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Abstract
More than one hundred years ago, Thorstein Veblen wrote a powerful critique of neoclassical economics that castigated the discipline for turning the individual into a “lightning calculator of pleasures and pains, who oscillates like a homogeneous globule”, or equivalently, for the individual’s static maximization of utility based on exogenous preferences. His critique is relevant even today, since there are economists who still continue to criticize the assumptions of *homo economicus* and exogenous preferences, and insist on introducing more realism to economic theory. Furthermore, recent developments in game theory and experimental economics, which stand at the cutting-edge of economics today, are far more accommodating to the ideas of institutions that were central to Veblen’s theory than neoclassical economics.

The goal of this paper is to examine the strengths of the Veblenian critique of neoclassical economics. In particular, it investigates whether or not Veblen’s rejection of the axiomatic approaches to economics is merely an attack on neoclassical economics which fails to provide an alternative positive theory. Starting with their conception of the individual, going through their theoretical frameworks, and ending with an investigation of how they approach a concrete issue, this paper offers a comparative exposition of the Veblenian and neoclassical approaches to economic theory. [*excerpt*]

Keywords
neoclassical economics, Thorstein Veblen, game theory, experimental economics

THE STRENGTH OF THE VEBLENIAN CRITIQUE OF NEOCLASSICAL ECONOMICS

Svetoslav Semov

I. Introduction

More than one hundred years ago, Thorstein Veblen wrote a powerful critique of neoclassical economics that castigated the discipline for turning the individual into a "lightning calculator of pleasures and pains, who oscillates like a homogeneous globule", or equivalently, for the individual's static maximization of utility based on exogenous preferences. His critique is relevant even today, since there are economists who still continue to criticize the assumptions of *homo economicus* and exogenous preferences, and insist on introducing more realism to economic theory (Tsakalotos 2005, 894). Furthermore, recent developments in game theory and experimental economics, which stand at the cutting-edge of economics today, are far more accommodating to the ideas of institutions that were central to Veblen's theory than neoclassical economics (Hodgson 2007, 328).

The goal of this paper is to examine the strengths of the Veblenian critique of neoclassical economics. In particular, it investigates whether or not Veblen's rejection of the axiomatic approaches to economics is merely an attack on neoclassical economics which fails to provide an alternative positive theory (Hunt 2002, 343). Starting with their conception of the individual, going through their theoretical frameworks, and ending with an investigation of how they approach a concrete issue, this paper offers a comparative exposition of the Veblenian and neoclassical approaches to economic theory.

Seven sections follow. The first describes the notion of the individual in orthodox and heterodox economics. The second focuses on the different methodologies of these two strains of economics as developed out of their conceptualization of the individual. The third section presents the mainstream theory of consumption. The theory of Thorstein Veblen is used as a representative of heterodox economics and, consequently, the fourth section describes Veblen's theory of conspicuous consumption. The fifth outlines a specific case – credit card debt – to which the two theories of consumption are applied. The sixth provides an accommodating picture of Veblenian thinking in the face of mainstream economics. The last section assesses the ideas presented and offers a conclusion.

II. Origins of the concept of the individual in economics

A theory is defined by the way in which it conceptualizes the individual (Davis 2003, 16). Orthodox economics places a greater emphasis on the individual and conceptualizes it as a relatively autonomous and atomistic being. In contrast, heterodox economics regards the individual as a being embedded in social and economic relationships.

The orthodox notion of the individual originates with John Locke and his idea that there must always be something about the individual that remains unchanged (Davis, 24). The individual's consciousness is disengaged from the world. There is a dualistic separation of the individual from the world. However, this presents the dilemma of how the inner subjective worlds of individuals link with the outer objective world. In *The Wealth of Nations,* Adam Smith (Davis, 24) only superficially resolved the dilemma by using the concept of unintended consequences and the idea that the market worked as if governed by an invisible hand. Yet Smith did not explain the precise mechanisms with which human psychology produced its effects on the market.

At the end of the nineteenth century a new strategy for linking Locke's two worlds emerged – the theory of choice used by the early neoclassicals (Davis, 25). They understood individual human behavior specifically as choice behavior. In contrast to Smith's metaphorical treatment of how subjective interest is at work in the market, neoclassicals explained how subjective interest became material. That was achieved, for example, by using the concept of marginal utility to derive an individual's demand for goods.

Contemporary mainstream economics took the neoclassical approach a step further towards the total elimination of subjectivity. Locke's dilemma was resolved not by making a better connection between subjective and objective but by totally dispensing with the former. Consequently, all psychological content of the concept of the individual was emptied out (Davis, 26). His preferences came to be taken as given, rendering their character irrelevant to the analysis of rational choice.

The heterodox version of the individual originates in the thinking of mid-nineteenth century authors such as Karl Marx and Emile Durkheim. Marx's view of the individual is rooted in the theory of historical materialism (Davis, 109). There are two main components to this theory. The first is that the character of a society's production and associated economic relations explain how its political and cultural relationships develop. The second is that all societies possess two main classes: one which supports the other through its work, and a second to direct the labor of the first. There is not much space for an important role of the individual. The individual is seen as a bearer of class identity and, consequently, not an independent agent. To put it differently, Marx is seen as the principle source of a tradition of economic thinking that treats the individual as being determined by social relationships.

The work of Durkheim further continues this tradition (Davis, 110). He criticizes neoclassical economics for its individualist orientation and contends that human nature is shaped by society. Society is an independent entity and needs to be examined on its own. Furthermore, the group thinks and acts quite differently from the individuals comprising it. As a result, if economic analysis falls on the individual it may fail to explain what takes place at the level of the group.

The framework for thinking about the individual established by Marx and Durkheim is used to various degrees in heterodox economics ever since. Original institutional economics, Marxism, Post-Keynesian, New Institutional and

Austrian economics provide a descriptively richer, contextually subjective, and fuller illustration of the individual than the concept of rational and economic man found in orthodox economics (Wrenn 2006, 489). Through discussions of mental models, structure, and agency, they are able to address the actual range of human behavior and reach beyond simple utility maximizing motivations. This does not suggest that these diverse groups of thought share a common method, but, rather, that, they possess common theoretical ground with respect to the conceptualization of the individual. A major common thread is the interdependence of agent and structure - in other words, interactive agency, where the individuals are affected by each other and by the institutional setting (Wrenn, 489). Clearly, this has its roots in the Marx-Durkheim framework of thought.

III. Methodology

Using this rather simplistic dichotomy between orthodox and heterodox economics, Thorstein Veblen's work could be easily classified as heterodox. Veblen proposed that economics should be reconstructed as a "post-Darwinian" science. Basing his arguments on the core ideas of Darwinism, Veblen insisted on developing causal explanations, where a cause is understood as necessarily involving transfers of matter or energy (Hodgson 2003, 86). Divine, spiritual or uncaused causes are ruled out. When Veblen's understanding of Darwinism - in terms of a commitment to a detailed and sequential causal analysis – is transferred to the realm of economics, it meant that human intentionality and values also have to be explained.

The central tenets of orthodox economics are in stark contrast to those of heterodox economics. The ongoing debate between the two is multi-layered. One of the dimensions of that debate positions the "positive" realm of facts and theory against the "normative" realm of values. In heterodox economics, as observed in Veblen's understanding of Darwinism, the entanglement of values and economic theory is essential, for economics is concerned with reality and values are an integral part of it (Tsakalatos, 894). In contrast, orthodox economics bases its assumptions on *homo Economicus* and exogenous preferences (Tsakalotos 2005, 894). Its proponents claim that it should be devoid of values and based solely on facts. They refuse to consider values as open to rational scrutiny. In other words, they do not require inquiry into their genesis but understand them as "revealed preferences" in the market with a price tag attached to them (Tilman 2006, 103). Furthermore, if their origin is at issue at all, it is for philosophers, sociologists and cultural anthropologists to further inquire.

As already suggested in the preceding section, an important dimension of the debate between orthodox and heterodox economics is based on their conceptualization of the individual. In orthodox economics, the individual and his rationality are viewed as separate or isolated from the rest of society and social relations. This is the so–called "undersocialized conception of human action" (Yilmaz 2007, 842). The individual is seen as having an internalist view of rationality – he is formed from the inside out (Wunder 2007, 833). Tastes, preferences, and beliefs also come from inside the person and are thus exogenous. The claim here is analogous to the case of values – the field of economics is restricted to internalist rational action, whereas the study of irrational action is relegated to sociology.

In contrast, heterodox economics, as suggested by Veblen's insistence on a full explanation of human intentionality, employs an externalist view of rationality – tastes preferences and beliefs are socially constructed. Veblen's concept of the individual is one in which the primary aspects of its beliefs are the result of the groups to which the individual belongs and the social norms and institutions to which the individual adheres (Wunder, 833). As explained later, Veblen's depiction of "invidious distinction" and "emulation" as powerful forces, illustrates the case of the individual following the group. To put it differently, economic analysis, because of its ability to impact the institutional framework, should be more sensitive to the endogeneity of preferences and values (Tsakalotos, 899).

Another facet of the debate between orthodox and heterodox economics is the clash between the realism and the predictive capacity of economic theories. In "The Methodology of Positive Economics," Milton Friedman argues that the ultimate goal of positive economics is the development of a theory or hypothesis that yields valid and meaningful predictions about phenomena not yet observed (Friedman 1966, 7). Such a theory should be a complex mixture of two elements – it should construct a "language" designed to promote systematic methods of reasoning and it should contain substantive hypotheses that abstract essential features of the complex reality.

He goes on to contend that truly important and significant hypotheses are found to have assumptions that are wildly inaccurate descriptive representations of reality - the more significant the theory, the more unrealistic the assumptions (Friedman, 14). The reason is that a theory cannot possibly be thoroughly realistic in the immediate descriptive sense so often assigned. Any attempt to achieve this kind of realism renders a theory useless. To put it differently, according to Milton Friedman, any criticism of the axiomatic approaches of orthodox economics is largely beside the point unless supplemented by evidence that a hypothesis differing in its assumptions from the theory being criticized yields better predictions for a wide range of phenomena. The ultimate test of the assumptions of a theory is the validity of its predictions.

Consistent with Milton Friedman's critique of unorthodox approaches as presenting merely criticism without yielding better predictions than the theory being criticized, Peukert argues that what Veblen offers instead of *Homo economicus* is *Homo absurdus* (2001, 544). Veblen's intention was not to advance a theory in any positive sense. According to Peukert,

> He [Veblen] had only one scientific aim, which he pursued by three different means. This aim was a radical and deconstructive critique of what he called prevailing habits of thought. He did not, and did not

> want to, unfold a positive, new, and evolutionary approach which could practically be applied to the analysis of economic processes. He did not pretend to uncover any developmental logic of economic history or institutions. Instead, his destruction of deterministic theories and implicit teleological tendencies should be interpreted as his attempts to uncover the implications of the basic freedom of human choice and valuation. (2001, 544)

As already suggested, the heterodox approach to economic theory, as represented by the work of Thorstein Veblen, differs radically from the orthodoxy. Veblen's insistence on causal analysis emphasizes an inquiry into the genesis of values and rationality in a push toward more realism, whereas orthodox economics adheres to the importance of the predictive capacity and facts, associated with a theory. Undoubtedly, one of the most powerful attacks on Veblen is Peukert's assertion that the former is merely constructing *homo absurdus.* The comparison between Veblen's theory of conspicuous consumption and the mainstream theory of consumption that follows, suggests that this might not be the case.

IV. The mainstream theory of consumption

A huge break in orthodox economics that had implications for consumption theory is to be found in Irving Fisher's work on interest (1930). Fisher objected to the classification of incomes as wages, rent, profits and interest in classical theory (Landreth, 267). He saw interest not as a share of income received by capital but as a manner of examining income flows of every kind. Fisher used the concept of intertemporal choices that he traced back to John Rae and Eugene Böhm-Bawerk (Chao 2007, 231). He argued that people prefer present over future consumption. This "human impatience" in its marginal form determines the rate of interest as the premium between the exchange of present and future goods (Chao, 231). Moreover, individuals can alter their income flows, and accordingly, consumption, by saving or borrowing (Landreth, 269). Consequently, the consumption level is a function of interest rates: at higher levels of interest, the quantity of consumption will decrease.

The starting point of the modern macroeconomic theory of consumer behavior are two theories developed in the 1950s by Milton Friedman and Franco Modigliani – the permanent-income hypothesis and the life-cycle model of consumption respectively (Jones 2008, 250). They were based on Fisher's intertemporal choice model. Both of them stem from the observation that people prefer to smooth their consumption over time. This is nothing more than an application of the standard theory of diminishing marginal utility. The permanent-income hypothesis then says that people will base their consumption on the constant income stream that has the same present discounted value as the actual income stream rather than on their current income. The life-cycle model of consumption applies the same reasoning to a person's lifetime. Consumption is based on "average" lifetime income rather than on income at any given age.

One crucial element of the framework of intertemporal choices is the expectations of future income when consumers face uncertainty. Friedman adopts the framework of adaptive expectations in forming expected income as a proxy for permanent income. However, this was challenged by Robert Hall's rational expectations revolution in the 1960s as the latter was seen as a more realistic account of how consumers form their expectations (Chao, 232). Hall's theory suggests that the consumer uses today's consumption as the best predictor of future consumption because any available information was included in today's consumption. In other words, Hall proved that consumption is a "random walk" – its future value is only a function of its present value. Hence, other variables, particularly, current and past incomes, can be excluded from the consumption function.

Although this is in clear contradiction with the conclusions of the theories of Friedman and Modigliani, economists usually see Hall's theory as a continuation of the life-cycle-permanent income hypothesis. The reason is that Hall's consumption theory contains a Fisherian framework in which the representative consumer intertemporally allocates his/her wealth on consumption (Chao, 232).

Chao argues that even if a model is not supported by empirical data when the model is considered as containing the true structure, it is not rejected, but instead a new model is constructed with the same true structure and certain modifications (240). Furthermore, economists hold a strong prior belief in economic theories that are based on well-specified optimization-based behavioral assumptions. All of this means that while anomalies may reject the permanent income hypothesis or the life-cycle hypothesis, this will only make economists modify the "true structure", the Fisherian framework, instead of abandoning it (Chao, 243). In other words, the Fisher-Friedman-Modigliani theory could be seen as the core of the mainstream theory of consumption.

V. Veblen's theory of conspicuous consumption

Veblen's theory of conspicuous consumption is an extension of his concept of the "social" individual. In contrast to the orthodoxy's static maximization of utility in an intertemporal framework, Veblen develops a model in which preferences are determined socially according to the position of an individual in the social hierarchy (Trigg 2001, 100). Veblen's theory of conspicuous consumption starts with the development of a leisure class whose members are not required to work, but appropriate a surplus[20] produced by the working class. Once societies start to produce that surplus, the relationship between private property and status grows in importance. To own property is to have a status in the hierarchy that emerges; to have no property is to have no status.

20 Surplus here denotes the excess output above and beyond what is necessary to produce the means of livelihood of the worker.

The accumulation of wealth could, of course, indicate that a person is efficient and productive, but Veblen contends that inherited wealth confers even more status. The money provides the most prestige, since it establishes the most distance from the work required for its accumulation. Key to the transformation of wealth into status is the social performance of the individual. Status stems from the opinion of the other members of the society regarding the position of an individual in that particular society. In order for this position to be established there must be a display of wealth. Veblen delineates two main ways for this to be done – through extensive leisure activities and through lavish expenditures on consumption. Their common feature is that they must entail a wasteful component.

In principle, both methods are equally effective in displaying wealth – all that is required is an effective network for the word to get around about a person's degree of leisure and the objects he or she possesses. Veblen argues, however, that as societies become more mobile, the display of wealth through consumption becomes more important than the display of leisure, since people will be less informed about the leisure activities of others. Such consumption has a separate label in Veblen's analysis – *conspicuous consumption.* It denotes spending on artifacts of consumption that would enhance the social position of the individual.

Conspicuous consumption is viewed by Veblen as one of the paramount factors in determining consumer behavior. This applies not just to the rich, but also to all social classes. The result of this theory is that members of each stratum in the society will emulate those above them and try to rank as high as possible in comparison to the rest of the community (Hunt 2002, 338). Another important facet of the theory is that the process is never ending; what at one time may confer status may later be acquired by all and confer no status, leading to a chronic dissatisfaction. In other words, the core of Veblen's theory of conspicuous consumption is that consumption is socially determined and does not come from within the individual (Trigg, 100).

VI. Credit Card Use and Abuse: A Veblenian Analysis[21]

There is an enormous amount of consumer credit card debt in the United States. Revolving credit card debt is about $900 billion and has increased at 9 percent over the past decade (Scott 2007, 567). This became possible through an institutional change that lead to reduced regulation on credit card lending. The U.S Supreme Court's 1978 Marquette Decision was primarily responsible for that. The ruling stated that only the usury ceiling of the state in which the bank is located and not that of the state in which the consumer is located, will restrict the interest rates (Scott, 568). Thus, it enabled banks to charge whatever interest rates they want on their credit cards loans by moving their credit card operations to states where there were limited usury laws. Consequently, credit cards exploded in use (Scott, 568).

21 This section is heavily borrowed from Scott, Robert H.

The Fisher-Friedman-Modigliani theory of consumption, which as already explained is the building block of mainstream theories of consumption, does not account for why consumers took advantage of the available credit cards and began steadily accumulating debt at exorbitant interest rates, in most cases unable to repay that debt later (Scott, 568). In order to construct the theory, which was already explained, Friedman and Modigliani had to make broad assumptions (Scott, 569). These included – individuals are rational, they have access to perfect information, possess foresight and stable and well-defined exogenous preferences. Furthermore, the life-cycle-permanent income hypothesis assumes away any role institutions may play in consumer spending/borrowing decisions. It makes individuals solely responsible for their credit card debt. Consequently, any public policy attempt to decrease it is doomed as the impetus comes solely from within the individual.

Veblen's theory of conspicuous consumption could be used to treat the credit card issue in an entirely different way (Scott, 570). As already mentioned, Veblen's theory stated that the propensity for emulation and conspicuous consumption are pervading traits of human nature. It is not standard items that guide our consumption, but rather those items that are just beyond our reach. Furthermore, most people want to be living in one class above what they presently live in.

Applying this to the issue of credit cards means that a large portion of borrowers will over-spend, first, because of the ever-rising income inequality in the U.S. that pushes people toward emulation, and, second, because of the easy access to credit, given without the necessary consideration of whether it could be repaid (Scott, 570). By borrowing people will have the ability to reach to a higher class level. The problem is further aggravated by the fact that, today, the variety of goods and services offered is unparalleled to any other time in history. Expensive clothes, vacations, restaurants – all that is easily available because of credit cards.

Besides the emulative human nature, a Veblenian analysis identifies another cause for the credit card debt problem – the companies (Scott, 570). Veblen sees companies, such as the credit card ones, that are trying to produce nothing of substance and still get a profit as predatory lenders. Credit card companies extend credit to people arbitrarily, and when people fail to pay, they raise interest rates to absurd levels.

They also charge penalties and fees, which further aggravate the problem. Using Veblen's metaphor, a parasite/host relationship emerges between debtors and credit card companies. Credit card companies drain their hosts, making a yearly profit of $90 billion dollars, 30 percent of which is generated from penalty fees (Scott, 571). The most profits are made from people who accumulate a considerable debt. Therefore, there is a clear incentive for credit card companies to maximize the financial indiscretion of individuals, luring them into borrowing that could not be repaid.

As already mentioned, the neoclassical theory of consumption attempts to explain the enormous levels of credit card indebtedness as stemming from within the individual and thus gives no prescription for how to address the problem. In contrast, a Veblenian approach to the issue provides clear policy options (Scott, 571). The driving force behind the credit card problem is the social influence on consumers to spend and the institutional setting that puts no reins on that. The first solution may be curbing the increasing income inequality in the United States, which is one of the factors, that spurs the never-ending process of emulation described by Veblen. People are quick to increase their consumption as income rises but they are slow in decreasing it after a relative fall in income. Thus, the widening income gap should be addressed as it reduces the relative income of a huge portion of the population.

The second solution is to directly address the institutional setting. As already mentioned, households are not able to handle the level of credit that the credit companies seek to provide them. Thus, a reasonable measure is to regulate credit card lending operations. In particular, a maximum limit should be put on credit card interest rates, fees and penalties. This would ensure that borrowers are given an amount of credit they can handle (Scott, 572).

In summary, a Veblenian analysis of the credit card over-borrowing problem provides clear-cut policy options. In contrast, the neoclassical approach gives no prescriptions whatsoever. The reason is that it disregards the role of institutions and assumes a rational individual that could not be experiencing an irrational problem of over-borrowing.

VII. Changing face of mainstream economics

The revival of Veblenian thinking is not limited to the particular example of credit card use. The face of modern economics is much more accommodating to Veblen's ideas than the core neoclassical economic theory ever was (Hodgson 2007, 328). During the 1980s, game theory established itself at the cutting-edge of mainstream economics, in part because of theoretical problems in general equilibrium analysis. The results of it depend on particular rules and modes of play of the game. Instead of everything being in contact with everything else as in general equilibrium analysis, game theory assumes limited interconnectedness. Thus, it is more accommodating to the ideas of institutions and rules.

Experimental economics also examines human interaction under designed system of rules (Hodgson 2007, 328). In simulating markets in the laboratory, experimental economists must set up a specific institutional structure. This, of course, challenges the neoclassical notion of the abstract market as a universal form of human interaction, free from any specific rules (Hodgson, 328). Experimental economics also makes the case for a situated rather than context-independent concept of rationality. It claims that generalized rational preferences should be replaced by rules of thumb specific to the particular situation. It rejects the idea that people come to problems equipped with a complete set of preferences and clear decisions.

Recent work in psychology has also undermined the rational deliberative thinking model of neoclassical economics (Hodgson, 329). It has been argued that this model downplays both the temporal and situated aspects of human reasoning. Instead of considering individuals as having representative models of the world in their brains, psychologists claim that human cognition depends on the social and material environment and on the interactions with other people. This is definitely a move away from the mind seen as an independent rational deliberator.

In summary, the core of neoclassical economics – the individual as a primary and given self – has been undermined by all these recent developments. Furthermore, the adoption of a context-dependent rationality as that is found in experimental economics and psychology is consistent with Veblen's institutional economics in which agency and structure are mutually dependent.

VIII. Assessment of ideas and conclusion

In orthodox economics the individual is emptied out of all psychological content. His preferences are takes as given and his character is treated as irrelevant to any economic analysis. In contrast, the heterodox strand of economics views the individual as determined by social relationships. Veblen's individual, being a social creature, falls squarely in that category.

As a corollary of its way of conceptualizing the individual, orthodox economics takes an axiomatic approach to economic theory. It claims that any criticism of that approach is ineffective unless it constructs a theory that yields better predictions than the one being criticized. On the contrary, heterodox economics, as represented by Thorstein Veblen's theory, insists on a causal explanation of any characteristics attributed to the individual.

Two completely different theories of consumption stem from the two approaches – Veblen's theory of conspicuous consumption and the mainstream theory of consumption. The first one stresses the social determination of consumption – individuals are always trying to emulate the spending habits of those that live one class above them. The second one treats the consumer as a rational being using an intertemporal framework to calculate his or her choice between present and future consumption.

Following Peukert's assertion that Veblen creates no theory in any positive sense and Friedman's defense of the superiority of the axiomatic approach to economic theory as capable of yielding better outcomes, it would be expected that the mainstream consumption theory is omnipotent, while Veblen's theory of conspicuous consumption – totally ineffective. However, the case of credit card "use and abuse" suggests the opposite.

The Fisher-Friedman-Modigliani theory attributes the enormous amount of credit card debt in the United States to the choices of the individual; that is a tautology is employed – the aberrant behavior of the individual is explained as coming from within the individual. In contrast, Veblen's theory of conspicuous consumption provides clear-cut policies that can address the issue (Scott, 571).

These include curbing the increasing income inequality in the United States and changing the current institutional setting – regulating credit card companies.

In summary, the particular case of credit card use and abuse shows that Veblen's theory of conspicuous consumption, while avoiding the axiomatic approach of orthodox economics is still capable of providing solutions to concrete problems. Furthermore, it suggests that it may not be the case that the more unrealistic the assumptions of a theory, the more powerful it will be, as Milton Friedman contends. By being a more accurate description of reality, Veblen's theory does not render itself useless. On the contrary, it makes a better policy proposal than its mainstream counterpart. Moreover, the strength of Veblen's analysis is not limited to a particular case or to a single theory. Some recent developments in the mainstream of economics – game theory and experimental economics – are rather accommodating to institutions and rules. This calls for a revival of Veblenian Institutional Economics (Hodgson, 325).

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