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What Is the Essence of Institutional Economics?

Geoffrey M. Hodgson

The term "institutional economics" was announced by Walton Hamilton at a meeting of the American Economic Association in 1918 [Hamilton 1919]. Institutionalism dominated American economics, at least until the 1940s. Listing a number of perceived attributes of this school, Walton Hamilton [1919, 309-11] claimed that institutional economics alone could unify economic science by showing how parts of the economic system related to the whole. Institutional economics was not defined in terms of any normative stance. Hamilton [1919, 313] declared: "It is not the place of economics to pass judgments upon practical proposals." However, its appeal as a theory was that allegedly it could be used as a basis for policy. According to Hamilton [1919, 314-18], institutional economists recognized that:

> *The proper subject-matter of economic theory is institutions. . . . Economic theory is concerned with matters of process. . . . Economic theory must be based upon an acceptable theory of human behavior . . .*

This was expanded by the following observations:

> neo-classical economics . . . neglected the influence exercised over conduct by the scheme of institutions . . . Where it fails, institutionalism must strive for success . . . it must discern in the variety of institutional situations impinging upon individuals the chief source of differences in the content of their behavior [1919, 318].

The author is Research Professor of Economics, University of Hertfordshire, United Kingdom. *He is particular grateful to Perry Bezanis, Michael Keaney, Stefan Kesting, Anne Mayhew, Julie Nelson, and Malcolm Rutherford for information, criticism and discussions. This paper was presented at the annual meeting of the Association for Evolutionary Economics, Boston, Massachusetts, January 6-9, 2000.*

Hamilton"s description of institutionalism requires refinement, but in its essentials it has endured the test of time. It can be rephrased and expanded in terms of the following five propositions:

1. Although institutional economists are keen to give their theories practical relevance, institutionalism itself is not defined in terms of any policy proposals.
2. Institutionalism makes extensive use of ideas and data from other disciplines such as psychology, sociology and anthropology in order to develop a richer analysis of institutions and of human behavior.
3. Institutions are the key elements of any economy, and thus a major task for economists is to study institutions and the processes of institutional conservation, innovation and change.
4. The economy is an open and evolving system, situated in a natural environment, effected by technological changes, and embedded in a broader set of social, cultural, political, and power relationships.
5. The notion of individual agents as utility-maximising is regarded as inadequate or erroneous. Institutionalism does not take the individual as given. Individuals are affected by their institutional and cultural situations. Hence individuals do not simply (intentionally or unintentionally) create institutions. Through "reconstitutive downward causation" [Hodgson 2000] institutions affect individuals in fundamental ways.

Most of these points are direct elaborations of ideas from Hamilton's [1919] text. However, regarding point (4), Hamilton did not mention the words "open system." The phrase did not become widely used until after 1945. Institutional economists such as K. William Kapp [1968, 8] and Shigeto Tsuru [1993, 73] made the idea of the economy as an open system one of the defining characteristics of institutionalism. Furthermore, Hamilton did not use the words "evolving" or "evolutionary," although institutionalists have become fond of these terms.

Point (1) may prove controversial, so it will be discussed in more detail below. It is perhaps the only point that any institutionalist may wish to remove from the list. Certainly, some institutionalists will wish to add to or elaborate on the above five points. The contention here is that they contain the "hard core" of the institutionalist tradition.

I further assert that the single most important defining characteristic of the old institutionalism is proposition (5). Among other schools, the new is distinguished from the old institutional economics principally in these terms. Other criteria do not demarcate the old institutionalism so readily. Other schools of economic thought also express some concordance with propositions (1) to (4). In contrast, proposition (5) is a guiding thread through the whole institutionalist tradition, from Veblen to

Galbraith, and it is rarely acknowledged or developed elsewhere. I make this argument below. Let us first look at proposition (1). Subsequently, later sections of this essay will examine the common features of institutionalist theory and discuss some of the implications.

Is Institutionalism Defined by Its Policy Pronouncements?

In the wider world, economics is often perceived and judged in terms of its policy prescriptions. Economics claims to be a science, but policy issues appear everywhere. Even those who adhere to the notion of a "value-free" economic science are often the very same people who are keen to pronounce policies.

The institutional economist Gunnar Myrdal is well known for his emphasis on the unavoidability of value judgments in social science. He wrote: "Valuations are present in our problems even if we pretend to expel them. The attempt to eradicate biases by trying to keep out the valuations themselves is a hopeless and misguided venture" [Myrdal 1958, 131]. But this does not mean that positive and normative statements are epistemologically indistinguishable. For Myrdal, facts and values were not the same thing. Values neither "emerge automatically" from facts nor is the choice of value premises an arbitrary matter. In short, Myrdal believed that "values are always with us," but he did not make the mistake of treating values as equivalent to facts. In social science, statements about fact are always contaminated with values. However, this does not mean that facts and values are equivalent.

Economic policies are very important. Nevertheless, to convince and carry scientific authority, policies have to claim a theoretical basis. Whether from the political right or left, a policy in the modern world has to invoke to some theoretical justification. For reasons of both legitimization and logic, policy has to attempt to ground itself upon theory. Furthermore, in order to change the world it is first necessary to understand it. We must discern its underlying structures and forces before we can appraise the set of feasible possibilities for policy.

It is not being suggested that the positive *and* the normative can be entirely separated, at least in the social sciences. Contrary to the "positive economics" proposed in the neoclassical textbooks, it is impossible to separate completely (positive) judgments of fact from (normative) judgments of value. Statements of fact and value are typically intermixed. However, facts and values are not the same thing.

Accepting that normative values are "always with us" does not mean that we should always judge a theory primarily by its normative values. To accept a complex interrelationship between the positive and the normative does not mean that we abandon all aspects of the distinction. Statements attempting to explain what *is* are confused with statements about what *ought* to be. Yet knowing that many people in the world today are poor is not the same thing as saying that they should remain impoverished.

While important, normative aspects of institutionalism are not very useful, nor sufficiently precise, as defining criteria. One can find a huge diversity of normative opinions within institutionalism. There are prominent examples of fairly conservative institutionalists, such as Arthur F. Burns—a friend of, and collaborator with, Veblen's student Wesley Mitchell—who advised Republican President Eisenhower in the 1950s. Other institutionalists have socialist views. Others are closer to the political center. Policy outputs do not tell us very much about the overall nature of institutionalism.

Any attempt to define institutionalism in terms of policy outputs would run into severe difficulties. Consider some possible policies. Can institutionalism be defined, in part, in terms of a critique of market solutions to economic problems?

Many institutionalists have criticized pro-market policies and have proposed various forms of economic intervention and planning. However, so too have neoclassical economists. (Neoclassical economics is defined as the type of economics invoking the standard textbook principles of rationality, maximization and equilibrium.) The problem of using a disposition towards planning and against markets to define institutionalism would be that many neoclassical economists would then be institutionalists.

Many of the pioneers of neoclassical economic theory, including Léon Walras, Alfred Marshall and Philip Wicksteed, were sympathetic to socialist or social-democratic ideas. By today's standards, some of them would be leftist radicals. Walras, for instance, called himself a "scientific socialist." His theoretical efforts in economics were motivated by a desire to demonstrate the economic advantages of price regulation and the public ownership of natural monopolies, including land. Marshall was concerned about the problems of poverty in Victorian Britain, and was sympathetic to worker co-operatives. Wicksteed also advocated land nationalization and had sympathetic and personal links with the socialist and radical movement.

Several neoclassical economists have promoted radical, interventionist or socialist ideas. For example, Irving Fisher advocated substantial reflationary measures during the Great Depression. Another group of neoclassical economists in the 1930s—led by Oskar Lange—used neoclassical economic tools to argue for the superiority of a version of socialist planning.

Still later, leading neoclassical general equilibrium theorists Kenneth Arrow and Frank Hahn declared their sympathies for various interventionist and social-democratic economic policies. Indeed, Hahn and others have attempted to justify the whole general equilibrium theoretical project as an attempt to demonstrate the *limits* of the market mechanism.

Even more recently, alleged Marxists such as Jon Elster and John Roemer have explicitly embraced neoclassical tools of economic analysis, while retaining leftist political credentials. True, there are many conservative and pro-market neoclassical economists. But neoclassical theory spans the conventional political spectrum—from the extreme pro-planning left to the extreme pro-market right—and thus is not definable in terms of the policy stances of its adherents.

Can institutionalism be defined, in part, in terms of a concern for greater equality and wealth? Institutionalists do not have a monopoly on egalitarian sentiments. And there is nothing in the core of neoclassical theory that necessarily leads us to inegalitarian conclusions.

Indeed, in the early part of the twentieth century, some economists saw neoclassical utility theory as supporting the policy prescription of income redistribution and greater equality. If individuals have a diminishing marginal cardinal utility of income, then making incomes more equal may increase overall utility. However, these egalitarian policies did not find ideological favor among many neoclassical economists; they adopted the Pareto criterion instead. A policy of taking from the rich and giving to the poor is not Pareto efficient. With this auxiliary assumption, the policy conclusions of neoclassical welfare theory were changed from egalitarian to conservative. The core presuppositions of neoclassical theory are in fact enormously flexible in policy terms, depending upon which auxiliary assumptions are chosen.

True, neoclassical theory is based on the idea of the given individual. And the ideology of political individualism sits quite comfortably upon it. But the assumption of given, utility-maximising individuals does not itself contain any normative notion concerning the maximization of human freedom or the minimization of the role of the state. It is one thing to say that the analytical and the normative ideas may dovetail easily. But this does not necessarily mean that one flows logically from the other.

The fact that neoclassical theory can readily be packaged as either pro-market or anti-market is a symptom of its failure to provide an adequate explanation of how markets work. It really concedes too much to neoclassical theory to suggest that it has an adequate theoretical foundation upon which to build any pro- (or anti-) market policy. Neoclassical theory is essentially neither pro-market nor anti-market, because it has no adequate theory of markets at all. Instead of associating it with markets, it would be more accurate to say that neoclassical theory was *blind* to real markets, and consequently to their virtues or vices.

It is a serious mistake to dismiss mainstream economics on policy grounds, especially if we are concerned about policy. The mistake becomes more serious because it gives unwarranted credence to mainstream theory as a means to generate well-grounded policies. The dismissal of a theory because of its alleged policies unwittingly bolsters the theory, by giving it much more credit, as a viable policy engine, than it deserves.

Furthermore, turning science into an ideology would disable any attempt to get better scientific explanations of social and economic outcomes we may wish to change. Instead of persuading the scientific community of the causes of poverty or unemployment, we simply take up an ideological posture against it. We thereby abandon our role and duty as scientists. Our ability to change and improve the world is diminished by some degree. Any alternative approach to the mainstream must first stake its claim to be an identifiable approach to economics on the basis of its incisive *analysis of what is*, rather than on its judgments of what *ought* to be.

Other Criteria: Interdisciplinarity, Institutions, Evolution, and Open Systems

We now consider three more of the defining characteristics of institutionalism, as listed above, namely (2), (3) and (4). I argue that these are necessary, but far from sufficient, to define institutionalism.

Consider the worthy attribute of interdisciplinarity. It is to its merit and enrichment that the old institutional economics draws upon other disciplines such as anthropology, sociology, political science, and psychology.

However, the nature of interdisciplinarity is difficult to pin down. Neoclassical economics could also claim to draw on other disciplines. Chicago economists Gary Becker and Jack Hirshleifer have asserted that their economics makes use of insights from biology. Political science and sociology have been invaded by neoclassical approaches based on rational choice. The neoclassical economist can also be comfortable with some individualistic schools of thought in anthropology and psychology.

Furthermore, not all interdisciplinary endeavors are worthwhile. Many disciplines contain individualist and other assumptions from which institutionalism would disassociate. A richer concept of the individual may also be found in anthropology or psychology, but we also find impoverished and unsuitable ideas in these disciplines. Institutionalists may be more thorough and committed in their use of interdisciplinary resources, but interdisciplinarity does not define institutionalism.

The old institutionalism emphasizes the importance of institutions in economic life, and attempts to understand their role and their evolution. Especially in the 1940-1975 period, mainstream economists neglected the study of institutions. This is not the case today. With the arrival of the new institutional economics, mainstream economists have analyzed institutions, albeit as outcomes of decisions of rational, maximizing agents. The old institutionalists cannot claim to be the only school of economics to study institutions.

Consider the idea that institutional economics is "evolutionary." The nugget of truth here is that institutionalist writing is concerned with processes of structural transformation, emergence and change, which are often neglected in the mainstream literature. The problem, however, is that the word "evolutionary" is extremely vague. It is now widely used, even by economists using neoclassical techniques. "Evolutionary game theory" is highly fashionable. Even Walras is described as an evolutionary economist [Jolink 1996]. Above all, "evolutionary" is now a voguish word that everyone seems keen to use. In precise terms it signifies little or nothing.

Some take it to mean the use of biological analogies; other self-proclaimed "evolutionary economists" see no value in them. A narrower and more precise meaning of "evolutionary" that successfully demarcates institutionalism from other approaches has not yet been elucidated or adopted [Hodgson 1993b, 1999].

We come to the institutionalist understanding of the economy as an "open system." This is clearly an important insight of the old institutional economics, at least in the sense that it is recognized that the economy is part of a natural environment, embodied in a system of social relations, and affected by technological and other changes. So far so good. The problem in using this as a demarcation criterion is that more substance needs to be given to the notion of a "system," and more explanation is required of the characteristic of it being "open" as opposed to "closed." The idea of a system is an important but difficult concept. It connotes some idea of a closely structured interaction between interdependent components. But the boundary of the system may be fuzzy and difficult to establish.

What is an *open* system? Arguably, it is a system that is open to flows of matter, energy or information across its boundary—a system in actual or potential interaction with its environment. Is a national economy engaging in trade with other countries an open system? If so, then standard neoclassical macroeconomics has also embraced open systems. Insofar as neoclassical economics deals with the environmental impact of economic activity, it might also be said to be dealing with an open system.

A narrow version of the "open system" doctrine could rule out a significant fraction of the institutionalist literature, whereas a wider version would also admit much of neoclassical theory. The open system doctrine is not a precise signifier of the historical boundaries of institutionalism. Until it receives further refinement, it is at best an important but imperfect criterion.

In summary, the first four characteristics, (1) to (4), are important but not sufficient to define the old institutionalism. Taken separately, or together in any combination, they are not enough. We must turn to the fifth criterion.

The Institutionalized Individual

The first task in this section is to identify a common theme that pervades institutionalism, from the writings of Veblen in the 1890s and after, to Galbraith and the present day. A notion that the individual is not given, but can be reconstituted by institutions, pervades the tradition of old institutionalism from its predecessors in the historical school to its modern successors. For instance, Veblen [1899, 190-1] wrote:

> The situation of today shapes the institutions of tomorrow through a selective, coercive process, by acting upon men's habitual view of things, and so

> altering or fortifying a point of view or a mental attitude handed down from the past.

For Veblen, this was a basis for a fundamental critique of mainstream economics. In 1909, he elaborated the argument more fully:

> The wants and desires, the end and the aim, the ways and the means, the amplitude and drift of the individual's conduct are functions of an institutional variable that is of a highly complex and wholly unstable character [Veblen 1919, 242-3].

Likewise, Hamilton [1919, 318] wrote of the "most important" defect of neoclassical economics: "it neglected the influence exercised over conduct by the scheme of institutions under which one lives and must seek his good." Later he continued the same theme, seeing each institution as "imposing its pattern of conduct upon the activities of men" in a manner consistent with the notion that institutions possess causal powers above that of individuals alone. Hamilton [1932, 89] continued: "Institutions and human actions, complements and antitheses, are forever remaking each other in the endless drama of the social process."

Writing in 1899, Commons [1965, 3] saw institutions "shaping each individual." Commons [1934, 73-4] likewise made it clear that "the individual with whom we are dealing is the Institutionalized Mind. . . . Individuals . . . meet each other . . . prepared more or less by habit, induced by the pressure of custom . . ."

In an early article, Mitchell [1910, 203] made a similar point:

> Social concepts are the core of social institutions. The latter are but prevalent habits of thought which have gained general acceptance as norms for guiding conduct. In this form the social concepts attain a certain prescriptive authority over the individual. The daily use by all members of a social group unremittingly molds those individuals into common patterns without their knowledge, and occasionally interposes definite obstacles in the path of men who wish to act in original ways.

In his study of the evolution of money as an institution, Mitchell [1937, 371] emphasized how it changed human mentality and nature:

> Now the money economy . . . is in fact one of the most potent institutions in our whole culture. In sober truth it stamps its pattern upon wayward human nature, makes us all react in standard ways to the standard stimuli it offers, and affects our very ideals of what is good, beautiful and true.

Likewise, Clarence Ayres [1944, 84] explained:

> "wants" are not primary. They are not inborn physical mechanisms and they are certainly not spiritual attributes. They are social habits. For every individual their point of origin is in the mores of his community; and even these

traditions have a natural history and are subject to modification in the general process of social change.

The idea that individual tastes are not given, but are shaped by institutional circumstances and by particular influences such as advertising, is a major theme in the writings of Galbraith. For instance, in the *New Industrial State,* Galbraith [1969, 152] insisted that individual "wants can be synthesized by advertising, catalysed by salesmanship, and shaped by the discreet manipulations of the persuaders." The theme persists throughout his writings. Indeed, no author has brought these ideas to the attention of the modern reader more clearly and resolutely than Galbraith. His analysis puts particular emphasis on the effects of advertising on individual wants. This is one version of the core institutionalist story. More generally, institutionalists recognize the potential influence of many institutions on individual habits, conceptions, and preferences.

Such ideas permeate and endure through institutionalism as a whole. Institutionalism is distinguished from both mainstream economics and the "new institutional economics" precisely for the reason that it does not assume a given individual, with given purposes or preference functions. Instead of a bedrock of given individuals, presumed by the mainstream and new institutional economics, the old institutionalism holds to the idea of interactive and partially malleable agents, mutually entwined in a web of partially durable and self-reinforcing institutions [Hodgson 1988]. No other criterion demarcates so clearly the old institutional economics, on the one hand, from new institutional and mainstream economics on the other [Hodgson 1993a].

Note that the acceptance of the institutionalized individual does not immediately rule out the possibility that institutionalism and neoclassical economics may be complementary. Although Veblen wished to purge economics of classical and neoclassical errors, other institutionalists searched for some complementarity between neoclassical and institutional economics. This group included leading institutionalists such as Commons, Mitchell, J. M. Clark, Paul Douglas, and Arthur F. Burns. They all saw institutionalism as compatible with aspects of Marshallian price theory. Commons [1931] in particular argued for some complementarity between the schools. This is a controversial position. But it shows that the complete exclusion of neoclassical economics from institutionalism would rule out Commons and others from the institutionalist canon.

Upward and Downward Causation

Having identified the most important common theme in old institutionalism, it is necessary to enquire more deeply into its meaning. Several versions of this doctrine have surfaced over the years. It is also necessary to deal with some potential misunderstandings and rebuttals.

Perhaps the most frequent attack on the notion that individual tastes and preferences are molded by circumstances is the criticism that this leads to some kind of structural or cultural determinism. The individual, it is said, is made a puppet of social or cultural circumstances.

Admittedly, some old institutionalists have promoted such a deterministic view. When Ayres [1961, 175] wrote that "there is no such thing as an individual" he was giving succor to such ideas [Rutherford 1994, 40–41]. The danger is to see social order as a primarily "top down" process in which individuals are formed and cajoled by institutions, with a neglect of individual autonomy and agency. The Ayresian version of institutionalism has been so prominent in the post-1945 era that many commentators take it to be representative of institutionalism as a whole.

However, such predominantly "top down" versions of the core institutionalist idea are not common to all institutionalists. This is clearly the case with both Veblen and Commons. For instance, Veblen [1919, 243] argues that institutions are the outcome of individual behavior and habituation, as well as institutions affecting individuals:

> The growth and mutations of the institutional fabric are an outcome of the conduct of the individual members of the group, since it is out of the experience of the individuals, through the habituation of individuals, that institutions arise; and it is in this same experience that these institutions act to direct and define the aims and end of conduct.

Writing in 1899, Commons [1965, 6-8] wrote similarly of the dependence of institutions upon beliefs:

> Social beliefs . . . furnish the basis in the affections of each person which alone makes possible his responsiveness to the appeals of those with whom he must coöperate. The institution in which he finds himself is both the cause and effect of his beliefs. . . . Common beliefs and desires are the vitalizing, active force within the institution.

These statements show a valid recognition of both the dependence of institutions upon individuals and the molding of individuals by institutions. In the writings of Veblen and Commons there is both upward and downward causation; individuals create and change institutions, just as institutions mold and constrain individuals. Institutionalism is not necessarily confined to the "top down" cultural and institutional determinism with which it is sometimes associated.

The great merit of the institutionalist idea that institutions shape individual behavior is that it admits an enhanced concept of power into economic analysis. Power is not simply coercion. For Steven Lukes [1974], the overemphasis on the coercive aspect of power ignores the way that it is often exercised more subtly—and often without overt conflict. He points out that supreme power is exercised by orchestrating the thoughts and desires of others.

These subtle considerations are absent from mainstream economics. Preference functions are not subject to reconstitutive downward causation. This is so even when an attempt is made to "explain" tastes. Becker [1996] tries to show that cultural and other influences can alter preferred outcomes by adding cultural and other factors to the arguments of these functions. However, culture does not alter the preference functions themselves.

A problem with this analysis is that it cannot deal with the genuine evolution and fundamental development of the individual. It attempts to make all explanations of social phenomena reducible to the given individual, but in doing so it has to make the individual preference function immutable. The preference function is already "there," ready to deal with unpredictable and unknowable circumstances. We already know essentially what is to be learned.

Learning typically takes place through and within social structures, and at least in this sense it is an important case of reconstitutive downward causation. Neoclassical economics has great difficulty accommodating the notion of learning because the very idea of "rational learning" is problematic. It treats learning as the cumulative discovery of pre-existing "blueprint" information, as stimulus and response, or as the Bayesian updating of subjective probability estimates in the light of incoming data. However, instead of the mere input of "facts" to given individuals, learning is a developmental and reconstitutive process. Learning involves adaptation to changing circumstances, and such adaptations mean the reconstitution of the individuals involved. Furthermore, institutions and cultures play a vital role in establishing the concepts and norms of the learning process [Hodgson 1988]. Accordingly, the reconstitutive nature of learning is partly a matter of reconstitutive downward causation. To put it bluntly: if we are to accept fully the notion of learning into social theory, then the concept of reconstitutive downward causation must also be sanctioned.

Conclusion

It has been argued here that a concern for policy issues may be an attribute of institutional economics but it cannot be its defining characteristic. Necessary features of institutionalism include the recognition of the importance of insights from other disciplines, of institutions and of open and evolving systems.

Nevertheless, the single most important characteristic of institutionalism is the idea that the individual is socially and institutionally constituted. The argument here is that all the old institutional economists, from Veblen to Galbraith, embrace the notion that the individual is molded by cultural or institutional circumstances. Within institutionalism, there are many variants of this view.

However, the notion of "reconstitutive downward causation" is found neither in mainstream economics, nor in the new institutionalism. The tradition there is to take the individual as given. His or her preference function, even if it includes cultural variables as arguments [Becker 1996], is immanently conceived. The emphasis there is on "rational choice" with given preferences in specified circumstances. Welfare judgments are based on the assumption that the choice made by the individual is the "best" one in the circumstances.

The implications for abandoning this view and adopting the approach of the old institutionalism are enormous. Conceptions of social power and learning can be placed at the center of economic analysis. This means that institutionalism is more able to address questions of structural change and economic development. It is more useful, for instance, in dealing with issues such as long-term economic development, the problems of less-developed economies, or the transformation processes in the former Soviet bloc countries. On the other hand, the analysis becomes much more complicated and less open to formal modelling. In normative terms, the individual is no longer taken as the best judge of his or her welfare. This opens up the difficult question of the discernment and evaluation of human needs.

This theoretical agenda—including matters of power, learning and welfare—is at the center of institutionalism, and it remains as vital and exciting as it was 100 years ago.

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