



A Modern Reader in Institutional and Evolutionary Economics

KEY CONCEPTS

Edited by
GEOFFREY M. HODGSON



European
Association for
Evolutionary
Political
Economy

A Modern Reader in Institutional and Evolutionary Economics

EUROPEAN ASSOCIATION FOR EVOLUTIONARY POLITICAL ECONOMY

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Edited by Geoffrey M. Hodgson

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Edited by

Geoffrey M. Hodgson

*Research Professor, University of Hertfordshire Business School,
UK*

EUROPEAN ASSOCIATION OF EVOLUTIONARY POLITICAL ECONOMY

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Introduction

Geoffrey M. Hodgson*

The book is the first of what is hoped to be a series of readers produced by the European Association for Evolutionary Political Economy (EAEPE) through Edward Elgar Publishing. The aim of these volumes is to present an exciting and diverse body of work in economics and related disciplines, to undergraduate students, graduate students and lecturers. Much of this work is not discussed in standard textbooks. Yet it is of enormous importance in understanding the manifest turbulence and transformations in the modern world.

With the exception of the present introduction, the essays reprinted here have all been published before. They all appeared in collections of papers presented at successive EAEPE conferences and workshops since 1990. In compiling this reader, key papers have been selected from conference volumes between 1990 and 1996 inclusive.¹ The papers have been selected not simply on their merit and importance but also to provide a coherent structure for the reader as a whole. Furthermore, the specific focus of this reader is on ‘key concepts’ and that too is reflected in the choice of papers.

The first aim of this introductory essay is to place these essays in the historical and theoretical background of recent developments in economics and other social sciences. In recent years there have been enormous changes, especially within and on the fringes of economics itself. Some of these developments are sketched in section 1. Section 2 outlines the conceptual and theoretical foundations of institutional and evolutionary economics. Section 3 briefly summarizes the contents of the essays reprinted here.

1. ECONOMICS FROM THE 1970s TO THE 1990s

If we could travel back in time just a few years to 1970, we would be struck by the remarkable difference between economics as taught then and as taught today. First, although the formalization of mainstream economics was then proceeding apace, it had not reached the levels that we find now. In the 1970s, even prestigious journals such as the *American Economic Review* and the

Economic Journal carried a significantly lower proportion of mathematical articles.

Second, non-mainstream viewpoints within economics had a stronger following and could be found in many university departments of economics. 'Post Keynesian' economics was launched in the early 1970s by Joan Robinson, Alfred Eichner, Sidney Weintraub and Paul Davidson (Lee, 2001). Within this grouping, a minority were engaged in the famous 'Cambridge' debates over capital theory (Harcourt, 1972). It seemed to many at the time that a major theoretical flaw in mainstream economics had been identified. However, the main preoccupation of Post Keynesianism was macroeconomics. In addition, Marxian economics experienced a major global revival, partly as a consequence of the political radicalization of the student movement. Accordingly, during the 1970s, economics included sizeable non-mainstream tendencies, such as Marxism and Post Keynesianism.

Herbert Simon was awarded the Nobel Prize for economics in 1978, and his criticisms of mainstream economics became more influential. In addition, Nicholas Georgescu-Roegen (1971) published an important theoretical work with major implications for both economic theory and policy. Friedrich Hayek received the Nobel Prize in 1974 and this heralded a revival of 'Austrian' economics, particularly in the United States. Economists of the Austrian school were highly critical of the informational assumptions and equilibrium analyses of mainstream economics. However, unlike most other critics of mainstream economics, they promoted a highly pro-market policy agenda. This helped them to survive in the 1980s, in the ideological environment of Ronald Reagan and Margaret Thatcher.

Several important developments occurred within mainstream economics in the 1970s, of which a few can be mentioned. In microeconomics, neoclassical approaches remained dominant, with their common emphasis on rationality, maximization and equilibrium. In some respects there was a growing self-confidence in this approach, with theorists such as Gary Becker applying it to new areas of enquiry such as the family. The perceived cutting edge of neoclassical theory was general equilibrium analysis. However, in the 1970s, general equilibrium theorists such as Gerard Debreu, Rolf Mantel and Hugo Sonnenschein discovered severe problems within this approach. These problems would eventually prove fatal for this research programme (Kirman, 1989; Rizvi, 1994a).

Another striking event in the 1970s was the inauguration of the 'new institutional economics'. The term was coined by Oliver Williamson (1975) and was also broadly associated with work from a variety of viewpoints by Ronald Coase, Douglass North, Mancur Olson, Richard Posner and others. These were important developments, not least because they opened for analysis the 'black box' of the firm and other institutions.

In macroeconomics, perhaps the most significant mainstream development in the 1970s was the renewed assault on all varieties of Keynesianism. It was argued that Keynesian theory involved ‘*ad hoc*’ assumptions, and instead macroeconomics should be placed on the ‘sound microfoundations’ of general equilibrium theory (Weintraub, 1979). Milton Friedman promoted his own version of monetarism as an alternative to Keynesianism. The ‘new classical economics’ of Robert Lucas and others also became prominent.

The ideological climate changed markedly in the late 1970s. On the whole, Marxian economics failed to extricate itself from its arcane doctrinal debates and lost its theoretical momentum by the early 1980s. The only significant grouping of Marxian economists to survive the 1980s were those – such as John Roemer and John Elster – who had openly embraced mainstream theoretical and mathematical tools, such as neoclassical equilibrium analysis and game theory.

As a result, the 1980s opened with the main non-mainstream approaches to economics in difficulties. Post Keynesianism was under severe attack from the monetarists and Marxism was in severe decline. The Cambridge critique of the neoclassical aggregate production had been largely ignored. Frank Hahn (1982) rightly pointed out that the Cambridge critique of capital theory does not apply to disaggregated approaches such as general equilibrium theory. In these new circumstances, no school of non-mainstream economics made much headway.

Furthermore, mainstream economics itself, dramatically but quietly, shifted its cutting edge from general equilibrium theory to game theory. This became the main theatre of theoretical controversy within mainstream economics (Rizvi, 1994b).

At the same time, new critiques and alternatives began to develop. On the fringes, there was a steady increase in both ‘evolutionary’ and ‘institutional’ themes in the 1980s. Kenneth Boulding’s (1981) book *Evolutionary Economics* appeared as one of the first of many in this new evolutionary wave. It was followed quickly by the classic work of Richard Nelson and Sidney Winter (1982) *An Evolutionary Theory of Economic Change*. These and other works brought into the limelight a very different type of approach to economic theory and analysis.

At roughly the same time, and especially in France, the *régulation* school had come into being through a work published originally in French in 1976 by Michel Aglietta (1979). In the 1980s, the *régulation* approach provided a bridge between Marxism and some newer evolutionary and institutionalist themes.

Also during the 1980s, there were significant developments in both the ‘new’ and the ‘old’ institutionalism. While the new institutionalism proved increasingly influential, some of its followers made links with the Austrian

school, establishing links with the work of Carl Menger and subsequent Austrians (Schotter, 1981; Langlois, 1986).

In North America, a small group of 'old' institutionalists had formed the Association for Evolutionary Economics and the *Journal of Economic Issues* in the 1960s. While the old institutionalists had been overshadowed by Marxism and Post Keynesianism in the 1970s, the new situation in the 1980s provided the old institutionalists with an opportunity. After all, developments within or close to mainstream economics had put institutions back on the agenda. In addition, through the efforts of Americans such as Warren Samuels (1979), Marc Tool (1979) and others, the 'old' institutional economics began once again to be noticed. In addition, the Association for Institutional Thought was founded in the early 1980s. It continues to meet alongside the gatherings of the Western Economic Association in the USA.

These initiatives helped to revive interest in the works of such institutionalists as Thorstein Veblen, Wesley Mitchell, John Commons and Clarence Ayres. Significantly, several of their books were reprinted in the 1980s and 1990s. The most important living representative of the American institutionalist tradition – John Kenneth Galbraith – had already achieved prominence through his popular and challenging works.

The Santa Fe Institute was founded in 1984. It had an impact on the development of complexity theory and promoted non-reductionist discourses in both the social and the natural sciences (Waldrop, 1992). Another important and fertile development in the 1980s was the growth in interest in the methodology of economics, stimulated by publications such as those by Mark Blaug (1980) and Bruce Caldwell (1982).

The year 1988 was marked by a remarkable number of influential publications and developments. An influential work by Amitai Etzioni (1988) led to the foundation of the Society for the Advancement of Socio-economics (SASE). Horst Hanusch (1988) produced an edited volume on *Evolutionary Economics* that signalled a strong revival of interest in the ideas of Joseph Schumpeter and the formation of the International Joseph Schumpeter Association. A larger, seminal collection of essays – edited by Giovanni Dosi, et al. (1988) – focused on technical change and also proclaimed some strong 'evolutionary' themes. Finally, a work of mine may have helped the revival of the old institutional economics in Europe and America (Hodgson, 1988). The European Association for Evolutionary Political Economy was conceived at a meeting near London in 1988. It emerged as a broadly based and pluralist forum for the development of institutional and evolutionary economics.

Between 1980 to 1990, the profile of non-mainstream economics had changed globally and dramatically. In 1980, dissident economics was dominated by macroeconomics of Marxist and Post Keynesian hues. By contrast,

in 1990, the picture was much more diverse. It involved unorthodox developments in microeconomics as well as in macroeconomics, and it included novel and prominent evolutionary and institutionalist themes.

However, in the meantime, mainstream economics had become more formal and narrow. Several departments of economics that had formerly accommodated non-mainstream economists, were by 1990 entirely under mainstream control. This was particularly noticeable at the University of Cambridge. Its leading non-mainstream theorists, Nicholas Kaldor, Joan Robinson and Piero Sraffa, all died in the 1980s. By 1990 the department was under neoclassical control. Similar changes occurred at many other institutions, including Rutgers University in New Jersey, which had previously been a Post Keynesian citadel.

After the fall of the Berlin Wall in 1989 and the end of the Cold War, the ideological environment changed. An important effect of this was to create more space within mainstream economics for analyses of the limitations of the market mechanism and justifications for some forms of state intervention. In addition to the extreme pro-market views that were still propounded in Chicago and elsewhere, rising mainstream theorists such as Joseph Stiglitz and Paul Krugman defended some role for state intervention and the regulation of markets. A wider variety of ideological viewpoints could be found among leading mainstream economists. The mistaken view that the debate between mainstream and dissident economics was primarily over ideology or policy was undermined.

However, what was noticeable about this ideological shift within the mainstream was that all positions had to be articulated within the increasingly formal language of mathematical economics, with less attention than in the 1970s to real world institutions and history. Although mainstream economics itself had changed enormously in the period, it increasingly defined itself in narrow, formalistic terms.

As a result, many non-mainstream economists were excluded from mainstream departments and journals. Institutional and evolutionary economists did not entirely reject mathematics as a tool, but they were critical of the tendency of the mainstream to become immersed in mathematical technique for its own sake. Consequently, many non-mainstream economists working in this area found employment in business schools, science policy units, departments of public policy and so on. Important work on the nature of social institutions was also carried out in social theory and philosophy (Searle, 1995). These matters of disciplinary demarcation affected the development of both mainstream and non-mainstream economics in the 1990s.

Institutional and evolutionary economics developed a broad global network, with a particular concentration in Europe. As well as important theoretical developments, it had an impact on economic policies, particularly

in the areas of technology policy, innovation policy, competition policy and corporate strategy. Several governments in Europe had advisors who were particularly inspired by these approaches. As the millennium drew to a close, it was clear that institutional and evolutionary economics had had a major impact, and it faced exciting new challenges for the next century.

In addition, important developments within mainstream economics pointed to issues raised already by the dissident economists. For example, Douglass North (1990) and Masahiko Aoki (2001) moved towards more open-ended and evolutionary theoretical analysis. The idea that all theory has to start simply from given individuals was abandoned by some. Instead, individuals were placed in a historical and institutional context. This work led to a degree of convergence with the evolutionary ideas of the 'old' institutionalists.

2. THE HISTORICAL AND THEORETICAL FOUNDATIONS OF INSTITUTIONAL AND EVOLUTIONARY ECONOMICS

Indeed, the developments in the last three decades of the twentieth century generally helped to rehabilitate the approaches of the historical school and the 'old' institutionalists. The historical school prevailed in Germany from the 1840s to the 1940s. The 'old' institutionalists were dominant in America between the First and Second World Wars. Within these schools of thought, evolutionary and institutional themes were common. These former schools still provide quarries of ideas. Their systems of thinking were not centred on, nor overly encumbered by, the neoclassical concepts of rationality, maximization and equilibrium.

Both American institutionalism and German historicism were immense and diverse movements and it is impossible to summarize their ideas in detail here. What should be emphasized, however, is that they held to a conception of economics that was much broader than the idea of the subject promoted by mainstream economists today. Within their capacious conception of the subject a number of important theoretical themes can be found. Some of these themes have been revived in modern institutional and evolutionary economics today.

Historical Specificity

Modern institutional and evolutionary economists endorse a theme that has been prominent in the writings of American institutionalists, German historicists and Marxists. From their viewpoints, it is recognized that socio-economic systems have changed substantially and enormously through history and that

there are also important variations between different socio-economic systems at any point in time. From a realist point of view, changes and differences in reality have implications for the type of theory to be developed (Mäki, 1989; Lawson, 1997). Consequently, attempts to create general or universal theories in social science face the problem of dealing with this real variation and diversity. General theorizing faces an ontological constraint. Attempts to erect general theories in social science have either failed in their own terms to be truly general, or have acquired highly limited explanatory powers (Hodgson, 2001).

As a result, economic and social theorists are obliged to build theories that in part involve historically or geographically specific assumptions. Although all theorizing involves some general categories and elements, effective theories also involve specific and particular assumptions. Marx recognized this in his analysis of capitalism. The German historical school developed methods and taxonomies to deal with particular historical developments. The American institutionalists focused on the nature of specific economic institutions. These schools recognized that the value of any general theory in social science is, at best, highly limited. Instead their focus was on particular systems, institutions and mechanisms.

Similarly, the essays in the present volume do not pursue the chimera of a purely universal theory. Of course, some general concepts – such as knowledge, power, evolution and open systems – are thematic for institutional and evolutionary economics. But an attempt is made to link their exposition to real economic processes and relations. For example, it is important to understand and explain key phenomena such as prices, but the exposition of price theory in large part depends on the analysis of historically and institutionally specific market relations and pricing mechanisms. In addition, markets are not the universal ether of all human interaction but a highly specific type of social formation. In short, markets themselves are historically specific institutions.

Evolutionary Orientation

In contrast to the traditional equilibrium and steady-state orientation of much economic theory, institutional and evolutionary economists place much greater emphasis on processes, changes and structural transformations. The recognition of the historical specificity of socio-economic systems itself points to the processes of evolution and system change through time. While much of economic theory attempts to focus principally on that which is common to all socio-economic systems, institutional and evolutionary economics also emphasizes the differences and the changes in socio-economic systems.

Of course, all theorizing must take some items as given. But from an evolutionary perspective a theorist is obliged to give some justification and