GEOFFREY M. HODGSON

CONCEPTUALIZING CAPITALISM

INSTITUTIONS

EVOLUTION

FUTURE

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Institutions, Evolution, Future

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TO THE UNNAMED, UNCOUNTED, AND UNSUNG PAST HEROES OF MANY NATIONS WHO HAVE INCREMENTALLY TINKERED AND EXPERIMENTED: THEIR INNUMERABLE INSTITUTIONAL INNOVATIONS HAVE LED TO MASSIVE WEALTH.

AND TO THE MANY UNKNOWN CHAMPIONS TO COME WHO WILL HELP ENSURE THAT THE PROCEEDS OF THE SYSTEM SHALL BE MORE FAIRLY DISTRIBUTED, THAT ECONOMIC GROWTH SHALL LEAD NEITHER TO ARMAGEDDON NOR TO THE RUINATION OF OUR NATURAL ENVIRONMENT AND THAT HUMANITY MAY MOVE TOWARD AN EVEN BETTER FUTURE—MAYBE EVEN BEYOND THE BOUNDARIES OF CAPITALISM ITSELF.

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Preface

Whether capitalism be retained, reformed, or replaced, we must understand what it is and how it works. This requires sharp categories as well as factual knowledge. Capitalism is a complex constellation of different institutions. To comprehend it we need clear understandings of property, exchange, markets, money, capital, and other elements. Once I had the idea of writing a modern version of Thomas Robert Malthus's *Definitions in Political Economy* (1827) where the meanings of such concepts would have been tackled. But the economic crash of 2008 gave me the idea of focusing instead on capitalism and its essence.

This book is about the nature of capitalism. I argue that our understanding of that system has been impaired by the deep corruption within the social sciences of key terms such as *property*, *exchange*, and *capital* as well as by the ongoing preoccupation by economists with mathematical technique over real-world substance. Conceptual precision is as vital as mathematical precision, yet economists pay relatively little attention to the former.

I have been inspired by great writers on capitalism—including Karl Marx, Max Weber, Joseph A. Schumpeter, John Maynard Keynes, and Friedrich A. Hayek—but their accounts have limitations, as I explain below. While the present book is eclectic, I adopt a distinctive theoretical approach; it puts the role of law at the center without reducing everything to law alone. It is described as *legal institutionalism*. This emphasis on legal realities helps establish sharper and superior concepts of property, exchange, market, firm, and capital.

Much of the core narrative and basic structure of the book was tested on a group of economics students with a series of lectures in 2011 at Shandong University in China. It was received with some enthusiasm, and the book project was born. Its title emerged from a 2012 seminar at the Center for the History of Political Economy at Duke University, where Bruce Caldwell kindly invited me to outline my book venture for critical discussion. During a rerun of the course in 2012 at Shandong University, the students remained enthusiastic and even corrected some flaws in my argument. I also received helpful feedback from students who attended a fuller series of lectures based on the book given at the Université Paris I Panthéon-Sorbonne in early 2014. Among the many who have helped me with discussions and comments are Richie Adelstein, Amitai Aviram, Christian Barrère, Jens Beckert, Peter Boettke, Marcel Boumans, Robert Butler, Bruce Caldwell, Ana Castro, Rutger Claassen, Michael D. Cohen, Jean-Philippe Colin, Frank Currie, Hulya Dagdeviren, John B. Davis, Simon Deakin, Frank Decker, Christine Desan, Ronald Dore, Gary Dymski, Christoph Engel, Chukwunonye Emenalo, Steve Fleetwood, Nicolai Foss, David Friedman, Francesca Gagliardi, Pierre Gervais, David Gindis, Charles Goodhart, Avner Greif, Jerry Hough, Anne-Claire Hoyng, Kainan Huang, Geoffrey Ingham, Thorbjørn Knudsen, Richard Langlois, John Linarelli, Richard Lipsey, Vinny Logan, Tariq Malik, Renate Mayntz, Deirdre McCloskey, Perry Mehrling, Claude Ménard, Philippe Minard, Zhihong Mo, Paolo Moreira Franco, Grimot Nane, Guinevere Nell, Richard Nelson, Klaus Nielsen, Bart Nooteboom, Ugo Pagano, Katharina Pistor, Bharat Punjabi, Ernesto Screpanti, Itai Sened, J.-C. Spender, Robert Steinfeld, Rolf Steppacher, Virgil Storr, Arthur Stinchcombe, Wolfgang Streeck, Andrew Tylecote, Richard Van Den Berg, Derek Wall, Randy Wray, Xueqi Zhang, and anonymous referees.

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Throughout the text, all emphases in quotes are in the original, unless otherwise noted.

Introduction

The Great Financial Crash of 2008 and the subsequent global crisis have led many people to question the viability of capitalism or to consider major reforms to its financial and corporate institutions. Alongside this, spectacular economic growth rates in China, India, and elsewhere since 1980 have revealed the potential dynamism of private enterprise and markets as well as the role of strategic guidance by governments. We need to understand the nature of capitalism, the sources of its dynamism, and its frailties.

The word *capitalism* was once unfashionable, except among opponents to that system. That has changed. In 2012 the words *capitalism* and *socialism* were the two most consulted entries in the Merriam-Webster online dictionary (Merriam-Webster 2012).[1] This book addresses capitalism, with a much shorter critical discussion (in chapter 12) of socialism.

Readers looking here for an ideological tract, either for or against capitalism, will be disappointed. Although I consider the future of capitalism near the end of this volume, my main purpose is to understand the nature of the beast and to establish some conceptual tools to dissect its inner structure. I shall also argue that some mix of market competition and state regulation is unavoidable in any complex modern economy, thus disappointing advocates of unfettered market competition and of socialism (at least as originally defined). Some further policy questions are raised in chapters 15 and 16—particularly the thorny problem of inequality. But generally the book is more about understanding capitalism than policy. Consequently, for example, analysis of the post-

1. They were followed, incidentally, by touché, bigot, marriage, democracy, professionalism, and globalization.

1970s rise of neoliberal ideology is consigned elsewhere (Crouch 2011; Mirowski 2013).

Although recent events and developments are mentioned, the book does not focus on them. Instead, it addresses the nature of capitalism and its possible future in the twenty-first century. The supreme purpose is to understand what capitalism is and to establish it as a historically specific and relatively recent phenomenon. It is neither a historical analysis nor an exposition of models. There is no new theory of its origins here, and I do not develop a new analysis of capitalist growth or development.

Instead, I point to the explosion of growth that started in Europe in the eighteenth century and try to identify institutional developments that preceded or coincided with this expansion. Thereby some possible causes are suggested: future empirical work by economic historians will have to test their relative significance. But no empirical inquiry can start without some initial identification of key institutional developments that make up the modern order. This is not a trivial task.

The Contribution of This Volume in Brief

There are many books on capitalism: so what is added here? My position is different from both Marxism and much promarket libertarianism. This is apparent from my overall analytic approach, including my assessment of the constitutive role of law and the state within capitalism, my conceptual treatments of property and capital, and my appraisal of postcapitalist possibilities. From diametrically opposite policy positions, both Marxism and promarket libertarianism focus on markets. But just as important within modern capitalism is the role of property as collateral, to secure loans for enterprise. Specific legal and financial institutions are needed to make this possible, yet in many accounts of capitalism they are omitted.

Many define capitalism as private ownership plus markets. This loose definition fails to focus on the key features of the modern dynamic epoch. By most definitions, markets and private property are much older than capitalism, as it is defined here. If capitalism is a particular historical formation, then we must identify its essence more precisely. I argue that private ownership and markets are necessary but insufficient to define capitalism.

Some advocates of capitalism downgrade its distinctive features. By treating capitalism as (nearly) universal, they blur the boundaries of this historically specific system. Many see contractual exchange as a "natural" phenomenon. For one famous writer, *all human action* is "exchange." He and others see production as an "exchange with nature." Some treat politics as a matter of individual contract and exchange, thus viewing all power and authority as commerce. Every activity becomes an exchange, and delimited notions of commerce lose their meaning. Simultaneously, the concept of contract is itself devalued by notions of "psychological contract" or "implicit contract" that may involve neither individual consent nor legal enforceability. Capitalism is equated with markets, which in turn are regarded as synonymous with exchange. Some leading authors favor a "market for ideas" (treated as synonymous with freedom of expression), overlooking whether ideas are actually owned, bought, or sold (and maybe suggesting markets as the solution to almost every problem). Firms too become markets. Everything is a market. Markets and contracts become omnipresent. As terms, *market* and *contract* too lose their meaning. Against these degradations of our conceptual armory, an appraisal of the virtues and vices of capitalism requires a superior conceptual framework that is more sensitive to great institutional innovations in history.

In short, the language required to understand capitalism has been deeply corrupted by economists and other social scientists. Vital concepts—including law, property, exchange, markets, and capital—have become so degraded that mainstream, Marxist, and other approaches have difficulty identifying the core unique features of capitalism. A new understanding is required that builds on redefined concepts. Relatedly, the physicalist metaphors that underlie much of economic analysis have to be discarded for more adequate and illuminating alternatives.

Mainstream economics has further analytic problems in dealing with capitalism. Central to some prominent definitions of capitalism are institutions such as money and firms. But both are treated poorly. As Frank Hahn (1965, 1980, 1987, 1988) explained, general equilibrium theory cannot explain why agents hold on to money. If we follow Keynes (1936, 1937) and regard money as a means of dealing with uncertainty about the future, where *uncertainty* by definition refers to future events concerning which "there is no scientific basis on which to form any calculable probability whatever" (Keynes 1937, 215), then mainstream economics again proves inadequate because it has banished this concept of uncertainty from its discourse (Hodgson 2011a). I argue later that the concepts of capital in mainstream economics and in Marxism are also deficient. Turning to the firm, Frank H. Knight (1921, 271) argued that its existence is also "the direct result of the fact of uncertainty." A similar explanatory emphasis on uncertainty is endorsed by others, including accounts that rely on transaction costs (Loasby 1976; Dahlman 1979; Kay 1984; Langlois 1984). By downplaying uncertainty, mainstream economics also lacks an adequate explanation of the existence of the firm. Mainstream thinking has severe limitations in coping with core capitalist institutions such as money, markets, capital, and firms.[2]

I argue that, while markets are central to capitalism, capitalism is not simply a market system: unavoidably it contains different subsystems of governance, production, distribution, and exchange. Furthermore, capitalism cannot in principle have markets for everything or bring everything within the orbit of commodity exchange.

In particular, under capitalism there can never be a complete set of markets for future labor power. For there to be full futures markets for labor, all workers must enter into contracts for their expected working life. This would be tantamount to voluntary bondage, limiting the freedom of workers to quit their employment. Paradoxically, pushing markets to their limits would mean the return of slavery for the workforce.[3] Unlike owned capital, free labor power cannot be used as collateral to obtain loans for investment. At least in this respect, capital and labor do not meet on a level playing field, and this asymmetry is a major driver of inequality.

A further consequence of missing markets for future labor power was identified by the great economist Alfred Marshall (1920, 565). Marshall pointed out that, if the employer spends money on employee training and skill development, this investment cannot be secured by futures contracts and will be lost to the employer if the worker quits. As a re-

2. This exposes the limitations of MacKenzie's (2006) "performativity" thesis—that economics creates the phenomena it describes. Of course, many ideas from economics have changed the real world. But mainstream economics comprehends some features of capitalism so poorly that it cannot be primarily responsible for their creation. For further criticisms of the performativity thesis, see n. 5, chapter 2 below, and Hodgson (2010c).

3. Some libertarians—such as Nozick (1974)—have argued that voluntary slavery should be permitted. This goes with the assumption that the individual is always the best judge of his or her interests and that these judgments where possible should be honored. See Hodgson (2013b) for a critique of this assumption.

sult, without compensatory arrangements or incentives, employers will underinvest in human learning and education.

These missing markets and factor asymmetries are central to capitalism, but they are rarely discussed by modern economists. We need to look more closely at the system that dominates our world.

Despite the 2008 crash, most economists still seem more interested in mathematical technique than the big questions about modern capitalism.[4] Mathematics is an indispensable tool. But the dominance of mathematical technique in contemporary economics has crowded out valuable discourses seeking conceptual understanding of and precision concerning capitalism and other economic formations. Mathematics is said to bring rigor. But conceptual precision is also needed. Unfortunately, economists are not trained to be meticulous about concepts. Many do not even try. Mathematics involves symbolic constructions of beauty and finality. The task of conceptual precision is no less tough but much messier. It is always unfinished.

Theorists of Capitalism

Inspirational thinkers that have helped us understand capitalism include Karl Marx, Max Weber, Joseph A. Schumpeter, John Maynard Keynes, and Friedrich A. Hayek.[5] Over 150 years ago, Marx rightly predicted the global spread of capitalism. There has been a revival of Marxist thinking since the Great Crash of 2008, and much discourse on capitalism is unavoidably influenced by Marx. His contribution is magisterial. But, for reasons that I discuss in this book, I find Marxist and other approaches inadequate and invalid in key respects.

Marx put less emphasis than Schumpeter and others on finance, and, where he did so, he was burdened by a flawed substance theory of money,

4. The preoccupation of economists with mathematical technique over real-world substance has been criticized by Krueger (1991), McCloskey (1991), Blaug (1997, 1998), Friedman (1999), Krugman (2009), and many others. But I do not concur with Lawson's (1997) argument that mathematics is ruled out by the open and complex nature of economic phenomena (Hodgson 2006a, 2012).

5. Hayek (1973, 61–62) disapproved of the word capitalism because before the 1970s it was largely used by critics of the system. He wrote instead of the "free system" and the "Great Society." Clearly he was referring to a system dominated by market exchanges and individual private property.

where money was treated more as a substance such as gold and less as a system of shared rules, representations, and understandings. He was also impaired by the labor theory of value, which he inherited from Adam Smith and David Ricardo. Centering his account on the class struggle between workers and employers and on the role of labor as the circulating blood of the capitalist body, he gave relatively less attention to the dynamic combinations of finance, knowledge, and innovation.

Both Marx and Schumpeter were mistaken in regarding the evolution of the system as one of unfolding primarily or exclusively "from within"—from its own economic core.[6] The development of individual capitalist systems is important, but capitalism must also be understood as a global, interacting population of different national formations, each with different types of subsystems. Furthermore, capitalism is always conjoined with state power. Marx and Schumpeter paid insufficient attention to the constitutive and economic roles of the state and to capitalism's political and legal nature.[7]

While Schumpeter rightly emphasized the driving forces of money capital and finance, he saw the rhythms and crises of the system as resulting from inner, multiple-frequency cycles rather than from the interactions between different capitalisms or between different subsystems. Both Marx and Schumpeter failed to underline the role of collateralizable property in the creation of finance for enterprise.

Hayek and other Austrian school economists provided an invaluable understanding of the nature and role of knowledge and markets in eco-

6. Marx (1976, 619) focused on class antagonisms and "the development of the contradictions" that impelled the system down its preordained historical path. Schumpeter (1954, 391) favorably described Marx's theory of capitalism as "evolutionary" because "it tries to uncover the mechanism that, by its mere working and without the aid of external factors, turns any given state of society into another." Schumpeter (1934, 63) elaborated: "By 'development,' therefore, we shall understand only such changes in economic life as are not forced upon it from without but arise by its own initiative, from within." Schumpeter (1942, 83) also wrote of "industrial mutation . . . that increasingly revolutionizes the economic structure from within." Of course if we define the object of analysis sufficiently broadly—say global capitalism—then almost everything is from within, and nothing is external. But Marx and Schumpeter both referred to the development of national economic systems.

7. Marx (1976, 916) of course emphasized that capitalists "employ the power of the state," and he wrote: "Force is the midwife of every old society which is pregnant with a new one." But, while he highlighted the role of force in the historical development of capitalism, including in the subjection of the working class, he did not see the state and its legal system as constitutive of social relations or social classes.

nomic systems, despite their insufficient appreciation of capitalist institutions and the role of the state and their challengeable theory of money. From a very different policy perspective, John Maynard Keynes remains extremely important, particularly for his understanding of money, the fragility of markets, and the consequences of uncertainty.

Weber understood the role of the state and a "rational legal system" in capitalism. I also acknowledge the influence of others from the German historical school, including Albert Schäffle, Gustav Schmoller, and Werner Sombart. Members of this school understood long ago that neither laissez-faire nor wholesale planning would work and that the way ahead was a reformed and regulated capitalism that protected property and stimulated innovation.

No less important are the original American institutionalists, particularly Thorstein Veblen and John R. Commons. Although they lacked a comprehensive theory, they enhanced our understanding of the institutional and legal foundations of capitalism and also emphasized the role of technology in revolutionizing social life. I also draw on the work of other mainstream and heterodox economists as well as that of historians, sociologists, anthropologists, psychologists, philosophers, political scientists, and legal theorists.

Key Aims of This Work

Given the primary aim of understanding the essence of capitalism, matters of extensive historical exegesis and detailed empirical description are omitted. But of course we must rely on crucial facts of history, and of different capitalisms in time and space, to achieve this primary mission. This is not a book of economic history but one that relies on economic history and comparative analysis to reach a clarificatory and analytic goal.

This foremost objective gives rise to a number of other aims. While private property and markets are among the key defining institutions of capitalism and vital sources of its historically unprecedented dynamism, I argue that capitalism, property, money, markets, and corporations typically depend on, and are partly constituted by, the state. This does not simply mean that the state is necessary to correct "market failures" or that empirically the role of the state has been important. The state was vital to bring capitalism into being and is needed to sustain its existence. As Dani Rodrik (2011, xviii) argued: "Markets work best not when states are weakest, but when they are strong."

This again puts me at loggerheads with many libertarians and Marxists.[8] Despite their different political standpoints, they share the view that markets and private property can be understood with minimal reference to the state. For libertarians, the system is essentially a "spontaneous order," and state planners or designers play a secondary or even inessential role. For most Marxists, the system consists of economic relations between antagonistic social classes; the state is there mostly to represent the bourgeoisie and to keep the working class under control. The state and law are seen as part of the superstructure, but not of the "economic" base. There are nuggets of truth in both standpoints, but together they downplay the vital and constitutive role of law and the state.

It is not that any state will do. Crucial is the role of law. For capitalism to prosper, the state has to sustain and operate within an effective legal framework. Here again I counter leading libertarians who argue that law is essentially custom and does not necessarily require something like a state. Others argue that what matters is control or possession: not legal rights established by statutory courts and state legislatures. For example, Armen Alchian (1977, 238) defined a "property right" as the probability that a decision over use will be effective. Oliver Williamson (1985a, 184) argued explicitly that "transaction cost economics" should address "private ordering" rather than legal institutions such as courts.

Marx argued that law is part of the "superstructure" and focused instead on the underlying "relations of production" that make up "the economic structure of society, the real foundation." But how these vaguely defined "relations of production" (presumably involving property, rights, and rules) can be understood without immediate reference to law has always been a mystery to me. If social classes are defined in terms of ownership of the means of production or as employees of owners, then legal concepts such as the employment contract and property ownership are essential to these definitions. Reference to law is primary and essential.

8. Some Marxists and post-Marxists attempt to rescue Marx from his cruder and unacceptable formulations. I respect these efforts but ask why they wish to retain their "Marxist" affiliation? The answer, I speculate, may lie in a desire to maintain the political project to replace capitalism with socialism. If so, it would have more to do with ideology than science.

Law is a central mechanism of social power, and Marxists unconvincingly regard it as secondary.

In economics and sociology, law is often vaguely described as *formal* and then pushed aside, as if it were no part of the rules and relations of vital social organizations such as the firm and the family. An amazing consensus—treating law as epiphenomenal rather than constitutive—pervades the social sciences. But it has remarkably little supporting argument. In contrast, I argue that rules and relations constitute social reality and that some of the most important and powerful social rules are legal and statutory in nature.

Of course, an unenforced law or right is not an operative social rule in fact. But, when the rule of law prevails and laws are enforced, these become powerful social rules. They are backed by authority and have the perceived legitimacy of sovereign power. Transgressors face possible punishment. Much of the de jure then becomes de facto.

Taking law seriously does not mean ignoring rules and practices that are undefined in law. The "informal" norms of culture and convention also matter greatly. When law is nonexistent or ineffective, they are everything. And, even when law is strong, there are zones of discretion where much else is important. The fact that legal rules determine far from everything does not mean that law can be ignored.

Law is not treated here as set of statements or statutes in dusty books. Laws are made meaningful and have effect within legal institutions, including those of legislation, judgment, and enforcement. The legal focus here is on institutional facts, not proclamations alone.

Downgrading law does not simply mean that a crucial function of the modern state is neglected. The accounts of Marx, Alchian, Williamson, and others are inadequate in terms of human motivation as well. There is no recognition of legally sanctioned rights, and everything becomes a matter of mere possession. The individual is treated simply as a "pleasure machine," simply seeking the use of things to maximize his or her utility. Missing here—as highlighted by Adam Smith—are impulses to behave morally, respect authority, and seek justice alongside greed and the quest for pleasure (Hodgson 2013b).

The demotion of law and the conflation of property with mere possession cannot be defended on the grounds that they are sufficient to understand or predict behavior. To some degree, people take account of rules concerning justice and morality, even if their supreme motive is greed.

To understand capitalism we need a fuller account of multifaceted human nature. But this does not mean that capitalism is simply a reflection of the latter. Instead, it is a specific system with the capacity to harness human dispositions in a particular manner.

My third aim is to counter the still-widespread view that capitalism is an eternal or natural order. Along with Marx, the historical school, the original institutionalists, and others, I argue that capitalism is a relatively recent phenomenon. Capitalism is much younger than the state: it requires special forms of state that cannot confiscate property arbitrarily at will, that are effectively restrained by laws, that have internal checks and balances, and that are faced with countervailing (democratic or other) powers that help protect a relatively autonomous legal system. Such states are necessary to legitimate and protect property rights and to enforce contracts. They required peculiar circumstances and a long time to evolve. Foreshadowed in the Italian city-states, they did not appear on a national scale until the seventeenth century, in Britain and the Netherlands.

My fourth aim is to develop workable definitions of capitalism and of its constituent institutions. To do this, I must counter academic habits of neglect concerning definitional tasks. Lamentably few social scientists these days have a solid grounding in philosophy, including the philosophy of their own discipline. Many in my experience cannot distinguish acts of definition from those of abstraction or description. Many seem to believe that adequate definitions will emerge with little reflection, during or after some process of empirical investigation: stew the facts, and definitions will congeal. But all inquiry is theory driven: it requires conceptual guideposts, all of which depend on *prior* definitions.

As an example, consider Thomas Piketty's (2014) breakthrough work in *Capital in the Twenty-First Century*. The book is driven by forceful data and a little precise mathematics, so why do we need to care about concepts and definitions? The truth is that Piketty had to reverse more than two centuries of abuse of the notion of capital by economists and sociologists to make his case. After an age of terminological obscurantism, his data would have us return to the commercial meaning of the concept.[9]

I have had arguments with eminent social scientists who, in post-

9. While Piketty (2014, 46) commendably removed inalienable assets such as "human capital" and "social capital" from his definition of capital, it still requires sharpening, as noted in chapter 7 below.

modernist or poststructuralist fashion, have taken their "antiessentialism" so far as to oppose all definitions. If they are right, then scientific conversation must stop because scientific progress requires researchers with shared understandings achieved through articulated definitions. Definitions are vital because science is a social process, requiring communication of meaning. Definitions are often fuzzy, and their meanings can shift. But they are still necessary.

The modern literature on varieties of capitalism counters the traditional Marxist and market-fundamentalist notions that only one type of capitalism (or one developmental track for capitalism) is feasible, normal, or desirable. Those counterarguments are important. But variety does not imply that it is impossible to define capitalism; this would be a misunderstanding of what *definition* means. As in biology, variation across a population does not preclude a common essence for a genus or a species. In fact, the understanding of that common essence helps us appreciate the nature and scope of the variation or change.

A particularly important definitional task is to help clear up a mess caused by the promiscuous application of the term *capital* by economists and sociologists. Today we find *human capital*, *social capital*, *cultural capital*, *natural capital*, *erotic capital*, and a great deal else. Of course, if this word *capital* were clearly defined (and typically it is not), then we could understand each other. But we would then need another term to describe *capital* in its original and pecuniary meaning. The phrases *human capital* and *social capital* end up as aids to misunderstanding what *capital*-ism is really about. Some may adopt a distinction between (say) *finance capital* and (say) *social capital*. But a problem here is that what is described as *social capital* has been around for millions of years. Given these confusions, one can misunderstand the whole meaning of *capitalism* and neglect the real *capital* at its core. Attention to definitions is not simply a means to improve clarity in communication. Inadequate definitions can obstruct understanding of the object of analysis. This has happened with capitalism.

The central role of the state within capitalism means that we must address politics as well as economics. John Kenneth Galbraith (1987, 299) wrote: "The separation of economics from politics and political motivation is a sterile thing. It is also a cover for the reality of economic power and motivation. And it is a prime source of misjudgment and error in economic policy." Similarly, Douglass C. North, John J. Wallis, and Barry R. Weingast (2009, 269) argued: "The seeming independence of the economic and political systems on the surface is apparent, not real. In fact, these systems are deeply intertwined." I also concur with Bruce R. Scott (2009, 4) in his claim that capitalism is both "a political phenomenon" and "an economic one" and that "specifically it requires the visible hands of political actors exercising power through political institutions." Capitalism always involves legal and political institutions: pure "anarchocapitalism" is an unrealizable fantasy.

Elements of Legal Institutionalism

The approach here differs from much of mainstream "law and economics," which is often about utility-maximizing individuals acting under legal constraints. Relatively little is learned from law itself. The approach of *legal institutionalism* is different.[10] It makes claims concerning the nature of social reality and (more complex) individual motivation, at least in modern, developed socioeconomic systems. It does not yet provide a full theoretical approach, but it does provide some tentative and limited indications concerning theory and policy.

In legal institutionalism there are three primary ontological claims. When addressing property rights many economists highlight agent-object relations, where objects are conceived in physical terms. Often neglected are agent-to-agent interactions that engender and sustain shared interpretations, meanings, understandings, rules, and institutional facts (Searle 1995). Among these many rules, and their matters of meaning and interpretation, are legal obligations and rights. Much economic activity consists of exchange, allocation, interpretation, or adjudication involving legal rights or obligations. An economy is much more than the physical creation, transformation, or transfer of material things.

The second ontological claim concerns the nature of law. It is argued that law (at least in the fullest and most developed sense) necessarily involves both the state (broadly construed to involve a realm of public ordering) and private or customary arrangements. Reduction of law to just

10. See Deakin, Gindis, Hodgson, Huang, and Pistor (in press). The term legal institutionalism has been used by some legal scholars to refer to institution-orientated theories of law (La Torre 1993; MacCormick 2007). I use it to denote legally grounded approaches to the institutional and economic analysis of capitalism, as envisioned by Commons (1924), Samuels (1989), and others.

one of these two aspects is mistaken. Law involves an institutionalized judiciary and a legislative apparatus.

The third ontological claim is that law—understood as an outcome of both state intervention and private ordering—accounts for many of the rules and structures of modern capitalist society. Consequently, law is not simply an expression of power relations but also a constitutive part of the institutionalized power structure and a major means through which power is exercised. This claim applies primarily to modern developed economies. In underdeveloped societies the rule of law may be compromised by greater arbitrary power. But, even in these cases, at least in the modern world, law still plays an important role.

Models of the spontaneous development of law typically rest on relatively small numbers of agents and underestimate the complexities and uncertainties in developed societies (Knight 1992; North 1994; Sened 1997; Mantzavinos 2001). Law is developed by organs of the state, including judges and legislatures. While it may often itself reflect customary experiences, it is a means of overcoming some of the complexity and uncertainty of multiple, complex, devolved interactions in large societies.

Legal institutionalism upholds that an understanding of crucial legal rules is necessary for economists and other social scientists. This is not to say that law is everything. Many social rules are not laws. The law is necessarily incomplete and sometimes self-contradictory. There are important areas of social life that rely on frequent interpersonal action rather than the anonymous generalities of law. Nevertheless, in analyzing modern capitalism an understanding of the role of law is vital.

Legal institutionalism shares with other institutional approaches a common emphasis on the importance of social rules. Indeed, constitutive and procedural rules are the stuff of social life, and institutions are essentially systems of shared social rules. Legal institutionalism adds to this the further claim that many of the more important and powerful rules are legal in character and that they are backed by the power and authority of the state.

One immediate consequence of this vision is the literal impossibility of complete deregulation or of an unregulated economy or market. Rules are everywhere: they are vital for social and economic life. All that can be attained is to change some rules or to remove some to allow others to do more work. Rather than universal deregulation, legal institutionalism addresses the difficult research question of what kind of rules are appropriate for each particular circumstance. Given the com-