

**Are we forgetting something? Remarks on the connections between
Douglass North's Contributions and Original Institutional
Economics**

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Abstract: Douglass North's latest works have become central to the current discussion regarding the differences and similarities between the New Institutional Economics (NIE) and Original Institutional Economics (OIE). This paper seeks to contribute to this debate offering a specific analytical perspective to evaluate North's contributions. After defining a set of philosophical and methodological principles that specifies OIE, we seek to verify if and how North's work relates to these foundations. We believe that this methodological perspective brings to light a fundamental issue not stressed by earlier analyses: the profound difference between the institutionalisms regarding the role of market order as a mechanism of human sociability.

Keywords: Douglass North, New Institutional Economics, Original Institutional Economics, Philosophic Foundations, Market Order.

JEL Classification Codes: B15, B52, B25, B41

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Introduction

Douglass North's work has become central to the current discussion regarding the differences and similarities between the New Institutional Economics (NIE) and Original Institutional Economics (OIE). North can be considered as one of the most conspicuous representatives of the NIE in the fields of Economic History and Economic Development. On top of this, since the publication of his *Institutions, Institutional Change and Economic Performance* in 1990, scholars have accounted for a change of North's perspective, and important efforts were made since then to identify convergent tendencies between NIE and OIE.

Curiously, most of the work on building bridges between North's latest writings and OIE takes a common analytical path: One starts presenting North's ideas and afterwards seeks connections with OIE-related authors. Such a strategy gives prominence to the connections but tends to erase the differences. In this sense, our objective is to reverse this approach; after defining a set of philosophical and methodological principles that specifies OIE, we seek to verify if and how North's work relates to these foundations. This new methodological perspective highlights a profound difference between North and OIE when considering how they understand the role of market order as a mechanism of human sociability.

1. The transformations in North's thought and its reception in OIE.

All of the way into the mid-1990s, OIE adopted a rivaling posture against NIE. The approximation of NIE with neoclassical behavioral assumptions was of easy identification and formed an insurmountable barrier between the two institutionalisms.¹ However, this incommensurability began to be challenged within OIE in the mid-1990s, inspired by the content of North's new perspective.²

Scholars interested in the commonalities between OIE and NIE highlighted three major advances found in North's later publications. (1) the incorporation of a path dependent understanding of historical processes, (2) the admission that institutions are subject to power relations, and (3) the adoption of a structure-agency reference for understanding human behavior.

Rutherford (1994) emerged as one of the first OIE thinkers who pointed out that North was moving away from the principles dear to NIE, through downplaying the central concept of efficiency. For Rutherford, the "new North" emphasized that historical processes could generate

different types of institutional structures. Thus, to understand a specific institutional framework, history, as an open-ended and path-dependent process, could then take on a central role. In a similar sense, Dugger (1995:454) pointed out that North “(re)discovered that historical processes matter and he has changed his mind about history.”³

The cumulative and open-ended character of historical processes highlights the role of interests and power relations in establishing an institutional framework. As Rutherford (1994:45) and Caballero and Soto-Oñate (2015:968) proposed, North accepted that institutions could be created and modified according to the interests and goals of organizations with bargaining power. In this sense, the establishment of predatory and parasitic activities could be a possible consequence of this dynamic.⁴

Perhaps the most blatant similarity between North and OIE lies in North’s “cognitive turn.” This refers to his abandonment of rational choice agents and the adoption of a hybrid behavioral model that combines, in DiMaggio’s (1998) words, social-constructivism and rational action. Reasoning along similar lines, Groenewegen, Kerstholt, and Nagelkerké (1995) suggested that this “new North”⁵ was close to an “institutional individualism” that incorporated the conflicting relationship between rational action and ideology.⁶ Indeed North defended the role of the sociocultural environment in the mental constitution of agents through what Nielsen (2001) named a “cognitive institutional approach.” Dequech (2002) pointed out that the mental models described by North presented profound cognitive functions manifested through the processes of learning, communication, and transfer of knowledge to other generations. Institutions would cease to be just “rules of the game” external to agents. In contrast, rules would define the very way that agents think. Thus, an approximation with the OIE’s conception of agency is inevitable. As Hodgson (2007:14) emphasized: “[North] accepts that institutions or a ‘common cultural heritage’ can somehow reduce divergences between the mental models held by different individuals, or otherwise affect individual beliefs or goals. This leads us back to a theme in the old institutional economics concerning the role of institutions in melding preferences.”

2. The theoretical and methodological foundations of OIE

OIE’s enthusiasm for North’s new ideas is understandable. Similarities and bridges can indeed be readily be identified. However, we believe that important and understated issues concerning the relation and connections between the “new North” and OIE emerges when we emphasize some of the fundamental theoretical and methodological principles of OIE.

a) The object of study of economics and its specificities

As Stanfield (1999:232) states, for the OIE's perspective, economics is "... an established process for the provisioning of society." In the view of Samuels (1991:105), its object of study is "the evolution of control and organization of the economy as a whole." The OIE holds that economics is not restricted to the study of markets or societies with markets, and it is not limited to the study of the activities that pass only through markets. For OIE, economics is a reflection on how the economic system works in the broadest sense. Economics is concerned with how human societies organize themselves in order to generate livelihoods and ultimately reproduce themselves to carry on over spans of time.

b) The entry point of OIE

Proponents of OIE care about social reform. Institutionalists think that the task of a social scientist is not only to understand reality, but also to contribute to making the world a better place. Institutionalists hold what could be considered as a normative value. Namely, economics (and the social sciences in general) should serve to eliminate "invidious distinctions" in society, such as those based on race, gender, social class, etc. Various institutionalists have advocated this engagement, particularly Myrdal (1969), who emphasized that it is impossible for value-free science to exist. In this sense, when looking at any society, institutionalists prioritize two issues: a) culture (i.e., institutions) and b) the distribution of power among its groups.⁷

c) The relationship between structure and agency

We hold that OIE is fundamentally "holistic". OIE tradition highlights the temporal preeminence of societies over individuals. However, at no time does OIE suggest that individuals are merely rule-following automata. To find a reasonable balance marked by the institutionalist view, Hodgson (2002, 2004) proposed as an OIE methodology the principle of "reconstitutive downward causation."⁸ According to Hodgson, higher-level entities control lower-level entities without interfering in the causal relationships of the components of the levels, and their actions can alter (reconstitute) higher forms.⁹

Concepts surrounding "habits" and "instincts" appear as two other key components necessary for understanding the relationship between agency and structure in OIE. For Veblen (1898,1914), individuals display instincts that are a product of the evolution of the species, indicating certain natural inclinations of behavior.¹⁰ Habits, in turn, are also inclinations that human beings present and that originate from both individual and social experience.

d) Institutions and market skepticism

Thinkers protecting and advancing the OIE positions understand that individual conduct does not depend on one's decisions, but stems from how society structures relationships between individuals. According to Hodgson (1988:10), an institution is "[a] social organization which, through the operation of tradition, custom or legal restraints, tends to create durable and routine patterns of behavior."

An important consequence is that there cannot exist a natural state "free of institutions", and this violates how market order is typically depicted. Every market is the product of some rules, which in turn can be considered, in the view of Bromley (2006,41) as an "interference" in those previously accepted. There is, therefore, no spontaneous order; for all order is built, and "institutions constitute this constructed order"¹¹

According to OIE, every institution is a pattern of conduct socially prescribed and value-oriented. One fundamental concept in OIE is that there are two categories of values in every institution — ceremonial and instrumental — and can be described by the "Veblenian dichotomy."

In sum, ceremonial values are those that maintain "invidious distinctions". In this sense, the market economy should be understood as a system of social control determined mainly by ceremonial values. Far from the - view of the market - as an efficient rational order, Veblen's analyses arrived at an opposite conclusion, as Dugger (1990:429) highlights: "[Veblen] conceptualized the market as a faulty gear in the industrial economy's transmission. Veblenian markets were dangerous interstices in the industrial economy, where fraud, delay, sabotage, and pecuniary predation in general were allowed free play."¹²

e) Technology and institutional change

Changes in technology are the main source of institutional transformation for OIE. Additions to society's "knowledge fund" is incorporated in accordance with the society's ceremonial or instrumental standards of conduct. The instincts of workmanship and of idle curiosity, described by Veblen, are to be found at the roots of these changes, and are driven, as Bush (1987:1080) stresses by the "application of evidentially warranted knowledge to the problem-solving processes of the community". At the same time, however, the choice of a technology among the possible options remains subjected to the power-struggle taking place between different actors. OIE tradition understands that concepts like property rights, contracts, firms (corporations), and so forth, must be studied from the perspective of power in mind. When ceremonial values

predominate, the new knowledge can become encapsulated so as not to challenge the prevailing structure of power controlling a society. However, as Bush (1987) teaches us, progressive institutional change may indeed emerge. When this is the case, instrumental patterns resulting from technological innovation could undermine and replace - ceremonial patterns.¹³

3. An old “new North”?

North’s works published since his landmark book of 1990 suggests affinities with OIE traditions. We understand, however, that the emphasis on some similarities overlooks the dissimilarities and, therefore, takes a naïve attitude about North’s views when contrasting them with OIE. We believe that a comparative effort based upon OIE’s theoretical principles vis-a-vis the ideas of the later North might assist in illuminating the debate.

a) The bridges built: Rationality, culture, and power

Incorporating culture to explain agent’s actions is a striking feature of North’s later writings. North (1990,1994,2003,2005) emphasizes the limits of the substantive rationality hypothesis, restricting its applications to competitive markets with defined prices (*easy choices*) (see Denzau and North 1994:4). North (2005:24) pointed out that when complexity and uncertainty are involved, “rationality assumption fails to adequately deal with the relationship of the mind and the environment.”

North (2003:8-9) took cognitive science and its connectionist model as a reference to describe human behavior. For North, the learning process is established through an interpretive structure, genetically determined initially, and later developed from the experiences of the agents. Further, these experiences are dependent upon the linguistic and sociocultural environments. The human brain incorporates them in a classificatory structure that conforms to an interpretative reference for the environment, something delineated by North (1994:332) as a “mental model”.¹⁴ Finally, Denzau and North (1994:8) suggest that mental models allow for the establishment of a mechanism of “representational redescription” that enables the elaboration of abstract generalizations from specific mental patterns.

Relying upon the concept of “mental models,” North concluded that institutions cease to be limited to “rules of the game” that determine the scope of action of agents with substantive rationality, affecting how agents understand the world.¹⁵ There is a direct link between culture as a shared “mental model” and the cognitive constitution of the agents, and this is highlighted by the specialized literature as a point of convergence with OIE.

Another important feature of this approximation is the relationship that North establishes between the asymmetry of power and institutions. If institutions are the rules held by the society, then organizations (state, businessmen, workers, etc.) are the players. It is in the interest of organizations to shape institutions according to their objectives, which can be conflicting. From this perspective, North (2005:67) establishes that the difference in development between nations depends upon how the power relations in each country under consideration determine its institutional structures, with a myriad of possible outcomes, since in “rare cases the government designs and enforces a set of rules of the game that encourage productive activity.”

From this analysis some important similarities with OIE becomes clear. First off, North proposes a relationship between structure and agency that is compatible with OIE (see item 2.c). Although North neither describes the process of “reconstitutive downward causation” nor speculates upon the relationship between instincts, habits, and institutions, he does address similar issues and describes the cognitive role of culture while giving prominence to the agency’s role in building an institutional framework. Second, when considering that institutions are built according to the interests of organizations, North touches upon a fundamental issue of OIE: institutions serve to crystallize specific interests (see item 2.d).

b) North and the OIE on markets and competition

An understanding of the limits of human sociability within the market order poses itself as an issue that clearly separates North from OIE. North’s more recent contributions seeks to advance an understanding of the importance of institutions and knowledge in the process of economic change. For this, he started from the concept of “artifactual structure,” which is best described as a society’s cultural inheritance: beliefs, institutions, tools, instruments, and technologies inherited from past generations. This artifactual structure also includes cognitive elements that allow agents to reduce degrees of uncertainty surrounding their choices, both when dealing with physical (external) and human environments. Relying upon this definition, North (2005:36) creates a fundamental hypothesis: “The richer the cultural context in terms of providing multiple experimentation and creative competition, the more likely to be successful survival of the society.” In North’s framework, the difference in economic development between countries stem from how their different artifactual structures deal with new experiences. The failure of an artifactual structure is manifested by its failure to create adequate cognitive building blocks for new environmental demands. In this sense, North seeks to understand precisely how institutions

collaborate to construct different types of artifactual structures and, mainly, how these institutions determine different routes of development. Distinctions between institutional structures that favor personal or impersonal exchanges, register as key for understanding how and why different paths of development are chosen.

North understands that, historically, developed countries have built a set of specific institutions that serve to reduce transaction costs of specialized agents, allowing decision making to occur from price signaling. For North, what are today developed countries were able to establish “well-adapted” institutional structures that kept relatively lower costs for an increasing amount of transactions. For North, democracies with decentralized market economies, well-defined property rights and efficient enforcement mechanisms are the best approximation of a well-adapted institutional framework.

North notes that developed market economies are structured through institutions that both encourage decentralized attempts to innovate and enable rapid elimination of errors. This sort of economies exhibit institutional frameworks that measure property rights at low prices, and provide incentives that encourage decision-making in competitive markets. Contrariwise, underdeveloped countries tend to lack this kind of artifactual structure, since their structure favors personal relations over impersonality. This specific type of structure with roots visible in the beginnings of civilization (and human genetics), represents an obstacle to the development of a greater portion of humankind because it cannot effectively adapt to new experiences in a decentralized and efficient manner. ¹⁶ The problem remains that nations with this kind of structure find difficulty in becoming free itself from economic and political relations of the clientelistic ties. North’s (2005:2004) conclusion proves explicit in this sense “The inability of the third world to exploit the promise of modern technology is in stark contrast to the developed world and reflects an institutional framework that prevents the development of impersonal exchange and consequent productivity developments.”

North tends to dismiss the importance of the predatory aspects of market that Veblen and his exponents maintain. The OIE skepticism about the institutions that constitute the market order (see item 2.d), is missing. For Veblen, market institutions legitimize the practice of sabotage of production by businessmen. As Veblen (1904,1914,1919) pointed out; market results are not normally determined by efficiency measured in terms of factor productivity, but rather in economic terms, whereby pecuniary gain imposes itself as fettering production. In this sense, key

points emphasized by OIE, such as the social inefficiency of the price system, do not fit into North's description. Thus, the understanding that the institutionalist *ethos* intends to promote a more just society (highlighted in item 2.b) can be depicted only narrowly for North, since for him an institutional structure that sustains sociability in market terms is the most beneficial institutional model. Consequently, this centrality attributed to the markets clashes with the emphasis placed upon a wider understanding of the provisioning process as defended by the OIE tradition (see item 2.a).

North's positive characterization of the market order clashes with another OIE principle: the role of technology and institutional change. As mentioned in item 2.e, technological change, as a manifestation of basic human instincts, remains central to OIE materialist view. This describes the source of institutional change that could be considered progressive so long as it does not become encapsulated by ceremonial values. It is technological change and the evaluation of its impact on the existing institutions that would allow us to understand the direction of this change. In contrast, for North, technology responds to the (economic) incentives of a specific institutional structure. For North, technology is reactive instead of playing an active role in the process of institutional change.¹⁷

Within market order, therefore, technological innovation for North plays a similar role as for Schumpeter: it increases the knowledge fund of society but does not present itself as a potential source of change in the values that underpin sociability. In this sense, it is clear that North understood that market economies, as present in developed countries, establish an institutional structure that provides incentives for innovative activities in production. The innovation here appears only because of these incentives and not as the source of institutional change.

4. Concluding Remarks

Great interest among OIE researchers regarding the possibilities for promising intellectual exchange with NIE seems well founded. . However, there is an observable tendency for some researchers to compromise key tenets of the OIE tradition. As but one example, Hodgson (2014:606) can be quoted: "All modern institutionalists can learn from original institutionalists, despite their limitations. They may even help in dealing with the acknowledged 'glaring gaps' and 'black holes' in the NIE." In our view, such a strong statement apparently establishes a problematic hierarchy between the institutionalisms, proposing a theoretical priority of NIE over OIE.

Despite Hodgson's controversial conclusion, we were interested here just in pointing out that building bridges involves identifying common paths of inquiry, but also reflecting on incompatibilities and limitations. This also includes choosing whether the identified similarities compensate for the differences. The case of the compatibilities between North's last works and OIE presents this problem. Certainly, we can identify interesting intersections between the institutionalisms on the questions of rationality, culture, and interests; however, a more detailed investigation of certain principles reveals important incompatibilities. This is born out especially when considering how the tradition of OIE understands the nature of the market order and the role of technology in institutional change.

Undertaking comparisons between the visions of North's and the OIE tradition may serve to obfuscate rather than clarify. In this respect, the vision that the market order comprises a set of predatory institutions that compromise the construction of a more just society clearly distinguishes OIE from other institutionalisms, including North's. Obviously, the researcher may seek to loosen this conflict between the market order and OIE's commitments to a fairer society to seek an intersection with the NIE. However, we believe that the socioeconomic, political, and environmental situation of our contemporary world compels us to point out and even underline non-negotiable principles within the original institutionalist tradition.

¹ The distances between the institutionalisms could not be greater, as Hodgson (1989:250) proposed out: "[W]hatever its merits, the 'new' institutionalism is to be criticized from proceeding largely on pre-Veblenian assumptions." When referring to Douglass North, Hodgson is clear about his proximity with neoclassical economics: "In terms of theoretical fundamentals [...] North, Olson, Posner and Thomas are the closest to orthodox neoclassical theory, particularly in the adoption on standard, mechanical version of maximizing rationality, without regard to serious problems of information" (252-253).

² If in his early works (e.g. North and Thomas, 1973) the emphasis fell on the rational agent responding to relative prices. In North's latest works new questions are found, such as the role of ideology, power-struggle, path dependence, and the maintenance of inefficient institutional structures. The "new North" is already conspicuous in his book *Institutions, Institutional Change and Economic Performance* (1990) and especially in a later one, *Understanding the Process of Economic Change* (2005), as well as in a set of articles published between those dates.

³ Similarities between North's new understanding of history proved to be compatible with the cumulative and anti-teleological understanding of OIE. This enabled Zoubalakis (2005) to classify North as an "evolutionary scientist" in line with the tradition established by Thorstein Veblen (1898).

⁴ In this sense, Dugger (1995) welcomed North's new ideas: "[He] recognizes that growth and improvement are not inevitable, however. Path dependence can also lead to stagnation or decline. This is because institutions are not established for their social efficiency. Instead, they are established to serve the interest of those who are powerful enough to establish them" (456).

⁵ The authors' reference is North (1981,1990)

⁶ As Dequech (2002:568-569), we use the "shared mental models" as synonym for "ideology."

⁷ As Samuels (1995:574) points out: "Both individuals and culture matter as power, which governs which individuals will have greater or less impact on the transformation of culture."

⁸ In a spirit akin to the concept of "reconstitutive downward causation," the "new North" combines the cognitive aspect of institutions with the capacity of agents to change institutions by themselves. Wren (2006) points out that like Veblen, North has an interactive agency conception, where "[the] interaction between structure and agent fundamentally changes the individual's mental models and agency while agent action partially directs structural evolution" (488).

⁹ Social systems cannot be explained only in terms of individual intentions as well. Accordingly, we should also highlight the existence of "collective intentions" (Davis, 2003), which must be compatible with the individual intentions, but which are only adopted by the user.

¹⁰ In particular, Veblen highlights the instincts of workmanship, idle curiosity, parental bent as well as the predatory one.

¹¹ As Bromley emphasizes, those who claim "there is no free lunch" curiously think that market is a free lunch!

¹² Similarly, Samuels (1995:573) states: "The ultimate determinant of the allocation of resources is not some abstract market mechanism but the institutions, especially the power structures, which structure markets and to which markets gives effect."

¹³ Initially, there is a phase of institutional adjustment: the new technology becomes habitual and gradually erodes the ceremonial values, and in the second phase, through a circular causation process, the community extends the use of new technology to solve problems not considered previously (Bush,1987).

¹⁴ It is important to highlight that North (2003,2005) seeks to oppose this cognitive view from that derived from artificial intelligence: "Most of what we are doing these days in cognitive science is evolving away from the view that the mind works like a computer [...] Today, more and more we have come to the conclusion that the way in which the mind works is based on pattern-based reasoning" (North,2003:8-9). It should be reminded that pattern-modelling has been considered a major methodological feature of OIE (Wilber & Harrison, 1978)

¹⁵ As North highlights: "The process of learning is unique to each individual but a common institutional/educational structure will result in shared beliefs and perceptions. A common cultural heritage, therefore, provides a means of reducing the divergent mental models that people in a society possess and constitutes the means for the intergenerational transfer of perceptions" (North, 2005:27).

¹⁶ In North's (2005:119) words: "The genetic architecture that evolved from our three million years as hunter/gatherers was geared to a world of small group interaction which predisposed us to engage in the kind of small-scale cooperative behavior that characterized clan, tribe, and other small groups interactions necessary for survival in a hostile physical environment. *That genetic architecture did prepared us for personal exchange. It did not prepare us for a world of impersonal exchange.*"

¹⁷ North (2005:61) emphasizes: "If the highest rate of return in an economy comes from piracy we can expect that the organizations will invest in skills and knowledge that will make them better pirates. Similarly, if there are high returns to productive activities we will expect organizations to devote resources to investing in skill and knowledge that will increase productivity."

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