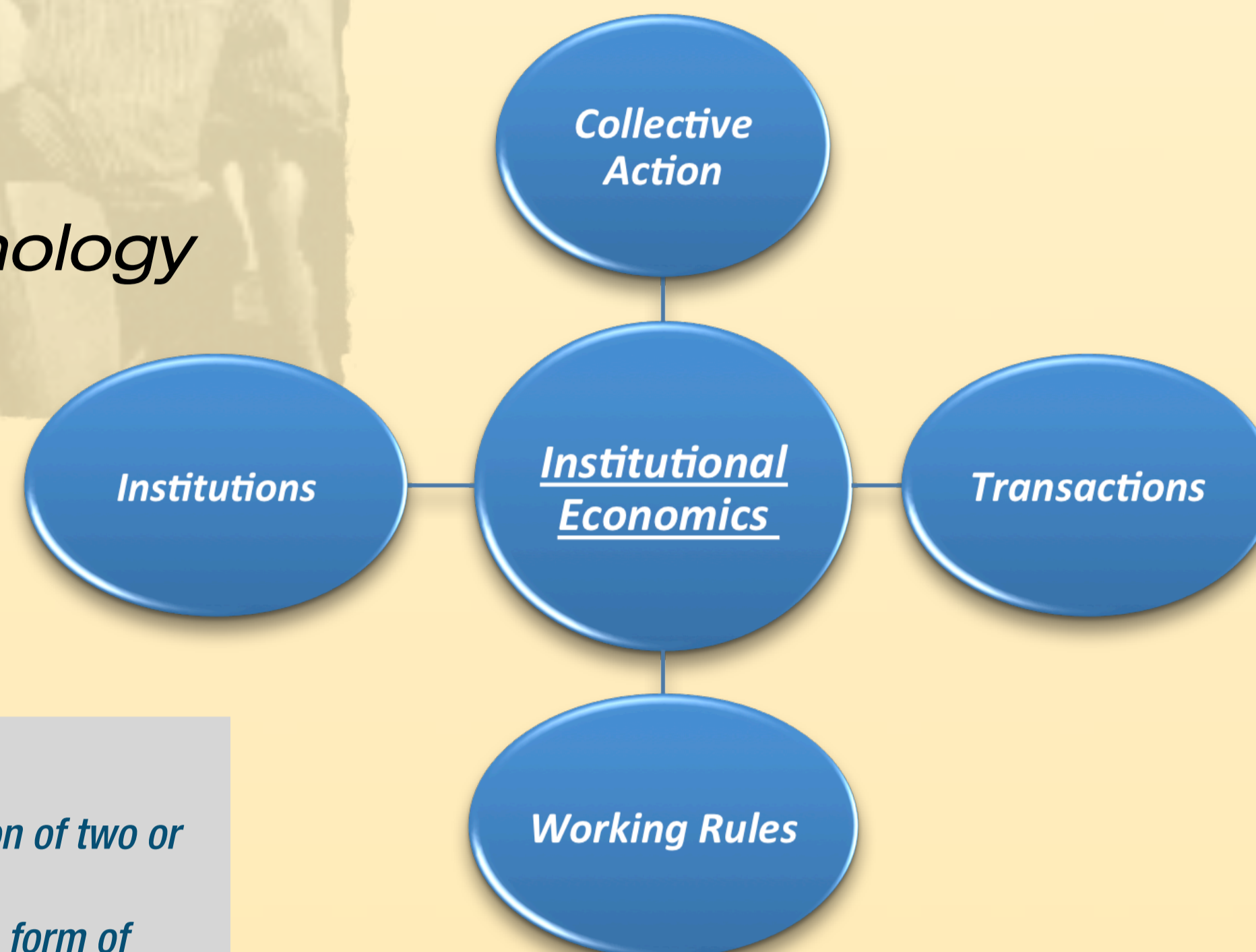


"An invasion of armies can be resisted, but not an idea whose time has come"  
Victor Hugo, French poet and playwright

# Institutional economics

- Drawbacks of the laissez-faire theory
- Economic and social threats connected with monopolization of markets
- A need for social and state control over the economy
- A need for integrating economic studies with studies in other social sciences, like history, psychology and sociology



**Institutional economics, known by some as institutionalist political economy, focuses on understanding the role of human-made institutions in shaping economic behavior. In the early twentieth century, it was the main school of economics in the United States, is concerned with the social systems, or "institutions," that constrain the use and exchange of resources (goods and services) and their consequences for economic performance. Economic activities take place in the context of the restraints of society, both formal and informal, that encourage and limit the activities of those agents. Institutional economics takes into account these restraints that institutions lay on members of society, and thus hopes to better understand the economic activities that take place therein and in so doing to benefit society.**

## Working rules

Working rules are different 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. Exists also 4 relations of possible conflict of interest: Competition, Discrimination, Economic power, Working rules. The assumption behind "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 manager, or other executive, gives orders—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.

## Institution

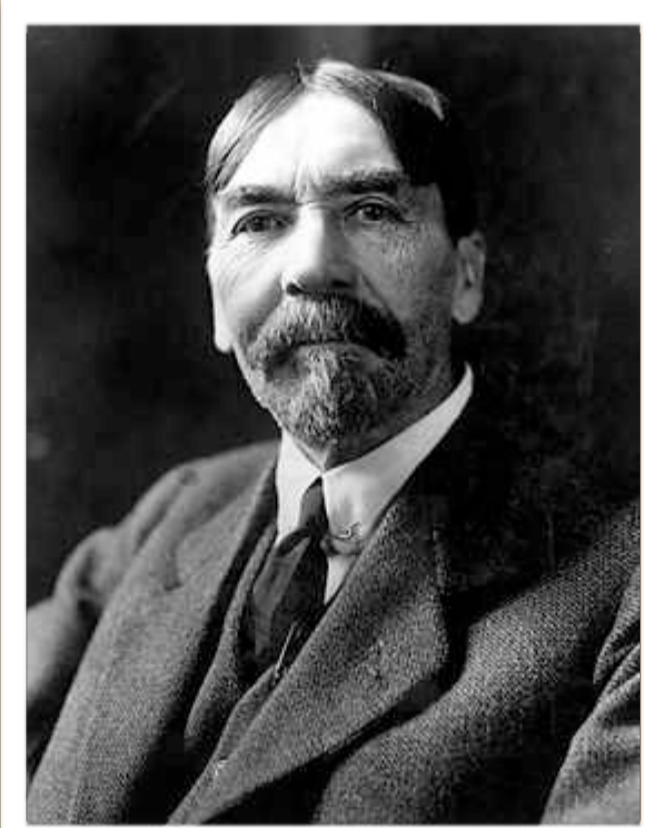
Institutions are the humanly devised constraints that structure human interaction (made up of formal constraints, informal constraints and their enforcement characteristics). Together they define the incentive structure of societies and economies. Institutions and the technology employed determine the transaction and transformation costs that add up to the costs of production.

## Collective action

-This collective action refers to the collaboration of two or more individuals in pursuit of a common goal  
-Economics is based on collective action in the form of transactions that involve the exchange of resources. Analysis of these collective sanctions provides the correlation of economics, jurisprudence, and ethics which is prerequisite to a theory of institutional economics.

## Transaction

The smallest unit of the institutional economists is a unit of activity—a transaction, together with its participants:  
Bargaining transactions  
Managerial transactions  
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.



**Thorstein Bunde Veblen (1857-1929)**  
The Theory of the Leisure Class (1899), where he criticized materialistic culture and wealthy people who conspicuously consumed their riches as a way of demonstrating success. Conspicuous leisure was

another focus of Veblen's critique. In The Theory of Business Enterprise (1904) Veblen distinguished production for people to use things and production for pure profit, arguing that the former is often hindered because businesses pursue the latter. Output and technological advance are restricted by business practices and the creation of monopolies. Businesses protect their existing capital investments and employ excessive credit, leading to depressions and increasing military expenditure and war through business control of political power. Veblen warned of problems he saw inherent in the excesses of "the American way"—the tendency for wasteful consumption—although he stopped short of advocating an alternative. However, his work laid the foundation for the school of institutional economics.



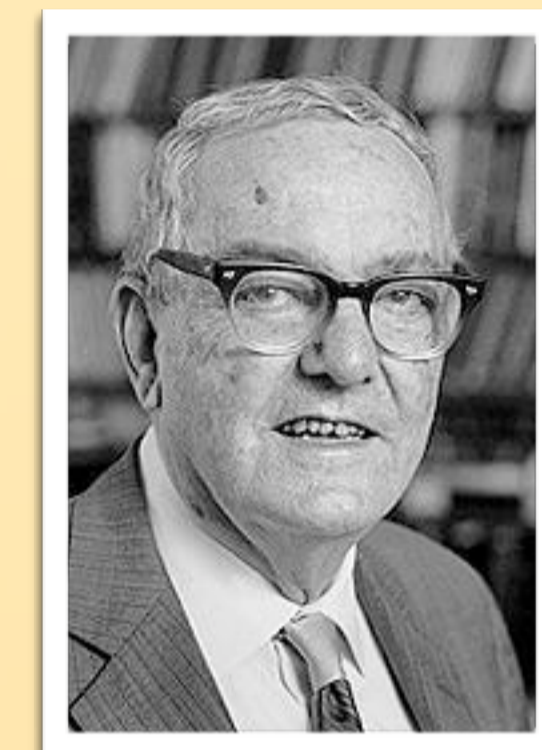
**John Kenneth Galbraith (1908-2006)**  
was critical of orthodox economics throughout the late twentieth century. In The Affluent Society (1958), Galbraith argued that voters reaching a certain level of material wealth begin to vote against the common good. He coined (or at least popularized) the term

"conventional wisdom" to refer to the orthodox ideas that underpin the resulting conservative consensus. In The New Industrial State Galbraith argued that economic decisions are planned by a private bureaucracy, a technostucture of experts who manipulate marketing and public relations channels. This hierarchy is self serving, profits are no longer the prime motivator, and even managers are not in control. Because they are the new planners, corporations detest risk and require steady economic and stable markets. They recruit governments to serve their interests with fiscal and monetary policy, for instance, adhering to monetarist policies which enrich money-lenders in the City through increases in interest rates. While the goals of an affluent society and complicit government serving the irrational technostucture are met, public space is simultaneously impoverished.



**Joseph Alois Schumpeter (1883-1950)**

the Austrian economist, was a pioneer in talkings of innovation management. Around the 1930s Schumpeter started studying how the capitalist system was affected by market innovations. In his book "Capitalism, Socialism and Democracy" he described a process where "the opening up of new markets, foreign or domestic, and the organizational development illustrates the same process of industrial mutation, that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one". He called this process "creative destruction". After analyzing the capitalist model Schumpeter tried to understand what companies would be in a better position to innovate. He developed a theory where a company's ability to innovate was mainly connected to its size. Initially he defended that small companies should be in a better position due to their flexibility while large companies might get trapped in bureaucratic structures.



**Herbert Alexander Simon (1916-2001)**

was an American political scientist and polymath, whose research ranged across the fields of cognitive psychology, computer science, public administration, economics, management, philosophy of science, and sociology, and was a professor, most notably, at Carnegie Mellon University. With almost a thousand, often very highly cited, publications he is one of the most influential social scientists of the twentieth century. Simon was known for his research on industrial organization. He determined that the internal organization of firms and the external business decisions thereof did not conform to the Neoclassical theories of "rational" decision-making. Simon was mainly focusing on the issue of decision-making within the behavior of what he termed "bounded rationality." "Rational behavior," in economics, means that individuals maximizes their utility function under the constraints they face (such as their budget constraint, limited choices, and so forth) in pursuit of their self-interest. Bounded rationality is a central theme in behavioral economics. It is concerned with the ways in which the actual decision-making process influences decisions. Theories of bounded rationality relax one or more assumptions of standard "expected utility theory."

- With the development of theories of asymmetric and distributed information an attempt was made to integrate institutionalism into mainstream neoclassical economics, under the title of "New Institutional Economics" (NIE). NIE attempted to extend economics by focusing on the social and legal norms and rules that underlie economic activity. However, using Neoclassical economics to explain areas of human society normally considered outside them, NIE eventually failed to avoid criticisms of reductionism and lack of realism: The same criticism that was leveled at neoclassical economics for effectively ignoring institutions.
- NIE has its roots in Ronald Coase's fundamental insights about the critical role of institutional frameworks and transaction costs for economic performance. Thus, initially, NIE analyses took into account: organizational arrangements, transaction costs, credible commitments, modes of governance, persuasive abilities, social norms, ideological values, decisive perceptions, gained control, enforcement mechanism, asset specificity, human assets, social capital, asymmetric information, strategic behavior, bounded rationality, opportunism, adverse selection, moral hazard, contractual safeguards, surrounding uncertainty, monitoring costs, incentives to collude, hierarchical structures, bargaining strength, and such.
- However, later on NIE departed from both mainstream Neoclassical economics and "old" institutional economics. NIE economists reversed the attempt by "old" institutional economists to use history and the study of institutions to explain economic behavior, instead using neoclassical economics to explain history, social relations, and the formation of institutions.
- Neoclassical economics preferred a general approach (a metatheory) to economics that was based on supply and demand. This, in turn, depended on individuals (or any economic agent) operating rationally, each seeking to maximize their individual utility or profit by making choices based on available information. Thus, the new institutional economics, by avoiding issues accompanying Coase's approach, was an attempt to reduce institutions to "rational" and "efficient" agents whereby resolutions to the problem of transaction costs would not arise.

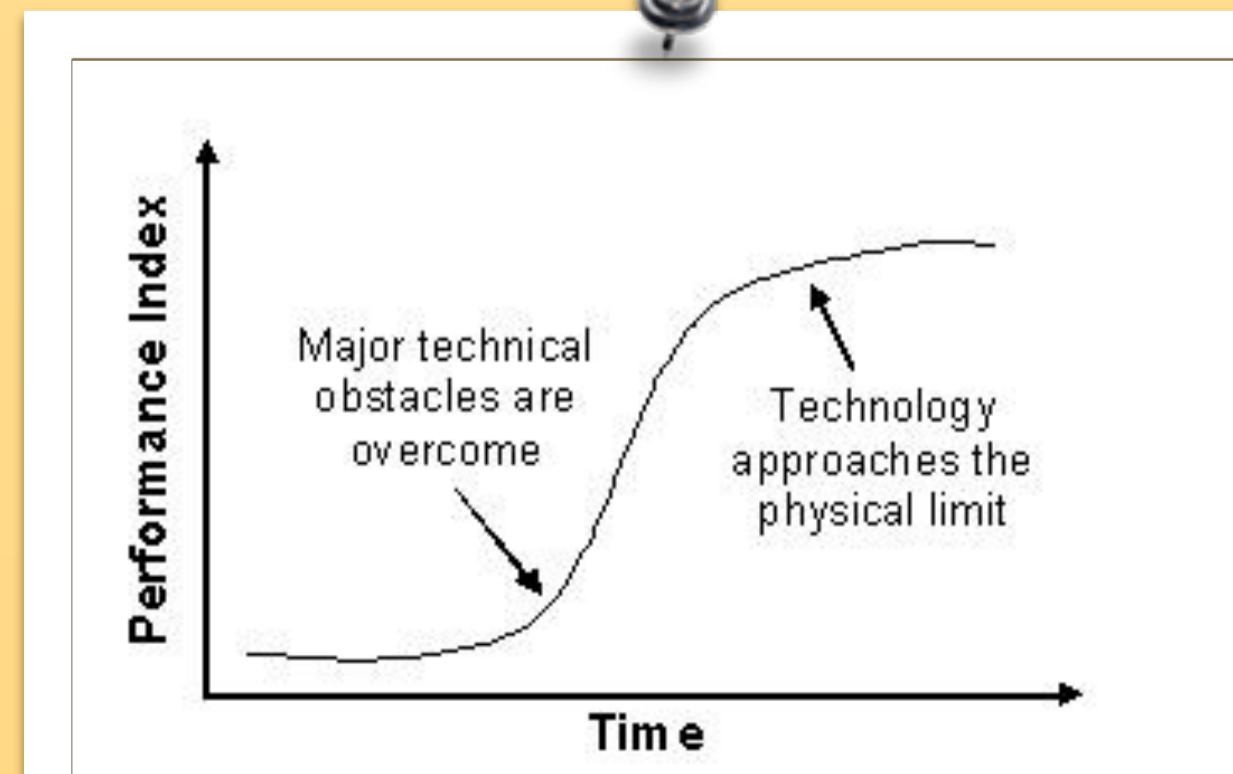
As a result of the previous models of theories of innovation, it is should be concluded, that an innovation is the implementation of a new or significantly improved product (good or service), or process, a new marketing method, or a new organizational method in business practices, workplace organisation or external relations.

## The General Theory of Innovation

3 crucial reasons:

- The process of creating theory of innovation was based on the historical analysis of evolutionary processes of real-world systems: products, processes, services, companies, markets.
- The systems were deliberately chosen of different natures, technology-based and not technology-based.
- The investigation focused on both the systems themselves and (mostly) on the relationships the systems had with their respective environments.

The investigation wanted to uncover the driving forces behind the process of evolution, including identifying those factors that cause the need for innovations/solutions as well as those conditions that caused emergence of the problems and determined subsequent success or failure of the proposed solutions. The following are a few examples of the investigated systems:  
The use of currency evolved from the barter of goods (cattle, grain, etc.) to silver ingots guaranteed by Cappadocian rulers (2200 B.C.), to the first crude coins made from a naturally occurring amalgam of gold and silver (640 B.C.), to Chinese paper money (800 A.D.), to bank-backed notes (1633-1660 A.D.), to the first credit card (1950s), to electronic money.  
Message delivery evolved from sending a messenger on foot, to a messenger on horseback, to the creation of regular mail service, to mail service supported by cars, trains and planes, to faxes, to next day delivery, to email.



Overall, the S-Curve is a robust yet flexible framework to analyze the introduction, growth and maturation of innovations and to understand the technological cycles. The model also has plenty of empirical evidence, it was exhaustively studied within many industries including semiconductors, telecommunications, hard drives, photocopiers, jet engines and so on.

		Complementary Assets	
		Freely Available	Tightly Held
Inimitability	High	Difficult to make profits	Holder of assets profits
	Low	Innovator profits	Highest bargaining power profits

The Teece model can be used not only to predict who will profit from an innovation but also to understand what company will have higher incentives to invest in certain innovations. The major flaw one can find this theory is the lack of empirical evidence, which results from the difficulty to isolate the immutability and the complementarity effects from other fact