

The History of Economic Thought and Its Role for Rethinking Economics¹

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“A science that hesitates to forget its founders is lost” – (Whitehead 1916, p. 413).

When Alfred North Whitehead addressed the British Association in 1916, he anticipated one central aspect that characterizes modern research. Following his statement, science was to be considered a body of knowledge organized by the logic relations of its elements. As such it was organized knowledge itself, much detached from its historic founders and their outdated beliefs. According to this view, the scientific progress is linear in that it adds new ideas, if they prove to be correct, to the existing body of knowledge while wrong ideas are set aside. Ideas that have once been considered wrong will, in this absolute perspective, not turn correct any time soon and can thus be safely dismissed. As a consequence, the historic knowledge of the past does not matter. The only knowledge that does matter is the once-historic knowledge that has survived the test and is now crystalized in modern textbook summaries. In this process, the originator of the idea as much as her opponents of the time become irrelevant.

It is very much debatable whether the late Whitehead (1927), who took a much more relativist stand in his philosophical work *Process and Reality*, would re-issue such a statement. But that is not our concern here. What is more important is that much of today's science is organized in just the fashion that was described by Whitehead. Mathematics, for example, consists of a set of theorems that mathematicians to this day were able to prove. This knowledge is constantly updated and condensed in modern textbooks while any reference to its origins and the works involved can be neglected. Neither students nor researchers in mathematics do actually read Gauss' *Disquisitiones arithmeticae*. Similarly, a physicist in her study of the mechanics of the universe does not consult Newton's *Principia Mathematica*. Rather, she draws on a large body of secondary literature that has already put Newton's theorems and all the relevant revisions of them during the last centuries into the context of modern knowledge.

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I would like to thank Joachim Zwegner who has first introduced me to the history of economic thought and who has greatly influenced me since. I am also indebted to Ivan Boldyrev and Michael Wohlgemuth for discussions in further seminars. For all mistakes, however, I bear the sole responsibility.

In economics we have experienced a similar shift. Since Paul Samuelson (1948) economics has become what is sometimes referred to as “textbook economics.” Most of the knowledge that is considered to be relevant is condensed in formal treatments of the subject: Samuelson, Mankiw & Taylor and Mas-Colell, Whinston & Green. To the student of economics these works set in stone what economics is. They define what it is worth to think about as an economist and what is not. Meanwhile economics has long forgotten its founders. Neither are publications in the leading journals concerned with the history of economic thought, nor do textbooks discuss the ideas of, say, Adam Smith or John Maynard Keynes. The history of economic thought has long disappeared from most curricula while mathematics, notably optimization, statistics and game theory have taken its place.

Of course, this phenomenon of negligence is not new to the historian of economic thought. Mark Blaug, in whose memory I write this essay, has often complained of the arrogant attitude of today’s economics and its disregard for historic ideas and economic literature in general. Following the results of the study “The Making of an Economist” in which David Colander and Arjo Klamer (1987) discovered a prevailing disinterest in the history of economic thought among students of economics, Blaug attributed the deficiency to economics being stuck in an “intellectual game played for its own sake” (1988, 13). According to him, economists – from their teachings, over the textbooks they wrote and to their research – showed an unhealthy obsession with the use of mathematical models. The victim of this excessive formalism, as Blaug (2001) noted later, was the history of economic ideas. Since many ideas of past thinkers from Adam Smith, over John Maynard Keynes to Friedrich Hayek could not be expressed as rigorously as the mathematical language of the time demanded, their study soon became abandoned. From the formalist point of view, their intellectual legacy must have seem what Arthur Pigou once has called the “wrong ideas of dead men” (quoted from Blaug 2001).

Over the last decade, the situation of the history of economic thought has not changed much, and if it has, the change was not for the better: neither in the teachings of economics nor in leading research does the history of economic thought receive much credit. And yet, there is a renewed interest in the history of economic thought by those who wish to reform economics. Why that is, and what role the history of economic thought might play in rethinking economics, will be the central questions of my essay.

What is, and to what end do we study the history of economic thought?

We start with Joseph Schumpeter (1954) who is a good case in point to explain what the history of economic thought is *not*. His *History of Economic Analysis* is one of the major works in the reconstruction of economic ideas of the past, and yet his approach differs considerably from that of Mark Blaug and the history in economic thought in general. Schumpeter’s main idea is to look for ideas

of the past and analyze them with modern methods. Maybe, he asks, past thinkers have had insights that are not yet incorporated in the mathematical models of neoclassical economics. The history of economic analysis is then used for rewriting those past ideas in the language of neoclassical models. Whereas, all those ideas that cannot be rewritten in mathematical formalism, also called the intellectual “lumber room” of history (Schumpeter 1954/1997, 4), are considered to be unscientific or wrong.

In the history of economic thought, however, ideas are neither considered wrong or right. Rather than being judged against the standard of neoclassical economics, they are viewed in the context of their time. Why did Jean-Baptiste Colbert think agricultural production was the (near) alone source of social prosperity? In whose influence did the German historical school stand? And so on. This approach has the advantage that it takes the historic positions seriously, rather than dismissing them without any honest attempt to understand them. Besides this, the history of economic thought has much to offer for those who wish to reform economics. In the rest of this essay, I will offer three key lessons from the history of economic thought that might become important when rethinking economics.

Becoming less fond of absolute knowledge

The first lesson the history of economic thought can teach us is to put the knowledge of modern economics into the perspective of our own time. Unlike sometimes suggested, economics is not, or should not be a fixed body of abstract laws that characterize rational, and thus, economic behavior. These mathematical propositions formally derived from a set of assumptions are by no means the absolute and universal truths of economic behavior. Rather, they are the particular insights of modern neoclassical economics, which is itself embedded in modern life. Over the course of history, economy and society have changed as much as what is considered to be economic man and his behavior. As the objects of economics change, however, so should economics.²

What is considered to be sound economic behavior is not universally fixed but changes across space and time. That behavior in economic situation strongly depends on the participants’ cultural background can be regarded one of the central insights of experimental economics. Consider alone Henrich et al. (2005) in which a team of several social scientists including the economists Samuel Bowles and Herbert Gintis conducts game theoretic experiments in 15 indigenous societies and finds

² Against this view stands, of course, Robbins’ famous definition of economics as the study of “human behavior as a relationship between ends and scarce means which have alternative uses” (1932/2007, 15), following which economics is not the study of a particular object such as the economy or human behavior in the economy but rather a methodology of constrained maximization independent of time and place. This statement has arguably been constitutive of the neoclassical paradigm like few others and it has been at the basis of an approach that has been fruitful for almost a century. I do not believe, however, that it will remain the leading research paradigm for quite another century.

strong cultural differences in their economic behavior. Whatever his other qualities, homo oeconomicus is not the universal expression of an economic man. Likewise, concepts of economic behavior differ throughout the history of economic thought. Adam Smith's idea of "self-love" is not quite so close to the neoclassical axiom of utility maximization. And the utilitarian tradition in which the latter stands is today something different than it was in the days of John Stuart Mill. Who is considered to be an entrepreneur has shifted from the heroic innovator in Schumpeter's work to the cold calculating Kirznerian arbitrageur and back again to the creative start up scene in the 21st century.

What economic policies are in vogue also strongly depends on their historic context. Keynesianism was the answer to the Great Depression, while Friedman's monetarism took up the challenge of stagflation in the 70ies. In the time before 1914, economists valued a stable international monetary system over national policy independence, in the interwar period it was the other way around. Today it is still different (just look at Greece...). Free trade made sense for Great Britain in the early 19th century, who at that time was the economically most advanced country, and so it did for David Ricardo (1817). For the U.S. and Germany, far less industrialized at the time, protectionism enabled them to compensate for Britain's early advantage and catch up. The position is reflected by that time's German-American economist Friedrich List (1856). Today, trade and development policies are dominated by the "Let us open all markets"-Washington Consensus approach. Not so much because free trade is universally better, but because it serves the capital and high-skilled labor abundant countries of the western world and prevents catch-up development.

To make sense of these different views, historians of economic thought place them in their respective historical context. Judged against the background of neoclassical economics many of these once-held beliefs seem wrong. But if understood as a product of their time, they are neither wrong nor right. This is not to be some extreme relativist's position. Nor is it to deny that there has been progress in economics. Aquinas' medieval belief that the price of a product is determined by the divine value embodied in that good is far off. Wrong still, but much closer is Marx in that the price of a good relates to the amount of labor that has gone into it. Better is the modern conception that the price is determined in the interaction of supply and demand, and better still, that in full competition it reflects the producers' marginal cost, theoretically at last. So there seems to be progress in economics at last. One does not need to become some extreme relativist, though, to admit that many of the economic insights once held were soon found to be wrong as science was progressing through the continually changing historical context. This is the first lesson that the history of economic thought can teach us: Economic ideas do often depend on their historical context and are, thus, contingent. With this in mind, one is inclined to become more modest. But also one realizes that the paradigm of neoclassical equilibrium economics is not set in stone. It has been helpful for a long time and still will be. Among the many approaches history has seen, however, it is not the only approach to the subject of

economics. Neither is mathematics the only language in which economic ideas can be expressed, nor must all concepts be formulated in too abstract a rigor. Economists need not always maximize, and economics need not necessarily be static. This might appear trivial to the longstanding heterodox economist, but to us who have learned in our first years that there is not much else besides mainstream methods and their results, the history of economic thought offers a refreshing alternative.

Observing different paradigms at work

Once one has realized that much of the current mainstream economics approach is contingent, it becomes worthwhile to think about different paradigms. Following Thomas Kuhn a paradigm consists of “universally recognized scientific achievements that, for a time, provide model problems and solutions for a community of practitioners” (1962/2012, xlii). Based on earlier successes a paradigm forms a framework that provides scientists with a special perspective to look at their objects. This perspective includes a selection of questions and problems that are considered worth the analysis. It also includes a set of assumptions that form the basis from which to start working. Last but not least, it specifies a particular scientific language in which problems and solutions are to be formulated.

This special perspective of a paradigm is what causes different paradigms to be incommensurable. That is to say, one paradigm’s ideas can hardly be translated into another paradigm. Either because the insight solves a problem that in the other paradigm is not considered worthwhile (or as is often the case in economics is already assumed away), or because the idea directly contradicts the other paradigm’s assumptions, or because it simply cannot be expressed in the other paradigm’s language. This incommensurability of different paradigms is also a major reason why so many heterodox schools of economics have been ignored by the neoclassical mainstream, or to put it the other way, why heterodox schools often struggle to come to terms with neoclassical reasoning. It is also the reason why the history of economic thought has become so neglected. Many of its insights simply cannot be reformulated in the mathematical language of these days’ economics. So here comes the second insight we can gain from studying the history of economic thought: we can observe how different paradigms of the past work. We can learn from the problems they felt to be confronted with, the questions they posed, how they tried to tackle them, and how, in that, they contradicted it each other. We can learn what light their approaches shed, and where they were blind. And ultimately, we can come to learn how they differ from neoclassical economics, and how they can help us in rethinking economics today.

Let us only consider a few examples of such different approaches in the history of economic thought. Homo oeconomicus is an ever calculating man, who knows every detail of his economic life, and if he does not know something, he is at least aware of his ignorance and can estimate the probabilities with

which the relevant events will occur. In a complex world this is, of course, a gross distortion of how we think and act. Most of the time we do not know all the events that can happen. They are, in the sense of Derrida (2003) impossible to us: we cannot think of them until they have occurred. Nor can we estimate their respective probabilities. In the history of economic thought this idea runs as far back as to the early 20th century when Frank Knight (1921) was the first to introduce the distinction between risk and uncertainty. Following him, risk was to be considered the property of an event that is, although not sure to happen, at least certain in the sense that we know with which probability it is going to happen or not. Uncertainty, on the other hand, describes events of which we do not even with which probabilities they are going to occur. The latter, as George Shackle (1992) observed, makes rational behavior and thus, much of neoclassical economics impossible. Through the history of economic thought the “paradigm of uncertainty” has influenced some great economists and has led to interesting, sometimes quite different insights. For John Maynard Keynes (1936/1964) and Hyman P. Minsky (2011a; 2011b), for example, uncertainty was at the root of speculation and its being driven by emotions rather than reason. For F. A. Hayek (1958), whose idea we will consider more closely now, uncertainty was the main reason why economic, or more generally social systems cannot be centrally engineered. According to him, a single person or small group of could never oversee the whole economy. Its central plan must be decided under a “pretense of knowledge” (Hayek 1989). Because of this, a socialist economy that lacked a market system to co-ordinate the decentralized knowledge of its participants was bound to fail. An interesting insight in the history of economic ideas, however, is that Hayek’s thought was directed as much against socialist ideas as against the neoclassical paradigm. In the so called calculation debate he fought (alongside Ludwig von Mises) against the neoclassical economists Enrico Barone (1908), Fred Taylor (1929) and Oskar Lange (1936; 1937), who proposed that the Walrasian system of equations could be used to plan and run the economies of real world countries. This idea was not the misfit thought of some deviants in neoclassical economics for it became directly associated with Kenneth Arrow’s and Gérard Debreu’s revival of general equilibrium economics. And as late as 1974 Arrow suggested that “with the development of mathematical programming and high-speed computers, the centralised alternative no longer seems preposterous” and socialism seemed to be feasible again (1974, 5). Today the danger, posed by neoclassical economics’ overconfidence in the calculability of economic decisions and risks, comes from the other end of the political spectrum. The belief that economic man will be reasonable enough to foresee the consequences of his actions has been at the root of market liberalization. Prior to the finance crisis in 2007/2008, for example, large parts of the economic profession clung to the belief that there was no overvaluation on the housing market. Why would there? No one would buy a house if it was too expensive, or if the default risk of the mortgage loan was too high, would he? Yes, he would. Simply because it was impossible to foresee the consequences. The investments were subject to uncertainty

rather than risk. Finance markets (markets in general, but most notably finance markets) are complex systems characterized by interdependencies and non-linearity. What happens next is subject to so many factors that it cannot be predicted. In order to admit that, however, one must step out of the neoclassical paradigm and turn to the historical accounts, be it those of Knight, Keynes, Shackle or Minsky.

Yet another paradigm that might be worthwhile to trace through the history of economic thought is that of the economic system as one that is continually evolving. Neoclassical economics is often statics, or comparative statics at best. This is not because dynamic systems are not worthwhile to analyze. Rather, it is because dynamics are just much more difficult to be formulated mathematically. Many ideas in the history of economic thought concerning the evolution of economic systems have thus been expressed verbally. Take for example Thorstein Veblen (1898), whom we will examine more closely below, Joseph Schumpeter (1912/2004) and Friedrich Hayek (1991). None of their works has been written in mathematical language³ and still, their ideas have reached a considerable degree of abstraction. They analyze the evolution of preferences, the evolution of the economy in business cycles and the evolution of institutions. In doing so, they examine the roles of economic crises, entrepreneurship, innovation and destruction and decentralized knowledge, most of which topics are structurally underdeveloped in neoclassical economics. Again there is a lot to learn from their approach. As Geoffrey Hodgson (2004) does, we can ask whether “evolution” in their works is only a lively image of something that evolves (It. *evolvere*: unfold, develop) or whether economic evolution in its general mechanism follows Darwinian or Lamarckian concepts. These insights can then be incorporated when rethinking economics. Another understanding of studying these historic works relates to the distinction between predictive and explanatory theories. Following Milton Friedman’s (1953) positivism, neoclassical economics has often valued predictive power over explanatory. Evolutionary theories, however, are by their nature explanatory. They can explain business cycles and evolution of institutions stores tacit knowledge. Alas, they cannot predict at which exact date the next financial crisis will hit, nor how institutions will evolve in the future. This is so, because evolution relies to a considerable extent on randomness and is, thus, an open-ended process.

These two examples, I feel, do demonstrate the power of historic approaches. Studying them is not only inspirational, but also reveals much about the strength and weaknesses of the various paradigms. It shows how they did and still do contradict neoclassical economics, how they remain relevant until today, and ultimately how we can make use of them when rethinking economics.

³ Admittedly though, Schumpeter did not share the skepticism that Veblen and Hayek felt towards mathematics. Rather, his works show a deep admiration of Walras and his mathematical formulation of general equilibrium (Arena 2002).

From paradigms to substantial theories

Having observed the general usefulness of historical paradigms, we will now move to some more substantial insights. In our aim to rethink economics, which ideas in the history of economic thought, though widely neglected, should be part of a new economics? In my opinion, there are numerous such historic ideas that can still be of use today even though they are neglected by orthodox theory. I will consider two examples more closely. Regarding both I am not yet entirely certain whether they can be regarded as ultimately correct, but I feel that, at least, they deserve more attention than orthodox economics until today has paid them.

The first is Hyman P. Minsky's financial instability hypothesis. Following the financial crisis in 2007/2008, we can safely say that financial markets need not be stable or efficient at all times. Theorizing about instability in the economy, however, has long been hindered by orthodox economists, most notably the proponents of the efficient market hypothesis who did and still do claim their superiority. Minsky, though, is one the key figures in analyzing such market failures. Although his ideas have been developed more than a quarter century ago, he did foresee the events of the recent crash.⁴ Particularly interesting for explaining the crisis is his distinction between hedge finance, speculative finance and Ponzi finance (Minsky 2011a, 22ff.). Oversimplifying a bit, this classification runs from those who plan to repay there (say, mortgage) loan and its interest, to those who can neither pay back their debt nor its interest. The latter Minsky calls Ponzi borrower. To finance their credit and its interest, they have to rely on rising (say, house) prices. In a stable economy, most borrowers will be hedge borrowers. Those few who speculative or Ponzi loans that default here and there are too few to harm the robust system. As speculators realize solid profits, their expectations will rise accordingly. Higher expectations drive the demand and thus the price of the (financial) products subject to speculation. As the expectations keep growing, the economy becomes "euphoric" (Minsky 1982/2015, 144): risk evaluations become increasingly optimistic. To maximize their profits, speculators (but also ordinary people) will then move from hedge-finance to Ponzi-finance units. As soon as a critical number of Ponzi-financed loans is reached, the system will become increasingly prone to chain reactions and snow ball effects. Not before too long, the bubble will burst.

What interests here is not so much my, admittedly rough, sketch of his theory. Rather, it is Minsky's general insight in the relation of stability and instability in capitalistic systems. Solid profits drive expectations and prices and ultimately, lead to an overheated market and its crash. The financial system's instability is caused by its former period of stability. Of course, such a paradoxical idea is

⁴ He did not, of course, predict the exact date or any particular details. He simply knew that "it" would happen again at some point (Minsky 1982/2015).

neither compatible with analytical language, nor with neoclassical equilibrium economics. Still, it is worth consideration.

The second example to be examined here, is that of Veblen (1899/2007) and his idea of “conspicuous consumption.” While Minsky’s works might be relevant to us because, after all, the nature of growing expectations and speculations has not changed that much over the time, in the case of Veblen it is because the social context has changed. In order to be not misunderstood here, conspicuous consumption, i.e. status consumption based on a preference the symbolic meaning of a good rather than its use, is nowadays as present as it might was in late 19th century America. What has changed is the social context. Today we are more concerned about the consequences of decades of economic growth. Even though increasing GDP and creating jobs are still very high on the political agenda, politicians and civil society realize now that economic systems cannot grow endlessly. Keynes’ (1930/1963) assertion that in the future people will work only 15 hours a week has not yet come true, but one day it will. With rapidly increasing productivity, a slowdown in employment is inevitable. So how could a paradigm of post growth economics look like? Here, Veblen might be an enlightening source of inspiration. Let us look at the concepts of conspicuous consumption and conspicuous leisure. Suppose, that some share of our yearly consumption is conspicuous, and that, with growing consumption the rate of status consumption will further increase. As we will buy more status goods, so will our neighbors, leading to an unsustainable spiral of ever-increasing consumption. What however, if leisure rather than consumption became the status symbol of the 21st century? Economics could then break the path dependency associated with conspicuous consumption and perpetual growth. Economics, then, would still deal with scarcities, most notably that of time. And the market economy would still be governed by a powerful incentive, namely leisure time as a status symbol, that would drive economic competition, innovation and qualitative growth. Maybe it is worth the thought. As becomes evident from my thoughts, they are rather speculative. It is not entirely clear how a new paradigm in economics could look like. Nor do we know whether Minsky or Veblen should be incorporated when rethinking economics. But that they should is not quite the point here. Their examples serve as a demonstration of the great richness in the history of economic ideas, and as an inspiration for the work to come.

A social science that has forgotten its founders is lost

We have started with Whitehead’s view that science solely consists of today’s knowledge and therefore should not be concerned with past ideas, and Blaug’s critique thereof, and here shall we end. We have seen that the history of economic thought is of great use to us. However far economics has or shall progress in the future, by no means should we forget what sometimes seems hardly more than

the “wrong ideas of dead men.” For once, because the history of economic thought teaches us that each generation of economists is largely a product of its time. The answers found depend as much on the problems one comes upon, the questions one poses and the methods one applies, and as such they are subject to our value judgements. As historical context and perspective change, so does economics. Also, we see that different paradigms are able to shed light on particular parts of economics while they must remain blind to others. Here, the history of economic thought grants us with a valuable insight into the different perspectives from which scientists have tried to look at economic questions. We see how different paradigms work and how a pluralism of paradigms can, in their incommensurability, provide us with a more complete picture of economics. Also, we gain insight into past ideas, some of which might be worth reconsidering as the circumstances change, some of which have been ignored far too long. And ultimately, both will help us to rethink economics in the 21st century.

So what is wrong with Whitehead’s statement? Not much. As likely as not, Whitehead never intended to rethink any science. With respect to mathematics and the natural sciences, this makes much sense. After all, the objects of, say, physics have barely changed in the scientific process. The laws of the universe are still the same, and so are the laws of logic. More than anywhere else, knowledge in mathematics and the natural sciences can be regarded absolute and universal. The confusion, however, arises from the popular belief that economics is by any means a natural science. Or that by treating economics as such, one does it any favor. This confusion has haunted us for too long a time. Economic laws are neither absolute nor universal. As culture, economic systems and our perspective on them change, so does economics. Economics is, after all, a social science. In this lies the most valuable insight of studying the history of economic thought. And in reclaiming economics as a social science lies our first challenge when rethinking economics.

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