

# **The Institutional Analysis of Real Estate Markets: the Economic Value of Land**

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## **Abstract**

Over the last century, the discipline of economics has witnessed the adoption of the so-called ‘institutional approach’. More recently, the “old” Institutional Economics (Veblen, Commons, Mitchell) is being distinguished from the “new” Institutional Economics (Coase, North, Williamson). Within this context, it is important to ask whether the institutional approach is offering anything fundamentally new to economic methodology, or whether this approach has simply broadened the scope of economics in order to enlarge its explanatory power. Although there is awareness within the study of economics that it is neglecting the social structures, it is clear that the discipline has not been able to incorporate these structures into itself. What is missing within Institutional Economics, above all, is a unifying set of principles, and this absence indicates a methodical problem.

In this paper I propose to establish the methodical incompleteness of the institutional approach in economic theory on the basis of the philosophy of H. Dooyeweerd (1894-1977). As I see it, the fundamental problem of institutional economics has been that it has not recognized that economic norms must be connected with the structures of individuality. Basing my argument on Dooyeweerd’s “new theoretical thought” (1953-58), I propose a number of sociological principles upon which to base a relationship between economic norms and the structures of individuality.

After establishing these sociological principles, I apply them to the question of the economic value of land. At present, it is the so-called ‘residual method’ which is primarily used to reckon the economic value of land or as the case may be the market price of land. This method is essentially based on Ricardo’s differential land-rent theory. The starting point of the modern approach is that the total residual value of the production-column will settle at the bottom. Thus in the process of establishing a price, the production factor “land” is considered to appropriate the residual value. Nevertheless, empirical analysis suggests that the residual value is being divided among a number of different production factors. The question then arises as to whether there is a conceptual paradox within the present method of land valuation. I propose that this paradox can be overcome by taking into account the sociological principles that lead to the emergence of the different social meanings of land. When this emergence is understood, it becomes clear that there are a number of different norms of economic valuation. Once these emergence and norms are properly taken into account, a more consistent methodology of land valuation can be established.

## 1 Introduction

The economic value of land has played an important role in the overall development of economic theory, especially as land has not just an economic but also a social function. As far back as the period before the Classical Economists, it was considered justifiable to charge rent on land, in contrast with charging interest on money, because land has a natural fertility. The Physiocrats absolutised this thought in declaring that only agriculture can produce a value-surplus, although Quesnay's *Tableau Economique* showed that farmers ("classe productive"), in producing the value-surplus, were dependent on landowners ("classe des propriétaires") and traders ("classe stérile"). The Classical Economists extended the concept of value-surplus. Ricardo showed in his *Principles of Political Economy and Taxation* (1821) that the whole produce of land should be allotted to the different classes (rent, profit and wages). Ricardo's principle ideas on value and on rent of land form the scientific basis for the explanation of the economic value of land. All subsequent land-value theories can be considered applications of these principles. One of the reasons that the development of theory on the economic value of land has more or less stagnated since Ricardo is that Neo-Classical Economists have completely failed to see the connection between land and social structures. They approached the concept of the economic value of land only under the phrase "law of nature". Everything was expressed in terms of money; thus the value of land was expressed only in terms of cost or revenue. The normative character of economic organisation totally disappeared. Since the beginning of the last century, the Institutional Economists criticised mainstream economic thought, arguing that it was operating on too high a level of abstraction in explaining economic phenomena. Institutional Economics ought to be expected to shed new light on the economic value of land. But is Institutional Economics really able to connect economic norms to social structures? Contemporary economic thought, in my opinion, has lost the notion of how economic norms can be connected to social structures. This paper therefore proposes a number of sociological principles upon which to base a relationship between economic norms and the social structures.

## 2 Definition of the problem

Land in the desert or at the bottom of the sea is worthless from an economic perspective. Rural land has a low value, but that value increases immediately when it becomes possible to develop houses on it. This is explained, of course, by the law of supply and demand or by the concept of scarcity. For a more specific explanation, however, it is necessary to have an insight into sociological structures. The question is: to what extent is Institutional Economics in a position to provide this insight?

In Institutional Economics, the "old" Institutional Economics is distinguished from the "new" Institutional Economics:

- the old Institutional Economists (e.g. Veblen, Commons, Mitchell) take their starting point from sociological structures, often constructed from a non-economic perspective, to explain economic phenomena;
- the new Institutional Economists (e.g. Coase, North, Williamson) explain sociological structures from an economic perspective.

Both, old and new Institutional Economists use a so-called "institutional approach". What is this institutional approach? The old Institutional Economics worked by constructing sociological structures using the explanatory tools of other disciplines such as biology, history or psychology. They explained economic phenomena from this sociological viewpoint. The new Institutional Economists see "institutions" as the variable to be explained. They use economic methods to explain sociological structures. Coase can be regarded as the founder of this movement with his famous question: 'Why does a "firm" emerge at all in a specialised exchange economy?' In Coase's view, the existence of a "firm", as opposed to the "market", has its basis in the transactions cost (Coase, 1937, 390). The sociological entity of the "firm" is thus explained by the economic analysis of the transactions cost. In this thought, Coase saw the "state" as a "super-firm". The "state" is able to arrange things with the lowest transaction costs because of its regulatory powers (Coase, 1960). However, can the sociological structures (e.g. "firm", "market", "state") properly be explained by an economical analysis?

The first question that I ask in this paper is:

*What is the relationship between economic norms and sociological structures in a scientific approach?*

The answer to this question can be seen as a critique of current institutional analysis. In answering the above question, I draw on the philosophy of Herman Dooyeweerd (1894-1977). We will deal with Dooyeweerd's:

- 1) distinction between institutional and non-institutional communities;
- 2) relationship between causal explanation and normative judgement;
- 3) concepts of modality and individuality.

In order to gain a good understanding of Dooyeweerd's philosophical approach, one needs to read his works. *A New Critique on Theoretical Thought* (Dooyeweerd, 1953-1958) may be regarded as his standard work. In this paper I especially refer to the analysis given in his article *Fundamental Problems of Sociology*" (1948).

In current economic thinking, the economic value of land is determined by the residual value approach. The starting point of this approach is that the total residual value of the production-column will settle at the bottom. Thus, in the process of establishing a price, the production factor "land" is expected to appropriate the residual value.

Nevertheless, empirical analysis suggests that the residual value is divided among a number of different production factors (e.g. "capital" and "labour"). The question then arises as to whether there is a conceptual paradox within the present method of land valuation. The residual approach uses household figures like cost, revenue and prices. Apart from the question as to whether these concepts are scientific, this approach, in my view, is not able to offer an adequate causal connection between the economic value and the sociological meaning of land.

The second question that I ask in this paper is:

*What is economic value of land, when the connection between economic norms and sociological structures is taken into consideration?*

The explanation of the economic value of land, in my opinion, has to take into account the sociological principles that lead to the emergence of different social meanings of land. In answering this second question, I draw on the ideas of Ricardo set out in his *Principles of Political Economy* (1821). I then set Ricardo's principles of value and of land rent over against the sociological view argued by Dooyeweerd. After this, my paper aims to demonstrate that the economic value of land expresses itself in different ways, depending on the sociological structures out of which land emerges. When this emergence of the land in sociological structures is understood, a more consistent methodology of land valuation can be established.

### **3 A critique of current institutional analysis**

#### **3.1 Institutional and non-institutional**

The concept of 'institution' has, over time, become broader in its definition. Initially, an institution was a definition for a typical community. A community is any societal relationship which has the character of a whole joining its members into a social unity, irrespective of the degree of intensity of the communal bond (e.g. "family", "firm", "church", "state" etc.). The communal relationship is thus differentiated from inter-communal (or inter-individual) relationships in which individual persons or communities relate without being united into a solidary whole. Such relationships may show the character of mutual neutrality, free cooperation or antagonism, competition or contest (Dooyeweerd, 1957, 177).

According to Dooyeweerd, institutional communities are both natural and organized. Institutional communities, by their very nature, encompass their members to an intensive degree, continuously or at least for a considerable part of their life, and in a way independent of their will. The "state" is an organized institution into which someone is born. Although a person can become a citizen also in other ways, no citizen is able to change his nationality at will (Dooyeweerd, 1957, 187).

Non-institutional communities are, in Dooyeweerd's view, voluntary associations. These organizations which in modern differentiated society show an immense diversity in nature and formation have either an associatory or an authoritarian form of government. Non-institutional organizations typically come out of an historical power formation (in contrast to natural communities which are unorganized communities and have an organic beginning).

An organization provides a certain continuity to communities that lack a natural foundation, so that the organisation becomes independent of the life-span of its individual members. The "firm" is a non-institutional community. This organization is based on the principle that people are free to join or quit. Joining a "firm" is usually done by means of an employment contract (Dooyeweerd 1957).

In inter-communal (or inter-individual) relationships, there is no relationship of authority or subordination. This does not mean, however, that in these relationships individuals and communities are socially equal. These relationships show great inequality, for example, influenced by factors such as age, class or rank, trade or profession. All these differences in social position lack a real integration within inter-communal relationships. (Dooyeweerd, 1957). Inter-communal relationships, even though they do not form a community, are nevertheless marked by typical structures. For example the free market, with its corresponding free competition, is founded historically on typical economically-based inter-communal relationships.

Especially since Durkheim's very broad interpretation of the term "institution", this term has lacked a consistent meaning in sociology. Durkheim identified institutions with the totality of "social facts", conceived as facts which, independent of the consciousness of individuals, originate from a "collective consciousness", and as such impose themselves upon the individuals. He distinguished corporate institutions with longer lasting patterns of behaviour such as law, morals, language, occupational, customs, from collective modes of existence such as styles of building, traffic, etc. Dooyeweerd objected to this terminology because, in his opinion, it led to a levelling out of the fundamental structural difference that he saw between institutional and non-institutional communities (Dooyeweerd, 1957, 187-189).

Just as in the discipline of sociology, Institutional Economics also lacks a consistent definition of institutions. According to Veblen, founder of the old Institutional Economics, institutions are settled habits of thought common to the generality of humankind. The new Institutional Economists, however, argued that the core ideas of institutionalism concern habits, rules and their evolution. The term institutions is generally used rather loosely, and may often overlap with the meaning we give to terms such as organisations, customs, traditions, norms and rules.

***The first point of attention in regard to the current institutional approach is:***

The extremely broad interpretation of the term 'institution' runs the risk of levelling out the fundamental difference between institutional and non-institutional communities. Economic value of land analysis needs the insight that there is an unbreakable correlation between communal and inter-communal relationships.

**3.2 Causal explanation and normative judgement**

Why has the concept of institution grown so vague, especially with regard to the distinction between communal and inter-communal relationships? One important reason is methodical. In contemporary social studies, causal explanation and normative judgement are strictly separated. In social studies it is assumed that "social facts" can only be observed in the same way as objective phenomena are determined in natural sciences. To ascertain social facts in their objective givenness, all normative judgement should, according to modern sociology, be eliminated. Science should not decide what ought and ought not to be in a society; science should concern itself only with so-called reality. This basic assumption is an important dogma of modern sociological method. One of the results has been that Dooyeweerd's insight into the correlation between communal and inter-communal has remained hidden.

Human relationships always presuppose norms; otherwise they simply cannot exist. To ask whether "firms" exist or not, is the same as asking which human relationships make up a "firm"? Without applying norms, this principal distinction cannot be made. Neglecting these norms, a "firm" can be seen as an alternative for the "market", or the "state" can be seen as a "super-firm".

Social classes are not perceptible entities as such. The distinction between the class of "landowners" and "non-landowners" presupposes the concept of "ownership". The title of "ownership" is only comes into force as a

consequence of juridical norms. The division of population into “landowners” and “non-landowners” is meaningless unless the criterion of “means of production” is accepted. The “means of production” is a concept that is only laid down by economic norms. The entities of “ownership” and “means of production” arose out of social intercourse under the presupposition of the norms of social contact. Which “social facts” would be left if we disconnected causal explanation from normative judgement? Due to the distinction between causal explanation and normative judgement social science, and thus economics, is not able to see scientific causation. Scientific causation demands a comparability of cause and effect. That cause and effect are bound up together puts them within reach of science. The economic value of land cannot be explained by legal norms or psychological norms of need, but only by economic norms (Dooyeweerd, 1948).

It is therefore necessary to make a distinction between a naive pre-theoretical and a theoretical attitude (Dooyeweerd, 1953, 1955, 1957). In the pre-theoretical experience the different aspects of reality are indissolubly linked. A theoretical analysis splits up reality into various modal aspects (e.g. historic, economic, juridical, moral, etc.) The antithetical relation is based on pure abstraction and does not correspond to reality. Naive experience is not a theory of reality. In the pre-theoretical attitude of common experience we find ourselves completely within empirical reality with all its functions and aspects. It may be compared to the difference between the theoretical attitude of an economic scientist and the naive non-theoretical experience of a business-man. Theoretical abstraction uses an antithetical relation. Naive experience is characterized by the relation subject and object. In naive experience we attribute without hesitation objective qualities of cultural, symbolic, economical, juridical and even moral character to things of our common life which cannot have a subjective function in these specific aspects of reality. We know very well that they cannot function as subjects which live together in a social commerce or make value-judgments. We know perfectly well that these objective qualities belong to them only with reference to the subjective functions of any living or rational being with regard to the above-mentioned aspects (Dooyeweerd, 1948).

***The second point of attention in regard to the current institutional approach is:***

Causal explanation in social science is impossible to achieve by eliminating normative judgement. An economic scientific explanation is only possible by using theoretical abstraction. On the basis of this abstraction, economic law and norms can be discerned. This abstraction needs to be distinguished from the naive pre-theoretical attitude in which different aspects of reality are indissolubly linked. We do not explain anything when we assume a causal relation between events which are viewed under different modal aspects.

### **3.3 Modalities and individualities**

In the previous paragraph it has been stated that for scientific causality a distinction is necessary between modalities and individualities. When this difference is lacking there is a risk of identifying individualities (like “firm”, “state”) with modalities (like “economic aspect”, “juridical aspect”). The universal modalities of being do not refer to the concrete “what” of things or events, but are only the different modes of the universal “how” which determine the aspects of our theoretical view of reality. The different aspects are not reality itself, but are only modalities of being. A purely “biological”, “economic” or “juridical” reality does not exist. Biological, economic, or juridical aspects of reality, however, do exist. No single aspect stands by itself; every one of them refers within and beyond itself to all the others. They only come together in the continuous operational coherence of a structural unity of irreducible modal functions. Each real thing, each real event, each real living being, each real social connection functions within the totality of aspects, either in subjective or in objective functions. This (empirical) reality does not offer itself to naive experience in abstracted aspects, but in typical structures of totality and individuality. Individualities embrace all modal aspects. Thus the individuality is a typical groupage of the modal aspects within structural totalities, although we never actually experience these individualities as an addition sum of modalities. In their framework, the different aspects are grouped in a typical manner and bound together in an individual totality and unity. The modal aspects are grouped in such a typical manner that the whole structure is characterized by one of them, which is called the inner directive or qualifying function. Without insight into this double structure of reality (the modal structure and the structure of individuality) a scientific application of causality is impossible (Dooyeweerd, 1953, 1957).

The substantial difference between individualities of human society, like “firm”, “market” and “state”, can only (in causal and normative manner) be explained by the typical way in which all the different modal aspects are grouped together towards an entity. According to its structural principle community in its different types is not a natural fact but a normative task, which can be realized in a better or worse way. For this reason it is perfectly understandable that in our time the adherents of a consistent a-normative conception of empirical sociology in the sense of Max Weber show a tendency towards the complete elimination of the idea of community from their field of research. “Firm”, “market” and “state” are looked upon as ideal-types, as a result of which no insight into their normative tasks are given. The elimination of the normative idea of community implies that of the inter-communal relationships insofar as the latter can no more be conceived in their proper societal sense apart from their normative structural principles. This is due to the very correlativity of these two foundational kinds of relationships. Apart from its structural principle, no single societal relationship can be theoretically established and examined in its factual realization without denaturing its societal meaning (Dooyeweerd, 1957).

All typical structures of individuality of human societal relationship are of a normative qualification. This is what distinguishes them in principle from animal types of symbiosis. This also implies that they require a human shaping on a cultural basis and can only be realized in particular societal forms which differ from the various cultural areas and the level of historical development of the latter. These societal forms are social products of the process of human shaping and exhibit the same typical totality-character as the typical structural principles to which they give a positive form (Dooyeweerd, 1957).

Land (and its function and purpose according to houses, streets etc.) can as such only exist in human society in a subject-object relation. Land functions in all modal aspects: in its physical, biological and psychological aspects (in its sensual perceptible qualities), in its logical aspect (its logical marks), as well as in its historical aspect of culture development (it is a human product of culture) as well as in its linguistic aspect (its symbolic meaning), in its aspect of social intercourse as well as in its economic aspects (its function of an economic good), in its aesthetical aspect as well as in its juridical aspect, etc. As we will see in the next paragraph, land can function in different structures of individuality of human society. In analysing the economic value of land, it is especially important to look at those structures of individuality which have the economic qualifying function.

***The third point of attention in regard to the current institutional approach is:***

Insight into scientific causality is only possible in the awareness of the double structure of reality: the modal structure and the structure of individuality. Individualities embrace all modal aspects without difference. The modal aspects are grouped in such a typical manner that the whole structure is characterized by one of them: the so-called ‘inner directive’ or ‘qualifying’ function. The substantial difference between individualities of human society can only be explained by the typical way in which all the different modal aspects are grouped together towards an entity. Thus, all typical structures of individuality of human societal relationship are of a normative qualification.

#### **4 The economic value of land**

It is common practice nowadays to determine the economic value of land by the residual value-method. The residual value of land is the value of the final product (e.g. house, office) diminished by the production costs. The amount that is left is the “maximum price” that a developer should pay for the land. The starting point of this method is that the land possesses residual value; without the land, no houses or offices can be built. Thus in the process of establishing a price, the production factor “land” appropriates the residual value. Nevertheless, empirical analysis suggests that the residual value should be divided among a number of different production factors. Just as “land”, “capital” or “labour” are also indispensable in the development process. This analysis of (neo)classical thought leads to an intellectual cul-de-sac : the scarcity of the different production factors modifies the distribution of the residual value. How can we find a way out of this problem?

First we need to realize that land as an economic object, only exists in respect to human subjective valuation, but is not reducible to it. By that, we have principally chosen a position against the so-called subjective and objective

valuation-theory. To gain causal insight in the economic value of land, we need to see what role land has in social structures.

#### 4.1 Economic modalities: value and rent

In our effort to understand the economic modalities we draw on the ideas of Ricardo set out in his *Principles of Political Economy* (Ricardo, 1821). Ricardo's 'differential rent of land-theory' contains the most fundamental principles on valuation of land. For clarity's sake it needs to be said that Ricardo used the natural scientific approach by ascribing the character of a for all times applying "law of nature" to the economic phenomena. This is most obviously expressed in the way that Ricardo, following Adam Smith, based economic value on the metaphysical idea of "labour". As Ricardo expressed it, "The toil and trouble of acquiring it or, having acquired it, the toil and trouble which it can save to himself" (Ricardo, 1821, 12-13). As mentioned above, this natural scientific outlook is in defiance with the normative character of the economic aspect of reality. The economic value is a normative concept through and through, which makes no sense in a natural scientific method. In spite of this, the power of Ricardo's analysis is his use of theoretical abstraction combined with his focus on the economic aspect of reality. That is why his principles on value and on rent of land in terms of economic modalities are still very useful.

Concerning the idea of value, Ricardo initially follows the ideas of Adam Smith (Ricardo, 1821,11):

"The word value has two different meanings, and sometimes expresses the utility of some particular object, and sometimes the power of purchasing other goods which the possession of that object conveys. The one may be called the value in use; the other value in exchange... Utility then is not the measure of exchangeable value, although it is absolutely essential to it."

In this description of the double meaning of value, an important distinction has been made between the internal orientation (value in use) and the external orientation (value in exchange). The awareness that there is a correlation between the two meanings of value is also expressed in the words: utility is not the measure of exchangeable value, although it is absolutely essential to it. We need to keep in mind that Ricardo looked in a natural scientific way for the ultimate value that is invariable for the purpose of more distinctly pointing out the causes of relative variations in the value of other things. He could not, of course, succeed in finding the ultimate value, because the economic value is a normative concept.

When the economic value is seen as a normative concept, the matter is looked at from a completely different perspective. The distinction between "economic value" in a communal relationship and in an inter-communal relationship becomes important. The "economic value" in a communal relationship is determined by the authority of specific rules of valuation in the community. In inter-communal relationships any relation of authority or subordination is lacking. These relationships show a great inequality in the manner valuation takes place. The difference between the value in communal relationships and in inter-communal relationships can be shown by the concept of rent.

Ricardo explains the concept of rent as follows (Ricardo, 1821, 69):

"....If all land had the same properties, if it were unlimited in quantity, and uniform in quality, no charge could be made for its use, unless were it possessed peculiar advantages of situation. It is only then because land is not unlimited in quantity and uniform in quality, and because in the progress of population, land of an inferior quality, or less advantageously situated, is called into cultivation, that rent is ever paid for the use of it...."

The important issue, as Ricardo states, is that rent exists by the differential "fertility" of land. The question arising from our perspective is whether this difference is always reducible to land itself. Is it not, rather, the difference in economic function, and thus the economic valuation, of land in human relationships?

Continuing our analysis, we could state that rent comes into being when there is a correlation between the value in communal relationships and in inter-communal relationships. In other words, rent is the difference between the value in communal and the value in inter-communal relationships.

#### **4.2 Individualities: market and firm**

One of the identification marks of economic modalities (e.g. value, rent) is that they do not exist as realities in themselves. The terms of value and rent can only be expressed in relation to individualities. There are at least two important individualities with an economic qualification: the market and the firm. In both cases, the correlation between the value in communal and in inter-communal relationships is a first condition.

In case of the market, value expresses itself in inter-communal relationships. There is a great inequality in the manner in which valuation takes place. The most important norm is that the lowest value in the inter-communal relationships qualifies the value in the market. The rent in the market, is the difference between the lowest value and the other values.

In case of the firm, value expresses itself by the communal relationships. The firm uses its own valuation rules that are typical for that communal relationship. It is characteristic of the firm that it stands between two or more markets. The most important norm is that rent is a precondition for value to be expressed in a firm. This rent depends on the different values of markets, and modifies the value of the firm. Thus, the value of the firm is the value which make a rent possible, according to the different given market values.

Depending on which role land plays in above mentioned relationships, land gains its economic value. The above concepts of market and firm have been described in the most basic form. How these concepts are expressed in reality depends on human shaping on a cultural basis and can only be realized in particular societal forms which differ according to the various cultural areas and the level of historical development of the latter.

### **5 Conclusion**

Land is a good example of an object which gains its economic value in the context of human relationships. Research into the economic value of land thus forces economic method to make a connection between economic norms and social structures.

The current Institutional Economics is a movement which tries to do this. In this paper a critique has been given of the current institutional approach. The extremely broad interpretation of the term institutions in this approach runs the of levelling out the fundamental difference between communal and inter-communal relationships. The background of eliminating this distinction is the dogma in social science that causal explanation and normative judgement should be disconnected. As a result the double structure of reality, the modality structure and individuality structure, is not seen.

The economic value of land can only be conceptualized when a distinction is made between the economic modalities (e.g. value, rent) and the individualities (e.g. market, firm). The economic modalities express themselves in a normative way, which characterize the specific individuality. In order to be able to make these distinctions the sociological principle of correlation between communal and inter-communal relationships is necessary. For example, the value in the “market” expresses itself in terms of inter-communal relationships. The most important norm is that the lowest value qualifies the value in the “market”. The value in the “firm” expresses itself by the communal relationships. It is characteristic of the “firm” that it stands between two or more “markets”. The most important norm is, taking into account its own communal valuation rules, that there at least a rent remains given the different “market” values. Land as an economic object, emerges in different individualities in which it can exist in respect to human subjective valuation. As a result the economic value of land is never reducible to land itself, but depends on

human shaping of typical individualities on a cultural basis. Once this is properly taken into account, a more consistent methodology of land valuation can be established.

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