Neoclassical Economics as a Theory of Politics and Institutions

Anton D. Lowenberg

Introduction

There are essentially two types of social science explanations of politics and institutions. One approach is to focus on the behavior of the rational individual agent and treat macrostates as outcomes of interaction between individual agents. This is the methodology of neoclassical economics. An alternative approach is to start with social structures and historical context, and to view the individual as merely a passive reflection of these. In economics, this "agentless" emphasis on social structure is characteristic of Marxian, radical, and institutionalist theory.

Ultimately, the usefulness of any research program is to be judged on its ability to explain an increasing number of hitherto unexplained phenomena.[1] A "progressive" research program, to borrow the terminology of Lakatos (1978), possesses an expanding empirical content. Theories within a progressive research program are able to explain novel facts or regularities that were previously unexplained. Conversely, a "regressive" research program is one whose theories require continuous ad hoc changes in order to shore up the fundamental axioms upon which they are based. The theories in a regressive research program continually confront empirical refutation, and they must be amended accordingly.

My purpose is to argue that neoclassical economics encompasses a progressive research program, whereas Marxism, institutionalism,

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The author is Associate Professor of Economics at the University of Colorado at Denver.

[1]A research program (or paradigm) is a cluster of theories all of which are based on a common "hard core" set of axioms, assumptions, or beliefs. The notion of a research program in this sense is due to Lakatos's rational reconstruction of the growth of scientific knowledge (Lakatos 1978).

and other "holistic" methodologies in economics[2] suffer important drawbacks that impede their explanatory power. I use the term "neoclassical" here very broadly; it includes all theories that are based on the economizing behavior of individual value-maximizing agents. This term would embrace standard textbook theories of production and consumption; the property rights and transaction costs approach to industrial organization, law, history, and social institutions; public choice theories of politics and constitutional arrangements; and even Austrian economics.[3] By contrast, nonneoclassical theories are those that posit the primacy of social structure and assign little role to the individual agent. In addition to Marxian economics, nonneoclassical theories include institutionalism—a theory that regards market exchange as a function of underlying power relations in society.[4]

In this paper, I will start by showing that neoclassical rational choice theory has rapidly expanded its empirical content and explanatory power. Recent theoretical developments have brought many aspects of collective and institutional choice explicitly into the domain of economic theory. Therefore, in the next section I will demonstrate that the typical criticisms leveled against neoclassical economics by radical and institutionalist detractors no longer have much validity. Following that section I will examine some of the weaknesses inherent in structuralist and functionalist theories, and then I will show how some practitioners of modern radical economics have attempted to rescue their paradigm by injecting elements of the neoclassical method. This discussion is offered as evidence of the regressiveness of the structuralist research program when compared to the rational individual choice approach.

The Extension of Neoclassical Economic Theory

In addition to the standard price-theoretic analysis of market exchange and production, neoclassical economics now also provides testable theories of institutions and nonmarket interactions. The extension of the scope of economic theory into this area is evidence

[2]See Boland (1982) on the distinction between methodological individualism and methodological holism.

[3]This is not to deny the substantial differences between these various subprograms. As long as they share some crucial hard-core axioms, different paradigms can be viewed as belonging to the same overall research program even if they contain conflicting propositions or theories. On the relationship between subprograms and the larger research program, see Remenyi (1979), Cross (1982), Weintraub (1985), and Heijdra and Lowenberg (1988).

[4]For a good brief summary of the major differences among neoclassical economics, Marxism, and institutionalism, see Medema (1989).

of the progressivity of the neoclassical research program. It also debunks the claims of Marxians, post-Keynesians, institutionalists, and other nonneoclassical economists that only their respective schools are able to deal adequately with institutions. Orthodox Marxians, for example, have traditionally rejected the methodology of neoclassical economics on the grounds that it is based on an atomistic isolated individual and is, therefore, unable to supply a theory of history, social institutions, collective behavior, or anything else that lies outside the realm of narrow market exchange (Hunt and Schwartz 1972, p. 8).

It is certainly true that the basis of neoclassical economics is methodological individualism. The individual is modeled as an evaluating, choosing, and acting agent (Buchanan 1987, p. 244). Aggregate social phenomena (of both the market and nonmarket variety) are then explained in terms of individual actions and their interrelations (Vanberg 1986, p. 80). Every observed social outcome is treated as an endogenous product of a process of individual choice and exchange, in the context of perceived constraints. The much touted (and thoroughly misunderstood) assumption of "individual rationality" is really quite innocuous. It simply means that individuals strive to make themselves as well off as possible, given their tastes and the resources and knowledge that they possess.[5] This assumption does not imply that the rational actor of neoclassical economics pursues only pecuniary wealth. Anything that is valued by the individual is a legitimate source of utility. Whether something is valued depends on whether individuals reveal by their behavior that they are willing to sacrifice some other object of utility in order to attain more of the "good" in question. This good might be a marketed commodity like apples or oranges, but it could also be a less-tangible form of satisfaction like charitable giving or the propagation of some ideological or religious belief. The minimal assumption required for this economic theory of human behavior is simply that identifiable self-interest (for example, net wealth, social position, fairness, altruism, etc.) motivates the choosing individual. Note that this assumption does not give primacy to the pursuit of narrowly conceived economic interests, nor does it impute any mali-

[5]The method of neoclassical economics is, in fact, a variant of what Karl Popper calls "situation analysis"—individuals' actions are dictated by the logic of a situation in which they find themselves, assuming that they will use only those actions that are most appropriate to their situation. See Hands (1985, p. 84); Boland (1982, p. 32); and Latsis (1976). Langlois (1986, p. 236) points out that the advantage of situational analysis is that it renders unnecessary a detailed psychologistic study of the internal mechanisms of human decisionmaking. A knowledge of the agent's environment (including institutions) serves as a substitute for a detailed knowledge of his or her psychology.

cious or selfish motives to the individual agent.[6] Furthermore, it obviates the oft-repeated complaint of nonneoclassicals that the rational choice framework cannot explain altruism.[7]

One of the great discoveries of such 18th-century political economists as Mandeville, Hume, Tucker, Ferguson, and Adam Smith is that self-interested individual behavior can have unintended, but nevertheless beneficial, consequences for society. Unrestricted individual exchange will ensure that scarce resources flow to their highest valued uses. This efficient outcome—what Hayek (1976, p. 99) calls "the spontaneous order of the market"—is not, and indeed cannot be, brought about through the design of any person or group. Individuals are driven primarily by their own self-interest, and no single individual or group of individuals can possibly possess enough information to implement the kind of massive coordination that is effected by market prices.[8] This view does not by any means preclude the existence of benevolent motives, but benevolence is scarce (it usually does not extend very far beyond close family and acquaintances). Therefore, a rationally organized society will economize on its use, rather than rely upon it to achieve an efficient allocation of resources.[9]

Apart from market resource allocation, many aggregate social outcomes can be modeled by means of so-called "invisible hand" explanations. Institutions, rules, mores, culture, tradition, and other behavioral regularities are often explained by economists as products of evolutionary-competitive processes.[10] This explanation is what Menger originally referred to as "organic" evolution of social conventions (Schotter 1986, p. 118). In the Mengerian research program, institutions are treated as the explananda of invisible hand theories (Langlois 1986, p. 247). The latter theories characterize institutions and rules as the products of a process involving the separate actions of individuals who do not deliberately intend to bring about the outcomes in question, but whose collective pursuit of individual interests is sufficient to ensure those outcomes (Vanberg 1986, pp. 80–81). This notion of a spontaneous social order emerging as an unintended consequence out of a catallaxy of individual exchanges has been formulated most explicitly by the Austrian school, although its intellectual heritage includes earlier ideas such as Mandeville's

[6]See Buchanan (1987, p. 245).

[7]See, for example, Dearlove (1989, p. 225) for a recent statement of this mistaken view.

[8]See Vanberg (1986, p. 78) and Lavoie (1989, p. 627).

[9]See Coase (1976).

[10]See Gray (1984, pp. 33–34) and Witt (1989).

"Private Vices, Public Virtues" and Adam Smith's own conception of the invisible hand of the market.[11] Contemporary examples of the invisible hand type of explanations include Douglass North's theory of economic history (1981), the property rights and transaction costs theory of industrial organization (Demsetz 1967 and Williamson 1985), the economic theory of the common law and the family (Posner 1977 and Becker 1976), and the economic theory of constitutions and rules (Brennan and Buchanan 1985). Common to all of these is the axiom that rational individuals will seek to exploit profit opportunities (broadly conceived) whenever they arise, which in turn ensures that welfare enhancing institutional innovations will occur whenever the net benefits are positive. Again, the term "benefit" is to be interpreted to include more than just pecuniary gains.

However, the economic theory of political and social institutions does not treat all institutional forms as spontaneous, socially desirable products of a catallaxy of individual wealth maximization. Within the broad rubric of neoclassical economics there has developed the field of public choice, which provides an economic theory of politics on the basis of the same methodological individualism that underpins other branches of neoclassical economics. Central to public choice theory is the recognition that optimal resource allocation does not always arise spontaneously out of individual optimizing behavior, because of various prisoner dilemma problems associated with the pursuit of collective outcomes. This theory makes it necessary to study the political processes through which individual preferences are translated into social structures. Public choice theory is informed by several converging strands of scholarly inquiry. These strands include most importantly Wicksell and Buchanan's approach to the economics of rule making; Duncan Black's work on collective choice exercized through committees and voting (a work that draws on earlier insights on social choice by the Marquis de Condorcet and Lewis Carroll); Anthony Downs' economic model of political exchange under democracy; Gordon Tullock's analysis of the welfare costs of rent seeking; Stigler and Peltzman's "capture" theory of regulation; and the theory of interest groups, which starts with the political scientists Truman and Bentley, and which is further developed by Olson and more recently formalized by Becker.

While there are important differences that separate some of these schools, there are considerable areas of overlap. For example, Chicago-style political economy generalizes the economic theory of regulation into a theory of politics that has much similarity to the Virginia

[11]See Heijdra, Lowenberg, and Mallick (1988, pp. 298–99).

school. These variants of public choice theory all share the assumption that individuals are no less self-interested in their capacity as political actors than they are in the economic sphere. This assumption represents a definite movement away from the older tradition in neoclassical economics, which treated the government essentially as a beneficent social engineer.

Some public choice models are voter oriented. According to this approach, political entrepreneurs (politicians) are interested only in gaining or retaining office. They adopt platforms and implement policies that they believe most closely accord with the preferences of the majority of voters. Government policy is viewed as an essentially passive reflection of the desires of the median voter. This theory explains why, in a two-party polity, both parties will tend to position themselves close to the political center at election time.

But as Kuran (1988) points out, the vote-centered theory has several deficiencies. It fails to explain, for example, why the distribution of political influence across discernable groups of voters is disproportionate to their size. It also fails to explain why in most societies—democratic or otherwise—large amounts of resources are devoted to influencing the way people know, think, and want. An alternative public choice approach comprises what Kuran calls "group-centered" theories. According to this perspective, politics can be analyzed as a process of competition among numerous private interests seeking influence over government policy, with the state acting as an impartial broker of wealth transfers between suppliers and demanders (Becker 1983 and Tollison 1989, p. 294).[12] Although the resultant political outcomes seldom embody efficient resource allocations in the usual Pareto sense, they do maximize the influence-weighted sum of utilities of the constituent interest groups.[13] The

[12]A similar distinction between voter- and group-oriented approaches is made somewhat more rigorously by Denzau and Munger (1986). In their model, the voter-based theory is one in which voters are fully informed and the prime concern of legislators is to discover the preferences of their geographical constituencies. The group-based theory, on the other hand, implies that voters are rationally ignorant of everything except the resource expenditures of legislators on their behalf, but, since those resources come from interest group contributions, it follows that interest groups largely control the legislator's actions.

[13]There are, however, significant differences between the Chicago and Virginia versions of the interest group theory of politics. Chicago political economy presents a strictly *positive* theory of politics. According to this approach, competitive lobbying among interest groups will tend to produce efficient outcomes, in the sense that the deadweight costs of government wealth transfers are minimized (although they are still large relative to the transfers they sustain). The existence of government redistribution is taken for granted. The Virginia school, by contrast, focuses attention on the inefficiencies created by special interest group behavior and rent seeking. It is a reformist,

weight attached to each group depends on its relative efficiency in exerting political influence, which in turn depends on its ability to overcome the incentive for its members to free ride on the pursuit of collectively sought outcomes. Olson, in his classic work (1965) on collective action, shows that selective (or excludable) incentives are necessary to transform a coalition of rational individuals into a "privileged" interest group.

In some variants of this model, politicians and bureaucrats are assumed to have their own goals, which need not coincide with those of their constituents. Politicians, for example, might desire certain public interest policies, which reflect a broad ideological conception of what is good for society as opposed to the special interests of the pressure groups whose lobbying and support brought the politicians into office. There is considerable debate among public choice theorists about whether legislators are constrained always to vote in accordance with what their constituents want, or whether there is scope for them to indulge their own ideological preferences. Stigler, Peltzman, and others of the Chicago school believe that the appearance of ideological voting is, in fact, an illusion, masking underlying economic interests or processes of vote trading (logrolling) that are coincident with the self-interest of constituents (Tollison 1989, p. 294). But logrolling does have the effect of tying together diverse interests in alliances that enable each interest group's preferred policy to be enacted, to the detriment of the median voter's well-being. Bureaucrats, too, might be more interested in maximizing the size or budget of their departments than in serving the interests of either politicians or voters. Thus, some group-centered theories of politics do allow for a considerable degree of slack in the principal-agent relationship between constituents and political entrepreneurs.

Related to the group-centered approach are the notion of rent seeking and the capture theories of economic regulation. Abstracting from the special (and relatively rare) case of decreasing costs, all *permanent* monopoly profits are treated as artifacts of government restrictions on entry.[14] Producer groups will expend resources to persuade or pressure the government into enacting such regulations. Rent-seeking expenditures generate welfare costs for society as a

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utilitarian approach, which implicitly compares the existing regulatory system of redistribution with some putative benchmark of efficiency (perfect competition) in which redistribution does not occur (Tollison 1989, p. 295; Gray 1987, p. 44).

[14]Otherwise, economic profits are temporary rewards for enterprise or risk taking, which provide the impetus for economic growth and innovation and are ultimately competed away by entry of new producers or development of new products. See DiLorenzo (1988).

whole, on top of the standard deadweight costs associated with any deviation from competition. Rent seeking is usually characterized as wasteful because it uses up resources to redistribute the existing social dividend rather than to enlarge it.[15]

Models of interest group competition and rent seeking have much explanatory power. It is evident that a great many interventions of government in the market—such as occupational licensure laws, health and safety regulations, farm subsidy programs, and protectionist tariffs and quotas, to name but a few—create benefits for organized industrial or labor interests who usually lobbied for them in the first place. Almost all of these policies serve to preclude less-organized groups of producers or workers from competing with the beneficiary groups, thereby preserving substantial rents for the beneficiaries. Of course, the number of people who actually benefit from most government regulations is small compared to the numerous consumers who are hurt by higher prices. The regulations are welfare reducing for society, which means that the losers lose more than the winners gain.[16] But this is precisely one of the most powerful predictions of the group-centered theory of politics. Small groups have greater relative political influence than large ones because the benefits sought by small groups are highly concentrated among their members. As such, individual members of small interest groups have an incentive to contribute resources to the pursuit of the group's collective goal (Olson 1965). Even though the welfare costs of special interest regulations are enormous (witness the costs to U.S. consumers of agricultural price supports or the quota on imported sugar), these losses are spread thinly over a vast number of individuals. (It is instructive to note that the most effective pressure in the United States for freer trade policy comes from exporter groups, not consumers.)

Public choice theories of interest groups and rent seeking have one thing in common with Marxian and radical theories. Both explain social outcomes as products of relative group influences. In the case of orthodox Marxism, the state is viewed as an agent of the ruling class and all government policies are treated as functional to the interests of this class. Public choice theory suggests simply that

[15]See Buchanan (1980).

[16]However, it could be argued that some regulations, while affording protection to producer groups from competition, also have positive external effects that outweigh their costs. For example, limiting entry into the liquor retailing business, and thereby raising prices, prevents the sale of liquor to minors because the rents accruing to the holders of liquor licenses provide substantial collateral insuring against malfeasance (Svorny 1987).

the more influential interests will gain at the expense of the less influential. But the former interests are not always identified with capital nor the latter with labor. As Stigler reportedly observed, if he is a Marxian, he is a better Marxian than Marx (Tollison 1989, p. 296).

However, neither the voter-oriented nor the group-oriented theory, in its simple formulations, represents the last word of neoclassical economics on political and institutional change. Recent work by some economists recognizes that collective action quite often occurs, not as a response of elected politicians to the preferences of the median voter, nor even as the result of organized interest group pressures. The free-rider problem notwithstanding, rational individuals are observed to make anonymous contributions to political causes and even to take to the streets in large crowds without evidence of explicit incitement by organized interests or the presence of selective incentives (witness recent events in Eastern Europe). Clearly, any appreciation for the causes of institutional change requires an understanding of ideology. According to Sartori, ideology is "an important variable in explaining conflict, consensus, and cohesion . . . [and] the decisive variable in explaining mass mobilization and manipulation" (cited in Higgs 1987, p. 45).

There is a growing consensus among neoclassical economists that social change is often ushered in by changes in prevailing beliefs, which are strong enough to overcome the usual proclivity of the rational individual to avoid costly political participation. For Higgs (1987), ideology enables individuals to consume a feeling of solidarity or belonging with other, like-minded, individuals. The degree to which one's self-perceived identity corresponds with the standards of one's chosen reference group is a positive argument in the individual's utility function, and the willingness to trade off material well-being for this nebulous quality helps to explain political action in a large-group context (Higgs 1987, pp. 42–43). North (1981, p. 49) argues that ideology is an economizing device by which individuals interpret their environment, obviating the need for costly information gathering. People occupying different positions in the social division of labor will generally have different experiences of the world and, therefore, different ideologies.[17] But Kuran (1988) shows that ideology itself is endogenous to the process of public discourse. Individuals will find it privately advantageous to espouse an ideology publicly if they believe that the majority of their fellow citizens also

[17] "As the distribution of occupational, ethnic, and other attributes changes because of industrialization, urbanization, or international migration, a society's ideological composition presumably changes, too" (Higgs 1987, p. 53). See also North (1988).

believe it. Hence, interest groups will often attempt to portray their goals as popular in order to shape the ideological preferences of the majority in their favor.

Criticisms of the Neoclassical Theory of Society

Modern critics of neoclassical theories of politics and institutions focus on two main lines of attack. Some have argued that the expansion of neoclassical economics into the domain of nonmarket behavior is limited by informational and cognitive constraints on individual decisionmaking capabilities. Nicolaides (1988), for example, maintains that the neoclassical rationality hypothesis cannot be applied uniformly to all areas of human choice, because individuals will separate their perceptions of the world into arbitrary segments to make information more manageable. Thus, individuals will use different decision rules for different circumstances. Nicolaides characterizes this problem as "the inherent paradox and inextricable limit to the expansion of neoclassical economics" (p. 324).

To illustrate this purported limit to the expansion of neoclassical theory, Nicolaides offers an example of a neoclassical model of market interaction in which some sellers are Muslims and derive utility from praying at certain times of day, during which they must close shop. He claims that profit maximization is not an appropriate assumption in this case because the Muslim sellers are willing to sacrifice profit for religious observance at a rate of substitution that (he assumes) is invariant to other market prices. However, such preferences can easily be incorporated into the structure of an economic model with fruitful results. An example is Becker's approach to race or sex discrimination in labor markets, in which a nonpecuniary source of satisfaction, which reduces pecuniary wealth, enters the model in the form of a self-imposed tax on the producer (Becker 1976). While it might be supposed that these producers will ultimately be driven out of the market, this outcome does not necessarily occur in the presence of entry barriers (which can be cultural in origin) or if there is not a sufficient number of suppliers unaffected by the religion/discrimination tax.

More generally, the claim that neoclassical economics ignores the problem of information is a specious indictment. Limitations of information and knowledge, far from being alien to neoclassical economists, are central to their analysis. Scarcity of information, like any other resource, is axiomatic to rational individual choice theory and is often incorporated in the formal structure of the models in the same way as other resource constraints. The search for knowledge is precisely what drives the entrepreneurial process of discovery. Uncovering new and hitherto unknowable profit opportunities is the role of the entrepreneur, broadly conceived as an agent of either market or nonmarket institutional change. Viewed from a dynamic perspective, many types of competition for profits are simply instruments used by the market process to eliminate imperfections in knowledge that hinder exchange (DiLorenzo 1984, p. 187). In fact, the very existence of temporary monopoly profits and quasi-rents is itself often created by opportunities or incentives to discover new products, techniques, and methods that continually arise in the competitive process (Littlechild 1981, pp. 355–59). Hence, information and knowledge are a vital part of neoclassical analysis, especially in the "process" view of competition.

Another line of attack against the extension of economics into the field of politics comes from institutionalists who object to methodological individualism on the grounds that it ignores the impact of social structure on individual preferences. Thus Dearlove (1989, p. 223) argues that it is important to try to *understand* (as opposed to predict) political developments by interpreting their significance in the kind of larger context that offers meaning to the actors and participants. He accuses the neoclassical perspective of focusing on abstract individuals and their preferences and, therefore, of failing to get to grips with institutional behavior and the workings of concrete political systems (Dearlove 1989, p. 230). According to Dearlove, although public choice theory attempts to explain what rational individuals will do given the pattern of existing norms and institutions, there is no attempt to account for the character of the larger system within which actors behave.

The accusation forwarded by Dearlove, however, is false, especially when we take into account some of the more recent advances in the neoclassical theory of institutions and ideology. The importance of institutions in neoclassical models essentially varies with the purpose of the particular model in question. For some purposes it is adequate to treat institutions as exogenous constraints, part of the "situation" that dictates a certain course of action by maximizing agents. Social institutions, in this context of situational analysis, often serve an information-economizing role. They place constraints on individuals, which restrict the dimensions of their problem situations and thereby reduce the cognitive demands placed on individuals. Alternatively, however, if the purpose of the theorist is to explain the evolution of institutions themselves, this can be accomplished by treating institutions as the explananda of a theory in which rules of human interaction emerge spontaneously out of the separate actions of self-interested individuals, without intentional design (Heijdra, Lowenberg, and Mallick 1988). This is an example of the invisible hand type of explanation that I referred to earlier. It is consistent with the Mengerian notion of organic evolution of institutions.

Dearlove further argues (1989, p. 232) that the public choice approach ignores constitutions, except in making normative prescriptions for constitutional reform. But this is also an incorrect statement. The public choice perspective is, in fact, a constitutional perspective, since it emphasizes the rules shaping individual incentives, and the process of cooperation under alternative sets of existing rules (Dorn 1987, p. 284).

Ultimately, however, the success of neoclassical economics as a theory of institutional change must be judged in terms of its explanatory power relative to competing approaches. It is not appropriate to criticize neoclassical economics on the grounds that its assumptions are not realistic or that they are not testable (*assumptions* of a theory are not intended to be tested, only its predictions). Yet this inappropriate criticism is precisely what some nonneoclassical writers do when evaluating neoclassical models. Nicolaides (1988, p. 320), for example, contends that because of imperfections of information, the different choices confronting an individual cannot be evaluated in terms of a single utility function. He also maintains that the neoclassical assertion that rules of behavior are information-saving devices has never been tested empirically (Nicolaides 1988, p. 322). Whether or not these complaints are valid is beside the point. The proof of the pudding is in the ability of neoclassical theory to explain and predict better than its competitors, not in the descriptive realism of its assumptions. I will turn now to examine the competition.

Structuralist and Functionalist Theories of Society

Marxism and institutionalism are structuralist theories. This means that individuals are viewed as products of a social structure within which they live. These theories abstract from the autonomy of the individual agent in favor of the view that individuals are important only in as much as they are the bearers of a particular social structure. As Dearlove (1989, p. 219) points out, structuralist perspectives on politics are problematic because they oversocialize individuals and treat them as passive in the face of grand social changes that come from nowhere and over which individuals have little comprehension and control. There is also a strong element of functionalism in these theories, in the sense that individual actions are treated as somehow determined by the needs of the system as a whole (Dearlove 1989,

p. 230). All behavioral patterns or institutions have a function that explains their presence.[18] Thus, as Dearlove observes, the structuralist-functionalist approach fails to deal with causes and mechanisms and, in ignoring the microfoundations of social theory, that approach can make only speculative claims about macrostructures and long-term changes.

Marxian and radical economics are prone to a particularly strong form of functionalism that has been labeled "objective teleology," in which a purpose is postulated without a purposive actor.[19] Marxian explanations of society are good examples of objective teleology, in the sense that all endogenous social outcomes are viewed as serving the needs of capitalism or the capitalist class. Institutions exist precisely because they are functional to capitalism. Even those institutions that are clearly antithetical to the interests of capitalists are given a functionalist explanation, as evidenced by Marx's analysis of the (anticapitalist) Bonapartist state in France, which Marx asserts was necessary for the survival of capitalism.[20]

There are two difficulties with functionalist explanations. First, since there are no intentional actors whose actions are instrumental in bringing about observed institutions, it is not clear how those institutions are actually created (Elster 1985, p. 17). John Roemer (1981, p. 9), for example, complains that the standard Marxian theory of capitalist crisis postulates "socialist transformation without a mechanism." Similarly, Jon Elster (1982, p. 460) points out that the functionalist explanations that are pervasive in Marxian theory generally posit a purpose without a purposive actor. He draws a grammatical analogy to a "predicate without a subject." Everything that happens in a capitalist society necessarily corresponds to the needs of capitalism. The same point is made by Michael Taylor (1988, p. 96) who observes that structuralist, functionalist, and other "holistic" theories are typically coarse-grained in the sense that they relate macrostates directly to macrostates without supplying a mechanism to show how the one brings about the other.

It is well understood by neoclassical economists that collective outcomes have attributes of public goods, which means that self-interested individuals will not necessarily contribute to the pursuit of those outcomes even if the individuals all stand to benefit from attaining them. Of course, collective action is undertaken, often suc-

[18]On functionalism, see Langlois (1986, p. 249); Vanberg (1986, p. 83); Elster (1982, p. 454); and Roemer (1981, p. 9).

[19]See Elster (1982).

[20]See Marx and Engels (1979, p. 143), cited in Elster (1982, p. 458).

cessfully, despite the free-rider problem. But the choice processes that actually serve to transform individual value-maximization into collective goods must be explained or modeled explicitly because these processes are by no means self-evident. For example, how did thousands of capitalists in Bonapartist France get together and establish an "anticapitalist" state so as to obscure from the masses the true configuration of political power?

Public choice theory postulates an intentional actor—the value-maximizing individual—who provides an explanatory link between individual behavior and collective action. Marxism and other structuralist perspectives, by contrast, are based on methodological holism, according to which the prime unit of analysis is not the individual, but the class or group. Methodological individualism, on the other hand, allows economists to address the complexities of political exchange—such phenomena as preference cycling in voting, logrolling in representative democracy, and evolving ideology—which derive from the pursuit of individual self-interest in the political arena. Structuralist approaches contain no comparable mechanism to explain the actual formulation and exertion of class interests.

A second problem with functionalist explanations is that they are inherently untestable and, therefore, fail to fulfill the main positivist standard of scientificity.[21] If the emergence of all social and economic institutions is explained simply by the fact that they are functional to the capitalist mode of production (for example), then their existence can always be accounted for on these grounds alone. As Elster points out, almost any social outcome can be rationalized by arguing that it serves either the interests of the capitalist class or the interests of "capital" (capitalist institutions as a social system), especially when the latter interests are often viewed as separate from (even antagonistic to) capitalist class interests in order to ensure the legitimacy of capitalist hegemony. It is difficult to refute empirically such a claim. Consider, for example, some predictions of Marxian crisis theory: The capitalist system must go through crises because they are necessary to the demise of capitalism, the rate of profit must fall because only in this way can a crisis be precipitated, and the working class must become impoverished because otherwise it could not perform its revolutionary task (Roemer 1981).[22]

[21]See Popper (1965). See also Caldwell (1982) for an excellent treatment of positivism.

[22]On the predictive failures of Marxian economics, see Gordon (1987). He argues that the labor theory of value (which is not really a theory at all, but a definition) yields a series of propositions about the world. When translated into neoclassical terms, these propositions are easily shown to be incorrect. On the flaws inherent in the labor theory of value, see Stigler (1977) and Brooks, Heijdra, and Lowenberg (1990).

Marxian Emulation of Neoclassical Economics[23]

If imitation is the sincerest form of flattery, then at least some Marxian social theorists have recently provided the strongest possible vindication of neoclassical economics. Efforts by so-called analytical or rational-choice Marxians to emulate the microfoundations of neoclassical value theory and the interest group pluralism of public choice theory testify to the explanatory superiority of the neoclassical approach. These imitative moves by the structuralist school are also evidence of its regressiveness as a research program, in as much as they involve ad hoc changes to the basic research strategy (inconsistent with the underlying axioms) in order to shore up the whole program.

The rational-choice Marxians recognize that the lack of a mechanism in functionalist and structuralist theories is due to the lack of *intentional actors,* and they propose to remedy this by providing Marxism with "microfoundations" (something that no doubt would be anathema to a classical Marxian). The microfoundations that are suggested by Elster reduce to nothing other than the application of game theory. This application is seen as a way to bring rational agents into Marxian explanation. According to Elster (1982, p. 473), the use of game theory does not mean that we merely "*assume* that the cooperative outcome will be realized simply because there is a *need* for it; rather we exhibit *a causal mechanism whereby it will be achieved.*" Elster (1988, pp. 227–28) characterizes the relationship between the state and capital as an interaction among at least three strategic actors—workers, capitalists, and the state—although he recognizes that it is problematic to treat these aggregates as actors.

For Roemer, the microfoundations of Marxism should consist in "deriving the aggregate behavior of an economy as a consequence of the actions of individuals, who are postulated to behave in some specified way" (Roemer 1981, p. 7). For example, in his chapter on the falling rate of profit, Roemer assumes that a technical innovation is introduced only if it increases profits for an *individual* representative capitalist. Roemer (1985) also invokes game theory to provide a micro-theory of revolutions and conflicting ideologies. For example, he uses game theory to argue that it is rational for a revolutionary entrepreneur confronting an entrenched leader to adopt a progressive ideology (favoring the poor over the rich), while the ruler will rationally choose a conservative ideology. Selective adaptation ensures that the progressive strategy will be used by the successful revolutionary (Roemer 1988, p. 244).

[23]This section draws on Heijdra, Lowenberg, and Mallick (1988).

Other Marxian scholars have also attempted to enhance the explanatory power of their models by adopting microfoundations. Wallerstein and Przeworski (1988) view the relationship between wages and profits as a strategic game between workers and capitalists. Taylor (1988) uses an explicitly microeconomic theory of collective action, based on Olson's seminal work, to explain revolution. Olson's approach suggests that the most successful collective action takes place when incentives apply selectively to individual members of interest groups depending on whether or not they contribute to the provision of the collective good. Without such selective incentives, collective action is more likely to occur in small groups than in large ones, or in large groups that are federations of smaller ones. In the context of revolutionary collective action, Taylor argues that rebel mobilization requires existing networks of local communities to provide effective social sanctions and to facilitate spontaneous conditional cooperation. In essence, community membership creates an iterated game in which participation in rebellion is conditional on others continuing to participate, which in turn is guaranteed by continuing membership in the community (Taylor 1988, pp. 68–69).

The rational-choice Marxians, however, still fail to identify the chief distinguishing feature of neoclassical economics that really separates it from Marxian theories of institutional change. Elster, for example, accuses neoclassical economists of being as guilty of objective teleology as are Marxians. He singles out Posner's theory of the common law and North and Thomas's theory of history as functionalist explanations. In fact, at a superficial level, the argument could be made that invisible-hand explanations of institutions, like their Marxian counterparts, are essentially functionalist. After all, neoclassical economic theories of institutional arrangements attribute the evolution of new institutions to the fact that they maximize the social dividend.

However, a more careful examination reveals that the key difference between neoclassical explanations and functionalist theories is that the former provide a general account of the actual mechanisms of social adaptation (Gray 1987, p. 43). Intentional maximizing behavior of individuals is sufficient to yield predictable outcomes, including (unintended) configurations of rules and institutions. Thus, neoclassical economic theory tells a story about how acting, choosing individuals bring about social outcomes, and thereby avoids the caveat of functionalism. To the extent that invisible-hand explanations are causal-genetic stories about how individual actions unintentionally lead (or might have led) to the emergence of some institutional structure, they must be distinguished from functionalist explanations that focus not on the *process* through which the structure emerges but on the processes that *maintain* the structure once established (Langlois 1986, p. 248). Both the Posner and the North-Thomas theories are based on the idea of a catallaxy of self-interested individuals, out of whose rational maximizing behavior emerge rules or institutions that provide the foundations for a spontaneous social order.

Neoclassical economists, therefore, do not need to adopt some device such as game theory to escape the explanatory vacuousness of functionalism, precisely because their theories already possess the microfoundations that some Marxians are apparently now finding it necessary to emulate. This very attempt to imitate methodological individualism on the part of Marxian scholars like Elster and Roemer provides strong testimony to the scientific superiority and expanding empirical content of the neoclassical approach, when compared to the structuralist alternative.

In the realm of political theory, too, there are Marxians whose work bears a remarkable resemblance to that of the interest group and rent-seeking schools of public choice. Marxian writers who are exponents of the structuralist political theory of Poulantzas essentially embrace a conception of politics that approximates the interest group pluralism of public choice. According to Poulantzas (1974), there are many levels of social activity within the polity, each of which encompasses a possible locus of conflict between competing fractions of capitalist and labor classes. Theorists in this structuralist tradition have been concerned to identify those groups of workers and capitalists whose interests may be contradictory within modern capitalism. A central assumption in this literature is that workers and other groups respond rationally to their objective interests. Class interests are clearly distinguished from the empirical concerns of particular members of classes (Calhoun 1988, p. 156). Although the microfoundations of collective action are not addressed by the Poulantzasian structuralists, policies enacted by the state are viewed as outcomes of a complex process of interaction between fractions of classes, or interest groups, which is not necessarily inconsistent with the public choice approach (Dollery 1988).

Conclusion

I have argued that Marxian, radical, and institutionalist economics do not possess the expanding empirical content that characterizes neoclassical economics. The reason is that these structuralist theories start with the group or class, without a theory of individual purposive behavior. Therefore, the structuralist approach lacks any conception of an intentional actor and, consequently, relies on functionalist explanations. Aggregate outcomes are explained by virtue of the fact that they are (must be) functional to the survival of the ruling class, for example, or the capitalist system. Functionalist theories are inherently untestable and, therefore, unscientific according to positivist criteria of what constitutes science.

On the other hand, neoclassical economics, which is based on methodological individualism, starts with a conception of the individual as an acting, choosing, rational agent. Building upon this foundation, neoclassical economic theory has been used successfully to explain an increasing number of social phenomena, ranging from institutions, law, and politics to ideology and history. Institutionalist and other nonneoclassical criticisms of these extensions of neoclassical economics are shown to be fallacious. Furthermore, some radical scholars have adopted the rational-choice microfoundations of neoclassical economics, testifying to the progressiveness of the neoclassical research program relative to its main competitors.

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Should We Fret about Our Low Net National Saving Rate?

Henry N. Goldstein

Introduction

Relative to most other industrial countries, the United States has recorded low ratios of saving and investment to GNP since the end of World War II. The official accounts show a further decline in the 1980s in the U.S. net saving rate, which counts the U.S. budget deficit as a negative component. Many analysts maintain that this recent decline in the ratio of net national saving to GNP threatens accustomed improvements in our national living standards and makes the United States highly vulnerable to a cutoff of foreign investment funds.

Thus, Alan Greenspan (1989, p. 15) has argued:

> The U.S. [budget] deficits of recent years are threatening precisely because they have been occurring in the context of private saving that is low by both historical and international standards. Historically, net personal plus business saving in the United States in the 1980s is about 3 percentage points lower relative to GNP than its average in the preceding three decades. . . .
>
> Under these circumstances, such large and persistent deficits are slowly but inexorably damaging the economy. The damage occurs because deficits tend to pull resources away from net private investment. *And a reduction in net investment has reduced the rate of growth of the nation's capital stock.* This, in turn, has meant less capital per worker than would otherwise have been the case, and

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The author is Professor of Economics at the University of Oregon. He wrote this paper while he was Visiting Economist with the U.S. Department of State, Bureau of Economic and Business Affairs, Planning and Economic Analysis Staff. The views expressed are not necessarily those of the U.S. Department of State. He is indebted to Frank de Leeuw, Bill Dewald, Jo Anna Gray, Tom Hall, Dan Ihara, Bill Niskanen, Kathleen Scanlon, Barry Siegel, Herbert Stein, George von Furstenberg, and Michael Ulan for their many useful comments and suggestions.