

CHAPTER 1

Definitions and issues

Throughout the history of economic thought, attempts have been made to incorporate issues relating to institutions¹ and institutional change within the discipline. The most obvious example is that of the American institutionalist tradition of Veblen, Mitchell, Commons, and Ayres. But institutional analysis of various kinds can also be found in the works of classical economists such as Adam Smith and J. S. Mill; members of the German, English, and American historical schools; Marx and other Marxians; Austrian school members such as Menger, von Wieser, and Hayek; Schumpeter; and neoclassicals such as Marshall.

This book concentrates on the two major traditions of institutionalist thought in economics. The first is the American institutionalist tradition that began at the turn of the century and has continued uninterrupted (although with large swings in popularity and prestige) to this day. The second is a more recent development, but one that can be seen as a revival and considerable expansion of the institutionalist elements to be found in classical, neoclassical, and Austrian economics,² elements that had fallen into neglect in the intervening period. The former tradition is now often called the “old” institutional economics, or OIE, while the latter is usually called the “new” institutional economics, or NIE.³

1.1 The old and the new institutionalism

The old institutionalism consists of that tradition of thought associated with Thorstein Veblen, Wesley Mitchell, John R. Commons, and Clarence Ayres, and with the more recent contributions of Allan Gruchy, Wendell Gordon, Marc Tool, and the many others represented in the pages of the *Journal of Economic Issues*. Despite claims to the contrary (Gruchy 1947, 1972), the OIE does not represent a single well-defined or unified body of thought, methodology, or program of research. Within the OIE there are two research programs of major theoretical significance. The first is associated with Thorstein Veblen, and with the development and modification of Veblen’s system undertaken by Clarence Ayres. This program is built around the concept of a fundamental dichotomy between the business or pecuniary and the industrial aspects of the economy. This is also expressed in a more general way as a dichotomy

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between institutional and technological or between ceremonial and instrumental ways of doing and thinking (Waller 1982; Munkirs 1988). In very sweeping terms, this program focuses on investigating the effects of new technology on institutional schemes, and the ways in which established social conventions and vested interests resist such change. Institutions, then, need not be well adapted to the available instrumentalities, the criterion of judgement usually being some notion of “instrumental value,” which in turn is based on a more or less broad definition of “community serviceability.” These ideas are often coupled to a view of the structure of the modern economy that emphasizes the political and economic power of large corporate interests.

The second major program within the OIE has its roots in the work of John R. Commons and is now represented by writers such as Warren Samuels and Allan Schmid (Schmid 1978; Samuels and Schmid 1981). This program concentrates on law, property rights and organizations, their evolution and impact on legal and economic power, economic transactions, and the distribution of income. Here, institutions are seen largely as the outcome of formal and informal processes of conflict resolution, the criterion of success being whether the institution has generated a “reasonable value” or “workable mutuality” out of conflict. In some respects, this program is complementary to the Veblen–Ayres approach, which does not explicitly address the judicial and political processes of conflict resolution central to Commons’s work, but there are points of tension and even of outright conflict between them. For example, Commons ([1924] 1968: 376, [1934] 1961: 673) himself directly attacks both Veblen’s approach and his “cynical antithesis” between business and industry, and this conflict extends into the value concepts used by each (Ramstad 1989). It is also the case that the Commons tradition – owing to its emphasis on transactions, property rights, and organizations – has closer links with the NIE than does the Veblen–Ayres tradition. Nevertheless, as will be seen in later chapters, Commons’s approach still differs from anything found in the NIE in significant ways.

It is probably true that the NIE is just as disparate as the old (Coats 1986; Maki 1987; Andersen and Bregn 1992). One major strand is to be found in the work on property rights (Demsetz 1967; Alchian and Demsetz 1973) and common law (Posner 1977, 1981). Another strand is that concerned with public choice processes, including those involving rent seeking and the activities of distributive coalitions (Olson 1982; Mueller 1989). A third important element deals with organizations and includes the agency theory developed from Jensen and Meckling (1976), and work on transactions costs stemming from Coase (1937) and uti-

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lized extensively by Oliver Williamson (1975, 1985). Further aspects are provided by game theorists, some of whom use game theory primarily to model action within given institutional situations (Shubik 1975), while others use it in a more ambitious attempt to explain the evolution of the social institutions themselves (Schotter 1981). Many of these elements can be found combined in the institutional economic history of Douglass North (1981, 1990). The new institutionalism has also been defined to include Austrian and neo-Schumpeterian efforts to explain various types of institutional development in invisible-hand or evolutionary terms (Hayek 1967, 1973, 1979; Nelson and Winter 1982; Langlois 1986a).

As with the OIE, in some respects these programs complement each other, but differences and disagreements do exist. Douglass North criticizes both those who take a *purely* rent-seeking approach to government activity and those who limit their analysis to alterations in contracts occurring *within* a given basic institutional framework. North also argues forcefully for a much fuller recognition of the importance of notions of fairness and ideology in institutional change (North 1984, 1986). Agency theory and the transactions cost approach of Williamson have differences too. Williamson (1987a, 1990) points to differences in the basic unit of analysis and in the *ex ante* focus of agency theory as opposed to the *ex post* approach of transactions cost economics. Most agency theorists are also more orthodox in their assumptions concerning maximizing behaviour than is Williamson. More fundamentally, Langlois (1986b) argues that the NIE *should* concentrate more on spontaneous, invisible-hand, processes. He claims that certain key problems with the NIE stem from its “neoclassical core,” and argues that the NIE should move in a more Austrian direction (Langlois 1989: 291–294). It is certainly possible to distinguish between a more neoclassical and a more Austrian “wing” to the NIE. The vast majority of the work in the NIE belongs in the former category (Eggertsson 1990). The latter would include Langlois’s outline of a program, Hayek’s work on institutions, Nelson and Winter’s neo-Schumpeterian evolutionary economics, and, possibly, some of the work in game theory.⁴

Given the nature of these bodies of work, one might question the usefulness of the simple two-way division into old and new institutionalisms. Indeed, in some cases it will be necessary to make finer distinctions – into Veblen–Ayres, Commons, neoclassical, and Austrian divisions, for example – but for many purposes the Veblen–Ayres and Commons traditions can be grouped together in contrast to both the neoclassical and Austrian. This can be seen most clearly in the criticisms that each levels at the other. The new institutionalist, whether neoclassi-

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cal or Austrian, complains of the old institutionalists' lack of theory; tendency to argue in holistic terms rather than in individualistic terms; use of a "behaviouristic" rather than a rational choice (or intendedly rational choice) framework; failure to give sufficient emphasis to *economizing* as "the main case"; and failure to appreciate the importance of unintended and evolutionary processes in institutional development, as opposed to processes of collective decision making and institutional design (Seckler 1975; North 1978; Schotter 1981; Coase 1984; Williamson 1987b; Ault and Ekelund 1988). The OIE is thus portrayed as descriptivist and anti-formalist, holist, behaviourist, and collectivist. Old institutionalists also reject individualistic welfare criteria and are more interventionist, favouring greater government involvement to correct institutional failures. Of course, some of these labels apply better to some old institutionalists than to others, but it is hard to deny all truth to the characterization, particularly when old institutionalists willingly apply many of the same labels to themselves (Gruchy 1947; Wilber and Harrison 1978; Dugger 1979a). It seems that what new institutionalists see as faults, the old claim as virtues.

The old institutionalists, and those more sympathetic to their position, make the opposite set of criticisms of the new. They argue that its theory is often too abstract and formal; that it sometimes adopts an extreme, reductionist, version of individualism; that the individual is seen as an overly rational and overly autonomous being, constrained, but not otherwise influenced by, his institutional and social setting; that orthodox welfare criteria are not appropriate for appraising institutional change, and that a complacent attitude prevails concerning the efficiency characteristics of markets and of institutions that emerge spontaneously (Mirowski 1981; Field 1981, 1984; Dugger 1983; Dow 1987; Hodgson 1988). The NIE is thus portrayed as more formalist (particularly in its neoclassical and game theoretic manifestations), individualist, reductionist, orientated toward rational choice and economizing models, and generally anti-interventionist. Again these labels apply more to some than to others, but again they are labels that new institutionalists have willingly applied to themselves, in part in order to clearly distinguish their work from the OIE (Coase 1984; Langlois 1986a).

1.2 Dichotomies and problems

Despite the disparity that exists within both the OIE and the NIE, it appears that the OIE and NIE can be usefully distinguished. This is not to suggest, however, that the old and the new therefore sit on opposite

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sides of a series of sharp *dichotomies*, although such a view is easy to slip into. Methodological and theoretical approaches in the social sciences often are dichotomized into formalist *versus* anti-formalist; individualist *versus* holist; rational choice *versus* behaviourist; evolutionary or invisible hand *versus* collectivist; non-interventionist *versus* interventionist. There is a certain ease and comfort in this way of thinking. To dismiss someone's work from further consideration, one merely has to show that it belongs on the other side and therefore can be of no use or interest for one's own program. Each side can pursue its own programs without worrying about the work or the implicit and explicit criticisms made by the other.

On the contrary, virtually all of these standard dichotomies are false and misleading. As this book makes clear, the extreme positions are untenable, any adequate social theory cannot be strictly on one side or the other, and many social theorists do, in fact, adopt more moderate and modest positions. For example, certain criticisms of formalist notions are shared by old and new institutionalists. Also, many individualists do recognize that the social whole deeply influences the individual, while most holists do agree that only individuals, not institutions, can act as agents of change. Similarly, even "behaviourists" like Veblen do not entirely exclude rational choice and economizing behaviour, while among more orthodox economists there is an increasing recognition of the limits to optimizing behaviour and the significance of "rule following." Again, it is impossible for invisible-hand theorists to deny the need for and actual historical importance of deliberative institutional design efforts, and equally hard for collectivists to deny that many conventions and institutions can (and do) grow up spontaneously. Finally, the difficulties that are involved in judging institutional change have created much debate in both traditions, debate that ranges over the welfare criteria to be used and the proper roles for markets and governments. Even the most ardent champions of the benefits of markets and of spontaneous institutional development have had to admit that such processes can sometimes lead societies astray, while interventionists must contend with the many and obvious examples of the failure of deliberate institutional design. To argue in this way is not to claim that there are no areas of serious disagreement, only that the alternatives involved do not resolve into simple either/or choices. This expands rather than contracts the number of possible positions.

The view taken in the rest of this book is that the traditional dichotomies are best thought of as representing methodological or theoretical *problems*. The debates over the merits and demerits of formal versus less formal techniques are reflective of the difficulties involved in the analy-

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sis of a complex evolving system. The arguments over holism and individualism concern, at base, the problem of the interrelationship between the individual and society. Society is created out of the actions of individuals, but it can also be argued that the individual, to some significant extent, is the creation of his social situation. Many of the debates over rule following versus rational choice models reflect a further aspect of this same problem. Clearly, most individuals do develop habits and routines and accept social conventions and norms. However, such rule following is not necessarily irrational or unconditional, although some types of norm-guided behaviour do strongly resist explanation in rationalist terms. The debate over whether to take a collectivist or invisible-hand approach to institutions relates to the question of the extent to which individuals, acting in their own interests, unintentionally generate social rules. Considerable disagreement surrounds this question. The issue of interventionism versus non-interventionism relates partly to the problem of whether such spontaneous processes of institutional development and change will necessarily operate in ways consistent with the economic and social advantage. However, particularly in the context of an evolving institutional system, terms such as “economic efficiency” or “social benefit” become uncomfortably difficult to define. These problems are common to both the OIE and the NIE. They, and the various ways they have been dealt with in each tradition, are the subject of the chapters that follow.

CHAPTER 2

Formalism and anti-formalism

Formalism is defined here as the use of an abstract language such as mathematics or symbolic logic in place of natural linguistic or literary methods of presentation. Formal systems were originally developed to investigate the rules of deductive inference, and for this purpose the exact meaning to be attached to the primitive terms employed is unimportant. For economics, however, the interpretation and economic meaning of terms is important, and the use of formal methods usually involves the construction of a “model” that both embodies a formal structure and provides the basis for interpreting the symbolism.

Using the terminology of formal and natural languages may give the impression that it should be possible to translate one into the other without much difficulty. It is true that some arguments can be translated from one language into another with relatively little difficulty or alteration of the content, but this is far from always the case. To formalize a theory is not simply to make it more precise; rather, some aspects of the theory are singled out to produce a highly idealized representation of it. In this, the ambiguity of natural language may be overcome, but at the cost of losing much of its richness and suggestiveness.

Although formalism can be traced far back in the history of economics, it is associated in particular with the development of neoclassical economics. Early neoclassical contributors such as Walras, Jevons, and Edgeworth drew on the example of physics and adopted the mathematics of constrained maximization (Mirowski 1989, 1991). Despite Marshall’s more eclectic approach,¹ mathematical formalism has since become one of the hallmarks of neoclassical economics. The chief advantage claimed for this mathematical formalism has always been that it increases the clarity and precision with which theoretical arguments can be stated. Formalism encourages the more explicit statement of assumptions, including initial conditions and behavioural hypotheses, and makes the derivation of implications not only more exact but also much more visible and open to examination. Although less frequently commented upon, another of its advantages is that it promotes the elaboration of sequences of models, with each model representing some development or modification to the assumptions or derivations.

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In both of these respects, neoclassical economics has had considerable success. In particular, formalization has enabled theorists to build upon and rapidly develop the work of their predecessors. Of course, formalization tends to bring with it an increased degree of abstraction from the particularities of a historical or institutional type. This high degree of abstraction has, however, traditionally been seen as more of a benefit than a cost, allowing the theorist to focus attention on those factors thought to be most important or of the most *general* relevance. Thus, abstracting from many of the complexities of the real world has frequently been seen as a necessary means of gaining insight into its functioning.

Those who have criticized formalism have usually done so on the grounds that the available formalisms are inappropriate or insufficient for the explanation of certain classes of social phenomena. It is often claimed that formal methods direct inquiry to those topics, or to the use of those particular assumptions, that are mathematically tractable. Equilibrium analysis based on the assumption of maximizing behaviour is a great deal more tractable than the analysis of sequential processes of change based on adaption, and it is not surprising that those traditions that have stressed the importance of process and raised questions concerning the use of maximizing assumptions have also been sceptical of the use of formal methods. Moreover, the same high degree of abstraction that creates generality may cause indeterminacy, indicating that the outcome reached in any particular case may depend on the specifics of the situation omitted from the model. For reasons such as these, those who reject formal methods tend to utilize more literary forms of theorizing, often (but not always) combined with studies of a historical, institutional, or case study nature.

The debate between formalists and anti-formalists has been a staple of methodological dispute in economics, often over the realism and relevance of economic theory. It is closely related to, but not identical with, the long-running debate over induction versus deduction. Formalism is identified with the study of deductive inference, and those classed as inductivists have generally been anti-formalists. Nevertheless, as the Austrian tradition demonstrates, a commitment to deductive methods need not imply the use of highly formal methods of inference. Although the induction/deduction distinction is one that is often found in the literature on the OIE, many of the issues involved have had much more to do with the appropriate degree of formalism than with induction or deduction as such. When the distinction is seen in these terms, it becomes apparent that members of the OIE and NIE have more concerns in common than is usually thought.

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2.1 Formalism and anti-formalism in the OIE

According to Langlois (1986a: 5), one of the central difficulties with the work of “early institutionalists” is that “they wanted an economics with institutions but without theory.” A similar argument, but in harsher terms, is made by Coase (1984: 230): “American institutionalists were not theoretical but anti-theoretical. . . . Without a theory they had nothing to pass on except a mass of descriptive material waiting for a theory, or a fire.” This view of the OIE as primarily descriptive and non- or even anti-theoretical in nature is by no means uncommon. It takes support particularly from Wesley Mitchell’s statistical work on business cycles and John R. Commons’s vast documentation of the history of the labour movement, but the impression of the OIE as anti-theoretical or purely descriptive is quite misleading. Even the work of Mitchell and of Commons contains theoretical underpinnings and theoretical purposes (Rutherford 1983, 1987). What is true is that old institutionalists reject the more orthodox neoclassical forms of theory and model building as overly formal, abstract, and narrow. The methodological dispute here is less over theory versus description than over the appropriate degree of abstraction to be used in the analysis of a complex evolving system. Since Allan Gruchy’s (1947) first major book, old institutionalists have frequently characterized the issue in terms of the less formal “cultural” or “holistic” perspective of the OIE versus the formalism of economic orthodoxy (Wilber and Harrison 1978; Gruchy 1987). Although not explicitly expressed in these terms, the criticisms of orthodox theorizing made by earlier contributors to American institutionalism are not dissimilar.

2.1.1 From Veblen to Clark

Veblen is perhaps best known for his stinging criticism of the psychological preconceptions of neoclassical and Austrian economics.² In Veblen’s view, both adopted the hedonistic view of man as a “lightning calculator of pleasures and pains,” a “homogeneous globule of desire of happiness” (Veblen 1898: 73). This comment of Veblen’s raises a number of issues, some of which will be examined in more detail in later chapters. Within the present context, what is most significant is Veblen’s argument that the assumption of the rational “hedonic calculus” combined with an assumption of a *given* institutional situation (including the “natural right of ownership”) leads to an economic theory that is nothing more than the detailed and rigorous deduction of the “rational response to the exigencies of the [given] situation in which man is placed” (Veblen [1909] 1961: 234–236). Such an economics lends itself

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to formal methods of presentation. The theory is a theory of the “normal” case, a highly refined and developed theory of equilibrium states, but one that simply excludes the issues of evolutionary institutional change ([1900] 1961: 164–165). Veblen even characterizes the so-called dynamic neoclassical theory not as a treatment of the underlying “phenomena of change,” but at most as a discussion of the “rational adjustment to change which may be supposed to have supervened” ([1909] 1961: 232). As a result, whenever any institutional phenomenon “is involved in the facts with which the theory is occupied, such institutional facts are taken for granted, denied, or explained away” ([1909] 1961: 233).

In place of this orthodox type of theory, Veblen wanted to substitute an inquiry into the evolution of institutions and their impact on human conduct. In this, he made repeated references to Darwin and to evolutionary biology as a model of “modern science.” By “modern science” he meant a focus on sequential, continuous, change explained in causal (as opposed to intentionalist) terms, and without any presumption of a final term or consummation (Veblen 1898). This institutional economics was not to be purely descriptive. He criticized the German historical school for having produced nothing more than a “narrative survey of phenomena” (1898: 72). What Veblen wished to produce was a “genetic account of an unfolding process,”³ a treatment of institutional evolution as a process of “cumulative causation.” For Veblen, this cumulative process was based less on rationalistic calculation than on habituation to material conditions and constraints:

The growth of culture is a cumulative sequence of habituation, and the ways and means of it are the habitual response of human nature to exigencies that vary incontinently, cumulatively, but with something of a consistent sequence in the cumulative variations that so go forward, – incontinently, because each new move creates a new situation which induces a further new variation in the habitual manner of response; cumulatively, because each new situation is a variation of what has gone before it and embodies as causal factors all that has been effected by what went before; consistently, because the underlying traits of human nature . . . by force of which the response takes place, and on the ground of which the habituation takes effect, remain substantially unchanged. ([1909] 1961: 241–242)

The issue of habituation versus rational choice will be discussed in more detail later, but Veblen’s notion of cumulative causation raises two other important points. The first is the claim that a proper treatment of institutional evolution should consist of more than a treatment of adjustment to a series of exogenously given shocks. Much of the NIE fails this test, dealing not with the internal dynamic of the system but only with the rational (or intendedly rational) responses to exogenously given changes in population, technology, trading opportunities, or