Institutional Economics

John R. Commons

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The difficulty in defining a field for the so-called institutional economics is the uncertainty of meaning of an institution. Sometimes an institution seems to mean a framework of laws or natural rights within which individuals act like inmates. Sometimes it seems to mean the behavior of the inmates themselves. Sometimes anything additional to or critical of the classical or hedonic economics is deemed to be institutional. Sometimes anything that is "economic behavior" is institutional. Sometimes anything that is "dynamic" instead of "static," or a "process" instead of commodities, or activity instead of feelings, or mass action instead of individual action, or management instead of equilibrium, or control instead of laissez faire, seems to be institutional economics.

All of these notions are doubtless involved in institutional economics, but they may be said to be metaphors or descriptions, whereas, a science of economic behavior requires analysis into similarities of cause, effect or purpose, and a synthesis in a unified system of principles. And institutional economics, furthermore, cannot separate itself from the marvelous discoveries and insight of the classical and psychological economists. It should incorporate, however, in addition, the equally important insight of the communistic, anarchistic, syndicalistic, fascistic, co-operative and unionistic economists. Doubtless it is the effort to cover by enumeration all of these unco-ordinated activities of the various schools which gives to the name institutional economics that reputation of a miscellaneous, nondescript yet merely descriptive, character of so-called "economic behavior," which has long since relegated the crude Historical School.

If we endeavor to find a universal circumstance, common to all behavior known as institutional, we may define an institution as collective action in control, liberation and expansion of individual action.

Collective action ranges all the way from unorganized custom to the many organized going concerns, such as the family, the corporation, the trade association, the trade union, the reserve system, the state. The principle common to all of them is greater or less control, liberation and expansion of individual action by collective action.

This control of the acts of one individual always results in, and is intended to result in, a gain or loss to another or other individuals. If it be the enforcement of a contract, then the debt is exactly equal to the credit created for the benefit of the other person. A debt is a duty enforced collectively, while the credit is a corresponding right created by creating the duty. The resulting social relation is an economic status, consisting of the expectations towards which each party is directing his economic behavior. On the debt and duty side it is the status of conformity to collective action. On the credit and right side it is a status of security created by the expectation of the said conformity. This is known as "incorporeal" property.

Or, the collective control takes the form of a tabu or

prohibition of certain acts, such as acts of interference, infringement, trespass; and this prohibition creates an economic status of liberty for the person thus made immune. But the liberty of one person may be accompanied by prospective gain or loss to a correlative person, and the economic status thus created is exposure to the liberty of the other. An employer is exposed to the liberty of the employee to work or not to work, and the employee is exposed to the liberty of the employer to hire or fire. The typical case of liberty and exposure is the goodwill of a business. This is coming to be distinguished as "intangible" property.

Either the state, or a corporation, or a cartel, or a holding company, or a co-operative association, or a trade union, or an employers' association, or a trade association, or a joint trade agreement of two associations, or a stock exchange, or a board of trade, may lay down and enforce the rules which determine for individuals this bundle of correlative and reciprocal economic relationships. Indeed, these collective acts of economic organizations are at times more powerful than the collective action of the political concern, the state.

Stated in the language of ethics and law, to he developed below, all collective acts establish relations of rights, duties, no rights and no duties. Stated in the language of individual behavior, what they require is performance, avoidance, forbearance by individuals. Stated in the language of the resulting economic status of individuals, what they provide is security, conformity, liberty and exposure. Stated in language of cause, effect or purpose, the common principles running through all of them are the principles of scarcity, efficiency, futurity, the working rules of collective action and the limiting and complementary factors of economic theory. Stated in language of the operation of working rules on individual action, they are expressed by the auxiliary verbs of what the individual can, cannot, must, must not, may or may not do. He "can" or "cannot," because collective action will or will not come to his aid. He "must" or "must not," because collective action will compel him. He "may," because collective action will permit him and protect him. He "may not," because collective action will prevent him.

It is because of these volitional auxiliary verbs that the familiar term "working rules" is appropriate to indicate the universal principle of cause, effect or purpose, common to all collective action. Working rules are continually changing in the history of an institution, and they differ for different institutions; but, whatever their differences, they have this similarity that they indicate what individuals can, must, or may, do or not do, enforced by collective sanctions.

Analysis of these collective sanctions furnishes that correlation of economics, jurisprudence and ethics which is prerequisite to a theory of institutional economics. David Hume found the unity of these thee social sciences in the principle of scarcity and the resulting conflict of interests, contra to Adam Smith who isolated economics from the others on assumptions of divine providence, earthly abundance and the resulting harmony of interests. Institutional economics goes back to Hume. Taking our cue from Hume and the modern use of such a term as "business ethics," ethics deals with the rules of conduct arising from conflict of interests, arising, in turn, from scarcity and enforced by the moral sanctions of collective opinion; but economics deals with the same rules of conduct enforced by the collective economic sanctions of profit or loss in case of obedience or disobedience, while jurisprudence deals with the same rules enforced by the organized sanctions of violence. Institutional economics is continually dealing with the relative merits and efficiency of these three types of sanctions.

From this universal principle of collective action in control, liberation and expansion of individual action arise not only the ethical concepts of rights and duties and the economic concepts of security, conformity, liberty and exposure, but also of assets and liabilities. In fact, it is from the field of corporation finance, with its changeable assets and liabilities, rather than from the field of wants and labor, or pains and pleasures, or wealth and happiness, or utility and disutility, that institutional economics derives a large part of its data and methodology. Institutional economics is the assets and liabilities of concerns, contrasted with Adam Smith's Wealth of Nations.

But collective action is even more universal in the unorganized form of custom than it is in the organized form of concerns. Custom has not given way to free contract and competition, as was asserted by Sir Henry Maine. Customs have merely changed with changes in economic conditions, and they may to-day be even more mandatory than the decrees of a dictator, who perforce is compelled to conform to them. The business man who refuses or is unable to make use of the modern customs of the credit system, by refusing to accept or issue checks on solvent banks, although they are merely private arrangements and not legal tender, simply cannot continue in business by carrying on transactions. These instruments are customary tender, instead of legal tender, backed by the powerful sanctions of profit, loss and competition, which compel conformity. Other mandatory customs might be mentioned, such as coming to work at seven o'clock and quitting at six.

If disputes arise, then the officers of an organized concern -- a credit association, the manager of a corporation, a stock exchange, a board of trade, a commercial or labor arbitrator, or finally the courts of law up to the Supreme Court of the United States -- reduce the custom to precision by adding an organized sanction.

This is the common-law method of making law by the decision of disputes. The decisions, by becoming precedents, become the working rules, for the time being, of the particular organized concern. The historic "common law" of Anglo-American jurisprudence is only a special case of the universal principle common to all concerns that survive, of making new law by deciding conflicts of interest, and thus giving greater precision and organized compulsion to the unorganized working rules of custom. The common-law method is universal in all collective action, but the technical "common law" of the lawyers is a body of decisions. In short, the common-law method is itself a custom, with variabilities, like other customs. It is the way collective action acts on individual action in time of conflict.

Thus collective action is more than control of individual action -- it is, by the very act of control, as indicated by the aforesaid auxiliary verbs, a liberation of individual action from coercion, duress, discrimination, or unfair competition by other individuals.

And collective action is more than control and liberation of individual action -- it is expansion of the will of the individual far beyond what he can do by his own puny acts. The head of a great corporation gives orders whose obedience, enforced by collective action, executes his will at the ends of the earth.

Thus an institution is collective action in control, liberation and expansion of individual action.

These individual actions are really trans-actions instead of either individual behavior or the "exchange" of commodities. It is this shift from commodities and individuals to transactions and working rules of collective action that marks the transition from the classical and hedonic schools to the institutional schools of economic thinking. The shift is a change in the ultimate unit of economic investigation. The classic and hedonic economists, with their communistic and anarchistic offshoots, founded their theories on the relation of man to nature, but institutionalism is a relation of man to man. The smallest unit of the classic economists was a commodity produced by labor. The smallest unit of the hedonic economists was the same or similar commodity enjoyed by ultimate consumers. One was the objective side, the other the subjective side, of the same relation between the individual and the forces of nature. The outcome, in either case, was the materialistic metaphor of an automatic equilibrium, analogous to the waves of the ocean, but personified as "seeking their level." But the smallest unit of the institutional economists is a unit of activity -- a transaction, with its participants. Transactions intervene between the labor of the classic economists and the pleasures of the hedonic economists, simply because it is society that controls access to the forces of nature, and transactions are, not the "exchange of commodities," but the alienation and acquisition, between individuals, of the rights of property and liberty created by society, which must therefore be negotiated between the parties concerned before labor can produce, or consumers can consume, or commodities be physically exchanged.

Transactions, as derived from a study of economic theories and of the decisions of courts, may be reduced to thee economic activities, distinguishable as bargaining transactions, managerial transactions and rationing transactions. The participants in each of them are controlled and liberated by the working rules of the particular type of moral, economic or political concern in question. The bargaining transaction derives from the familiar formula of a market, which, at the time of negotiation, before goods are exchanged, consists of the best two buyers and the best two sellers on that market. The others are potential. Out of this formula arise four relations of possible conflict of interest, on which the decisions of courts have built four classes of working rules.

(1) The two buyers are competitors and the two sellers are competitors, from whose competition the courts, guided by custom, have constructed the long line of rules on fair and unfair competition.

(2) One of the buyers will buy from one of the sellers, and one of the sellers will sell to one of the buyers, and, out of this economic choice of opportunities, both custom and the courts have constructed the rules of equal or unequal opportunity, which, when reduced to decisions of disputes, become the collective rules of reasonable and unreasonable discrimination.

(3) At the close of the negotiations, one of the sellers, by operation of law, transfers title to one of the buyers, and one of the buyers transfers title to money or a credit instrument to one of the sellers. Out of this double alienation and acquisition of title arises the issue of equality or inequality of bargaining power, whose decisions create the rules of fair and unfair price, or reasonable and reasonable value.

(4) But even the decisions themselves on these disputes, or

the legislative or administrative rules prescribed to guide the decisions, may be called in question, under the American System, by an appeal to the Supreme Court, on the ground that property or liberty has been "taken" by the governing or judicial authority "without due process of law." Due process of law is the working rule of the Supreme Court for the time being, which changes with changes in custom and class dominance, or with changes in judges, or changes in the opinions of judges, or with changes in the customary meanings of property and liberty.

Hence the four economic issues arising out of that unit of activity, the bargaining transaction, are competition, discrimination, economic power and working rules.

The habitual assumption back of the decisions in the foregoing classes of disputes is the assumption of equality of willing buyers and willing sellers in the bargaining transactions by which the ownership of wealth is transferred by operation of law. Here the universal principle is scarcity.

But the assumption back of managerial transactions, by which the wealth itself is produced, is that of superior and inferior. Here the universal principle is efficiency, and the relation is between two parties, instead of the four parties of the bargaining transaction. The master, or manager, or foreman, or other executive, gives orders -- the servant or workman or other subordinate must obey. Yet a change in working rules, in course of time, as modified by the new collective action of court decisions, may distinguish between reasonable and unreasonable commands, willing and unwilling obedience.

Finally the rationing transactions differ from managerial transactions in that the superior is a collective superior while the inferiors are individuals. Familiar instances are the log-rolling activities of a legislature in matters of taxation and tariff; the decrees of communist or fascist dictatorships; the budget-making of a corporate board of directors; even the decisions of a court or arbitrator; all of which consist in rationing either wealth or purchasing power to subordinates without bargaining, although the negotiations are sometimes mistaken for bargaining, and without managing, which is left to executives. They involve negotiation, indeed, but in the form of argument, pleading, or eloquence, because they come under the rule of command and obedience instead of the rule of equality and liberty. On the borderline are partnership agreements which ration to the partners the benefits and burdens of a joint enterprise. These rationing transactions, likewise, in the American system, are subject finally to the working rules (due process of law) of the Supreme Court.

In all cases we have variations and hierarchies of the universal principle of collective action controlling, liberating and expanding individual action in all the economic transactions of bargaining, managing and rationing.

Since institutional economics is behavioristic, and the behavior in question is none other than the behavior of individuals while participating in transactions, institutional economics must make an analysis of the economic behavior of individuals. The peculiar quality of the human will in all its activities, distinguishing economics from the physical sciences, is that of choosing between alternatives. The choice may be voluntary, or it may be an involuntary choice imposed by another individual or by collective action. In any case the choice is the whole mind and body in action -- that is, the will -- whether it he physical action and reaction with nature's forces, or the economic activity of mutually inducing others in the transaction.

Every choice, on analysis, turns out to be a three-dimensional act, which, as may be derived from the issues arising in disputes, is at one and the same time, a performance, an avoidance, and a forbearance. Performance is the exercise of power over nature or others; avoidance is its exercise in one direction rather than the next available direction; while forbearance is the exercise, not of the total power except at a crisis, but the exercise of a limited degree of one's possible moral, physical or economic power. Thus forbearance is the limit placed on performance; performance is the actual performance; and avoidance is the alternative performance rejected or avoided -- all at one and the same point of time.

It is from forbearance that the doctrine of reasonableness arises, while performance means either rendering a service, compelling a service, or paying a debt, but avoidance is non-interference with the performance, forbearance or avoidance of others. Each may be a duty or a liberty, with a corresponding right or exposure of others, and each may be enforced, permitted, or limited by collective action according to the then working rules of the particular concern.

If institutional economics is volitional it requires an institutional psychology to accompany it. This is the psychology of transactions, which may properly be named negotiational psychology. Nearly all historic psychologies are individualistic, since they are concerned with the relation of individuals to nature, or to other individuals, treated, however, not as citizens with rights, but as objects of nature without rights or duties. This is true all the way from Locke's copy psychology, Berkeley's idealistic psychology, Hume's skeptical psychology, Bentham's pleasure-pain psychology, the hedonistic marginal utility psychology, James' pragmatism, Watson's behaviorism, and the recent Gestalt psychology. All are individualistic. Only Dewey's is socialistic. But the psychology of transactions is the psychology of negotiations. Each participant is endeavoring to influence the other towards performance, forbearance or avoidance. Each modifies the behavior of the other in greater or less degree. This is the psychology of business, of custom, of legislatures, of courts, of trade associations, of trade unions. In popular language it resolves into the persuasions or coercions of bargaining transactions, the commands and obedience of managerial transactions, or the arguments and pleadings of rationing transactions. All of these are negotiational psychology. It may be observed that they are a behavioristic psychology.

But these are only names and descriptions. A scientific understanding of negotiational psychology resolves it into the smallest number of general principles, that is, similarities of cause, effect or purpose, to be found in all transactions, but in varying degree. First is the personality of participants, which, instead of the assumed equality of economic theory, is all the differences among individuals in their powers of inducement and their responses to inducements and sanctions.

Then are the similarities and differences of circumstance in which personalities are placed. First is scarcity or abundance of alternatives. This is inseparable from efficiency, or the capacity to bring events to happen. In all cases negotiations are directed towards future time, the universal principle of futurity. Working rules are always taken into account, since they are the expectations of what the participants can, must or may do or not do, as controlled, liberated or expanded by collective action. Then, in each transaction is always a limiting factor whose control by the sagacious negotiator, salesman, manager or politician, will determine the outcome of complementary factors in the immediate or remote future.

Thus negotiational psychology is the transactional psychology which offers inducements and sanctions according to the variable personalities and the present circumstances of scarcity, efficiency, expectation, working rules and limiting factors.

Historically this transactional psychology may he seen to have changed, and is changing continuously, so that the whole philosophies of capitalism, fascism or communism are variabilities of it. In the common-law decisions it is the changing distinctions between persuasion and coercion or duress, persuasion being considered the outcome of a reasonable status of either equality of opportunity, or fair competition, or equality of bargaining power, or due process of law. But economic coercion and physical duress are denials of these economic ideals, and nearly every case of economic conflict becomes an assumption or investigation, under its own circumstances, of the negotiational psychology of persuasion and coercion. Even the managerial and rationing negotiations come under this rule of institutional change, for the psychology of command and obedience is changed with changes in the status of conformity, security, liberty or exposure. The modern "personnel" management is an illustration of this kind of change in negotiational psychology.

All of this rests on what may he distinguished as three social relations implicit in every transaction, the relations of conflict, dependence and order. The parties are involved in a conflict of interests on account of the universal principle of scarcity. Yet they depend on each other for reciprocal alienation and acquisition of what the other wants but does not own. Then the working rule is not a foreordained harmony of interests, as assumed in the hypotheses of natural rights or mechanical equilibrium of the classical and hedonic schools, but it actually creates, out of conflict of interests, a workable mutuality and orderly expectation of property and liberty. Thus conflict, dependence and order become the field of institutional economics, builded upon the principles of scarcity, efficiency, futurity and limiting factors derived from the older schools, but correlated under the modern notions of working rules of collective action controlling, liberating and expanding individual action.

What then becomes of the "exchange" of physical commodities and the production of wealth, as well as the consumption of wealth and satisfaction of wants by consumers, which furnished the starting points of the classical, hedonic, communist and other schools of economists? They are merely transferred to the future. They become expectations of the immediate or remote future, secured by the collective action, or "institution," of property and liberty, and available only after the conclusion of a transaction. Transactions are the means, under operation of law and custom, of acquiring and alienating legal control of commodities, or legal control of the labor and management that will produce and deliver or exchange the commodities and services, forward to the ultimate consumers.

Institutional economics is not divorced from the classical and psychological schools of economists -- it transfers their theories to the future when goods will be produced or consumed or exchanged as an outcome of present transactions. That future may be the engineering economics of production of the classical economists or the home economics of consumption of the hedonic economists, which depend on physical control. But institutional economics is legal control of commodities and labor, where the classical and hedonic theories dealt only with physical control. legal control is future physical control. Future physical control is the field of engineering and home economics.

Thus it may be seen how it was that the natural rights ideas of the economists and lawyers created the illusion of a framework, supposed to be constructed in the past, within which present individuals are supposed to act. It was because they did not investigate collective action. They assumed the fixity of existing rights of property and liberty. But if rights, duties, liberties and exposures are simply the changeable working rules of all kinds of collective action, looking towards the future, then the framework analog disappears in the actual collective action of controlling, liberating and expanding individual action for the immediate or remote future production, exchange, and consumption of wealth.

Consequently the final social philosophy, or "ism" -- which is usually a belief regarding human nature and its goal -- towards which institutional economics trends is not something foreordained by divine or natural "right," or materialistic equilibrium, or "laws of nature" -- it may he communism, fascism, capitalism. If managerial and rationing transactions are the starting point of the philosophy, then the end is the command and obedience of communism or fascism. If bargaining transactions are the units of investigation then the trend is towards the equality of opportunity, the fair competition, the equality of bargaining power, and the due process of law of the philosophy of liberalism and regulated capitalism. But there may be all degrees of combination, for the three kinds of transactions are interdependent and variable in a world of collective action and perpetual change, which is the uncertain future world of institutional economics.