

## Revisiting Institutional Law and Economics – The Inadequacy of the Chicago School: the Case of Personal Bankruptcy Law

*“Bankruptcy is perhaps the greatest and most humiliating  
calamity which can befall an innocent man”  
– Adam Smith*

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From an evolutionary perspective, bankruptcies may be seen as an important selection mechanism. Bankruptcy, however, has not received much attention in the economics literature. As the quotation from Smith, above, intimates, bankruptcy is an unpleasant process for individuals, their families and for wider society. Bankruptcy laws differ widely across countries and even within a federalized country such as the United States. Filing practices within a country also differ substantially across regions as well as among social groups (Fay, Hurst, and White 2002). Thus, bankruptcy is not the uncomplicated selection mechanism in the economic realm it sometimes is believed to be.

This paper discusses how one may *evaluate* bankruptcy regimes from an economic perspective. It contrasts the instrumental rationality approach of the Chicago (law and economics) school with the instrumental valuation principle (IVP) from original Institutional Economics (OIE) in the context of personal bankruptcy.

### **Personal Bankruptcy**

Recently most developed countries have experienced some increase in the number of personal bankruptcies. Conventionally, personal bankruptcies tend to be framed as failures of self-control (cf. Starr, forthcoming), although there is clear evidence that malevolence is only involved in a minority of cases (Congressional Budget Office

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(CBO), 2000).<sup>1</sup> Some mainstream economists also frame personal bankruptcies as personal failures (cf. Fay, Hurst, and White 2002).<sup>2</sup> This highlights the enduring vilification of the individual as bankrupt and the pejorative nature of the term.

Uniquely, and until recently, U.S. citizens had the potential to select from two alternative methods of declaring bankruptcy (Efrat 2001): Chapters 7 and 13. Under Chapter 7, debtors surrender all their un-exempted assets to a trustee; the trustee liquidates and repays creditors. Unsecured debts such as credit card debts, installment loans, medical bills and damage claims are discharged. Government-backed student loans, child support and alimony, and recent income taxes are not eligible for discharge. Homesteads tend to be exempted. Chapter 7 is an attractive avenue for filing for bankruptcy; constituting 70% of U.S. bankruptcy filings (CBO 2000). Chapter 13 is intended for filers who earn a regular income. Filers do not surrender assets; instead, a re-payment schedule, usually over a 3-5 year period, is arranged through due legal process.

As may be expected, there is a wide variety of institutional arrangements associated with bankruptcy. Some arrangements reflect the historical antipathy toward those unfortunate enough to experience bankruptcy (Kilpi 1998).<sup>3</sup> U.S. type Chapter 13 arrangements tend to be the norm in most developed economies. In the Netherlands and UK, for example, bankrupts must accept a repayment plan in effect drawn up by the creditors or their trustees: the converse of the latitude within the U.S. system.<sup>4</sup> While a judge can compel creditors to cooperate, creditors usually possess sundry instruments to pursue their interests.<sup>5</sup> Potentially, many creditors are not only motivated by the prospect of asset recovery, but also by a sense of grievance (Jungmann, Niemijer, and ter Voert 2001; Kilpi 1998) or even a Puritan ethos (Galbraith, 1976). In general, few assets are exempted. Any income above a legally defined minimum usually has to be surrendered entailing erosion in the material incentives for insolvents to earn additional income. Moreover, this may be conceived as attenuation in individual autonomy. In more liberal judicial systems, this attenuation is limited as debts tend to be discharged after three years. In less liberal systems, bankruptcy can amount to debt-bondage (peonage) when insolvents are denied their autonomy for more protracted periods, and in the extreme, indefinitely.

### ***A Chicago Interpretation of Personal Bankruptcy***

The dominating Chicago approach to law and economics usurped Ely-Commons inspired institutional law and economics some time ago (Mercuro and Medema 2006). The Chicago approach, typified especially by Gary Becker, Richard Posner, and Ronald Coase, reduces Commons' rich delineation of transactions into one essentially of commodity exchange in an overarching ubiquitous market. The defining feature of Becker and Posner's approach is a price-theoretic analysis of law (Engelmann 2005; Mercuro and Medema 2006). Posner in particular has justified this in terms of explaining legal and business practices within the parameters of "basic economic theory" (Posner 1978, 931). He avows the efficiency of common law on the basis that judges select legal rules that generate efficient outcomes within the cost

constraints of administering the legal system.<sup>6</sup> He declares: “It is *as if* the judges wanted to adopt the rules, procedures, and case outcomes that would maximize society’s wealth” (Posner 1990, 356 original emphasis). Legal rules are analogous to prices that influence rational individuals’ incentive structures. Contracts, supported by common law, are a key efficiency source in the market system.

Criminality and breaches of contract will occur when the associated costs are outweighed by the benefits. For an individual then, bankruptcy would represent efficient breach of contract. Individual declarations of bankruptcy will vary with its “price.” William Waller’s (2001) review of neoclassical studies of bankruptcy in the United States reveals that they generally support an increase in the relative price of Chapter 7 bankruptcy as a means of reducing returns. Clearly, the underlying objective in this literature is to attenuate the attractiveness of contractual breach. High “returns” to bankruptcy filing will mean that contracts will be easily breached, impeding the efficient operation of the market as transaction costs increase. Market exchange becomes less attractive, *ceteris paribus*. What to the Chicago approach is a statement of predictive fact, in the lenses of uncritical observers becomes a morally reprehensible act further vilifying the bankrupt.

Given its utilitarian roots, a Chicago school evaluation of bankruptcy is consequentialist (Kilpi 1998) within an individualist analytical frame. Becker and Posner’s rhetoric of universal commodification renders a conflation of all value into exchange value.<sup>7</sup> Deontological aspects are either merely assumed to be adequately embodied by exchange value, and hence the consequences of exchange and action, or assumed away. Exchange value furnishes the central defining feature of commodities: as a commodity is an entity that may be monetized, is produced *for* sale in a market (Polanyi 1944), and therefore property rights to the entity can be defined and transferred. Bankruptcy as breach of contract adversely impacts on the enforcement of property rights: the creditor is either totally bereft of, or only partially receives, her/his due rewards. The exchange value of the entity transferred is no longer an accurate evaluation of the value that is actually exchanged.

Interestingly, Waller’s (2001, 878) review of the mainstream literature reveals that rational choice models fail to explain observable behavior such as the sudden declaration of bankruptcy by those with good credit ratings and no history of delayed or missed payments, borrowing to save, and why there are not more bankruptcy declarations in the United States since almost any creditworthy household would gain financially. He thus makes clear that the rational choice approach is beset with explanatory problems. The broader institutional IVP offers a richer analytical and policy potential.

### ***Some Observations on IVP***

IVP recognizes individuals and practices to be embedded in an institutional environment, and can thus be argued to provide a framework for policy analysis. IVP is both sensitive to a given institutional environment shaping individuals, as well as able to question that environment. The principle embodies pluralistic values (Samuels

1995) and offers criteria for selecting, in Thorstein Veblen's terms, alternative institutional "furnitures." An OIE analysis of law comprehends broader legal and ontological contexts. The Deweyan association of scientific inquiry and social-well-being through the instrumental use of knowledge may guide policy formulation generally favoring inclusion, egalitarianism and technical progress. The increasing incidence of personal bankruptcies, for instance, is not merely to be understood as a case of *individual* financial mismanagement or rational opportunism. Post Keynesian and institutionalist analyses highlight how financial de-regulation combined with the social pressures of conspicuous consumption (embodied by a consumer society) constitute important sources of personal indebtedness. By contrast, the Chicago approach reduces social interactions to the trading of commodities, implying a single institutional form: ubiquitous markets where self-interested, calculating agents maximize utility.

From Dewey's theory of knowledge and his adumbration of the means-end continuum, value adopts a processual or ethical dialectical quality (Waller and Robertson 1993). Dewey argued: "All conduct that is not simply either blindly impulsive or mechanically routine seems to involve valuations. The problem of valuation is thus closely associated with the problem of the structure of the sciences of *human* activities and *human* relations" (1939, 383 original emphasis). This is in direct contrast to other principles of value, such as utilitarianism, where the acceptance of "given wants" would seem to infer an ethical relativism but in fact may engender an ethical absolutism. Specifically, Tool (1993, 126) argues that society distinguishes between admissible and inadmissible wants, and therefore, ". . . any unwillingness to uncritically accept the market satisfaction of wants evades judgmental responsibility." This can result in ethical absolutism that favors the status quo as it is seen as optimal by definition.

IVP is not absolute in that it does not imply a particular pattern of ownership or governance, and, "[a]ccordingly, it is neither identified with nor supportive of any Grand Alternatives, the isms of political economy – capitalism, socialism, communism – all of which offer timeless, institutionally defined economic models" (Tool 1993, 126). Instead, it furnishes *criteria* for the selection of alternative institutional structures that provide a *framework* of discourse and policy analysis (Samuels 1995; 1998). IVP furnishes a clear association between scientific inquiry and social well-being, with institutions being evaluated on the basis of the instrumental use of knowledge. As for Dewey, intelligence is an instrument for the advancement of social well-being (Samuels 1995), institutional change *should* be governed by intelligent action guided by desired future consequences of that action (ends-in-view), and this should be facilitated by widespread participation in decision-making processes that reflect the pluralism of society (Atkinson 1987; Samuels 1995; Tool 1993; 1995; and others). Tool (1995, 23 emphasis added), following Foster, designates the following as the essence of IVP:

. . . do or choose that which provides for the *continuity* of human life and the *noninvidious* re-creation of community through the instrumental use of knowledge.

The principle as a process of valuation provides a mode of discourse as opposed to a calculus of “best solutions” of valuation that can be conclusively reached (Samuels 1998). The worth of actions, measures and institutional arrangements and the problems of policy have to be addressed through inquiry (Avio 2004).

Yet, as Klein (1995) and Avio recognize, the principle of instrumental valuation resonates considerable ambiguity. What is the basis of judgment? Whose judgment counts? What are the guiding principles? This ambiguity may be inevitable given that the principle refers to a process of valuation: value emerges following inquiry and discourse. As Klein observes, for Hayek this could mean avoidance of “serfdom,” for Marx a classless society, and for some contemporary economists the freeing of the market. Thus:

The problem is in giving teeth to the notion of reasonableness . . . we might be left with very inadequate reeds on which to rely. (Klein 134, 138)

Klein notes various judgmental criteria from Veblen’s “enhancing human life”; Commons’ “reasonable value”; Clarence Ayres’ “toward a reasonable society”; to Marc Tool’s Veblenian invidious-noninvidious distinction. Tool’s delineation holds considerable appeal for us. Invidiousness refers to a comparison of individuals on the basis of providing some value or relative worth. Thus, invidious distinctions relate to judgments on the basis of race, gender, wealth, power, tradition, etc.: “[t]hose groups and individuals against whom invidious distinctions is directed are denied options, entitlements, and the full development of their capabilities (for example, access to education, occupation, or income). In consequence, the development of individuals’ creative potential and productive capacities (and their self-worth) are arrested or eroded” (Tool 1993, 122-123). In our view, this holds considerable currency in the evaluation of recent developments in personal bankruptcy legislation.

### ***Applying IVP: Some Observations on Recent Policy Initiatives and Bankruptcy Risks***

Empirical studies, even those for the country where both data as well as such studies are abundantly available (the United States), are inconclusive with regard to the effects of policy reforms on the number of filings for bankruptcy (CBO 2000).<sup>8</sup>

Taking out a loan is “simply behaving in the culturally approved manner,” in a society where “commerce is seen as essential to society” (Waller 2001, 872, 875-6). Criminalizing the debtor in the case of insolvency is, however, still very common in many countries (Efrat 2001; Kilpi 1998), even if the creditor is as much to blame for losses and financial mismanagement. To be sure, the vast majority of credits and loans have been extended *voluntarily* by creditors, usually financial institutions. If both debtors and creditors share responsibility for the (growing) incidence of bankruptcy, and if insolvency is caused mainly by circumstances beyond the control of debtors, in our view the state has a duty to protect its citizens from overly prolonged hardship

and certainly from autarky, and we believe that the IVP provides a sound platform for this argument. Certainly this duty extends beyond the corroded Keynesian welfare state, which offers limited guarantees of a minimum income to meet basic living requirements (certainly in the European model), but does not necessarily reconstitute an individual's autonomy as the personal effects of bankruptcy, such as loss of self-respect and dignity, can persist for a protracted period.

While amendments to bankruptcy laws appear not to have impacted on the goals of reducing the number of bankruptcies, assets involved in bankruptcy, or reducing fraud (CBO 2000; Jungmann, Neimeijer, and ter Voert 2001; Jungmann 2006; Kilpi 1998);<sup>9</sup> individual bankrupts have been affected. Reforms engendering increases in the "price" of bankruptcy have had to ". . . lower the losses associated with defaults," or even to "make the most profitable form of lending in the credit industry even more profitable" (Waller 2001, 875). In our view it takes a broader perspective to furnish a more comprehensive evaluation of changes in bankruptcy law. We suggest that IVP endorses a framework that analyzes the effects of public policy in terms of how bankruptcy risks are addressed by society (Zywicki 2005). Risks may be *reduced*, *shared* (by seeking scale), or are they *shifted* (reallocated) (cf. Moss 1992)? In terms of Figure 1, there is a progressive shift from cell II (United States) or cell IV (Europe) to cell I.<sup>10</sup> This is a movement that would not be countenanced by the IVP.

**Figure 1. Dealing with Risks**

| Risks      |                               | Solved by:  |                                 |
|------------|-------------------------------|---|---------------------------------|
|            |                               | Individual  | Society                         |
| Caused by: | Individual choices & behavior | I - individual responsibility ('you reap what you sow') | II - Solidarity (Sharing risks) |
|            | External circumstances        | III - Individual Solidarity (accept risks)              | IV- Collective Solidarity       |

Adapted from Schmid (2006).

The way in which risks are addressed prompts a critical perspective of existing institutional "furnitures." How a society deals with risks that may befall individuals should be considered by employing an overarching institutionalist IVP frame as opposed to a reductionist rational choice approach. U.S. bankruptcy law could well be regarded as an alternative to the welfare system that is in place in many European countries. Liberal bankruptcy law allows or even causes risks of insolvency to be shared by obliging creditors to accept responsibility, and therefore adopt greater consideration in their practices. However, as European countries continue to pursue neo-liberal policies, the Keynesian welfare state is at best attenuated. These countries do not tend to emulate U.S. Chapter 7 bankruptcy law, which in effect implies a shift of risks from the state to individuals, under the guise of the claim that individuals are to blame for their adverse financial circumstances.

Given the foregoing, the 1978 U.S. Bankruptcy Code (specifying Chapters 7 and 13) is a clear case of risk sharing across both creditors and debtors. Accordingly, this has some appeal within the auspices of the IVP as the propensities for discrimination and vilification are limited. Recent changes in the means-testing rule or changes in (homestead) exemption, included in most (U.S.) bankruptcy laws, such as the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act tend to make filing for bankruptcy less likely and less attractive (cf. Waller 2001). Risk is shifted to the individual, as the Act “presumes abuse” if a debtor earns more than a certain income – filing for Chapter 7 may be inadmissible and converted into Chapter 13. The rule, or the informal routine of limiting bankrupts’ borrowing capabilities (or only at highly unattractive conditions), is intended to reduce risks, but one that may just shift risks. Restricting certain types of credit (such as credit cards<sup>11</sup>), to particular groups of people (such as the prohibition of those deemed to be of high risk or insufficient income; DeJarnatt 1999) would reduce risks too, but may be unpalatable for others reasons, such as discrimination that further entrenches inequality (and also infringes the IVP).

### ***Some Concluding Remarks***

This paper has discussed some recent developments in bankruptcy law. It is a means for society to deal with (bankruptcy) risks, but is equally an arena for moral debate. Bankruptcy law can provide an alternative and a complement to a welfare system (Sullivan et al. 1989), and to some extent reflects a society’s valuation of individuals’ financial responsibilities, obligations and rights within an economy and society partially driven by “conspicuous consumption.” We have discussed the way in which countries have chosen to formulate policies regarding personal bankruptcy from a welfare perspective, arguing that the Chicago tradition, based in utilitarian ethics, does not allow one to make much of an evaluation. IVP offers greater analytical latitude beyond the rationalistic and individualistic properties underpinning contemporary reform. It highlights the need for dialogue, non-invidious distinctions, and education. It is perhaps apposite to consider whether in contemporary capitalism the consumer is adequately equipped to negotiate the perils of bountiful credit opportunities and the accompanying indebtedness.

### ***Notes***

1. In the United States, “no more than 5 percent” of filers could repay all of their debt yet filed for personal bankruptcy (CBO 2000, 24). Moreover, an astounding 15% of the U.S. population could benefit from filing for bankruptcy. Yet only 0.7% of the adult population actually has (CBO 2000, 21). Abuse of the liberal U.S. bankruptcy law thus seems to be limited.
2. Buckley and Brinig (1998) find that economic factors play a marginal role in the decision to file for bankruptcy, instead they highlight social factors such as the strength of filers’ social networks.
3. Among the filers are many small, upstart firms that have no legal title. There is a well-known overly confident feeling among (starting) entrepreneurs about their own chances for success. Entrepreneurs in the United States that own a firm that has no legal title can choose to file under Chapter 11, as any other business, and thus find their personal assets exempted from bankruptcy. The United States may well be more economically dynamic, partly because of its more lenient bankruptcy law.

4. Nonetheless, according to Efrat's (2001) extensive survey, the United States, the UK, and the Netherlands are all in the "liberal camp" of countries with lenient bankruptcy laws.
5. In order to qualify, potential filers must obtain a statement from their municipality relating to the causes of their financial problems. A repayment plan will be announced in a newspaper several times. Trustees can also insist that all personal surface mail directed via them. When creditors discharge a debtor, any remaining debt will remain publicly registered even if it is uncollectible; this will affect the debtor's ability to obtain future loans, leaving her in a state of semi-autarky.
6. Thus, ". . . common law adjudication brings the economic system closer to the results that would be produced by effective competition - a free market operating without significant externality, monopoly, or information problems" (Posner 1983, 4-5).
7. The conception of the commodity is central to both Marx's (1990) and Polanyi's (1944) investigations of capitalism. Marx considered that commodities as entities possess both exchange and use values. The use value of something is only realized in its use or consumption (Marx 1990). The inference here is that the usefulness of something cannot be assessed *ex ante*. Moreover, usefulness cannot be quantified, whereas exchange value can; the former adopts a qualitative property. Exchange value does not reflect the social relationships governing the production or consumption of commodities, and accordingly can only offer a limited explanation of bankruptcy (cf. Tilman 1998).
8. Changing exemption rules, means testing rules, etc., have had negligible effects on the number of personal bankruptcies or amount of money involved in bankruptcy procedures (Sullivan et al. 1989). Both of these are mainly associated with macroeconomic developments or unpredictable changes in personal circumstances (such as illness and unemployment) (Kilpi 1998). What is more, people from all walks of life file for personal bankruptcy equally (CBO 2000; Kilpi 1998; Sullivan et al. 1989).
9. The belief of the claim that fraud is prevalent in bankruptcy cases is unfounded. Even in liberal countries such as Canada and the United States, just over 2% of bankruptcy cases involve fraud (Kilpi 1998). Only a small fraction of people filing might indeed have been able to repay their original debt. Repeat bankruptcy is not a reality (Sullivan et al. 1989).
10. There are costs involved with bankruptcies. What bankruptcy law in effect does is to spread these costs across everybody who takes loans by increased interest premiums or reduced availability of credit in the market. To the extent that not only those taking (new) loans are affected, but indeed everybody in a society shares the costs, the movement has been from Box IV to Box I, rather than from II to I. There is, however, little empirical evidence, at least for the United States about such costs (CBO 2000).
11. Scholars have ascribed higher indebtedness by increasing numbers of households to increased availability of credit cards (Ausubel 1997; Waller 2001; Sullivan et al. 1989). Zywicki (2005, 1496-7) claims that this is due to a substitution from other high-interest kinds of credit into credit card debt, and possibly a sign of a "downward spiral of a defaulting borrower," possibly indicating (malevolent) strategic behavior on the filer's part as such debt is unsecured and will be discharged in bankruptcy.

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