

The dissent of the American Institutionalists.

Approaching the turn of the 19th century, economics was undergoing a radical change. The focus on production and conflictual relations between social classes that marked classical political economy was being replaced all over Europe by an approach that saw economic relations as harmonious as the focus shifted to exchange and a marginal framework.

At the same time in the US there seemed to be an endless supply of natural resources, the economy was developing at a rapid pace with the second industrial revolution, and to many, it seemed that hard work and thriftiness would yield prosperity. This belief is consistent with what is known as clerical economics which maintained that there is a divine link between ethical behavior and favorable economic outcomes; capitalism was viewed natural system that when allowed to operate freely yielded optima results.

While economics tended to be conservative America, a statement that was also true of Europe and which remains true today, there was great social unrest following the civil war.

- The labor movement which culminated in the American Federation of Labor.
- The antitrust movement which culminated in the Sherman anti-trust act and interstate commerce act.
- The progressive movement led by the General Federation of Women's clubs which sought legislative changes to reform the system.

In America, a group of dissenting thinkers referred to as Institutionalists emerged in response to clerical economics, the emerging dominance of the business enterprise, the changing scene of American society, and rising influence of Dewey's pragmatism. Pragmatism begins with an observation of current experience, followed by formulation of a hypothesis, and then the testing of the hypothesis. Contrasted with the methodology of classical and neoclassical which relied on deductive logic from a group of postulates or premises to discover laws or generalize. To be scientific, the neoclassical framework often precludes policy prescriptions from fear of making a value statement; while the pragmatic approach provides the basis for proposing action and leads to the conclusion that the concern of the social scientists is social engineering.

The luminary thinkers grouped as institutionalists and considered in this lecture includes:

- Thorstein Veblen
- Wesley Mitchell
- Clarence Ayers

The Veblenian Challenge

Introduction

Thorstein Veblen grew up in the rural Midwest in a Norwegian farming community. He left the farming life behind when he attended Carleton College in at age 17. Veblen's an anti-establishment behavior generated a legacy of anecdotes and stories, many of which refer to his prowess as a ladies' man.

After completing his undergraduate studies Veblen attended graduate school at Johns Hopkins with John Dewey who would become significant in Veblen's thinking. After only a year he transferred to Yale where he completed his Ph.D. Failure to find an academic job led Veblen to spend the next seven years reading on his own before becoming a student once more, this time at Cornell where he studied anthropology, sociology, and economics. His inquiry into many disciplines culminated in his first published work, *The Theory of the Leisure Class*. In this text are many phrases that have come to be associated with Veblen.

- Conspicuous consumption
- Captains of industry

Unfortunately, his unique descriptive phrases, anti-establishment wit, and unruly appearance are better remembered than the ideas perpetuated by his disciples in what is now known as Institutionalism. Veblen was vehemently opposed to the neoclassical tradition, who, in his view, failed to comprehend the innate drives of human and the basis of their often-irrational behavior. The mechanical laws of humans as conceptualized in Marshall's framework not only did not reflect human behavior, but it also failed to take account of the ever-changing cultural environment in which humans exist. Economics is not a physical science; it ought to, according to Veblen, be an evolutionary science with its basis in the humanities and social sciences.

Veblen's key points

Veblen challenged the hedonistic conception of human behavior. Quickly calculating the costs and benefits of a choice between alternatives neglects the cultural setting in which economic activity occurs. Behavior, rather, is shaped by the written and unwritten rules of society that govern interactions between community members as well as with the biosphere and physical world. Some important social institutions are family, church, schools, and corporations. Institutions are relatively static in the short run; however, they evolve over time.

If one accepts the role of institutions in governing behavior and which evolve over time, then the reliance on deductive method and concept of equilibrium borrowed from physics must be rejected. Veblen asserted that economics must reflect dynamic aspects of culture; as such, an evolutionary science like biology would be better suited as the prototype for studying economic behavior.

Economics as an evolutionary science

The economy is how society provisions for its material well-being. Changes in technology reflects a change in how society deals with the material means. Veblen believed that it was changes in technology that serve as the chief dynamic influence on human behavior. The dynamic influences on behavior conflict with those that derive from social institutions. The latter are referred to as ceremonial institutions which change very slowly, if at all, across generations.

An individual's behavior is strongly governed by their habitual relations to others in the group. This type of behavior is clear in consumption patterns that cannot be described by the rational calculation of marginal gains and losses, but which are more accurately described as being driven by habit. Society encourages consumption patterns which encourage "emulative display" and "conspicuous consumption." The lower classes in society will seek to emulate the consumption behavior of those who belong to the leisure class. The commodities acquired while emulating the leisure class provide utilities not only in use, but also in the conspicuous consumption implicit in the high price paid for it.

The standards set by the leisure class do not satisfy basic human needs to engage in useful welfare serving activities- these needs are said to derive from the "instinct of workmanship." The technological bent of society has been perverted by a culture that is biased towards wasteful and ostentatious consumption. The effect of this perversion is to propel members of the economic community, with great singleness of purpose, towards the largest possible acquisition of wealth; work that does not generate pecuniary gain is viewed unfavorably. A contradiction emerges in human behavior: a dichotomy exists between the reaction to the impact of dynamic technology and the influence of ceremonial patterns from prevailing institutions. Emulation of the leisure class destroys the link between the price system and consumer welfare. Implicit in the disconnect is a challenge to *laissez faire* policies.

Veblen took his assault against the private enterprise market system even further. In *The Theory of the Business Enterprise* Veblen uses the distinction between making goods (machine process) and making money (business) as the basis for the observation that monetary return is often proportional to the negative effect it has on the life process of the community. The community is best served by an uninterrupted flow of goods; however, pecuniary gain is often best served by interrupting the flow of goods. The community is abused by the "advised idleness" of industrial plants and the "capitalization of inefficiency" in which output is reduced to maintain prices. Advertising was also in Veblen's crosshairs. Advertising to promote the sale of fashionable goods contributes to making money for the business enterprise, not for making goods for consumer satisfaction. The conflict on human behavior between ceremonial institution of business and the instrumental machine process is an ongoing process and supports a central tenet of institutionalism: human behavior and experience are evolutionary in character.

Wesley Mitchell's Institutionalism

Critique of orthodox theory

Mitchell criticized the orthodox use deductive logic from simplified assumptions to arrive at general conclusions. One point of contention for Mitchell was the orthodoxy's inability to verify their laws empirically. This line of criticism inspired Mitchell to dedicate his entire career to empirical work which is highlighted by his appointment as the inaugural director of research at the National Bureau of Economic Research. While at the NBER pioneered the development of empirical indicators of the business cycle which are still maintained today, albeit by the US department of Commerce.

Mitchell as an empirical theorist

Theoretical and empirical are often thought of as two distinct methods of investigation. Theory involves generalizations arrived at by making logical inferences from premises to conclusions. Empiricism is then used to verify the validity of theory.

Mitchell used empirical work, not for validation, but rather to discover empirical correlations that can then inform the construction of theory.

Mitchell's business indicators: measurement without theory.

Mitchell set out to identify indicators which measured aggregate economic activity. The indicators were then used to identify business cycles. The indicators were also used to identify turning points: critical changes in economic activity that signaled the onset of a contraction or expansion. Empirically, Mitchell established that modern economies undergo continuous and sequential change as result of organization under the direction of business enterprise.

A cycle consists of expansions occurring at about the same time in many economic activities, followed by similarly general recessions, contractions and revivals which merge into the expansion phase of the next cycle; this sequence of change is recurrent, but not periodic; in duration business cycles vary from more than one year to ten or twelve years; they are not divisible into shorter cycles with amplitudes approximating their own.

Mitchell has been criticized for his failure to hypothesize causality; hence, the critique that his work constitutes measurement without theory. However, no single hypothesis can explain all cycles. Mitchell did not reject theory in his studies of the business cycle but did reject the monocausal analysis of mainstream who posited that business cycles were a disturbance to equilibrium rather than the outcome of an ongoing process.

Clarence Ayres' critique of orthodox economics

Ayres is known as the leading institutional economist of the post WWII era. His teaching career culminated in the intellectually congenial environment of the university of Texas- Austin which has come to be known as the Texas School of Institutional Economics.

His critique focuses on the neoclassical concept of equilibrium and their conviction that market forces propel prices to equilibrium levels which are consistent with moral justice. At the core of confusion in neoclassical economics, according to Ayres, is the theory of capital and savings. Orthodox views capital as a creation of savings which is given life through the relationship between savers and financial intermediaries. Ayres posted that progress emanated from the act of physical production: progress is a technological, not financial, phenomenon.

The relationship between savings and capital accumulation was developed by the second-generation Austrian Bohm-Bawerk. In this theory, consumption must be sacrificed to accumulate capital. Ayres countered with an empirical observation, the quantity of both consumer and producer goods has increased. Ayres argued instead that real capital is the product of invention, discovery, science, and technology.

According to Ayres critique, institutions of capitalism inhibit, rather than aid, growth.

Underconsumption is a problem that Ayres linked to an inequitable distribution of income and that savings accumulate from this inequality. Somewhat anticipating Keynes critique of Say's law, Ayres argued that savings will accumulate and sit idly because there do not exist sufficient outlets. Capitalism suffers a fundamental problem— technology has vastly increased the productive capacity, but consumers, most of whom work for wages, do not have sufficient purchasing power to absorb what they produce.

Concluding remarks

Veblen pushed for economics to be recast as an evolutionary science. The approach that follows from his pioneering work is carried forward with the Association for Evolutionary Economics and their *Journal of Economic Issues*. Veblen's legacy is strong and can be found in influential thinkers like John Kenneth Galbraith. Economics has not been reconstructed, causing many institutionalists to follow the approach of Mitchell, focusing on quantitative empirical work. Empiricist in this tradition believe in the necessity of being able to formulate economic concepts and give precise definitions to economic relationships. Other economists have followed in the tradition of Ayres and are attempting to develop theory of social value.