https://www.sciencedirect.com/science/article/pii/S0954349X18300407
https://doi.org/10.1016/j.strueco.2018.03.002
Guglielmo Forges Davanzati, Structural change driven by institutions: Thorstein veblen revised, Structural Change and Economic Dynamics, Volume 45, 2018, Pages 105-110, ISSN 0954-349X

# Structural change driven by institutions: Thorstein veblen revised

Guglielmo ForgesDavanzati

University of Salento, Department of History, Society and Human Studies, Lecce, Italy

https://doi.org/10.1016/j.strueco.2018.03.002Get rights and content

## Abstract

The aim of this paper is to provide a theoretical framework where, starting from the analysis of the behaviour of the firm in a Veblenian perspective, income distribution is primarily determined by technological factors, and where distributive conflicts (involving technicians vs. businessmen and workers vs. the leisure class) play a crucial role. The schema is intended to connect the works of Thorstein Veblen in the belief that the picture he presents in The theory of the leisure class is the "general case" with respect to the topics dealt with in his subsequent works

## 1. Introduction

Veblen's contribution to economic theory has been the object of a renewed interest (see, among others, Tilman, ed., 2003), with particular reference to two distinct aspects. First, his approach to institutions – defined as "special method of life and of human relations" (Veblen, 1975 [1889], p. 188) – has been re-proposed within the so-called new Institutionalism, with the aim of presenting a theory of economic behaviour (where instincts, habits, customs and transaction costs play a pivotal role) opposed to the mainstream 'rational choice' view (see Hodgson, 1988). Second, attention has been devoted to his arguments on "conspicuous consumption" and imitation phenomena, and the relation between consumption on the part of the "leisure class" and the process of income distribution. Within this line of research, the recent contribution by Bowles and Park (2005) is worth noting. They show that – assuming that emulative processes are in operation also between classes (i.e. the working class emulates the leisure class) – working hours increase in proportion to the inequality of income distribution. Their model is based on some arguments put forward by Veblen in The theory of the leisure class: both technological aspects and the role of the banking sector – which are extremely significant in Veblen's theoretical framework – are not taken into consideration.

The aim of this paper is to provide a theoretical framework where, starting from the analysis of the behaviour of the firm in a Veblenian perspective, income distribution is primarily determined by technological factors, and where distributive conflicts (involving technicians vs. businessmen and workers vs. the leisure class) play a crucial role. The schema is intended to connect the works of Thorstein Veblen in the belief that the picture he presents in The theory of the leisure class is the "general case" with respect to the topics dealt with in his subsequent works (cf. O'Hara, 2000, p.70). The following interpretation will be proposed. Given the Veblenian picture in The theory of business enterprise (Veblen, 1904), the firm is described as a locus of conflict, involving the "technicians" (engineers and industrial experts) – driven by the "instinct of workmanship" and whose aim is to apply new scientific knowledge in the production process – and "businessmen" driven by "predatory" attitudes and only interested in money profits via the management of the financial structure of the firm.1,2 While technicians are interested in expanding production, thus reducing prices, businessmen aim at gaining money profits by increasing prices. At the same time, businessmen are also interested in technical improvement since it allows a more rapid turnover of capital and, as a result, more profits. In this theoretical context, it will be shown that income distribution is primarily affected by the prevalence of technicians or businessmen in setting firms' targets: the more the firm is of a 'workmanship-type' (i.e. the greater the technicians' power), the higher the real wages and level of employment, and the lower the profit/wage ratio. Moreover, it will be argued that the leisure class also affect income distribution, mainly via its control of the financial market. It is worth noting that the existence of unemployed workers – in Veblen's view – is the normal condition in a deregulated market economy: unemployment is "deliberate and habitual" (Veblen, 1921, p.71).3

The exposition is organized as follows. In Section 2 a critical reconstruction of Veblen's theory of the firm is presented. Section 3 deals with the effects of firms' behaviour on income distribution and Section 4 concludes.

## 2. The microeconomic plane: the firm as a locus of conflict

The basic idea underlying Veblen's theory of the firm is that the management of its financial structure is separated from the control of the production process. This functional separation, which can be identified with the dichotomy between "business" and "industry", is the result of a historical process, where larger sized firms required specific attention to their financial aspects, hence enhancing the division of labour within the firm:

"The pecuniary side of the enterprise came to require more unremitting attention, as the change for gain or loss through business relations simply, aside from mere industrial efficiency, grew greater in number and magnitude. The same circumstances also provoked a spirit of business enterprise, and brought on a systematic investment for gains" (Veblen, 1904, ch.III).

In contemporary economies, according to Veblen, the functional separation between business and industry results in the potential conflict between those who manage the "pecuniary side" of the firm ("businessmen𔄦) and those who control the production process ("technicians" or "engineers").5,6 This conflict is described in these terms:

"In the normal course of business touching this matter of industrial consolidation […] the captain of industry works against, as well as for, a new and more efficient organization. He inhibits as well as furthers the higher organization of industry" (Veblen, 1904, ch.III).

Businessmen need technicians for two main reasons. First, given the division of labour within the firm, businessmen are unable to directly contribute to the production process, in an institutional context where technical knowledge plays a pivotal role. In this sense, the employment of technicians is a precondition for the production itself. As Donald A. Walker (1977, in Tilman, 2003, vol.II p.67) stresses: "Technicians are important because […] they keep the industrial machinery in operation".7 Second, technical improvements can positively affect profits insofar as they reduce the turnover of capital. This issue will now be explored.

Veblen maintains that “there are two chief means of shortening the interval of the turnover, currently resorted to in industrial business”, and that they are “the adoption of more efficient, time-saving industrial processes” and advertising.[8] In a long footnote (n.5, ch.V) of The theory of business enterprise, he clarifies:

“The turnover will count for more in gross earnings at current rates if instead of his own capital alone the business man also engages whatever funds he can borrow by using his capital as collateral. The turnover counted on capital (value of the industrial equipment) plus credit, at current rates, will be greater than that counted on the capital alone used without credit extension. The turnover may be expressed as the product of the mass of values employed multiplied by the velocity. Hence, if credit be taken as indeterminate fraction (capital/n) of the capital used as collateral, we may say that Turnover = (1/time)(capital + capital/n), i.e.
$T = (1/t)(c + c/n) = (c + c/n)/t$; $t = (c + c/n)/T$.

The algebraic statement serves to bring out the equivalence between an acceleration of the rate of turnover and an increase of the volume of business capital”.[9]

In this formulation, T is revenue per unit of time, i.e. what firms obtain by selling their product via the use of time-saving techniques, while c is money capital obtained via self-financing and c/n is the amount of bank credit. By setting an exogenous length of the production process (L), expressed in terms of money revenue per unit of time and given by “the time ordinarily allowed in the line of industry in which he is engaged”, extra-total revenues (ΔR) for the individual firm (with respect to its competitors) become:

$$\Delta R = T - L = [(1/t)(c + c/n] - L \qquad (1)$$

Note that in this theoretical framework, competition is conceived as a process devoted to gain differential advantages, in particular aimed at obtaining extra-profits with respect to the competitors.[10]

This reflects Veblen’s view of the division of labour within the firm, in the sense that the typical function of the businessmen is to manage the “pecuniary side” of the firm and, hence, to deal with the banking system. This condition establishes a positive relation between investments and revenues, which can be limited by the value of the interest rate. The rationale for this relation, according to Veblen (1904, ch.V), is to be traced in the “trite commonplace that the earnings of any industrial business [is] a function [of] the volume of business”.[11] Veblen adds that high interest rate can disincentive entrepreneurs’ demand for credit, hence reducing the turnover of capital: “on funds obtained on credit the debtor has to pay interest” and “This sets a somewhat elastic limit to the advantageous use of loan credit in business”. This argument leads to the following result: for a given technology, the increase (decrease) in the interest rate determines a reduction (increase) of T. Thus “earnings” increase as the interest rate declines.

As we have seen, Veblen also refers to advertising as a means of increasing T. This occurs because the rate of turnover can be dependent on the “competitive pushing of sales”, by selling before the competitors and accelerating the sales. In this sense, rapidity (in producing and selling) can be a relevant variable in the competitive struggle. Moreover, advertising is waste, since “competitive advertising is an unavoidable item in the aggregate costs of industry. It does not add to the serviceability of the output […]. What it aims at is the sale of the output, and it is for this purpose that it is useful. It gives vendibility, which is useful to the seller, but has no utility to the last buyer”.

As Kenneth J. Arrow (1975, in Tilman 2003, vol.II., p. 48) emphasises: “These expenditures […] can be regarded as wastes; they yield indeed a competitive advantage but no social advantage”.

In view of the arguments above, the potential conflict between technicians and businessmen manifests itself in the underutilization of capital, or, in Veblen’s words, in “perversion”.

“The ownership of the capital goods affords a discretionary power of misdirecting in the industrial process and perverting industrial efficiency, as well as inhibiting or curtailing industrial processes and their output, while the outcome may still be profitable to the owner of the capital goods” (Veblen, 1908, p.108, italics added).

Veblen (1908, p.107) adds that “The most comprehensive principle involved in […] business management is that of rising prices, and so increasing the net gains of business, by limiting the supply”.12

Veblen derives the conclusion that “there must always be a certain variable margin of unemployment of plant and manpower” (Veblen, 2001 [1921], p.9, italics added).13

3. The macroeconomic plane: institutions and income distribution

The schema above includes three macro-agents: banks, firms and workers. Setting aside the factors determining technicians’ wages (which can be considered salaries for highly skilled workers), interest, profit and wages can now be determined in the light of Veblen’s conflictual view of the firm and his arguments on bank-firm relationships.

a) Credit, production and the interest rate. As we have seen, Veblen maintains that firms need finance from the banking system in order to increase their money capital and, hence, by increasing the volume of investments, to obtain higher profits.14 Veblen refers to c + c/n as an “indeterminate fraction (capital/n) of the capital used as collateral”. The relation between credit and production is analysed in two distinct ways.

i) Due to competitive pressure, the individual firm is forced to expand its capital via the use of credit, but “since the advantage to be derived from this expedient is a competitive advantage only, the universality of the practice results in but a slight, if any, increase of the aggregate earnings of the business community” (Veblen, 1904, ch.V).

ii) Insofar as firms are not homogenous, the credit system tends spontaneously to contribute to the increase in the size of the biggest firms: “since an advance of credit rests on the collateral as expressed in terms of value”, firms with a higher amount of collateral obtain a higher amount of credit and, hence, can expand, thus gaining further advantages over their (smaller) competitors. As a result, an ‘imperfect’ credit market is likely to spontaneously generate a selection of firms on the basis of their collateral, thus allowing the expansion of the bigger firms and the possible bankruptcy of the smaller firms. As Rutherford (1980, p.437) stresses, the distinction “between large corporations with market power and small undertakings such as independent farmers” is a key feature of Veblen’s picture of capitalist economies.

Note that, in both cases, bank-firm relationships do not affect the volume of aggregate production, but simply redistribute aggregate profits among firms. While bank decisions on the amount of finance to extend to firms does not modify the aggregate value of the production, variations of the interest rate do so: an interest rate rise, in fact, “diminishes the aggregate net profits […] in that it requires them to pay interest” (Veblen, 1904, ch.V, italics added). The inverse relation between interest rate and investments holds in contexts where uncertainty does not exist, or, in other words, an increase in the interest rate reduces investments only insofar as entrepreneurs' expectations are not significantly optimistic. "The market fluctuations in the amount of capital" – Veblen (1904, ch. 6) remarks – "proceed on variations of confidence on the part of investors, on current belief as to the probable policy or tactics of the guild of politicians, and of the indeterminable, largely instinctive, shifting movements of public sentiment and apprehension. So that under modern conditions the magnitude of the business capital and its mutation from day to day are in great measure a question of folk psychology rather than of material fact".

A further consideration can be made. In his essay On the nature of capital, Veblen (1908, pp.132 ff.) refers to "great financiers" as the individuals who operate in the financial market, gaining "a tax on commonplace business enterprise". He also maintains that the leisure class is composed, among others, by those who supply firms with money capital without directly contributing to the production process (in this sense, members of the leisure class can be seen as "absentee owners").15 In this picture, the ultimate source of the firm's finance is the banking system, controlled by the leisure class, and the capacity of the banking system to produce money appears to be the key issue16: "Broadly speaking" – Veblen (1905, p. 470) emphasises – "banking is profitable chiefly because the banker lends more than that he has or borrows", and "the banker [can] create a new volume of credit".17 This occurs in cases where "in making a loan on collateral, which is not of the nature of a bill of sale, the banker, or any similar concern doing a credit business of this kind, creates a new volume of credit" (Veblen, 1905, p.470, italics added). As a result, the interest bill (as a "tax on profits") is what the leisure class gain via its unproductive activities, devoting it to "conspicuous" and competitive consumption.18

b) Profits, wages and unemployment. In view of the schema above, while profits depend on the size of the firm and on the "docility" of technicians, wages are assumed to be fixed at the subsistence level. In reviewing Böhm-Bawerk's The Positive Theory of Capital, Veblen (1892) remarks that "the laborer, from the point of view of consumption of products, is no longer a 'laborer': he is a member of society simply, and his share of the product of industry is the share of an individual member of society". This means that wages enter the total demand for consumption goods, and that high wages imply high demand.19 In view of this point, an exogenous increase in (money) wages has a positive effect on total demand for consumption goods, hence stimulating firms to produce more via the increase in the stock of used capital. The increase in the stock of fixed capital, in turn, determines an increase in employment and an increase in real wages via the increase in output (Q).20 Moreover, an exogenous increase in (money) wages induces firms to increase their demand for finance from the banks, thus increasing their capitalization. Insofar as the increase in firms' capitalization has a positive effect on their production, it also generates an increase in the degree of utilization of capital and, as a result, an increase in real wages and employment. Accordingly, wage increases determine the increase in firm size and in the level of employment. Note also that money wage pressures generate a reduction in the price level: the main cause of inflation is, in view of the discussion above, a reduction in the degree of capital utilization.21 A possible counterbalancing effect can be traced in the increase in the money interest bill due to the increase in finance, which could produce a decline in investments and, hence, in employment and real wages.22

If wage increases drive economic growth, the ultimate cause of wage increases must be traced. In The engineers and the price system, Veblen refers to a "limit of tolerance" in order to set the minimum level of wage consistent with no social conflict. The limit of tolerance has two dimensions: an economic dimension, i.e. the impossibility to survive in a 'decent' way in the event the current wage is systematically lower than the subsistence wage (depending on the institutional and social setting); a moral dimension, i.e. a non purely rational reaction to the violation of the prevailing canon of equity. This latter dimension derives from Veblen's idea that workers react to a decrease in their wages when, due to the violation of their "limit of tolerance" (Veblen, 1921, p.76), they feel they do not have "anything to lose by such an overturn of the established order as would cancel the vested rights of privilege and property" (Veblen, 1921, p.61). The "limit of tolerance" can be conceived as the minimum level of the long-term real wage consistent with no reaction on the part of workers. Its determination, according to Veblen (1921, p.76), "would be a hazardous topic of speculation". In more general terms, Veblen maintains that conflict is driven by their 'perception of social injustice'.23 As he points out, income distribution is based precisely on moral variables24:

"The principles and practice of the distribution of wealth vary with the changes in technology and with the other cultural changes that are going forward; but it is probably safe to assume that the principles of apportionment – that is to say, the consensus of habitual opinion as to what is right and good in the distribution of product – […] have always been such as to give one person or class something of a settled preference above another". And (ib., p.113, italics added): "Principles (habits of thought) countenancing some forms of class or personal preference in the distribution of income are to be found incorporated in the moral code of all known civilizations and embodied in some form of institution" (Veblen, 1908, pp.112-113, italics added).

If the limit of tolerance is violated, "popular discontent" and the consequent social conflict occurs (Veblen, 1921, pp.12 ff.). In view of the arguments above, the following conclusion can be drawn: the lower the 'limit of tolerance', the higher the wage claims and the higher the degree of capital utilization and employment. Furthermore, by assuming the limit of tolerance as an exogenous given, the possible causes of its violation are to be traced. Although Veblen is unclear on this issue, it can be argued that the violation of the limit of tolerance ultimately depends on the 'rapacity' of the leisure class.25 Even if the leisure class as a whole is interested in preserving the existing social order, on the microeconomic plane the competition in consumption can lead the individuals belonging to the leisure class to 'exploit' the industrial system to a degree so as to produce a decline in real wages. Unintentionally, the members of the leisure class behave in such a way as to produce social conflict, and this is a spontaneous outcome of a deregulated market economy. Hence: the higher the bargaining power of the leisure class with respect to businessmen, the higher the intensity of competition to consume within the leisure class, and the more probable it is that the "limit of tolerance" will be violated and that social conflict will occur. Social conflict, in turn, is more likely to occur the higher the degree of solidarity there is among workers.26 The stability of the system – i.e. "institutional inertia" – is thus guaranteed only in the event that the members of the leisure class are in a position to co-ordinate their action, thus maintaining their level of consumptions at values consistent with no reactions on the part of workers.27

## 4. Concluding remarks

This paper dealt with Veblen's theory of the firm and income distribution. The re-reading of Veblen's contribution proposed here leads to the following main results. First, the firm is conceived as a locus of conflict, involving businessmen – interested in money profits – and technicians – interested in expanding production. The outcome of the bargaining within the firm determines the level of output and the level of real wages: the more firms are of a 'workmanship-type' (i.e. the less docile the technicians are), the higher the resulting level of output and real wages. Second, at the macroeconomic level, it is argued that an exogenous wage increase can have a positive effect on the degree of capital utilization, both because of the positive effect of wage increases on the total demand for consumer goods and because of their effects on the degree of firms' capitalization. Accordingly, high wages can be associated with high level of employment. Third, it is shown that institutional change, driven by social conflict, is likely to occur in cases where the members of the leisure class – competing in consumption – drive an 'excessive' amount of resources from the productive sector, so as to produce systematic violations of workers' "limit of tolerance" and hence enhancing their reaction.

## References


P.F. Asso, L. Fiorito, Human nature and economic institutions: instinct psychology, behaviorism, and the development of American institutionalism, J. Hist. Econ. Thought, 26 (4) (2004), pp. 445-477

S. Bowles, Y. Park, Emulation, inequality and work hours: was Thorstein Veblen right?, Econ. J., 115 (507) (2005), pp. 397-412

P.D. Bush, The theory of institutional change, J. Econ. Issues, XXI (September (3)) (1987)

C. Cordes, Veblen's 'instinct of workmanship', its cognitive foundations, and some implications for economic theory, J. Econ. Issues, XXXIX (March (1)) (2005), pp. 1-20

S. Cutrona, Veblen and the firm, M.E.L. Guidi, D. Parisi (Eds.), The Changing Firm. Contributions from the History of Economic Thought, Angeli, Milano (2005), pp. 260-280

D. Dillard, Money as an institution of capitalism, J. Econ. Issues, 21 (4) (1987), pp. 1623-1647

S. Edgell, Veblen in perspective, His Life and Thought, M.E. Sharpe, New York (2001)

G. Forges Davanzati, Ethical Codes and Income Distribution. A Study of John Bates Clark and Thorstein Veblen, Routledge, London-New York (2006)

A. Graziani, The Monetary Theory of Production, University Press, Cambridge: Cambridge (2003)

G. Hodgson, Economic and Institution. A Manifesto for a Modern Institutional Economics, Polity Press and Basil Blackwell, Cambridge/Oxford (1988)

A.H. Mouhammed, An Introduction to Thorstein Veblen's Economic Theory, The Edwin Mellen Press, Ceredigion (2003)

P.H. O'Hara, Marx, Veblen, and contemporary institutional political economy, Principles and Unstable Dynamics of Capitalism, Edward Elgar, Cheltenham (2000)

P.H. O'Hara, Veblen and Sweezy on monopoly capital, crises, conflict and the state, J. Econ. Issues, XXXVIII (December (4)) (2004), pp. 969-987

G. Parker Foster, B. Ranson, Thorstein Veblen on money and production, Econ. Soc. (1987), pp. 221-228

H. Peukert, The paradoxes of happiness in an old institutionalist perspective, J. Econ. Issues, XXXIX (2) (2005), pp. 335-345

M. Rutherford, Veblen on owners, managers, and the control of industry, Hist. Polit. Econ., 12 (3) (1980), pp. 434-440

M. Rutherford, Thorstein Veblen and the processes of institutional change, Hist. Polit. Econ., 16 (1984), pp. 331-348

L. Schute, John Maurice Clark: A Social Economics for the Twenty-first Century, Macmillan, London (1997)

R. Tilman, The Legacy of Thorstein Veblen, 3 vols, Elgar, Cheltenham (2003)

R. Tilman, Colin Campbell on thorstein veblen on conspicuous consumption, J. Econ. Issue, XL (March (1)) (2006), pp. 97-110

S. Tsuru, Istitutional Economics Revisited, University Press, Cambridge: Cambridge (1993)

T.B. Veblen, Böhm-Bawerk's definition of capital and the sources of wages, Q. J. Econ., vol. 6 (January) (1892), pp. 247-252

T.B. Veblen, Mr. Cummings's strictures on The theory of the leisure class, J. Polit. Econ., 8 (December (1)) (1899), pp. 106-117

T.B. Veblen, Credit and prices, J. Polit. Econ., 13 (June (3)) (1905), pp. 460-472

T.B. Veblen, Industrial and pecuniary employments, The Place of Science in Modern Civilization and Other Essays (1906), pp. 279-323,(1901)

T.B. Veblen, On the nature of capital: investment, intangible assets, and pecuniary magnate, Q. J. Econ., 23 (1) (1908), pp. 104-136

T.B. Veblen, Christian morals and the competitive system, Int. J. Ethics, vol. 20 (January (2)) (1910), pp. 168-185

T.B. Veblen, The Vested Interests and the State of the Industrial Arts, B.W. Heubsch, New York (1919)

T.B. Veblen The Engineers and the Price System, Batoche Books, Kitchener (1921)

T.B. Veblen, Absentee Ownerhip and Business Enterprise in Recent Times The Case of America, B.W. Huebsch, New York (1923)

T.B. Veblen, The Theory of Business Enterprise, (1904),(New York: A. M Kelley 1965a)

F.L. Viano, Cognitive models and enterprise: veblen revisited, M.E.L. Guidi, D. Parisi (Eds.), The Changing Firm. Contributions from the History of Economic Thought, Angeli, Milano (2005), pp. 227-259

H. Wolozin, Thorstein Veblen and human emotions: an unfulfilled prescience, J. Econ. Issue (2005), pp. 727-740