

# INSTITUTIONAL ECONOMICS





NEW

SZÉCHENYI PLAN

# INSTITUTIONAL ECONOMICS

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Author: János Mátyás Kovács

Supervised by János Mátyás Kovács

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## Week 6

“Old“ Institutional Economics IV  
From the American institutionalist  
school to old-new ”critical realism”

János Mátyás Kovács

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# American "old" institutionalists

- Where does it come from? British historicism as a kind of institutionalism? A direct source: American economists study in Germany at the turn of the 19th and 20th centuries (Adams, J. B. Clark, Ely – the "Germans"); Schmoller's decisive impact: critique of the free market and the rationality postulate; at the same time, borrowing marginalism from Knies; from Schmoller: theory of the firm, the firm as social organization.
- Institutionalists take over the leading academic positions in the US during the first decades of the 20th century (Ayres, J.M. Clark, Knight, Commons, Mitchell, Hamilton, etc), and become chief advisors in the course of the New Deal and WW II
- Veblen marks the breakthrough: it is not only the neoclassical school that moves overseas; institutionalist research in the US also attains the European level (the American hegemony will be irrevocable with the NIE).

# American "old" institutionalists (cont.): Veblen

- How many American institutionalisms are there? Veblen's influence is very strong; Commons and Mitchell are the next leading figures, and the school ends with Galbraith incorporating the decline of the discipline (growing distance from the European (German) institutionalists).
- Veblen's innovations (Hodgson)
  - Both the individual and the institution are in the focus of research
  - Agency and emergence postulated simultaneously
  - Habitual roots of rational decisions
  - Neither methodological individualism nor collectivism, nor biological reductionism
  - Knowledge and learning in the evolutionary process
  - Rejecting teleology in historical explanation

# American "old" institutionalists (cont.): Veblen

- *The Theory of the Leisure Class* (1899)
- *The Theory of Business Enterprise* (1904)
- Natural selection of institutions
- Definition of institution: prevailing "habits of thought" (pragmatism: it is not the Hegelian *Geist* that appears in the institution); the "habits of thought" are rooted in the "habits of life".
- Biological arguments? Used only when it comes to selection and instincts.
- Veblen against a) Marxian determinism, b) the organicism of the historicists and c) the utilitarianism of the marginalists
- He regards the dominant thinkers of the time as pre-darwinists: they indulge in taxonomical rather than genetic research.

# American "old" institutionalists (cont.): Veblen

- Praising Schmoller for a Darwinist interpretation of the origin, growth and survival of institutions
- Reproaching the neoclassical (this is his term) scholars for depicting the economic agents as hedonists ("a lightning calculator of pleasure and pain")
- Instincts and habits are the prime movers (James' and Dewey's impact); in modern terms: endogenization of preferences
- Cumulative changes (process versus equilibrium)
- Evolutionary interplay of instincts ("workmanship", "parental bent", "idle curiosity", "emulation", "predation", etc) and institutions

# American "old" institutionalists (cont.): Veblen

- Stages of development from the savages to large industry
- Conflict between industry and business (workmanship and predation): critique of capitalism
- Technological progress: quicker than the change of instincts and habits; institutional inertia, "imbecile institutions": anticipating the concept of path dependence?
- Evolution has no purpose (challenging the Marxists).
- The (good) institutions: sustaining and increasing knowledge and culture

# American "old" institutionalists (cont.): Hamilton

- Hamilton (1918) coins the term “institutional economics” in contrast to that of “value economics”.
- Definition: an institution is a “cluster of social usages” that marks “a way of thought or action of some prevalence and permanence”; it is embodied in habits, and determines the frames of economic activity
- Distinction between informal and formal institutions
- Institutional conversion: the core of institution moves from one cultural matrix to another
- Drifting and ambivalent institutions; institutions that turn into their opposite

# American "old" institutionalists (cont.): Commons

- Commons: social reformism rather than evolutionism (Veblen: against a normative approach); looking for a "reasonable capitalism"
- Starting point: American capitalism with its specific institutions
- *The Legal Foundations of Capitalism*, 1924
- *Institutional Economics. Its Place in Political Economy*, 1934
- Combining law, ethics and economics
- Conflicts of interest and mutual concessions instead of postulating a harmony of interests; social psychology rather than individual psychology
- Natural selection is complemented with an artificial one: informal rules and habits (but not instincts as with Veblen) become formal (legal) ones.

# American "old" institutionalists (cont.): Commons

- Ideal types of economic systems (following Weber but not attaching spirits to the various systems); periodization: scarcity, abundance, stability
- Classification of institutions; characteristic traits: durability, sovereignty, legitimacy, working rules, sanctions, transactions
- Institutional economics is "proprietary economics": origin of the property rights school?
- Key concept: transaction ("unit of transfer of legal control") instead of the traditional economic notions of labor, commodity, needs or exchange; one can exchange not only commodities but also rights
- "Legal-economic nexus": source of "law and economics"?
- Distinction of strategic and routine transactions
- Definition: institutions control individual action by collective action

# American "old" institutionalists (cont.): Mitchell

- Follower of Veblen but his theory requires quantification
- NBER: powerful influence, national income accounting, analysing business cycles, evolutionary approach, rigorous empirical research
- Macroeconomics without modelling; institutional explanations (roots: the concept of national economy in the German Historical School)
- Economic behavior is to be studied *en gros*; mass behavior is standardized by institutions (e.g., money); it can be grasped by statistical methods.
- Individual motives are rather stable; twisting today's terms: microeconomics needs some macro-foundations.

# Borderline-case: Knight

- He calls himself an institutional economist (“institutional as much as possible”).
- Challenging both the Darwinists and the behaviorists
- Accepting Sombart’s and Weber’s views on the historical conditions of calculative rationality
- Combining institutionalism with Marshall (strong Austrian influence): “The task of institutionalism is that of accounting historically for the factors treated as data in rationalistic, price-theory economics” (1937).
- Universal economic laws (choice under constraints); but not all laws are universal, they have to be studied together with the institutions that determine the conditions of choice.
- Neoclassical techniques: NIE forerunner?

# Borderline-case (cont.): Keynes

- Keynes does not quote the German historicists (he did not read Marx (Robinson)), and keeps a distance from the American institutionalists as well (yet, we have to deal with him here because of the close American links of Keynesian theory)
- The price of the "general theory" is the abstraction from specific institutional components: Keynes also considers it general inasmuch as it should apply to Anglo-Saxon capitalism as well as to the Nazi economy (e.g., reference to the fundamental psychological law or to "animal spirits").
- Original solutions for a great institutional crisis while scholars like Mitchell prefer just to describe it.
- The institutionalists in the US accept the Keynesian therapy (what they dislike is subsequent model-building), and support its implementation as government advisors and officials.

# American "old" institutionalists (cont.): decline

- Neoclassical victory over institutionalism:
  - Death of Commons and Mitchell (Ayres becomes the leader of the school)
  - The philosophical and psychological roots dry out
  - Growing demand for quantification/formalization
  - The institutionalists fail to construct a general theory (like the Germans before)
  - Keynes steals the show
  - The comparison of Big Systems (capitalism versus communism) does the same
  - German language ceases to serve as a *lingua franca* of economics
  - Galbraith is weightless
  - Schumpeter (1931): "Institutionalism is nothing but the methodological errors of German historians. ... This, of course, is the one dark spot in the American atmosphere."
  - The American institutionalists lose their own *Methodenstreit* with Koopmans and the Cowles Commission, 1947–49.

# American "old" institutionalists (cont.):

## Galbraith

- Guarding the tradition, provoking the mainstream, popularizing institutional thought by means of spectacular concepts
- Proposing price regulation, questioning the idea of consumer sovereignty (*Affluent Society*) and the notion of the competitive firm (*New Industrial State*)
- Pursuing political economy, swinging between economic science, politics and journalism (Krugman calls him a political entrepreneur)
- He is interested in the nature of economic power (technostructure, state capture, relations between *Big Business* and *Big Labor*); the concept of "counterveiling power"
- "Conventional wisdom": challenging the neoclassical postulate; institutional dependence of knowledge

# Toward critical realism

- Can "old" institutionalism be revived?
  - Probably yes: it has been sustained at many places
  - Probably no: it has been sustained at many – incompatible – places
- Thus far, we have spoken of Marxist, German (British), Austrian and American varieties of OIE (and their combinations)
- Disregarding other schools/tendencies:
  - Polányi
  - French regulation school (see next presentation)
  - Critical realism

# Toward critical realism (cont.)

Polányi:

- “Lonely fighter“, outsider, coming too late/too early
- *The Great Transformation* (1944)
- Economy as an “institutional process”
- Reciprocity, redistribution, exchange: patterns of integration/coordination
- Embeddedness/disembeddedness of the economy
- Critical realism:
  - Hodgson: uphill struggle to revitalize “old“ institutional thought
  - Recipe: finding many predecessors, and combining their partial theories in a critique of the neoclassical paradigm
  - *How Economics Forgot History*, 2001
  - *The Evolution of Institutional Economics*, 2004

# Toward critical realism (cont.)

- Evolutionism in the wake of Veblen and Darwin; no formal modelling; variability, inheritance, selection; "bringing life back in economics": demand for realism
- Thesmology: science of institutions
- Key concepts: emergence, multi-layered causality in the relationship between individuals and institutions
- There is no empirical research without theory; no understanding of behavior without history; no realism without a critical approach.

# Readings

## **Mandatory**

Veblen: Why is Economics Not an Evolutionary Science?, 1898

Commons: Institutional Economics, 1934 (chapters)

Knight: Institutionalism and Empiricism in Economics, 1952

Boulding: A New Look at Institutionalism, 1957

Rutheford: Institutional Economics: Then and Now, 2001

Polányi: The Great Transformation, 1944 (chapters)

## **Additional**

Galbraith: New Industrial State, 1969 (chapters)

Hodgson: The Evolution of Institutional Economics, 2004 (chapters)

# Annex

## Biographical sketches

- Veblen
- Commons
- Polányi

## Final questions

- Predecessors/successors of the school
- Friends and foes
- Discoveries
- Changes in the research program