

## **Module 3**

### **Lecture 25**

#### **Topics**

#### **3.10 Critique of the neo-classical theory I**

##### **3.10.1 The German Historical School**

##### **3.10.2 The American Institutional School**

#### **3.10 Critique of the neo-classical theory I**

Two main criticisms: historical criticism and institutional criticism. However, there are some contemporary criticisms of the general equilibrium theory posed by contemporary economists which we will see in later lecture.

##### **3.10.1 The German Historical School**

- The German historical school begun in 1840 extended into nineteenth century. They have two sub branches such as the old and young historical schools The main proponents of the older historical school were
  - 1.** Friedrich List (1789-1846).
  - 2.** Wilhelm Roscher (1817-1894).
  - 3.** Bruno Hildebrand (1812-1878).
  - 4.** Karl Knies (1821-1898).
- Their main criticism was that the classical economic theory did not apply to all times and cultures. It applied to industrial England but not to an agricultural economy.
- Some of the scholars belong to this school, thought that the theoretical deductive (i.e. the neo-classical paradigm) and historical inductive methods are compatible but most of them, particularly Knies objected to any use of abstract theory.

- List had a strong nationalist view and argued that free trade may be beneficial for industrially developed England but not so for backward Germany and the U.S. He was so popular in the United States that he was referred to as the father of American Protectionism.
- They believed that chief task of economics is to discover the laws governing the stages of economic growth and development. For example List stated that economies in the temperate zones can be divided in five stages: nomadic life; pastoral life; agriculture; agriculture and manufacturing; and manufacturing, agriculture and commerce.
- Hilderbrand on the other hand proposed that three economic stages are barter, money and credit.
- The major proponent of the *younger historical schools* was Gustav von Schmoller (1838-1917). They did not go for the construction of grand theory. They were more interested in finding solution to different social problems. They preferred to use inductive methods. They thought that offering enough empirical evidence may lead to emergence of new theories.
- The application of marginal analysis as developed by Menger Jevons and Walras in the early 1870s had little or no influence in Germany, where the academics was under the influence, of the historical school.
- Historical school was so strong that abstract theorist following the Marginalist-Neo-classical tradition could not find academic employment in Germany. As a result development of economics discipline suffered in Germany for several decades.

### **3.10.2 The American Institutional School**

- Thorstein Veblen (1857-1929) pioneered the branch of American heterodoxy that is often called institutionalism.
- Veblen himself was an interesting character.
- He was a son of Norwegian immigrant. He attended Carlton College and then did his Ph.D in philosophy from Yale. But he was unable to obtain a job in teaching

apparently because of his atheistic views. At the age of thirty five he secured a post doctoral fellowship at Cornell University.

- He was finally appointed an instructor of economics at University Chicago and given the editorship of Journal of political economy.
- Veblen was not interested in correcting the internal inconsistencies. He criticized the general theoretical structure of the neo classical economics that presupposes that natural law exists and things come to a rest at long run equilibrium.
- Veblen's criticism was that this is teleological (goal oriented) and pre Darwinian. According to Darwin there is no purpose in evolution but in economics forces evolve to reach some notion of long run equilibrium.
- According to Smith pursuit of self-interest by everyone leads to social good. Veblen mentioned that Smith's doctrine may be true under a competitive scenario but not any more in economies dominated by large corporations. He said that orthodox economics is based on some assumption supported by hedonistic psychology. Given the assumptions, neo classical theory is logically flawless. But Veblen said that these assumptions are all wrong. Orthodox economics analyze decision making based on current institutions. Veblen mentioned that we must analyze the evolution of institutions. Individuals find themselves acting in accordance with established patterns of behavior that are a legacy of past interaction between individual and culture. Orthodox economic theory ignores this behavioral structure.
- There are some fixed underlying characteristics of human behavior that Veblen calls *instincts*.
- The instincts of parenthood, work membership and idle curiosity according to Veblen, would lead humans to produce efficiently. There is another instinct which Veblen calls acquisitive instinct which results in self-seeking behaviors. Such instincts can benefit individuals but can cause trouble to the society. It is to be noted that his thought on the relation between the individual benefit and social benefit greatly differs from that of Smith.
- The instincts of parenthood, workmanship and idle curiosity lead to what Veblen called technological/industrial employments involving matter of fact relationships.

- There is another type of behavior which is non-instrumental and pre scientific ways of approaching the unknown -- Veblen termed it *ceremonial*. This is reflected by the customs of totems and taboos which involve unquestioned submission to an unknown authority. This is static and past binding.
- Ceremonial behavior in the modern culture manifests itself in that Veblen called pecuniary (or business) employment.
- Veblen maintained that in a pre-industrial economy where craftsmen owned their tools and materials, and the instincts of parenthood and workmanship was the driving one. With the development of economy people were more interested in making money than making goods. In a modern economy *pecuniary (or business)* employment goes up. Veblen said that the *pecuniary (or business)* employment represents the *ceremonial behavior* in a modern economy.
- In such a economy professions such as money lending, absentee ownership, and management jobs become more common. In this time *acquisitive instinct* becomes the major one.
- In 1899, Veblen published *The Theory of the Leisure Class*.
- He used his dichotomy of instinct of workmanship and acquisitive instinct to explain conspicuous consumption, conspicuous leisure, pecuniary emulation, and dress as an expression of the pecuniary culture.
- Veblen maintained that in a modern society predatory power manifest itself in employment that results in high income for a few members of the society. Large income is of little value if it cannot be displayed. Hence our culture supplies a number of mechanisms to permit them to be displayed. Conspicuous consumption in the most efficient mean of displaying this. Sometimes male and female members of a family share the burden { male is engaged in predatory activity while the female displays the family wealth
- Veblen said that pecunarily employed people who are the high income and the leisure class are the best example of people who are completely detached from the actual production.

- This means a member of such a class cannot take pride in actually creating anything. Therefore one has to derive pride from pecuniary command. Veblen maintained that in a modern society jobs in high management, finance banking etc are ceremonially acceptable even though their duties do not involve any honest work.
- Veblen also had theories about the stability and long run tendencies of capitalism.
- During the prosperity phase of the business cycle credit expands and high value is placed on making profit through financial operations. The value of capital is overvalued to support the extra credit. But then after sometime the gap between the real earning power of capital and the value of capital expressed in security prices becomes apparent.
- Then the down cycle of capitalism starts leading to liquidation and retrenchment. During this phase weak firms are taken over by large firms.
- Veblen was not only critical of the capitalist regime, he was also quite critical of Marx who launched the most consistent criticism against the capitalist system.
- Veblen however did not predict anything about the future of capitalism. He mentioned that a socialist state or an undemocratic nationalist state can emerge after the destruction of capitalism.
- His main concern was that the economics discipline should study the evolutionary mechanism for the society. He also emphasized the importance of studying institutions for prescribing correct policies. Stability and long run tendencies of capitalism.