

Alternative Approaches

18.1 ENGLISH HISTORICAL ECONOMICS

Background

The 1870s saw the rise to prominence of historical economics, both in England, where confidence in classical political economy had collapsed, and in Germany, where the deductive, Ricardian version of classical political economy had never gained a firm hold.¹ Though there were links between the two, Cliffe-Leslie and Ingram in particular being well aware of the writings of the German school, the origins and nature of the two variants of historical economics were very different.²

The man usually taken to be the forerunner of English historical economics is Richard Jones, whose *Essay on the Distribution of Wealth and the Sources of Taxation* (1833) contained a forthright criticism of Ricardian doctrines, blaming their inadequacies on Ricardo's method. On rent, for example, Jones argued that Malthus had proposed his theory of rent as an explanation of specific historical circumstances, but that

Mr Ricardo, however, overlooking altogether the limited extent of the field to which these principles were readily applicable, underook from them alone to deduce the laws which regulate the nature and amount of the revenue derived from land at all places, and under all circumstances; and not content with this, proceeded from the same narrow and limited data, to construct a general system of the distribution of wealth, and to explain the causes of variations which take place in the rate of profits, or amount of wages over the surface of the globe. [Ricardo had produced a hypothetical system which] a single comprehensive glance at the world as it actually exists, is sufficient to show to be utterly inconsistent with the past and present condition of mankind.³

The reason for these errors was that men preferred "the way of *anticipation* to that of *induction*": a structure of doctrines was erected on observations of only a small portion of the earth's surface.⁴ This is not to say that Jones rejected deductive reasoning altogether, but rather that he believed that economists needed to spend more time on observation before proceeding to deduction: "they have quitted *too soon* the duty of dwelling long and humbly among things, that they might *prematurely* take up the more fascinating employment of laying down those maxims of imposing generality".⁵ Thus when Jones investigated rent, his treatment comprised an analysis of numerous different types of rent.

There was also, however, another side to Jones' work. This was his contention that political economy must be concerned with "the economical structure of nations", by which he meant

the relations between the different classes which are established in the first instance by the institution of property in the soil, and by the distribution of its surplus produce; afterwards modified and changed ... by the introduction of capitalists.⁶

Only a knowledge of this structure, or "economical anatomy" could explain the past fortunes of different peoples.⁷

In addition to Jones, two other influences need mentioning as important background to English historical economics. Firstly, there was Sir Henry Maine's work on jurisprudence in which, instead of trying to reconstruct law in the light of rational principles, as was the approach of Bentham, he argued that law was to be studied historically and comparatively. Cliffe Leslie pointed to Maine's having exposed the fallacies inherent in the concepts of nature and natural law, exploding the myth that there was a "code of nature" against which legislators could go at their peril.⁸ Secondly, there was the influence of Comte, and his call for a unified social science. This ruled out of order the classical abstractions.

Cliffe Leslie

The writer who opened the English debate on method in the 1870s was Cliffe Leslie,⁹ with his article on "The political economy of Adam Smith" (1870). Leslie's main argument was that political economy did not comprise a body of natural laws, for its "laws" were not universal and immutable, but varied from age to age and from place to place.¹⁰ Smith, Cliffe Leslie contended, whilst recognizing this for earlier writers, had failed to see that it applied to his own system.¹¹ Cliffe Leslie also stressed the importance of induction in Smith's work, arguing that his combination of induction and deduction enabled him to avoid errors into which his followers had fallen.¹ Smith's use of induction, however, had not gone far enough, for

under the bias given by the theory itself, partly because the method of interrogating nature itself was new, and the canons of induction unsettled, conceived that ... nature when interrogated, confirmed his anticipations of nature.¹³

In addition, Cliffe Leslie criticized the notion that political economy should be based on the assumption of selfish behaviour, arguing that this was not Smith's approach.¹⁴ Cliffe Leslie thus argued that Smith's authority could not be claimed for the contentions of contemporary, abstract political economy.

This argument was developed in what Ingram (1893) later described as "the first systematic statement by an English writer of the philosophic foundation of the historical method",¹⁵ Cliffe Leslie's article "On the philosophical method of political economy" (1876). In this, his first contention was that the heterogeneity both of wealth itself, and of the desire for wealth, was important, but that deductive economics neglected both. Because it threw no light on the nature of wealth (whether it comprised, for example, buildings, land or ornaments),¹⁶ and because it failed to consider the variety of human motivations (treating those other than the desire for wealth as disturbing causes, or frictions), "the abstract a priori and

deductive method yields no explanation of the causes which regulate either the nature of the amount of wealth".¹⁷ As regards the distribution of wealth, this depended not only on exchange, but also on the ownership of property, to explain which historical investigations were needed.

From this Cliffe Leslie went on to argue that the evolution of society must be considered as a whole.

The truth is, that the economy of every nation, as regards the occupations and pursuits of both sexes, the nature, amount, distribution and consumption of wealth, is the result of a long evolution in which there has been both continuity and change, and of which the economical side is only a particular aspect or phase. And the laws of which it is the result must be sought in history and the general laws of society and social evolution.¹⁸

Moral, political and economic causes had to be considered together: "Every successive economic stage [in social progress] ... has an economy which is indissolubly connected with the physical, intellectual, moral, and civil development."¹⁹ The philosophical method of political economy had to be one which expounded this evolution, involving economic, political and social institutions.²⁰

Three years later (1879) Cliffe Leslie published a further, and in some ways more penetrating criticism of orthodox political economy, one based not so much on inductive reasoning as on a theoretical argument.²¹ This argument was that orthodox political economy postulated more than simply a general pursuit of wealth: it also postulated "full knowledge and foreknowledge", or full information and perfect foresight, to use modern terminology. Without this postulate, Cliffe Leslie argued, the uniformity of wage and profit rates crucial to orthodox theory would disappear: competition will work to equalize returns only if people can identify lines of business in which returns are unusually high or low.²² If uniformity of wage and profit rates were abandoned, so too must be the cost of production theory of value. Cliffe Leslie argued that the complexity of the economy was increasing, and with this the extent of uncertainty.

Industrial liberty and the division of labour, the two pillars of Adam Smith's system, produce an economic world, the vastness, complexity, and incessant changes of which are absolutely incompatible with the main postulates of the Ricardian theory.²³

Bagehot

The historical relativity of economic doctrines was also accepted by Bagehot (1876), a supporter of deductive political economy. He criticized those who suggested that English political economy was applicable to all states of society with the argument that the causes with which it dealt were the main ones only in "a society of grown-up competitive commerce, such as we have in England".²⁴ In such societies other causes could be grouped under the heading of "friction", whereas in other "un-economic" societies these other causes were the most effective ones. Bagehot thus wanted the

authority of political economy “minimized” in the sense that “its authority should be upheld, but its frontiers marked”.²⁵ If this were done, political economy could be less abstract, for once the claim to universal applicability had been abandoned, doctrines could be illustrated with facts from the societies to which they did apply. Bagehot’s aim, in examining the postulates of English classical political economy, namely the free mobility of capital and labour, was to show that “it is not a questionable theory of unlimited extent, but a most certain and useful thing of limited extent”.²⁶

Whilst he accepted the logic of the historical criticism, Bagehot still accepted the scientific status of orthodox economics. His reason for accepting much of classical economics, rather than rejecting it as did Cliffe Leslie, was simply his interpretation of what he observed going on around him. Where Cliffe Leslie saw factors as being immobile, what struck Bagehot was their mobility. They reached different conclusions not because they held different methodological views, but because they interpreted the empirical evidence in different ways.

Ingram

Whereas Cliffe Leslie and Bagehot derived their ideas from English sources, Ingram’s approach was influenced by Comte, whom he described as “the greatest master who has ever treated of sociological method”.²⁷ In his address to the British Association in 1878 he presented a Comtean critique of orthodox economics, made up of four points.²⁸ (1) He argued, like Jones and Cliffe Leslie, that economic phenomena could not be separated from other aspects of society.²⁹ Even on issues where the economic aspects were the most important, such as that of free trade versus protection, an adequate treatment would require non-economic aspects to be considered. (2) He criticized orthodox economists for conceiving and presenting their concepts in a “viciously abstract” way.³⁰ His criticism was not abstraction per se, but that it lost contact with reality. As an example, he cited Cliffe Leslie’s argument that “desire for wealth” was used to include a great variety of wants, different in their nature and effects. (3) The place of deduction had been exaggerated, according to Ingram, for deduction was possible only in simple cases: “social phenomena are in general too complex, and dependent on too manifold conditions, to be capable of such a priori determination”.³¹ In contrast to Senior’s unjustifiable attempt to deduce all the phenomena of industrial life from four postulates, Ingram argued that the place for deduction was in verifying and controlling inductions. Furthermore, the historical dimension of economics could not be ignored, social facts of any complexity being incomprehensible apart from their history.³² (4) Related to this was Ingram’s final point, that the conclusions, both theoretical and practical, to be drawn from political economy were much less absolute than orthodox economists suggested.³³ Economic theorems were applicable only to a certain stage of development. For Ingram, the conclusions of orthodox political economy were not valueless, but were limited in their applicability.

Sidgwick and Marshall

Of the economists who sought to preserve the Ricardian tradition the most important were Sidgwick and Marshall. Sidgwick's approach in his *Principles of Political Economy* (1883) was conciliatory, arguing that the wave of criticism to which political economy had been subject, from Cliffe Leslie as well as from Jevons, had been salutary, but that it had been carried too far. Sidgwick described his aim as being "to eliminate unnecessary controversy, by stating these results in a more guarded manner, and with due attention to the criticisms and suggestions of recent writers".³⁴ He argued that the opposition between inductive and deductive methods had been urged in "needlessly sharp and uncompromising terms".³⁵

Sidgwick's approach to method could be described as pragmatic, for rather than advance a particular method for general use he considered separately the three branches of the subject: production, distribution and exchange.³⁶ For production, he found predominantly inductive methods appropriate.³⁷ Distribution and exchange, on the other hand, were more amenable to deductive treatment, except when it came to dynamics, for which induction from historical facts was most important.³⁸ Whilst Sidgwick saw an important role for the deductive, hypothetical method, however, he argued that its application always required the use of induction, the line later taken J. N. Keynes.³⁹

Marshall's method⁴⁰ followed Sidgwick's, though he went further towards the historical approach. Important was his argument that

we may not assign any universality to economic dogmas. For that part of economic doctrine, which alone can claim universality, has no dogmas. It is not a body of concrete truth, but an engine for the discovery of concrete truth, similar to, say, the theory of mechanics.⁴¹

Marshall thus stressed continuity with the English classical economists, whilst sidestepping the issue as to whether their doctrines were valid or not.⁴² Whilst Marshall argued that it would be "difficult to overrate" the importance of the work done by the historical school in "tracing the history of economic habits and institutions",⁴³ he contended that "they do not in any way help us to dispense with the use of the economic organon: but rather make use of its aid at every step".⁴⁴

The emergence of economic history

The outcome of these controversies was twofold. Orthodox economists came, by and large, to recognize, to a greater or lesser extent, a role for historical as well as deductive analysis. But more important was the emergence of economic history as a subject separate from both economics and history. One economic historian has placed the subject's "take-off" in the period 1882–1904, its creation a subject in its own rights, being due in particular to four pioneers: J. E. Thorold Rogers, Arnold Toynbee, W. J. Ashley and William Cunningham.⁴⁵

Rogers remained orthodox in his economic theory, seeing historical

research as providing illustrations of independently derived historical laws. This approach was exemplified in his *History of Agriculture and Prices in England* (1866–1902) and his *Six Centuries of Work and Wages* (1884), in which he brought together a wealth of statistical information on English economic history. Toynbee's importance, by contrast, was that, in Ashley's words,

at a time when the study of political economy had sunk to its lowest point in England, he did perhaps more than any other man to create a new interest in it, a new belief in its seriousness as a scientific discipline, a new hope that in it might be found some help towards the solution of pressing economic problems. ... He turned this new interest in the direction of the historical examination of social development, and of the direct examination of existing phenomena.⁴⁶

His lectures of 1881–1882⁴⁷ first popularized the term “the industrial revolution”, laying great stress on its adverse social consequences.

Perhaps the most important figure in the development of the subject, however, was Cunningham,⁴⁸ whose contribution was twofold. Firstly, he provided the subject's first textbook, *The Growth of English Industry and Commerce* (1882). He continued to advance the subject in successive editions of this, which grew enormously in size. Secondly, Cunningham emphasized the need for economic history to be treated as a separate subject from economics. In 1889 he provided the first direct attack on Marshall's “The present position of economics”, arguing that as long as economists such as Mill and Marshall were

prepared to exclude a large range of phenomena from consideration, or take pains to represent the transactions of mediaeval life in such a shape as they shall appear conformable to modern practice, they must expect to be charged with a disregard of the facts.⁴⁹

Economic history, Cunningham claimed, was not to be treated merely “as a field from which we can cull additional illustrations of universal truths”, but should “enable us to understand actual life both in the past and in the present”.⁵⁰ This attack on Marshall's position was followed by a further attack on economists' use of economic history. In “The perversion of economic history” (1892b), Cunningham criticized Marshall's use of economic history in his *Principles*.⁵¹ Economic history, Cunningham contended, was paying the price of being too fashionable, ordinary economists, assuming free competition and the laws of supply and demand, professing themselves extremely interested in history, wishing to do anything they can for it. He continued, “To this polite desire it is surely not discourteous to reply, *Laissez faire, laissez aller*.” This, however, was what economists would not do; they would neither leave it alone nor pursue it seriously, trying “to incorporate some of its results into that curious amalgam, the main body of economic tradition; and the result is the perversion of economic history”.⁵²

The first professor of economic history was not Cunningham, but Ashley, appointed to a chair at Harvard in 1892. Whilst Ashley derived his interest in economic history from English sources, he was the English

historical economist most influenced by the German historical school.⁵³ Comte's influence was strong, Ashley seeing the generalizations towards which historical inquiry must work, not as "mere corrections or amplifications of current economic doctrines", but as "conclusions as to the character and sequence of the stages of economic development".⁵⁴ Ashley's overall tone, however, was, unlike Cunningham's, conciliatory.⁵⁵ He called, in his inaugural lecture (1893) for a truce in the controversy, suggesting that economic theorists and economic historians should try for the next twenty years to leave each other "severely alone", remaining silent where they could not reach agreement.⁵⁶

This agreement to compartmentalize the subject was not, however, the result of Ashley's abandoning his Comteist ideas, for he remained sceptical as to the value of economic theory. It was rather that he was content for the two approaches to be judged by their results. His early hopes of creating a historical economics capable of proving a serious rival to economic theory were, however, disappointed. Thus he was unable to reconcile himself to the compartmentalization he had earlier advocated, seeking closer links with economics which might, he hoped, transform the latter.⁵⁷

The consolidation of economic history came in the 1920s, when a number of economic historians tested, in a series of detailed studies, the generalizations made by the pioneers. Typical of the work resulting from this stage was Clapham's *Economic History of Modern Britain* (1926).⁵⁸ The subject had become separate from economics, economics becoming increasingly innocent of history, and historians increasingly innocent of theory.⁵⁹ After Clapham's "Of empty economic boxes" (1922) there were no more methodological battles between economic historians and economists.⁶⁰ Economic history of the inter-war period was a very different creature from the historical economics of the late nineteenth century.⁶¹

18.2 GERMAN HISTORICAL ECONOMICS

Background: the "older historical school"

German historical economics, it is usually argued, stemmed from the work of three economists, whose writings date from the late 1840s, Roscher, Hildenbrand and Knies, the first important contribution being by Roscher in 1843. Roscher was concerned not to oppose but to supplement and complete the Ricardian theory.⁶² As to Ricardian methods, he considered that they could serve as a counter to any laziness in the use of "historico-statistical" and "practical-political" methods.⁶³ He was, however, unlike the Ricardians, concerned with the social organism as a whole, wishing to analyse the effects of various institutions on the nation's well-being, and to supply rules which could guide statesmen.⁶⁴ This approach was characterized by Schmoller as an attempt to connect the teaching of political economy with the "cameralist" tradition of training administrators. If the classical doctrines were to be of any use to administrators they had to be corrected and kept as close as possible to facts.⁶⁵

Hildenbrand, on the other hand, set a very different objective for his work. It was

to open a way for an essentially historical standpoint in political economy and to transform the science of political economy into a body of doctrines dealing with the economic development of nations.⁶⁶

Hildenbrand, in contrast to Roscher, was thus a critic of the classical conception of political economy which viewed the economy as a network of exchanges between men motivated by the pursuit of self-interest.⁶⁷ His more positive contribution to providing laws of development was to distinguish three stages, based on observable changes in monetary and credit institutions, these being those of natural, monetary and credit economies.

Yet another, different, view was taken by Knies (1853) who questioned not only English classical political economy, but also Hildenbrand's claim that there existed natural laws of development. He adopted a relativistic approach to political economy.

The conditions of economic life determine the form and character of economic theory. Both the process of argument employed and the results arrived at are products of historical development. The arguments are based on the facts of concrete economic life and the results bear all the marks of historical situations. The generalisations of economics are simply historical explanations and progressive manifestations of the truth. Each step is a generalisation of the truth as it is known at that particular stage of development. No single formula and no collection of such formulae can ever claim to be final.⁶⁸

*Schmoller and the "younger" historical school*⁶⁹

Though Roscher, Hildenbrand and Knies did much to establish historical economics in Germany, their approaches were very different from each other, and despite the frequent use of the term, no true "school" emerged. The emergence of a distinctive historical school occurred in the 1870s with the work of Schmoller, whose influence dominated German economics until 1918. One of the reasons for the sudden waning of Schmoller's influence was his close association with the Hohenzollern empire, for he was instrumental in founding, in 1872, the *Verein für Sozialpolitik*, an organization committed to drawing the working class away from revolutionary causes by a policy of social reform.⁷⁰ Unlike the American Economic Association, which soon abandoned similar aims, the *Verein* continued to support this policy, its members, including Schmoller, becoming closely involved with Bismarck's social policies. This is not to say, however, that Schmoller subordinated political economy to political purposes, for his emphasis was very much on letting facts speak for themselves.

Like his predecessors and his English historical contemporaries, Schmoller stressed the organic nature of social phenomena. Where he differed from Hildenbrand and the Comteists was in denying that historical research should be concerned with discovering natural laws of economic develop-

ment: "We cannot even say whether the economic life of humanity possesses any element of unity or shows any traces of uniform development, or whether it is making for progress at all."⁷¹ He argued that whilst some generalizations might be made,

By cloaking propositions as "laws", one gives them an appearance of necessity which they do not possess, or one gives too high an importance to comparatively insignificant truths, thereby misleading those who apply them.⁷²

Though for practical purposes it might be necessary to refer to a law of development, such a law was neither an empirical law nor similar to scientific laws.

The method adopted by Schmoller's school was the production of detailed historical monographs. Judgements were to be made on the basis of the facts of each individual case. Despite his opposition to Menger's use of abstract methods, however, Schmoller, especially in his later work, did not advocate pure empiricism, devoid of theory, and neither did he claim economics to be an exclusively historical subject. He himself worked primarily, though not exclusively, on historical material, but this was not the case with all his pupils. Spiethoff being the prime example of one who gave much attention to theory.⁷³

Schmoller's main work, his *Grundriss der Volkswirtschaftslehre* (Outline of Economic Doctrines) (1900) illustrates his method. Perhaps its main characteristic is its wide scope (Ashley, for example, described it as an "olympian survey") covering issues such as the nature and origin of various institutions, neglected in most treatments of economics. Each topic was treated in four ways: historically, statistically, analytically and practically.⁷⁴ Though Schmoller's theory was weak, he showed no reluctance to theorize, taking, for example, part of his theory of value from Menger and Böhm-Bawerk.⁷⁵ The value of Schmoller's *Outline*, and of the historical school more generally, was in its bringing together an enormous variety of historical and empirical material. Its weakness was that it failed to integrate it. Schmoller's *Outline* remained, in Mitchell's words, "a treatise of beginnings".⁷⁶

*Spiethoff, Sombart and Weber*⁷⁷

In the reaction against the ideas of Schmoller and the *Verein für Sozialpolitik* which took place in the early part of the twentieth century, a variety of directions were pursued. In some ways closest to Schmoller was Spiethoff, with his work on business cycles.⁷⁸ Whilst Spiethoff made much greater use of theory than did Schmoller, he confined himself to fairly simple theories, investigating facts in detail, and describing the patterns which emerged. In addition he claimed to be providing an explanation relevant only to specific historical circumstances. Thus, for example, his business cycle theory was applied only to the period 1822–1913. There were, however, substantial differences between his approach and Schmoller's. One was that he confined his attention to economics. More important, however, was his

later recognition of a large number of “styles” of economic life, analysis of each requiring its own economic theory as well as concepts drawn from timeless pure theory.⁷⁹ A “style” was the form economic activity assumed in a given era, and it was characterized by certain uniformities, in particular uniformities in institutional patterns.⁸⁰ Such generalizations were far from Schmoller’s scepticism as to the possibilities of discovering economic regularities.

Even further from Schmoller’s cautious approach was that of Sombart, exemplified in his *Modern Capitalism* (1902). Where Schmoller had been careful in building up historical evidence, Sombart appeared careless and insubstantial. What he did provide, the reason for the book’s success, was a speculative framework, influenced by Marx, for understanding economic history. An economic system was characterized, for Sombart, not only by its technology and institutions, but by its “spirit”, the force embodying the creative drives of a culture and inspiring the whole life of an era.⁸¹

More important, especially for the social sciences as a whole, however, than either Spiethoff or Sombart, was Weber, known primarily for his work on the Protestant origins of capitalism⁸² and for his methodological writings.⁸³ His contribution to the latter was twofold. Firstly there was the neutrality, or value-free nature, of economic science.⁸⁴ Definite policy conclusions could not be drawn from positive studies, as a result of which he argued that social scientists should not attempt to use their authority to advance their own ethical or political ideas. Secondly, Weber advanced the concept of the “ideal type”. These were mental constructions that emphasized certain features of reality at the expense of others in order to facilitate the formulation of hypotheses. The classic example of this is the “economic man” of economic theory.

Though Weber’s plea for a value-free social science influenced economists, and though Spiethoff’s contribution to the business cycle formed the starting point for much future work, the main influence of the historical school’s successors was outside economics. Economics never became sufficiently wide in scope to encompass the ideas of Sombart and Weber. The issues they raised were left to sociologists and economic historians.

18.3 AMERICAN INSTITUTIONALISM: VEBLÉN

Introduction

It would be very misleading to project the present-day situation backwards and to see American economics as having been dominated, throughout the twentieth century, by “neoclassical” economics. Equally important, at least until the 1920s, was Institutionalism. Institutionalism owed something to German historical economics: the aims of the American Economic Association, for example, were very similar to those of the *Verein für Sozialpolitik*.⁸⁵ The main influence on Institutionalism, however, was not German but American: the savage critique of orthodoxy provided by Thorstein Veblen.

Veblen was concerned, however, with much more than economics. His attacks on economic orthodoxy formed but a part of a sustained critique of American society and culture. His *Theory of the Leisure Class* (1899), in which he made full use of his unrivalled literary powers to satirize American society, brought him popular acclaim.

Cultural evolution

Central to Veblen's theory is the view that economic development is about changes in the methods of doing things. Where orthodox economists laid great stress on capital accumulation, Veblen argued that it was changes in the human factor which were more important:

The physical properties of the materials accessible to man are constants: it is the human agent that changes, – his insight and his appreciation of what these things can be used for is what develops. ... The changes that take place in the mechanical contrivances are an expression of changes in the human factor.⁸⁶

As for capital goods, these are

facts of human knowledge, skill and predilection; that is to say, they are, substantially, *prevalent habits of thought*, and it is as such that they enter into the process of industrial development.⁸⁷

Veblen's main task, therefore, was to explain changes in the prevailing habits of thought, or institutions.

All economic change is a change in the economic community, – a change in the community's methods of turning material things to account. The change is always in the last resort a change in habits of thought. This is true even of changes in the mechanical processes of industry.⁸⁸

Veblen's theory of how these institutions change was based on a complicated evolutionary process in which the material conditions of life interact with habits of mind. The starting point is that the prevailing conditions of life give rise to certain habits of mind, or institutions. From this starting point, several processes then operate. (1) Technology develops, the character of this development depending on the nature of the prevailing institutions. (2) Institutions develop, but, because people become conditioned to accept certain ideas, and because of the power of vested interests, institutions can be sustained after they have lost touch with the underlying material conditions of life. (3) Sometimes, however, technological development results in the creation of new habits of mind, strong enough to overthrow the dominant institutions. The process then repeats itself.

The evolution of institutions is central to this process. A crucial aspect of this evolution is the interaction of economic with non-economic institutions. This works in both directions. On the one hand, economic institutions (habits of mind formed in the process of earning a living) come to permeate other areas of life. Veblen's *Theory of the Leisure Class*, for example, is an examination of the impact of business values on taste and

fashion. His *The Higher Learning in America* deals with universities, showing how business principles have displaced principles of scholarship.⁸⁹ Thus Veblen could write,

The economic history of any community is its life history in so far as it is shaped by men's interest in the material means of life. This economic interest has counted for much in shaping the cultural growth of all communities. ... An evolutionary economics must be a theory of a process of cultural growth as determined by the economic interest.⁹⁰

On the other hand, economic interests are influenced by other interests (aesthetic, sexual, humanitarian, devotional, etc.), because

since each of these passably isolable interests is a propensity of the organic agent man, with his complex of habits of thought, the expression of each is affected by habits of life formed under the guidance of all the rest.⁹¹

Related to this interaction of habits developed in different activities is the tendency of any institutional system to develop an internal coherence. An institutional system comes to be

pervaded by a certain characteristic logic and perspective, a certain line of habitual conceptions having a degree of congruity among themselves, a "philosophy" as it would once have been called.⁹²

Over time this institutional logic comes to be elaborated and refined, and to find expression in laws and organizational forms.⁹³ It is thus because of the complexity of the forces influencing the way in which a culture develops, rather than because a culture becomes completely static, that discrepancies can develop between a culture and the habits appropriate to the underlying material conditions of production.

Business enterprise and the machine process

Veblen's theory of cultural evolution is illustrated by his analysis of American industrial society as he found it in the 1890s. His analysis ran in terms of two institutions: the machine process and business enterprise, different habits of thought being associated with each. The machine process for Veblen meant more than simply the use of mechanical devices, though this was included.⁹⁴ It denoted the whole system of production in which mechanized processes were used, a system which had several important aspects. No individual process was self-sufficient, the system containing "a more or less delicately balanced complex of sub-processes". It required quantitative precision and uniformity: "mechanical standardisation" had replaced "craftsmanlike skill" as the means whereby different processes were made to work efficiently together.⁹⁵

The machine process is run, however, for the sake of business enterprise, the motive of which is pecuniary gain. Because pecuniary gain, rather than production or economic welfare, is the criterion according to which industry is run, production will not be organized in such a way as to maximize welfare.

The economic welfare of the community at large is best served by a facile and uninterrupted interplay of the various processes which make up the industrial system at large; but the pecuniary interests of the businessman in whose hands lies the discretion in the matter are not necessarily served by an unbroken maintenance of the industrial balance.⁹⁶

Businessmen might gain, for example, by disturbing the system, providing opportunity for speculation.⁹⁷ In addition, prices are raised where possible, and attempts are made to increase monopoly power through acquisition of other businesses or through advertising. A feature of advertising is that it is competitive, which means that sellers have to undertake it, even though it contributes nothing to the usefulness of the goods produced: "It gives vendibility, which is useful to the seller, but has no utility to the last buyer."⁹⁸ Veblen thus sees the existence of "parasitic" lines of business:

Work that is, on the whole, useless or detrimental to the community at large may be as gainful to the business man and to the workman whom he employs as work that contributes substantially to the aggregate livelihood.⁹⁹

The gains of these unproductive occupations come out of the aggregate product of the other occupations.¹⁰⁰

These two types of activity are important, according to Veblen, because each type of activity inculcates a different spiritual attitude:

The spiritual ground of business enterprise ... is given by the institution of ownership. "Business Principles" are corollaries under the main proposition of ownership; they are the principles of property, – pecuniary principles.¹⁰¹

In contrast, the machine process enforces a standardization of conduct and a habits of explaining things in terms of cause and effect. "Its metaphysics is materialistic, and its point of view is that of causal sequence."¹⁰²

Veblen thus saw American industry and society as dominated by the institution he called business enterprise, business habits of mind pervading all American culture. One result of this business activity and the continual search for pecuniary gain was mechanization and the extension of the machine process. The machine process, however, inculcates habit of mind inconsistent with the principles of business enterprise.

On the basis of this, Veblen argued that two classes would emerge: those employed in running business, and those running the machine process. These two classes would have different habits of thought: one class would think in terms of natural rights, the other in terms of cause and effect. Of particular importance would be the growth of matter-of-fact habits amongst the working class, for they, ceasing to think in terms of natural rights, would be unable to understand the justification for business enterprise and would turn to socialism. His conclusion was that the regime of business enterprise was unlikely to be long lasting.¹⁰³

This conclusion was similar to that reached by Marx, but with a fundamental difference. This difference is the difference between the Hegelian and Darwinian versions of evolution: where Marx saw the historical process as leading to a definite goal, Veblen's view of the world

was Darwinian.¹⁰⁴ Evolution, for Veblen, involved a “colorless sequence of phenomena” linked by chains of cause and effect.¹⁰⁵ It was only individual behaviour which was purposive, or teleological. On the other hand, it can be argued that Veblen’s evolutionary scheme is a dialectical one. In the words of a recent writer,

competing institutional principles arise from the technological changes introduced as a result of the institutional structure of the old system. ... The internal logic of a system [gives] rise to contradictions that create its own transformation.¹⁰⁶

Economic theorizing and culture

This theory of cultural evolution forms the basis for Veblen’s critique of economic theories. This critique is centred on the distinction between two “spiritual attitudes or points of view”:¹⁰⁷ the evolutionary and the non-evolutionary. Characteristic of all non-evolutionary points of view is the explanation of economic phenomena in terms of some purpose. The most basic such attitude is animism: attributing purpose to aspects of nature. He described the Physiocratic system as animistic.

Nature then is the final term in the Physiocratic speculations. Nature works by impulse and in an unfolding process, under the stress of a propensity to the accomplishment of a given end. The propensity, taken as the final cause that is operative in a given situation, furnishes the basis on which to co-ordinate all our knowledge of those efficient causes through which nature works to her ends.¹⁰⁸

The Physiocrats were never satisfied with an explanation, according to Veblen, until they had related an economic phenomenon to this process of nature working towards a given end.

The nature of the teleology underlying economic reasoning changed substantially between the Physiocrats and, for example, Clark or the Austrians, particularly important in the transition being the Utilitarians’ stress on human pleasure and pain, rather than the design of God, as the ultimate standard for judging economic life. Behind these changes, however, the animistic method of reasoning persisted.

The ultimate laws and principles which they formulated were laws of the normal or the natural, according to a preconception regarding the ends to which, in the nature of things, all things tend. In effect, this preconception imputes to things a tendency to work out what the instructed common sense of the time accepts as the adequate or worthy end of human effort. It is a projection of the accepted ideal of conduct. This ideal of conduct is made to serve as a canon of truth, to the extent that the investigator contents himself with an appeal to its legitimation for ... the “controlling principles” that are conceived intangibly to underlie the process discussed.¹⁰⁹

Thus, though the nature of the teleology changed substantially, economic phenomena were still explained by showing how they could be deduced from generally accepted postulates, such as “economic man” and perfect competition. This approach Veblen called “taxonomic”. Referring to such reasoning, he perceptively argued the following.

Of course, this perfect competitive system, with its untainted “economic man”, is a feat of the scientific imagination, and is not intended as a competent expression of fact. It is an expedient of abstract reasoning; and its avowed competency extends only to the abstract principles, the fundamental laws of science, which hold only in so far as the abstraction holds. But, as happens in such cases, having once been accepted and assimilated as real, though perhaps not as actual, it becomes an effective constituent in the inquirer’s habits of thought, and goes to shape his knowledge of facts. It comes to serve as a norm of substantiality or legitimacy; and facts in some degree fall under its constraint, as is exemplified by many allegations regarding the ‘tendency’ of things.¹¹⁰

Against the attitude underlying such reasoning Veblen set the evolutionary point of view, which he regarded as the attitude of modern science. From an evolutionary point of view the sole type of explanation involved cause and effect:

The modern scientist is unwilling to depart from the test of causal relation or quantitative sequence. When he asks the question Why? he insists on an answer in terms of cause and effect This is his last recourse.¹¹¹

Impersonal sequences of cause and effect are *all* that is sought.

What gave this interpretation of economic theories its power was that these points of view were not taken as a datum, but were explained as the products of certain types of economic activity. The late eighteenth and nineteenth centuries, for example, saw the growth of the machine process and the extension of business enterprise, each bringing with it its own habits of thought. At the time of Smith and the Physiocrats, for example, the machine process, though still very underdeveloped by later standards, was more highly developed in England than in France.¹¹² Veblen uses this to explain why the matter-of-fact attitude was stronger in British than in French thought: despite its fundamentally teleological design, for example, stronger traces of a cause-and-effect attitude can be seen in *The Wealth of Nations* than in French work of the same period. Turning to the nineteenth century, the dominance of the taxonomic approach, in both classical and neoclassical economics, can be accounted for as reflecting the ever stronger influence of business enterprise, with its judgement of everything in terms of value. The utilitarian emphasis on value as the main problem of political economy, in contrast to Smith’s stress on production, is explicable in terms of this habit of mind.

Veblen produces an interesting explanation of the crises which occur in economic theory. Confidence in economic theories is shaken, not because they are disproved, but because they become out of touch with the prevailing habits of mind, as is illustrated by his account of the demise of classical political economy.

In the days of the early classical writers economics had a vital interest for the layman of the time, for it formulated the common sense metaphysics of the time in its application to a department of human life. But in the hands of the later classical writers the science lost much of its charm in this regard. It was no longer a definition and authentication of the deliverances of current common sense as to what ought to come to pass; ... and it was also out of touch with that realistic or evolutionary habit

of mind which got under way in the middle of the century in the natural sciences. It was neither vitally metaphysical nor matter of fact, and it found very few outside of its own ranks.¹¹³

Veblen's critique of orthodox economics

These ideas formed the basic for Veblen's devastating critique of orthodox economics. There were several strands to this.¹¹⁴ (1) He criticized orthodox economics for being based on outmoded, "animistic" and "teleological" preconceptions, as a result of which it suffered from being "taxonomic".¹¹⁵ (2) He attacked hedonism, on which, he argued, orthodox economics was based, as being inadequate as an account of human motivation. (3) He criticized both deductive and inductive methods.

A natural inference from Veblen's view of knowledge as determined by prevailing habits of thought would be that he held a purely relativistic view of knowledge. This was, however, not the case. Veblen clearly regarded "matter-of-fact", or "evolutionary", knowledge, which explained things in terms of cause and effect, as superior to the "pre-Darwinian" theories at which he directed his criticism. The habits of mind engendered by the machine process, which led people to see things in terms of cause and effect, gave genuine insights into how the world worked.

There are two aspects to Veblen's criticism of hedonism. One is his theory of instincts. He argued that people are motivated by a variety of instincts: the drive for technological improvement (workmanship); the drive towards providing for the welfare of family and society (parental bent); and the drive to produce coherent explanations of the world (idle curiosity).¹¹⁶ Hedonism is inadequate as a psychology on which to base economics. There was, however, a more profound objection to hedonism. Veblen argued that the main determinant of behaviour was not instincts, but institutions. Institutional principles, once established, come to replace the instincts as the goals of action: they occupy the interest to such an extent as commonly to throw their own ulterior purpose into the background and often let it be lost sight of.¹¹⁷ Because of this Veblen argued that it was wrong to take behaviour as determined by psychology. Individual preferences should be treated as endogenous, not exogenous, the most well known example being "conspicuous consumption", where the value of a good bears no relation to its real worth. The real importance of Veblen's theory of instincts was rather that the instincts provided a normative criterion against which to judge institutions: institutions are judged on the basis of their compatibility with the instincts (as an example, see his denunciation of advertising, quoted above).¹¹⁸

Veblen's criticisms of deductive theory (that it was defended irrespective of whether or not it was consistent with empirical evidence) and of induction (which did not provide a theory of anything) were designed to pave the way for the acceptance of the genetic methodology which he continually advocated.¹¹⁹ Veblen never succeeded, however, in providing a workable alternative methodology. His main success (assuming that it is

regarded as a success), therefore, was as a critic. According to one commentator, "It cannot be doubted that his destructive attacks caused bewilderment among his contemporaries and, in so far as they were successful, tended to undermine their faith in orthodox economic theory."¹²⁰ In Arrow's words, Veblen's attacks "undermined the never-very-secure hold of neoclassical thought on [the] teaching of American economics".¹²¹ The task of providing a workable alternative to neoclassical economics thus fell to others.

18.4 AMERICAN INSTITUTIONALISM: MITCHELL

Mitchell and Veblen

Mitchell's claim to immortality rests with the empirical work for which he and his colleagues at the National Bureau of Economic Research were responsible. Mitchell was, however, one of Veblen's two leading disciples, and it is important to see him in this light.

Three aspects of Veblen's theory were particularly important for Mitchell. (1) Mitchell, like Veblen, was very critical of theories based on the assumption that wants, or preferences, were given. (2) He accepted the importance of Veblen's distinction between business and industry, or between the pecuniary and technological phases of economic life. The business cycle, the subject of Mitchell's most important work, was seen as a phenomenon arising out of the nature of business enterprise, but one which had important repercussions on the process of making goods. (3) He took over Veblen's view of the organic, evolving nature of society. He thus objected to the use of simple theories, stressing the complexity of economic phenomena.

Beyond this, however, Mitchell's approach was *very* different from Veblen's. Despite his scepticism as to the value of much orthodox theory, he nonetheless used those parts of it which seemed appropriate. For example, although Mitchell's conception of the business cycle problem may have been taken from Veblen, it can be argued that the details of his theoretical account of the business cycle, in which the interdependence of all prices and quantities played an important role, owed as much to Walras as to Veblen.¹²²

Mitchell's method

Mitchell's clearest statement of his method is provided in his Presidential Address to the American Economic Association, "Quantitative analysis in economic theory" (1925). He started by quoting Marshall's dictum that "qualitative analysis has done the greater part of its work".¹²³ However, rather than finding the makings of a new *methodenstreit* in these words, he went on to argue:

We do not speak of qualitative *versus* quantitative analysis. We do not seek to prove that one type should predominate over the other. Instead of dogmatizing about method at large, we are experimenting with method in detail. In the measure of our proficiencies, we all practise both qualitative and quantitative analysis, shifting our emphasis according to the tasks we have in hand. ... Such differences of opinion as flourish among us turn chiefly on our expectations concerning the relative fruitfulness of qualitative and quantitative work.¹²⁴

Thus when Mitchell, later in this address, criticized the deductive economics of Jevons and Marshall, the tone of his criticism was very different from that of Veblen's attacks on hedonism. Mitchell was content to argue that, because of better data and access to better techniques, quantitative workers were in a position to estimate directly phenomena such as the influence of supply and demand on price, that qualitative workers had been forced to approach only indirectly through deduction. From this he drew the conclusion that

it seems unlikely that the quantitative workers will retain a keen interest in imaginary individuals coming to imaginary markets with ready made scales of bid and offer prices. Their theories will probably be theories about the relationships among the variables that measure objective processes.¹²⁵

The old explanations provided by economists such as Marshall and Jevons would be disregarded rather than refuted. He likened this change towards quantitative reasoning to the shift amongst psychologists towards stimulus-response sequences and the quantitative analysis of behaviour.

This attitude also underlay Mitchell's work on the cycle. Though he started his work with a survey of previous theories of the cycle, he did not see the task of quantitative work as being to test these. Though such theories might give insights into some of the processes at work, the phenomenon of the cycle was too complicated to be explained by any simple model. The features of actual cycles had to be distilled from statistical data.

More importantly, Mitchell re-interpreted the concepts he took over from Veblen. Consider Mitchell's description of the relation between business and industry:

Much of their [quantitative workers'] data will consist of two great groups of time series. One group shows variations in the output, stocks, shipment, or orders for economic goods expressed in physical units The second group of time series shows variations in quantities expressed in monetary units. The relations between these two groups will be an obvious problem of just the kind that quantitative workers enjoy attacking. They cannot content themselves by staying always on the money level of analysis, or always on the commodity level; and they cannot pass back and forth between the two levels without realizing what they are doing.... Out of this technical characteristic of the statistical data we may expect to come to a close scrutiny of the relations between our pecuniary institutions and our efficiency in producing and distributing goods.¹²⁶

Though the theme is Veblen's, the methodology is very different. Similarly, for Mitchell, the organic nature of society implied that it was not

possible to represent the evolution of the economy with a single time series (such as GDP). To describe the business cycle, for example, it was necessary to examine a whole variety of indicators.¹²⁷

Interpretation

Mitchell was not an advocate of pure empiricism, for it was only certain types of economic theory that he rejected. It was because Mitchell attached great importance to the complexity of economic phenomena that he spurned simple theories. In the light of this, a recent writer concluded that:

Mitchell was, of course, extremely foresighted in recognising so long ago the crucial distinction between simple hypotheses readily recognisable as embryonic, if relatively useless, economic theory and complicated hypotheses less recognisable but far more likely to lead to progress in solving economic problems.¹²⁸

The most important example of this is probably Mitchell's rejecting the "neoclassical" emphasis on equilibrium (a relatively simple hypothesis) in favour of the "institutionalist emphasis on economic process" (a complicated, but allegedly more fruitful hypothesis).¹²⁹

On the other hand, despite Mitchell's use of economic theory, his emphasis was overwhelmingly on induction: on the need to derive hypotheses directly from empirical data. Furthermore, a crucial characteristic of deductive reasoning is that assumptions have to be stated sufficiently precisely for it to be possible to work out exactly what the theory does predict. Mitchell's preference for very complicated theories, therefore, made the use of deductive reasoning very difficult. Thus although Mitchell did use economic theory, it is not very misleading to regard him, at least in his Presidential Address, as having advanced an inductivist research programme. It is possible to say of Mitchell what he said of Marx: "He may not have gotten his leading ideas out of his study of historical records, that is quite true, *but no one does.*"¹³⁰

18.5 AMERICAN INSTITUTIONALISM: COMMONS

Collective action

The starting point for Commons' economics is the fact of scarcity. He differs from neoclassical economists, however, in arguing that in the absence of any constraints on individual action, disputes between individuals concerning command over scarce resources will be settled by physical force. Such a situation is inefficient, not least because it creates insecurity, making it difficult to plan for the future. Collective action, therefore, is needed to impose constraints on individual behaviour, thereby creating opportunities for others.

If transactions are to go on peaceably without resort to violence between the parties there must always have been a fifth party to the transaction, namely a judge, priest,

chieftain, ..., who would be able to settle the dispute, with the aid of the combined power of the group to which the parties belonged.¹³¹

Institutions, for Commons, are the mechanisms through which collective control is exercised: "we may define an institution as collective action in control, liberation and expansion of individual action".¹³² Such collective control may comprise either unorganized customs or organized action through *going concerns*, such as the state, the family, the church, the corporation, the trade union, etc. Each of these institutions will have its own set of *working rules*:

Working Rules are continually changing in the history of an institution, and they differ for different institutions; but, whatever their differences, they indicate *what individuals can, must, or may, do or not do, enforced by collective sanctions*.¹³³

Three aspects of such collective control of individual action need to be mentioned.

- (1) The existence of rules governing behaviour creates opportunities as well as imposing constraints:

collective action is more than control of individual action – it is ... a *liberation* of individual action from coercion, duress, discrimination, or unfair competition by other individuals. ... [In addition] it is *expansion* of the will of the individual far beyond what he can do by his own puny acts. The head of a great corporation gives orders whose obedience, enforced by collective action, executes his will at the ends of the earth.¹³⁴

Perhaps the most basic opportunity is that provided by *property*: the institution of property gives one individual control over a resource through restraining others from exercising control over it.

- (2) Because of the variety of types of control, institutional economics, for Commons, comprised not only economics, but also ethics and jurisprudence:

ethics deals with the rules of conduct arising from conflict of interests, arising, in turn, from scarcity and enforced by the *moral* sanctions of collective *opinion*, but economics deals with the same rules of conduct enforced by the collective economic sanctions of *profit* or *loss* in case of obedience or disobedience, while jurisprudence deals with the same rules enforced by the organized sanctions of *violence*. Institutional economics is continually dealing with the relative methods and efficiency of these three types of sanctions.¹³⁵

- (3) It was the availability of an outside arbitrator which enabled ethical considerations to be brought in, for without the possibility of appeal to some objective authority, bargains would be determined simply by power. Against the charge that concepts such as "reasonable value" were merely matters of opinion, he argued that such concepts could be given precision by arbitrators or through the legal system, the final arbitrator being the Supreme Court of the United States. Thus for Commons, "Reasonable Value is the Court's decision of what is reasonable as between plaintiff and defendant. It is objective, measurable in money, and compulsory."¹³⁶

Transactions

Commons' basic unit of analysis was the *transaction*. A transaction involves "the alienation and acquisition, between individuals, of the *rights* of property and liberty created by society".¹³⁷ Commons distinguished three types of transaction: bargaining, managerial and rationing transactions. The first two are transactions between a legal superior and a legal inferior. A rationing transaction involves the "rationing of wealth or purchasing power by a superior authority",¹³⁸ an example being the levying of taxation by the state. Managerial transactions involve the relationship of command and obedience involved in the organization of production, as between a manager and an employee.¹³⁹

Bargaining transactions, on the other hand, involve a voluntary agreement between legal equals. A characteristic feature of a bargaining transaction is that it involves a double transfer of ownership: ownership of one resource is exchanged for ownership of something else.¹⁴⁰ Legal equality, however, does not imply that the two sides to a bargain have equal bargaining power, for the terms of a bargain will depend on the ability of each party to withhold something that the other party wants. This will depend on the alternative opportunities available. The use of such bargaining power may, however, be restrained by working rules: some alternatives may be ruled out, or limitations may be placed on the use of power. The law, for example, may require equal opportunities, fair competition; or it may prevent unreasonable use of bargaining power, and ensure due process of law.¹⁴¹

The relationship between scarcity and working rules is summed up by Commons when he argues that implicit in any transaction are three social relations:

the relations of conflict, dependence and order. The parties involved are involved in a conflict of interest on account of the universal principle of scarcity. Yet they depend on each other for reciprocal alienation and acquisition of what the other wants but does not own. Then the working rule is not a foreordained harmony of interests, but it actually creates, out of a conflict of interests, a workable mutuality and orderly expectation of property and liberty.¹⁴²

Thus collective action, for Commons, is a prerequisite for bringing order out of the conflicts of interest created by scarcity.

Institutional change

Transactions thus depend on the working rules of the going concern within which they take place? But where do such institutions, such going concerns with their working rules, originate? Commons rejected any idea that institutions were given once-for-all, as if by some fixed social contract. The key requirement of working rules is *workability*: the requirement that they enable the going concern to function properly. Working rules, Commons argued,

are necessary and their survival in history is contingent on their fitness to hold together in a continuing concern the overweening and unlimited selfishness of individuals pressed on by scarcity of resources.¹⁴³

Institutions are problem solving mechanisms which evolve in response to new problems:

They grow out of the settlement of disputes and the combined action of the group as a mass in offense or defense with other groups. This necessarily means the selection of good habits and practices of individuals as against bad habits and practices that weaken the group as a whole.¹⁴⁴

One means of changing working rules is through political power. Political and judicial institutions are subject to change as much as any other institution, for they must be workable: they must be capable of solving problems in a sufficiently equitable and efficient manner to enable the system to continue. As is any form of activity, the use of political power is itself subject to working rules.¹⁴⁵

The means of changing working rules on which Commons placed most emphasis, however, was the process of common law. When a dispute arises, it may be settled by the courts. The courts decide, on the basis of what they consider reasonable, whether or not certain practices are desirable. In coming to their decisions they consider not only statute law, but also

the inducements to efficiency, the Circumstances of Scarcity at the time and place, the expectation of the Future, the good and bad practices of the two parties, as well as the good and bad Common Practices of similar persons under similar conditions.¹⁴⁶

The decisions of the courts give precision to customs and rules. Through the courts, not only ethical and ideological attitudes, but also economic considerations are brought to bear on institutions.

Commons' attitude towards economic policy followed as a natural corollary of this view of institutions and the way they evolve. He saw policy as being concerned with the development of improved working rules. The task of policy makers was not to search for ideal solutions to problems, but to search for workable improvements. Though Commons also made proposals for constitutional reform, designed to make the political and judicial processes more effective in solving problems,¹⁴⁷ his most important work was on specific economic problems. Throughout his career Commons was involved in proposing, and advising, on legislation, both in Wisconsin and at the Federal level.¹⁴⁸ His influence on legislation was enormous, covering civil service reform, factory legislation, workmen's compensation, unemployment insurance, interest rate control, rural credit and taxation measures, inheritance taxation, property assessment laws, immigration laws, monetary policy and industrial relations. In addition, he had an enormous influence on policy through his students: "through his students Commons was the intellectual origin of the New Deal, of labor legislation, of social security, of the whole movement in this country [the US] towards a welfare state".¹⁴⁹

Commons, Veblen and economic theory

Commons' ideas had much in common with those of Veblen: they both stressed the purposive nature of economic activity; and they both emphasized the evolving nature of economic institutions. Commons' ideas differed from Veblen's, however, in several important respects, the result being that his system is *substantially* different from Veblen's.

Most important is Commons' view of institutions as constraining behaviour. For him, individuals' desires and instincts still operate, but are controlled and guided by institutions. This led Commons to reject Veblen's dichotomy between business and industry. Veblen had seen a sharp distinction between pecuniary and technological criteria as criteria for social choice.¹⁵⁰ This dichotomy, according to Commons, arose because Veblen had failed to consider the constraints which have been evolved, through the courts, to control business activity:

The historical explanation of Veblen's cynical antithesis of business and industry is in the failure to trace out the evolution of business customs under the decisions of the courts, as he had traced the technological customs. Such an investigation reveals the evolution of his "intangible property", which has consisted in making the distinction, not allowed by Veblen, between goodwill and privilege, goodwill being the reasonable exercise of the power to withhold, and privilege being the unreasonable exercise of that power.¹⁵¹

Through the courts property had been linked to "reasonable" value:¹⁵² anything reasonable, whether reasonable value, reasonable wages, reasonable safety or reasonable conduct, would be sustained by the courts.¹⁵³ This explains his remark, in the preface to his *Legal Foundations of Capitalism* (1924), that in trying, with his students, to reconcile the decisions of the courts with the writings of the economists, "what we were really working on was not merely a theory of Reasonable Value, but the Legal Foundations of Capitalism itself".¹⁵⁴

Because of his starting point, namely the conflicts arising from the scarcity of resources, Commons' economics is easy to relate to orthodox, "neoclassical" economics. Commons minimized the novelty of his own teaching:

The problem now is not to create a different kind of economics – "institutional" economics – divorced from previous schools, but how to give to collective action, in all its varieties, its due place throughout economic theory.¹⁵⁵

His *Institutional Economics* (1934) was subtitled "Its Place in Political Economy".

Commons' concerns, however, were much wider than those of orthodox economics. Orthodox economics dealt only with bargaining transactions, whereas Commons saw these as merely one type of transaction. In addition, Commons was concerned to investigate the constraints on behaviour, seeing these as endogenous. Commons' main interest was in what he called *strategic* transactions: transactions which altered the constraints within which what he called *routine* transactions took place.¹⁵⁶ Thus he was, for

example, more interested in the transactions which established property rights and the limits on competition, than in how product prices were determined subject to these constraints. This explains his emphasis on legal processes. His approach was thus in a sense complementary to that of orthodox economics.

Despite the profundity of his contributions, Commons' economic theory has largely been neglected. To many economists his writings were incomprehensible.¹⁵⁷ His writings have been described as "a tangled jungle of profound insights".¹⁵⁸ Though he had influential students, their influence was on legislation, not on basic theory. He has also suffered from being grouped together with Veblen as an "Institutionalist", for this has helped obscure his place as an independent economic thinker.

18.6 MARXIST ECONOMICS

The golden age of Marxism

The decades leading up to 1914 can legitimately be described as the golden age of Marxism. In the words of one authority,

The period of the Second International (1889–1914) may be called without exaggeration the golden age of Marxism. Marxist doctrine had been clearly enough defined to constitute a recognizable school of thought, but it was not so rigidly codified or subjected to dogmatic orthodoxy as to rule out discussion or the advocacy of rival solutions to theoretical and tactical problems.¹⁵⁹

In continental Europe in particular, there was extensive discussion of many aspects of Marxist theory, both amongst people describing themselves as Marxists, and with opponents of Marxism who nonetheless took Marxism seriously.

Despite this interest in Marxism, and despite the roots of Marxist economic theory in English classical economics, Marxist and mainstream economics, with notable exceptions, went their separate ways. In England few prominent economists took Marxism seriously, an exception being Wicksteed's (1894) attempt to use Jevonian marginal utility analysis to criticize the Marxian theory of value.¹⁶⁰ Edgeworth, for example, reviewing a book published in 1920, wrote "We have much sympathy with those who hold that the theories of Marx are beneath the notice of a scientific writer".¹⁶¹ In the United States, with its greater tolerance for divergent approaches, there was a tendency to treat Marxian economics as yet another system to be considered alongside others. Thus although prominent economists, such as Mitchell,¹⁶² commented favourably on Marx, his ideas had little impact on economic thinking. It was in Europe that both developments in Marxist economics, and the interaction of Marxian and orthodox ideas were greatest. Within Marxist economics the most important development was perhaps the theory of imperialism, associated with the names of Hilferding, Bukharin and Lenin, according to which imperial

expansion overseas could be explained in terms of surplus capital seeking profitable investment opportunities. Imperialism was thus important as a means of explaining why it was that capitalism was managing to survive, and even prosper, despite Marx's predictions to the contrary.¹⁶³ It was out of debates on the viability of capitalism, an issue connected in Marx's theory with the recurrence of economic crises, that Tugan-Baranovsky's work on cycles emerged.¹⁶⁴ But although Tugan-Baranovsky's work on the cycle fed into the emerging orthodox literature on the business cycle, the most important instance of the interaction of Marxist and orthodox economics during the period was the interchange between Böhm-Bawerk and Hilferding, Böhm-Bawerk being widely regarded as the period's most important critic of the Marxian system.¹⁶⁵ This interchange is revealing, for it explains the difference between the orthodox and Marxist approaches to the subject, and hence why their interaction was so unproductive.

Böhm-Bawerk and Hilferding

The occasion for Böhm-Bawerk's attack on the Marxian system in his *Karl Marx and the Close of his System* (1896) was the publication, in 1894, of the third and final volume of *Capital*.¹⁶⁶ This was particularly important because in the first volume Marx had promised that he would later provide a reconciliation of the contradiction involved in assuming both a labour theory of value based on a uniform rate of exploitation, and the fact that competition will produce a uniform rate of profit. Böhm-Bawerk had earlier (1884) predicted that no satisfactory explanation would be forthcoming, since the assumptions of a uniform rate of exploitation and a uniform rate of profit were, except in certain very simple cases, irreconcilable.

When Marx's volume III was published, Böhm-Bawerk found that Marx's solution had been simply to abandon the labour theory of value, in the sense that he accepted that prices would not be proportional to labour values.¹⁶⁷ In Böhm-Bawerk's view this undermined the whole Marxian system, for it could no longer provide an explanation of the ratios in which goods were exchanged.¹⁶⁸ The explanation that the labour theory of value "ultimately" determined prices – the line of causation running from aggregate surplus value to prices via aggregate profits and the average rate of profit – was considered, by Böhm-Bawerk, unacceptable. All this argument achieved was to show that labour value was one of the factors determining price. Furthermore, Marx's system could cope neither with explaining the prices of goods not produced by labour, nor with the problems caused by differences in the quality of labour.¹⁶⁹

To show the importance of this for Marx's system as a whole Böhm-Bawerk argued that Marx had simply taken the labour theory of value on the authority of Smith and Ricardo, because it fitted in with his socialist preconceptions, building up a system based on this. As he realized that it was insufficient simply to postulate a labour theory of value, for this could not be taken as a self-evident proposition, he constructed a variety of artificial and fallacious arguments to support it. Marx, in his attempt to

justify a system based on an out-dated and refuted theory of value, simply ignored the evidence that exchange values were not determined by labour values.

Herein lies, I believe, the alpha and omega of all that is fallacious, contradictory, and vague in the treatment of his subject by Marx. His system is not in close touch with the facts. Marx has not deduced from facts the fundamental prices of his system, either by means of a sound empiricism or on a solid economico-psychological analysis.¹⁷⁰

Hilferding's response was to argue that Böhm-Bawerk's criticism was the result of a much too narrow view of economics, according to which the main purpose of the subject was to explain relative prices. Bourgeois economics, according to Hilferding, considers merely the relationship between man and nature, between commodities and individual wants.¹⁷¹ In contrast, Marxian economics was concerned with exchange value as a social phenomenon, not as a means of determining prices.¹⁷² Böhm-Bawerk, according to Hilferding, confused value and exchange value and price.¹⁷³ Thus Hilferding did not attempt to refute Böhm-Bawerk's arguments on their own ground, for he saw something more to the labour theory of value than merely a means of explaining prices. "It is therefore because labor is the social bond uniting an atomized society, and *not because labor is the matter most technically relevant, that labor is the principle of value*".¹⁷⁴ Labour value had, for Hilferding, a deeper meaning connected with the role of exploitation in Marx's view of history.¹⁷⁵ Marx, according to Hilferding, was concerned not to explain relative prices, but to explain the evolution of capitalism.

Connected with this last point is Hilferding's other main criticism of Böhm-Bawerk: that the subjectivist approach, explaining prices in terms of the relationship between needs and wants, was ahistorical, for "The natural conditions under which labor is performed are unalterably given to society, and from these conditions therefore changes in social relationships *cannot* be derived."¹⁷⁶

Because value was a social relationship, it could not depend on the factors posited by the Austrians. It would be more correct to argue, however, not that the Austrian theory of value denied the social nature of value, but that it interpreted it in a different way. Instead of making almost animistic generalizations about the way society worked, the Austrian approach was to look for the underlying factors that explained why social relationships took the particular forms they did.¹⁷⁷

In conclusion, it can be argued that the main difference between Böhm-Bawerk and Hilferding was that they had different views of the purpose of economic theory. As one historian of Marxism has said of Marx's theory,

Its purpose is not to describe the quantitative relations between phenomena so that we can more easily influence events, but to unmask the anti-human character of a society in which production is entirely geared to the multiplying of exchange value; to lay bare the "alienation" of social life. ... A theory of this kind is not so much an explanation as an ideological appeal, and must be understood as such."

Referring to the exchange between Böhm-Bawerk and Hilferding, he goes on to argue, "The controversy between Marxists and critics of the theory of value is thus insoluble, as the latter expect from a general economic theory something that Marx's doctrine is unable to provide".¹⁷⁸ Böhm-Bawerk's desire was for a scientific economics based on facts, which meant that, once the labour theory of value had been abandoned as an explanation of relative prices, it was almost inevitable that he, and similarly-minded contemporaries, would dismiss the partly normative and metaphysical labour theory of value as of no significance.

The transformation problem

In 1907 an important contribution was made to the Marxian theory of value with von Bortkiewicz's solution to the transformation problem. Von Bortkiewicz pointed out that in his solution to the transformation problem Marx had illegitimately mixed together prices and values. To obtain prices Marx had added profits to the *value* of the constant and variable capital used up on production.¹⁷⁹ Von Bortkiewicz argued, correctly, that the appropriate procedure was rather to add profits to the *price* of the capital used up in production. This meant that it was necessary to formulate two separate systems, one dealing with values, the other with prices.

In the *value system*, using the notation of chapter 12,

$$\begin{aligned}c_I + (1 + e)v_I &= o_I \\c_{II} + (1 + e)v_{II} &= o_{II}.\end{aligned}\quad^{180}$$

The value produced by each sector comprises constant capital used up in production, variable capital and surplus value, surplus value being a fraction e of variable capital. In the *price system*, on the other hand,

$$\begin{aligned}(1 + r)(p_I c_I + p_{II} v_I) &= p_I o_I \\(1 + r)(p_I c_{II} + p_{II} v_{II}) &= p_I o_{II}\end{aligned}$$

where r is the profit rate, and p_I and p_{II} are the ratios of price to value in each of the two sectors.¹⁸¹ The significant features of these equations are: (1) that the rate of profit is applied to the total capital stock, not merely to variable capital;¹⁸² and (2) that constant capital is valued using the price of capital goods, with variable capital being valued using the price of wage goods.

Making the further assumption that "simple reproduction"¹⁸³ was taking place, and that total profits equalled total surplus value, von Bortkiewicz went on to show that these equations could be used to determine a set of prices.¹⁸⁴

18.7 CONCLUSIONS

Throughout the period, and above all from the 1870s to the mid 1920s, orthodox economics was subject to a sustained attack from the advocates of

rival approaches. Common to all these attacks was the charge that contemporary deductive theory was unhistorical, but despite this common strand, there was much greater diversity amongst critics of orthodoxy than amongst its supporters. Whilst there were substantial differences between, for example, Marshall's "neoclassical" approach and Austrian "subjectivism", their theories shared a common structure, differences concerning primarily the interpretation of this structure. With the critics of orthodoxy, on the other hand, the differences were more fundamental. The approach of the German historical school was close to those of Mitchell and Ashley, for example, but the differences between English, German and American variants remained, nonetheless, substantial. Given the nature of the historical approach, it was perhaps inevitable that differences in national circumstances would cause economists to have different outlooks. Historical economics travelled less well than more mathematical economics.¹⁸⁵ American concern with big business, for example, had no real parallel in England, for the structure of the industrial system was very different. When we take account of Veblen and Marx, who also wished to emphasize the historical evolution of economic systems, the picture becomes even more complicated.

This welter of historical criticism had remarkably little impact on the main body of economic thought, though particular branches of the subject owed much to it. A variety of reasons for this have been suggested. The Marxian explanation, for example, runs in terms of the class interests of the bourgeoisie. Whilst this explanation is hard to refute, there are strong grounds for scepticism. Many mainstream economists, for example, were keenly interested in the interests of the working class, and in projects of social reform. Similar objections can be raised to Veblen's explanation that hedonistic economics, of which marginal utility theories form a part, reflect pecuniary habits of mind.

An important reason for the survival of mainstream economics was that some of the criticisms were answered very effectively. Particularly important here is Allyn Young's criticism of the view, put forward by Veblen, and taken up by Mitchell, that mainstream economics was flawed because it was based on a defective view of human nature, namely hedonism. The part of this critique that Young attacked was the view that "Economic theory rests and always has rested, upon the concept of human nature posited by the economist".¹⁸⁶ Taking as his example Ricardo's system, Young argued,

It is impossible to deduce Ricardo's system from psychological postulates, unless the postulates are made so numerous that there is a one-to-one correspondence with every separate *element* in his system. In short, Ricardo's postulates are found only *in* his system; in fact, I believe it is substantially accurate to say that they *are* his system. Professor Mitchell has charged economists with having rationalized economic behaviour. He himself ... has rationalized economic science. For exposition's sake, or because they thought logical consistency required it, or for some much more subtle and obscure reason, economic theorists have often presented their doctrines as though they flowed from some first principle. But the first principle is generally purely ornamental, like the meaningless "desire for wealth". The real soundness of a system of thought depends on its internal consistency and upon the accuracy with

which it summarizes the pertinent parts of experience. These considerations hold true not only for so-called deductive economics (the “deduction” is only a matter of expositional form) but also for ‘institutional’ or any other variety of economics.¹⁸⁷

Whatever its merits as a view of the capitalist system, institutionalism did not score highly on this criterion. Young reached the conclusion that “Veblen is a man of genius, but the term scientist does not fit him. He is something that may be as good or better: an artist, an impressionist, painting the picture of the world as he sees it”.¹⁸⁸

The fundamental reason for the survival and prosperity of the orthodox approach, however, would appear to be the inadequacy of the alternatives offered, none of which provided a satisfactory means of analysing the questions to which most economists sought answers. There was widespread agreement, for example, that historical analysis could play an important role in analysing the evolution of national economies over long periods of time, though even here few generalizations could be sustained, but most economists were interested in far more than this. Historical generalizations could not, for example, say anything about the effects of new forms of taxation or new forms of labour organization, both of which were important issues around the turn of the century. In addition, German historical economics was not equipped to analyse the inflation of 1923, and in the 1930s Institutionalism had little to contribute to an analysis of the world slump.

A further factor was that the advocates of a more inductive method failed to provide an alternative to “deductive” theory. When it came to constructive work, for example, both Schmoller and Mitchell made use of marginalist theories, Schmoller making use of Böhm-Bawerk’s work, Mitchell of Walras’. The method of the neoclassical programme, on the other hand, was one which proved capable of being employed to answer an ever-increasing range of issues. This is not to say that the insights of the historical economists or the institutionalists were not capable of being used to provide the foundation for an alternative to marginalist theory, though perhaps this is the case. It is rather that no one managed to show how this could be done.

Marxian theory did provide a real alternative to the marginalist conceptual framework, but here too there were serious inherent weaknesses. As Böhm-Bawerk pointed out, Marxian value theory was essentially Ricardian, and could be rejected on the same grounds: the objections concerning the pricing of non-produced goods, the problems raised by differing capital-labour ratios and those caused by the non-homogeneity of labour were all well known from classical criticisms of Ricardian theory. Thus in raising them Böhm-Bawerk was not introducing new arguments, but citing well established results. Though Marxists may have been able to justify the use of labour values as a normative concept, this was not the “scientific” concept that most academic economists were looking for.