

## THE INSTITUTIONAL DISTANCING FROM THE CLASSICISM

Criticism of the fundamental classical postulates is the main focus of attention of the institutional theory. In their works, a number of representatives of the institutionalism have expressed their strong disagreement with the hedonistic principles of profit and loss as being the primary motivating factors guiding human behavior. The main classical concepts have developed from relatively old tendencies, which have been dominating the way of thinking in XVII – XVIII century period. Due to its strong connection with the spiritual order the classical economic theory places the main focus on the individual rather than the group. Leading institutionalists question this view and embrace the idea, that individual's behavior can only be manifested in a social environment. This and other characteristics, present the classical theory in a static format, unable to react adequately to the dynamics of the social and economic development. Among the fiercest critics of classicism are Clarence E. Ayres and Thorstein Veblen. In this respect, the following article gives an unconventional view on some of the renowned representatives of the institutionalism with their well-grounded criticism of the classical orthodoxy.

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The perfect competition is a characteristic feature of the authentic classical analysis. One can hardly find any classical concepts or interpretations in the economic literature in which directly or indirectly there has not been an attempt to find the answer to the question how the perfect competition manifests itself and in what ways it affects the life of every single person. By definition, the classical economic theory is a market theory which rules can be monitored, explained and theoretically interpreted.

The theoretical analysis of the American institutional economist Clarence Ayres, a well-known follower and critic of Thorstein Veblen, is based on the view, which is characteristic of the mainstream institutional analysis: "From the individual's point of view, the economy represents a vast market ruled by merciless forces to which a person needs to adapt in the best possible way."<sup>1</sup> In other words, the market system is taken for granted by the individual and he/she must integrate within it by developing an adequate economic behavior. The quoted author's claim is the need for an economic indicator to measure behavior on the one hand and demand and supply, on the other. For a greater number of the old institutionalists, where Ayres undoubtedly belongs, the most important fact is that the market works as a system drawing attention on the price phenomenon. Separating the price system from the other life activities, according to the earlier institutionalists, is

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<sup>1</sup> Ayres, C. E. *The industrial economy: Its technological basis and institutional destiny*. Cambridge, 1952, p. 321.

inherent to the subject of economy. Institutional researchers are not strangers to the understanding that prices are directed by balanced powers which are not rigidly fixed and move up or down.

The theory of institutionalism is based to a large extent on criticism of the main classical postulates and methodological orthodoxy. The fundamental claim of the critical institutional publications is the view that a person's life is not motivated exclusively by pursuit of profit which is deeply rooted in the hedonistic principle of profit and loss. The institutionalists strongly doubt the value of that principle and try to question the importance of the consequences of hedonism. In his treatise "The theory of economic progress" C. Ayres says: "One of the most frequently voiced criticisms towards the orthodox economics is that it is based on the psychology, moral philosophy and theology of the XVIII century. They, as we well know, praise the older trends of thinking which are in even starker contrast with the present day. Economics is by no means the only science in which ancient delusions still exist, but it is the only science among the modern ones in which the XVIII century way of thinking (and before that) defines the prevailing tradition."<sup>2</sup> These older trends revealed in the manner of thinking can be traced as far back as the ancient Greek thinkers. Hedonistic principles are common for the Christian philosophy. There is a close link between the natural rights, as formulated in the Christian values system and the principle of the free market system in which all economic events are ruled by the invisible almighty hand. Veblen thinks likewise that the role of God the classic economic theory is one of its greatest delusions.<sup>3</sup> In "The Preconceptions of Economic Science" the founder of institutional paradigm states: "He (Adam Smith) thinks that the Creator is moderate with his interference in the natural order of things... the Creator has arranged the natural order in such a way so that it benefits the humankind; he has perfectly coordinated the driving forces of the natural order, including people's objectives and motives and the work they need to complete. The invisible hand rules not through interference but through an algorithm set in the book of Genesis. For the purpose of the economic theory the man is viewed as an egoist; but this economic person is an undistinguishable part of the natural mechanism and his egoism only serves as means to achieve the common good".<sup>4</sup>

If the hedonistic claim, the way Veblen and Ayres see it, is true then the purpose of the classical economics is to show how the natural order functions and which its main laws are. Any deviation from the natural state of things is viewed as unnatural and for that reason is of no interest. Here is how Veblen presents his beliefs:

1. The course of events can be diverted from the straight line of development towards that perfect well-being which would be its just completion.

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<sup>2</sup> Ayres, C. E. The theory of economic progress. New York, 1961, p. 5-6.

<sup>3</sup> Veblen, T. Essays in our changing order. New York, 1927, p. 200-218.

<sup>4</sup> Veblen, T. The preconceptions of economic science. – In: The place of science in modern civilization. New York, 1961, p. 115.

The natural direction of things could be diverted by unfortunate set of circumstances.

2. If things have become mixed up they will fall into place again by themselves only then when the interference in the natural way has been terminated; on the other hand, in the case of causal consequence the termination of intrusion alone will not bring about the same result, as well as when there had not been any interference at all.<sup>5</sup>

The concept of perfect competition follows the same logical line – the presumed ideal state of the economy where, it is presumed, the natural laws are in control of events. Price is regarded as natural. This type of natural state differs from reality. The theory abounds with examples illustrating how actual facts sometimes are accepted as abnormal and unnatural. Here are the arguments in Veblen's critical analysis: "The use of the adjective "real" by Adam Smith (real value, real price, for instance) serves as proof that the point of view includes a distinction between reality and fact. This has survived in a weaker version of the theories of price and expenses of Adam Smith's followers."<sup>6</sup>

Due to the strong connection with the spiritual order, the classical economic theory focuses on the individual rather than the group. It is assumed that this individual is reasonable in his actions. Veblen and Ayres disagree with the popular hedonistic preconception: "The hedonist understanding for the man as a fast calculating machine assessing pleasures and pain..., motivated by various stimuli, which change his direction but at the end of the day leave him unscathed. He has neither past nor consequential connections. He is an isolated, completed human entity in a stable equilibrium except for the blows that the existing forces are striking..."<sup>7</sup>

From the point of view of evolutionary science, which institutionalism claims to be, this classical concept is wrong. The history of civilization has proven the existence of group behavior which frequently produces irrational decisions. It can safely be argued that the individual needs to live in a society with all its ties and relationships in order to survive. Decision making is mostly a process taking place in an environment of varied circumstances. Here is how Veblen defends his economic anthropological point of view: "According to the modern anthropological research one human characteristics is that he willfully does something instead of simply receiving the pleasures and pains through the impact of the appropriate forces. He is not just a bunch of desires which have to be satisfied by the impact of the environment. He is rather a contiguously linked structure of inclinations..."<sup>8</sup>

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<sup>5</sup> *Veblen, T.* The preconceptions of economic science..., p. 116.

<sup>6</sup> *Ibid.*, p. 117.

<sup>7</sup> *Veblen, T.* Why is economics not an evolutionary science? – In: The place of science in modern civilization. New York, 1961, p. 73.

<sup>8</sup> *Ibid.*, p. 74.

Classical economic theory views the individual as a passive engine, driven by natural laws. It looks obvious that this would contradict the concept of the entrepreneur who is thought of as the main engine of the economy. Even he is led by the requirements of the market and makes his decisions taking into consideration the primary motivation – profit. The theory itself turns into a theological one, since the already adopted economic laws have been corrected with the adopted axioms. The theory serves as an explanation for the obvious facts of human behavior. This way it fulfils its own purpose – to give an explanation to something that has already been accepted as truth. Since the classical economic theory does not leave any ground for the exploration of the causal sequence of events it can only be a classifying science. Classifying meaning the theory simply registers and gauges the events of the economic life. Such behavior is a consequence of theological character of the classicism. Veblen shares his arguments and conclusions: “It (the classical theory) is like any other theoretical sciences descending from the rationalistic and humanitarian concepts of the XVIII century and its theoretical aim is the taxonomy – definition and classification, to categorize information, existing in a rational matrix of categories believed to comprise the Order in Nature. This order of Nature does not represent the actual succession of material facts but of the facts interpreted in a way that they meet the requirements of the taxonomy with regards to the logical succession and sense of justice.”<sup>9</sup>

These characteristics of the classical economy make the theory static and incapable of dealing with the dynamics of evolution and development. Its static character becomes even more obvious in the research methods being applied to the subject of economy. The classifications in this theory have been done using a system of price evaluation as an assessment of the economic processes and decisions. Because of these the price theory and related to it theoretical constructions form the foundations of classicism. It seems that according to the orthodox thinkers’ claims prices appear in the theory by necessity rather than as a natural phenomenon. Ayres does not miss the opportunity to put forward his institutional statement: “Our economic thinking has focused on the price because of one and only reason – the importance that was attributed to it in the theories of A. Smith and D. Ricardo.”<sup>10</sup>

To define the economy from the point of view of the price system as a mechanism which sustains the economy, and thanks to which it functions; to define economic problems from the point of view of their volume in dollars; to define the economic theory as a price one – all these stand for economic orthodoxy, argue Ayres and the society of the old institutionalists.<sup>11</sup> To the

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<sup>9</sup> Veblen, T. Professor Clark’s economics. – In: The place of science in modern civilization. New York, 1961, p. 191.

<sup>10</sup> Ayres, C. E. The theory of economic progress..., p. 19-20.

<sup>11</sup> Ayres, C. E. The industrial economy..., p. 14.

believers in the institutional values and rules has been more than obvious that only a small group of people are dealing with prices according to the explanation in the price theory. All this gives the institutionalists sufficient reasons to qualify the economic theory's preoccupation with prices and disregard of social influencing as a delusion.

The institutional paradigm's intrinsic part has been the inherent understanding that "tools, machines, technological skills and knowledge are certainly neither less scarcely distributed throughout the economy nor are they less important than prices due to their importance as means of organization of society. This is also applicable to the institutions of an organized society."<sup>12</sup>

According to the classical theory prices are to a great extent a measure of the supply and demand. To prove this statement the curves of supply and demand are used. Following the economic logic of the institutionalists the problem arises from the fact that in order to draw these curves we need to know the quantities and prices. It turns out that something which has to be derived at has been accepted beforehand as a fact. Even more, the very expression of "demand" does not reveal people's preferences but rather their actual purchases. All it means is that the curve of demand could only be drawn after all the facts we want to display have become known. Because what people want differs from what they actually buy. The conditional "if" plays a very important role in the classical theory because both according to Veblen and Ayres, if needs and demand were known as well as the supply then the curves could be drawn. Unfortunately, say the institutionalists, this isn't the case with the orthodox theoretical framework. What is known for certain is the actual volume of realized purchases on the market. These facts are of a statistical interest and cannot serve as a reliable basis for explanation of the economic behavior.

In the style of Veblen's sarcasm numerous examples of the way the classical theory has used its arguments have been published. These examples illustrate the stereotype of the classical theory to hide behind mathematical terms which makes it even less understandable not only for those tempted to apply a market way of thinking. The institutional criticism of the classical postulates continues with increasing fervor, some institutionalists state - when the classics claim that market negotiated prices are natural they only reveal their hedonistic nature. The statement, that the market and its consequences are being ruled by the law of nature, which guarantees precise results of the market system, needs to be explained. Following the acquired spirit of disagreement Veblen notes, that "...because of all above mentioned reasons the essential point regarding market values is their supposed approximation with the real values theologically attributed to goods under the supervision of the almighty law of nature".<sup>13</sup>

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<sup>12</sup> Ayres, C. E. *The theory of economic progress...*, p. 15.

<sup>13</sup> Veblen, T. *The preconceptions of modern science...*, p. 120.

The analysis of the dispute between the classical orthodoxy and the institutional criticism very clearly outlines the institutional theoretical project as an assembly of antitheses of the classical values and principles. From the point of view of the institutional corrective it is the individual alone who through his economic behavior changes the natural price. The institutional message is obvious – science should focus on the individual behavior which is influenced by society. In his groundbreaking work “The Wealth of Nations”<sup>14</sup> Adam Smith places the individual and nature at the forefront but only to the extent that the individual is perceived as a part of the natural order and plays the role of a producer and/or a consumer.

The first great authorities of the American institutionalism define the classical economic theory’s inclination to use the language of mathematics and its concentration in the financial side of the economic life as a shortcoming. The classical economists dedicate themselves to classification and accountability of the economic facts and events but this is not a search for the causes and effects of the economy. There is no explanation as to why things occur but instead there are descriptions and/or predictions of events from the position of the Creator.

### **Capital and Labour in the Institutional Interpretation**

How do we overcome the scarceness of nature through the combination of the means of production? This is one of the main questions for the institutional economists. In the orthodox theory the question about the role of human skills and technology has not been given a distinctive emphasis because capital and labor as factors are taken for granted. They have been paid for by the marginal product of labor. The institutional theorists discern an inadequate tautology there since the classical theorem has accepted certain values for something that will be proven at a later stage. The principle according to which labor (as a subject of appraisal) is paid for is an element of marginal analysis. This kind of analysis (wage is derived from the marginal product of the last added unit of labor) is true by supposition. The institutional understanding to a large degree is based on Veblen’s theoretical reasoning and deserves to be properly illustrated: “The reasonable balance between labor and wage calculated through natural law is a balance between wages and the end result, in other words, between payment for labor and the ability of labor to earn wages... We arrive at the following conclusion: the worker takes as much as he is willing to accept, while the consumer gives as much as he is willing to pay.”<sup>15</sup>

In the mirror of the institutional paradigm the theory of capital as a means of production seems more confusing compared to the theory of the other means – labor. On the one hand, creation of capital is a result of reasonable restraint. Thus, it is assumed that there is a capitalist who can save, while the worker

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<sup>14</sup> *Smith, A. An Inquiry into the Nature and the Causes of the Wealth of the Nations. London, 1776.*

<sup>15</sup> *Veblen, T. Professor Clark’s Economics..., p. 205.*

receives as much as he is willing to accept and he cannot save. The act of saving or resisting consumption already presupposes surplus of capital resource. The price of thus explained resistance is defined as interest. In fact, the main idea behind the theory of resistance is to correct the varied distribution of income. The institutional rebellion was caused by the circumstance that classical economists do not attribute growth and accumulation of capital to new technology. Accumulation of capital is regarded as a monetary phenomenon but when it is viewed as a means of production then it shows its physical nature. Capital goods and capital funds are often mixed up. In the effort to overcome the confusion the understanding for the phenomenon of capital as a capital goods fund springs up. Veblen is quite adamant that the expression "capital goods fund" is rather a confusing mixture of financial and non-financial terminology.<sup>16</sup> The discussion of capital as means of production with its incomplete explanation spreads just over a symbolic number of pages in the vast classical economic theory.

Whenever theories dwell on the mobility of capital it puts its monetary suit on. It is quite logical for such mobility to be authentic only within capital funds and capital goods and to be viewed in the context of the overall ownership. This fact, the American institutionalists note, remains outside the interest of classical interpretation, since the classical theory itself is disinterested in social relationships. If the classical theory had dealt with the rights of ownership as an expression of social interrelations then... "it would have led to the acceptance of the existence of non-material assets, this in its own right would have violated the law of natural recompense of labor and capital..."<sup>17</sup> But because of the hedonistic and utilitarian axioms of the classical theory this cannot be done. The conclusion, drawn by the earlier institutionalists, is that only physical assets can be productive and consequently capital and labor are the real means of production in a suspicious relationship. If these means are really scarce then they are so for certain people only. Firstly, labor is scarce for the capitalist who wants to produce for profit. Actually, only cheap labor is relatively scarce since the entrepreneur wants to produce at low costs. Secondly, capital is relatively scarce for the wage-labor since he does not possess the resources enabling him to save enough and accumulate capital. The question on the overall scarcity comes down to finding the answer "for whom"? It is also a question of possession as well as a mode of social attitude.

### **Classical Orthodoxy in the Focus of the Institutional Criticism**

Institutional criticism is also consistent regarding the theory of value. The classical concept, expressed through the value formulae, reveals its bias

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<sup>16</sup> *Veblen, T. Professor Clark's Economics...*, p. 196.

<sup>17</sup> *Ibid.*, p. 197.

towards the equilibrium. Clarence Ayres presumes that this has been done with the purpose to disseminate, yet again, the idea that natural laws regulate the market in the spirit and in line with the values of hedonism: "The equilibrium is of great importance for the economist because it is helpful. Equilibrium is good, dis-balance is bad. This, of course, is the older meaning of natural order. Order in nature was created to be beneficial."<sup>18</sup>

If productivity of production not only measured but also illustrated the creativity in each production process the creative power would be calculated within the value of the end product. The big question is – how do you measure productivity? The answer of the classical theory is that the consumer does it. If the useful qualities of the product match the actual satisfaction he receives from it, then productivity and utility (marginal productivity and marginal utility) as attributes of value, calculated into price, are equal. If, however, utility was measured by equaling it with productivity, then we get another tautology which unlocks the institutional sarcastic criticisms: "In fact, it would have been very good if it could be proven that social contribution into growth of capital and labor, engaged in the making of any given item, is exactly equal to the actual utility (satisfaction) it provides when used. Both factors (capital and labor) have been measured through the price at which the item was sold and purchased...Economic science does not possess the technical ability to do that. How could we know that prices measure productivity or value? We cannot. We just assume that they do so."<sup>19</sup>

Neither Veblen nor his followers and supporters deny that marginal analysis is important to some extent. If two people, one rich the other poor, placed in the same situation need to buy a product, their choice would be different. But that is all that could be said in a hypothetical situation like this. The pompous theoretic narrative often loads the obvious facts with scientific jargon and makes them difficult to understand by the common man. Veblen, Ayres and most old American institutionalists have expressed doubts in the credibility of marginal analysis. Its shortcomings are apparent and presupposed by this ominous conditional "if", which steers the classical theory into a verbal self-limitation – it is declared that the case is such and such ignoring any social influence on the individual. Veblen wants to turn out the methodological "lining" of the classical school, giving his reasons, annoyed by its attitude to take for granted, to deny or to passably exonerate any cultural or institutional phenomenon that was involved in the facts the theory is dealing with."<sup>20</sup> But even if we take the choice of the individual regarding some present or future consumption, influenced by the marginal utility of the present or future

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<sup>18</sup> Ayres, C. E. *The Theory of Economic Progress...*, p. 66.

<sup>19</sup> *Ibid.*, p. 80.

<sup>20</sup> Veblen, T. *The Limitations of Marginal Utility*. – In: *The place of science in modern civilization*. New York, 1961, p. 233.



satisfaction of desires, there is a limitation of the hedonistic type. Because this claim could be true if we admitted that there existed a rational, discerning economic person with perfect knowledge."<sup>21</sup>

The theory of institutionalism aims predominantly at the old-fashioned philosophy which is behind the classical theory. The attitude of hedonism towards human behavior is the target of critical publications. Behavior is an object of criticism because it does not reflect real life. Price theory has also been subjected to theoretical suspicion and denouncement because it represents a theological statement which views conclusions as granted. According to T. Veblen and C. Ayres the price theory should play only a secondary role in the overall classical theory. The quoted American institutionalists do not approve of the manner, adopted by the classical economists to explain their own theory, either. Institutional critics define this manner as classifying by character and unable to deal with social and technological problems. With regards to this Veblen says: "...The economics is hopelessly behind its time and is incapable of dealing with its subject in a way which will allow it to call itself a modern science."<sup>22</sup>

The institutionalists are willing to discard the whole classical theory and replace it with their own economic concept. They see the alternative in an evolutionary construction of cause and effect which will give explanation to abstract terms like prices, values and the economic side of human life, but only as a part of the social whole. That is why Ayres convincingly and tirelessly reiterates: "The economics studies the economy", and it is not "a science, dealing with production, distribution and consumption of goods."<sup>23</sup> In Veblen's publication "The Limitations of Marginal Utility" the author proposes a motivated institutional point of view as a borderline with classicism: "The evolutionary view does not leave ground for the formulation of the laws of nature with the language of precise normality, no matter whether it concerns the economy of another area of research... The evolutionary theory should be a theory of the process of economic life of a family or the society. The earlier hedonistic concepts, adopted by the classicists regarding human nature, human actions and the concepts of economic interest, do not provide material for a convincing theory of the development of human nature. The hedonists do not speak about economic interest with the words of action. Because of this, it is not understood and appreciated from the point of view of the cumulative growth of trends of thinking and has to be studied in the evolutionary format."<sup>24</sup>

The institutionalists' economic theory could be defined as a theory of a consistent, or rather, a cumulative change. Its conclusions are not such in the

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<sup>21</sup> Veblen, T. The limitations of Marginal Utility..., p. 234-235.

<sup>22</sup> Veblen, T. Why is Economics not an Evolutionary Science?..., p. 56.

<sup>23</sup> These are the opening words of C. Ayres's book "The industrial Economy".

<sup>24</sup> Veblen, T. The Limitations of Marginal Utility..., p. 235 and 237.

classical sense but could be developed and changed if conditions changed. The institutional theory does not describe how certain laws rule the economic processes but explains how certain conditions influence the economic behavior. Taking a deep look in society, its culture and institutions, one could see the direction of evolution in a more theoretical and abstract form so that the economic behavior can be understood.

The institutionalism is not only an economic but also a wide-ranging social theory with an emphasis on the economy. Because of this reason the institutional theory does not separate the individual's behavior from his environment. This is a theory of the economic behavior of society where individuals play a specific role but they cannot exist without it. According to Veblen, the difference between the classical theory and the institutionalism as evolutionary science is in the spiritual approach, the point of view. This is a difference at a fundamental level where facts are interpreted for the purpose of science or for the interest with which they have been evaluated.<sup>25</sup>

In contrast with the classical theory the institutionalism does not use a model as an instrument for interpretation; neither does it make similar limiting assumptions. An economist, using the methodology of the institutionalism observes society and its history and draws his answers from them as to why, where and how certain things occur.

### **Ceremonial Behavior and Technological Change**

According to the institutional theory the two primary and determining forces which affect the processes in the life of society are the technological progress and the ceremonial consistency. Technological progress is a driving dynamic force, while ceremonial consistency is a static force of self-preservation. The institutionalists regard technology as an actual manifestation of the industrial art. It is an application of all the tools of civilization including human activities and skills. By this definition<sup>26</sup> technology becomes not only a decisively dynamic factor in the economy but an antipode of every static in its character institution.

Applied technology is the organization of all skills with the purpose to create a specific thing and technological progress is achieved through the combination of human capabilities and the existing knowledge in a favorable environment for the creation technological innovations. In the institutional dictionary the word innovator stands for a person who turns out to be at the right place, at the right time and possessing the necessary knowledge. The institutional interpretation of the economic progress and the technological innovations could be compared to the socio-economic theory of Joseph Schumpeter. Ayres's explanation is that "all inventions are combinations of

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<sup>25</sup> Veblen, T. *Why is Economics not an Evolutionary Science?...*, p. 60.

<sup>26</sup> Ayres, C. E. *The Theory of Economic Progress...*, p. 7.

previous inventions.”<sup>27</sup> He adds that “sooner or later” certain combinations almost obligatory would have materialized in someone else’s hands.”<sup>28</sup> This understanding reminds of the captain of the industry – the entrepreneur, presented by J. Schumpeter as the engine of the economic dynamics which powers modern development.<sup>29</sup>

Technological progress is inevitable in mankind’s evolutionary progress and occurs regardless of conditions – either stimulating or obstructing its realization or scale. What could be changed is the frequency of the technological innovations but not the very process. The institutional statement is that through the accumulation of technical knowledge the technological progress ensures further advancement of society.<sup>30</sup> The example with the invention of Johannes Gutenberg illustrates the institutional viewpoint on the possibility to combine two different elements to create a third one which will push forward further progress. The inventor needed to make the right combination to achieve an alloy and to create the type of ink that can be applied to metal. The preconditions for that were already in place so the inventor only exercised the proper way of combining the elements. We could track the background of this example as well as its follow up to show how one invention could be used at a later time as an instrument for the creation of another one. The invention of the moving image and printing had a great impact on all events in the following years. Without this invention hardly any revolutions could have taken place or if they did that would have happened at a later stage and would have developed in a different way. Every innovation which in one way or another could be used as an instrument increases the chances of these instruments to be further combined and used for the creation of new ones. The ever increasing rate of making innovations can serve as a confirmation of this view.

In contrast with the classical theory the institutional one does not use the term “profit” and has a different view on the entrepreneur. Veblen, Ayres and other institutionalists argue that technological progress is a result of not just one competitive system which forces the entrepreneur to seek technological solutions. They believe profit as a motive is not responsible for the technological progress and that free market system is not the indispensable force of progress. The second factor influencing the economic life of people is the ceremonial behavior, i.e. the institutions. Here the term institution is being used in a very broad sense. It does not refer only to functional institutions like banks and insurance companies or social ones like the church. Institutions are the predominant trends in thinking, thinks Wesley Mitchell<sup>31</sup> as well as a line of economists, influenced by the institutionalism. In his book “The Instinct of

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<sup>27</sup> Ayres, C. E. *The Theory of Economic Progress...*, p. 112.

<sup>28</sup> *Ibid.*, p. 116.

<sup>29</sup> *Ibid.*, p. 125.

<sup>30</sup> Gordon, W. *Economics from an institutional Viewpoint*. Austin, 1973, p. 6.

<sup>31</sup> Mitchell, W. *Types of Economic Theory*. New York, 1969, p. 655.

Workmanship and the State of the Industrial Arts” Veblen also proposes a similar interpretation. In his book “Private Ownership of Land and Entrepreneurship” he provides a definition of the institution – one of the most often used notions in the institutionalists’ arsenal: “The institution is an established, accepted custom which has become axiomatic and obligatory by common approval.”<sup>32</sup>

The ceremonies can be viewed as inherited social behavior in society and because it has been adopted from earlier generations it was established as a commonly accepted value. Ayres presents the idea in the following way: “Ceremonial behavior determines the status not through ritual transfer of mystic powers alone but also through a series of beliefs expressed via the ceremonial adequacy or in which the whole power system of status reveals its presumed explanation and justification.”<sup>33</sup> All of these types of ceremonial behavior have a regressive impact in the sense that they preserve things the way they were. They are the regressive relatives of the technological progress. Inasmuch as they preserve things in their present state they become resistant to technological progress. This is how the pace of economic progress could be impacted. It would be wrong, however, to reach a conclusion that ceremonial behavior never changes. On the contrary, it changes albeit slowly. The driving forces of change are the circumstances in society which impose the adoption of new and different standards of life on a certain group or the whole society.

The institutionalists claim that changes in ceremonial behavior are consequences of technological change. The interrelationship or opposition to the technological progress and the ceremonial resistance determines the evolutionary progress in society. This opposition cannot be viewed as duplicity of social behavior. Ceremonial behavior and technological change do not work in opposition. They work together assisting each other. C. Ayres presents the institutional viewpoint in a most categorical fashion: “This difficulty (of the metaphysical duplicity of thought and body, which is the philosophical foundation for Hegel and the classical economists) could be overcome if it was clearly understood that the spread of technological and ceremonial aspects of organized behavior was a dichotomy, not duplicity. It means that we are trying to distinguish two aspects of one inseparable activity. In fact, these aspects are entwined and mutually determining... Actually, such differentiation does not define two separate domains in the way they the historical duplicity has characterized them. On the contrary, what is important is that these two behavioral functions are not just functions of the continual integrity of human behavior but they also give expression of the same basic rights and abilities which homolog is the organized behavior.”<sup>34</sup>

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<sup>32</sup> Mitchell, W. *Types of Economic Theory...*, p. 611.

<sup>33</sup> Ayres, C. E. *The Theory of Economic Progress...*, p. 170.

<sup>34</sup> *Ibid.*, p. 101.

The institutional economic theory pays a lot of attention to the non-material values in society – knowledge and experience, inherited from previous generations along with the new discoveries of modern society. For the American interdisciplinary economists the non-material values represent capital, in the sense that without them the material values would not exist. T. Veblen points out: “In every known cultural phase this overall reserve of non-material is relatively large and the history of its growth and usage represents the history of development of the material civilization. This is a knowledge of the methods and means, embodied in the material mechanisms and processes...”<sup>35</sup> Because these non-material goods, the knowledge of the methods and means, are too numerous to be remembered by a single person, society shares this knowledge. In fact, the history of humankind is a history of social and group life, not the history of an individual. The individual would be lost in a competitive environment, encouraging personal interest above the group one. Loyal to his research style, Veblen suggests the summary: “Now, irrespective of what would have been truthful for the human behavior and what not, in economic aspect a person has never lived as an isolated individual... From an economic point of view this is the distinguishing feature of the world of man from the world of the other animals.”<sup>36</sup>

According to the theoretical institutionalists, the economic evolution could be explained only outside the combination of group behavior and non-material capital accumulated in society. Veblen emphasizes that it is a function of the state of the industrial arts. That is why the economic development of society is inevitable but it depends on its knowledge.

### **Ownership, Workmanship, Instinct and Business Initiative**

In the institutional economic interpretation the ownership is only in control of the financial aspects of production and not the industrial arts. Veblen helps the authentic clarification of the link between industrial community and means of production: “In the hands of the industrial community (the workers) the non-material and the capital goods, owned by the capitalists, become means of production. Without them, or in the hands of people unaware of their use, the mentioned goods would not transform into means of production.”<sup>37</sup>

The indicated elements of industrial progress have been used by the American institutional economist in the context of the industrial revolution in Europe. The European society is a mixture cultures with inherited knowledge as non-material capital which favored that revolution. The ceremonial institutions changed significantly during the Reformation. The Catholic Church lifted the

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<sup>35</sup> Veblen, T. On the Nature of Capital. – In: The place of science in modern civilization. New York, 1961, p. 328-329.

<sup>36</sup> Ibid., p. 324.

<sup>37</sup> Ibid., p. 344-345.

earlier imposed restrictions on the scientific studies of nature. The European societies, particularly England, had been considered the frontier of civilization. Back then the industrial revolution took place in Europe, not in China. Namely, this revolutionary argumentation of the cause and effect is nothing less but a good example of the applied methodology of institutionalism.

In their major works, the American institutional economists emphasize the importance of the cause - effect sequence of the development of industrial production. Veblen thinks that the instinct of workmanship, influenced by society and inheritance, urges people to earn their living irrespective of the thought about profit and loss. This instinct is one of many others which developed in human history. The second one, no less important, is the aptitude for propagation, the parental instinct which could to a greater or lesser extent be regarded as a superstructure over the instinct of workmanship. Sometimes Veblen himself makes reservations which, in fact, equalize them. He states, that "the aptitude for propagation and the instinct of workmanship serve the same specific aim and they assist each another so strongly that they turn out very difficult to distinguish between."<sup>38</sup>

What results from the instinct of workmanship is industrial production without loss. This result does not become effective through the monetary system of the modern society but could be observed in the financial segment of production. Every instinctive action is intelligent to some extent and that makes the instinct of workmanship different from the instinct of animals. In combination with the state of the "industrial art" it determines the type and method of production as well as the achievements and the level of industrial development. From historians' viewpoint the institutionalists define ownership as a phenomenon which has no links with the items of luxury. But as soon as this possession becomes commonplace it gives those who declare their ownership over it the right to use it for their own benefit. Of course, what is earned in the form of money or goods above sustenance levels becomes a stimulus and a motive to own material means of industrial production. The institutional theory defines the advantage, earned in that way, as being partial result of their personal efforts. Non-material equipment in the community is acquired without the individual efforts of the users and owners of the industrial art."<sup>39</sup>

The institution of ownership has a rich history of its own. If ownership of women as a symbol of wealth dates back a long time, the ownership of material means of industrial production with its monetary expression is not a particularly ancient phenomenon compared to the history of civilization. Veblen' viewpoint is well presented in "The Theory of the Leisure Class": "Since the possession of women the concept of ownership has developed to include the products of the

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<sup>38</sup> Veblen, T. The Instinct of Workmanship and the State of Industrial Art. – In: Portable Veblen. 1973, p. 312-313.

<sup>39</sup> Ibid., p. 332.

respective industry...thus appeared the ownership on objects and people."<sup>40</sup> According to Veblen, the step over from personal to industrial ownership dates back to the Neolith<sup>41</sup> and its beginning is linked to the creation of two classes. In the process of the cultural evolution, notes Veblen, "the appearance of the leisure class coincides with the appearance of ownership."<sup>42</sup> For him these two institutions are a result of the same mixture of economic forces. With time, possession of wealth becomes a habit and custom. Financial success is viewed as a measure of prosperity. The watershed between the two classes the institutionalists place between those members of society who control the finances and those who only by nature have access to the industrial arts. Veblen himself does not propose a clear-cut line. In "The instinct of Workmanship" we read: "In the nature of things there cannot be a rigid and clear line of this phase of the industrial organization...So, this archaic culture in which industry has been organized on the basis of workmanship alone can spread as wide as to cover and merge with the next phase of the cultural medium in which the detail of the industrial organization are determined mainly by relations with the ownership..."<sup>43</sup>

Veblen defines the social class which is in control of the financial side of production as leisure. Its way of life becomes a model of follow. The leisure class looks for an occupation which the others must believe is a necessity and not just work for the sake of it. This type of occupation is mostly unproductive in the usual meaning of the word. Veblen explains that the term "leisure", applied to the appropriate class, means unproductive consumption of time.<sup>44</sup> Unproductive activities, according to the scholars of the old institutional thought, are the arts, politics and the wars. They are unproductive in the sense that they do not contribute to the improvement of the material conditions of life.

The process of production has two aspects in the concept institutionalism. The first one is the industrial, expressed in the instinct of workmanship, while the second one is the commercial, related to the ownership and the principles of modern industry. According to the most authoritative representative of the American institutionalism, T. Veblen, the theory of commercial initiative differs considerably from the production theory and is substantiated in the following manner: "The motive behind trade is cash profit and the method is basically purchase and sale. The aim in most cases is the accumulation of wealth. People whose aim is not to increase their ownership do not engage in business, at least not independently."<sup>45</sup> Consequently, the aim of

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<sup>40</sup> *Veblen, T.* The Theory of the Leisure Class. – In: Portable Veblen, 1973, p. 74.

<sup>41</sup> *Veblen, T.* The Instinct of Workmanship..., p. 332.

<sup>42</sup> *Veblen, T.* The Theory of the Leisure Class... p. 72.

<sup>43</sup> *Veblen, T.* The Instinct of Workmanship..., p. 329-330.

<sup>44</sup> *Veblen, T.* The Theory of the Leisure Class..., p. 90.

<sup>45</sup> *Veblen, T.* The Theory of Business Enterprise. New York, 1958, p. 16.

the entrepreneur is profit that can be obtained from a given productive activity and not the increase of the material prosperity of society. Investment made for the expansion of production is mostly a business process. The institutional economic theory regards the type of industry the investment was made in as of secondary importance.

Industrial production is being sustained in the name of business not the other way round. Veblen calls the people who are in control of this process "captains of industry" but it would be more correct to refer to them as captains of business.<sup>46</sup> The aptitude for accumulation of business wealth rather than for industrial progress is a destructive energy with negative consequences for the economy. With the hypothesis that industrial progress could be destroyed because of business aims he describes the realities that occur but are underestimated by a host of economists. In his criticism towards the leisure part of society Veblen gets even further – accusing businessmen in sabotaging the production process. In the name of cash profit they apply all possible means which leads to the sabotage of production. In the institutional concept the word sabotage describes any action which stalls or delays the natural process of production with the aim to support someone's initiative. Here is how Veblen defines sabotage: "Such actions as restriction, delay or prevention describe to a large extent the usual business behavior... Until a few years ago it was not unusual to speak about such actions as sabotage in cases where they suited the business interests of employers."<sup>47</sup>

The theory of business initiative with its two aspects – industrial production and business management aimed at maximization of profit – is as popular today as it was at the time of its creation. The automobile industry provides a good example as proof of this statement. At the beginning of 70-es of last century the German carmaker Porsche created a car which was capable of running 300 000 km. without showing any defects. The safety standards of the car were extremely high and it could have been mass produced at a price just 20% higher than the automobiles of the competition. The car was made to prove what was technologically possible but the business department decided not to produce it because within a decade the company would have lost its market for its less durable and less reliable cars. In this example business wins over engineers and mechanics. Similar types of business actions the institutionalists interpret as sabotage on behalf of the employer.

Advancement in industry and organizational improvement of the production process are results of business stimuli and are their side effects. Various examples from different economic spheres could be provided. Sizes in textile industry were introduced for the purpose of accountability rather than some production ones. Cutting production costs is mostly aimed at "reducing

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<sup>46</sup> Veblen, T. The Captain of Industry. – In: Portable Veblen, 1973, p. 382.

<sup>47</sup> Veblen, T. The Engineers and the Price System. – In: Portable Veblen. 1973, p. 432-433.



business management costs as well as the competitive costs of product marketing."<sup>48</sup> Business invariably takes care of the utility of its products since they must be sold to bring in profit. As a social critic Veblen bitterly comments: "For the business the crucially important part of production is to ensure that the goods are sold, they must be converted into monetary value, usefulness to society comes next."<sup>49</sup>

Convertibility into cash is being assisted by the advertising industry which is expanding and playing an important role in the politics of business. To claim, however, that advertising simply provides information for the customer would be incorrect. There is a strong competition in the advertising business for which reason success is measured by the volume of sold goods and services. Advertisements do not contribute to the utility of the sold products but add to production costs, which is a matter of ownership and is evaluated in this respect. It is neither a case of different organization of the production process nor of product improvement. The growth of monopolies is a natural development for the business. In Veblen's view, innovation occurs in monopolistic structures which makes them particularly desirable. The institutional comment on this is: "...Large business enterprises initiate changes in the industrial organization. Alternating different levels of value, of course, have a strong impact on the end products and the material prosperity of society but this effect comes as accidental with the strife for profit."<sup>50</sup>

Torstein Veblen draws two roads of development for the economic system (capitalism). The first one has been described in the treatise "The Theory of Business Enterprise" and predicts a catastrophe for the system because the power of decision making will be determinative and the production process will be affected by trends which are foreign for the development of the industrial arts. The second he discusses in the treatise "The Captains of Industry" where he outlines the hypothesis that the capitalist system evolves into a monopolistic organization. The power of decision making in it is diametrically opposed to progress while production capacity is accepted by definition as exceeding the level of consumption. Veblen does not just theorize and build his institutional constructions arguing with orthodoxy but he honestly wants to influence the process of evolution through his ideas and calls for the creation of an engineers' union. The critically inclined economist believes that they are able to engage the non-material capital for the benefit of society.

The ideologist of the old institutionalism relies on the organized force to build a society developing upon the rules of technocracy.

The old institutionalism is to a large extent non-uniform with regards to details on the interpretational level. The views of T. Veblen and C. Ayres,

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<sup>48</sup> Veblen, T. *The Theory of Business Enterprise...*, p. 27.

<sup>49</sup> *Ibid.*, p. 30.

<sup>50</sup> *Ibid.*, p. 29-30.

however, are fundamental for the intellectual movement. The criticism towards the economic orthodoxy could be understood best on the grounds of the generally presented system of values of the old institutionalism in the theoretic light of the highest authorities of the school:

1. Economics has been turned into an abstract definition of the reasonable economic person. Economists' core problem is to understand the institutional context in which individual's abilities develop.

2. Technology is partially institutional in character and institutions can have instrumental characteristics.

3. Institutions can assist but also delay economic development.

4. The technological system is an organization of intelligence. Both institutions and technology are founded on the habit of thought.

5. Each motive which is based on self interest is useless for the purposes of modern industry.

6. Market economy is a dynamic system and the economic science should understand how industry functions and should not try to predict development. The economy is an evolutionary system driven by forces which are cumulative in character.

The institutional paradigm is undergoing its internal evolution. The contents and scope of this evolution are being borne by the contemporary representatives of the American institutionalism which is markedly active not only within the frame of the American research tradition but also in the European institutional projects. Of course, the revival and enrichment of the institutional values follows the intellectual tradition of T. Veblen and C. Ayres who are accepted unconditionally as authorities of the original American institutionalism. Their works provide the terminology and instrumental approach through which realistic results of the institutional analysis can be achieved. The main difference between classicism and the early institutionalism is that the classicism adopts idealistic models while the institutionalism focuses on real life in which the economic behavior of people is formed. The orthodox economic theory is based on the philosophy of hedonism which defends the absolute tendency to pursue profit in every action. This prevents it from explaining a series of economic contradictions in modern civilization. Enriching the economic theory with sociological, psychological and anthropological aspects has been the undoubted contribution of the American institutionalism. The institutionalism represents a different research approach in the economic science which in some respects stands as an alternative to orthodoxy, while in others it suggests topics and analyses events which the classics have not included in their theoretical concepts.

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