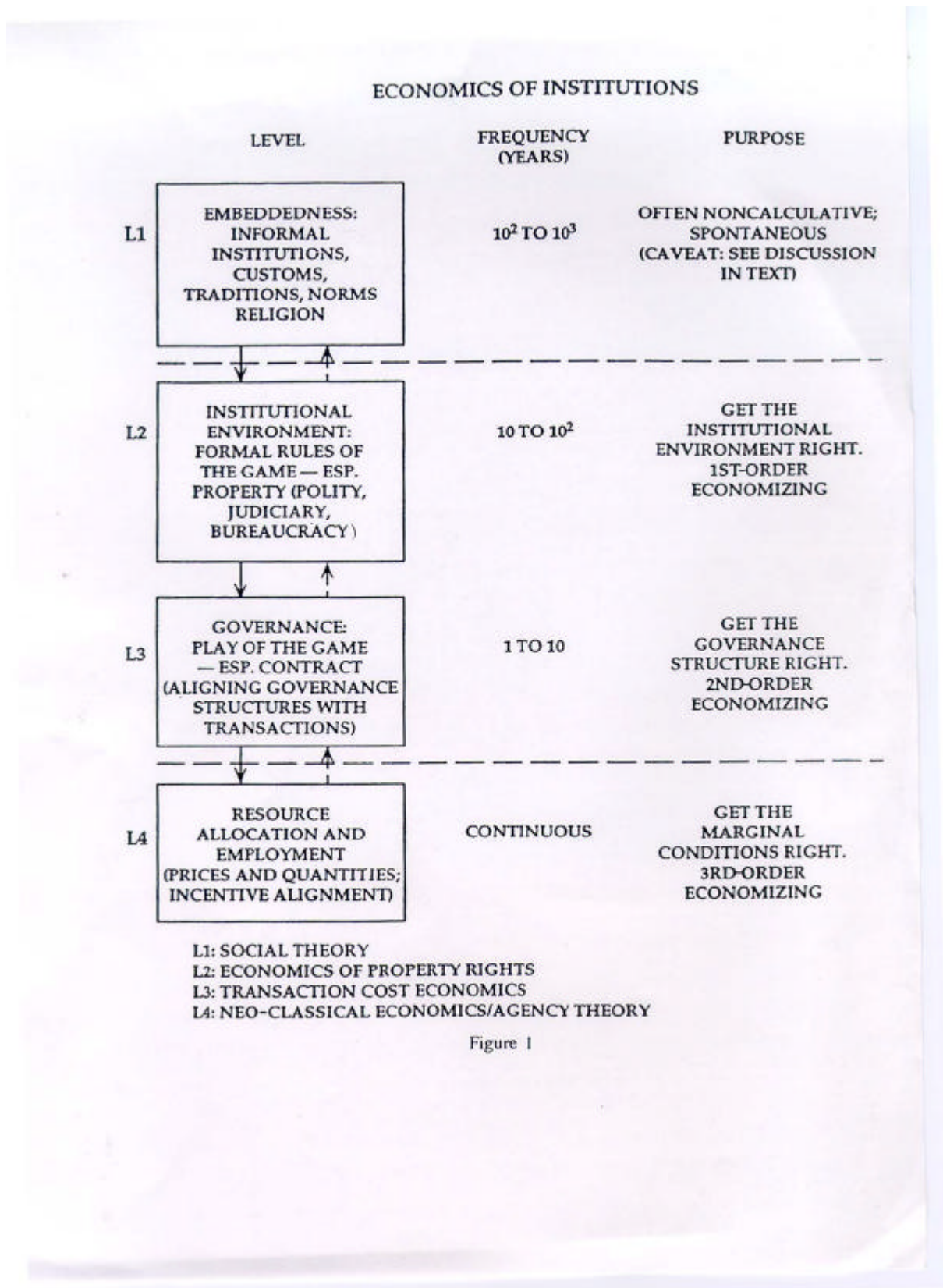
"Although in the fullness of time, the system is fully interconnected, for my purposes here, these feedbacks are largely neglected".

To neglect those interconnections is exactly what the OIE wants to avoid.

"The economy is an open and evolving system, situated in a natural environment, effected by technological changes, and embedded in a broader set of social, cultural, political, and power relations".

(Hodgson, 2000, 2)

This has implications for the modelling of the actor: methodological individualism is replaced by methodological interactionism (Agassi 1975).



Source: Williamson 1998

The idea of methodological interactionism is discussed in Agassi (1975) as 'institutional individualism' about which Rutherford (1994, 36) reports:

"where it is recognized that the social whole is more than a simple aggregation of individuals, and that the social context influences and conditions individual behaviour, while at the same time insisting that "full" explanation in social science should contain a specification of the mechanisms through which individual behaviour generates the social phenomena in question".

By endogenising the relation between individual and institutional environment the OIE is now capable to grasp variables like power, learning, perceptions and path dependency (David 1985, Tool 1988).

Technique

All styles abstract from reality and try to get hold of the essence: 'drawing is leaving things out', but that is done differently by the different styles. Likewise the techniques differs. The technique used by the OIE is very different from NCE and NIE, because the purpose of this style is very different. OIE technique is often presented as the so-called pattern model of which the basis is to be found in Kaplan (1964) and Diesing (1971).

An important distinction in OIE is between general and specific theory: at the general level abstract coherent theories can be distinguished which are nicely organised in separate disciplines: sociology, political science, economics, etc. The moment specific issues have to be analysed, like for instance the relationship in the Japanese keiretsu, one is forced to make general concepts specific with specific conditions of time and place. In doing so it is unavoidable to incorporate different explanatory variables from different disciplines: the analysis becomes inter-disciplinary.

Another important aspect of OIE technique is related to the rejection of positivism: with the theoretical structures reality is 'constructed' (Nooteboom 1993). With the 'mental maps' (Denzau and North 1994), with 'categories', the world is interpreted. In finding out what motivates people, why certain habits and rules guide behaviour and what the perceptions are that structure peoples 'reality', the steps of the technique of the pattern model distinguished by Wilber and Harrison (1978) can be helpful:

"The first step (...) is the 'socialization' of the theorist (...) the participant-observer attempts to remain close to the concrete form of the system (...). In remaining close to the reality of the system studied, the theorist is in a unique position to receive a wide variety of recurrent themes (importance of ceremony, target profits/mark-up pricing) that appear in a variety of contexts (...). These themes may take the form of an accepted practice (ceremonies), a cultural norm (conspicuous consumption), or a particular mode of production (competitive capitalism)(.....) The researcher constructs tentative hypothesis about parts of the system out of recurrent themes that become obvious to him or her in the course of the 'socialization process' (....) These hypothesis or interpretations of themes are tested by consulting a wide variety of data (previous case studies, survey data, personal observations, and so forth). (....) " we know the reason for something when we can fit it into a known pattern".

The pattern model is very different from the closed neoclassical models:

"However, since new data are constantly coming in and since the system itself is evolving, the model is constantly being revised and can neither be completed nor rigorously confirmed.

Again: the purpose is to get hold of the dynamics of the whole:

.....the techniques of observation and concept development should be such as to somehow capture and express this holistic quality".

(Rutherford 1994, 16)

Out of that type of research prototypes can be distilled that can help to structure the complex 'fullness of interdependencies' demonstrated in figure 4 (Groenewegen 2000).

Limitations and development

There seems to exist a trade off: the theory is very abstract and rigorous and limitly relevant for understanding specific situations, or the theory develops concepts close to reality and then it loses rigour. In that trade off NCE clearly chooses for rigour, NIE also but the TCE branch is willing to stretch the model beyond its limits, whereas OIE favours relevancy and realisticness at the cost of rigour. That made OIE the black sheep in the family of economists (see Coase 1984).

Institutional economics: from black sheep to white knight

Different styles produce different insights into the same issue. An important question then becomes the relevancy of the different styles. This depends on the type of question asked (does the issue fit the purpose the style was developed for?) and the conditions at hand (do these correspond with the situation assumed in the theory?). Basically the NIE (with differences between game theory and TCE) stays within the style of NCE: positivistic, methodological individualistic, information asymmetry/opportunism, optimal situations (fittest or fitter), no radical uncertainties, but calculable risks. It is interesting to see that developments in game theory and TCE drives research to the question: 'what determines then the outcome in reality if theoretically several possibilities exist?' Or: ' what are the institutional conditions at hand so I can argue which theoretical framework is a good 'lens to start with' (Ormerod 2000). Without knowledge of that kind of institutional specificities, NCE and NIE do provide insights in underlying mechanisms , but with respect to the understanding of real causalities these styles are more or less floating around. Only when historically grown institutional specificities are well described it is possible to understand why a specific path of institutional evolution occurs. In that sense OIE, that claims to provide those institutional insights should not be considered a black sheep, but a necessary complementary white knight saving economics as the queen of social sciences.

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