INSTITUTIONALISM AND EMPIRICISM IN ECONOMICS

By FRANK H. KNIGHT
University of Chicago

First, a plea to auditors or eventual readers disposed to be critical: Remember that my real title must be, "A Few Brief and Hasty Observations Suggested by the Topic Printed in the Program."

The word institutionalism recalls a movement in economic thought in this country that was active from a little before World War I until it was largely drowned by discussion of the depression, or perhaps boom and depression, and especially by the literature of the Keynesian revolution. It included three or four main branches, one of which was statistical economics—the obvious connotation of empiricism, and quite remote from any ordinary meaning of institution. And there were other "isms" more or less descriptively called "institutional" or "empirical." An explicitly practical approach, via discussion of social problems, was also prominent, though the name welfare economics is of later vintage. In fact, what the various protagonists had in common was antipathy to orthodoxy or classicism or theory or whatever cuss-word might be preferred to designate the abstract mechanics of utility, markets, and prices which had formed the primary content of the standard introductory course in economics.

Now, theorizing is a fancy some lean to and others hate. Or more commonly, perhaps, men like their own and abhor or reject that of others—often with a fanfare of being antitheoretical when they are notoriously likely to be most theoretical of all. Or again, they like to be original or interesting and hence "recognized" and more in demand. The psychology of believing and of controversy is at least as important as truth, and tends more and more to predominate over the latter interest, in my own thinking. Anyway, my task here is neither to bury theory nor to praise it, but to try to sketch the relationships between certain points of view that have been proposed for the study of economics. My only prejudice is—parodying what E. B. Wilson once said of mathematics in social science—that if we have theory, it should be correct; and I am sure that we shall always have it with us. (Like the poor, and partly for that reason.) However, I must say that looking at the history and at the present state and prospects of economic thought and of economic policy raises doubts as to how important correct theory actually is. But still I think it somehow ought to be correct, and that the difference might be practically significant.

Let me say, too, that I am not interested, or am negatively interested, in the jurisdictional dispute aspect of the question. I shall contend rather than argue, in view of time limits, that the proper relationship between different approaches is one of complementarity rather than of competition or substitution—using the jargon of consumption theory itself, which fits here. It is not either this or that or the other, but all of them, each in its proper place and proportion—like economic choices themselves. There is a place for abstract price theory, but it is a limited place. As a theorist, I feel as much annoyance at the attackers for not adequately stating these limitations, in their enthusiasm for demolition, as I do for their uncomprehending denunciation. The need in methodology is for a workably clear analysis of the problems and appropriate lines of effort at their solution—the functions of economists in the inclusive sense. Moreover, economics cannot be sharply demarcated from other social and human sciences, or even from the natural sciences, which impinge in manifold ways on the study of man and of human problems.

The appropriate starting point for economists in such a job analysis seems to me to be the notion of economy or economizing—making resources or means go as far as possible—following one *Oxford Dictionary* definition. It is noteworthy that this general meaning has been attached to the word quite recently, and the idea in any clarity is distinctive of modern thought. Still further, there is a hoary and deep-seated prejudice against the economic interest, which leads to gross misunderstanding—cf. the words stingy and materialistic. Economy applies to the use of any means to the achievement of any end or group of ends, whatever means are available, and whatever ends are actually pursued, idealistic or selfish, in good taste or bad; the means and ends are taken as given. The main qualification, an essential one, is that economics does not deal with technology or techniques, which are also taken as given, but with the apportioning and proportioning aspects of choices, where a plurality of ends are in view and a plurality of resources used. In the problem situation of any individual (including any group which in fact acts as a unit) there is a general principle of correct economy; it is that the total result is maximized by an apportionment which equalizes increments of result for equal increments of any resource. It is an a priori truth, and all general economic dicta are applications under different circumstances. Motives or desires are treated as forces, and the general result is a position of equilibrium. Such a mechanistic view of conduct is subject to sweeping qualifications—which form the basis, such basis as there is, for the attacks upon theory.

However, the whole theory of individual economic behavior is intro-

ductory—a preliminary to economics as a social science, which deals with economic organization. In the apportioning and proportioning decisions of a modern economy the ordinary individual plays a quite limited and indirect role. To a much greater extent, they are made by enterprises (individual entrepreneurs or firms), but in the main they result from the interaction of choices in a complicated network of markets. And economics is primarily a study of the system of markets. This in turn centers around a notion of general or simultaneous equilibrium—and of how far and why it is achieved or approximated or fails to be. And always in the background, if not in the foreground, are the practical questions of how far this is a good thing or of what to do about it when the result seems to be subject to improvement. The action in question is chiefly through political measures, presumably under a democratic system of law making and enforcement. We may note in passing that the market economy is far too much criticized because it "doesn't work" in accord with the abstract theory; the theoretical ideal (or model), miscalled "perfect competition," since there is no implication of rivalry, would be quite intolerable. Even at the level of individual choice it would be highly irrational to behave in close accord with the principle of economic rationality, a serious endeavor to maximize a satisfaction function. Competition in the proper psychological meaning is only one of many irrational motives which have both a real and a proper place in individual behavior in markets—not to mention errors of manifold kinds which are inevitably committed. But in varying degree, motives which are not realistically economic can be forced into that mode of description.

Even a Crusoe would not be (and ought not to be) economically rational. But the notion of equilibrium of a market economy is subject to much more sweeping limitations—or at least they are much more obvious. Descriptively speaking (ignoring value judgments), human responses bear no simple quantitative functional relation to their conditions as stimuli. They are subject to (unpredictable) delay, and to arbitrary or capricious variations in the preference functions which causal analysis must take as data, and many of the important conditions cannot be observed, still less measured. There may be thresholds which analysis can and should take into account (as Mr. Boulding's paper suggests), but I think not often. The main limitation lies in the nature and function of mind, which is to anticipate and project. Even consumers' wants and choices are in a large measure anticipatory and hence subject to error. For the entrepreneur, making productive decisions, it would be suicide to respond to the momentary price situation; he must adapt his policies to future conditions, more or less accurately forecast, even when "no change" is the best prediction he

can make. Thus he will take account of the apparent direction and velocity of changes in his pilot variables and beyond these of underlying causes and of ideal or normal values, as well as their actual levels. And he himself will have motives other than the desire to maximize the present worth of a future stream of pecuniary profit.

Worst of all, the future situation of any entrepreneur will depend on the predictions and decisions being made by others, extending more or less over the economy, even the world. But mutual prediction and action in accord with prediction are self-contradictory; hence individual decisions cannot be highly rational, not to say accurate, but must include an element of strategy. The parallelism with forces in equilibrium with the method of simultaneous equations is at best an analogy, serving for schematization, and must be used with great caution. A force has to be balanced by a resistance—in mechanics inertia or friction; this relation should be worked through and the concept of frictionless conditions much less carelessly employed, as it often points in quite the wrong direction. But such details, though essential, cannot be followed up here. Nor can the qualities of other analogies, including mechanical governors, the animal body, and others suggested by Mr. Boulding, which I also have used for expository purposes. New and unfamiliar terms, Greek derivatives in place of Latin, like homeostasis and cybernetics, seem to me to serve chiefly the purpose of attracting attention, to *épater le bourgeois,* and to give the profession something to talk about for a time. Closer analogies could be constructed by starting from the distribution of a flow, such as water or electric current, among a plurality of channels; but these would have to be modified in essential respects to fit the basic economic principles of diminishing utility and productivity. We must remember it is all a problem of exposition, and a balance or imbalance of forces making for change in opposite directions is clearly the essential fact.

The final problems of economics, as of any social science or any science, center in two things and the relations between them: first, to understand or explain some set of phenomena; and second, to use knowledge for the guidance of action. Thus we raise the question of the similarity or contrast between social and natural science. Only one main point can be noted here, and it has already been suggested in noting the impossibility of acting on the basis of mutual prediction. (And mutual control is a more palpable contradiction.) If economists were the hirelings of an absolute dictator, their task would be partly and abstractly analogous to that of science as the basis of technology. Only partly and abstractly, even then; for control of human beings must take account of the fact that they do have minds—opinion

and will—as mere physical objects supposedly do not. Hence their manipulation is largely a matter of coercion or persuasion and deception (really forms of coercion) which have no application to the purposive relations of men to physical objects. In a democracy, by contrast, the government is not really a ruler but an intermediary mechanism of group self-control. Consequently, the task of the social scientist in relation to practice is that of an expert and impartial counselor in the making of rules to govern associative life, by those who are to live under the rules. It bears little relation to the problem of prediction in terms of natural causality, for the purpose of interference from without and purposive redirection of the course of events. To be sure, the physical scientist is also a part of the physical universe; but he makes relatively little use of physics in deciding upon a course of action, even in designing an experiment (insofar as he can predict the result it is not an experiment); and much less in, say, a card game, a tea party, or his own market behavior.

The economist is up against special difficulties as soon as he ceases to take his individuals as given, specifically their wants, resources, and technology, and attempts to account for these data. He is up against history, and that is very largely a different sort of problem. And the "very largely" adds to the complication. For the given conditions at any time are in part the result of previous conduct of individuals which more or less fits the concept of effectively using given means to achieve given ends, but only in a limited degree, and no clear line can be drawn. Economizing is less a distinct sector of conduct than it is an aspect of most conduct, more or less the relevant aspect, depending on what one is trying to do. The same items of behavior are typically amenable to interpretation in quite different conceptual frames of reference. The problem of method here is that of the division of intellectual labor, and it clearly has no satisfactory solution. Specialization cannot practically be carried nearly as far as in the case of physical and biological science.

What needs to be said here is that the original purpose of economics on the classical price-theory line was educational or, one might say, propagandist. It was to show that free co-operation of individuals as consumers and producers, under the guidance of prices fixed by free purchase and sale in markets, is a way, and within wide limits a better way, than tradition and authority, to organize the efficient use of resources to achieve the freely chosen ends of individuals. (The philosophical assumption that this is the general end of economic society cannot be examined here.) For this purpose it does not matter what particular wants the individuals have or what concrete resources they

possess or what technical processes are known and available. Taking freedom as a fact and as the norm of policy makes these things irrelevant. The purpose of explaining that this comes about, and how, is not less important now than it was in 1776 or at any time in the past. But as the open market organization came into more unrestricted prevalence, unquestioned and even intolerable weaknesses developed; and discovery of the reasons for these and of suitable remedial action became important and then imperative. The matter of suitable action—separating evils reasonably attributable to the economic order from those which belong to the lot of man on earth—is of course more acute now than ever. For these purposes, price theory is in general fairly adequate, at least in the earlier stages of inquiry, without supplementing by other approaches. Institutionalism and the rest are therefore to be viewed as independent studies of the same broad subject matter from the standpoint of different objectives. And the task of methodology is to show what are these other points of view and the corresponding modes of attack. For the most part, they center in the area already suggested, accounting for the wants, resources, and technology which price theory takes as given. Only a few very general observations can be offered here.

I take up empiricism first, because what I have to say can be quite brief. To begin with the aspect of relation to policy, there is nothing it would seem possible to argue about; and in that of explanation, contributing to the understanding of economic phenomena, all that can be done is to indicate the character of a possible treatise. As to policy: As soon as any line of public action is decided on or even is chosen as worth investigating, the need for quantitative data to show the amount of effect to be expected from any amount of interference of a given sort is too obvious to need discussion before an audience of economists. In many cases, however, if not in most, such quantification will involve causal analysis, the inductive separation of different antecedent elements that can be acted upon, and perhaps also correlation of such elements with different elements in a composite effect. The study would call for co-ordination of abstract qualitative analysis with the use of statistical data to reduce the relation to quantitative terms.

Secondly, as to explanation. The sort of analysis just described involves a sort of explanation, the sort which Mill referred to as finding empirical laws, in contrast with causation proper, but which positivists hold to be the only possible type. Critical discussion of the positivist theory of knowledge is out of the question here, but two limitations are obvious. First, the field of investigation to be called "economic" must be defined in some other way. For one cannot tell empirically, by look-

ing at any act, whether it is economic or not; that depends on the intention and how far this is realized up to limits set by the means under command. In fact there are usually preferences in the use of means, also; and the distinction between means and ends is very loosely used. And then, any discussion of policy involves norms beyond subjective individual preferences. A social problem arises out of conflicts of private ends, and some objective comparison is obviously necessary to any adjudication. (This is said in awareness of the common view that interpersonal comparisons are unnecessary for the serious treatment of "welfare.")

The treatment of institutionalism, distinguished from quantitative empiricism, raises vast and difficult problems. As already observed, when we face the task of explaining the "givens" of the first stage of theorizing, we are in the field of history and must deal with behavior forms and social processes that are much less tractable intellectually than are market data or even utility comparisons. In particular, again to repeat, not much is explained by individual acts motivated by the maximizing principle. History is in large part more fruitfully considered in terms of culture patterns or institutions and their changes, or of individual acts motivated by rivalry, conformity and distinction, craving for victory, success, fame, creative self-expression, the crusading spirit—ends which do not realistically fit the formula of balancing marginal utilities. Now the term "institution" has two meanings, though, as usual, they widely and variously overlap. One type is called "crescive" (Sumner and Keller), since they "just grow," Topsy-fashion; they may be said to created by the "invisible hand." The extreme example is language, in the growth and changes of which deliberate action hardly figures; nor is there much serious effort to do anything about it. It is the fundamental institution, and law is in varying (and disputed) degree of the same kind. The other type is of course the deliberately made, of which our Federal Reserve System and this Association itself are examples. With age, the second type tends to approximate the first.

Accordingly, there are two main branches of institutionalism, properly so called. Of the first, German "historicism" is more or less the ideal type. In the American movement, it is best—but not very well—represented by Veblen, who is venerated, or damned, as the father of the institutionalist gospel. A variant is the legal economics of John R. Commons, in one phase of his work, and of Walton Hamilton and others. It would seem to be the special task of economic (or legal-economic) historians, in the interpretive side of their work; perhaps historical economics can be distinguished from economic history.

Marxism and the stage theories are especially in point. The great mystery, to me, is the relation between history as explanation and history as a problem, the thing to be explained. We do get a sense of understanding a situation by tracing its continuous development from some past beginning—which has to be rather arbitrarily chosen. Regarding Veblen, I must say—or "confess," from the standpoint of his admirers—that if he has any intelligible theory of history or specifically economic-institutional history, I cannot find it in his writings. I do not even see the meaning of cumulative change. His insistence on Darwinism as the pattern for all social science would imply a biological struggle for existence as the selective agent, and I cannot think that that carries us far in the interpretation of institutional change. Language would again be a leading case in point. To a limited degree it might apply to technological advance—disregarding much that can hardly be disregarded. The Marxist economic (or materialistic?) interpretation reduces to much the same thing. The idea of selective survival seems abstractly plausible (spontaneous variation much less so), but we surely have to look beyond biological elimination for the main selective principle. As to Veblen, the theory seems inconsistent with his diatribes against any "meliorative trend" and insistence upon colorless mechanism. But he inveighed in terms quite as sarcastic against a static or mechanistic view of human nature—his interpretation of hedonism and of classical economics. And he himself seems more concerned with "inveighing against" than with colorless description. The relations between history (or even evolution) and science as treating of the repetitive aspect of phenomena should also be mentioned as a subject for another treatise.

The second branch of institutionalism proper, as corresponding to the "made" type of institution, is represented by the later work of Commons. He called his main idea the collective control of individual behavior through working rules. He made long and careful firsthand study of certain examples of such institution building, primarily labor organizations and the law-making activities of the courts, culminating in the decisions of the U. S. Supreme Court. His scientific interest centered in reasonable value, decreed by authoritative or forcible action, in contrast with prices fixed in the open competitive market. Such action presupposes monopoly, either natural or contrived, particularly the collusive action of groups of wage earners. Commons was not concerned with the broad social effects of such action, especially with results of price fixing under general consumer and producer freedom—which must obviously result in either shortage or surplus. In fact, he shared the popular "prejudice" exaggerating the extent and social cost

of business monopoly and the general ineffectiveness of market competition, though he rather deprecated such violent and sweeping condemnation of classical economics or of capitalism as formed Veblen's most conspicuous interest. In his book, *Institutional Economics* (1934), he discussed at some length the relation between Veblen's position and his own. While cordially praising Veblen's work and frankly recognizing the large common ground between the latter and his own, he was critical of Veblen's methodological concepts. He says that according to Veblen's definition of science, in terms of the tests of validity embodied in modern technology, "there is no science of human nature," for in the human sciences, "the subject-matter itself is a pragmatic being, always looking to the future and therefore motivated by purposes."

In conclusion, let us glance at the philosophical root of the methodological controversies which are so characteristic of the social sciences, in contrast with those dealing with nature. In fact, they are hardly sciences, in the restricted sense which the word increasingly takes on, under the influence of natural science prestige and of positive, or pragmatic, philosophy. (The two are radically different, and their confusion is a major source of fallacy in the controversies over method in the social field.) In fact, any strictly empirical (or logical-empirical) theory of knowledge is largely misapplied in the interpretation of human data. For, to repeat (and as Commons said), human conduct is motivated and anticipatory; and to understand it, or to act intelligently in social situation of any kind, we must take account of beliefs, desires, and objective valuation which are neither directly observed nor at all accurately inferred—or especially predicted—from sense observation of behavior itself. Moreover, it is the motives which often interest us, more than acts in themselves.

Note that we must say "largely" misapplied. The crucial fact is that man exists in several universes of (his own) conceptual thinking, and no intellectual bridges connect these in any satisfactory way. Consequently, the right approach is a plurality of approaches, used in accord with the nature of problems in hand. Men are knowers as well as known, users and used, also liking and liked (and the opposites), individually and mutually and in groups of manifold complexity. We are physical beings, first of all, in which the laws of physics and chemistry hold good as they do outside our bodies, within the limits of measurement. And these sciences claim to yield the complete and only possible explanation of all that happens. Yet they obviously cannot explain the explaining activity itself, our knowing or using, or our divers social attitudes or emotions. This fact cannot be denied without asserting it;

for machines do not argue about their own nature and are not involved in error or prejudice, as must be true of at least one side in this as in other disagreements and conflicts. We do and must understand ourselves and other persons and social phenomena, in terms of many different categories, which we cannot logically interrelate.

This is true even of physical artifacts. We understand, say, an automobile, by knowing how it works, including its responses to various controls. Also by knowing what it is for and how it serves its purposes; also by knowing the history of its development, which involves much or all of the history of technology and of mind and civilization. There is some interconnection among these modes of understanding, but that in itself is a profound philosophical problem. In particular, the historical understanding contributes little and very indirectly to the utilitarian problems of using the car or repairing, building, or improving it. That is chiefly a matter of its mechanics, of how it works. History—even biological evolution—is of disappointingly little value for prediction and is not greatly improved when put, as far as possible, in quantitative and statistical terms as a basis for extrapolation. Man is a conventional animal; but he is also unconventional, as well as both rational and romantic in many senses. But all such statements, while true and illuminating, cannot be of much use in predicting or effecting concrete changes.

Many other ways of understanding which we have not mentioned are involved when the subject matter is ourselves and other men and the complex institutional structures into which men build themselves—largely unintentionally, through acts which aim only at adaptive or exploitative reaction to the existing situation. The various and warring psychologies should hardly be ignored, even in a brief survey. Beyond the many forms of causality, at least for the thinking of men themselves, they have a mysterious creative faculty, small but indubitably real, and their most important trait. They can make decisions, as individuals and as groups of various kinds, to change their own nature. This activity, the distinctive meaning of that word, is inherently irreducible to positive uniformity and predictable continuity.

Thus the final word in social science methodology, beyond using all categories of explanation and all figurative analogies, wherever they are helpful (and only there!) is this: that all rational explanation and directive action has serious inherent limits. The social problem is misconceived if viewed as parallel with that of science as the foundation of technology; it is chiefly a matter of agreement upon ends or, rather, establishing unity of purpose. Again we refer to democracy, a society committed to individual freedom as its primary value. With this much given, the fundamental part of economic analysis, both as explanatory

and as a guide to social policy, must—in spite of all sweeping limitations—be the mechanics of instrumental choice, demand and supply, and prices. Empirical-quantitative study is indispensable for determining how far to push any policy; but it is subject to much the same limitations, set by the inconstancy of men's desires and motives. Institutional-historical study is illuminating, but practically useful only in a very general way; we cannot, it seems, learn from history what to do or to expect in any present situation, nor even very definitely what not to do. Life and society are orderly, up to a point—which itself cannot be accurately determined. To have a mind means to change it occasionally; hence to act unpredictably—but not too often, too erratically, or too far, or it would cease to be mind. As intelligent beings, we live somewhere between causation and chaos.