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Post Keynesians Meet in Kansas City

By Fadhel Kaboub

More than 150 Post Keynesian economists came to Kansas City to participate in the 7th International Post Keynesian Workshop (June 22-July 3, 2002). This event was sponsored by UMKC’s Center for Full Employment and Price Stability (C-FEPS) and the Journal of Post Keynesian Economics.

The workshop started with a weeklong Post Keynesian Summer School (June 22 - 28, 2002), the first of its kind to be held in the US. Back in the 1980s, the Summer School took place annually in Trieste (Italy). Kansas City will now become the new venue for future Post Keynesian events. A group of 20 Post Keynesian Scholars lectured before more than 80 students from more than 20 countries. The lectures covered a wide range of topics in Post Keynesian economics such as PK methodology, price theory, monetary and fiscal policies, unemployment policies, labor markets, investment theory, inflation, distribution, growth, and development. Students and faculty enjoyed both formal and informal discussion groups throughout the workshop.

The second part of the workshop was the 7th International Post Keynesian Conference (June 29 - July 3, 2002), which took place at the Marriott Hotel in Kansas City. This year’s conference was the most attended conference in the history of the workshop. The next PK Workshop will take place in the summer of 2004 in Kansas City.
The recent imbroglio arising from corporate affairs of late has sparked some controversy. Several large, multinational corporations (e.g. Enron, Tyco, WorldCom) have been found to have engaged in questionable accounting practices. The facts are well known: these revelations precipitated massive layoffs, bankruptcy filings, and, via declines in stock prices, the destruction of billions of dollars of wealth. The controversy surrounds the economic conditions of those employees who not only were laid off but who witnessed the loss of their retirement savings.

There are some who have little sympathy for those employees/stockholders that held significant positions in their company’s stock. These employees violated the first and most primary rule of finance, “Do NOT put all your eggs in one basket.” One missive declared: “An employee that holds a significant amount of their 401K in the company that they work for is being just foolish.”

Against this view it may be argued that due to various constraints, many have little choice but to invest in company stock. Testimony surfaced from the Enron debacle detailing management pressures to hold one’s entire 401-K in Enron stock as a sign of loyalty and commitment.

However, it was pointed out, those employees so constrained were always free to leave and seek other employment. Freedom, came the response, does not guarantee success. Owing to various sociological constraints such as discrimination by age, race, or gender many are not as free to seek alternatives as suggested.

Claiming that freedom was lacking was taken as the removal of personal responsibility and falling back to blaming the system and making victims of the employees who, by the way, never complained when the company stock was rising. To this the retort came that free will and personal responsibility were not removed by the limitations of freedom. What had to be acknowledged was that individuals existed not as atomistic agents independent of others, but as inter-dependant social creatures living in relation to others. Further, it was argued, many of those relationships were “power” relationships were one party had the ability to control the outcomes of another’s choices.

“Fatalistic and pessimistic,” came the reply.

And so the debate continued between some who would blame the recently impoverished for their own ruin and others who see individuals as being caught in a social web of power from which are few opportunities to escape. To my way of thinking, this urge to blame the recently laid-off for their downfall is too easy and reflective of an attitude that separates privileged from the downcast. If one is successful, it must be due to the wise choices and hard work one engaged in. If one is a failure, it must be due to a lack of will or deficiency of character. After all this is America, the land of opportunity, the land where hard work will obtain rewards beyond measure. Such attitudes are reflective of that “rugged individualism” with which we so often described ourselves. Such attitudes are an outgrowth of the economic framework commonly accepted and
taught throughout the western world. Such attitudes, simply put, are wrong in that they ignore the interdependency which binds us into a society.

In the early 1700’s, the poor of Ireland were creating a burden upon English society. There were many who blamed the Irish for their own problems – lack of education, having more babies than they could reasonably support, as well as being lazy drunkards unwilling to work to earn a living. Writing in 1729, Jonathan Swift proposed a “rational” proposal to end the Irish problem. While Swift lived long before the neoclassical economic way of thinking was fully developed, his proposal represents the kind of result that could logically follow from viewing individuals as atomistic economic actors in an environment where the maximization of social welfare was the rational choice.

With all due respect to Jonathan Swift, this re-working of his 1729 solution to the Irish problem is offered to demonstrate where we might end up if orthodox economic thought ever comes to completely capture not only our economists but our politicians and citizenry.

D. Marshall Meador
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07 October 2002

A MODEST PROPOSAL
For preventing the recently impoverished people in the United States from being a burden to those workers who were smart enough to not invest their 401k’s in the company for which they worked, and for making them beneficial to the public.

It is a melancholy object to those who walk through this great land, or travel in the country, when they see the streets, the roads, and the cabin doors crowded with beggars of the formerly employed followed by three, four, or six children, all in rags and importuning every passenger for an alms. These foolish former employees, instead of being able to work for their honest livelihood because the companies for which they worked are now bankrupt due to the criminal actions of their corporate leaders, are forced to employ all their time in strolling, to beg sustenance for their helpless infants, who, as they grow up, either turn thieves for want of work or become similarly unemployed for lack of a society in which full employment was valued more than the pocketbook of the titans of industry.

I think it is agreed by all parties that this prodigious number of unemployed is in the present deplorable state of the land a very great additional grievance, and therefore whoever could find a fair, cheap, and easy method of making these unemployed sound and useful members of the commonwealth would deserve so well of the public as to have his statue set up for a preserver of the nation.

But my intention is very far from being confined to provide only for the unemployed of those recently bankrupted multinational firms; it is of a much greater extent, and shall take in the whole number of unemployed who demand our charity in the streets.
As to my own part, having realized that the only viable economic system is that which permits a complete laissez-faire attitude toward business so that those born to the boardroom may conduct their affairs in such a manner as to take advantage of the working class, have realized that those of the working class deserve what they get for reason of their ignorance. That they often have inadequate education, that they place their trust in management, that they would rather work than starve and so enter into a relationship where all the power is vested with those corporate titans that run our government and markets, is of little consequence. After all, if they did not like working for large international corporations where their retirement options are limited and where they are often required to invest in the company stock as a sign of loyalty, they could always move to Ireland. I have thus turned my thoughts for many years upon this important subject and maturely weighed the several schemes of other projectors. I have always found them grossly mistaken in their computation. It is true, a person recently discharged because the company has been brought to its knees by those who don’t understand that insiders on a board of directors gives the CEO and other executive officers the freedom to do what they think is best or that crony capitalism is for the ultimate good of the country, is costly to society due to their unreasoning demand for unemployment compensation, healthcare, and food stamps. To calculate only those costs is miss the externalities imposed by these unemployed, externalities such as the fall in government revenue because they no longer pay taxes, such as the blight on neighborhoods caused by the drop in property tax collections, such as the unsightly cardboard they use in building their windbreaks under the bridges of our highways, and the emotional stress caused by having to listen to them complain and clutter the newspapers and six o’clock news with their "sad" stories. After all, as any thinking individual will admit, people are free to choose their occupations. With very few exceptions individual are free to choose what education they earn and what they choose as their preferred occupations. People voluntarily choose to work for a particular corporation or perhaps even choose to become an entrepreneur. One decides on education, occupation, and no government official nor corporate entity makes that choice for them. In today’s society, there is no longer any reason to refer to race, gender, or socioeconomic standing as preventing one from exercising personal choice in the quest to achieve ones desires. Each will reap the rewards or suffer the consequences of their own choices, the power that society, industry, and economic standing may hold over individuals is, in the final analysis, illusory. This is the freest capitalistic system in the world. And it has been acknowledged by everyone who rationally evaluates the facts, from Nobel laureates to high school students, that unfettered democratic capitalism is the only system that allows the individual to flourish. That one may make choices which are subsequently negated by those with more economic power is of not important – this being America we are, when faced with failure, simply to try, try, try again. Not everyone in America owns a Porsche and a sailboat, but that is only because not everyone so chooses. Those individuals who whine about losing their retirement savings when their company goes bankrupt are getting what they deserve. As educated individuals, they never should have invested in their company stock. As individuals in a market economy, they were free to change employers. Little matter that they were over forty years old, there are laws against age discrimination. Little matter that they may have had others in the community who depended upon them, when they got the first hint that the management was criminal, they made the choice to stay and care for those others and in so doing rightly deserve to be out of a job. After all, they had the opportunity to change jobs. It cannot be said that they had grown used to making
D. Marshall Meador

$60,000 a year and the only alternatives were service sector jobs for $20,000 a year. As any educated man would realize, these millions are, in the final analysis, unemployed by their own choice because they refused to accept lower wages, hence their now miserable existence is doubly a burden on society for the extent of their greed in demanding a living wage has brought about their own ruin and created a burden upon society. It is for exactly these reasons that I propose to provide for them in such a manner as, instead of being a charge upon the working neighbors or the community or wanting food and raiment for the rest of their lives, they shall on the contrary contribute to the feeding, and partly to the clothing, of many thousands.

There is likewise another great advantage in my scheme, that it will prevent those voluntary suicides brought on by despair and that horrid practice of people demanding change, alas! too frequent among us, of the noble system of capitalism to avoid the discomfort of economic insecurity in the midst of plenty and the shame of their having been ignorant of how to make wise investment decisions, which would move tears and pity in the most savage and inhuman breast.

The number of unemployed in this land being usually reckoned eight million one hundred forty-two thousand, of which two million seven hundred eighty-three thousand have burdened our society for greater than fifteen weeks, (not including the one million four hundred thousand who have dropped out of the labor force for lack of job opportunities), of these I calculate there may be about six million who are women with children, from which number I subtract two million who are able to maintain their own children by means of prostitution (although I apprehend there cannot be so many, under the present distresses of the fear of STD’s); but this being granted, there will remain about six hundred sixteen thousand two hundred and fifty of independent means who were working only because they were bored staying at home managing the household staff. I again subtract two million three hundred forty-one thousand five hundred fifty for those who accept positions in the local fast food restaurant or other service industry at a 50% to 80% cut in hourly pay. Lastly, I subtract another two hundred eighty-one thousand ten who die within the year due to old age, exposure, or starvation. There only remain nine million eighty-five thousand nine hundred ninety who refuse to lower their wage demands so as to clear the markets. The question therefore is how this number shall be provided for, which, as I have already said, under the present situation of affairs is utterly impossible by all methods hitherto proposed. For, due to their unbending demands for a living wage, we can neither employ them in handicraft or agriculture; we neither build houses (I mean in the country) nor cultivate land; they can very seldom pick up a livelihood by stealing, for being too lazy to work they are likewise to slothful to steal, although I confess they learn the rudiments much quicker when the welfare checks stop.

I am assured by our merchants that an adult who did not learn their lessons in their former employment is no saleable commodity, and even when they come to this state they will not yield to accepting less than the prevailing wage as judged by local union scales (of which serious study should be addressed, given how such organizations distort the free flow of exchange between well meaning firms).
I shall now, therefore, humbly propose my own thoughts, which I hope will not be liable to the least objection.

I have been assured by a knowing academic of my acquaintance in Chicago that if one undertakes a cost-benefit analysis of the situation, those who refuse to lower their wage demands and who are either so un-educated or out-rightly speculative as to invest their retirement savings in one stock are best rendered into crop fertilizer. The resultant increase in fertilizer to the farm sector will bring about an increase in the supply of feed grains thus lowering the price of same. With the prices of feed grains thus lower, feed lot owners will be able to lower the cost of beef, pork, and poultry brought to market thus lowering the price to the consumer. The decrease in the price of feed grains may well be enough to allow for a lower price to the consumer and a higher profit margin for both feed lot operator and farmer. The fall in the price of food to the consumer will change the relative price of all other goods and the resulting income effect of the change in relative prices will, by conservative econometric estimates, result in GDP rising as much as 50 basis points. The increases in consumption thus derived has been shown to be pareto-optimal in that all remaining members of society are at least as well as before and some members (especially those who are members of boards of directors of large multinational firms) are better off.

I do therefore humbly offer it to public consideration that of the nine million eighty-five thousand nine hundred ninety already computed, twenty thousand be reserved for breed, whereof only one fourth part to be males, which is more than we allow to sheep, black cattle, or swine; and my reason is that such children are seldom the fruits of marriage, a circumstance not much regarded by our savages; therefore one male will be sufficient to serve four females. That the remaining nine million sixty-five thousand nine hundred ninety may, at a time determined by the lobbyists of the five hundred largest companies in the land, be offered in sale to the fertilizer plants throughout the land. In time, I am told, science will also be able to convert these willingly unemployed into food suitable for human consumption.

I grant this food may be somewhat dear, and therefore very proper for the Nobel laureates and economists who espouse the neoclassical cause, who, as they have already devoured most of the brilliant minds, seem to have the best title to the remainder.

New bodies will be in season throughout the year, but more plentifully in May and a little before and after; for we are told by a grave author, an eminent logical positivist physician, that hope being a prolific emotion in May when thousands are released from schools, there are more children born about nine months after graduations and proms than at any other season; therefore, reckoning a year after May, the markets will be more glutted than usual, because the number of working class to executive level infants is at least three to one in this land; and therefore it will have one collateral advantage, by lessening the number of union workers and non-managerial employees among us. I have already computed that the charge of supporting these who refuse to breed responsibly and who choose unemployment rather than accepting whatever wage is deemed just by the managers of multinational corporations is less than what their bodies will bring in an unfettered competitive market; and I believe no gentleman or lady of proper education would repine to pay at that level where the marginal cost of maintaining these bodies is just equal to the marginal revenue derived therefrom. It should be noted that positivists’
estimates of the nutritional value of these willingly unemployed workers, will make a dish of
excellent nutritive meat, when one has only some particular friend or their own family to dine
with them. Thus those properly educated in the ways of the market place and of diversified
investing will learn to be a good capitalist and grow popular among their neighbors; the
unemployed breeding stock will have what society through the market mechanism deems to be
adequate net profit and be fit until they produce another child.

Those who are more thrifty (as I confess the times require) may flay the carcass left after
rendering the body, the skin of which, artificially dressed, will make admirable gloves for ladies
and summer boots for fine gentlemen.

As to the city of Chicago, the area around the local university may be appointed for this
purpose in the most convenient parts of it; and butchers, we may be assured, will not be wanting.

I think the advantages by the proposal which I have are obvious and many, as well as of
the highest importance.

For first, as I have already observed, it would greatly lessen the number of union
members and working class, with whom we are yearly overrun, being the principal breeders of
the nation as well as our most dangerous enemies, and who stay at home on purpose to deliver
the country to heterodox thinkers who would incur fiscal deficits so as to create employment.

Secondly, the poorer workers who were not principled enough to leave the employ of
dishonest men and take up residence in other countries, will have something valuable of their
own, their bodies, which by law may be liable to distress and help to pay their landlord's rent,
their livelihood being already seized by bankruptcy court and money a thing unknown.

Thirdly, whereas the maintenance of those who voluntarily accept unemployment rather
than lowering their wage demands is high, the nation's stock of consumable bodies will thereby
be increased significantly, besides the profit of a new dish introduced to the tables of all
capitalists and entrepreneurs of fortune, not to mention all right thinking economists, in the land
who have any refinement in taste. And the money will circulate among ourselves, the goods
being entirely of our own growth and manufacture.

Fourthly, the constant breeders, beside the gain of subsidence by the sale of their
children, will be rid of the charge of maintaining them after the first year.

Fifthly, this food would likewise bring great custom to taverns, where the vintners will
certainly be so prudent as to procure the best recipes for dressing it to perfection and
consequently have their houses frequented by all the fine people who justly value themselves
upon their knowledge in good eating; and a skillful cook who understands how to oblige his
guests will contrive to make it as expensive as they please.

Sixthly, this would be a great inducement to marriage, which all wise nations have either
encouraged by rewards or enforced by laws and penalties. It would increase the care and
tenderness of mothers toward their children when they were sure of a settlement for life to the
poor babes, provided in some sort by the public, to their annual profit or expense. We would see
an honest emulation among the married women, which of them would bring the finest bodies of
their children to market. Men would become as fond of their wives during the time of their pregnancy as they are now of their mares in foal, their cows in calf, or sows when they are ready to farrow, nor offer to beat or kick them (as is too frequent a practice) for fear of miscarriage.

I can think of no objection that will possibly be raised against this proposal unless it should be urged that the number of people will be thereby much lessened in the land. This I freely own, and it was indeed one principal design in offering it to the world. I desire the reader will observe that I calculated my remedy for this one capitalistic land and for no other that ever was, is, or I think can ever be, upon earth. Therefore let no man talk to me of other expedients: of taxing our corporations; of using fiscal policy or deficit spending; of utterly rejecting the economic schema based upon *homo oeconomicus*; of curing the expensiveness of pride, vanity, idleness, and gaming in our corporate executive; of introducing a vein of parsimony, prudence, and temperance; of learning to love our country, in the want of which we differ even from the French; of quitting our animosities and factions; of being a little cautious not to sell our country and conscience for nothing; of teaching landlords to have at least one degree of mercy toward their tenants; lastly, of putting a spirit of honesty, industry, and skill into our corporate titans, who, if a resolution could now be taken to earn no more than ten times the average wage, would immediately unite us in the first steps towards a fair proposal of just dealing, though often and earnestly invited to it.

Therefore, I repeat, let no man talk to me of these and the like expedients till he has at least some glimpse of hope that there will be ever some hearty and sincere attempt to put them in practice.

I profess in the sincerity of my heart that I have not the least personal interest in endeavoring to promote this necessary work having no other motive than the public good of my country and the advancement of those practical and universal tenants of neoclassical economics which all reasonable souls know to be logically true.
The Perfect Fiscal Storm
By Fadhel Kaboub

More than 70 people attended “The Perfect Fiscal Storm” presentation sponsored by the A&S Dean’s Office and the Center for Full Employment and Price Stability (C-FEPS) at the administrative center on Wednesday October 23, 2002.

Mathew Forstater, C-FEPS Director and Assistant Professor at UMKC’s Economics Department, and Bryan Le Beau, Dean of the College of A&S, opened the roundtable discussion about the current fiscal crisis by expressing their concerns about the current economic situation at the state as well as the federal levels and its effect on higher education. Forstater also introduced the presenters and monitored the discussion with the audience, which included members of the Kansas City community in addition to UMKC students, faculty, and staff. Troy Nash, City Councilman (3rd District At-Large) and Fellow at C-FEPS, spoke to the audience about his own experience as a proponent of strengthening neighborhoods, creating jobs and helping youths. Nash acknowledged the role that both C-FEPS and UMKC’s Economics Department play in many Kansas City community development programs that he is engaged in especially the Prospect Corridor Renewal project, which focuses on one of the most crime-ridden corners in the United States, that of Prospect avenue and 39th street. Councilman Nash is currently working with neighborhood and community groups on the master plan for redeveloping the area.

L. Randall Wray, UMKC Economics Professor and Senior Research Associate at C-FEPS, was the main speaker on Wednesday. The title of his presentation was inspired by a statement made at a UMKC Board of Trustees meeting in June 2002, describing our current budget crisis as a ‘fiscal storm’. Wray argued that in fact it is a ‘perfect fiscal storm’, recalling the title of the book by Sebastian Junger, who described how the confluence of natural forces created the perfect storm in October 1991 that doomed the Andrea Gail in waves of over 100 feet. In our case, Wray explained that “a confluence of what we might call unnatural fiscal forces at the state, federal, and global levels have led our economy into a recession and will hinder recovery.”

Wray reminded the audience that since the Nixon era the growth of Federal spending has been decreasing and has led to a reduction in Federal support to state governments through what Wray called ‘devolution’. “Welfare programs were cut, payroll taxes increased, and fiscal stance was tightened,” said Wray, supporting his arguments with a number of statistical figures displayed before the audience. These tight fiscal policies make it very difficult for state governments to support social programs such as welfare and Medicaid, especially for the 49 states that are required by statutes or constitutions to run balanced budgets. Wray pointed out that the problem is that “state revenue is strongly pro-cyclical, increasing in a boom and falling in recession. And this is a big problem when the states are increasingly responsible for types of spending that need to rise in recession - like welfare and Medicaid.”

According to Wray, states governments typically cut taxes and increase spending in a boom (which helps to fuel the boom), and then raise taxes and cut spending in a recession
(thus adding to the depressionary forces that generate the recession). Replying to some of the comments and questions from the audience Wray said that “States are increasingly relying on regressive taxes, especially taxes on consumption, while like the Federal government they give tax credits and inducements to encourage saving.” This, he explained, depresses spending, especially in recession when the regressive taxes on consumption are increased at exactly the time that households are trying to cut back spending to increase rainy day funds.

How will we survive this ‘perfect fiscal storm’? The answer, according to Wray, is to reduce the payroll tax and make it more progressive, to increase government spending on public infrastructure, and to have the federal government bail out state governments. This will create jobs, boost income, consumption, and spending; thus bringing about an economic recovery.
Uzbekistan’s Financial System: Ten Years of Transition

By Alexandr Akimov*

Transition economies are those that are in the process of changing their economic system from the administrative-command economy to the market economy. This is the key factor uniting all Eastern and Central European countries and the former Soviet Union. However, every country has had its own historical evolution, its own culture, initial conditions and ability for transformation. Therefore, it is very important to analyze the applicability of a general model to the particular case of each country considering its own specifics. Western academicians as well as policy makers have tended to focus most of their attention to transition economics of Central and Eastern Europe for a number of reasons. Unfortunately, less attention has been given to countries of Central Asia in general, and Uzbekistan in particular. This article is devoted to the history and sequence of reforms of the financial system in Uzbekistan. It provides a clear picture of specific issues, which have arisen in Uzbekistan and allows for a further discussion on the issues related to financial development in Uzbekistan with a higher degree of confidence.

I. Uzbekistan’s Financial System before the Independence:

In order to have a clear picture of the financial structure of Uzbekistan before 1991, we should first consider the financial system of the Soviet Union, since the financial system of pre-independent Uzbekistan was an integral part of the communist financial system of the USSR. To analyze the Soviet financial system it is necessary to consider how the financial system functioned.

The allocation of investments is an important function for the financial system to fulfil. In market economies, decisions of investment-allocation are largely governed by a cost-benefit framework in which expected investment benefits are compared to estimated costs. Investment costs and benefits must be converted into present values using interest rates from financial markets. In the planned Soviet economy there were no financial markets - such decisions were made by planners and enterprise managers.

All the other functions of the financial system were executed by the banking system. The reason for this is the extremely low level of development of non-bank financial institutions (NBFIs). Furthermore, the vast majority of banking services was provided by Gosbank (the State Bank), which combined the services of a central bank and those of commercial bank, but owing to the absence of money and capital markets, Gosbank did not perform some traditional banking functions (open market operations, commercial paper transactions, and the like). It did, however, perform major functions such as granting short-term loans for working capital, overseeing enterprise plan fulfillment, and monitoring wage payments (as the center for all accounts). Thus, enterprises held their accounts with the local branch of Gosbank, upon which they were dependent for short-term credit to finance inventories and working capital. Receipts were normally deposited with the bank, and cash for wage-payments were drawn at the discretion of the bank. In addition, profit remained in special accounts at the bank.

Gosbank was the only provider of short-term credit, with interfim lending strictly prohibited. Indeed, with the exception of small payments, all interfim transactions were handled and supervised by Gosbank. Hence, Gosbank was in a unique position to monitor enterprise activities, as the single clearing agent and the sole source of short-term credit.

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In drawing up short-term credit plans and in controlling enterprise accounts, Gosbank played a largely passive role, providing the credit necessary to implement the physical plan. As for short-term loans, Gosbank granted credit for specific targeted purposes.

Besides Gosbank, there were also a number of specialized banks, which were fulfilling a complementary role to Gosbank. In the former Soviet Union such banks included Promstroybank (supporting industry and construction), Agroprombank (supporting agriculture), Sberbank (the national savings bank) and Vneshtorgbank (for business involving foreign exchange transactions).

NBFIs in the former Soviet Union were almost undeveloped. The only insurance company was Gosstrakh (State Insurance), which was entirely owned by the government. The variety and quality of its services was rather limited. There was also only one pension, also owned by the government. Other important features of the financial system of the Soviet Union were the absence of a capital market for government debt, enterprise debt and equities, absence of money markets and foreign exchange markets, restrictions on monetary circulation which, effectively, meant the absence of a universal payment system.

The dominant financial institutions in market economies, banks (or the subgroup otherwise known as commercial banks, money deposit banks, or similar banks) operate the mechanisms that enable money to circulate. Their liabilities (bank deposits or a subset of deposits) act as money since they are fully liquid, and the banks operate the mechanisms for transferring money and making payments, especially check-clearing systems. By contrast, the main characteristics of monetary circulation in the former Soviet Union were as follows:

1. Bank deposits were not able to act fully as money since they were not fully liquid. During times of chronic shortages and quantity rationing, neither deposits, nor cash were freely exchangeable for commodities [Kornai 1980].
2. The circulation of money in centrally planned economies is formally divided into two circuits with two distinct types of money: “passive” money and “active” money. Passive money consists of bank deposits for ministries, large enterprises and other state bodies. These passive money deposits increase or decrease as a result of “transactions” determined by the plan, therefore, they are debit and credit accounting entries, and do not confer any real entitlement to their owners. Active money, by contrast, consists of cash used for payments between the state system (ministries, enterprises and other units) and the general population. These cash payments are used for wages and salaries, transfer payments, and other payments; while, in the opposite direction, individuals use cash for retail purchases, tax payments, and for accumulating savings deposits. The consequence of having two circuits is that the characteristic identified above (i.e., the failure of monetary instruments to act as money) varies: in the “passive” circuit, deposits were highly illiquid because their use was completely to the plan; while in the “active” circuit, the use of cash had a greater degree of autonomy, although it was still subordinated to rationing and other administrative controls.
3. Even within each circuit, the payment mechanism was significantly underdeveloped and cumbersome.
4. Deposits and cash were not convertible into foreign currency by enterprises and individuals.
II. Uzbekistan’s Financial System since the Independence:

a) The Banking Sector:

After Independence in 1991, the departments of the Soviet banks located in Uzbekistan became the independent banks of Uzbekistan. A law was passed in February 1991, establishing the new structure of the banking system. The new structure envisaged the creation a two-tier banking system, with the Central Bank of Uzbekistan formed from the Uzbekistani department of Gosbank, as well as commercial banks based on various non-state forms of property. The primary tasks of the Central Bank included tasks to conduct monetary policy and bank supervision and to provide Uzbekistan with its own payment system.

The Uzbekistan department of Vneshtorgbank became the National Bank for Foreign Economic Activity of Uzbekistan (NBU). Its task was to give effect to government policy in the field of international economic activity, to service external economic transactions and to accumulate the nation’s foreign exchange reserves.

The legislation formed to regulate the banking system emphasized administrative measures of regulation. This was understandable in view both of the background from which policy makers and legislators had emerged, and of the primitive state of the financial system at the time. Since then banking legislation and reforms have steadily been improving, although the pace of the improvements has been very slow.

In 1997, foreign assets earlier held by the Ministry of Finance at the National Bank of Uzbekistan were transferred to the Central Bank. However, the NBU continues to be the depository of a large proportion of official gold reserves on behalf of the Central Bank. Money and credit policies, as well as foreign exchange allocation, are determined by the Chairman of the Central Bank, with the involvement of representatives of various government agencies and the banking sector.

As of July 2002, there were 36 commercial banks in Uzbekistan (35 at the moment): one state bank (fully owned by the government), 4 state-owned joint-stock banks, 11 joint-stock commercial banks with the capital participation, 14 private banks, 4 joint-stock banks with foreign participation and 2 subsidiaries of foreign banks. 28 banks were licensed to carry out foreign currency transactions, but the bulk of foreign exchange transactions were conducted by the NBU.

The NBU, which is state owned (planned to be partially privatized in 2004) is the largest commercial institution in Uzbekistan. Today, it accounts for nearly 70 percent of total commercial bank loans and about 85 percent of all transactions in foreign currency. In addition, there are 9 representative offices of foreign banks registered in Uzbekistan.

The development of commercial banking has been affected in Uzbekistan by direct government intervention in foreign exchange and financial markets. In addition to the rule limiting enterprises to one account, which seriously limits competition among banks, enterprise deposits can be withdrawn only for the payment of wages and travel expenses, in accordance with quarterly cash plans. The most important commercial banks are controlled by the government and follow the credit policies set by the Republic’s Monetary Policy commission, which gives priority to sectors in line with agricultural and industrial policies of the government.

In December 1997, compulsory reserve requirements at the Central Bank (CBU) were reduced from 25 to 20 percent of deposits (for deposits over 3 years, the reserve requirements were kept at 10 percent). The liquidity impact of the measure was neutralized with the auctioning of treasury bills yielding interest 1.5-2-percentage points higher than the rates ordinarily paid in treasure bill auctions. This step resulted in an
improvement in the income position of banks, since required reserves are not remunerated. Foreign currency deposits are not subject to reserve requirements at the Central Bank.

In November 1996, the Board of the CBU adopted new charts of accounts for the CBU and commercial banks. The new accounting system was introduced in March 1997 and has improved the quality of monetary statistics. However, commercial banks have experienced difficulty in using the new system. In addition, risk assessment, and corresponding classification of loans in commercial banks’ balance sheet, remains impaired by the fact that enterprises typically do not perform bookkeeping in accordance with internationally accepted accounting standards, and banks are inexperienced in risk assessment and risk management.

The banking system of Uzbekistan is characterized by a small number of relatively sophisticated banks (the NBU and some joint venture and private banks) along with the successors of the formal sectoral (specified on financing of particular sector of economy) banks. This second group of banks is undercapitalized, and has low-quality loan portfolios and limited bank management skills. These problems are aggravated by (i) the absence of adequate legal instruments (bankruptcy procedures, assets sequestering, etc.) to protect the integrity of the banks’ assets, and (ii) the way banking activity is taxed.

b) Non-bank Financial Institutions:

The formation of specialized NBFIs began in 1995 at the instigation of both the government and the private sector. Such as the Business Fund for financing small and medium sized business enterprises, the state insurance companies “Madad” and “Uzbekinvest”, and a number of private insurance and investment companies. But the information available on this sector is very limited and there is no statistical data at all. There were no significant attempts in Uzbekistan to reform the pension system. The single pension fund remains state-run and no private pension institutions have been created.

In late-1996, a new type of financial institution was created in Uzbekistan, called the Privatisation Investment Fund (PIF). Under this PIF scheme, it was envisaged to sell 30 percent of the shares of about 300 large enterprises to investment funds in a first implementation phase. It was further expected that in a second phase, shares of 300 more enterprises would be sold. Progress in implementing the scheme has been substantially slower than originally expected, although more than 80 investment funds and management companies have been established so far, and about 200 thousands individuals have bought shares in PIF’s.

c) Securities Market:

From 1994 to 1996, the development of the stock exchange took place alongside the development of the market economy including the privatisation and de-monopolisation process. Restructuring of corporate forms has led to the circulation of privatized enterprises’ shares.

Today, the market for these shares is still small in terms of quantity, variety, and volume of transactions conducted through the stock exchange. The low level of development of the market reflects to some degree the approach that has been taken to privatization. Shares have simply been distributed among the companies themselves, to selected foreign investors, outside shareholders, and to the state. Investors, who obtained shares in this way, had no real incentive or any real opportunities to trade these securities.
The low interest of potential investors in equities also reflects the absence of reliable information about the issuers of shares and the subsequent high risk of such investments. Although the Republic’s Stock Exchange “Tashkent” (RSET) – the only stock exchange in Uzbekistan – was established in January 1994, activity there is mainly connected with servicing new issues of securities as part of the privatization process.

Since 1995-1996, there have also been other types of securities issued in Uzbekistan: banks’ equities, deposit certificates, commercial bills and state’ treasury bills. But the availability of these securities is highly restricted (only three-year deposit certificates are available for individuals) and very few of these securities are issued.

In 2002, the Government of Uzbekistan has signed a Memorandum with the International Monetary Fund, in which Uzbekistan pledged to liberalize its financial system. In particular, the rule limiting enterprises to one account, cash withdrawal limits, government’s intervention into credit policy of commercial banks should be abolished. These measures indicate that some reforms in financial sector has pushed ahead; though their pace remains very slow. There is enormous scope of in-depth reforms to be applied by the government before effective financial system can be built.

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When Math is Not Enough: Kalecki’s Place in The History of Economics

By Gilberto de Assis Libanio∗

1 – Introduction

Michal Kalecki has an uncommon status in the History of Economics. He has made original contributions on many crucial issues addressed by the profession and has been pointed within some circles as one of the most important economists of the twentieth century.1 Nevertheless, he is neglected (and even unknown) by the vast majority of his peers. According to Harcourt “Kalecki is the most neglected of all great modern economists” [quoted in Sawyer 1985, 1]. This fact becomes clear when one examines some mainstream textbooks on the history of economic thought. Many examples can be found; I will mention but a few:

(1) In Schumpeter’s History of Economic Analysis (1954), Kalecki is barely mentioned. In a passage about the Keynesian theory, Schumpeter states: “The most successful of all theoretical systems that have been inspired by this will to simplify the structure of economic theory is the static system that is associated with the name of the late Lord Keynes. Many others have also been constructed, for example, by Amoroso, Frisch, Kalecki, Pigou, Tinbergen, Vinci” [Schumpeter 1954, 1143-4]. Note, however, that Kalecki’s name does not even appear in the “Index of Authors” at the end of the book.

(2) Two other (randomly chosen) History of Economic Thought textbooks completely ignore Kalecki [Oser and Blanchfield, 1975; Ekelund Jr. and Hebert, 1990].

(3) Blaug [1990] mentions Kalecki just once, but not in relation to his main contributions in the macroeconomic field: “According to Kalecki’s much discussed ‘principle of increasing risk’, the subjective risk to the firm of increased indebtedness rises with …” [p.526]. It is remarkable that Kalecki receives no attention in the Keynesian System chapter, as well as in topics such as “effective demand” and “economic dynamics”. About the Keynesian Revolution, however, Blaug states that “it could be argued that the apotheosis of Keynes came even earlier in 1944, when the UK White Paper on Employment Policy, William Beveridge’s Full Employment in a Free Society, and The Economics of Full Employment: Six Studies in Applied Economics by the Oxford Institute of Statistics, followed one another within the space of nine months” [Blaug 1990, 643-4]. But note that the third publication has a strong component of Kalecki’s ideas, besides a chapter written by Kalecki himself (ch.2 – “Three ways to full employment”).2 Blaug seems not to pay attention to that.

(4) Perlman and McCann, Jr. (1998) mention Kalecki in a footnote with biographical information, in a section entitled “Joan Robinson and Cambridge Socialism.” Although Kalecki is described as a “brilliant Marxist writer” [Perlman and McCann 1998, 405], there is no discussion about his work. Only an extract could be found about it (in the same footnote): “[Kalecki] published an important pamphlet entitled Essays on Business Cycle Theory (The importance of this work lies in its

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statement of the theory of effective demand, which predates the theory as stated by Keynes in 1936)” [Perlman and McCann 1998, 405n].

(5) In Niehans (1990), one can find some quite superficial references to Kalecki, in which he is always cited along with R. Frisch. For example: “In the early 30’s, Ragnar Frisch and Michal Kalecki were the first to condense business cycle theory to mathematical models” [Niehans 1990, 314]. How? There is no explanation for that, since Niehans never presents formally some of Kalecki’s models. Kalecki is “introduced” inside a section devoted to R. Frisch, in a chapter called “The Planners.” Here, there is a one-paragraph description of Kalecki’s “Macrodynamics Theory of Business Cycles” (1935), although the formal model is not presented. On the other hand, note the following passage: “Kalecki later prided himself on having anticipated Keynes. In fact, he far exceeded Keynes not only in economic substance but also in analytical rigour and in lucidity of exposition” [Niehans 1990, 376]. Once more, there is no further discussion about such a strong assertion and no elements to persuade (or, at least, inform) the reader. How and why did Kalecki “far exceed” Keynes? And, if this is the case, why are Kalecki’s ideas not discussed in some detail? Those are some of the questions that will be discussed later.

The general impression that one gets by this short search on History of Economic Thought books is that Kalecki is not recognized at all by his contributions on important issues related to the dynamics of a capitalist economy. He is sometimes mentioned either as someone who writes about “planning” (what he actually did, specially in the 50’s) or as a mere “follower of Keynes,” because of the similarities between their works3 and because of Kalecki’s relation to Cambridge economists in the late 30’s, particularly Joan Robinson.4 But he is, most of the time, simply neglected or ignored in the mainstream literature.

What are the reasons for Kalecki being neglected? One possible explanation can be found in the approach to the history of thought used by Niehans (1990), who maintains that a piece of analysis should be considered as long as it contributes somehow to the edifice of present-day orthodox economics: “The essential criticism is thus performed not by the historiographer but by the history of economics itself. In a biological selection process the fitness of a species is judged not by the observing biologist but by its survival.” [Niehans 1990, 2]

Indeed, the fact that Kalecki’s work was in sharp contrast with neoclassical orthodoxy prevented it from being a “brick in the mainstream edifice.” It is worth noting this fact, especially when one thinks that Kalecki’s approach could in many respects be conformable to neoclassical economics: (a) Kalecki used formal models; (b) Kalecki did empirical work and used some econometrics. However, most of his assumptions did not fit the conventional reasoning. Sawyer (1985) points to the main aspects in which Kalecki contrasted to the orthodoxy of his time: (a) the rejection of a competitive view of the world, and the assumption that capitalist economies could be better characterized as semi-monopolistic or monopolistic (what leads him to a mark-up theory of price determination); (b) the absence of equilibrium analysis and the emphasis in the evolution of the economic system through time; (c) the fact that Kalecki “made virtually no use of those standard tools of neo-classical economics – the utility function and the production function” [Sawyer 1985, 10-11]; (d) the use of social classes, rather than individuals, as the basic unit of analysis.
Nevertheless, saying that Kalecki departed from the orthodoxy of his time is just a partial explanation, since other non-mainstream economists are usually considered, even in a critical perspective. One could argue that Kalecki is neglected simply because his work is really not important and deserves no further consideration. However, such an interpretation is not compatible to the admiration Kalecki receives out of mainstream circles and to the way he is referred to by authors who give him little importance – what is exemplified by the above quotations from Niehans (1990) and Perlman and McCann, Jr. (1998).

Other possible reasons are related to biographical aspects. Patinkin (1982) emphasizes that Kalecki came from Poland, that “was in the backwaters” [Patinkin 1982, 58], from the viewpoint of economic theory, and that Kalecki was himself “further isolated intellectually by virtue of his being largely an autodidact [in economics]” [Patinkin 1982, 58]. In addition, one needs to consider that Kalecki wrote a lot of his work in Polish and French and, therefore, many of his potential readers could not reach his work at first. Feiwel (1975) describes Kalecki as a “very modest man” [Feiwel 1975, 15] and stresses that he silenced for a long time about his priority in publication of elements of Keynes’s General Theory. Besides, Feiwel (1975) mentions some characteristics of Kalecki’s style: “Perhaps it was the very taciturnity of Kalecki’s mode of expression, the restraint in the language, and the utmost concentration of thought that made his writings so difficult to understand and rather unpopular among his fellow economists” [Feiwel 1975, 13]. Sawyer (1985) also focuses on Kalecki’s “terse and laconic” [Sawyer 1985, 8] writing style and states that “in further contrast to much writing in the field of economics, Kalecki made few references to the work of others, whether by way of justification for what he was saying or as object of criticism” [Sawyer 1985, 8]. In fact, Kalecki was not trained as an economist, and was not concerned with a dialogue with the economics orthodoxy (I will come back to this point later). Note that in all these aspects there is a sharp contrast between Keynes and Kalecki that can help to understand why the former received full attention during his lifetime and after, whereas the latter has been mostly neglected or forgotten (more on the relation between Keynes and Kalecki in section 3).

In this paper, I intend to reflect on Kalecki’s work and compare it to Keynes’s, in order to clarify on the lack of consideration Kalecki has always received in the mainstream of the profession. The remainder of the paper is organized as follows: In the next section, some of the main aspects of Kalecki’s theory of business cycle will be discussed. Section III addresses the relation between Kalecki’s and Keynes’s works. As a conclusion, I will draw some considerations about the relevance of Kalecki’s macroeconomics and his place in the History of Economic Thought.

2 – Kalecki on Theory

This section examines some of the most important theoretical contributions of Kalecki. It does not intend to be a full description and discussion of all the issues Kalecki addressed, but rather a brief outline that focuses on those aspects of Kalecki’s work that: (a) are related to the analysis of capitalist economies, specially in the “macroeconomic” sphere; and/or (b) are somehow related to questions also addressed by Keynes, so that
similarities and differences between them can be discussed (what will be done in the following section). The above selection criteria means that Kalecki’s contributions to the analysis of socialist and underdeveloped economies, as well as issues that could be loosely classified as “microeconomic,” like the mark-up theory of price determination, will not be discussed here, except to the extent that those contributions appear as an element in the analysis of the macrodynamics of capitalist economies.

2.1 – Principle of Effective Demand

For a long time, economists have acknowledged the idea that national income is always equal to the national product and also equal to the total of expenditures (in consumption and investment, for example) in a given period. These are nothing but identities, relations that always hold; given the way those magnitudes are defined.

The usual way in which the XIX century political economy looked at those relations can be described by the so-called Say’s Law: “every supply creates its own demand”, i.e., the production of any good creates purchasing power that will be immediately used to demand another good. In aggregate terms, it means that all incomes (wages, profits etc.) are fully spent on the acquisition of goods and services. Note that, in this case, there is a causal mechanism, between aggregate production and expenditure, in which the former determines the latter.

Kalecki is quite critical of that perspective: “[Say’s] law has certain affinities with the laws of preservation of matter and energy. The difference, however, is that it is definitely wrong. It implies that the value of national income is constant. If, for instance, less is spent on consumption then pro tanto more is spent on investment. But it was always clear that this is not the case, since the value of national income is subject to abrupt changes. (…) To discard the law of the preservation of purchasing power meant admitting the possibility of general overproduction.” [Kalecki 1964, 62, cited by Feiwel 1975, 10-11] According to Kalecki, Say’s Law was endorsed for a long time among economists because of an inadequate application of household experience – where income is given and less consumption means greater savings – to the economy as a whole.

Kalecki asserts that the correct relation between aggregate income and expenditure rests on the so-called “principle of effective demand.” In a nutshell, it can be stated as: “aggregate expenditure determines aggregate supply.” It means that expenditures can be considered as “independent variables” that lead to a given level of output, which in turn generate an amount of profits and wages (income) equivalent to what has been spent on consumption and investment.

Kalecki analyses the economy in terms of social classes (capitalists and workers) and defines different kinds of expenses for each class. Workers are assumed to earn wages (W) and spend all their income immediately (income W equals consumption Cw, with no savings). However, this is just a simplifying assumption that is not crucial to the argument. Capitalists are assumed to earn profits (P) and to spend on consumption (Cc) and investment (I). Kalecki emphasizes the role of capitalists’ expenses, since these are not necessarily related to previous income, i.e., not necessarily equal to the level of profits earned in the previous period. The qualitative difference between workers and
capitalists consists in the fact that workers’ expenses are restricted by their income, while capitalists’ are not. Therefore, workers’ expenses simply reflect changes in national income (given the income distribution) and are not subject to spontaneous changes. If this is the case and if the principle of effective demand holds, it follows that fluctuations in national income and product are caused by fluctuations in capitalists’ expenses on consumption and investment.\(^\text{10}\)

This leads to the well-known proposition that workers spend what they earn and capitalists earn what they spend. Consider, once more, the identity between national income (profits and wages) and aggregate expenditure (workers’ consumption, capitalists’ consumption and investment). Since workers’ consumption equals wages \((W = C_w)\), it follows that the amount of profits is equivalent to capitalists’ expenses on consumption and investment \((P = C_c + I)\). According to the principle of the effective demand, causality would run from expenses to income (thus, in this case, from \(C_c\) and \(I\) to \(P\)). Kalecki’s point is that capitalists cannot individually decide how much to earn, but they can decide how much to spend. Therefore capitalists, as a whole, determine by their spending decisions aggregate profits and – given the income distribution – national income and product.

However, it is worthy to note that changes in the distribution of income can also change the level of national product. Since distribution affects the composition of the total income \((P + W)\), it also affects – due to different propensities to consume out of wages and profits – total expenditure. These influences, as well as the determinants of income distribution, will be discussed later in this section.

Another implication of the previous analysis is the possibility of involuntary unemployment and excess productive capacity in the economy, due to an insufficient level of effective demand. Note that this can never be the case if Say’s Law holds, since production implies demand and can only be limited by the amount of productive resources.

The fact that expenses in consumption and investment are the main determinants of national income is a crucial element in Kalecki’s theory of the business cycle. In particular, Kalecki assumes that consumption tends to present certain stability (due to habits, for example), and thus investment is the most important variable in the dynamic of the cycle. This is what will be discussed next.

### 2.2 – Investment and the Business Cycle

Kalecki’s theory of business cycle has been presented in slightly different forms along his works. This paper does not intend to discuss the differences among the three versions (dating from 1933, 1943 and 1968) and will focus on Kalecki’s first version, from “An Outline of the Business Cycle Theory” (1933), originally published in Polish, and first published in English in 1935 [Econometrica, vol. 3].\(^\text{11}\)

As mentioned before, Kalecki considered investment as the main determinant of the cycle because of its independence from previous periods’ income and its greater variability when compared to other components of aggregate expenditure. Kalecki addressed two basic questions to analyze the cycle: (a) what determines investment; and (b) what influences investment exerts upon profits and national income. In particular, Kalecki was able to build a model in which cycles were endogenously generated by the
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The mutual interaction of the positive effect of higher income on investment and the negative influence of a greater capital stock on the decision to invest.

Kalecki's basic model considers a closed economy, with no population growth and no technical change. In order to focus on the cyclical component of the system, Kalecki assumes the absence of a secular trend in the economy. In addition, it is assumed that workers do not save and that aggregate inventories remain constant throughout the cycle. In this model, gross real profits (P) are given by the sum of capitalists' consumption (Cc) and gross accumulation (A) – "equal to the sum of the production of investment goods" [Kalecki 1933, 69]:

\[ P = Cc + A \]  \hspace{1cm} (1)

Assuming that capitalists' consumption is relatively inelastic and consists of an autonomous part (Bo) and a part that depends on gross profits:

\[ Cc = Bo + \lambda P \]  \hspace{1cm} (2)

where \( \lambda > 0 \).

From (1) and (2), we get:

\[ P = (Bo + A) / (1 - \lambda) \]  \hspace{1cm} (3)

Once more, capitalists' income (gross real profits) depends on the production of investment goods and on the autonomous component of their consumption expenses. On the other hand, Kalecki states that the decision to invest is motivated by anticipated gross profitability, which may be estimated from the actual gross profitability of existing plants - defined as the ratio between aggregate real gross profits and the existing capital stock (\( P/K \)). The interest rate \( i \) is also included as an explanatory variable in the investment function, although Kalecki considers that "the interest rate is of secondary importance for the will to invest, the factor of prime importance being unquestionably the gross profitability of existing plants." [Kalecki 1933, 97-8] Thus, Kalecki arrives at the relation:

\[ I/K = f (P/K, i) \]  \hspace{1cm} (4)

where \( I \) stands for investment, and \( f \) is an increasing function of \( P/K \) and a decreasing function of \( i \). Substituting (3) into (4), we get:

\[ I/K = f [(Bo + A)/K, i] \]  \hspace{1cm} (5)

At this point, another simplifying assumption is made: the rate of interest \( i \) is considered an increasing function of the gross profitability \( P/K \). Kalecki argues that the interest rate rises in the upswing - due to an increased demand for money in circulation - and falls in the downswing (note that \( P/K \) is also procyclical). According to Kalecki, the positive relation between the interest rate and gross profitability is only a crude approximation, that may be maintained only so long as "(i) \( i \) is the 'market' rate, i.e., we
leave aside interventions of the central bank; and (ii) there is no crisis of confidence when, during the depression, the rate of interest raises." [Kalecki 1933, 74]

Then, it follows from (5):

\[
\frac{I}{K} = g \left[ \frac{(B_0 + A)}{K} \right]
\]  \hspace{1cm} (6)

If we assume \( g \) to be linear, equation (6) can be written as:

\[
\frac{I}{K} = m \left[ \frac{(B_0 + A)}{K} \right] - n
\]  \hspace{1cm} (7)

where the constant \( m \) must be positive since \( g \) is an increasing function. In addition, the parameter \( n \) is also assumed to be positive (actually, this is a necessary formal condition for the investment equation to describe a cyclical pattern).

Multiplying both sides by \( K \), we finally get Kalecki's investment equation:

\[
I = m (B_0 + A) - nK
\]  \hspace{1cm} (8)

which shows that the volume of investment orders is an increasing function of the gross accumulation \( A \) and a decreasing function of the capital stock \( K \). Equation (8) makes it possible for Kalecki to state a mixed difference and differential equation for \( I \) as a function of time. The solution to this equation shows that \( I \) exhibits harmonic oscillations with a constant, increasing or decreasing amplitude. The coefficients \( m \) and \( n \), as well as the length of the gestation period of investments, determine the period of oscillation, and the rate of progression and regression of the cycle amplitude.\(^{12}\)

As stated before, the basic mechanism of the business cycle in Kalecki's model lies in the interaction between investment, profits and capital accumulation. When investment orders increase, the production of investment goods also increases (effective demand) stimulating further investment orders. However, as long as gross accumulation \( A \) exceeds the level of replacement requirements, it leads to an increase in the capital stock \( K \), that has a negative effect on gross profitability and, therefore, on investment demand. Initially, this effect restrains the rate of increase in investment orders, and at a later stage promotes a decline in investment orders, starting the declining phase of the cycle.

Summing up: the cycle in Kalecki's model is caused by the dual role performed by investment in a capitalist economy, where it represents - at the same time - expansion of aggregate demand and creation of productive capacity. According to Kalecki, "We see that the question, 'What causes periodic crises?' could be answered shortly: the fact that investment is not only produced but also producing. Investment considered as expenditure is the source of prosperity, and every increase of it improves business and stimulates a further rise in investment. But at the same time every investment is an addition to the capital equipment, and right from birth it competes with the older generation of this equipment. The tragedy of investment is that it causes crises because it is useful" [Kalecki 1939, 318].
2.3 - Distribution and income determination

As we have mentioned before, the distribution of national income is an integral element in Kalecki’s theory of income determination. The starting points are the principle of effective demand and the idea that capitalists and workers have different propensities to consume – workers’ is close to 1, capitalists’ is smaller than that. As aggregate income is determined by aggregate expenditure, and the latter depends on workers’ expenses out of wages and capitalists’ expenses out of profits, the distribution of national income affects the level of aggregate output.

Kalecki discusses these questions in different papers and books. We will focus on his *Theory of Economic Dynamics* (1954), in which Kalecki addresses the problem of income determination in three steps: (a) what determines the shares of wages and profits in national income; (b) what the relation between investment and profits is; and (c) what the relation between investment and consumption expenses and output is.

The distribution of income is governed by the so-called ‘degree of monopoly’, a parameter which depends on the structure of the industry, the intensity of price competition and product differentiation, the power of labor unions, among other factors. According to Kalecki, the ‘degree of monopoly’ is closely tied to relation between unit prime costs \( u \) and prices \( p \): the higher the ‘degree of monopoly’ the larger the gap between unit prime costs and prices tends to be. Therefore, the higher the profits’ share in national income tends to be.

On the other hand, Kalecki [1954, 225] shows that the relative share of wages in the value added of an industry \( w \) can be represented as:

\[
w = \frac{1}{1 + (k - 1)(j + 1)} \tag{9}
\]

where \( k \) reflects the degree of monopoly and \( j \) is the ratio of the aggregate cost of materials to the wage bill.

For the economy as a whole, the wage share depends also on the relative importance of particular industries on the composition of aggregate output. Thus, the portion of wages in national income is determined by the degree of monopoly, the ratio of raw material prices to unit wage costs and the industrial composition of value added. Note that “a rise in the degree of monopoly (…) causes a fall of the relative share of wages in the value added.” [Kalecki 1954, 226]

Kalecki also establishes a relation between the real wage and salary bill \( V \) and real gross income \( Y \):

\[
V = aY + b \tag{10}
\]

Or, dividing both sides by \( Y \):

\[
\frac{V}{Y} = a + \frac{b}{Y} \tag{11}
\]
where \( b \) is a positive constant subject to long run fluctuations, and \( a ( < 1 ) \) is a distributional parameter which denotes the part of the relative share of wages and salaries in \( Y \) that does not depend on the level of \( Y \).

The second step in the theory of income determination is the analysis of the relation between investment and profits. It is assumed, for simplicity, that the economy is closed and that both government expenditure and taxation are negligible. As we have seen before, the decision to invest is motivated by anticipated profitability but, at the same time, profits are determined by capitalists’ expenses, including investment. Kalecki [1954, 248] summarizes the effect of investment on profits as:

\[
Pt = (I_{t-s} + Bo)/(1-q)
\]  

(12)

where \( Bo \) is a constant that represents the autonomous part of capitalists’ consumption, \( q \) is the marginal propensity to consume out of profits, and \( s \) is the time-lag between investment expenses and profits.

Finally, the question of how aggregate income is determined can be addressed. Defining aggregate profits as the difference between total income and the wages and salaries bill, and substituting in equation (11), we get:

\[
\frac{(Y - P)}{Y} = a + \frac{b}{Y}
\]

or

\[
Y = (P + b)/(1-a)
\]  

(13)

Combining equations (12) and (13), the national income, in time \( t \), is determined by investment expenses and structural parameters:

\[
Y_t = \frac{I_{t-s} + Bo + b.(1-q)}{(1-q).(1-a)}
\]  

(14)

Thus, under simplifying assumptions, national income is determined by investment with a time-lag. Note also that variations in national income are caused by fluctuations in investment expenses, just like in the Keynesian multiplier:

\[
\Delta Y_t = \frac{\Delta I_{t-s}}{(1-q).(1-a)}
\]  

(15)

To summarize: in Kalecki’s theory, capitalists’ consumption and investment expenditures govern the amount of aggregate profits. The distributional factors, in turn, determine labor’s income. In particular, the share of wages in national income is the inverse of the degree of monopoly. Therefore, aggregate consumption and employment are shaped by autonomous expenses of profit earners jointly with workers’ consumption, which depends on the determinants of distribution.
3 – Is Kalecki a Keynesian?

This section discusses the relationship between the works of Kalecki and Keynes. In particular, I intend to argue that to consider Kalecki as a disciple of Keynes involves a misunderstanding of Kalecki’s theoretical contributions, as well as his intellectual background and some methodological aspects of his work. In other words, there are many reasons to answer with a negative to the question that entitles this section, and more than that, there are reasons to doubt even the way in which the question is posed. I shall argue that Kalecki’s work comes from another tradition in economics, that it is superior to Keynes’s in many respects and that it has, despite some similitude, many particular aspects that prevent us from bracketing their ideas together.

The point here is not to deny the historical importance of Keynes. As Kalecki himself recognized [Feiwel 1989], Keynes’s international reputation and ability to place his concerns on the center of the stage probably played a significant role in the dissemination and recognition of the Keynesian Revolution. Besides that, the fact that Keynes’s work was somehow closer to the orthodoxy created less resistance to his ideas and allowed him to raise a debate and receive lots of attention, contrarily to Kalecki. Be it as it may, the aim is to acknowledge that Kalecki deserves another place in the History of Economics, not as a follower of Keynes, but as an intellectual who made, by himself, original and fruitful contributions to the field.

3.1 – Kalecki and Keynes: similarities and differences

Kalecki and Keynes came from different intellectual traditions. Keynes received his economic training in Cambridge, under the influence of Marshall, while Kalecki never had formal training in economics. Having obtained a degree in engineering, he was self-educated in economics, influenced by the works of Marx, Rosa Luxemburg and Tugan-Baranovski. Not only was Kalecki’s background in economics was quite different not from that of Keynes, but also from that of most American and British economists of the time. This fact in part explains the originality of Kalecki’s work, not restricted to the “habitual modes of thought”, but at the same time helps to explain the disregard his work received.

According to Sawyer (1985), Kalecki should be seen as working within the classical or Ricardian-Marxian approach, whereas Keynes can be seen within the neoclassical tradition (Marshallian, in particular), although he became critical of some aspects of that approach. If this is the case, one can expect to find a great amount of differences between their works. Therefore, it might be better not to include Kalecki’s and Keynes’s works in the same chapter of the history of economic thought. Or, as Sawyer states it: “if that line of argument is accepted and the idea that classical and neoclassical traditions reflect the two basic and opposed schools of thought within economics (…), then placing Kalecki and Keynes together is likely to lead to confusion” [Sawyer 1985, 185].

One more element should be considered about their different backgrounds: the fact that Kalecki's contacts with problems of business cycles came basically through statistical and descriptive work analyzing commodity markets, first as an economic journalist and then as an employee at the Research Institute of Business Cycles and Prices.
Despite their differences, Kalecki and Keynes share some important conclusions in their works. It is clear that they have reached similar points through independent ways, since they did not know each other works and they have not met before 1936. Actually, Kalecki was surprised when he first read Keynes's *General Theory*, and considered that most of the elements of a book he had in mind were already there, stated independently by Keynes.\(^{14}\)

The most important points where Kalecki and Keynes get close to each other are: (i) the principle of effective demand; (ii) the importance of investment as the variable that guides the economic system; and (iii) the possibility of persistent involuntary unemployment. The first one was discussed before and is basically related to the refutation of Say’s Law. Kalecki and Keynes, through different routes, devised the reversion of the causal mechanism between aggregate demand and supply. Actually, as Kalecki was not trained in orthodox economics, he did not have to struggle to get rid of Say's Law. Keynes, on the other hand, discussed the difficulties in dismissing Say’s Law; as is well known, he recognized in the *General Theory* that "the difficulty lays, not in the new ideas, but in escaping from the old ones" [Keynes 1964, viii].

The second element of convergence concerns the role of investment in the economic system. Although there are particular aspects in which Kalecki's and Keynes's theories of investment differ from each other, an important common feature is the idea that the decision to invest is the crucial element that governs the path of the economy. Both Kalecki and Keynes acknowledged that consumption presents a greater stability and that investment is subject to sudden and abrupt changes, which explain economic fluctuations. Besides this, when the equality between investment and savings is concerned, both recognized that the causational mechanism would run from the former to the latter - what is also a consequence of the principle of effective demand. In other words, independent changes in the investment expenses would generate an equivalent level of savings, through changes in output and income.

Finally, Kalecki and Keynes share the recognition that full employment is not the normal state of affairs in the capitalist economy, and thus should not be a necessary theoretical result. Keynes considered full employment as a limit position in the economic system, as likely as any other equilibrium position, and one that could be achieved only if the effective demand generated by investment expenses, along with the propensity to consume, would be equal to the output in which there was no involuntary unemployment. Kalecki, on the other hand, did not analyze this question in terms of equilibrium values, but rather asserted that the economy is subject to cycles and that the fluctuation in the level of employment is a basic characteristic of the system that prevents full employment to occur in most of the times.

There are many points, however, in which Kalecki and Keynes diverge. I will argue that the differences in background provide good explanation for this fact and help to understand some of the basic characteristics of their work. In other words, Kalecki’s background in Marxian economics, his professional experience and his engineering degree are essential to understand his work in economics. The same could be said about Keynes: his Marshallian background, his professional experience, and his personal interests seemed to shape his work.
The first noticeable difference in their theories consists on the underlying structure of the economy. In Kalecki, elements of oligopolistic and monopolistic behavior are introduced, while in Keynes perfect competition is assumed. This leads to different perspectives on price formation: mark-up over unit prime costs (Kalecki) vs. marginal cost analysis (Keynes).

The second element to be stressed is the basic unit of analysis. Social classes play an important role in Kalecki’s theory, while Keynes starting points are individual firms or households. The emphasis on social classes also brings Kalecki to discuss the functional income distribution and to incorporate this variable as an essential component of his model. Keynes does not consider that and deals with aggregate variables only.

Another important difference stands on the fact that Keynes works on a static equilibrium context. He focuses on the equilibrium levels of investment, savings, income, and employment. Kalecki, on his turn, presents dynamic models that analyze the performance of the economy through time, and that stress the cyclical behavior of the relevant variables, rather than their equilibrium levels at a point in time.

The above difference also reflects on Kalecki’s and Keynes’s theories of investment. Keynes works basically in the Marshallian short-run, in which capital stock is constant, and the decision to invest relies on the so-called marginal efficiency of capital, compared to the interest rate. In Kalecki, the stock of capital evolves along the business cycle and represents an important influence on the decision to invest (together with anticipated profitability of capital goods).

Kalecki’s and Keynes’s investment theories also highlight another distinction: the relative importance of ‘subjective’ and ‘objective’ elements. The former counts more in Keynes’s theory, while the latter are more important in Kalecki’s. “In particular, the technology of production and investment plays a prominent part in Kalecki’s models, whereas Keynes relies on many psychological observations on consumption, investment, and liquidity behavior that are absent in Kalecki’s exposition” [Johansen 1968, 160]. Note that Keynes placed emphasis on expectations and the impact of uncertainty on economic processes and explicitly admitted that some of the most important elements of the *General Theory* are the “three fundamental psychological factors” (propensity to consume, liquidity preference, and expectations of future returns from capital goods).

Finally, there are important differences concerning the use of mathematics and econometrics. According to Johansen, “Kalecki was unabashingly mathematical and used some rudiments of econometrics, while Keynes hesitated in using simple formulas and was very skeptical towards econometrics” [Johansen 1978, 161]. It is worth noting that Kalecki is somehow recognized by the pioneering of the mathematical methods used in some of his models (e.g. Niehans quotation in section I) and has made extensive use of empirical analysis. Keynes, on his turn, was not much devoted to empirical studies and did not consider econometrics to be a valid method of research, especially because of the instability resultant from the incidence of subjective factors (values, motives, expectations, and uncertainties) in economics. His positions regarding those questions are made clear, when Keynes states “the main *prima facie* objection to the application of the method of multiple correlation to complex economic problems lies in the apparent lack of any adequate degree of uniformity in the environment.” [Keynes 1973, 316]; or “How far are the results mechanically and uniquely obtainable from the data, and how far do they depend on the way the cook chooses to go to work?” [Keynes 1973, 288]
4 – Conclusion: Is Kalecki relevant anyway?

This paper addresses the place of Michal Kalecki in the History of Economics and discusses some aspects of his work on the theory of business cycles, particularly in comparison to Keynes’s theory.

One of the general conclusions that can be outlined is that Kalecki’s work does not receive serious attention inside the mainstream of the profession, despite the eulogies he gets when his works are mentioned and despite some similarities between the quantitative instrumental used by Kalecki and the mainstream of his time. Some reasons for this inconsideration have been advanced in the text, and I would like to reinforce one of them, quoting Sawyer: “The failure to consider Kalecki’s work seriously is symptomatic of the dominance of neo-classical economic theory in the teaching of economics, and the manner in which alternatives to neoclassical economics are excluded from serious consideration” [Sawyer 1985, 2].

On the other hand, when Keynes and Kalecki are compared, it seems that the latter cannot be considered a follower of the former. Indeed, their theories present important and irreconcilable differences, despite some elements in common. Some of those differences have been discussed, and the fact that Keynes was closer to the orthodoxy (due to his Marshallian background) provides a good explanation for his greater acceptance within the mainstream. Actually, “Keynesian macroeconomics” was one of the elements of the post-WWII orthodoxy in America, together with mathematical modeling in microeconomics, and econometrics as a crucial empirical tool. In this case, one could (ironically) argue that Kalecki “met all the requirements”: he used math, he used econometrics, and he was a “Keynesian”. The problems that prevented Kalecki from being considered may be: his math and his econometrics are used under assumptions that “do not make sense”, and Kalecki is “too Keynesian”, not conformable to the Neoclassical Synthesis.

However, I think Kalecki’s approach provides a sound and coherent foundation for the macroanalysis of capitalist economies, based in more realistic and relevant assumptions. Besides, it does not require the utilization of (always questionable) equilibrium concepts, it avoids some of the criticism directed towards Keynes’s theory (e.g. “it is too psychological!”), and it may be quite useful as a general guide to macroeconomic policy. But, of course, to accept Kalecki inside the Pantheon of the orthodoxy would involve a sharp change in the way economics is done and taught, so one cannot expect but to see him as an “outsider.”

Notes

1. The Cambridge Journal of Economics is a good example. From its foundation (in 1977) until 1994, it stated in its instructions to contributors that “the economic approach rooted in the traditions of Marx, Kalecki and Keynes has much to contribute to the understanding and treatment of current economic and social issues”. In 1995, the text has been modified, but Kalecki is still pointed out as an important influence: “The Cambridge Journal of Economics, founded in the tradition of Marx, Keynes, Kalecki, Joan Robinson and Kaldor, provides a focus for theoretical, applied, interdisciplinary and methodological work…”
2. Kalecki worked in the Oxford Institute of Statistics between 1940 and 1944, along with other well-known economists, like J. Steindl. During this period, Kalecki published many articles in the Bulletin of the Oxford Institute of Statistics, starting in June 1940 with “A Scheme for the Curtailment of Consumption,” and ending in December 1944 with “Employment in the United Kingdom during and after the transition period.” His bulletin articles, in themes such as employment, inflation, distribution of income, money supply and budgetary policy, usually presented the combination of detailed empirical work within a broad theoretical perspective. The book published in 1944, which Blaug refers to, is somehow a joint-product of the economists of the Institute, although each chapter is signed by a specific author: “The book is the product of close teamwork and intensive discussion among all the contributors” [Oxford University Institute of Statistics, 1944, vi].

3. According to Osiatynski [1990, 4], the Essays on the Theory of Economic Fluctuations (1939) – in which Kalecki tried to fill in some gaps in Keynes’s analysis, as well as to integrate it to his own theory of business cycles – provided the basis for this interpretation.


5. Such an approach could be criticized in many respects. See, for example, Yonay [1998]. But this task is not going to be performed here, although it does not mean agreement with Niehans’s perspective. I simply recognize that this approach is frequently used, and consider this fact as an explanatory element.

6. The quotation marks are used here because Kalecki’s theory, contrarily to Keynes’s, cannot be strictly classified as microeconomic or macroeconomic. Actually, one of the strengths of Kalecki’s analysis of the business cycle is the interaction between micro and macro aspects.


8. An example of that is the concept of “degree of monopoly”, which is important in the determination of the income distribution and, as a consequence, influences the level of national income or output.

9. The principle of effective demand is clearly stated by Keynes in the General Theory [1964, ch.3]. According to Patinkin (1982), the theory of effective demand as an explanation of a state of ‘underemployment equilibrium’ in a capitalist economy constitutes Keynes’s central message.

10. This explanation considers a private closed economy. The same logic can be applied to an open economy, in which net exports are included among the components of expenditure, as well as an economy in which there is government (government expenses are also considered independent of previous income and this idea is used by Kalecki to argue for fiscal policy as a tool to stimulate the economy).

11. Note that this is the only of Kalecki’s papers cited by Niehans (1990). For a presentation of the different versions of Kalecki’s theory of business cycle, see Steindl (1981).
12. See Kalecki [1933, section 2] for details.

13. Keynes and Kalecki were completely different in their personal backgrounds, in their style, etc. According to Feiwel [1975, 47]: “[Keynes and Kalecki] came from two radically diverse social, cultural, and economic strata. They differed in almost as many aspects as can distinguish men: background, social position, education, experience, political outlook, and not the least in predisposition and temperament.” This section will not discuss biographical aspects in detail, though. For a brief comparison between their personal background and attitude, see Feiwel [1975, ch.2].

14. In a review of the General Theory, Kalecki states that it is “without any doubt, a turning-point in the history of economics.” [Kalecki 1936, 223]

15. This is one of the points criticized by Kalecki in his review of the General Theory [Kalecki 1936]. An important feature of this criticism is that the marginal efficiency of capital depends on the aggregate demand, which in turn depends on investment expenditure. This leads to a cumulative aspect of investment that is not discussed at all by Keynes.

References


Gilberto de Assis Libanio

Brace, 1964.


Original Institutional Economics and New Institutional Economics: Revisiting the Bridges (Or the Divide)

By Jairo J. Parada *

Introduction

Institutional economics remains today an influential field in economics, despite the prevalence of orthodox neoclassical economics in most economics departments and policy-making institutions. The interest in this field has increased in the last fifteen years, and a section on “institutions” is common in international meetings in our discipline. There is a consensus that “institutions do matter” and that “determinants of institutions are susceptible to analysis by the tools of economic theory” [Matthews 1986, 103; Williamson 2000, 595].

It is also well known that mainstream Neoclassical economics has recently incorporated the study of institutions based on the assumptions of this paradigm, modifying its former habit of ignoring institutions, or by taking them as given. Indeed, today, attempts to explain institutions on the basis of rational choice models combined with game theory approaches are common. However, two basic strands of economic thought regarding institutions maintain an important presence in our field today: 1) the Original Institutional Economics (OIE) based on the tradition of Veblen, Ayres, Commons, and Mitchell; and 2) the New Institutional Economics (NIE) based on Ronald Coase’s theory of transaction costs. NIE is known as the North-Williamson school, and it has extended its theoretical developments to different areas such as property rights economics (Demsetz, and Alchian), Public Choice (Olson, and Mueller), and the theory of the firm (Schotter, and Shubik). 2

The purpose of this paper is to present the main differences between NIE and OIE. In doing so, I challenge some of different proposals among OIE economists that call for building bridges between the two approaches. My perspective does not preclude the possibilities of a dialogue. I admit that when I began this research, I was optimistic about the possibilities of building bridges between the OIE and the NIE. However, a theoretical examination of the works of the main NIE’s economists led me towards the idea that the divide between these two approaches to Institutional economics is outstanding. Indeed, both approaches have different ontologies and epistemologies and this result cannot be ignored for the sake of eclecticism.

In NIE, one can find statements that OIE has no theory, or that OIE consists of data collection without theory – despite Williamson’s recognition of Commons’ work. Yet, in the OIE field one easily encounters voices of dialogue and reconciliation with NIE. However, NIE’s economists do not pay much attention to OIE’s messages.

* This paper was written under the supervision of Professor Philip Klein of the Economics Department at Penn State University during the Winter of 2001. The original version has been updated and enriched after one year of graduate work among institutionalist scholars at the Department of Economics of the University of Missouri-Kansas City, during the Fall of 2001 and Winter of 2002. I would like to thank an anonymous referee for helpful comments on earlier versions of this paper. I, of course, take full responsibility for the ideas presented here.
Stanfield, a recognized OIE scholar, has optimistically proposed that “OIE and NIE will choose to develop the institutionalized transactions that can serve their particular niche of the human division of labor” [Stanfield 1995, 465]. In the same mood, Rutheford suggests that “the reconciliation of the rational and the rule-guided aspects of human behavior and to the development of a theory of ideology and ideological change” [Rutheford 1995, 450]. Later on, writing about the increasing popularity of North and NIE, Stanfield asserts that “those who do OIE should undertake the development of a more systematic and unified analytical framework. This effort may well lead toward an integration with NIE” [Stanfield 1999, 247-248].

Without ignoring some important theoretical developments in North’s work, I contend that NIE is a school that operates on the periphery of the Neoclassical paradigm and that the bases of OIE are more closely linked to an evolutionary (Darwinian) economics.\(^3\) OIE is therefore quite distinct from the Neoclassical paradigm. As far I am concerned, despite the temptation of following the road of eclecticism, the task of integrating the OIE and NIE suggested by Stanfield seems impossible.

My conclusions are derived from an analysis of the main issues regarding research programs (including methodology), the concept of institutions, the transaction costs approach, the firm, and the state. In addition, I underline the differences and similarities between the OIE and NIE with respect to the Neoclassical paradigm. Finally, I lay out some of the tasks that OIE’s scientists need to undertake in order to face the challenge that NIE actually represents to OIE’s survival.

**Methodology**

In this section, drawing on some of Rutherford’s (1994) arguments, I discuss the methodological differences between NIE and OIE regarding the following topics: a) formalism vs. anti-formalism, b) individualism vs. holism, and c) induction vs. deduction.

a) If we define formalism as “the use of an abstract language such as mathematics or symbolic logic in place of natural linguistic or literary methods of presentation” [Rutheford 1994, 7]. Neoclassical economics represents the highest degree of formalism. Its well-developed mathematical models in micro and macroeconomics, combined with game theory models and stochastic approaches, have made graduate economics programs more attractive to math and engineering students than to students interested in economics with its political, social and cultural implications. Building ‘models’, represented by a set of assumptions, equations, calibration of parameters, simulation models, and econometric testing, have become the usual tools in our profession, but not among the majority of OIE economists.

This trend gives the false impression that OIE has no theory, despite the efforts made by OIE economists during the last century. This is not the place to debate the issue whether Mathematics is simply a valuable tool in our field and does not guarantee that our theories are better or worse. It is a challenging endeavor for Institutional economics to incorporate its theoretical framework in a set of equations due to the complexity of the issues, as some game theorists have discovered lately. Here, however, one must recognize that OIE’s style of presenting theories has been very informal and rhetorical, even though some have made serious attempts to formalize ideas in models.\(^4\)
NIE economists have not been unified on the formalization issue. One can find mathematical models in game theorists such as Shubik and Schotter, but curiously the theory of transaction costs which is the core of NIE was never formalized by Coase himself, who was able to present the theory with simple arithmetic examples accompanied by a nicely written prose. At the same time, Williamson uses some mathematical models in his theory of the firm but without getting much into mathematical intricacies. North uses some basically cliometric techniques but his analysis hinges upon an historical approach.

Hence, we can conclude that NIE is less formal than neoclassical economics but somewhat more formal than OIE. It could also be the case that Rutheford is correct in asserting that more formalist and non-formalist methods are needed for the advancement of both OIE and NIE [Rutheford 1994, 50].

b) With respect to individualism or holism, this is a methodological issue that strongly divides OIE and NIE. Even though one can find some sort of middle ground between holism and individualism in Commons,5 it is very clear that OIE’s analysis is based more on the role of society in defining values, mores and formal institutions, without denying of course the interaction and feedback processes between the individual and society.6

In the case of NIE, its approach is basically individualistic; its point of departure is the individual itself. In NIE’s analysis, institutions are derived from individual behavior, through interaction among individuals. Here, NIE remains faithful to Neoclassical economics. As Hodgson has pointed out, “the individual, along with his or her assumed behavioral characteristics, is taken as the elemental building block in the theory of the social or economic system… it is thus possible to distinguish the New institutionalism from the ‘old’ by means of this criterion. The distinction holds despite important theoretical and policy differences within the new institutionalist camp” [Hodgson 1993, 6]. Hence, Rutheford’s call for developing some sort of ‘institutional individualism’ as a middle point between OIE and NIE remains eclectic. In this matter, Rutheford departs from OIE’s main methodological and epistemological characteristics [Rutheford 1994, 50].

Another important matter between OIE and NIE is the role of rationality in rules followed by society. This is too complex a theme to develop here, but one can also distinguish important differences. OIE always underlines the role that habits, norms, and institutions play in directing human behavior, without discarding some rationality in individual behavior but constrained by the social and economic environment. OIE has always questioned the utility maximizer individual since Veblen’s famous description of her (him) as a ‘lightning calculator’.

However, if one carefully reviews Eggertsson’s (1990) and North’s work (1981 and 1990), the basic neoclassical assumption about human individual behavior still remains (despite some improvements in North’s later works) giving stronger role to informal institutions in shaping human behavior. Williamson (1985) introduces an individual that is not a utility-maximizer but is still subjected to bounded rationality. Some behavioral assumptions are crucial in Williamson’s analysis. First, Williamson borrows from H. A. Simon the notion of bounded rationality in contrast to the neoclassical rational assumption of profit maximization. For Simon, actors are “intendedly rational, but only limitedly so” [Simon 1961, xxiv]. The idea stems from Simon’s vision of the modern firm as composed of a set of cooperative decision makers who need to make decisions via their limited capacities, constrained by limited information, and tied to a social group. Individual firms
strive not to maximize profits but to find solutions to the problems they face. In sum, “people don’t know everything and so they make mistakes; moreover each person may know different things” [Alchian and Woodward 1988, 65-78].

The second assumption upon which Williamson bases his theoretical work is that economic agents are affected by opportunism, which he characterizes as “self-interest seeking with guile” [Williamson 1985, 47]. Opportunism causes appropriate safeguards to be devised ex-ante in the face of contracts between parties. Moreover, this individual follows an opportunistic behavior with guile [Williamson 1985, 388-389]. This aprioristic assumption about human behavior still remains within the individualistic ontology of neoclassical economics.

One cannot deny that these important assumptions in Williamson’s theory modify somewhat the traditional underpinnings of neoclassical economics. Notwithstanding these advances, Hodgson is right when he claims that “Williamson’s break from neoclassical theory is partial and incomplete, and much of the core neoclassical apparatus is retained. In fact, Williamson’s claimed departure from orthodoxy sits uneasily alongside his repeated invocation that agents are marked by ‘opportunism’ […]. Despite much discussion on ‘altruism’ by neoclassical economists, self-interest remains a typical assumption of the mainstream of economic theory” [Hodgson 1993, 11].

c) Last but not least, there is a divide between OIE and NIE regarding the method to be used. OIE has always been linked with the inductive method, following John Dewey’s pragmatic or instrumentalist philosophy. As Stanfield asserted, OIE relies more, although not exclusively, on the comparative method, which uses case studies to create an ethnographic record from which generalizations are derived [Stanfield 1999, 236]. On the other hand, if one carefully reviews Eggertsson’s, North’s, and Williamson’s methodology, one finds that NIE has basically a deductive method as in neoclassical economics. Their point of departure is always an individualistic one with some behavioral assumptions from which they have built concepts on institutions, governance, state, and so on. It is true that North is basically an economic historian, but he approaches history from a framework built rather closely on neoclassical assumptions.

However, regarding the issue of the predominance of the inductive method among OIE scholars, it is important to recognize that there has been a confusion that many OIE economists have themselves contribute to disseminating. Indeed, if one reviews carefully the epistemology involved in what Dewey called ‘inquiry’, the basic concept is far from the idea of the inductive method. As Sturgeon pointed out, “the cumulative and dynamic character of the continuum of inquiry, and the continuum of value, arise out of and are based upon instrumental valuing and knowing, not ceremonial valuing and knowing, which are discontinuous in character” [Sturgeon 1984, 605-606]. Therefore, it is incorrect to characterize pragmatist Methodology as inductivist.

In sum, despite some similarities that could be suggested between OIE and NIE, from a methodological standpoint the divide is stronger than the chances of a possible unification. This fact, of course, does not rule out a constructive dialogue between the two approaches. OIE is based more on a realist Dewey-based pragmatic ontology and epistemology where as NIE remains faithful to the positivist ontology.
Institutions

Both schools of thought recognize the role of institutions and agree that institutions do matter. Yet, it is necessary to take a closer look at the concept of institutions they use and the idea of their evolution and design. OIE’s concept of institutions rests on the Veblenian idea that institutions are prevalent habits of thought with respect to particular relations and functions of the individual and society [Veblen 1899, 132]. Based on the Veblenian dichotomy, changes in institutions occur through an evolutionary process. Ayres underlines the role of culture in shaping institutions while Commons proposes his famous definition of institutions as collective action in control, liberation, and expansion of individual action [Commons 1990 (1934), 69]. From this, one can see that institutions in OIE are viewed from a holistic and historic standpoint, though not wholly culture-based, without neglecting the role of individual action, as Commons underlined, but through collective processes. Also, the evolution of institutions in OIE is based more on an evolutionary approach suggested by Veblen’s view of the Darwinian analogy. Here, habits play a crucial role, based on history and culture but stemming also from the biological nature of man as a ‘social animal’. Institutions are not simply built on some economizing device such as the reducing transaction costs rationale.

NIE’s perspective on institutions (such as firms, markets, and property rights) has been developed on the basis of transaction costs theory. There is always some ‘efficiency’ rationale behind the evolutionary process of institutions aimed at the reduction of these transaction costs. Initially North defines institutions as “a set of rules, compliance procedures, and moral and ethical behavioral norms, designated to constraint the behavior of individuals in the interests of maximizing the wealth or utility of principals” [North 1981, 202]. This definition underlines the contractual (written or unwritten) relationships or ‘terms of exchange’ between principals and agents.

This definition incorporates the traditional assumptions of neoclassical analysis of individuals maximizing utility, but they are subject to constraints that make possible human organization, thus limiting certain types of behavior. Otherwise, as North points out, “in the absence of constraints we exist in a Hobbesian jungle and civilization is impossible” [North 1981, 203].

The dynamics of the theory comes from the continuous tensions between the gains from specialization in economic activities and the increasing costs that arise from the same process of specialization. These increasing transaction costs include information costs, agency costs, costs of shirking and opportunism, costs arising from uncertainty, costs of measuring quality of the goods and quality of the output, costs of enforcement of property rights, costs of compliance and costs of detecting violations. All these costs are going to constantly redefine the rules of the game, which will generate changes of the structure through the political process. For this reason, North asserts that “economic history conceived as a theory of the evolution of constraints should not only explain past economic performance but also provide the modern social scientist with the evolving contextual framework within which to explain the current performance of the political-economic system” [North 1981, 209].

In a later work, North defines institutions as “rules of the game in a society” or “human devised constraints that shape human interaction” [North 1990, 3]. Institutions have to be integrated into economics and economic history in order to show how they
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shape the evolution of societies through time. The set of choices of an individual are defined and limited by these institutions. Therefore, institutions play the essential role of reducing uncertainty for individuals and society as well [North 1990, 4].

North distinguishes organizations from institutions, or equivalently, it becomes necessary to differentiate the rules from the players. Organizations are “groups of individuals bound by some common purpose to achieve objectives” [North 1981, 5] (i.e., political, social, economic, educational…). Institutions determine organizations, but at the same time, these organizations affect the evolution of institutions.

The inclusion of organizations in the analysis is an innovation in North’s work, compared with his former writings, and enriches his analysis on change and economic performance. However, North remains faithful to neoclassical analysis and methodological individualism when he asserts that his theory on institutions must “begin with the individual” as long as institutions are the creation of human beings. Hence, his unit of analysis is the individual except that in his theoretical framework, institutions impose pervasive restrictions on the choice set that individuals face. This methodological position, according to North, will be the unifying thread in his social science research.

In earlier works, North had embraced the neoclassical idea that competitive pressures would lead to the elimination of inefficient institutions. In his later writings, he contends that organizations, through their interaction with institutions, are going to tailor the process of institutional change. This feedback process is the explanation of why inefficient institutions – from an economic growth perspective – are able to remain through centuries. Hence, the reason for this problem is going to be found in the incentive structure generated by the institutions regarding the organizations and the feedback process that this implies for the changing opportunity set for individuals [North 1981, 7].

Looking at institutions as ‘rules of the game’, or ‘human devised constraints’, is simply a redefinition of the choice set of individuals under neoclassical utility maximization framework based on the rational choice vision. Whereas, the Veblenian idea of institutions is basically an evolutionary and social one, underlying habits of thought of individuals regarding their interaction within the community.

Moreover, Ayres also reveals a ‘social’ vision of institutions when he examines the relationships between technology and ‘ceremonial’ institutions. With respect to Commons, institutions are defined as collective action in control, liberation and expansion of individual action. For that reason, the ‘institutional’ individual in OIE and its unit of analysis (‘transactions’ in Commons’ view) is quite different from North’s, although they could arrive at similar conclusions. Also, as some authors have pointed out, institutions are not only constraints but also instruments of social change. 10

North builds on Coase’s transaction costs when he criticizes the neoclassical analysis of human cooperation based on perfectly defined property rights and a costless process of acquiring information. Based on a game theory approach with no-repeated games, if information is incomplete, following North’s analysis, it is necessary to look for a different theoretical explanation regarding the successful history of Western economies, where political and economic exchange has been so extended. In order to solve the free-rider problem posited by Olson (1965), North is forced to accept some additional behavioral assumptions that are going to improve the limitations of rational choice models: 1) institutions modify the price individuals pay for having ideas, ideologies, and dogmas; thus, ideology plays a crucial role in the decision-making process of individuals; and 2)
individuals process information from an environment through subjective perceptions of reality that affect their choices. For these reasons, institutions help reduce uncertainty for individuals; however, this does not necessarily mean that these institutions have to be efficient.

North develops his theory of institutions from the neoclassical theory of human behavior, but he also adds Coase’s theory of transaction costs. He claims that, in the real world, it is costly to transact because of the costliness of measurement (the value of an exchange to the partner with all the problems of moral hazard and adverse selection it could imply) and the fact that enforcement of contracts and property rights is also costly. North states that neoclassical theory takes enforcement for granted but, in reality, it can come from internal codes of conduct, from the social environment, or from the state itself [North 1990, 33].

According to North, important elements in transaction costs arise from informal and formal constraints, as well as the cost of enforcement. Here, North is going to pay more attention to the set of values he calls ‘informal constraints’. These constraints are determined by culture, and, in the Veblen-Ayres tradition, play an important role in determining human behavior and economic activity. North recognizes that “informal constraints are pervasive features of modern economies as well” [North 1990, 39], solving coordination problems and enforcing codes of conduct. Later on, North will emphasize how important they are in the evolution of institutions and path dependence.

With regard to the ‘formal constraints’, referring to political and judicial rules, economic rules, and contracts, North underlines their function in facilitating exchange and reducing transaction costs. On this topic, one could think of Commons’ approach when he proposed his categories of bargaining, managerial, and rationing transactions in order to analyze the ‘working rules’ of economic activity. In fact, some authors think that, in this area, there is common ground between North and earlier Institutionalists.11

Despite these points of contact, one has to recognize that the vision that OIE has of institutions is quite different from NIE’s. As Hodgson states, “once institutions have emerged on the basis of individual behaviors, they are seen simply as providing external constraints, conventions or openings to individuals who are taken as given. It is assumed that individuals’ actions lead to the formation of institutions, but institutions do not change individuals, other than supplying information or constraints. The possibility that individuals themselves may be shaped in some fundamental manner by social institutions is not considered” [Hodgson 1993, 8].

In sum, neoclassical economics tends to ignore institutions in its theoretical framework, although in the last decade it has tried to incorporate them from a game theoretical perspective. NIE, being located on the periphery of Neoclassical economics, has developed an important amount of work on institutions, but its vision on them remains different from OIE’s. To OIE, institutions are an historical and evolutionary outcome where rational man is a simplistic and misleading picture of human behavior and where markets are not an eternal feature of human society.

**Transaction Costs**

This theoretical tool is crucial to the NIE theory. For that reason, it is necessary to analyze it more deeply in this paper. Let’s start by establishing that neoclassical economics
had ignored this concept for a long time until Ronald Coase won the Nobel Prize. However, despite this fact, the only thing that mainstream economics recognizes from it as important is the “Coase Theorem”, and it is common knowledge that many graduate economics departments ignore the theory altogether in their courses. Transaction costs have become a key theoretical category in Coasean economics, because, without them, many aspects of the functioning of the economic system remain unexplained, including the emergence of the firm itself.

Transaction costs are the costs of using the price mechanism – that is to say, the cost of discovering trading partners, negotiating contracts, and monitoring performance. Dahlman (1979) suggests that transaction costs include search and information costs, bargaining and decision costs, and policing and enforcement costs. Usually, these costs will be registered, in a macro account framework as the income of police, security personnel, lawyers, brokers, clerks, managers, and entrepreneurs. Transaction costs stem from the fact, according to Coase’s insight, that the use of the price mechanisms is not costless [Medema 1994, 17]. Following Medema’s (1994) view, one can see that transactions and their costs play an important role in Coase’s economics, even though Commons was more explicit in taking the transaction as the basic unit of economic analysis through the concepts of bargaining, managerial and rationing transactions. Here, we can find a theoretical link between Commons’ institutional economics and Coasean economics.

From this point of departure, when one accepts the role of transaction costs in an economy, one begins to explain, according to Coase, the existence of certain economic institutions, as long as they have been created as mechanisms to reduce transaction costs in a society [Medema 1995, 165]. In the real world, it is not easy to measure transaction costs because they are embedded in the accounting process of any economic activity. However, Douglass North attempted to measure the “transaction sector” for the U.S. economy in order to explain the important role of these costs in a developed economy. The results were striking: the transaction sector of the US economy was approximately 46% of the GNP in 1970.

From a microeconomic perspective, Williamson builds on Coase’s definition of transaction costs (i.e., “the costs of running the economic system”) as being equivalent to ‘friction’ in physical terms. However, Williamson distinguishes between ex-ante transaction costs (e.g., drafting a document or contract, negotiating and safeguarding an agreement) and ex-post transaction costs (e.g., maladaptation costs, misalignments) [Williamson 1985, 21]. This idea of combining ex-ante and ex-post transaction costs reveals important differences between the traditional neoclassical industrial organization approach and the NIE view.

NIE’s approach leads us to place institutions at the center of the analysis, where the law and the economic role of government are going to be a decisive matter of analysis and inquiry somewhat far away from the neoclassical world of zero transaction costs. These issues are going to be points of divergence between Coasean analysis and mainstream economics. Also, the introduction of the transaction costs analysis is going to be a crucial contribution for understanding the economic, political, and social institutions in a modern society, strongly upgrading Common’s analysis of transactions even though, from a paradigmatic view, his analysis is closer to mainstream economics.
OIE does not ignore transaction costs in its analysis as different authors have underlined quoting Veblen’s famous work on *The Theory of Business Enterprise* [Knoedler 1995, 385]. However, the logic in using this tool has been different from that of NIE. In NIE, the rationale that guides the usage of the transaction costs approach has been the economizing principle. In OIE, the logic of reducing transaction costs among firms is based on pecuniary strategies more linked to the control of markets and enhancing the economic power of corporations [Knoedler 1995, 393].

North himself saw the necessity of going beyond the economizing principle in order to explain institutional change [North 1990, 86]. North clearly evolves beyond his initial works where he accepted the efficient neoclassical theory of institutions. Moreover, he proposes a bargaining approach to explain stability in a society, moving away from the mainstream thesis on the evolution of institutions. To a certain extent, North is now closer to Commons’ ideas on economic power based on the “limits of coercion” that define the set of possible outcomes between the parties involved in transacting.

Informal constraints are recognized by North also as an important source of institutional stability despite discontinuous changes caused by revolutions and radical changes in the formal rules, as social scientists have discovered in Eastern European economies after the withering of socialism. He recognizes, as the “old” Institutionalist did before, that “informal constraints […] have great survival tenacity because they still resolve basic exchange problems among the participants, be the social, political or economic” [North 1990, 91].

As a consequence, what determines, according to North, the path of institutional change? Basically, two forces: 1) increasing returns, where organizations acquire feedback about the continuous changes between them and institutions, learn by doing, and increase the profitability of their businesses; and 2) imperfect markets characterized by incomplete information, where transaction costs are important and the behavior of agents is affected by ideology and limited information. These two forces are going to determine what North calls ‘path dependence’ in order to define the limitations of the choice set that agents face through a process of link-decisions through time. As North points out, “path dependence means that history matters” [North 1990, 100].

The notion of “path dependence” has been carefully defined by Paul David as “a quite precise set of connotations […] that refers to a property of contingent, non-reversible dynamic processes, including a wide array of processes that can be properly be described as ‘evolutionary’” [David 2001, 15]. However, OIE’s idea of path dependence is developed from a Darwinian vision of the economy where the ‘path’ in which societies are ‘locked-in’ is not compared with an ideal one followed by Anglo-Saxon societies. To OIE economists, each path becomes a specific one. In that sense, from a policy-making perspective, the ‘solutions’ cannot be always to approximate these institutions toward some ‘ideal’ set. According to OIE, these policies should be developed from a perspective more inspired in a pragmatic (Dewey) theory of value.

To sum up, despite North’s attempts to break up with the economizing principle in transaction costs, it is clear that OIE approximates transaction costs from a different perspective, based more on the notion of economic power in the case of the firm. The core of NIE economists, except North, remain faithful to the rationale of the economizing principle in dealing with the transaction costs theory and applying it to different scenarios such as the firm, organizations, markets, and the law.
The Firm

The firm has been considered by NIE economists as one of the most important institutions of the modern world and they have devoted a lot of efforts to analyze it, to examine its evolution, and to theorize the governance structure within the firm itself. There are significant differences between neoclassical economics, OIE and NIE regarding this important theoretical element in economics. Neoclassical economics defines the firm on the basis of the production function, which at the same time is just a technology. Given input prices, the production function defines a cost function. Hence, technology is the main factor determining the size of the firm. Neoclassical economics ignores the governance structure within the firm as long as it considers that it could be explained through a replication of the market system.

NIE starts with a different approach. Coase underlines that economic theory has been characterized as an analysis of choice, but in this sense, “economics has no subject matter” [Coase 1988, 3]. The problem with this view, according to Coase, is that the entities, on which economic analysis is based, are empty, without substance. The consumer is reduced to a set of preferences, and the firm is just a production function with a technology behind it. Therefore, According to Coase, “we have consumers without humanity, firms without organization and even exchange without markets” [Coase 1988, 3]. Coase claims that economic theory needs to take a more realistic approach in which the firm, the market, and the law play a crucial role in the functioning of the economic system. For him, economic policy implies a choice among different social institutions that are created by the law or are supported by it [Coase 1988, 28].

In “The Nature of the Firm”, Coase points out that the economic system is coordinated by the price mechanism, but this does not mean that there is no planning by individuals within the firm. External to the firm, everything is coordinated through the price mechanisms but, within the firm, the market transactions are eliminated and substituted by the entrepreneur – coordinator. For Coase, “the distinguishing mark of the firm is the suppression of the price mechanism” [Coase 1988, 36]. For Coase, using the price mechanism is costly, and this fact is the basis for the creation of firms. By forming an organization under the command of some authority, some marketing costs are saved and a firm can be established.

Following Coase’s analysis, it is not enough to have uncertainty in the economic system to generate firms, as Knight asserted. Coase sees the firm as a system of relationships that become real when the command of the resources is under the direction of the entrepreneur. Thus, firms become larger as the entrepreneur organizes additional transactions. If the number of transactions organized becomes smaller, the firm will be smaller too [Coase 1988].

The size of the firm, according to Coase, is not just a problem related to the optimal output according to the cost curve. Coase recognizes that the entrepreneur function is subject to decreasing returns where the cost of organizing an extra transaction within the firm comes to a point where it is equal to the cost involved in performing the transactions in the open market or the costs of organizing such an extra transaction by another firm. But he also underlines the fact that as long as the organized transactions of the firm increase, the likelihood of the entrepreneur making wrong decisions increases as well.
Finally, the supply price of many factors of production could rise for a firm that becomes larger, thus losing the advantage of being ‘small’. According to this approach, the size of a firm is defined by the threshold consisting of the point where the costs of organizing certain transactions within the firm may be greater than the costs of carrying out the transactions in the market [Coase 1988, 43]. Coase considers incorrect the argument that the reason for the existence of firms is the division of labor because the price mechanism takes care of the problem of specialization.

Similarly, according to Eggertsson (1990), the ownership structure of firms will depend on the structure of property rights, incentives, and technological characteristics of the production function. This production function can be defined as:

\[
Q = F(R) \quad (L, K, M, C, T)
\]

Where, 
- \( Q \) = output
- \( M \) = material inputs
- \( L \) = labor
- \( T \) = vector representing technology
- \( K \) = capital
- \( C \) = set of external rules of the game from which \( T \) is chosen

\( F_R \) is a production function (from a set \( F \)) that corresponds to a specific property rights structure. \( R \) is going to depend on legal restrictions, penalties for behavior, state enforcement, contract arrangements, and mores. The external rules of the game delimit \( C \) from which a defined technology \( T \) is chosen.

As one can see, the NIE’s production function – following Eggertsson – is more complex because the traditional neoclassical ones are better suited to handle chemical and engineering processes as compared with those more based on human interaction with agency relationships. Eggertsson compares the case of open corporations with shareholders of a closed corporation, mutuals and nonprofit organizations. In the open one, the separation of shareholders from managers creates agency problems that are solved through capital market competition in the case of shareholders; and by the market for managers, where constraints are imposed on the opportunistic behavior of the managers; market competition allows the lowering of agency costs. In the case of a closed corporation, contradictions among shareholders are not easily solved with high transaction costs. Usually, its managers are personally connected with some of the shareholders, generating high transaction costs. Mutuals and non-profit organizations face agency problems and shirking between managers and owners. The case of ‘political firms’ (state-owned firms) is also analyzed where according to Eggertsson, evidence shows lower productivity compared with private ones, but where their existence is explained for political reasons such as a taste for these kinds of firms, information costs disadvantages not available to voters, or mechanisms for wealth distributions or guarantee of employment to some groups [Eggertsson 1990, 152].

Williamson (1985) has been elaborating, since the 1970s, a more developed NIE theoretical framework for the firm. Using Frank Knight’s idea about ‘diminishing returns to management’ and quoting Coase’s famous question, “Why is not all production carried on in one big firm?” [Coase 1988, 133], Williamson develops former ideas based on his previous works on Markets and Hierarchies. He shows that any sort of production requires a governance structure within the firm where contractual relations arise between the owners of the firm, labor, suppliers, and buyers of the final product. This governance
structure economizes transaction costs on the one hand but, on the other, it also generates some losses. The equilibrium between these two processes will determine the size of the firm. Then, Williamson defines two kinds of technologies in the production processes: general-purpose technology, and special-purpose technology. The later corresponds to those technologies that require greater investments in specific durable assets. The former refers to products less standardized than the second. Thus, in order for a firm to be able to adopt this sort of technology, it would require a more complex set of contracts with safeguards and credible commitments from both suppliers and buyers. This would be necessary in order to protect the investments that special purpose technology requires. Based on this, Williamson explores different sorts of governance structures characterized by private ordering of disputes, credible commitments, the hostage model of contracting, engaging of the supplier, franchising techniques and so on.

In the case of OIE, it is known that an adequate and developed theory of the firm based on the work of Veblen and Commons has not been built. However, these two authors left methodological and theoretical indications in order to build an evolutionary theory of the firm [Hodgson 1999, 219]. Starting with the early writings of Veblen in his *Theory of Business Enterprise*, Commons’s powerful analysis of transactions (managerial, rationing, and bargaining transactions), and based on the ‘going concerns’ as units of economic activity, OIE has initiated an analysis of the firm from a methodological point of view at odds with NIE’s [Hodgson 1999, 218].

A posterior development in OIE came with the works of John R. Munkirs, an economist, in his own words, “rooted in America’s institutionalism”[Munkirs 1985, ix]. Building on Adolph Berle’s ideas about corporations as ‘quasipolitical institutions’, Munkirs updated Institutionalist views on American capitalism, seeing corporations as a structured totality of technology, mass production, distribution, and corporate concentration of power [Munkirs 1985, 42].

The notion of Centralized Private Sector Planning (CPSP) is crucial in Munkirs’ analysis. He asserted that the CPSP “may be viewed as a process whereby the production and distribution activities of the economy’s key corporations and industries are organized and coordinated so as to bind these corporations and industries together into a functionally integrated production and distribution system” [Munkirs 1985, 60].

Later, William Dugger (1980) studied in detail the dynamics within the corporate enterprise as an expression of corporate power. He starts paying attention to the study of corporate bureaucracy embedded in a pecuniary culture, despite its technocratic orientation [Dugger 1980]. The organizational evolution of the business enterprise has been characterized by shifts towards decentralization and diversification. However, Dugger claims that “US enterprises are becoming more top-heavy, even though some decentralization and de-diversification are taking place” [Dugger 1985b, 409]. The recent mergers and acquisitions during the 90s are just another sample of the same process.

From a leftwing radical perspective, Palermo (2000) states that Williamson’s analysis cannot separate the issue of economic power from the efficiency principle. Even though Williamson recognizes that power matters when contracting conditions are problematic, Palermo claims that with Williamson’s approach “it is not suitable to sustain either normative prescriptions or historical interpretations of the institutions of capitalism” [Palermo 2000, 585]. Palermo proposes a research program where economic power is a pervasive element within the firm and within the market, not being incompatible with the
theory of the firm and being harmonized with a class analysis. Original Institutionalists would agree with Palermo’s insights on the limitations of Williamson’s NIE, but they will be reluctant to give such weight to any class analysis. As Klein (1992) pointed out, “Institutionalists rarely focused explicitly on class in analyzing modern market-oriented economies” [Klein 1992, 543].

Williamson’s approach represents a step forward in analyzing the organizational complexities within the firm and a good development in applying transaction costs theory. However, there is a risk in ignoring some Veblenian insights on the variety of pecuniary strategies of the firms throughout modern business history as Janet Knoedler (1995) pointed out. Last but not least, governance structures within the firm surely cannot be isolated from the realities of economic power. Hierarchies are not just a choice under bounded rationality and opportunism, they also stem from the social and political structure of a society that are translated into wealth and power inequalities.

The State

As Olson (1965) correctly pointed out a long time ago, neoclassical economics did not have a theory of the State. It reduces it to some aspect of fiscal policies and taxation, aiming basically to determine which public services should be managed by the State. Lately, state activities have been analyzed through the theory of Public Goods. As Olson posited, neoclassical economists “had a comprehensive theory which explained why most economic needs should be met by private enterprise; so it is natural to ask for a systematic explanation of the exceptional class of functions they thought should be fulfilled by the state […]]. Even in this century, Pigou, in his classic treatise on public finance, gave collective goods for the most part only implicit treatment” [Olson 1965, 102]. Later on, rational choice theorists would supply Neoclassical economics with a theory of the State. In NIE, it is well recognized that the absence of a theory of the State implies many flaws in its historical analysis of institutions. Eggerston considers a positive theory of the State to be crucial to NIE. In the end, enforcement of property rights depends on power, and the state is able to have economies of scale in the use of violence [Eggerston 1990, 61]. In this approach, rulers are trapped in an agency problem. Hence, there is no guarantee that the structure of property rights defined by the State is necessarily consistent with rapid economic growth. Political institutions are more stable than the rational-choice theorists assumed. Despite the results of Arrow’s impossibility theorem, in the real world, political institutional arrangements are more stable because they are based on economic power and are designed to foster cooperation among decision-makers. Ideology also plays an important role, and following North, Eggertsson accepts that the stock of social values is a form of capital. Without supporting ideology, the costs of enforcement of property rights and monitoring citizen’s activities become extremely high. Eggertsson does not discard the rational choice approach but he seems to find it deficient in explaining the stability of political institutions.

Based on North’s work, Eggertsson delineates some elements of a NIE Theory of the State. In a society, the stock of knowledge and the endowment of resources define the technical upper limits for productivity and output. Then, according to the community’s political structure, a system of property rights is defined. This fact at the same time generates a feasible set of organizations. Those who minimize transaction costs and
maximize output determine the structural production frontier. Some political systems create incentives that bring the structural production frontier close to the technological frontier. Through a process of political change, it is possible to foster this process of approximation, and to undertake a cost-benefit evaluation of the reforms in which the costs of political change have to be included.

According to North, historical evidence seems to corroborate the proposition that states usually do not supply structures of property rights suitable to economic growth due to ‘failures of organization’. Egbertsson claims that North’s theory of the State is some sort of duality. On the one hand, the State is the classic Hobbesian predator but, and on the other, Egbertsson recognizes the productive and positive side of the government.

Egbertsson states that the joint effects of information asymmetries and the role of transaction costs, added to struggles over distribution of wealth, generate a propensity of states to create a structure of property rights that is inconsistent with economic prosperity. To illustrate this thesis, he analyzes the case of countries in tropical Africa and the agency problems in Soviet type economies. The case of public finance and property rights in early modern Europe is also presented. In sum, according to Eggerston, the stock of institutional changes in a society through obsolescence and new investments generates marginal changes. A credible commitment by the State to stable property rights helps in promoting investments and lowers the transaction costs. Eggertsson recognizes that NIE still needs to develop a theory of the State, even though he presents some important insights.

North (1981) recognizes the powerful analysis that neoclassical economics has built based on the work done by Baumol, Buchanan, Tullock and Downs, where a theory of choice has given an acceptable approach to the study of the State. North recalls that two general types of explanations for the State exist: 1) the contract approach (Rousseau); and 2) the predatory or exploitation theory (Hobbes, and Marx). However, these two strands are not able to explain why there has been a tendency for states to generate inefficient property rights on the one hand, while on the other, having some sort of instability that in the end leads to economic change and economic decline [North 1981, 23].

In order to solve this puzzle, North proposes the following model for the State:

1) There is a wealth or utility maximizer ruler by which the State trades services (protection and justice) for revenues (taxes). The State behaves as a discriminating monopoly, devising specific sets of property rights for each set of constituents in such a way that the State is able to maximize the ruler’s revenue. There are opportunity costs for the members of this society that constrain the behavior of the State because of potential rivals to the ruler within the same society or external to it.

2) The State provides the rules of the game with the aim of specifying the rules of competition and cooperation while reducing the transaction costs in order to maximize output or wealth.

3) There are continuous tensions between the ownership structure that maximizes income for the ruler and ‘efficient’ property rights that reduce transaction costs and promote growth [North 1985, 25].

According to North, the ruler is not omnipotent. He/she has two basic constraints: first, he/she must avoid offending powerful constituents (competitive constraint); second, there is a transaction-costs constraint where by the collection of revenues is affected by the
structure of property rights. However, in order to explain the possibility of collective action
North parts company with neoclassical analysis regarding the free-rider problem. For this
reason, North recognizes the need of a theory of transaction costs and a theory of ideology.
He borrows from Coase the theory of transaction costs. The necessity of a theory of
ideology arises from the contradiction that the State faces. On the one hand, the State
specifies rules that maximize the income of the ruler and his group. On the other, the State
needs to devise rules that lower transaction costs to enhance growth. To achieve this, it is
necessary to have a set of ideological convictions that constrain individual behavior.
Otherwise, the transaction costs of compliance, monitoring and enforcement will be very
high. Thus, ideology plays a central role, making the contractual relations between the
ruler and the constituencies legitimate [North 1981, 44].

Throughout history, one can observe the actions of large groups that could not
possibly have appeared under the logic of the free-rider approach. For that reason, North
maintains that the neoclassical theory of the State neglects the important role of ideology.
Ideology becomes an economizing device to simplify the decision-making process, being
very linked to moral and ethical judgments. Ideology is modified when individuals find
that their experiences do not match their ideology. The stronger the ideology in an
economic system, the lower the costs of maintaining the present structure.

Based on this vision, North proposes that changes in economic history do not occur
only because of changes in relative prices, as the neoclassical model assumed, but also
because of changes of ideologies that drive individuals and groups to act against a given
structure regarding their vision of the fairness of the situation they endure [North 1981,
58]. Throughout North’s work, one can see a dual position. In some cases, the State is seen
as the necessary third-party enforcer that lowers transaction costs and guarantees property
rights. In others, the State is a source of insecurity and a factor in increasing transaction
costs.

OIE finds this analysis of the State very weak, insofar as it does not deal with the
concept of economic power as a result of a complex interrelationship between the polity
and the economy. They claim that this interaction between the polity and the economy is
also based on a social belief-system where the role of government in enhancing the life
process is guided by the evolutionary process by which a society endeavors to build values
internally. The State is not just a third-party enforcer among agents or in a principal-agent
framework. This view of the State leads us to better understand the differences between
OIE and NIE scholars. The latter have more favorable views of markets and a more
negative view of the government [Rutheford 1994, 162]. However, this does not mean that
OIE economists are more interventionists than NIE economists. OIE economists would
claim that it is necessary to examine the role of the government in enhancing the life
process, whereby the government would not only pay attention to the allocation of
resources through market mechanisms but also to the deployment of resources to achieve
those ‘collective oughts’ [Klein 1994b, 200].

Conclusions

I have reviewed the crucial discrepancies that show clearly that even though a
dialogue between OIE and NIE can be fruitful, it must also be balanced, with both the
similarities and contradictions between these two approaches spelled out. The fruits of this
dialogue are very beneficial to both schools of thought, but it is very unlikely to generate integration. The reasons are straightforward. OIE has been built from a heterodox paradigmatic view that is at variance with NIE. In my opinion, NIE remains today still on the periphery of the neoclassical paradigm.

I have attempted to show the significant differences, despite some complementarities, between OIE and NIE regarding methodology, conception of institutions, transaction costs, the firm and the theory of the State. In all of these, even though there are some complementarities with respect to the criticism of neoclassical economics, I am afraid that the divide is still greater than the possible bridges. Moreover, from a policy perspective, both strands of institutional economics end up with quite different sets of recommendations.

NIE economists do not look forward to a dialogue with OIE economists. Eggertsson stated that “[his] working rule was to limit the study to contributions that did not alter the core of economic approach, particularly the rational-choice model, and to seek a new synthesis of neoclassical and institutional economics […] Neoinstitutional Economics is the term [he uses]” [Eggertsson 1990, xii]. If we recall Coase’s words regarding the change in economics that is necessary in order to incorporate the analysis of institutions, he asserts that “this change will not come about, in [his] view, as a result of a frontal assault on mainstream economics. It will come as a result of economists research on branches or subsections of economics adopting a different approach, as indeed is already happening” [Coase 1998, 73-74].

From a methodological standpoint, the only possibility that NIE could move to some positions closer to OIE would be based on a reassessment of NIE’s ontology and epistemology. As Hutchison underlines, “if, therefore, in the new institutional economics, the high level of abstraction, which limits so much of modern microeconomics, is to be reduced, then the need for a considerable shift away from the primarily deductive method of much of classical and neoclassical theory, towards more empirical, historical and institutional methods, will have to be undertaken” [Hutchison 1984, 42].

For OIE, important tasks also need to be undertaken. OIE, based on Veblen’s insights on evolutionary processes, should take a closer look at evolutionary theory, without discarding the usage of empirical and econometric techniques [Hodgson 1993, 22]. OIE must also develop a better theory of individual and collective agency, based on its Veblenian traditions but incorporating the state of the arts of current biology, physiology and Dewey’s psychology.

Moreover, the relation between Nature and Nurture (biology and culture or society) regarding the conditioning of human behavior should be approached from a creative perspective without conflating agency with culture. This theoretical development would be necessary to allow OIE to part company with the hermeneutic or ‘culturalist’ tradition that is still predominant among its own rank and file members. Only in this way, could these two different approach on institutions from distinct paradigmatic views, produce and nurture new perspectives on what Institutional economics is all about.

Notes
1. I prefer using the term ‘Original’ instead of ‘Old’ in order to avoid prejudices about an ‘out of fashion institutionalism’ and a ‘new’ or ‘modern’ one.
2. Here, I am not going to include the Austrian thought represented by Hayek as belonging to NIE because doing so would expand the scope of the inquiry unnecessarily. Austrian
economics, in my opinion remains very close to mainstream economics despite its differences with neoclassical economics.

3. Evolutionary economics in the sense of a Darwinian perspective on economy and society as Veblen (1898) posited in “Why is economics not an evolutionary science?” This vision has nothing to do with Spencer’s idea of survival of the fittest.

4. See Klein (1994a), where he analyzes the demand theory and the impact of changing tastes. Also, Paul D. Bush (1989) tried to formalize models to represent mathematically the theory of instrumental value. Moreover, there seems to have been a change in the last issues of the Journal of Economic Issues where we can see more papers based on some econometric research. The problem regarding this matter, in my opinion, has been the predominant ‘culturalist’ or hermeneutic influence in OIE that implies a usage of research techniques more closely linked to this social science paradigm. But it is fair to recognize that this is not the case of all OIE economists who have been incorporating other methods. See, for example, Williams, W. et al (2002).

5. I recall here Commons’ notion of institutions that involve specific relations or ‘transactions’ among individuals or groups of individuals embedded in a specific hierarchy. Commons was also very well aware of the importance of Dewey’s Social Psychology in attempting to grasp a theory of agency [Commons 1990 (1934)].

6. One must recognize, however, that a complete theory of agency and structures must be rebuilt within OIE in order to part company with the hermeneutic paradigm. This theoretical development should be based more on the Darwinian tradition that Veblen supported and it should take into account all the modern developments in biology, physiology, and psychology regarding individual and social human behavior.

7. It must be clarified of course that pragmatist Methodology has nothing to do with logical empiricism or logical positivism.

8. This dichotomy is explained by C.E. Ayres who states that “what happens to any society is determined jointly by the forward urging of its technology and the backward pressure of the ceremonial system” [Ayres 1962 (1944), ix].

9. This is a very simplistic version of the idea. Very complex matters remains to be developed within OIE such as the role of technology in institutional change in order to avoid technological determinism, and a more developed theory of individual agency based on the Darwinian Veblenian tradition regarding the role of instincts, habits, and behaviors.


12. A review of the well-known and widely used textbooks of Varian (who ignores transaction costs all together) and Mass-Collel, Winston and Green (just one page) reveals this problem.


16. This can be seen in Williamson’s work about the theory of the firm and also in Eggerston’s views when he analyses the evolution of property rights as well as in earlier works of North.

17. A good example of these policies were the contributions of many Institutional economists to the creation of successful social policies after the Great Depression and World War Two regarding social security programs, unemployment compensations and others.

18. In Coase’s language, these ‘marketing’ costs are basically the costs of using the price mechanism. The concept has nothing to do with the usual marketing cost of a product.

19. This theorem stated that under certain assumptions about people's preferences between options, it is always impossible to find a voting rule under which one option emerges as the most preferred.
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ISBN: 0333775759

ISBN: 0765606321

ISBN: 1840640073