

**Marian Noga**

Wrocław University of Economics

---

## METHODOLOGICAL INDIVIDUALISM VERSUS HOLISM IN INSTITUTIONAL ECONOMICS

---

**Summary:** In this paper, the author presents his hypothesis about complementarity between methodological individualism and holism, arguing that there is not one view regarding the application of those methods of economic research. Therefore, positive verification of this hypothesis is a basis for the conclusion, in which the author confirms that the paradigms of mainstream economics have to be modified and include the research of institutional economics.

**Key words:** methodological individualism, holism, institutional economics, paradigm of mainstream economics.

### 1. Introduction

The school of institutional economics is not a uniform direction. The streams of institutional economics have their roots and sources of inspiration already in the German and English historical school. If the streams of institutional economics are to be understood as an economics alternative to the mainstream economics, which widely uses the category of institution in its analyses, the following are distinguished in contemporary economic thought:

- a) institutionalism and neo-institutionalism;
- b) theory of public choice;
- c) new institutional economics (NIE) comprising:
  - theory of agency,
  - theory of property rights,
  - theory of transaction costs;
- d) new economic history [see Sobiech, Woźniak 2005, p. 134].

Individualism and neo-institutionalism introduce methodological holism to the analysis of economic reality, as a method of holistic recognition of economic phenomena in the always defined historical, social, and cultural context. NIE, in turn, proposes to “leave” the methodological individualism as a research method for the economic reality, which is a postulate of a specific synthesis of neo-classical economics and institutionalism.

In the relevant literature, this “rupture” in the heart of institutional economics is widely discussed and very often demonstrated as a juxtaposition of the holistic recognition of economic phenomena proposed by the classical institutionalism and the stance of methodological individualism, which assumes that all economic phenomena and processes and the corresponding economic categories should be possible to derive (deduce) by the “last instance” from the economic behaviour of individuals, that is micro-economic entities, which is proposed by NIE.

“There are no two institutionalists that agree on the essence of institutionalism” [Sobiech, Woźniak 2005, p. 135]. This induced me to seek the solution of this problem related to the methodology of researching the economic reality by institutional economics. The aim of this paper is to make an attempt to answer the question whether the methods of the economic reality proposed in the heart of institutionalism with use of methodological holism are mutually complementary, which permits incorporating institutional economics achievements into mainstream economics and modifying the paradigm of mainstream economics.

## **2. Institutionalism versus neo-classical theory and mainstream economics**

There is no doubt that the “old” institutionalism of T. Veblen, W.C. Mitchell, and J.R. Commons emerged as a specific criticism of the research of the economic reality proposed by the classical scholars, such as A. Smith, D. Ricardo, and the neo-classical scholars (J.S. Mill, J.B. Say, A. Marshall, L. Walras, C. Menger, A.A. Cournot, V. Pareto, etc.). The streams that emerged later in the heart of institutional economics: neo-institutionalism (J.K. Galbraith, G. Myrdal, A.G. Gruchy, C.E. Ayres, K. Polanyi), new institutional economics (J.M. Buchanan, G. Tullock, A. Downs, M. Olson), and new economic history (cliometrics – R.W. Fogel, D.C. North) also critically referred to the concept of neo-classical recognition of rationality of management and management analysis in general. Although the stream of institutional economics is not uniform, the following differences between this entire stream and the neo-classical school may be indicated:

- lack of satisfaction with a high level of abstraction in the neo-classical theory, particularly with the static climate of the orthodox theory of prices;
- need to integrate economics with other social sciences;
- lack of satisfaction with the random and non-methodical empiricism of the classical and neo-classical researchers, manifested in the calls for conducting more detailed academic research;
- demand for increased social control over economic activity and forming attitudes promoting state interventionism [Blaug 1994, p. 710].

Those differences determined by Mark Blaug, in my opinion, do not concern all streams of institutionalism since, e.g., NIE wanted to decrease the intervention of the state into the economy to a minimum and in this sense the fourth point does not apply

to NIE. In addition, M. Blaug argues that institutionalism has not provided a good alternative to the neo-classical economy, so it gradually “left the stage” [Blaug 1994, p. 712]. Further Blaug writes: “... in order to overcome an old theory a new one is necessary; the mere devastating criticism of the assumptions and gathering of new facts will not suffice” [Blaug 1994, p. 712].

I consider the foregoing reasoning as erroneous because of the following reasons. Firstly, the results of the research on institutional economics do not necessarily form a new economics paradigm since it suffices to modify the mainstream economics paradigm. Secondly, Mark Blaug assumes *a priori* that the methodological holism accepted by the majority of economists from the institutional school is (absolutely) substitutive in relation to the methodological individualism being the basis of research on the economic reality in the neo-classical school. In this paper, I am going to prove the foregoing wrong, i.e., methodological holism is complementary with methodological individualism. Therefore, the occurring differences, e.g., between the neo-institutionalists and NIE representatives in this respect, do not bring about a “split” in the contemporary institutionalism. Obviously, this does not mean that institutionalism is a uniform theory of contemporary economic thought, developing outside mainstream economics.

At this point, I would like to present both the common features of the main streams of institutionalism and the differences between them:

a) Management always takes place in a specified historical, social, cultural, and political context. The use of the models of *homo oeconomicus* in research on the economic reality is as legitimate as research on *ceteris paribus*. However, it is difficult to use the classical *homo oeconomicus* model, since it is difficult in the contemporary world, in the era of globalisation, to isolate individuals from the cultural, historical, social context, etc. The ambiguity of defining, e.g., what is and what is not a cultural context does not mean that such a phenomenon does not occur and that it should not be taken into account in economic research. Obviously, this creates the need to conduct interdisciplinary research.

b) Influence on management and the effectiveness thereof is exerted by institutions. Although there is no single generally accepted definition of an institution, the definition by Douglass North is quoted by almost everyone in the literature. The writer defines the institutions as the rules of the game or more formally – humanly devised constraints that shape human interaction. As a result they provide the incentive structure in the interpersonal exchange: political, social and economic. Institutional changes shape the evolution of societies in time and therefore they constitute the key to understand historical transformations [North 1990, p. 3; after Stankiewicz 2007, p. 55]. Representatives of all streams of institutionalism believe that the effectiveness of management hinges on the institutional framework of management and social capital is a significant factor of economic growth.

c) Institutionalists, neo-institutionalists, and NIE representatives wish to change the main economics paradigm, since it is *de facto* a paradigm of neo-classical

economics. At this point, I would like to emphasise that a change of the paradigm does not need to mean the rejection of the paradigm of the mainstream economics, since a significant modification of mainstream economics may be made here by incorporating the results of the research of the institutional school. This is my conclusion resulting from the analyses of various works of the institutionalists, who have varied convictions on the same topic.

**Table 1.** The points that divide the institutionalists

No.	Problem	Institutionalism and Neo-institutionalism	NIE
1	Method of research on economic reality	Methodological holism	Methodological individualism
2	Scope of state interventionism	Broad intervention of state into economic processes	Limiting intervention of state into economy to minimum
3	Source of institutional framework of management	Institutions shaped by culture, politics, and other interpersonal relations	Institutions shaped by exchange of goods and services, i.e., by market
4	Changes in operation of institutions	Ineffective institutions are changing and disappearing under the influence of the interaction of culture, politics, and history	Ineffective institutions are disappearing as a result of competition

Source: author's own work.

While analysing the common features and differences in the heart of the institutional school, it can be noted that, firstly, all streams of the institutionalism school propose the holistic approach to the researched economic phenomena, which means that a managing entity always acts in a defined historical, social, cultural, and political context.

Secondly, the primary difference in the institutional school is the NIE representatives adhering to methodological individualism in research on the economic reality, while the remaining streams of the institutional school propose the use of methodological holism in the economic research.

Thirdly, the occurrence of differences in the methodology of research on the economic reality in the heart of institutionalism, in my opinion, is not a ground for a "split" in the institutional school. Although the fundamental assumptions of NIE and the methodological individualism proposed by the economists of this stream constitute a postulate of a specific synthesis of institutionalism and neo-classical economy, this only confirms my hypothesis that institutionalism does not propose to replace the paradigm of mainstream economics (the neo-classical paradigm) with another one, only to modify it.

Nevertheless, a scientific problem to solve is to answer the following question: Is methodological individualism as a method of research on the economic reality

a substitutive or complementary method in relation to methodological holism? To answer this research question is the aim of this paper.

### 3. Complementarity of methodological individualism and methodological holism

M. Rutherford argues that methodological individualism is defined by the three following statements:

- a) Only individuals have goals and interests.
- b) The social system and its changes result from the actions of individuals.
- c) All serious sociology phenomena can be ultimately explained in the approach to such theories that deal with only individuals, their mood, resources, and mutual relations. In philosophy this process is defined as reductionism [Rutherford 1996, pp. 27-32; Stankiewicz 2007, p. 70; Noga 2009a, p. 11].

In the relevant literature only the first statement does not arouse major opposition. However, the other two require a comment. Each managing entity acts in a defined social, cultural, political, and historical context. Even if we assumed that the entity itself defined its goals and interests, that entity does not act in isolation from other entities and then the phenomena of enterprise, competition, and innovation arise, as well as interpersonal and inter-organisational relations. Teams of economic activity are created, and compete and co-operate with one another. Own undertakings are compared with market undertakings. Interpersonal and inter-organisational relation networks come into being [Olesiński 2010, p. 7]. If the Internet is added here, then the second statement is untenable, since the actions of networks, organisations, and the Internet determine the actions of entities, not conversely.

The third statement is an example of a structural analysis, where the compound phenomenon can be always divided into parts and specify the relations between the parts and between the parts and the whole. This does not mean the superiority of the entity over the whole. W. Stankiewicz defines methodological holism also with use of three statements, i.e.:

- a) The social whole is bigger than a part thereof.
- b) The social whole significantly affects and conditions behaviours or operation of a part thereof.
- c) Behaviour of individuals should be deduced from general or social matters, intentions or forces that are *sui generis* and apply in a social system as a whole and to the position (or function) of individuals inside this whole [Stankiewicz 2007, p. 68].

The foregoing statements of methodological holism arouse heated discussions in the relevant literature, in particular, concerning the limits of the autonomy of an individual, the cohesion of a social group, the concept of the socialised human (*homo socialis*). In my opinion, the third statement is also an example of reductionism, such as the third statement by Rutherford, concerning methodological individualism. M. Blaug argues that methodological individualism is substitutive in relation to

methodological holism and rejects methodological holism, since the latter does not take into account the freedom of an individual as the superior value [Blaug 1994, pp. 699-712]. This is an example of an extreme form of methodological individualism and we may well formulate an extreme form of methodological holism, where the superiority of the social group over the individual occurs. Therefore, the relevant literature postulates attempts to reach a compromise between both methodologies.

W. Stankiewicz argues that the following concepts are the case:

a) “Global supervenience”, which means that a holistic nature of social concepts is assumed as the “hard core” in research on society, but at the same time it is assumed that the domain of individual facts is more fundamental than the domain of social facts.

b) “Institutional individualism” emphasises the impossibility to embrace and explain all the relations in research, and therefore out of necessity research embraces selected relations and limited judgements. The endogenisation of all institutions to a theory based on knowledge of physical and psychological states is simply impossible.

c) “Methodological structuralism” rejects extreme versions of individualism (overestimation of the authority of individual) and holism (excessive driving force of a social group) [Stankiewicz 2007, p. 69].

In my opinion, an attempt to reach a compromise as to the use of both methodological individualism and methodological holism in the research on the economic reality is basing the contemporary economy on the foundation of system rationality. The extreme form of methodological individualism is based on the assumption that collective rationality does not exist. The extreme form of methodological holism accepts, in turn, that only the actions of a social group can be rational, not of an individual – as was written by e.g. Oskar Lange in his “*Ekonomia*”, Volume I.

What is system rationality? J. Unold conducted research on the mechanism of creation of the community adaptive process spiral, which provides a model of how individual, unpredictable, and often irrational actions of individuals comprise – in analogy to the phenomena occurring in the quantum world – the adaptive and spiral process of community behaviours. Since this process is isomorphic, it is predictable. This research is consistent with the theory of chaos from which a new comprehension of order and disorder emerges, since close correlations between the two states exist. They are currently understood as two faces of one phenomenon. Therefore, they do not exclude one another – indefiniteness of behaviours at the individual level and the predictability of behaviours at the community level. In this situation the system rationality means that irrationality of individuals composing a given system does not necessarily mean the irrationality of the entire system [Unold 2003, pp. 8-11]. This means that if in the real economic reality difficulties occur in applying optimisation rules, the rational behaviour should be understood as adaptive actions. Thus a rational choice of a goal would not depend solely on subjective preferences

of the subject but mainly on external conditions and external systems [Unold 2003, pp. 8-11]. System rationality is adaptive rationality.

What follows from the aforementioned system rationality concept? On the one hand, system rationality does not disturb political freedom. On the other hand, system rationality based on adaptive behaviours, which are of a more general nature than optimising behaviours, constitutes an expression of methodological holism, since in the processes of economic reality cognition we research the behaviours of a community of individuals composing a certain system (society, social, regional, national group, etc.). As a consequence, this means that system rationality incorporates – as a theoretical and practical foundation – methodological individualism and methodological holism.

What is most valuable in system rationality is that even unpredictable behaviours of individuals can be defined as predictable at the community level, in accordance with the theory of chaos. This is particularly important in the research on the behaviour of the stock market, capital markets, and the entire economy [Noga 2009b, p. 293].

The conducted system rationality analysis underlying management in the contemporary economy authorises the Author to state that methodological individualism is complementary to methodological holism. In order to understand economic reality well, both those methodologies should be employed, the more so that the economics must formulate predictive conclusions as a result of its research. Otherwise economics will cease to be a science and become a scientific reflection.

## 4. Conclusion

The analysis of the essence of methodological individualism and methodological holism conducted in the present paper allows stating that both those methodologies are mutually complementary and may be employed as combined and not separate research methods. This is extremely important for the institutional school since so far there has been no agreement as to a common stance related to a defined research method, despite the fact that institutionalism espouses the “holistic approach to economic phenomena”.

At this point, I would like to emphasise that institutionalism was created and developed at the time when behavioural economics was emerging. This is important because management must take into account not only such factors as the capital, scientific and technology advancement, land, qualifications, and the level of employed manpower, but also behaviours of a human responding to external stimuli, i.e., the stimuli coming from the closer and farther environment.

The paradigm of mainstream economics should be modified by incorporating therein the results of research of the entire institutional school, behavioural economics, behavioural finance, the influence of culture and politics on the economy [cf. Noga 2010]. The analysis of the relations between methodological individualism, which underlies the paradigm of mainstream economics, and methodological holism

conducted in this paper does not authorise to reject the “old” paradigm and replace it with a “new” paradigm. This is due to the fact that methodological individualism is complementary to methodological holism.

## References

- Blaug M., *Teoria ekonomii. Ujęcie retrospektywne*, PWN, Warszawa 1994.
- Noga M., *Makroekonomia*, Wydawnictwo Uniwersytetu Ekonomicznego we Wrocławiu, Wrocław 2009a.
- Noga M., *Szkice z makroekonomii*, CeDeWu PL, Warszawa 2009b.
- Noga M., *Culture and the paradigm of mainstream economics*, [in:] M. Noga (ed.), *Economics. Macroeconomics*, No. 9, Publishing House of Wrocław University of Economics, Wrocław 2010.
- North D.C., *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge 1990.
- Olesiński Z., *Zarządzanie relacjami międzyorganizacyjnymi*, C.H. Beck, Warszawa 2010.
- Rutherford M., *Institutions in Economics. The Old and New Institutionalism*, Cambridge university Press, Cambridge 1996.
- Sobiech K., Woźniak B., *Ekonomia instytucjonalna*, [in:] M. Ratajczyk (ed.), *Współczesne teorie ekonomiczne*, Wydawnictwo AE Poznań, Poznań 2005.
- Stankiewicz W., *Ekonomia instytucjonalna. Zarys wykładu*, [second edition], Wydawnictwo Prywatnej Wyższej Szkoły Businessu, Administracji i Technik Komputerowych w Warszawie, Warszawa 2007.
- Unold J., *Dynamika systemu informacyjnego a racjonalność adaptacyjna. Teoretyczno-metodologiczne podstawy nowego ujęcia racjonalności*, Wydawnictwo AE Wrocław, Wrocław 2003.

## INDYWIDUALIZM A HOLIZM METODOLOGICZNY W EKONOMII INSTYTUCJONALNEJ

**Streszczenie:** W artykule Autor prezentuje hipotezę, że indywidualizm metodologiczny jako metoda poznawania rzeczywistości gospodarczej jest komplementarny, a nie substytucyjny, względem holizmu metodologicznego. W łonie ekonomii instytucjonalnej nie ma jednolitego poglądu, którą z tych metod należy stosować w badaniach rzeczywistości gospodarczej. Dlatego też pozytywne zweryfikowanie hipotezy badawczej pozwoliło Autorowi wysunąć postulat, aby zmodyfikować paradygmat ekonomii głównego nurtu, uzupełniając go o efekt badań ekonomii instytucjonalnej.

**Słowa kluczowe:** indywidualizm metodologiczny, holizm, ekonomia instytucjonalna, paradygmat ekonomii głównego nurtu.