THE INSTITUTIONAL APPROACH TO ECONOMIC THEORY

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I. *Introduction*

An explanation of the "institutional approach" to economic theory is a plea for a particular kind of theory. It is possible to come upon the same object from different angles; but more often those who take different routes chance upon different things. The "institutional approach" doubtless has some importance because it is a happy way to acceptable truth, but its significance lies in its being the only way to the right sort of theory. An appeal for "institutional economics" implies no attack upon the truth or value of other bodies of economic thought, but it is a denial of the claims of other systems of thought to be "economic theory." This, however, is no pointless struggle in method to be carried on by breaking syllogisms over concepts and by engaging in polemics over niceties in statement. On the contrary, it involves the very nature of the problems which the theorist should set himself; its real issue is over what economic theory is all about.

II. *The Nature of Economic Theory*

The thesis here set forth is that "institutional economics" is "economic theory." This involves putting a particular meaning upon a word which has meant many things. From the first, economic inquiries have gone pell-mell across frontiers at which they should have stopped; they have halted where logic would have pushed them forward; and they have been dominated by vacillating and conflicting purposes. To catalogue the subjects to which the term "economic" is applied is to belie the careful definitions of the science pent up in books; to find an economic theory consistent with this multiform expression is to dissipate that theory in polychromatic reality. In general, particular subjects such as money, transportation, and accounting have been set off from "general economics." From the latter two bodies of doctrine have developed which aspire to the dignity of "economic theory." One of these is primarily concerned with the origin and manifestations of value. It is represented by such treatises as Smart's *Theory of Value*, Boehm-Bawerk's *Positive Theory of Capital*, and Clark's

Distribution of Wealth. The concern of the other is the customs and conventions, or, if you please, the arrangements, which determine the nature of our economic system. It is represented in classical economics by Smith's account of mercantilism, Whately's discussion of how competition organizes industrial activity, and Mill's exposition of the relation of the state to industry. Typical examples from modern economics are Cannan's account of the function of property in economic organization, Veblen's discussion of the dependence of wealth upon machine-technique, and Hobson's analysis of the relations under modern technical conditions of work to welfare. Between the two lies the issue of what is economic theory.

Institutional and value economics have many things in common. Both can claim a line of development running back to early classical economics. Both have emerged as by-products of the play of the human mind with the practical problems of social well-being. Both furnish materials that can be taken into account in passing upon questions of practical moment. The champions of each insist that its task is the positive one of garnering materials and formulating principles. Yet in actual use each has the taint of mixing judgments of goodness and badness into exposition. Only in recent years has value theory escaped a formal association with *laissez faire* and now even its most positive statements bear in such terms as "utility" and "productivity" and in the wording of principles implications about the worthwhileness of prevailing arrangements. Likewise institutional economics, in telling the elements which make up the economic system, passes judgments upon them. It is not in the legitimacy of their claims to stand in the line of succession, nor in their pretenses to unbiased scientific statement, nor in their dispositions to stray away after ethical judgments that the two differ. It is rather in their conceptions of the nature of the economic order.

The claim of value economics to the dignity of "economic theory" is not lightly to be put aside. In common speech it is recognized as "economic theory." This is not the place for the chapter in the history of economics which recounts how the two rival systems strove for the dominance of classical doctrine, nor for the equally interesting one which relates how at the passing of the older system institutional theory was dissipated and value theory passed into the inheritance. It is enough that it is built around "value," which is the most important concept in the science; it enjoys the prestige of the older body of doctrine; and that it is the most subtle, the most general, and the most articulate body of thought in economics. Yet its claim must be disallowed. Its merits are due to a failure to recognize the complexity of the relations which bind human welfare to industry. As our conception of the economic order has become larger and more intricate, value theory has hedged its problem about with greater limitations. At present its whole endeavor is an explanation of the nature of economic value and of the forms of income in which it expresses itself. The conclusions which it suggests about the kind of industrial society in which we live are indirect. They appear only because value theory is derived from the classical doctrine of the organization of industry upon the principle of free competition. Aside from such accidental statements, it is a specialized subject of inquiry with as little right to the dignity of "economic theory" as the theory of money or of accounting.

"Institutional economics" alone meets the demand for a generalized description of the economic order. Its claim is to explain the nature and extent of order amid economic phenomena, or those concerned with industry in relation to human well-being. In the words of Edwin Cannan, it attempts to tell "why all of us are as well off as we are" and "why some of us are better off than others." Such an explanation cannot properly be answered in formulas explaining the processes through which prices emerge in a market. Its quest must go beyond sale and purchase to the peculiarities of the economic system which allow these things to take place upon particular terms and not upon others. It cannot stop short of a study of the conventions, customs, habits of thinking, and modes of doing which make up the scheme of arrangements which we call "the economic order." It must set forth in their relations one to another the institutions which together comprise the organization of modern industrial society.

III. *Characteristics of Institutional Economics*

The case for institutional economics requires a reduction of the definition above to a catalogue of particulars. This, however, cannot be attempted here. Instead there will be presented for acceptance, for qualification, or for rejection a list of five tests which any body of doctrine which aspires to the name of economic theory must be able to meet. It is believed that institutional economics alone can meet these tests.

1. *Economic theory should unify economic science.*—The task of a general body of theory in any subject is to give unity to its investigations. At present economics is badly in need of such a unifying agent. Its sprawling frontiers reach from value theory across money, taxation, and transportation to salesmanship, insurance, and advertising. Each of these subjects has its own point of attack, its own method, and its own personnel. Those who seek truth in these remote fields of inquiry know little and care less for value theory. For all the constraints of neo-classical theory, each of these subjects tends to develop an isolated body of thought. As a result economics today tends to break up into a large number of overlapping but unrelated inquiries and to lose the unity which in times past has been its source of strength. The mechanics of value determination possesses no magic which will draw together such divergent elements. Only institutional economics can perform that service. In describing in general terms economic organization it makes clear the kind of industrial world within which such particular things as money, insurance, and corporation finance have their being. It shows their nature by pointing out the parts they play in this larger whole. Its statements, always tentative, always enriched by inquiries in particular fields, are properly the point of departure for such specialized studies.

2. *Economic theory should be relevant to the modern problem of control.*—Students of economics should spend their efforts upon subjects worth investigation. If learning were a mere search for hypothetical truth, the principles governing the economic life of cave men, the inhabitants of Mars, or of a Crusoe-infested island might be worth formulating. But economists are few, time has scarcity value, and relevant subjects come faster than they can be seized. It is not the place of economics to pass judgments upon practical proposals. But, quite in keeping with its scientific character, it can impartially gather the facts and formulate the principles necessary to an intelligent handling of such problems. Such relevancy has always marked economics in the periods of its most fruitful development. Thus Adam Smith's point of departure was the relationship of economic organization to national wealth; thus Ricardo's principles are an outgrowth of his concern with the currency and bullion controversies; and thus the best work of the Austrian school grows out of a refutation of Marxian socialism.

If institutional economics has a relevancy which neo-classical economics has not, it is because problems have changed. Early classical economics was formulated by men who sought to remove the artificial restrictions which had been imposed upon industry. *Laissez faire* was a formal and explicit part of its statement. It tended to show the beneficence of an industrial system automatically organized in response to the pecuniary self-interest of individuals. It made the scheme of arrangements wherein lay the real organization of society a part of the immutable world of nature. Since the neo-classical doctrine has passed into the inheritance, the formal defense of *laissez faire* is gone, though it still lingers implicitly in terms and the statement of propositions. Formally it is concerned with the mechanical way in which the values of goods and of shares in distribution emerge in the market. But it has no concern with the organization of that market, the nature of the transactions which occur there, or the less immediate facts of the distribution of opportunity, property, and leisure upon which the size of these shares rest. Its explanatory terms are not matters subject to control.

A shift in problems and a general demand for control has made institutional economics relevant. This shift has been due partly to a discovery that institutions are social arrangements capable of change rather than obstinate natural phenomena, partly to a consciousness that activity, once apparently voluntary, is controlled by subtle conventions and habits of thought, and partly to the bad taste which *laissez faire* has left with us. But, however it has come about, there is a demand for an economics relevant to problems of control.

3. *The proper subject-matter of economic theory is institutions.*—The demand that economic theory relate to institutions is implicit in the plea for its relevancy. If it is to be germane to the problem of control it must relate to changeable elements of life and the agencies through which they are to be directed. Such elements of life and directive agencies are alike institutions. Control is exercised by modifying the arrangements which make up our scheme of economic life in such a way as better to satisfy our needs or our whims. Control is exercised through the peculiar agencies which we have at hand.

A control of particular aspects of economic life requires a knowledge of particular institutions. If one would deal intelligently with inflation, he must understand the organization of society in its financial aspects. This includes a knowledge of the price system, the level of prices, the place of credit in industry, and the relation of the unit for measuring pecuniary values to the maintenance of the economic order. If one would understand the corporation problem, he must learn the peculiar features of this form of business, the various devices which together make up its organization, and the place which it takes in industrial society. And if one would pass upon any of the many proposals for changing things in such a way as to enable some of us to make more and others less, he must know the relationship of the things he would change to the distribution of income. It is not enough to assert with the neo-classicists that one receives the value of his services in the market; for, if matters subject to control are changed, he will still receive the value of his services, but he may pocket a different sum. He must understand, in addition, the conventions of competition, of contract, of property, of inheritance, of the distribution of opportunity which make incomes what they are.

In like manner a control of the development of industrial society is contingent upon a knowledge of the bundle of conventions and arrangements which make it up. The basis of material wealth in the machine technique, the scheme of natural rights which still inheres in the legal system, the resolution of all industry into a multitude of specialized and interdependent tasks, the rise of a complicated business mechanism which intervenes between wealth and welfare, the concentration of direction in the hands of an industrial hierarchy, the scheme of arrangements known as the wage-system, which is the means by which the laborer establishes a connection with industry—these and a hundred other things like them must be recognized by one who would direct, or, if he be an economic theorist, watch, industrial development.

4. *Economic theory is concerned with matters of process.*—If economic theory is to treat of institutions it must know both the kinds of things institutions are and the kinds of things they are not. Value theory deals with its phenomena as if they were physically complete, independent, unchangeable substances. The only variations which it admits are quantitative. At the beginning of one of its problems a certain situation exists; then a disturbing force makes its appearance; this is followed by a series of actions and reactions which continues until the normal is restored or an equilibrium is reëstablished. By adding or subtracting units from a combination or by combining equations, formulas are found in terms of which economic values may be reduced to pecuniary terms.

Such a method of procedure has, quite appropriately, been called "economic statics." Of late years a recognition of the limited number of problems upon which such an analysis throws light has led to a demand for an "economic dynamics." This, however, has served but to enlarge the older analysis by increasing the number of factors to be considered in attempting to understand problems. Both alike deal with physically distinct things; both alike reduce their problems to mechanical formulas; both alike find solutions in equilibria and quantities.

But the subject matter of economic theory cannot be handled in any such way. Competition, property, the price structure, the wage system, and like institutions refuse to retain a definite content. Not only are things happening to them, but changes are going on within them. A law, a court decision, a declaration of war, a change in popular habits of thought, and the content of property rights is affected. An increased demand for labor, a refusal of the nation to allow strikes, an enforced recognition of unionism, an establishment of wages upon living costs, and the wage system becomes different. Both by a change in its relation to other things and by subtle changes going on within, each of these institutions is in process of development. And, if this is true of particular institutions, it is likewise true of the complex of institutions which together make up the economic order. We need constantly to remember that in studying the organization of economic activity in general as well as in particular, we are dealing with a unified whole which is in process of development.

To this method the terms "historical" and "genetic" are frequently applied. The first, because of the associations which the word history brings up, is particularly unfortunate. It suggests an account of things which have happened to the subject of discussion during a definite period of time. Its emphasis is wrong because it is upon the accidental facts of past associations, not upon the essential nature of current reality. If it is rightly understood the term "genetic" is much better. But it must not be allowed to suggest a far-away, uninteresting, and irrevelant search for "origins." It must mean what the word so clearly implies that the thing is "becoming." Thus used the word "genetic" suggests, not a historical account, but a method of analysis. It goes to the past only with the end in view and so far as is necessary to explain what a thing is in terms of how it came to be. The economic system, which is so baffling and unintelligible to us, is not so much an interesting group of real things as a curious stream of tendencies. Many of these move slowly, some of them seem immutable. Yet the whole complicated affair which we call Modern Industrialism has existed for a very brief period in human history. If control is to be exercised, it is not to be by tinkering with this or that. It must be by changing the nature or functions of the institutions which make up our scheme of economic life. To insist upon treating such things genetically or as in process is nothing more than to insist that they are subject to conscious control.

5. *Economic theory must be based upon an acceptable theory of human behavior.*—After all control and institutions and processes are immediate things. They can all be translated into terms of human conduct. The exercise of control involves human activity and leaves its mark in the changed activity of others. Institutions, seemingly such rigid and material things, are merely conventional methods of behavior on the part of various groups or of persons in various situations. The changes which processes reveal are merely changes in human actions. It is necessary, therefore, that economic theory should proceed from an acceptable theory of human conduct.

In the past economics has been fortunate in using a theory of conduct in harmony with the general thought of the age. It has been unfortunate in taking this unconsciously from the common sense of the times rather than arriving at it by careful observation and analysis. This has led to a disposition to preserve it as part of a traditional body of doctrine long after it had ceased to have meaning to those who had looked at it too critically. In no respect does neo-classical economics more nearly resemble the body of doctrine from which it sprang than in its theory of the individual who knows the alternatives with which he is confronted and seeks his own greatest material good measured in pecuniary terms. The one touch which the economist has added to the theory as he took it from the ethicist is in making a pecuniary expression of self-interest a part of human nature. The extreme individualism, rationality, and utilitarianism which animated eighteenth century thought still finds expression in neo-classical economics.

In its stead a theory of motives must be used which is in harmony with the conclusions of modern social psychology. At its best the older theory of conduct presented in self-interest nothing more than a blanket formula. One had to go behind it to find the concrete influences which animated the behavior of individuals. At its best it made all activity the result of conscious endeavor by individuals who knew thoroughly their own interests even in an environment as complex as ours and who ruthlessly set out to attain them. It falls short of explanation because self-interest is not a simple thing that can be easily discerned, but a huge bundle of conflicting values wherein the present and the future are at variance. It assumed that each judgment could be based upon the real facts of the situation and could be made in detachment. It failed to note that my life and yours is a continuous thing, and that what I do today constrains my acts of tomorrow. It overlooked the part that instinct and impulse play in impelling one along the path of his economic activity. And, most important of all, it neglected the influence exercised over conduct by the scheme of institutions under which one lives and must seek his good. Where it fails, institutional economics must strive for success. It must find the roots of activity in instinct, impulse, and other qualities of human nature; it must recognize that economy forbids the satisfaction of all instincts and yields a dignified place to reason; it must discern in the variety of institutional situations impinging upon individuals the chief source of differences in the content of their behavior; and it must take account of the limitations imposed by past activity upon the flexibility with which one can act in future.

IV. *Conclusion*

The characteristics which have been discussed present a bare outline of the case for institutional theory. They all require explanation, elaboration, and illustration. Another champion would doubtless pick out other characteristics, such as the concept of society which underlies it, its freedom from utilitarian bias, its harmony with current tendencies in ethics, psychology, and politics, and the reliance which it places upon a scientific study of fact. But such things are implicit in the description given, which is typical rather than exhaustive.

It must be readily admitted that like the things with which it deals, institutional theory is in process. But it opposes the accomplishments of neo-classical theory with something more than mere promises. Here and there is much that can be fitted into a theory of the institutional organization of industrial society. Smith, Mill, Whately, and other classicists have given us much which with restatement can be used. The writings of the neo-classicists, even those of the type of Clark and von Wieser, are not without pertinent material. The English classicists, Marshall, Pigou, Chapman, have materials for us; for in England the older economics has never lost the general concern which the Austrian and the American utility theorists have taken from it. The writings of the socialists, particularly Marx and La Salle, stripped of their application to proposals for reform, contain many a bit of sound analysis. In recent years the English "welfare school," particularly Webb, Hobson, Cannan, Tawney, and Clay—if writers with problems and approached so differently may be grouped together because of their common departure from neo-classical analysis—have made substantial contributions and have given the beginnings of a formal statement of a theory of economic order. American thought has lagged largely because efforts which in England have taken a constructive bent here have been spent in criticism of neo-classical doctrine. Yet H. C. Adams, Cooley, Veblen, and Mitchell—to mention only the leaders—have made substantial contributions to an understanding of our system. Nor must we forget the lay economist. In a rapidly developing society such as ours the learning of the schools tends to become formal and scholastic. It requires fertilization from thought which grows out of a fresh attack upon a new problem. The contributions of Graham Wallas may be mentioned as a single example of what the non-professional economist has to offer.

Yet, when all these contributions are amassed, it is doubtful whether at this time a general description of the economic order can be given. It may require a decade or more for a process of trial and error to produce a relatively consistent body of thought. Even then it will lack the clear-cut, definite, and articulate character of neo-classical theory. Its concern with reality, its inability to ground a scheme of thought upon a few premises, its necessity of reflecting a changing economic life, alike make its development slow and prevent it from becoming a formal system of laws and principles. It must find in relevancy and truth a substitute for formal precision in statement.

The future of institutional theory is uncertain. The history of economics suggests that survival has often depended upon the ability of doctrine to fit in with the habits of thought of the times. If the next decade demands formal value theory that avoids a discussion of what the economic order is like, institutional economics will fail. If it demands an understanding of our relationship to the world in which we live, it will survive. But survival will be assisted by the development of a theory of the economic order, vital, true, and relevant to the problems of the times.