CHAPTER 1

The New Institutional Economics: an introductory essay

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If there is to be no sudden establishment of a new intellectual order among economists, can there at least be a new direction that will gradually draw economists away from their tired repetition of stale and sterile arguments? Some economists believe this new direction could come from the creation of a new "institutional economics," which would take as its main focus the study of human action, in both its individual and group manifestations.

— Leonard Silk
New York Times
September 24, 1980

1.1 Introduction

The essays in the volume are, to say the least, a rather diverse lot. It may thus seem somewhat odd to maintain that these chapters are reflections of certain identifiable common themes and that these themes represent new directions in economic theory. Anyone who would bundle such essays into a single book, and who would further describe them all as essays on "the New Institutional Economics," surely owes the reader an explanation.

That is what this chapter tries to do – to identify a set of common themes that (I assert) run through the chapters of this book. More ambitiously yet, I will try to connect the currents in this book with a larger stream of thought that has lately begun flowing through economic thought.

The skein of ideas I will be concerned with comprises (if I may switch metaphors abruptly) a number of identifiable strands. Principal among these, in my view, would be the evolutionary theory of Nelson and Winter (1982) and other work influenced by Joseph Schumpeter (1934, 1942); the modern Austrian school (Kirzner 1981), especially as influenced by the work of F. A. Hayek (1948, 1967); the transaction-cost

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The economics of Oliver Williamson (1975, 1979); and certain aspects of the property rights literature inspired by Ronald Coase (1937, 1960). There are other affinities and sources of influence, notably Herbert Simon (1955) and the behavioralist school.

To paraphrase Mark Blaug (1980), I am concerned with how this particular group of economists explains economic phenomena. My intention is not to define the boundaries of any school or research program, except perhaps incidentally. Even less do I plan to attack orthodoxy or anything else. It is the themes themselves that interest me. This is in part a detective story, an attempt to ferret out the inexplicit bases of a common pattern of reasoning; and it is also in part an exercise in intellectual engineering, a rational reconstruction (in the broad sense) of an underlying framework. As a result, what I have to say will be partly descriptive and partly critical. The danger of a synthesis of this sort is that the unity of thought it portrays can be more the product of intellectual gift wrapping than a manifestation of the ideas themselves; how much this is so in the present chapter the reader will have to judge. (In Chapter 10, where I explore some of the relevant methodological issues in greater depth, I will renounce even these slight pretensions to be speaking for others.)

1.2 Institutionalism old and new

The first problem is to find a name for this bundle of ideas. None of the options is wholly satisfactory, but for present purposes “the New Institutional Economics” is probably the best choice. The name was popularized by Williamson (1975) and is now fairly widely known. I will spare the reader most of the taxonomic pros and cons. The principal advantage of this name is its currency, along with the fact that it captures one of the main themes that sets the ideas in question apart from the mainstream view. Among the disadvantages is that I may be using the term here in a sense slightly different from, or at any rate broader than, the one it has taken on in association with Williamson’s work.

Another disadvantage of this name is that it encourages one to associate this new brand of institutional economics with the original Institutionalism of the early century. And this is not an empty concern. For it is perhaps fair to say that this modern institutionalism reflects less the ideas of the early Institutionalists than it does those of their opponents.

The American Institutionalist school was a diverse and eclectic group that included the likes of Thorstein Veblen, John R. Commons, Wesley Mitchell, and Clarence Ayres. In fact, it was so loosely structured a school that the major commonality among its members was perhaps
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their opposition to the developing neoclassical viewpoint. It is true that many of the concerns for which these writers are remembered are similar to the ones I am dealing with in this essay. That economics is too narrow a field and should include more ideas from philosophy and from the other social sciences; that economic phenomena should not be analyzed solely in terms of static equilibria but as processes with a history and a future; that economics should be a more “evolutionary” science – all of these are themes as congenial to the old institutionalists as to the new.

Writing in 1898, Veblen assailed the economics of his time for not being a truly evolutionary science, “a genetic account of the economic life process” (Veblen [1898] 1919, p. 72). He considered the classical economics of Adam Smith and his followers to be merely taxonomic, mired in a prescientific state from which evolutionary biology had, since Darwin, successfully extricated itself. By contrast, the marginalist or early neoclassical economists – whom he identifies, interestingly enough, with Carl Menger and the Austrian branch of the marginalist revolution – did succeed in creating a theory of value that is suitably genetic, as far as it goes. But, to Veblen, the marginalists continue to labor under a faulty conception of human nature drawn from an outmoded hedonistic psychology, which accounts for their misguided preoccupation with a creature called homo economicus. Veblen’s justly famous caricature of this creature is a microcosm of his critique of the marginalists.

The hedonistic conception of man is that of a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire in happiness under the impulse of stimuli that shift him about the area, but leave him intact. He has neither antecedent nor consequent. He is an isolated, definitive human datum, in stable equilibrium except for the buffets of the impinging forces that displace him in one direction or another. Self-imposed in elemental space, he spins symmetrically about his own spiritual axis until the parallelogram of forces bears down upon him, whereupon he follows the line of the resultant. When the force of the impact is spent, he comes to rest, a self-contained globule of desire as before. Spiritually, the hedonistic man is not a prime mover. (Veblen [1898] 1919, p. 73)

Marginalism, he is saying, is a Newtonian approach to economics. Its models are cast in terms of forces obeying determinate laws, and explanations for economic phenomena are sought not in a causal and sequential process taking place in time, but in the necessary and sufficient conditions for an atemporal equilibrium. The economic agent thus becomes a passive reactor rather than a true actor. The agent’s behavior conforms to, and is rational in the light of, the specified forces to which
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he or she is subject; it is never influenced by habit, convention, institutions, or other factors not given in the choice-problem he or she faces.

Putting aside the several complex issues the passage raises – issues to which I return in Chapter 10 – this remains, I think, a critique with which one can be sympathetic on a number of grounds. The problem is that the methods of analysis used by Veblen and the Institutionalists were not themselves particularly congruent with the spirit of this critique.

To complain about the mechanistic Newtonian character of neoclassical models, and to object to an unrealistic hedonistic psychology that makes *homo economicus* passive and inhuman, is certainly to strike a very humanistic note. One would thus expect that Veblen would insist on substituting a more humanistic, a more “realistic,” psychological assumption. In fact, quite the opposite is the case. Caught up in the materialism of his day, Veblen actually argued for a kind of proto-Skinnerian behaviorism,¹ and wished to rid economics of any sort of human intelligence and purpose (Kirzner 1976, p. 36; Seckler 1975, passim). The conflict between his humanistic rhetoric and his behaviorist psychology is a tension that Veblen was never able to resolve, and it largely vitiated the promise of his evolutionary alternative to marginalism.²

But the significant point is not that Veblen and the Institutionalists largely failed to live up to their own rhetoric; the true irony is that it was precisely the target of Veblen’s attacks – Carl Menger – who was laying the groundwork for a very fruitful approach to the evolutionary and the institutional.³ As William Jaffé (1976) has pointed out in his dehomogenization of the marginalist revolutionaries, Menger, far from concentrating on Newtonian equilibrium and ignoring institutions, was actually interested in disequilibrium economics and institutional economics: “Thorstein Veblen’s strictures upon what he considered the Austrian

¹ Note that behaviorism (the psychological doctrine) is to be distinguished from behaviorism in the sense of Herbert Simon.
² “Forced from humanism, unable to accept either historicism or behaviorism, Veblen fled into obscurantism; that is one of his secrets” (Seckler 1975, p. 85). See also Coats (1954, 1976) for the view that “Veblen’s attempt to formulate an alternative ‘evolutionary’ research programme in economics failed completely” (Coats 1976, p. 47). One can tell a similar, if not exactly identical, story about most of the other early institutionalists. The desultory and idiosyncratic Commons, for example, whom Williamson (1975, pp. 3, 254) lauds for seeing the individual transaction as the “ultimate unit of analysis,” simultaneously adhered to an incompatible methodological holism in which “individual wills are concealed into a form of collective voliency or will-to-action” (Gruchy 1972, p. 41).
³ Indeed, to Seckler, “Veblen’s choice of Menger and the Austrian School for attack becomes perhaps one of his greatest, although completely unintended, jokes” (Seckler 1975, p. 145).
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The preconception of human nature fit Jevons's or Walras's theory much better than they do Menger's” (Jaffé 1976, p. 521).

Menger spent a good part of his career embroiled in an intellectual battle over methodology – the Methodenstreit – with the German Historical School. The latter attacked theoretical economics for ignoring the diversity and effects of social institutions; more than that, they contended that this diversity invalidated all theoretical inquiry, since it implied a multiplicity and idiosyncrasy in human behavior refractory to analytical generalization. Menger's response was not to deny the importance of institutions, but rather to argue that institutions are themselves social phenomena in need of theoretical explanation (Lachmann 1971, pp. 55–6). Thus Menger has perhaps more claim to be the patron saint of the new institutional economics than has any of the original institutionalists. For it is in Menger's sense – and not in the antitheoretical sense – that these more recent writers are institutionalists.4

Thus, unlike earlier debates – and contrary to many perceptions about more recent debates – the current dialectic between neoclassical economics and institutionalism does not involve a disagreement about the possibility or value of pure theory. The problem with the Historical School and many of the early Institutionalists is that they wanted an economics with institutions but without theory; the problem with many neoclassicists is that they want economic theory without institutions; what we should really want is both institutions and theory5 – not only pure economic theory informed by the existence of specific institutions, but also an economic theory of institutions.

1.3 Emerging themes

There are always a number of dimensions along which one could scrutinize an intellectual structure. The following interrelated themes are thus not the only ones possible, but they do seem to me to distill much of the essence.

1. Although definitely rational in a true sense, the agent of economic theory is not best conceived as rational in the narrow sense of maximizing within a framework of known alternatives.
2. Economic phenomena are in large measure the result of learning over time by economic agents; economic explanation

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* See Vanberg (1982) for a similar treatment of old versus new institutionalism. Indeed, Vanberg uses the term “der neue theoretische institutionalismus” – the new theoretical institutionalism.

* I am indebted to Roger Garrison for this concise way of summarizing the matter.
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should thus be a dynamic exercise – dynamic not merely in the sense of dynamic neoclassical models, but in a sense best rendered as evolutionary.

3. The coordination of economic activity is not merely a matter of price-mediated transactions in markets, but is supported by a wide range of economic and social institutions that are themselves an important topic of theoretical economic inquiry.

These themes do not emerge with equal emphasis in all the works I will cite; some writers who explore one of the themes may even do so in a manner antagonistic to the other themes. But I maintain that all three are necessary for a complete account.

1.4 Rationality

Complaints about the conception of rationality in neoclassical economics have a long history. Such complaints are usually interpreted – not always incorrectly – as denials that economic agents do behave, or should be represented as behaving, rationally. In the present case, such an interpretation would be unwarranted. The real issue is not whether agents should be seen as rational, but whether their rationality should be portrayed exclusively as the conscious maximization of an explicit objective (such as utility) within the constraints of well-defined alternatives.

Since I spend a good deal of time on the question of rationality in Chapter 10, let me not dwell on it here. I should note in passing that this theme is perhaps most evident in the three chapters following this one. In Chapter 2, Stephen Littlechild ties together the themes of rationality and of process: His three of types of market process are driven by three different conceptions of the nature and appropriate scope of rationality in modeling. In Chapter 3, Brian Losby is also concerned with both process and rationality, and he finds his lens in the growth-of-knowledge literature that lies in the foreground of present-day philosophy of science. And, in Chapter 4, Ronald Heiner uses results from signal-detection experiments to explore the nature of rational behavior and extends his attempts to model that behavior using the reliability-condition framework he has recently introduced (Heiner 1983). In Chapter 8, Oliver Williamson also raises the issue of rationality in economics, aligning himself with the semistrong conception found in the work of Herbert Simon. This he distinguished both from the strong form of rationality in neoclassical economics and from a weaker form – what he calls “organic” rationality – that he associates with evolutionary modeling.
1.5 The dual role of institutions

1.5.1 Competition as a process

As I’ve already suggested, the connection between institutions and economic theory is a bidirectional one. On the one hand, institutions influence economic phenomena, and this implies a need for economic theories in which institutional influences and constraints play a role. Perhaps the best illustration of this sort of institutionalism lies in the area of competition theory, where process views of competition are coming together with property rights approaches to create an alternative to the traditional neoclassical microeconomics of competition (and to its policy handmaiden, the so-called structure-conduct-performance paradigm). In the other direction, institutions and economic theory meet to the extent that theory can be brought to bear to explain the various economic and social institutions themselves. This section examines the first of these topics, and Section 1.5.2 takes a look at the second.

There are a number of ways to describe the difference between a process view of economics (and hence of competition) and what I believe it is fair to call the mainstream standard. One of these ways may be to distinguish the former as “dynamic” and the latter as “static,” at least as long as we are careful about what we mean by those terms.6

The heart of the distinction is that, in a process analysis, events are represented as taking place sequentially in real time.7 By contrast, in a neoclassical analysis (as I am using the term), one is normally concerned with an equilibrium situation – an equilibrium defined not as the end-result or rest-state of a process, but as the condition of logical consistency among a group of mathematical relations. Thus a process analysis can be static in the sense that the process may have an eventual equilibrium state. And a neoclassical analysis can be dynamic to the extent that a variable labeled “time” may enter into relations whose consistency constitutes the equilibrium. But the meanings of dynamic and static are very different in the two cases.

Mathematical general-equilibrium theory in the tradition of Walras is the best-developed area of economics in which the static conception of equilibrium reigns, although the basic approach has filtered down to almost all other areas, including competition policy. General-equilibrium theory is built entirely around this idea of equilibrium as the logical consistency of relations. One searches for a fixed point, a particu-

6 On the slipperiness of these terms see Machlup (1963).
7 Time can also enter as a variable in a nonprocess model, but it necessarily plays a very different role. On this see O’Driscoll and Rizzo (1985, chap. 4), who distinguish between the Bergsonian time of process models and the Newtonian time of neoclassical equilibrium analysis. See also Fusfeld (1984).
lar vector of prices and quantities for which all the system’s equations are simultaneously satisfied.

In a series of articles in the 1930s and 1940s, Hayek (1948, chaps. 2, 4, 8) argued that, although this model is valuable for illustrating the complex interconnectedness of the economy, to take it literally is to misconstrue much of the economic problem facing society. That problem, he argued, lies less in allocating a given set of resources according to consistent logical principles than in adapting successfully to changed conditions and in using effectively the knowledge dispersed throughout society. As an alternative to the Walrasian logical-consistency notion of general equilibrium, he offered a process approach in which economic agents are portrayed as having plans or strategies and in which equilibrium occurs when those plans come into mutual consistency after a process of learning (Hayek 1948, chap. 2).

Many of the theorists who helped to raise the general-equilibrium edifice to its current state of elegance have lately expressed rather similar misgivings. Frank Hahn (1973) has even reinvented Hayek’s proposal and offered it as a new research program for general-equilibrium theorists – an offer that, unhappily, has so far attracted few takers (Littlechild 1982).

The static (logical-consistency) equilibrium approach is also prominent in applied competition theory. Here, as in general-equilibrium theory, the problem to be solved by competition is the allocation of a given set of resources to given ends. Aside from imperfect information (the failure of one or more buyers or sellers to know all the relevant facts of the hypothesized allocation problem), the principal impediment to a socially efficient allocation is the possession of “market power” by an agent, that is, the ability of the agent to affect the market price by manipulating the amount he or she sells. Not surprisingly, the normatively preferred market structure is atomistic or perfect competition, a situation in which no seller (or buyer for that matter) is able to affect the market price of the commodity in question.\(^8\)

In this theory, the discipline of the market consists entirely in limiting the discretion producers have in setting the prices they will charge. One competes not by taking action but, in a real sense, by being unable to take action.

Perfect competition limits discretion completely. No action a firm takes can affect the price it can obtain for its product. There are also a number of “imperfect competition” variants in which the firm has

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\(^8\) I am, of course, ignoring a number of other assumptions of this model: perfect homogeneity of product, exogenous cost-curves deriving from fully understood production functions, etc.
discretion to adjust within a range its price asked and quantity offered. The most famous version of this, of course, is monopoly, in which there exists, for reasons unexplained, only one firm selling a given product in a given market. Unlike the perfectly competitive firm, which would lose fully all its customers if it charged more than the going rate, the monopoly would lose only some of its customers if it increased the price of its product. In view of this, the monopoly can maximize its profits by setting a price higher than its marginal costs, a maneuver that not only transfers income from consumers to the monopoly (relative to the equivalent perfect-competition case) but also results in a level of output less than the “social optimum.”

Another version of imperfect competition is that noted variant of monopoly, oligopoly. The number of firms involved here ranges between two (duopoly) and perhaps a half-dozen, a circumstance that leaves oligopoly theory in a position somewhat analogous to that of the three-body problem in physics: Whereas the analysis of one body is analytically tractable, the analysis of an intermediate handful is not.

In an oligopolistic situation, price and quantity decisions among firms are very much interdependent. This is not a problem in the competitive case because no one’s actions can affect the ruling price; and in the monopoly case, there is no one else. But life is not so simple in oligopoly. Since the optimum price depends not only upon variables subject to the oligopolist’s own control but also on variables subject to the control of competitors, the oligopolist’s choice at any time is governed by his expectations about the behavior of those competitors.

As a consequence, the theoretical hope – dating from Cournot (1838) – that social optimality could be deduced solely from the number of firms in a market had to be abandoned in favor of the structure-conduct-performance (SCP) paradigm. According to this schema, one evaluates performance (proximity to social optimality) by examining not only the market structure but also the conduct or behavior of the firms in the market. This is not in theory a move toward a process view (although it sometimes has that effect in practice): One looks at behavior only to fill in the blank of indeterminacy created in oligopoly theory by the problem of expectations; one looks exclusively for evidence of collusion or of “anticompetitive practices” in order to determine whether the oligopoly in question should be viewed as closer to the competitive or to the monopoly pole.

One might well complain that I have painted a misleading caricature of the literature of industrial organization. There have indeed been many subtle and interesting kinds of industry analysis carried out ostensibly under the SCP banner. But this work typically refuses to take the
formal theory seriously, relying instead on a sort of economic intuition and common sense that, if formalized, would look much more like a process view of competition than like the SCP paradigm.\(^9\) Taking the formal theory seriously can indeed lead to absurd conclusions; and it has led many economists, representing a fairly wide range of the political spectrum, to advocate, for example, the forcible chopping up of all “concentrated” industries irrespective of the history, growth rate, competitive environment, technology, institutional constraints, or any other factor specific to the case.

It is a persistent theme among the writers I’m concerned with in this essay that the heterodoxy they advocate is not merely a break with recent tradition but actually a return to an earlier, perhaps sounder, tradition (Nelson and Winter 1982, p. 45; Loasby 1976, p. 47; Klein 1977, p. 68; Kirzner 1981, p. 112). And, in the theory of competition, the earlier tradition is that of Adam Smith and the classical economists:\(^{10}\) “Smith’s concept of competition was decidedly not one in which the firm was passive with respect to price but was, rather, one in which the market moved toward equilibrium through the active price responses of its various participants” (McNulty 1967, p. 397; see also McNulty 1968). Moreover, Smith never viewed competition as involving perfection; he talked exclusively of “free” competition, “a phrase designed to capture the meaning of free entry into competition, against a background of medieval restrictions and regulations” (Dennis 1977, p. 99, emphasis in original).

The Walras-Cournot vision lay somewhat dormant during the early part of the century, a time dominated by the thought of economists such as Alfred Marshall, J. B. Clark, and Frank Knight. But Walras was rediscovered in the 1930s, and by the fifties and sixties had come to dominate economic thought almost completely. But there always remained a few voices of protest. In addition to Hayek (1948, chap. 5), there was J. M. Clark (1940, 1961), who long advocated a processlike view that he called “workable” competition. Most influential of all was probably Joseph Schumpeter, who offered a provocative account of competition as “creative destruction.”

Schumpeter admitted the validity of the perfect-competition model (or, more correctly, of a commonsense empirical counterpart of some-

\(^9\) This is essentially the same argument that Richard Nelson makes in Chapter 6 in the context of the productivity-growth slowdown of the 1970s.

\(^{10}\) Alfred Marshall, who, a bit like Menger, always kept one foot firmly in the classical tradition, also receives generally good marks from these authors (Nelson and Winter 1982, p. 44; Loasby 1976, p. 47). Although his well-known partial-equilibrium analyses did not usually reflect it, Marshall was quite interested in biological analogies and evolutionary ideas (see Loasby in this volume).