

## **THORSTEIN VEBLÉN AND THE RISE OF THE BEHAVIORAL ECONOMICS**

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### **Abstract**

*This article presents Thorstein Veblen's perspective on economics. Long before Herbert A. Simon and Daniel Kahneman, Veblen was among the first economists criticizing the mathematization of economics and the need to include in its theories concepts from psychology. His view was that economics needed to become an evolutionary science and human behavior, in particular, should be seen as a result of the influence of instinct and habit. Even though Veblen's contribution to embeddedness of psychology into economics has been left behind and only seldom is written about it, he was the first economist to draw the path which today we call it behavioral economics.*

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### **1. Introduction**

Despite the fact that most economists of his time were sharing Vilfredo Pareto's view on economics, Thorstein Veblen was among the first economist that tried to replace the pure economic theory with a theory based on reality and empirical facts. Veblen's view on economics is one of an archaic science, similar to primitive botany, where taxonomy is predominant, and where the main concern of economists is to define and classify concepts such as "value" and "profit". In his own words: "*Economics (...) still shows too many reminiscences of the <natural> and the <normal>, of <verities> and <tendencies>, of <controlling principles> and <disturbing causes> to be classed as an evolutionary science.*" (Veblen, 1898, p.381) The taxonomy included in economics and considered scientific in nature by economists is in opposition to natural sciences, which have far outstripped this stage:

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*"Economic science is living over again in its turn the experiences which the natural sciences passed through some time back. In the natural sciences the work of the taxonomist was and continues to be of great value, but the scientists grew restless under the regime of symmetry and system-making. They took to asking why, and so shifted their inquiries from the structure of the coral reefs to the structure and habits of life of the polyp that lives in and by them.. (...) All the talk about cytoplasm, centrosomes, and karyokinetic process, means that the inquiry now looks consistently to the life process, and aims to explain it in terms of cumulative causation."* (Veblen, 1898, p.384) Veblen's perspective is that as well as natural sciences, economics must become an evolutionary science: *"an evolutionary economics must be the theory of a process of cultural growth as determined by the economic interest, a theory of a cumulative sequence of economic institutions stated in terms of the process itself."* (Veblen, 1898, p.393)

## **2. Veblen's critique**

The veblenian critique is directed equally at the Classical School and the Austrian School (Veblen, 1898, 1899a, 1899b, 1900), but especially against the neoclassical school, the critique of the latter being notorious in the literature. (Veblen, 1898, 1909)

The classical economy is characterized by Veblen as an animistic science. (Veblen, 1899b) Referring to Adam Smith's work, Veblen notes that: *"Both in the <Theory of the Moral Sentiments> and in the <Wealth of Nations> there are many passages that testify to his abiding conviction that there is a wholesome trend in the natural course of thing (...) An extreme resort to this animistic ground occurs in his plea for freedom of investment."* (Veblen, 1899b, p. 396) The classical economy is based on preconceptions such as natural order and the invisible hand, and based on them *"the ultimate laws and principles which they formulated were laws of the normal or the natural, according to a preconception regarding the ends to which, in the nature of things, all things tend."* (Veblen, 1898, p. 382) Human behavior itself is guided by this natural order and by its laws. Under these conditions, classical economic theory is a theory of how the causes of natural order occur and how natural laws impose different conditions and restrictions on human behavior in the attempt of agents to achieve their ultimate goal - wealth.

In contrast, the neoclassical school proposes a passive and inert individual, isolated from the environment in which he lives. Veblen criticizes the neoclassical economics that he finds static and preoccupied with the

distribution of goods and less with production and consumption: *"The limitations of the marginal-utility economics are sharp and characteristic. It is from first to last a doctrine of value, and in point of form and method it is a theory of valuation. The whole system, therefore, lies within the theoretical field of distribution, and it has, but a secondary bearing on any other economic phenomena than those of distribution - the term being taken in its accepted sense of pecuniary distribution, or distribution in point of ownership. (...) Similarly, as regards attempts to make use of this principle in an analysis of the phenomena of consumption, the best results arrived at are some formulation of the pecuniary distribution of consumption goods."* (Veblen, 1909, p.620) The lack of dynamics and the axiomatic basis of neoclassical analysis make it an antinomy with modern, evolutionary sciences that take into account the phenomena of growth and change: *"To the modern scientist the phenomena of growth and change are the most obtrusive and most consequential facts observable in economic life. For an understanding of modern economic life the technological advance of the past two centuries - e. g., the growth of the industrial arts - is of the first importance; but marginal-utility theory does not bear on this matter, nor does this matter bear on marginal-utility theory. (...) the hedonistic postulate and its propositions of differential utility neither have served nor can serve an inquiry into these phenomena of growth."* (Veblen, 1909, p. 621). And he goes on and says: *"As to the causes of change or the unfolding sequence of the phenomena of economic life they have had nothing to say hitherto; nor can they since their theory is not drawn in causal terms but in terms of teleology."* (Veblen, 1909, p.621) Also, by putting the concept of utility into the center of neoclassical economic analysis, other important factors such as property, money and institutions are also lost. Under these auspices human behavior is *"conceived of and interpreted as a rational response to the exigencies of the situation in which mankind is placed; as regards economic conduct it is such a rational and unprejudiced response to the stimulus of anticipated pleasure and pain - being, typically and in the main, a response to the promptings of anticipated pleasure, for the hedonists of the nineteenth century and of the marginal-utility school are in the main of an optimistic temper."* (Veblen, 1909, p.623 ) In this way, human behavior is not explained by the cause-effect relationship, but rather by sufficient reason, based on a priori premises. Marginal utility theory provides an inadequate explanation for human motivation, which is the basis of human behavior, and in this case, the economic behavior of man.

On the other hand, the failure of the Austrian school to make the economy an evolutionary science has its origins in their conception of human nature, which they and their predecessors consider in hedonistic terms: *"The hedonistic conception of man is that of a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact. (...) The hedonistic conception of man is that of a lightning calculator of pleasures and pains, who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact."* (Veblen, 1898, p.389)

### **3. Economics as an evolutionary science**

In order to free the economic science of preconceptions, Thorstein Veblen proposes institutionalism, which abandons the neoclassical paradigm of balance and focuses on change and evolution. The rehabilitation of the economy as a modern and evolutionary science is based on concepts from anthropology and psychology and starts from the object and methodology used in economic analysis. In Veblen's view, the object of the economy is to research human behavior in relation to the material means of life, given the broader context in which this behavior takes place: *"Any science, such as economics, which has to do with human conduct, becomes a genetic inquiry into the human scheme of life; and where, as in economics, the subject of inquiry is the conduct of man in his dealings with the material means of life, the science is necessarily an inquiry into the life-history of material civilization, on a more or less extended or restricted plan."* (Veblen, 1909, p.627-628) At the same time, Veblen rejects the methodological positivism that he sees as insufficient in research because he neglects the importance of the things unseen in scientific analysis and theories. While modern science uses the causal relationship as the foundation of theoretical formulations, the economy is still based only on what can be learned. An example of this is the neoclassical vision of human behavior, a vision that: *"It deals with this conduct only in so far as it may be construed in rationalistic, teleological terms of calculation and choice. But it is at the same time no less true that human conduct, economic or otherwise, is subject to the sequence of cause and effect, by force of such elements as habituation and conventional requirements."* (Veblen, 1909, p.626) Thus, in order to be a modern science, the economy must also include ontological hypotheses and causal explanations of the economic phenomena investigated. Veblen pleads for a deductive

science, which also takes into account the causal relationships that can not be directly observed, but which must be assumed, which are vital for scientific research.

The veblenian economic theory is based on three pillars: instinct psychology, philosophical pragmatism, and Darwin's evolutionary principles. Veblen takes the concepts of <instinct> and <habit> into instinct psychology and builds around their own vision of economic behavior. The instinct is regarded as an innate propensity or predisposition of human nature which together with the material context influences the institutions, while habits are conscious instincts and adapted to the purposes to which they are directed. It is the instinct that determines the intelligence because "*the intellectual functions themselves take effect only on their initiative of the instinctive dispositions and under their surveillance.*" (Veblen, [1914] 1918, p.30), the two being inversely proportional. The instinct is regarded as a precondition for intelligence, not as an antinomy. Instincts can not be changed, being hereditary features of human nature, but their instinctive behavior can be altered by the personal development of the individual and under the influence of the environment in which he lives. In other words, instinctive behavior can be transformed through the habits learned by the individual during his lifetime. Unlike instincts, habits have a cultural dimension, being directly determined by the environment.

Human behavior is seen by Veblen under the influence of instinct and habit. The instinct is seen as the foundation of human preferences and the main determinant force of human action, because according to the author the instinct is the one that awakens the emotion, the emotion that determines the human actions. Nature, through instinct, and education, usually become two complementary forces in explaining human behavior. (Veblen, [1914] 1918) Habits, with their cultural component, are mechanisms through which the individual weighs the things around him, determining both his perception of the world around him and his thinking and deliberation. Habits are cultural features, specific to the space and time the individual lives, institutional rules learned from past generations. Habits learned in a social and cultural context denote an individual's propensity, but they are not behaviors. Habits can guide actions, but do not identify with them. They are lessons learned cumulatively by past generations and bear changes over time. Human nature must be seen as a coherent structure of propensities and habits. Unlike his contemporaries, Veblen is the basis of human instinct, not rational thinking. He argues that rational thinking is preceded by habits, deliberate thinking being used when

more habits are in conflict, or when the situation is complex. Thus, the individual learns some patterns of thought and deliberation, so that when he meets the same situation he will know how to act in a more efficient way. (Veblen, 1906) The action as part of economic behavior is seen as the use of material objects and the historical circumstances available to achieve a present economic interest. The economic action in this case is teleological because it is always directed to a certain purpose. (Veblen, 1898) The basis of all actions is the whole of learned habits that Veblen sees as institutions. These institutions are dynamic, which is why the analysis and economic theory must be dynamic. Thus, human behavior in the veblenian vision is an evolutionary one based on the instinct, which is a given of nature. It precedes the custom learned by people in society. Habit in turn precedes thinking. Instinct and habits are the basis for the motivation of human behavior.

#### **4. Conclusions**

Thorstein Veblen's perspective on economics is one of the first that attempts to include psychological concepts into economical theories. He argued that economics should abandon old preconception such as natural order or axiomatic assumptions and try to include concepts such as instinct and habits in defining human behavior. This should be seen as a result of the influence of instinct and habit, the first being the biological determinant of human preferences, while the latter is the cultural dimension of the behavior.

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