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THE PLACE OF INSTITUTIONAL ECONOMICS* IN ECONOMICS**

Onur ÖZSOY***

I. Introduction

The main purpose of this study is to show the place of institutional economics in economics.

Economic theories are drawn from the economic activities of human beings. All economic theories have their own analytical tools in order to examine the economic activities of human beings. The main analytical tool of classical economics is supply and demand; Keynesian economics uses aggregate consumption and investment. The Veblenian Dichotomy¹ is the main analytical tool of the institutional aspect. Therefore, institutional economics has been shaped by the Veblenian dichotomy and has taken a special place in the world of economics.

The second section of this study explains how institutional economics defines economics and how it differs from other approaches. The third section of this study exposes the method that is used by the institutionalists to find out solutions to the real life social, political and economic phenomena. The forth section of this study illustrates

*Veblen wrote his revolutionary article titled "Why is Economics not an Evolutionary Science?", which was published in Quarterly Journal of Economics, in 1898. In his article, Veblen precisely defined institutional economics. Institutional economics is also known as evolutionary economics.

**This article is dedicated to Thorstein B. Veblen, who is the founder of Institutional Economics.

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¹In his works, Veblen expressed the dichotomy in two distinct forms: institutional and *technological*. To Veblen, economic life is best understood as the simultaneous evolution of *technology* and *institutions*. The term dichotomy differs from the term duality. Dichotomy in general is a division into two separate but related parts; however, duality, like dichotomy, consists of two parts, but there are no relations among the parts.

the theoretical concepts of institutional economics and gives a broad overview of principle ideas of institutional economics. Furthermore, section four compares the institutional economics with Keynesian and classical economics in some respects. The forth section includes some conclusions and implications.

II. Definition of Institutional Economics

The traditional view of economics defines the economics as allocation of scarce resources among insatiable wants. On the contrary, the institutional view of economics defines the economics as a social science that examines material aspects of human existence. Thus, in its widest sense the institutional economics is a study of how and in which way human beings make a living.

The widest definition of economics by the institutionalists means that the number of legitimate questions that may be asked and issues that may be brought about by the current economic systems is devastatingly increased. Another meaning of the institutionalists' view of defining economics is that in order to address the questions and issues that are raised by the current economic systems and situations knowledge from other areas such as political science, anthropology, philosophy, psychology, history, biology, physics, chemistry, sociology, history of science and technology are integrated into the inquiry. This can cause some degree of confusion for the reader and may raise question how and in what respect such areas are relevant to economics. The answer for these questions is straightforward. Human activity occurs as a whole. It is broken into parts with each aspect creating patterns of human behavior. There are no political activities that are not separate from economic activities. Similarly, social activities are closely related with economic and political activities. Also, history permits societies to see where they have been and how they got to where are, and helps to extrapolate where they will be headed. Therefore, when institutionalists focus specifically on economic activities, they try to examine them in the context of the whole human behaviour.

This should not be understood as whenever institutionalists encounter with economic problems or issues they always use all the available knowledge that are mentioned in above paragraph. It should be understood as other areas of human knowledge are not automatically excluded because they lie outside of the scope of economic inquiry.

Additionally, institutional economics is a way of dissecting the economy and economic behavior based upon the evolution of social practices, and the relation to survival and making a living. Institutional economics investigates the way human beings make a living, through analyzing the interaction of technology and institution, and how these two components can jointly determine "the material well being of all of us taken together."²

III. Method of Institutional Economics

²Brazelton, Sturgeon, Weintl, *Alternative Streams in Economic Analysis*, p. 66.

In the process of analysing economic problems, we economists use various different types of methods. Methods appear to be the most important and may be the most difficult part of the field of economic.

Institutional economics is built on the *evolutionary method*. That is:

A way of knowing and doing what relies on experience, experiment, trial and error. It is based on the proposition that what we know and do is an ever changing cumulative process. A process in which what we have known and have done develops, gradually or sometimes rapidly, into what we know and do.³

The evolutionary method strongly supports the idea that knowledge progresses as a continuous process. According to institutionalists' view, knowledge may not be advancing and kept continuously in every aspect of life. Knowledge is not either absolute or immutable in character. As pointed out above, knowledge, in time, can evolve and change.

The evolutionary method incorporates with the *means ends continuum*. This continuum is based on the idea that there is no final end toward which the economy is moving. Rather human beings are moving toward an endless succession of means each of which becomes an end. This is a never ending process. When a human being faces with a problem, his willingness to solve this problem becomes his end-in-view. He selects a means to this end hoping to reach to a solution of the problem. If the problem is solved, the human being will not stop living and confront other problems. Thus, this shows as that there is no final end that means become ends. This view can have very complex implications. First implication is that when there are several ways to solve the problem how do we choose the means to an end. Second, once chosen how do we know if we are right. Third, if we are wrong what do we do about it. All of these questions involve not only how we know, but what we know and what we value.

The continuum of means and ends is based on attempting to understand the consequences that stem from choosing alternative means. Moreover, the process of selecting these means is built on the proposition that continuity of life process is important and valuable. But how do we know which means will yield which consequences. According to the institutionalists' view individuals and societies base these selections on two different ways of knowing and doing: experiment, science and empirical evidence, and superstition, myth and belief in supernatural forces. These two ways posit a fact based cause and effect relationship. Nobody believes in supernatural forces without believing in the fact of these forces.

In addition to this, the institutionalists analyze the economy as a whole as part of an evolutionary process. From this point of view, Institutionalists have constructed a scientific paradigm for the analysis of the evolving economic system in which disequilibrating forces are more prominent than equilibrating forces. Moreover, the institutional theory emphasizes that individuals have both competitive and cooperative or

³Ibid, p. 67.

collective psychological tendencies. In advanced industrial western economies, there is an emergency conflict between individual action in the private sector and collective action in the public sector. This conflict has many disequilibrating effects, and this can be resolved by the institutional economists' opinion only when collective action in the public sector provides the necessary overall guidance for individual action in the private sector.

IV. Theoretical Concepts of Institutional Economics

According to institutional economic theory, the economy is the product of cumulative action carried out and gained significance from the culture of society. Culture is defined as the past experiences of both material and immaterial of a group of people. Obviously each person is born in a particular culture, and absorb basic features such as language, customs, traditions. They also absorb the other aspects of the culture, its particular myths and legends as well as tools and skills culture provides the milieu for the continuity and growth of human experience. Cultures are not simply conglomerations of human activities. Moreover, since it is these activities we select to understand, we break culture down into pieces to try to see how the pieces work and we try to fit pieces back together. The two major aspects that we break culture into are technological and institutional. Therefore, all cultures have two heritages, two way of knowing, valuing, doing, analyzing and this means that both aspects of culture are ways of behaving and both explain human behaviour, including economic behavior. The institutional heritage is based upon a ceremonial system that is derived from myths, legends, and traditions. As defined culture is a product of interaction of tools and symbols, technological and institutional forces these characteristics of culture shape the human behaviors and the activities of human beings. Therefore, as mentioned earlier all cultures have two different accumulated modes of behavior that constitute their social knowledge. The first form of behavior is institutionally and the second form of behavior is technologically determined. Recognition of the technological and power aspects of behavior and their relationships to each other, is involved in the separation that was common to Veblen's work the dichotomy of business and industry. Because to Veblen, industry is productive process of making goods while business is the predatory process of making profits. Therefore, to Veblen economic life as best understood as the simultaneous evolution of technology and institutions. The back grounds for considering the technological – institutional dichotomy as a meaningful tool for social analysis are the concept of social structure and the modern anthropological development of the concept of culture.

Institutions involve traditions and patterns of behavior which are neither feasible, in the direct sense, nor are capable of taking space. Furthermore, institution is regarded by institutionalists as a nondynamic organized, learned aspect of human behavior. The institution is social phenomena that can only be verified by the use of ceremonial logic. Ceremonial behavior has its heritage the accumulation of myths, symbols, and legends that are currently diffused throughout the existing culture. We can not take the cultural differences as given in our analysis because the institutional factors must be part of the subject matter under investigation. Therefore, it can be thought that institutions are concerned by Veblen to be patterns of behavior and primarily habitual in character.

In addition to that, an institution is assumed to have historical development that is subject to change, even though they may seem to display the character of performance. However, these characteristics of institutions do not suggest explanations for changes that are continuously going on in institutional patterns. Therefore, the dynamic elements can

be found in the technological view, thus, institutional – ceremonial concept is past binding non-dynamic organized, learned aspect of human behavior. On the other hand, technological aspect of the institution is dynamic and changing, evolutionary, in concept never ending, continuous organized, learned part of human behavior. If we can not see our technological complement in developmental terms, we can not understand the social consequences of technological growth and its impact on institutional behavior patterns. The difference between the old habits and the new models of behavior brought on by technological will usually create an unsettling situation and uneasy adjustment to the new conditions of experience. However, the facts of technological development and growth are definitive and fundamental in the sense that they continue to advance and grow and condition our lives in a never ending process of development. This does not mean that technological will always continue to develop in an irrespective manner of the nature of the institutional patterns around it; however, it does not mean that it will be the technological growth that will be decisive to look back institutional patterns. The effects of technological developments are to shake the institutional patterns and require change of habitual ways of doing things. As a result of this, the concept of technology is explained by institutionalists as an internally dynamic, organized, learned aspect of human behavior. This aspect of human behavior develops and accumulates from the process of tool using. Also the process of trial and error results in cultures developing new skills, tools and thus new forms of human behavior. Since all inventions, the technological process may be regarded as self-correcting in the sense that it will always comply with the requirements of the means-end continuum. Therefore, the technological aspect of human behavior is changing and never ending. Therefore, the principles of economics can not be adequately constructed without analyzing the institutional and technological aspects of human behavior.

As is stated above, economic theories are closely related to human behavior. According to Veblen, human behavior is problematical; whenever a problem arises in real life, we economists try to use different types of tools and/or methods to find out solutions. However when we find a solution to a real life economic problem, another problem arises. If an economist tries to solve a real life problem, he has to apply the theoretical concept. As Jerry L. Petr concisely points out that the economic problem has been identified in accordance with the recognition of a discrepancy between what is and what ought to be between what goes on here and what ought to go on here.⁴ The resolution of an economic problem has been identified as the destruction of that discrepancy. Since what ought to be in economic relationships is the application of the theory of value, and since economic problems can not be resolved or conceived without some comprehension of what ought to be, it becomes clear that significant economic analyses necessarily involves the application of the theory of value. As is pointed out above, because of the evolutionary nature of the institutional approach, its main concern is the changes in social and economic life. Therefore, as Atkinson states, it is crucial from an economist's view of point whenever there are economic problems to be solved in real life, social values must always be incorporated into the theory and analysis. As a result of this, the principal duty of economists is to try to find out theoretical basis, tools and methods to solve real economic and social problems facing real people in their everyday life. As is mentioned above, institutionalists use the instrumental theory of

⁴Petr, Jerry L., "Fundamentals of an Institutional Perspective on Economic Policy", *Journal of Economic Issues*, vol. 18, no. 1, March 1984.

valuing in the process of solving real life economic and social problems. Indicated by institutionalists, there is no permanent solutions to economic and social problems that human beings encounter in everyday life, because as social scientists (especially economists) find out solutions or the problems in the on-going life process, other problems arise. Consequently, the institutional theory of valuing calls for evaluating the alternatives to any problem by the use of instrumental logic and the process of trial and error. Adaption of new values should bear in mind their positive contribution to life process. Since it is determined that life is an on-going, active process - in other words, the theory of institutional economics is based upon the idea of the ends in view - therefore, institutional economics casts the solution proposals for the social and economic problems in a form designed to influence the course of society toward such ends.

Moreover, according to institutional economic theory, institutionalism is the way of improving conditions both in social and in economic lives by using available tools that societies in which we live have. People's wants and needs can change as technology evolves and social and economic conditions of societies improve as a result of new tool creation process and inventions. Thus, according to institutionalist economic theory, social and economic conditions and lives of societies are continuum, with development and adaption being its precise characteristics. Consequently, institutional economists have to account today's developments to propose suitable policy adaptations for tomorrow. Additionally, institutional economic theory strongly supports the idea that the evolution of societies would continue until the end of the world. As a result of this continuity of development and accumulation of human knowledge and of technological conditions that societies have, institutional economic theory is regarded as being active rather than passive. Because institutional economic theory is fact-based, the objective of institutional economic theory is experiment-based rather than elegant, to explain real world phenomena rather than artificial and imaginary world phenomena. For example; the institutional theory of consumption and production tries to explain why we consume and what we do, and what and how we consume goods and services by evaluating real life experiences. Therefore, institutional economic theory is aimed to meet people's real needs and wants, and to make life bearable for all of us.

Additionally, institutional economic theory is holistic in its nature. According to institutional economic theory, most of the problems that societies face today are political and must be seen in historical perspective. Furthermore, institutionalists indicate that consumption and production processes are not only related to past experiences, but are also politically affected by each other.

Furthermore, in institutional economic theory, the relationship between theory and policy proposals is defined as non-dogmatic, and democratic in nature. In institutional economic theory, economic institutions define the production, distribution and consumption of goods. To the institutionalist approach economic policies have to be changed and designed to catch technological changes. Moreover the institutionalist approach includes democracy in the process of policy formation. In order to improve the life process, principle holds an important place. The quality of human experience is the *end-in-view*. Policies are drawn with respect to the quality of life. Thus, it is expected that society would be involved in policy formation. Therefore, the community provides final policy evaluation.

In the institutional economic theory, economic institutions define the production, consumption and distribution of goods. The central scope of the IET is the nature of economic institutions. However, in the classical economic theory, the production, consumption and distribution of goods are defined by laws. Furthermore, classicists assumed that economic process were based on objective, mechanical laws and not on man-made organization and arrangements. Furthermore, the classicist consider that economic variables interact in a mechanical manner. This process of interaction would lead society to an absolute reality, if it is left alone. This reality is attained through observing natural laws which lead to natural order. The classicists also believe that the form of the economic organization is fixed.

On the contrary, to institutionalists, the form of the economic organization changes through technological progress because, to them, technological progress is a dynamic and never-ending human behavior. On the other hand, institutionalists handle economics as an evolutionary aspect of human nature.

Furthermore, institutionalists have solutions to current economic problems as well as social problems. One of the major shortcomings of conventional economics is that it does not include within its scope a consideration of many of the social and political factors that are closely associated with economic factors in the real world. The recent tendency to convert economics into political economy is evidence of the growing recognition that all these factors should be integrated as far as possible in dealing with such problems as domestic and international instability, environmental deterioration and the gap between the rich and poor countries. Since the institutionalists do not believe in fixed boundaries to the scope of economics, they have emphasized the importance of an interdisciplinary approach to the problem of the developed and the underdeveloped countries.

Institutionalists are not utopians: they always deal with real world economic phenomena, and they generally try to solve the economic, political and social problems which society faces. To them, society is an ever-changing organic pattern of closely interrelated and interdependent institutions amenable to intelligent control by their members, and problems of society are all mixed and composite; thus, the institutionalists handle the problems as a whole. Furthermore, institutionalists are holistic and evolutionary in their analyses. From this point of view the institutionalists share basic ideas with the marxist approach.

Another area to which institutional economic theory has contributed is concerned with the decline in the effectiveness of Keynesian economics as a means of solving the pressing problems of industrial western economies. Institutionalists believe that obviously the Keynesian approach has an explanation for the recovery from a depression or recession; however, the Keynesian approach has difficulty in explaining how to keep economic stability at a full employment level once it has been reached. On the other hand, the Post-Keynesian approach seems to handle the problem of industrial western economies such as France, Germany and the Scandinavian countries. In these countries, the income policies and the identification of national goals show that a degree of cooperation among organized business, labor and the government is necessary if these

issues are to be handled successfully.⁵ The institutionalists state that their approach, which emphasizes the role of collective action in control of individual action in the economic sphere, has much more to offer economists who are moving towards a Post-Keynesian economy than does conventional Keynesian economics.

Lastly, institutionalists' ideas of economic theory are related to the future. The mainstream institutionalists, such as Ayres, Myrdal, Colm and Galbraith, the economics of future will be political economics. Although there is no time period specified, world economics seem to be changing in that direction.

V. Conclusions

In conclusion, institutional economics stresses looking at the economy as a whole, as part of an evolutionary process. Although the institutional, Keynesian and Marxist approaches have some similarities, the institutional approach differs from classical economics in terms of their principals. The institutional economic theory is related to and shares some ideas with other social and physical sciences because institutionalists see society as a changing and *never-ending* living organism; and thus, institutional economic theory takes the social and economic problems with in the society and try to come up with solid and concrete solutions within the society. Moreover, institutionalists believe that the main scope of economic theories is institutions. To them, the mechanical economic laws offer nothing to solve real economic phenomena or to provide suitable economic policies. The institutionalist economic theory is realistic and non-dogmatic in its scope and institutionalists are activists and optimists.

Therefore, it is clear enough that institutional economics has solutions to all social, economic and political problems that today's societies face, influences recent economic theories, and would certainly influence future economic theories. The institutionalists economic theory can be the approach of the twenty-first century, and the future aspect of economic theories is most likely to be shaped by the hands of institutionalists.

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⁵Gruchy, A. G., *Comparative Economic Systems*, pp. 12-13.

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