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## **Economic process as institutionalization of values Karl Polanyi's institutional theory and its ethical consequences\***

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### **Abstract**

This article is devoted to a critical reconstruction of Karl Polanyi's institutional theory and its ethical consequences. Starting with the distinction between the formal (neoclassical) and the substantive (institutional) understanding of the economy, the article proceeds to discuss the main forms of institutional integration of economic life described by Polanyi: reciprocity (symmetry), redistribution (centricity), and exchange (market). In this context, the author examines the connection between the work of Karl Polanyi and the economic anthropology represented by the works of Richard Thurnwald and Bronisław Malinowski. The author argues that three main forms of institutional integration of economic life introduced by Karl Polanyi can be interpreted both as analytical tools to describe institutions and as a grand scheme for the classification of different economic systems. The next section of the article is devoted to a comparison between the institutional theories of Douglass North and Karl Polanyi. For North, the main explanatory category is the idea of transaction costs, whereas for Polanyi the key idea is that of the social embeddedness of the economy. When speaking about the social embeddedness of the economy, Polanyi draws our attention to the inseparable bonds which exist between economic institutions on the one hand, and culture, social structure and politics on the other. This theoretical difference between North and

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Polanyi, the author argues, has important ethical consequences. If Polanyi is right, then institutions are not only alternative solutions to a certain economic problem (i.e. the efficient allocation of resources, the reduction of transaction costs) but above all they are the embodiment of different conceptions of a good life. In conclusion, the author emphasizes the political dimension of Karl Polanyi's institutional theory, along with its intriguing promise of liberating our social and political life from the economic fallacy, that is, from the unfortunate tendency to think about society in market terms.

**Keywords:** Karl Polanyi, Douglass North, institutionalism, ethics

**JEL Classification:** A13, B31, B52, Z13

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## 1. Introduction

Not only did the 2008 financial crisis cause a major shock to the global economy, but it also contributed to the revival of the debate on how to practice economics as a science. The undermined confidence in neoclassical economics, which largely determines the way of thinking of political and business elites, stimulated an interest in unorthodox schools of economic thought, in particular the Post-Keynesian approach, the Marxist tradition and various forms of institutionalism. The philosopher who was referred to particularly frequently was Karl Polanyi, the author of the work published in 1944 titled *The Great Transformation. The Political and Economic Origins of Our Time* (2010). It contains the original analysis of the rise of free market capitalism in 19<sup>th</sup>-century England and its collapse in the interwar period. It should be noted that the renaissance of interest in Karl Polanyi's work was manifested primarily in the field of political sciences, sociology and anthropology.<sup>1</sup> Economists, with few exceptions, still do not refer to the views of the Hungarian thinker too frequently (cf. for example: Cangiani, 2011, pp. 177–197; Maucourant & Plociniczak, 2013, pp. 512–531). Given that Karl Polanyi considered himself an economic historian and a continuator of the institutional thought in economics, the situation seems paradoxical.

The aim of this article is to present the approach that Karl Polanyi developed to study the economies of pre-modern and modern societies. His work can be regarded as one of the versions of old institutionalism and can be juxtaposed with the achievements of such authors as Thorstein Veblen, John R. Commons and John Kenneth Galbraith. What distinguishes Polanyi's approach from the concepts of the above-mentioned thinkers is that it has its roots in the European intellectual

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<sup>1</sup> The following joint publications bear testimony to the interest in Polanyi's thought: *Reading Karl Polanyi for Twenty-First Century: Market Economy as a Political Project* (2007) edited by Burga & Agartan (2007) and *Market and Society. The Great Transformation Today* (2011) edited Hann & Hart (2011).

tradition, especially in the achievements of the German historical school and the work of the Austrian economist Carl Menger.<sup>2</sup> In fact, it is the great Austrian to whom Polanyi ascribes the distinction between the formal and substantive approach to studying the economy, which became the foundation of his own theory (cf. Polanyi, 1971, pp. 16–24).<sup>3</sup> And yet, the most original aspects of the Hungarian thinker's creative output are related to his fascination with anthropology and the works of such authors as Richard Thurnwald and Bronisław Malinowski. Drawing on the findings of anthropology, Polanyi formulated a general typology regarding the forms of institutional integration of economic life occurring in different types of societies. The author of this article will seek to prove that Karl Polanyi's institutional theory allows us to show a connection between economics and ethics in a new light. In Polanyi's view, the economy is an institutionalized process of providing goods and services. Economic institutions do not operate in a vacuum but are socially embedded and, thus, associated with the moral code of a given society. Therefore, any form of institutionalization of economic life consolidates a specific set of ethical values. Karl Polanyi's approach emphasizes the relationship between the plurality of values and the multiplicity of forms in which economic processes can be institutionally integrated. At the same time, the philosopher was convinced that in capitalist societies, ethical and institutional pluralism is threatened with the tendency of markets to expand and to condition gradually more and more spheres of social life. And so, Karl Polanyi's research project was motivated by the moral imperative to go beyond *the economic fallacy* involving a false identification of the economy with the market (Polanyi, 1977, p. 6).

## 2. Formal and substantive understanding of the economy

The starting point for Karl Polanyi's deliberations is the distinction between a formal and a substantive approach to the study of economic life (cf. Stanfield, 1986).<sup>4</sup> On the origins of the formal understanding of economics, Polanyi (1957a, p. 243) writes:

The formal meaning of "economic" derives from the logical character of the means-ends relationship, as apparent in such words as "economical" or "economizing." It refers to a definite situation of choice, namely, that between the different uses of means induced by an insufficiency of those means. If we call the rules governing the choice of means the logic of rational action, then we may denote this variant of logic, with an improvised term, as formal economics.

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<sup>2</sup> Polanyi's attempt to combine the neoclassical and the historical-institutional approach is discussed later in the article.

<sup>3</sup> According to Polanyi, the distinction appeared in the second posthumous edition of Menger's *Principles of Economics* published in 1923; yet, it was not addressed later by his followers.

<sup>4</sup> Cf. an equally popular discussion on the distinction between economics as the rational choice theory and economics as the study of the economy in the work of Ha-Joon Chang (2015).

Thus, in a formal sense, economics is the science dealing with the logic behind the choice between alternative uses of limited means. Economics advises on how to make these types of choices in the most effective way, i.e., leading to the maximization of utility. Clearly, not every choice presupposes a situation of scarcity. For example, when faced with the moral dilemma of choosing between good and evil, or deciding which of numerous forest paths to take on a walk, do not assume that resources are limited and, therefore, they lie outside the scope of economics (Polanyi, 1957a, p. 246). Nonetheless, economics, along with its basic postulate of maximizing the marginal utility, applies to every situation that presents the choice between finite means. In Lionel Robbins' work entitled *An Essay on The Nature and Significance of Economic Science*, the formalist view on the subject and scope of economics takes on a canonical form. Its more contemporary version was put forward by Gary Becker in his economic theory of human behavior (Robbins, 1932, pp. 1–22; Becker, 1990, pp. 19–39). It can be observed that the formal definition of economics, as the study dealing with the allocation of resources under the condition of scarcity, lays the conceptual foundation for the neoclassical theory, which determines the character of modern mainstream economics.

In opposition to the formal model, there is a substantive understanding of economics as the study focusing on economic processes. Karl Polanyi (1957a, p. 243) explains:

The substantive meaning of economic derives from man's dependence for his living upon nature and his fellows. It refers to the interchange with his natural and social environment, in so far as this results in supplying him with the means of material want satisfaction.

In order to satisfy their desires, people undertake specific actions, interacting with other humans and nature. Three aspects of these actions can be distinguished: ecological, technological and social, which refer respectively to the use of natural resources, available technology as well as human values and the institutions that give them direction. The sum of activities which are meant to form the material basis of existence constitutes the notion of an economic process. On a substantive plane, the economy is regarded as the institutionalized process of production and allocation of goods. Karl Polanyi explains that the concept of a process suggests an analysis in terms of motion. It is about both the movement in space (moving goods from place to place) and changes in allocation (passing goods from hand to hand). According to Polanyi, economic processes—of production and distribution—can be analyzed with regard to the movement of goods (Polanyi, 1957a, pp. 249–250).<sup>5</sup> Their motion is not chaotic, but they set regular patterns. Those are institutions, in the opinion of Polanyi, that make economic processes repetitive and predictable.

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<sup>5</sup> Strangely enough, Polanyi also applies this method of analysis to production: "What occurs on the process level between man and soil in hoeing a plot or what on the conveyor belt in the constructing of an automobile is, prima facie a mere jig-sawing of human and nonhuman movements. From the institutional point of view it is a mere referent of terms like labor and capital, craft and union, slacking and speeding, the spreading of risks and the other semantic units of the social context" (Polanyi, 1957a, p. 249).

The instituting of the economic process—maintains Polanyi (1957a, pp. 249–250)—vests that process with unity and stability; it produces a structure with a definite function in society; it shifts the place of the process in society, thus adding significance to its history; it centres interest on values, motives and policy. Unity and stability, structure and function, history and policy spell out operationally the content of our assertion that the human economy is an instituted process.

As indicated, the substantive approach is closely related to institutionalism in economics and in social sciences.

Proposing a distinction between the formal and the substantive approach, the Hungarian thinker questions the universalist aspirations of neoclassical economics. In his view, neoclassical economics describes the decision-making process in the modern market economy. Its crowning achievement is the price formation theory. In essence, it is a market theory—and nothing more. Contrary to declarations, the formal approach does not provide a convincing argument that would explain the behavior of people in all historical periods and in almost every sphere of social life. To Polanyi, a human is first and foremost a social being. Outside the domain of market competition, people are not guided by the postulate of maximizing their utility, but by different rules of conduct, set by norms that exist in a given community, obligations resulting from the kinship, religious beliefs or endeavors to improve one's social status. The assumption of limited means and the postulate of utility maximization do not reflect the universal condition of "economic man," but solely a particular dilemma of an individual who operates under market conditions.

As Gareth Dale points out, introducing a distinction between a substantive and a formal understanding of economics, Karl Polanyi sought to reach a kind of compromise between neoclassical economics and the German historical school (cf. Dale, 2010, pp. 95–103). Neoclassical economics provides theoretical tools for analyzing the economy that is organized in a system of competitive markets, while non-market aspects of the economic order are the proper domain of institutional and historical inquiries.<sup>6</sup> The need to go beyond neoclassical economics is especially visible in such disciplines as sociology, economic history or economic anthropology, which examine the economies of pre-modern societies or the social and cultural aspects of the economic process. Karl Polanyi claims that the substantive understanding of economics he developed advances a general theory which allows the cognitive efforts of sociology, anthropology and economic history to be integrated. In accordance with the substantive approach, empirical research on the types of economies known to history is nothing more than investigating ways of

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<sup>6</sup> The consensus proposed by Karl Polanyi is now questioned by representatives of new economic sociology, who reject neoclassical analysis and put emphasis on the social embeddedness of markets. A discussion of their argument, however, would go beyond the scope of this article (cf. on the topic Beckert, 2009, pp. 38–55).

institutionalizing the economic process in different places and at different times. Hence, institutionalism offers the most general conceptual framework for all the social sciences dealing with the economic life.<sup>7</sup>

### **3. The forms of institutional integration of economic life: Redistribution, reciprocity and market exchange**

From the outset, institutional economics has had to face the problem of an *embarras de richesses*, namely the existence of a huge diversity of institutions in the economies known to history. And so, institutionalism requires theoretical tools that would allow the spectrum of possible institutional configurations to be classified and described. In an attempt to respond to this challenge, Karl Polanyi formulated a typology for institutional forms of integration of economic life. The Hungarian researcher was convinced that a few basic patterns or schemes lie behind the existing wealth of institutional systems. He refers to these recurring configurations as forms of integration, among which he distinguishes redistribution, reciprocity and market exchange (cf. Polanyi, 1957a, pp. 250–256).<sup>8</sup> Each of these forms corresponds to a specific type of institutional structure that supports it. Redistribution is related to *centricity* (the power is focused in the center of a system), reciprocity requires the structures based on the *symmetry* of social relations, whereas the relations of exchange assume the existence of a *market*. According to Karl Polanyi, empirical economies owe their coherence to the said forms of integration or to specific combinations. Let us have a closer look at the forms of institutional integration of the economy distinguished by the Hungarian thinker.

We will start with the analysis of the reciprocity principle. Karl Polanyi indicates that the development of institutional systems established on the reciprocity principle is independent of the motivations of individuals. Reciprocity as a type of integration requires not so much altruistic motivations as a social structure based on the existence of symmetrically arranged groups. The essence of the exchange organized on the reciprocity principle is that there is no strict equivalence relation between the parties of exchange. Therefore, goods do not have a strictly defined “price”, and the recipient simply undertakes to reciprocate the exchange act in the future. The economic relations that involve the idea of reciprocity are frequently based on the system of kinship. Karl Polanyi gives an example of Melanesia,

<sup>7</sup> The standpoint taken by Polanyi triggered a dispute in the field of economic anthropology between substantivists and formalists, who maintained that the methods of neoclassical economics have application to the study of pre-modern economies (cf. on the subject Hann & Hart, 2011, pp. 55–70).

<sup>8</sup> When Polanyi presented the above typology for the first time in the fourth chapter of *The Great Transformation*, he also listed householding, associated with the principle of autarky, as a separate type of integration; yet, in his later works, the philosopher treated householding as the combination of redistribution and reciprocity principles. The matter will be addressed further in the discussion. More recently, Wolfgang Streeck and Philippe Schmitter presented convincing arguments for recognizing the association based on representation of interests as the fourth basic mechanism of social integration. Cf. Streeck, & Schmitter, 1985, pp. 119–138.

where the exchange of gifts was grounded in the principle that a man's duty is to support his sister and her family (Polanyi, 2010, p. 58). This system led to the creation of a complex network of economic interdependencies between tribe members. One of the most complex exchange systems based on the principle of reciprocity was the Kula ritual described by Bronisław Malinowski, practiced in the Trobriand Islands, consisting in an obligatory exchange of gifts between the inhabitants of different islands of the archipelago (Polanyi, 2010, p. 61). Instances from anthropology do not mean that economic relations based on the reciprocity principle occur only in primitive communities. As noted by Karl Polanyi, the *lend and lease* policy, which was in force during the Second World War and allowed the lease of military equipment between the allies, was nothing more than a large-scale exchange system grounded in the principle of reciprocity (Polanyi, 1957a, p. 256).<sup>9</sup> A spectacular example of this principle in application is the movement for honorary blood donation, which proves that the logic of the gift and the idea of brotherhood are also of key importance in modern societies (cf. on this subject Titmuss, 1971).

Another form of institutional integration of economic life that Karl Polanyi identifies is redistribution—the principle which is expressed by the movement of goods to the center, where they are subsequently redistributed. There has to be a privileged point in the center of a social system so that economic relations based on the redistribution principle could occur. Thus, redistribution presupposes the existence of a certain social hierarchy. The most straightforward example of redistribution is the situation of hunting, after which the game is first taken by the leader of the expedition or the chief, and only then divided among the participants of the hunt or members of the tribe. Economic relations related to the principle of redistribution usually made use of a political organization. The economies of great empires, such as Babylonia and Egypt, as well as of the medieval feudal system were founded on the principle of redistribution. Polanyi points out that an extreme instance of a redistribution-based economic system was the economic model of the Soviet Union (Polanyi, 1957a, p. 256). Needless to say, the political nature of the redistribution principle meant that its outcomes varied significantly depending on whether a democratic or an autocratic political order was established in a given community.

The exchange principle, the third form of institutional integration of economic life distinguished by Polanyi, refers to market transactions. Market exchange, generally speaking, means the movement of goods between the parties to the transaction which is based on equivalency rates established by a tender. Market transactions, as a general rule, imply the existence of money and price-forming markets. While the principles of redistribution and reciprocity can be found in various institutional configurations, the principle of exchange is closely related to the institution of the market. In Karl Polanyi's opinion, the majority of the economies known to history owed their integrity to the principles of reciprocity or

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<sup>9</sup> This interpretation may raise doubts since the *lend and lease* system essentially consisted in the unilateral support offered by the United States to the other Allies. Nowadays, the free software movement is believed to be a magnificent example of how the logic of the gift works.

redistribution. Markets performed only a supporting role, for they were usually local in character and did not have an impact on the main factors of production, i.e., labor, land and capital. Markets steadily grew in importance from the 16<sup>th</sup> century to reach their apogee at the end of the 19<sup>th</sup> century. The collapse of the free-market economic order in the interwar period sparked a wave of retreat from market mechanisms and a return to institutions founded on the principles of reciprocity and redistribution.

Karl Polanyi derives the above typology of integration from the works of anthropologists, in particular, Richard Thurnwald and Bronisław Malinowski. In a work published in 1916 devoted to the system of arranged marriages in the Bánaro tribe of New Guinea, Richard Thurnwald observes that the exchange relations with an underlying principle of reciprocity are accompanied by the symmetry of social structure (Thurnwald, 1916, p. 258). Bronisław Malinowski elaborates on this argument in *Crime and Custom in Savage Society*, arguing that the principle of symmetry is of an institutional and not a psychological character, and its occurrence creates the basis for mutual obligations (Malinowski, 1980, pp. 26–27). Polanyi generalized the reasoning of Thurnwald and Malinowski, adding redistribution and market exchange as two additional forms of integration of economic life (cf. Polanyi, 1977, pp. 49–56). Karl Polanyi owes the anthropologists and their findings much more than just intellectual inspiration and exotic examples drawn from the descriptions of the economic life of indigenous tribes. From a theoretical standpoint, it is crucial to recognize the relationship between the existing institutional structure and the rules that govern economic life. Spontaneous acts of exchange will never lead to the creation of a market of their own accord, just as single gestures of altruism will not make the reciprocity principle the foundation of the socio-economic order. And whether it happens is determined by what type of institutions are dominant in a given society. Hence, the real lesson of anthropology consists in advancing a holistic thesis about the primacy of social and cultural factors over individual ones—the thesis leading to the rejection of the view that an institution originates in the sum of individual actions.

The typology of institutional integration of economic life developed by Karl Polanyi can be read in two ways. In the opinion of William Schaniel and Walter Neale, it should be interpreted through the prism of three patterns of the flow of goods—symmetry, centricity and market, which together allow all possible institutional combinations to be described (2000, pp. 89–104). Centricity defines the movement of goods along the center-periphery line of a given system, whereas symmetry means the movement between analogous points of the social structure. Market exchange, on the other hand, depicts the free flow of goods between unconnected points of a given system. Social institutions constitute a combination of these three basic formulas. The flow of goods patterns are not necessarily ascribed to any specific system of values. In certain situations, reciprocity will result in altruistic activities, while in others it will become a justification for an honorary revenge. A manifestation of such brutal reciprocity is Mafia vendettas or the military practices of some Maori tribes in which the wronged party is obliged to repay the aggressors for the inflicted harm with a vengeance (Schaniel & Neale, 2000,

pp. 98–100). As William Schaniel and Walter Neale point out, an unambiguous classification of a particular institution is not always an easy task (2000, pp. 96–97). For example, an Indian village with the caste system can be considered a system based on redistribution, in which crops are confiscated and distributed in the interest of the dominant caste. However, if we look at the caste system as an organized exchange of services between castes, we will be able to see elements based on the principle of reciprocity. William Schaniel and Walter Neale advocate that the choice of a dominant form of integration depends, in part, on the objectives of the study. Still, in their opinion, empirical institutions can be categorized using Polanyi's forms of integration and their various combinations.<sup>10</sup>

Polanyi's typology of can also be interpreted as an attempt to identify the basic principles that organize economic life—reciprocity, redistribution and market exchange. In line with this interpretation, patterns of the movement of goods are useful as long as they allow us to observe the dominant principle of integration. The householding category provides the best example of Polanyi's indecision. In *The Great Transformation*, he distinguished householding as the fourth type of institutional integration of economic life, which is to rely on the principle of autarky. And although ten years later, in the essay *The Economy as Instituted Process*, Polanyi came to the conclusion that householding is not a separate type of integration of economic life but merely a special type of redistribution, he still devoted a separate chapter of his next work *Dahomey and the Slave Trade*<sup>11</sup> to the analysis of householding as a separate form of institutional integration of economic behaviour. With regard to the patterns of the flow of goods, householding can indeed be perceived as a certain form of centrality. Yet, there is no doubt that it is founded on a different logic of functioning than the systems based on redistribution, reciprocity or market exchange. Considering the basic principles behind Polanyi's typology, there is a fundamental difference between market and other forms of institutional integration. In the view of the Hungarian thinker, market exchange is closely intertwined with the materialistic motive that lies behind the pursuit of profit, while the principles of redistribution and reciprocity may reflect a lifestyle characteristic of a given social group, interests of occupational groups, political ideologies, religious beliefs and national traditions. In this sense, we can say that they are embedded in moral codes that apply in a particular society. As stated by Karl Polanyi, it should be emphasized that non-market forms of integration of economic life are essential to maintain the pluralism in values and in the forms of social life.

Karl Polanyi's theory may also constitute a basis for the classification of economic systems according to the forms of institutional integration that prevail in them. In this respect, Polanyi's concept resembles the Marxist social formation theory, which recognizes the successive stages of slavery, feudalism, capitalism and communism. Polanyi considers Marx's proposal inadequate for at least two

<sup>10</sup> Karl Polanyi applies his own typology of integration to analyse the institution of the African kingdom of Dahomey, which in the 18<sup>th</sup> century was involved in the slave trade with European powers. Cf. Polanyi, 1966, pp. 33–95.

<sup>11</sup> On the category of householding in the thought of Karl Polanyi cf. Gregory (2011, pp. 133–160).

reasons. Firstly, Marx built his model focusing on the role of labor in the production system. This allowed him to single out its three forms, i.e., slavery, serfdom and wage labor. Polanyi sees the Marxian scheme as too simplistic since, in his opinion, the method of institutional integration of other factors of production, especially of the land, remains at least equally important. Secondly, the model of social formation presupposes a linear sequence of successive development phases, which Karl Polanyi strongly rejects (cf. Polanyi, 1957a, pp. 255–256). The Hungarian thinker asserts that the combination of production factors (labor, land and capital) and the indicated forms of integration (reciprocity, redistribution and market exchange) are decisive when it comes to the nature of a given social order. In most economic systems, dominant and subordinate mechanisms of integration can be distinguished. The dominant ones should be understood as those which permit the inclusion of labor, land and capital in the economic order (Polanyi, 1957a, p. 256).<sup>12</sup> For instance, Polanyi upholds that the economies of primitive societies were most often integrated through the kinship system based on reciprocity, while the market mechanism became the dominant form of economic integration no sooner than the 19<sup>th</sup> century. The relationship between dominant and subordinate patterns may change—over time, the institution playing a marginal role in the system may become one of the dominant mechanisms of integration. It is worth noting that the classification developed by Karl Polanyi recognizes a theoretical possibility that there might exist different types of the mixed economy, in which individual factors of production are integrated with the economic system through the medium of market, redistribution or the institutions based on reciprocity.

The Hungarian sociologist Ivan Szelényi adapted Polanyi's typology of the main political systems to analyze institutional transformations in Eastern Europe. Due to the fact that institutions based on redistribution, exchange and markets co-exist in all known economies, Szelényi considers Polanyi to be the theoretician of a mixed economy (1991, pp. 331–250). However, mixed economies can be divided into capitalist and socialist ones, depending on which of the integration mechanisms occupies the dominant role (i.e. comprises labor, land and capital). In the economies of real socialism, mechanisms based on central planning and redistribution predominated, while in the case of Western welfare states, despite numerous significant adjustments, the market kept a pre-eminent position in their economic systems. The role of complementary mechanisms—of the market in a socialist economy and of the state in a capitalist economy—is to correct the malfunctioning of dominant mechanisms. Based on this scheme, Ivan Szelényi (1991, p. 239) distinguishes four types of economic systems in industrial societies: economies following the pure market economy model, like the one of the United States; economies following the pure redistribution economy model, represented by the GDR or the USSR; mixed socialist economies, in which market plays a significant role, such as Hungary, China or Yugoslavia; and mixed capitalist economies represented by the Nordic welfare states. In the states of real socialism,

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<sup>12</sup> Even though Polanyi speaks here only about labor and land, in the light of the “fictitious goods” concept (labor, land and money) introduced in the eleventh chapter of *The Great Transformation*, it seems reasonable to put forward the capital as the third key factor of production.

the evolution of a political system occurred as a gradual increase in the importance of the market mechanism—first through a spontaneous development of the black market, then through conscious reforms. Nonetheless, as long as these reforms were limited to the commodity market, the economic systems of Eastern European countries remained essentially socialistic. Only when the factors of production were included in the operation of the market mechanism, and the labor and the land markets as well as a capital market were created, did the transition from mixed socialist economy to the capitalist one take place (cf. Szelényi & Kostello, 1998, pp. 305–326).

#### 4. Polanyi vs. North

Although Karl Polanyi's institutional theory aroused considerable interest in the field of anthropology, sociology and the political sciences, it rarely received the attention of mainstream economists. The exception to the rule was Douglass North, who developed his own version of institutionalism drawing on the ideas of Polanyi. Polanyi's theories, stresses North, pose a major theoretical challenge to neoclassical economics. At the heart of this challenge is the fact that the postulate of maximizing the profit, which is put forward by neoclassical economics, does not allow one to explain what function non-market institutions fulfill in the economy. The merit of Karl Polanyi is that while formulating his concept of institutional types of integration of the economy, he presents the problem of explaining non-market mechanisms of resource allocation in a particularly dramatic way. North (1977, p. 709) describes how Polanyi's theory challenges neoclassical economics:

But the point goes much deeper than even Polanyi realized, and poses a fundamental problem to the economist and economic historian. How do we account for substitutes for price-making markets of which families, firms, guilds, manors, trade unions, cooperatives, etc. are organizing institutions which allocate resources in place of markets. Most fundamental of all, how do we explain government?<sup>13</sup>

According to North, the categories of reciprocity, redistribution and market exchange developed by Polanyi, though not very precise, make it possible to observe institutional mechanisms of resource allocation, which are important from the perspective of economics. And so, North admits that Polanyi's critique of neoclassical economics is empirically accurate.

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<sup>13</sup> While interpreting the types of institutional integration of economic life in terms of competitive mechanisms of income allocation, North disregards the fact that in Polanyi's view they were to describe not only processes of distribution but also those of production.

Karl Polanyi cannot be so lightly dismissed—writes North (1977, p. 704)—and if his spirit does not haunt the new economic historians, it is only because they probably are not even aware that the ghost exists.

Although the “intuitive genius” of Karl Polanyi allowed him to perceive the limitations of neoclassical economics early on, in the opinion of Douglass North, the work of the Hungarian thinker is not free from fundamental errors (North, 1977, p. 716). The author of *The Great Transformation* makes use of historical sources selectively and definitely underestimates the significance of markets in pre-modern societies. In addition, Polanyi has little to say about the state and cannot define the dynamics of institutional change (North, 1978, p. 398). But most of all, the Hungarian thinker is not able to formulate an adequate economic theory explaining the functioning of various institutions in the old and modern economies. And that is exactly the theory that Douglass North’s version of institutionalism seeks to produce. The key to North’s new institutionalism is the idea of transaction costs. As North (1977, p. 710) states,

[...] the costs of defining and enforcing property rights—transaction costs—lead to non-price allocation of many goods and services today, because the costs of delineation or enforcement exceed the benefits.

In line with this hypothesis, non-market resource allocation patterns will emerge wherever the existence of specific institutional structures generates lower transaction costs than the enforcement of market agreements. North argues that the systems based on reciprocity, such as the Kula ritual described by Bronisław Malinowski and Karl Polanyi, can be considered “a least-cost trading solution where no system of enforcing the terms of exchange between trading units exists” (North, 1977, p. 713). In general terms, North maintains that “the organizational forms described by Polanyi make good sense in the context of the transaction costs of the time” (1978, p. 399). The scholar insists that, in the long run, any significant change in transaction costs can lead to institutional change. Owing to the fact that the development of technology generally results in the reduction of transaction costs, it should be expected that markets will increasingly gain importance as the main mechanisms for the allocation of resources (North, 1977, p. 710).<sup>14</sup>

<sup>14</sup> North, however, makes a reservation that his explanation of institutional changes in terms of a change in transaction costs is largely speculative. It is due to the fact that the notion of transaction costs is not precise enough in itself. As North writes: “To the degree that we can develop an ordinal ranking of transaction costs, then changes at the margin should produce predictable pressure for institutional rearrangement. The caveat to such an optimistic statement is that while we can and should be able to predict the direction of institutional change, the precise form it will take is still beyond the scope of the state of the art. We cannot as yet derive a specified supply function of institutional arrangements to provide such a determinate answer” (1977, pp. 715–716). But then, as North admits himself, if no empirically falsifiable claims can be made on the basis of the theory of transaction costs, it is difficult to see why we should consider explanations that refer to this idea as more scientific and privileged than alternative concepts pointing to such factors as culture, political power or social structure.

The theory of Karl Polanyi offers an alternative way of explaining institutional diversity, of which Douglass North was aware. The key to understanding Karl Polanyi's theory is his original concept of a socially embedded economy. "The human economy," states Polanyi (1957a, p. 250), "is embedded in institutions, both economic and non-economic." Building on the concept of the embeddedness of the economy in society, Karl Polanyi emphasizes the inseparable bonds that link an economic system with the social structure, culture and political life. We can, therefore, speak of the social, political and cultural embeddedness of economic processes.<sup>15</sup> The study of how the position of the economy in a society changes is based on the assumption that economic processes can be convincingly explained only as a part of a larger social whole. This perspective is traditionally adopted by social sciences, such as sociology, anthropology and political science; yet, it is also reflected in the old institutionalism of J.R. Commons, J.K. Galbraith and G. Myrdal. The theory of embeddedness advanced by Polanyi creates a convenient platform for the theoretical integration of these various approaches, while at the same time allowing them to keep their disciplinary distinctiveness. Accordingly, anthropology examines how an economic process is linked to the totality of people's motivations and valuations as organized in their culture (Polanyi, 2014, p. 134), whereas sociology ponders the relationship between the economy and social structure. From the point of view of a historian, studying the place that the economy takes in society involves examining the transformations of institutions on a specific time scale, while institutionalist political economy deals with various institutional configurations that exist in modern economic systems. Political sciences, on the other hand, can analyze institutions through the prism of their entanglement in the struggle for power, including the conflict between pro-market and anti-market political forces. Pursuant to Karl Polanyi's theory, the cultural, social and political variables grow into the role of factors that can explain the diversity of economic institutions and their transformations over time. Hence, the concept of embeddedness presented by Polanyi can be interpreted as an attempt to develop a common methodological denominator for various research approaches that are in opposition to neoclassical economics. The institutional theory was to provide a general conceptual framework for analyzing the changing role that the economy occupied in society, which includes a complex history of the relationships between institutionalized economic processes and the social, cultural and political environments in which they are embedded.<sup>16</sup>

Let us pause for a moment to look at Douglass North's critique of Polanyi's theory. The two thinkers differ in how they explain institutional diversity. As North himself points out, his method of institutional analysis grounded in the theory of transaction costs remains consistent with the assumptions of neoclassical economics

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<sup>15</sup> The concept of embeddedness as described by Karl Polanyi has become the subject of conflicting interpretations. Yet, elaborating on them would go beyond the scope of this article. Cf. on the topic: Gemici, 2008, pp. 5–33.

<sup>16</sup> One must admit that Karl Polanyi's comments on the role of particular disciplines assume the character of unsystematized impressions. Cf. on the subject Polanyi, 1971, pp. 16–17; 2014, pp. 133–135.

(1998, p. 247).<sup>17</sup> According to the scholar, institutions can be understood as different solutions to a purely economic problem of reducing transaction costs. It should be noted that on a plane of new institutionalism, the market is regarded as a model solution, and non-market institutions are interpreted as deviations from the market optimum caused by the existence of high costs of enforcing property rights. There is no doubt that Karl Polanyi would reject this kind of explanation. In his view, to understand economic institutions, we must acknowledge their social and cultural entanglement. Moreover, what really requires clarification is not the existence of socially embedded systems founded on reciprocity and redistribution, but the existence of the market as the mechanism of integration of economic life that is institutionally separate and relatively disembedded from social relations. From the perspective of Karl Polanyi's theory, Douglass North's concept appears as a peculiar return of economic formalism within the institutional tradition.<sup>18</sup> Polanyi would have considered this view heresy. After all, the main justification for the theory he presented was the imperative to go beyond the economic way of analyzing institutions by showing their social embeddedness. For this reason, Polanyi focuses on such factors as social structure, politics or culture, which are not easily analyzed in purely economic terms. Given these differences, it is not difficult to understand why Polanyi's thought is immensely popular among sociologists, anthropologists and representatives of political science whereas economists, for the most part, remain under the influence of new institutionalism (cf. for example: Blyth, 2002, pp. 3–44; Streeck, 2009, pp. 230–268).

## **5. Conclusions: the ethical dimension of Karl Polanyi's institutionalism**

While it was not the purpose of this article to settle the dispute between old and new institutionalism, the author would like to draw attention to the significant difference in how they present the ethical dimension of economic institutions. Douglass North sees economic institutions as, first and foremost, the solution to the problem of resource allocation. The primary reason for the existence of non-market economic institutions is the occurrence of transaction costs, because of which certain goods and services cannot be effectively provided by the markets. Karl Polanyi would reject this way of thinking. In the view of the Hungarian philosopher, institutions are not just alternative solutions to the economic calculation of transaction costs, but culturally embedded forms of social life. And it is precisely this embeddedness of institutions in different cultures, national traditions and

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<sup>17</sup> North keeps the neoclassical postulates on the subject of scarcity and competition but modifies the assumption about the rational behaviour of the participants of economic life.

<sup>18</sup> Admittedly, in later works North revised his idea by introducing elements such as mental models, ideologies or uncertainty. Cf. for example: Denzau & North, 1994, pp. 3–31. An interesting critique of the standpoint that Douglass North adopted later on (as well as of the theory of the rational choice in economics and political sciences) is presented by Mark Blyth (2003, pp. 695–706).

visions of the good life that makes them ethically significant. It is not difficult to find the Aristotelian motifs in Polanyi's work. He considered Aristotle to be the original discoverer of the economy (cf. Polanyi, 1957b, pp. 64–94). Observing the dynamic development of trade in the ancient world, Aristotle was the first to notice the difference between the requirements of a good life and the market imperative to constantly seek affluence. For Karl Polanyi, just as for Aristotle, the principal purpose of economic activity is not unlimited economic growth, but to provide a material basis for a good life. Adopting such a perspective, however, requires that the underlying ideas of modern economics be questioned, in particular, the assumption that resources are finite and needs are unlimited. While conveying a certain vision of a good life, community norms and institutions indicate which human needs and aspirations deserve approval. In line with the substantive understanding of economics, it is possible to define the minimum needed to satisfy needs, without which it would be hard to even imagine a good life, as well as to point to the needs that serve consumption solely for show, which have nothing to do with the ideal (cf. Kapp, 1965, pp. 297–309). Thus, accepting the substantive standards of rationality leads to recognizing the legitimacy of non-market criteria for the assessment of economic institutions and policies.

Undeniably, Karl Polanyi was a thinker engaged in polemics with free-market liberalism and its tendency to glorify the market order. However, the author of this article is of the opinion that seeing Polanyi's work as a demonization of the market and an idealization of the historically recognized orders that were based on the principles of redistribution and reciprocity would be off the mark. The proper conclusion that we should draw from the considerations of the Hungarian thinker is the observation that the pluralism of values must be accompanied by the multiplicity of forms in which economic life can be institutionally integrated. If there is something that the theory of Karl Polanyi strongly opposes, it is the submission of the whole of economic life to one idea, regardless of whether it might be central planning or the principle of unlimited market competition. An acceptable economic order is, to a lesser or greater extent, a mixed economy in which the diversity of institutions reflects the multitude of ideological choices and the complexity of historical experience. It does not mean that we should recognize Karl Polanyi as the theorist of social democracy. It seems that the Hungarian scholar was not satisfied with the choice between the economies based on central planning and market systems. His historical and anthropological inquiries were driven by the desire to go beyond ideological oppositions of the Cold War. Karl Polanyi was critical of the destabilizing consequences of unrestricted economic growth, opposed the commodification of nature and emphasized the importance of non-market ways of organizing production and distribution. The vision of a socially embedded market outlined by the author of *The Great Transformation* is in tune with the arguments which are currently being advanced by environmentalist critics of capitalism and post-growth theorists (cf. for example: Latouche, 2009).

In modern societies, the pluralism of values and the pluralism of institutions are threatened by the expansion of markets into all spheres of social life. A trend to constantly extend the sphere of influence of the market mechanism co-occurs

with a tendency to think about society in market terms, which Karl Polanyi refers to as *the economicist fallacy* (more on the subject in Polanyi, 1977, pp. 5–16). The economic contortion of contemporary culture has numerous serious consequences, the most severe of which might be the atrophy of political imagination. We lose our ability to think in political terms because strictly political concepts, such as order or justice, seem to us idealistic and devoid of significance when compared to hard “economic stimuli.” Analogically, non-market institutions based on prescriptive visions of justice are too frequently sold as “suboptimal” solutions to the purely economic problem of resource allocation. Institutional imagination, Polanyi argues, is essentially of historical character; it can be enriched by exploring the secrets of well-known economic systems. A reward for the effort put into getting to know the past is that, with a bit of luck, we may be able to free ourselves from the superstitions of our age. Therefore, the institutionalism of Karl Polanyi is a project for the liberation of our social and political imagination from the shackles of economism. As stated by Polanyi, studying history and institutions increases our freedom to adapt creatively to the major and minor economic transformations which will inevitably occur (Polanyi, 1977, p. xlii et seqq.).

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