Chapter Nineteen: The Institutionalist School:
(pg 369 - 396)

Historic Background

- An American School – began after the U.S. Civil War.
  - Rapid growth, but very unequal wealth distribution
  - Immigration meant downward wage pressure
  - Problems of Monopoly, Monopsony, Trusts (Cartels)
  - In General, the U.S. was more “wild west” than Europe
- How to deal with the problems of inequality and monopoly
  - Socialism, that will not work…
  - So instead, reform through the government; Progressivism
  - American econ was a product of the German Hist. School
    - But America was never Germany….

Major Tenants of the Institutionalist School

- Holistic, broad perspective
  - You can’t understand an economy just from its parts
    - Is a human “just” a bunch of mindless cells?
      - 99% DNA….
  - Social processes, Social Relationships, society….
- Focus on Institutions
  - An institution is more than just an organization for a part. Objective
  - They develop characteristics, dynamics, ideologies, etc.
    - The IBM way, Google inc., Slavery, etc.
  - Economic life is not regulated by economic laws…
    - But rather, by economic institutions
  - Can we reform credit, monopoly, absentee ownership, etc.
- Darwinian, Evolutionary approach
  - Rejected static analysis.
  - Not “what does the economy look like”, but rather
  - “how did it get here, and where is it going”
  - This meant know history, sociology, politics, etc.
- Rejected the idea of a normal equilibrium
  - Rather, circular causation, cumulative changes, and
  - Maladjustments to the economy.
    - Suboptimal “path dependent” outcomes, cycles, etc.
  - Collective action through government is often good and necessary
- Clashing Interests
  - Collective, cooperative behavior within groups
    - But not between groups
  - Business vs. labor, unionized/non unionized, young and old, renters..
  - Representative and impartial government to regulate conflicts
- Liberal, Democratic reform
  - Reform needed to bring about equitable wealth distribution
  - Laissez-faire inadequate and unjust, more government needed
- Rejection of Pleasure/Pain principle
  - Benthamite utility was overly restricting, and simplistic
  - Economics needed a better model of human motivation

Frued, phsychoanalys, etc.

Whom did the Institutionalists Benefit or Seek to Benefit?
- Sought to help the middle class and poor vs. the wealthy
- Unions, farmers, small firms.
  - Also govt. workers, humanitarians, reformers (busybodies)
- Non-economist academics

How was it valid, useful or correct for its time?
- They made economics more realistic, forced it to grapple with "real world"
- Raised belated, but long lasting, concern over monopolies and cycles
- The stress on Holistic work narrowed gap between economics and other SS
- They stressed empirical work, and this led to better data
  - NBER in 1920….

Which tenants became lasting contributions?
- In many ways, their agenda and methodology were taken over by keynsians
- Politically, the reform movements they started remain in place
  - Many U.S. laws are products of the movement
- Developmental economics, which is about creating econ. Institutions
- Neo-classical economics is now encroaching on institutional econ
  - As is Public choice and new institutional economics

Thorstein Bunde Veblen
- (American, 1857 – 1929)

- The Theory of the Leisure class
  - Conspicuous Consumption,
    - Upward sloping demand functions
  - Avoiding useful work,
    - (A form of Conspicuous consumption)
  - Conservatism
    - Whatever is, is correct. Against Change
    - But society is dynamic, so econ. Forces are changing
    - Thus the elite is resistant to change

- The Problem with Neo-Classical Economics
  - Neo-classical economics assumed "consumer sovieghnty"
    - i.e. we consumed goods to satisfy our material wants
  - But we don't – many of our wants are social (status), and competitive
    - If a great deal of consumption is wasteful by design…
  - Then we need to government intervention

  - "Hedonism" was also wrong as a theory
    - It pre-supposes "homo-economicus", who knows his wants,
      - Who makes instantaneous calculations to achieve them
    - We are social, are wants in part derived from our neighbors
    - And we certainly are not perfectly rational calculators

Instinct for Workmanship
We used to like work, because we liked achievement
But who in the modern factory system likes work?
The instinct to achieve has been replaced by
A striving for profits

Credit and the Business Cycle
A theory of the business cycle based on credit (can skip for now)

Solution to all the above problems: Soviet of Technicians
Conflict between industry and business, owners and renters, etc. etc.
how to regulate the conflict?
Not marx, and not socialism
Not electoral politics, just another form of conflict…
And not free markets, conspicuous consumption is zero-sum

His solution was the engineers….
They were rational, had the workmanship instinct
They were smart, socially homogenous
So they could lead us
Probably didn't really think it could happen

Wesley Clair Mitchell
Student of Veblen
NBER
Lots of work on business cycle

John Kenneth Galbraith 1908 - 2008

The Conventional Wisdom
Neo-classical economics used to be correct
But no more…
Now, it is just a guild system with barriers to entry
And it will not change due to better ideas
But only due to massive failure
(paradigm shifts)

The Dependence Effect
Modern capitalism is dominated by large firms
Who increasingly don't satisfy wants, they manufacture them
Producers decide what to produce
They then advertise, to convince consumers to want them
Consumers then purchase the goods
Are "goods" good, if the desire for them is based on commercials?
Neo-classical consumer sovereignty assumes consumer's have utility
But never addresses how utility preferences are formed

Firms create private goods, and the desire for private goods
Which means public goods are under-desired
And thus underproduced

We need more govt. to provide what consumer's really want
Shakespeare, parks, museums, swimming pools, etc.
Put a high sales tax on private goods, to fund public ones

The Theory of the Firm
Neo-classical theory explains corporations as profit maximizers
True maybe in the market sector – small firms
i.e. what we think of as a competitive sector
but NOT true for very large firms; the planning sector
Ownership and control are divorced….
And the planners are in control
They are the techno-structure, and can't be fired.
And they don't maximize the profits of far off share-holders
The techno-structure has two goals, a protective and affirmative one

Protective Function
You have to survive, so the shareholder must get some profits
The easy way to do this is get at least some profits, but
To do so in an uncompetitive market
Informal price fixing, deliberate differentiation, etc.
Firms shy away from direct competition
Prefer cartels and product differentiation

Affirmative Function
Expand
Growth of output, sales, revenue produces more employment
(employment, not profits, is what the engineers want)
So SALES, not PROFITS, are maximized

Neo-classical economics gets it all wrong
Monoplies don't maximize profits, they maximize sales

Policy implications:
Anti-trust is a waste, technology creates the firms…
Who then OVERPRODUCE
We need to combine market firms
to make them more competitive
And a giant planning board by the govt. to regulate all this

New Institutionalism and Douglass North, Oliver Williamson, Elinor Ostrom
Economic History, Firms and Transaction costs, Transaction costs and economic institutions, path dependency, new .