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Institutional economics and behavioral finance

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ABSTRACT

Finance, while largely emerging out of economics, has tended to overlook its own intellectual history. Perhaps because of this lack of attention to its intellectual history, an important connection between two important schools of thought, one in finance (behavioral finance) and the other in economics (institutional economics), appears to have been largely overlooked. The parallels between the two schools of thought are striking.

Institutionalism arose in opposition to the orthodoxy of mainstream microeconomic though being developed by such neoclassical economists as Jevons (1871) and Marshall (1890). Institutionalism rejected the idea of universal economic "laws" or theoretical systems. Rather, its adherents argued that economic behavior was hugely influenced by the participant's historical, social and institutional context. According to these adherents, understanding such behavior required an interdisciplinary approach.

Mainstream finance's basic modern portfolio theory model began with Markowitz's classic 1952 article. In the next twenty years the Capital Asset Pricing Model (CAPM) took shape. Behavioral finance is said to trace its roots back to a 1972 article by Slovic. Behavioral finance arose as an attempt to explain apparent inconsistencies between orthodox finance theory and real world financial market behavior.

Clearly both institutionalists and behavioralists are operating outside of the main stream of their discipline. Both believe that their view of reality is more realistic than that of the mainstream models. Both can cite a host of theoretical and empirical evidence to support their viewpoint. Both argue for a multidimensional (especially psychological) approach. Both see the mainstream approach as too simplistic. Both are criticized by the mainstream for their ad hoc approach and lack of a central theoretical model.

The history of economic thought is a well established, if somewhat neglected, subspecialty of the basic discipline. Finance, while largely emerging out of economics, has tended to overlook its own intellectual history. Most finance articles do start off with a survey of the relevant literature. That, however, is often as far as it goes. Systematic treatments devoted exclusively to the development of thought in finance are rare.

Perhaps because of this lack of attention to its intellectual history, an important connection between two important schools of thought, one in finance and the other in economics, appears to have been largely overlooked. The connection to which I refer is that between institutional economics and behavioral finance. The parallels between the two schools of thought are striking. Both grew out of an objection to the orthodox approach of the mainstream discipline. Both emphasize the importance of a broad multidisciplinary view of the relevant causative forces. Both look to the field of psychology for help in understanding the behavior of the markets and market participants. Both have a connection with the National Bureau of Economic Research (NBER). And, both have been a criticized for failing to produce a generalized model to put in place of the one that they attack. Moreover both have been criticized for being ad hoc.

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1. What is institutionalism?

In order to understand the parallels more fully and, more in importantly, in order to understand some of the implications of these parallels, we need to explore what the institutional school of economics is and was. Institutionalism began to emerge as a perspective in economics in the 1880s. It arose in opposition to the orthodoxy of mainstream microeconomic though being developed by such neoclassical economists as Jevons (1871) and Marshall (1890). Institutionalism borrowed somewhat from the German and Austrian historical schools and the works of Menger (1871). These historical schools emphasized the importance of empirical and inductive reasoning. They rejected the idea of universal economic "laws" or theoretical systems. Rather, its adherents argued that economic behavior was hugely influenced by the participant's historical, social and institutional context. According to these adherents, understanding such behavior required an interdisciplinary approach.

Institutionalists also stressed the importance of historical, social and institutional factors and their impact on economic behavior (Hodgson, 1988; Rutherford, 1994). The American Institutional School traces its beginnings to the work of Veblen (1899), a harsh critic of mainstream classical and neoclassical economics. His attacks focused particularly on Benthamite utility theory (1789). He strongly objected to the view that consumers were hedonistic lightening calculators of pleasure and pain responding solely to such stimuli in their economic decisions.

Two other names are almost always cited as giants in the development of institutionalist thought. Mitchell (1946) is particularly noted for his focus on empirical work and data collection, especially his work on business cycles and in the foundation of the National Bureau of Economic Resources. The third giant in the establishment of the instutionalism was Commons (1934). Commons' principal contributions were in the areas of labor, public utilities and law. He stressed the importance to economic activity of the concept of private property under laws, institutions and events.

Institutionalism flourished in the 1920s and remained a powerful force through the 1930s (Rutherford, 2000). Its influence waned as the Keynesian Revolution overtook classical and neoclassical economics. The institutionalist school of economics has, however, revived and in fact bifurcated. One institutionalist school goes under the name the new institutionalism (Williamson, 2000). The "old" institutionalism has also survived and continues to be active. The two sub schools differ in certain respect, particularly in the degree of formalism to their approach. Nonetheless they have the same root and much in common. While both new and old institutional economics continue to be represented in modern day economic thinking, my primary interest herein is in exploring the parallels between the contributions of the early "old" institutionalists and the work of modern day behavioral finance scholars.

2. What did institutionalists have to say?

From Smith (1776) to Marshall (1890), economists had explored the issues of markets, supply, demand, profits, competition, monopoly power, and the determinants of price and value. Malthus (1798), Say (1865), Ricardo (1817), Mill (1848), Marx (1867), Jevons (1871) and many others all weighed in with important contributions. Ultimately microeconomics produced a general equilibrium model (Walras, 1874; Samuelson, 1947). Under that equilibrium model prices were established in markets where supply and demand allocated scarce resources to their highest and best uses. Marginal analysis was extensively employed in order to achieve this optimum. Consumers allocated their own incomes to goods and services up to the point where they consumed each product optimally. Thus the (marginal) utility of the last increment of each product divided by its price equaled a similar ratio for all other products for each consumer.

Similarly each firm organized production such that the marginal product of each input divided by its price equaled that same ratio for every other input. A competitive market allocated capital and labor to their highest and best uses. Competition drove market prices down to the point where only normal profits were earned. As a result market prices were stabilized at their long run marginal costs which, in perfect competition in the long run, also equaled their long run average cost of production. As a result each product was priced at its long run incremental production cost and consumed up to the point where its ratio of marginal utility to the price was equal for every consumer. Such a system produced the best of all possible economic worlds. Pareto (1906) optimal shifts were not possible once such a general equilibrium was reached. To be sure no neoclassical economist actually believed that the real world fit this ideal. But the general equilibrium model did serve as an important point of departure for further analysis. It was and continues to be the fundamental microeconomic model taught in basic microeconomic courses on the subject.

The old line institutionalists, starting with Veblen, saw this model as a woefully unrealistic description of the world that they knew. They were working during the times of the robber barons (e.g. Frick) trusts (e.g. Standard Oil) and large amalgamations (e.g. U.S. Steel). The institutionalists, who saw a very different reality from that envisioned under the model of general equilibrium, sought to explain the world that they saw. To do so, they proceeded to derive insights into economic unit behavior (both consumer and firm) from other disciplines, especially psychology, anthropology, and sociology. Focusing particular attention on the consumer, institutionalists reject the idea of a homo economicus rationally allocating his or her scarce resources so as to maximize each individual's utility. Rather, the institutionalists saw and continue to see the consumer as subject to a variety of influences. In particular consumers are viewed as embedded in an environment of institutional influences. To the institutional economist these institutional influences go a long way toward shaping the consumers' spending patterns. Habits, norms, and rules of thumb all play a major role in such matters. So, for example, Veblen's concept of "conspicuous consumption", Ayres's (1944) idea that "invention is the mother of necessity" and Galbraith's concept of "want creation" (1958) are offered as important forces in consumption decisions. Tastes and preferences are viewed by the institutionalists as, to a large extent, endogenous to the system. The