



Research Article

Institutional Approach in Economics and Institutional Economic Thinking

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Abstract. Aspects of economic methodology contained in Institutional economics are often incorporated into orthodox economics. Orthodox economics means economic thoughts that use and continue classical economic views, such as free competition, perfect competition, consumer satisfaction. The person who was most influential and had a dominant role in the existence of the Institutional school was Thorstein Bunde Veblen. He criticized Classical and Neo-classical economic theories which ignored non-economic aspects such as institutions and the environment. In fact, Veblen considered that the influence of circumstances and the environment was very large on people's economic behavior. Unsupportive political and social structures can cause distortions in economic processes. For Veblen, society is an evolutionary phenomenon, everything is constantly changing. A person's behavioral patterns in society are adapted to current social conditions. If the behavior is suitable and accepted, then the behavior will continue. On the other hand, if a behavior is deemed unsuitable, the behavior will be adapted to the environment. These circumstances and environments are what Veblen called "institutions". In this case, it is explained that what Veblen means by

institutions are things related to norms, values, habits and culture. Furthermore, everything is reflected in economic activities, both in production and consumption.

Keywords: Institutional Approach, Economics, Institutional Economic

INTRODUCTION

Recently, the debate over *mainstream* and *non-mainstream economic thought* has become interesting again. One of them is the debate on Old Institutional Economics or *OIE*, *Neo Classical Economics* or *NCE* and *New Institutional Economics* or *NIE*. The debate has arisen since the award of the Nobel Prize in economics to Ronald Coase in 1991 with his writings entitled '*The Nature Of The Firm*' (1937) and '*The Problem Of Social Cost*' (1960), Douglas C. North in 1993 with issues *Credible Institutions and Commitment* (*Institutions and Commitment Credibility*), up to the award of the Nobel Prize in economics in 2009, to Elinor Ostrom in *Economic Analysis of Governance*, especially the *Public Interest* (*Economic Governance, especially Commons*) and Oliver E. Williamson in *Economic Analysis Governance*, especially *Company Boundaries* (*Economic Governance, especially Boundaries of the Firm*).

It cannot be denied that many institutional economics materials are extracted from various selected journals such as: *American Economic Review*, *The Journal of Institutional and Theoretical Economics*, *Journal of Economic Perspectives*, *Journal of Economic Literature*, and *The Journal of Law and Economics*. The development of *NIE* is increasing with the emergence of world communities that love *NIE theory* such as *the International Society for New Institutional Economics (ISNIE)* and *the European School on the New Institutional Economics (ESNIE)*.

OIE theory is a branch of economics that does not have an orthodox economic theory based on classical or neoclassical economics. They oppose neoclassical thinking because it is considered not to include *humanistic* aspects in its approach (Harris, et al., 1995 and North, 1990). They say that the *OIE* theory is not a physical institution but rather economic behavior driven by considerations and feelings that generally apply in certain circumstances and at certain times. Meanwhile, *NCE* theory still dominates as *mainstream economic thought* which still emphasizes market mechanisms. *NCE* was built with a theoretical approach and uses many assumptions. These assumptions include the existence of perfect information *obtained* by economic actors and the absence of transaction costs (*zero transaction costs*). Another assumption used by *NCE* is the competitive environment faced by economic actors, or perfect *competition*. *NCE* also assumes that every actor faces the same situation (*stagnant rational behavior*) and they are free to enter and exit the market (Furubotn and Richter, 1993 and North, 1990).

NIE theory exists because it is able to modify, develop and open the black box of the weak application of *NCE theory* in solving economic problems in the real world. *NIE* describes the imperfection of information and the existence of transaction costs. Every economic actor cannot freely enter and exit the market because not all actors

have the same information. Imperfect information results in transaction costs. The more imperfect the information (the existence of *asymmetric information*), the higher the transaction costs incurred by economic actors. In *NIE's view*, efforts are needed to minimize transaction costs. There are three reasons underlying the importance of the role of *NIE*. First, *NIE* is a theory that emerged from the *NCE framework*, but offers answers to refine and develop the theory. Second, *the NIE* is important in the context of economic policy in the 1990s because it challenged the domination of the market role by the orthodox *NCE*. Third, *NIE* is important because it is a theory built by adjusting institutional changes in relation to increasing economic growth (Furubotn and Richter, 1993 and Harris, et al., 1995).

The debate over these three theories becomes even more interesting when viewed from the research methodology paradigm used (Creswell, 2003, Darlinton and Scott, 2002, Hussey and Hussey, 1997). During ten years of observing the research results of the three *OIE*, *NCE*, and *NIE theories*, the *OIE* theory research methodology paradigm tends to be more phenomenological, characterized by small samples, case studies, inductive, direct observation, qualitative, and aims to modify the theory rather than test the theory. Meanwhile, *NCE's* research methodology paradigm tends to be positivist, characterized by large samples, deductive, quantitative, *modeling*, and aims to test hypotheses or test theories. In contrast to *OIE* and *NCE*, *the structure of the NIE* research methodology paradigm is more formal and informal or tends to be a mixture of positivist and phenomenological. This paradigm is characterized by combining quantitative and qualitative methodologies, using triangulated data and aiming to modify theory.

In 2000, Williamson introduced the evolution of *NIE* theory through four levels of social analysis as in Figure 1. The solid arrow line shows the relationship between higher and lower where the higher level determines the constraints on the level below it. The dotted arrow line shows the inverse relationship connecting the lower level and the higher level.

Williamson (2000) explains that the earliest institutional level is level I, namely social theory, which is the informal rules that are embedded in society, such as traditions, religion, norms, customs and embeddedness *conventions*. Level I analysis is strongly influenced by economic history and other social sciences. At this level, change occurs very slowly, spontaneously and naturally over centuries to millennia.

According to Williamson, level II is related to the institutional *environment*. Level II emphasizes the economics of *property rights* which consist of the rules of the game (law), politics and bureaucracy which include executive, legislative, legal and government bureaucratic functions. The definition of property rights and contract law is an important illustration. This level is usually called the 'level of the rules of the game of rights and obligations' or the 'level towards the institutional environment of first order economising'.

Level III emphasizes a governance structure that emphasizes contracts and transaction costs (*transaction cost economics*). Although property rights remain important, the legal system's function of defining contract law and contract protection cannot be ignored. At this level, it is usually called the level of how the

rules of rights and obligations are played out or 'the level towards the second order economic governance structure'.

Level IV emphasizes resource efficiency and incentive structures which constitute the neoclassical framework. Marginal analysis was developed where it is described as a production function. Price and output adjustments are more or less continuous. At this level, it is usually called the 'level towards the marginal conditions of third order eonomization'.

DISCUSSION

Understanding Institutional Economics

The word institutional in much literature is written as institution. The definition of institutions in economics is the rules of life, organization, beliefs and norms (North, 1990) in human groups. Life rules, organizations, or norms are formed from generation to generation (historically). Institutional economics gives a portion of appreciation to historical thinking as a reference for institutional ideas (institutions). Understanding the history of human life is a series of stories of values that have existed. North (1990) considers regulations in the form of institutions to be a form of limitation of human life in regulating interactions between people, so that the rules can be formal or non-formal rules (North, 1990: 4), official (state) or unofficial (local wisdom, awik-awik and so on).

Institutional Economics analyzes economic behavior with the assumption that institutions are not the same as organizations. Institutions are broader than organizations. The economic behaviors that occur, whether behavior that maximizes profits or behavior that does not maximize profits, are caused by institutional factors, both formal and informal. For example, economic behavior will be greatly influenced by applicable rules, regulations, laws, conventions, trends, or culture.

The old school of institutional economics emphasized the existence of differentiated decision making. There is decision making that is based on the concept of maximizing profits, but there is also decision making that is not based on the concept of maximizing profits. Many well-known exponents of the old school of institutional economics focus on decision making that is not based on the concept of maximizing profits and the various factors that influence it, such as psychological or legal factors. Through them, the Old School of Institutional Economics became known as an opposition to the Neoclassical School of Economics.

Several exponents after the exponents of the Old Institutional School of Economics tried to continue the economic concept of the Old Institutional School. The analysis put forward is more focused on efforts to answer the failure of the Neoclassical School of Economics. J. Schumpeter, G. Myrdal and K. Galbraith were among these exponents. Santosa (2008) groups them as Quasi-Institutional Schools which are different from the Old and New Institutional Schools.

The New School of Institutional Economics places more emphasis on the conceptualization of various things in the relationship between institutions, information and individuals/decision making. Various things that exist in this relationship include the concepts of transaction costs, property rights, public choice and game theory. Decision making may be decision making based on profit

maximizing behavior, it may be decision making not based on profit maximizing behavior. These choices in decision making occur because the decision maker has information originating from the surrounding institutions where the information is processed and processed based on one or more of the concepts of transaction costs, ownership rights, public choice and game theory.

Santosa (2008) analyzes that this conceptualization strengthens the position of the Institutional Economic School as the 'opponent' of the Neoclassical Economic School, Market Economy or the like. The conceptualization in the Institutional Economics School can be divided into institutional environment and institutional arrangement. Through this conceptualization, the importance of a holistic approach and diversification of economic education can be understood. Riyardi (2012) expressed the opinion that the distinction between institutions and organizations cannot be fully accepted. What is more appropriate is the organization as part of an institution where, like part of an institution such as rules or culture, the organization provides information in decision making. Another alternative is the organization as an institutional approach. In that situation, the organizational levels together with their capacities as in the OCA Tool can describe the organization as an institution that determines decision making as having the characteristics of expertise, specificity and incentives as stated by Sato (2000).

Figures of Thought

Veblen as the main figure of the institutional school had quite a lot of followers. Some of them that can be mentioned here are: Wesley Mitchell, Gunnar Myrdal, Joseph Schumpeter, and finally Douglas North.

Wesley Clair Mitchal [1874-1948] was a student, friend and admirer of Veblen. Apart from supporting and developing his teacher's ideas, he was also instrumental in developing quantitative methods in explaining economic events. One of his works that has become a classic is: business cycles and their causes [1913]. By using various statistical data he then explained the problem of economic fluctuations.

After the second world war he organized a research agency "national bureau of economic research" which allowed further development of research on national income, economic fluctuations or business cycles, changes in productivity, price analysis, and so on.

1. *Gunnar Karl Myrdal*

Gunnar Karl Myrdal has written many books, including: *An American Pomegranate*, *Value in Social Theory*, *Challenge to Affluence*, and *Asian Drama: An Inquiry into the Poverty of Nations*. One of Myrdal's messages to economic experts is to participate in making value judgments. . If this is not done, the theoretical structures of economics will become unreal. Myrdal believes that institutional thinking is very necessary in implementing development in developing countries. Myrdal won the Nobel Prize in economics in 1974 with FA Hayek for his services in contributing to economic thought, especially for the development of developing countries.

2. *Joseph A. Schumpeter*

Joseph A. Schumpeter was included in the institutional school because he said that the main source of prosperity does not lie within the economy itself, but outside it, namely in the environment and institutions of society. The source of prosperity lies in the entrepreneurial spirit of economic actors who architect development.

3. *douglas north*

Appreciation of institutionalism reached its peak in 1993 when Douglas North received the Nobel Prize in economics. So far, most economic experts have considered market mechanisms as the sole driving force of the economy, and ignored the role of institutions. North considers this to be wrong, because the role of institutions is no less important in economic development. He concluded that communist countries were destroyed because they did not have institutions that supported market mechanisms.

Regarding the radical changes in Eastern Europe and the former Soviet Union, North said that the reforms carried out would not provide real results just by improving macroeconomic policies alone but also needed the support of a set of institutions that were able to provide the right incentives to every economic actor. Examples of institutions that are able to provide these incentives are patent and copyright law, contract law and land ownership. What North means by institutions is slightly different from Veblen as the founder of the institutional school.

For Veblen, institutions are defined as norms, values, traditions and culture. However, for the North, institutions are the following laws and regulations that are coercive of these regulations and norms of behavior that shape interactions between humans over and over again. North looks at institutions, especially at the consequences of these institutions for the choices made by members of society.

Institutional Economic Thought Style

In the 20s in the United States, another school of economic thought emerged, called the " *institutional* " school of economics. Institutional economics or institutional economics is essentially a branch of economics that emphasizes the importance of institutional aspects in determining how economic and social systems work.

There are few similarities between the Institutional school and the Historical school, both of which reject the Classical method. However, the basic philosophy and political conclusions of the two schools are different. The Institutional School rejects the idea of experimentation as espoused by the Historical School. Likewise, the focus of institutional attention on economic problems in people's lives is different.

Aspects of economic methodology contained in Institutional economics are often incorporated into orthodox economics. Orthodox economics means economic thoughts that use and continue classical economic views, such as free competition, perfect competition, consumer satisfaction.

The person who was most influential and had a dominant role in the existence of the Institutional school was Thorstein Bunde Veblen. He criticized Classical and

Neo-classical economic theories which ignored non-economic aspects such as institutions and the environment. In fact, Veblen considered that the influence of circumstances and the environment was very large on people's economic behavior. Unsupportive political and social structures can cause distortions in economic processes. For Veblen, society is an evolutionary phenomenon, everything is constantly changing. A person's behavioral patterns in society are adapted to current social conditions. If the behavior is suitable and accepted, then the behavior will continue.

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CONCLUSION

Based on the explanation above, it can be said that in Institutional economic thought, Veblen said that people's behavior patterns experience changes both in producing and consuming, where in consuming they prioritize pleasure and indulgence in consumption, causing the emergence of the leisure class group. Then, in production, according to Veblen, entrepreneurs tend to have absentee ownership, where in developing their business they just sit around while those who run the business are paid professionals. Behavioral patterns like the ones above occur in American society, but it does not rule out the possibility that similar behavioral patterns also occur in Indonesian society today. With Veblen's theory, we know that actually people's behavioral patterns also need to be regulated, both in production and consumption.

Meanwhile, according to Imam ash-Syatibi's opinion, *maqashid al sharia* (benefit) will be realized if the five main elements of human life can be realized and maintained, namely religion, soul, reason, heredity and wealth. Benefit has very close relevance to the concept of motivation. Where the concept of motivation was born along with the emergence of the question of "why" someone behaves. Motivation is defined as all conditions of hard effort that arise from within humans which are described by desire, desire and drive. When linked to the concept of *maqashid al-syariah*, it is clear that, in the Islamic view, the motivation for carrying out economic activities is to fulfill one's needs in the sense of obtaining the benefits of life in this world and the hereafter.

Unmet needs are the main key in a motivation process. An individual will be encouraged to behave if there is a deficiency within himself, both psychologically and psychologically. Motivation itself includes effort, persistence and purpose. If people are motivated to always be creative and work hard, then this will be able to increase work productivity and overall economic growth.

So, there are differences in views between Veblen and Imam ash-Syatibi regarding consumer behavior and producer behavior. According to Veblen, the purpose of human life is merely worldly pleasure and prosperity, whereas according

to Imam ash-Syatibi in Islam we not only think about worldly welfare, but we also think about welfare for the afterlife.

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