Chapter 11
Institutional Economics:
The Historical Foundations of Institutional Economics

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ABSTRACT

Since the mid-19th century, the thinkers of historical school challenged the deductive, abstractive, and decisive methods of neo-classical economics. According to historical school, social terms have been changed within space and time. Therefore, they defended that the economic theories could not be universal but could only be relative. Instead of professing laws with universal validity, it is more important to reveal the changing structure of society with the extensive studies of economic history. The inductive method of German historical school brought a new perspective into economic theory with theorems such as to consider society as an organism beyond the individuals who would only seek their benefits and the necessity of historical followings in the economic events. From this point of view, it is possible to observe the traces of historical school in the old institutional economics literature.

INTRODUCTION

Institutional Economics emerged in the 19th century, and the thought of Historical School was influential for this emergence. Historical school is a consensus that is deeply influenced by pragmatism, empiricism and evolutionary philosophy. In this regard, the main theme of institutional economics is that the flow of historical events is different for every society and therefore, suggesting a universal method for economic problems is not possible. Institutional structure and human behaviors should be considered as changing and influencing processes each other with up and down causal relations. In other words, social behaviors and decisions reshape the institutions by influencing them, and in the same manner, institutions affect human behaviors with taken decisions and the policy executions. Within this context, institutional structure and society are the conclusions of processes which are interwoven. Thus, societies

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should be considered with some specific features, and they should be administered with policies that are suitable for these features.

The term ‘institutional economics’ was first coined by Walton Hamilton at the meeting of the American Economic Association held in 1919. Although the contributions were previously made regarding the importance and place of institutions in the economy, it was this period in which the term was named properly. The pioneers of the movement known as the old institutionalist school were T. Veblen, J.R. Commons and W.C. Mitchell (Hodgson, 2000: 317).

Even though institutional economics does not provide point-time equilibrium solutions as revealed by the Neo-Classical economics, it has different characteristics in terms of human behavior, the changing structure of societies, and a process-time economic understanding based on institutions (Chavance, 2009: 17- 18).

In the institutional economics literature, the criticisms towards the Neo-Classical economy are concentrated in three aspects: Firstly, institutional economics philosophers are opposed to Neo-Classical economics abstractions independent of time-and-space. Secondly, institutional economics thinkers are uncomfortable with the uniforming view of neoclassical economics which isolates people and differentiates them from economic, behavioral patterns.

The third is the opposition of Neo-Classical economics to theories disconnected from deductive history, society and other sciences (Hodgson 1998: 167; Mitchell 1935: 636; Kızılkaya, 2007: 12).

Although institutional economics contains a number of highly complex and alternative ideas, it is mainly concentrated on some common points such as reflecting social action rather than individual action, considering the economy with evolutionary thought, and emphasizing both experimental and historical observations (Ata, 2009: 11). The common sense that comes to mind upon considering institutional economics involves institutions and institutional structure which constitute economic processes that are perceived as the sub-branches of societal and social events. Moreover, it is more noteworthy to refer to an institution-based economic approach rather than a human-based economic approach (Demir, 1996: 65).

In his article entitled “What is the Essence of Institutional Economics?” Hodgson stated that the methodology of institutional economics which is comprised of the five elements should be explained in the following manners:

- Although institutional economists are eager to put forward practical theories, their proposals have not been identified politically.
- In order to develop an extensive analysis of institutional economics, institutions, and human behavior, institutional economics also investigates the works of other fields of science such as psychology, sociology, and anthropology.
- Since institutions are the key elements of every economy, the most important issue of economists should be the monitoring of innovation and change processes of institutions.
- Since the economy is an open and improving system, it is necessary to explain the social, cultural, political changes and strong social relations influenced by technological changes.
- Individual interests and utility maximization are considered to be inadequate or erroneous. Institutionalist thought is not an individual analysis. Therefore, individuals do not deliberately (or accidentally) establish institutions. The institutions influence and shape the individuals through “reconstitutive downward causation” (Hodgson, 2000: 318).