

## **CHAPTER THREE**

### **Heterodox Economic Thought**

#### **3.1 Early Critics of Neoclassical Economics**

Neoclassical mainstream approaches to economic theorizing have often dominated the study of economic phenomena and in the field of real estate specifically, neoclassical economic theories typified in classical real estate textbooks have often occupied the centre stage of property market studies. However, in recent times, more attention is being given to behavioural approaches to economic theorizing in recognition of the fact that human agents exhibit behaviours that are more complex than that represented in traditional mainstream economic theories. Specifically, the new institutional economics school (hereinafter referred to as NIE), a heterodox school of economic thought emphasizes the importance of the inherent behavioural attributes of human agents and its attendant consequences on human exchange interactions. It stresses the link between the associated consequences of human behaviour on exchange interactions and the emergence of institutions or governance structures, organic or designed, to create order and structure such exchange relations. Thus, the NIE approach to economic theorizing articulates the real-world dynamics of human interactions whilst emphasizing the institutionally contingent nature of human economic exchange. It combines economic theories with explicit human psychological assumptions as means to a better understanding of economic phenomena.

In the real estate market particularly, the role of human agents as investors, developers, intermediaries, fund managers, government agencies etc and the behavioral interrelationships between these agents and the institutions both formal and informal, which structure such relationships is central to the market process and dynamics of the market and ultimately the behaviour and outcome of the market. This is more so because of the peculiar nature of real estate asset; the decentralized market system through which it is exchanged and the complex legal process associated with its exchange. These factors function collectively to reduce the liquidity of real estate and contribute to its

asset specific nature due to the requirement for specialist market knowledge in form of market intermediaries who work to improve liquidity and attenuate risk for the investor. This underscores the increased attention on the role and importance of human agents in the transaction process and the institutions which govern such roles and the operation of the property market generally.

### **3.1.1 The Historical School**

The use of deductive method of reasoning by the Classical School gave rise to a class of critics known as the Historical critics. The critics who attacked Ricardo and his followers for the use of deductive method have often been put together and named as the Historical School. They were neither theorists nor their aim was to propound a theory. They refuse to accept the generalization made and to recognize the boundaries of the science determined by the classicists. The Historical school asserted that economic problems should be studied with reference to the past as well as to the present and hence they want to rebuild and formulate the science accordingly.

The reaction against the classical doctrines was most vigorous and prominent in Germany, and even the emergence of historical school may be ascribed to German. That is why some literature regards the school as the German Historical School.

The historical school defended and rationalized the German way of life by questioning the historical relevance of the British classical economic doctrines. The Germany that gave birth to the historical school was divided, weak, and primarily agricultural. Nationalism, patriotism, militarism, paternalism, devotion to duty and hard work, and massive government intervention all combined to change the pattern and promote industrial growth. Because Germany of the mid-nineteenth century was far behind England in the development of industry, its economists reasoned that government assistance was required for it to catch up.

In a nut shell, although the German enthusiasts readily accepted the English political economy, at the close of the 18th c after the Napoleonic war, it was detected that the German problems cannot be tackled with the help of

Classical's doctrines. In fact the doctrines were unsuitable for the conditions prevailing in Germany during those days. The Ricardian theories apparently were the result of the conditions existing in England, resulting from industrialization, Private enterprise & free trade. This cannot be made to apply to Germany where economic problems were chiefly the concern of administration.

### **3.1.2 The Old Institutional School**

- ❖ In the end of 19thc, economics had not yet become an evolutionary science (in other words a theory that focuses on process or an unfolding sequence having neither origin nor a final term).
- ❖ On the contrary traditional /classical theories/laws, equilibrium of Marshal Causes lead in the end to a system of economic Taxonomy.
- ❖ An evolutionary economic theory;
  - Have economic action as its subject.
  - Individual life admitably represents “an unfolding activity of a teleological kind i.e. one aims at certain objectives but this objectives are not immutable i.e. there is a cumulative process of adaptation i.e. means become an end and an end become a means & the process goes on.
- ❖ Hence there is no legitimate trend towards predetermined end (like classical or neoclassical) Rather there is cumulative sequence.
- ❖ One might say that in this approach institutional change is deemed endogenous to long term economic movement (non-teleological or finalistic)
- ❖ For Veblen this genetic method aims to recognize social phenomena into a theoretical structure in causal terms.
- ❖ Institutions are the result of a process where each state without an end without origin rather than classicals.

### 3.1.3 The New Institutional Economics:

(Oliver Williamson & Douglas North)

#### A. Williamson Transaction Economics:

- ❖ Williamson was the inventor of the term “New institutional Economics”
- ❖ He tried to analyze institutional matter with the instruments of standard economic theory with certain arrangements. He undoubtedly implies a certain relationship with the old institutional economics but his criticism of the latter remains.
- ❖ In 1940’s—neo classical economics was the dominant one (equilibrium and the invisible hand were dominant)
- ❖ In 1970’s new idea of institutional economics came up (New Institutional Economic) (NIE’s).
- ❖ They are indebted to original institutionalist (Schmoller and Veblen)
- ❖ The initial themes of NIE’s is **organizations** (essentially the firm, or in Williamson’s terminology, the **hierarchy**)
- ❖ Williamson;
  - ❖ He is A father of transaction cost economics
  - ❖ He Criticize the original institutionalist based on they have no general theory (Like Veblen or German Historical School)
  - ❖ He took an idea from “**Ronald Coase: The nature of the Firm.**”
- ❖ The firm is the dominant individual figure in Capitalist economy
- ❖ So why the firm is so important and the dominant figure?
- ❖ This explanation actually lies in the ‘costs of using the price mechanism’ or the ‘operation of a market costs’. These costs relate to the search for appropriate prices and to the negotiation of separate contracts
- ❖ When these costs are high, an individual may choose to work in a firm, placing himself voluntarily under the authority of an entrepreneur rather than selling his services or his products directly on the market. In this case, the firm replaces the market, permitting the ‘economizing’ of the costs involved in the determination of prices.
- ❖ He supposes, metaphorically speaking, that ‘**in the beginning there were markets**’ and goes on to state that firms sprang up from the market by differentiation, because of the importance

of transaction costs. These transaction costs are not taken into account in the neo-classical context, which considers only production costs.

- ✿ The author also distances himself from the neoclassical school by introducing his notion of ‘bounded rationality’ (partly borrowed from Simon) and his thesis of ‘opportunism’.
- ✿ ‘Contractual man’ differs from ‘economic man’ in that he is ready to lie and cheat to defend his interests.
- ✿ Contrary to earlier conceptions – where the economic institutions of capitalism are explained by reference to class interests, technology, and/or monopoly power – the transaction cost approach maintains that these institutions have the main purpose and effect of economizing on transaction costs.

### **B. Douglas North: formal and informal institutions:**

- ✿ He is a particularly significant exponent of the NIE’s.
- ✿ His work as an economic historian has evolved from a fairly radical neo-classical position, placing the accent on quantitative methods of measurement in history (‘cliometrics).
- ✿ Cliometrics’ is the application of econometrics on the past.
- ✿ The principal errors of neo-classical tradition, in his view are;
  - ✿ It ignores institution and time
  - ✿ It neglects transaction costs
  - ✿ It neglects the role of ideas and ideologies
  - ✿ Its concept of “**Rationality**”
- ✿ He emphasizes the concept of “**bounded rationality**” evoking the context of “**uncertainty**” involved in most economic & political decisions.

### **Formal and informal institutions, ‘enforcement’ For Douglas North:**

- ✿ For North, institutions are the humanly devised constraints that structure human interaction. They are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behavior, conventions, and self-imposed codes of conduct), and their enforcement characteristics. North uses the metaphor of ‘**rules of the game**’ to describe institutions, but from a perspective somewhat different from that of **game theory**.
- ✿ Starting with his 1990 book, North has increasingly stressed the role of **structures of belief**.

- If the neo-classical assumption of rationality is open to dispute, this is because ‘history demonstrates that ideas, ideologies, myths, dogmas and prejudices matter’
- Both ideologies and institutions can be viewed as ‘**classes of shared mental models**’
- In situations of great uncertainty, the individual faced with making choices goes through a learning process with the help of a mental model
- And then communication between individuals generates shared mental models, leading to ‘the creation of ideologies and institutions in a co-evolutionary process’
- The reader may have the impression of a rediscovery of a Veblenian thesis, according to which institutions are ‘**shared habits of thought**’
- In his early work, North adopted a neo-classical approach to institutions, in which the latter represented efficient solutions to economic problems.
- Through a progressive evolution, he then completely abandoned this approach and seemed even to reverse it by declaring that institutions are in reality based on power.
- Institutions are not necessarily or even usually created to be socially efficient; rather they, or at least the formal rules, are created to serve the interests of those with the bargaining power to create new rules. As a consequence, it is exceptional to find economic markets that approximate the conditions necessary for efficiency. It is impossible to find ‘political markets’ that do so. Note that entrepreneurs or ‘principals’ nevertheless remain, in his view, utilitarian rational maximizers

### **Organizations and institutions:**

- Contrary to original institutional economics, North states that it is essential to distinguish institutions from organizations.
- If institutions are the rules of the game, organizations and their entrepreneurs are the players.
- The rules define the way in which the game is played, while the teams try to win within the framework of these rules using strategy, co-ordination, competences and fair or foul means.
- Organizations are made up of groups of individuals bound by some common project to achieve objectives; these can be divided into political, economic, social and educational organizations

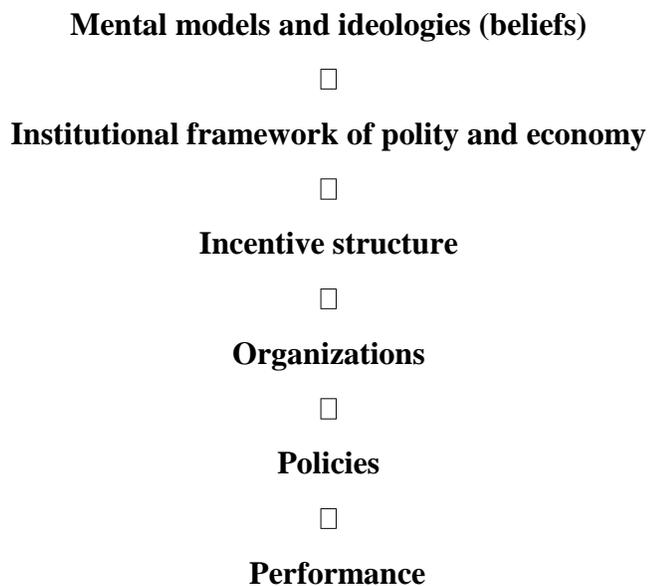
- The institutional framework conditions the type of organization that will be created, as it does their evolution, but in their turn the organizations will be at the source of institutional change
- That is, if the institutional framework rewards piracy then piratical organizations will come into existence; and if the institutional framework rewards productive activities then organizations – firms – will come into existence to engage in productive activities
- The institutional framework is usually a mixed bag of institutions with two contrary dimension;
  - that promote such productivity-raising activities and
  - institutions that provide barriers to entry, encourage monopolistic restrictions, and impede the low-cost flow of information'
- The existing institutions therefore determine the incentives or opportunities that will benefit pre-existing organizations, or entrepreneurs, which will then create new organizations; the organizations will in their turn evolve in the established framework but will also try to modify this framework (Like Veblen's cumulative causality).

### ***Institutional change and Performance for Douglas North;***

- In all cases, and in predominant fashion throughout history, institutional change is gradual and progressive; radical large-scale changes are rarer, consisting of war, conquest, revolution and natural disaster.
- The mental models also have a tendency to evolve progressively, in Darwinian fashion, over long periods, followed by briefer episodes of major change. This type of evolution recalls the 'punctuated equilibria' of Gould and Eldredge (Denzau and North, 1994).
- Formal and informal institutions are not subject to the same time frames with regard to change.
- While it is relatively easy to change rapidly or even overnight in the case of the formal institutions, the modification of informal institutions takes place very gradually.
- This is why revolutionary transformations are never as far-reaching as their advocates would like and why the transfer or imitation of formal institutions between countries does not achieve the hoped-for results.

- And economies that adopt the formal rules of another economy will have very different performance characteristics than the first economy because of different informal norms and enforcement.
- The implication is that transferring the formal political and economic rules of successful Western market economies to Third World and Eastern European economies is not a sufficient condition for good economic performance.

### **The causal sequence of change**



### **3.1.4 The Quasi institutionalist Paradigm:**

**(Joseph Schumpeter, Gunnar Myrdal & John Kenneth Galbraith)**

The modern institutionalist school consisting of Veblen, Commons, Mitchell and their followers remained a tightly knit group. However, there are other economists who followed the institutionalist approach but their line of work is too individualist to fit them in any group. In this lecture we discuss three such economists: Joseph Schumpeter, Gunnar Myrdal and John Galbraith.

#### **A. Joseph Schumpeter (1883 –1950)**

- Schumpeter was never interested about the equilibrium focused approach of neo classical economics.
- He was concerned about the dynamic aspect of the economies. He became famous for his concept of *creative destruction*.
- The idea of creative destruction deals with the destruction of old technology and products with the creation of new ones.
- He criticized the use of static models by the neo-classical group.
- He was not a Marxian even though he acknowledged the power of Marx's vision.
- He declared his interest and supports for the orthodox paradigm comprising mathematics and econometrics, even though his own work mostly did not use these techniques.

### **B. Gunnar Myrdal (1898-1987)**

- His major criticisms of orthodox economic theory center on:
  1. The role of value judgments,
  2. The scope and methodology, and
  3. The implicit Laissez faire bias of the orthodox theory.
- Myrdal concludes that attempts by orthodox Economists theorists to develop a positive science free of normative judgments have failed. He maintained that it is impossible to separate normative from positive
- He another major criticism against orthodox theory is that it is too narrowly defined. He also criticized economics for being so conversed about short run.
- Like Schumpeter he was also more interested about long run is economics where we can look at the development aspects of an economy.
- He said that orthodox economics is pre-occupied with equilibrium which is inappropriate for analyzing social outcomes.
- Myrdal was very critical of the way orthodox theories promote laissez faire as the best policy to follow. Myrdal believed that in the post-World War era western countries are going through welfare statehood. In this phase government takes welfare measures in piecemeal fashion to ease the pressure off the society. Hence there is a lack of coordination which can be remedied by overall planning of macroeconomic goals.

- Orthodox theory of growth is based on the logic of capital accumulation. In his study Myrdal found that orthodox theory is not very helpful for explaining situations in LDCs.
- He finds that labor efficiency in LDCs are very low. So that capital accumulation will not deliver the desired result.

### **C. John Kenneth Galbraith**

- Galbraith was a major critique of the orthodox economics but did not provide any alternative theoretical structure.
- His major work consists of three books:
  - 1) Countervailing power
  - 2) The Affluent society and
  - 3) The new industrial state.

#### **American Capitalism (1952)**

- Standard economics takes competition as the benchmark case and imperfect competition as the aberrations. From American economy experience however, it's very clear that Monopoly and Oligopoly are not aberrations but essence of the economy.
- He said that when competition declined following the rise of large corporations, another power started rising out of the customers or suppliers of the big corporations. He calls this power the *countervailing power*.

**For example**, growth of large corporation led to the growth of powerful unions. This countervailing power keeps a balance in the economy by restraining the existing power.

#### **The Affluent society (1958)**

- While American capitalism focuses on the efficiency of resource allocation in the private sector, in affluent society he concentrated on allocation of resources between private and public.
- He said that the orthodox price theory is good to explain allocation problem in a society which is concerned about providing basic necessities. A society such as the American one has solved that problem and now moving towards the production of low priority goods.

- He finds that with increase in GDP focus has shifted to producing even more. He contends that this is because of unequal distribution of income, individual insecurity and recurring economic depression. Societies try to solve these issues by having ever growing output.
- He maintained that in a traditional, scarcity based society preferences is exogenous. But in an affluent society desire is constructed by the producers
- This requires a completely new consumer theory which does not presuppose consumer sovereignty.

### **New industrial state (1967)**

- Nine years after the publication of *The Affluent Society*, *New Industrial State* was published.
- In this book he mainly criticized the orthodox theory of firm.
- He observed that Modern technology → Large scale firm. Large scale firms have the following characteristics
  - Separation of ownership and control.
  - Planning which includes the management of consumer preference is now essential.
- Orthodox theory assumes sovereign consumers who reveal their preference through price signal. Accordingly firms produce
- Galbraith says this sequence is a myth.
  - Firms can construct preference.
  - Social attitudes are constructed by techno structures.
- Hence, in American society, according to Galbraith, the sequence is reversed. It is the corporations which to a large extent can influence/control consumer's attitude. Affluent society and new industrial society project a darker reality than American Capitalism.
- However, going through Galbraith's work reveals some inherent inconsistencies.
- In American capitalism he was optimistic about the restraining capacity of countervailing which is completely missing in the next two books.
- In *The Affluent Society* and *The New Industrial State*, the corporations are the most powerful which can create demand and then meet then with supply.

- This provides a rather simplistic description of the society. Essentially this ignores all the inherent contradictions in a society.

### 3.1.5 Post-Keynesian and Institutionalism:

- There are similarities between the post Keynesian and institutionalist theories that allow us to understand not only the instability of contemporary economies but, most of all, the relevance of institutions in coordinating them.
- Keynes and the post Keynesians demonstrate that, in an uncertain and unknown world, economic agents prefer to retain money rather than make investment decisions. The consequence of this rational preference is the insufficiency of effective demand.
- In a similar vein, institutionalists believe that the “economic environment” has nothing to do with the notion of “equilibrium”.
- The post Keynesian and institutionalist theories try to answer the following questions:
  - How do agents make rational decisions?
  - How do agents form expectations concerning saving or investment?
  - Why do they retain (or decide not to retain) money?
  - Can the institutional environment influence the decisions referred to above? If so, in what way?
- Uncertainty is the fundamental element of Keynes’s theory.

*“Keynes without uncertainty is something like Hamlet without the Prince”  
... Minsky*

- For the institutionalists, uncertainty is related to the notion of bounded rationality described by Simon (1983). According to Simon, agents faced with incomplete information adopt strategies characterized by conventions.
- In the Keynesian and post Keynesian theories, the concept of uncertainty appears explicitly, while in the institutional theory it is implicit in the theoretical approach.
- The concept of uncertainty is very important because it allow us to understand not only the instability of contemporary economies but, most of all, the relevance of institutions in coordinating them.

- In such an economy, fluctuations in effective demand and employment occur because, in a world in which the future is uncertain and unknown, individuals prefer to retain money, postponing consumption and investment decisions.
- Minsky emphasizes the financial character of contemporary capitalism, in which institutions are fundamental in providing continuity and credibility to the system.
- Both schools reject the idea of stability subordinated to the cannon of long term equilibrium.
- The institutional environment, is culturally and historically conditioned, and is subject to permanent alterations and rearrangements.
- The existence of a process of structural transformation in economies, foreign to orthodox schools of thought, is fundamental to the post Keynesian and institutionalist frameworks.
- The affirmation that Keynesian and institutionalist thought are opposed to such hypotheses does not imply that the two schools are similar, but that the basic critiques of the capitalist economy and its functioning are very similar.

The similarity between Minsky and the institutionalists is in the critique of capitalism as inherently unstable, subjected to a process in which economic decisions must be made amidst

### **Assignment 10%**

- 1) Do you think that economic Laws are Universal like the Ten Commandments? Why/Why not?
- 2) Why institutions really matters in the study of economics?
- 3) What meant by institutional Inertia?
- 4) What was the main criticism by Veblen on Marxian theory? Explain using your working environment?