



UNIVERSITÀ DEGLI STUDI DI MACERATA

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Themes in an institutionalist theory of economic policy

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Quaderno di Dipartimento n. 81

Maggio 2016

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Abstract

The paper discusses the ends and scope of economic policy from an evolutionary and institutionalist perspective. I focus on how complexity and different types of coordination characterize the economy we live in. I then discuss how public coordination and change can be conceived of. I point out that the means to adequately deal with economic complexity depend on which social priorities prevail and on how the economy is conceptually framed in relation to those priorities. This requires the combined formulation of moral and cognitive value judgments and the non-separability of economic theory from the ends of economic policy.

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Introduction

The aim of the present paper is to discuss the ends and scope of economic policy from an institutionalist perspective. My point of departure is Wolfram Elsner's (2012) contention that "progressive institutional change remains an issue of proper deliberate, discretionary policy action, as institutionalists have always argued" (*ibid.*, p.33). I elaborate on this claim by focusing on how complexity characterizes the economy we live in. In particular I stress that, given the different types of coordination that exist within the economy, no pattern of economic evolution can be taken for granted. I then discuss how economic coordination and change by a public agency can be conceived of. I point out that, owing to the complex features of the economy, two issues must be jointly discussed. The first one is what ends policy-makers should pursue. This involves the formulation of moral value judgments, concerning what the ends are, thus what change is required. The second one is how policy-makers should frame the economy in order to devise the means to pursue those ends. This involves the formulation of cognitive value judgments, concerning how technical, historical, social and political circumstances determine what can and what cannot change.

The conclusion this discussion leads to is that it is not possible to conceptually separate economic theory from economic policy. Only when we properly identify what the societal priorities are is it possible to provide an outline of an economy's and of a society's evolution, and only when such an outline is available are choices actually possible. Thus, only through the interaction between moral value judgments and cognitive value judgments can we provide a means to adequately deal with economic complexity.

In the next section, I briefly discuss complexity. I distinguish diachronic and synchronic complexity, laying special emphasis on the latter in relation to the systemic openness of the economy. In the subsequent section I examine how coordination occurs in an economic system characterized by these two dimensions of complexity. I take into account relative prices and institutions but also purposive actions that actors take to change the rules of the game to their advantage. Given this multifarious coordination, the evolution of the economy may follow many different paths, which depend on policy choices. The final section of the paper deals with the implications that this framework has for a proper understanding of how economic theory and economic policy relate. Some brief concluding remarks end the paper.

Diachronic and Synchronic Complexity

Complexity is a multi-faceted phenomenon. A detailed discussion of its characteristics lies beyond the scope of this chapter. What I wish to point out is only some of its key features, along with their implications for economic analysis and economic policy.

Simon (1981) described complexity as "many variables interacting in a non-simple way". The non-simple way often depends on changes in the way a variable interacts with others, so that the interaction can never be taken for granted. These changes may result from endogenous processes that lead to the emergence of new variables or new patterns of interaction which are different from the past to the point that they could hardly be predicted beforehand. Intuitively, this is what

seems to precede phenomena such as the oil shocks of the 1970s, the fall of the Berlin Wall, the 9/11 attack on the Twin Towers.

The above examples refer to specific historical events, “black swans” that appear to be unpredictable because of their uniqueness. More common phenomena abound, however, including hyperinflation, core-periphery relations within and among countries, different rates of innovation and growth among industries, and financial instability. In order to deal with these kinds of “non-simple” interaction in the real-world economy, scholars need to appropriately frame the problem. Thus, Elsner (2015: 285) provides a list of properties that usually characterize complex systems. At a strictly microeconomic level they are a) composed of huge numbers of similar entities, with b) simple patterns of interaction among entities in connection with the c) adaptiveness of entities. At a macro level these features lead to 1) limited predictability of future states and limited reconstructability of past states by means other than those involving exact representations of the system; 2) nonergodicity; 3) emergence of structure, patterns and behaviors that are stable but not explicitly and trivially encoded into the systems’ micro-level.

Compared to conventional models, this framework allows a richer view of the economy in that it provides for a variety of possible outcomes that a given group of interacting entities may lead to, with equilibrium being only a very special case. It is flexible enough to accommodate different assumptions on the patterns of interaction, thereby allowing for a range of sub-disciplinary inquiries (e.g. industrial organization, economic policy, etc.) as well as for approaches centered on different views of evolution (institutionalist, Austrian, etc.). It provides an account of why and how institutions emerge through interaction. Although it is not restricted to dynamic systems, it provides conceptual and formal tools to investigate what we may refer to as diachronic complexity.

When we assume that we are dealing with dynamic systems, the usual *coeteris paribus* assumption - i.e. that all other things remain the same - is obviously useful in order to allow tractability but it is even more unrealistic than in conventional economics. In general, the entities of a system, or the system as a whole, may react to external events or even interact with other entities or systems within a higher-order system. This not only suggests that there are higher orders of complexity. It also stresses that a distinctive feature of the real-world economy is what Kapp (1976) referred to as sequential interaction within a cumulative process. It ultimately provides the key elements of a research program centered on evolution.

There is another notion of complexity that I would like to focus on, however, which I will refer to as synchronic complexity. Going back to Simon’s definition, the “non-simple way” that variables interact may depend not only on the number and types of interaction and on the types of adaptiveness of the entities but on systemic openness (Boulding, 1956; Georgescu-Roegen, 1976; Kapp, 1976; Chick, 2004)¹.

An open system is here defined as one that interacts with its surrounding environment in a way that is not knowable. Openness means that we do not know the actual boundaries of the system. Since everything is, in some way or other, connected to everything else, we are bound to assign a boundary to something we wish to investigate and, to this end, we may resort to heuristics. Whatever boundaries we choose to delimit the subject of our inquiry, however, is based on a

¹ I do not consider, here, non-dynamic types of complexity, such as fractals, that are not specifically associated to systemic openness.

discretionary decision. This means that there may always be something we do not take into account that may be relevant.

Note that this has nothing to do with the above mentioned removal of the *coeteris paribus* assumption. What is at issue is neither that there may be external shocks nor that a system may be part of a higher order one. The issue is that, depending on the non-simple way that social variables interact at every point in time - gender relations, industrial relations or the more or less extended nature of the family, just to mention a few examples – they may affect the economic system in a variety of ways. This is what makes it so difficult to draw a clear-cut distinction between economic and non-economic welfare. Moral sentiments (Smith, 2005) affect the quality of life by regulating procurement in one way or other. The clash that sometimes occurs between an individual's preferences and her values (Hirschman, 1984) suggests that the way ethics impinges on economic conduct is far from clear. At a macro level, when people react to the inconsistency between profitability and serviceability (Veblen, 1919), how this occurs depends on how effective ideologies, myths and ethical values are (Dugger, 2000) in justifying or, obversely, in denouncing the negative effects that contracted exchange has on society and social cohesion (Polanyi, 1944).

The boundary problem is accentuated by changes that may occur over time: What is irrelevant now may become relevant at some time in the future. Openness may depend on changes determined by the very processes that underlie diachronic complexity. Consider how the expanded use of petroleum as a key energy input for transport, for electricity and for heating, eventually changed the extension of these markets around the world, thus the type of interaction within and among them. Changes such as these affect relative prices but also the balance of power within society. A new industry such as the oil industry leads to the insurgence of vested interests in the exporting as well as in the importing countries. It is likely to affect the political regimes of the countries involved, either by empowering those vested interests within those countries or subjecting those countries to the economic and political will of foreign vested interests. These changes feed back on the cultural and religious values of the populations, sometimes determining radical changes in the polity, in international relations, in the balance between both domestic and international power groups. As we look at these historical processes, we are obliged to acknowledge that they affect the economic performance of the oil market, of a great many other markets, of trends in growth and in income distribution, etc.

These examples suggest that variables that are of minor relevance at some point in time may subsequently become more relevant. Thus, although the distinction between synchronic and diachronic complexity is useful on conceptual grounds the two types of complexity often are interdependent in the real world.

This brief outline of the key features of complexity raises the issue whether, and to what extent, there is a way to coordinate such a complex environment, possibly attaining order out of chaos. This is the topic of the next section.

Variety in Coordination

Relative prices associated to contracted exchange are generally considered the typical coordinating instance in a capitalist market economy. This claim needs to be qualified, however. It is fairly easy to acknowledge that the economies we live in are indeed coordinated by prices but also by a range of institutions. The role that institutions play remains an open issue among economists, however. New Institutionalists such as Coase (1937; 1960) and Williamson (1975;

1993a; 1993b; 2000) point out that the market operates in a relatively costly fashion, whereby it is possible to devise institutions that reduce those costs. Institutions therefore may allow a relatively more efficient allocation of resources, where efficiency is cost-effectiveness.

“Efficiency” as cost-effectiveness should not be confused with overall (Paretian) allocative efficiency. Cost-effectiveness only means that a single actor can reduce her costs. For instance, firm A may cut its transaction costs by taking over a company – firm B - that carries out R&D and sells it on the market. While this is convenient for firm A, it restricts the very scope of the market. The resulting firm (A + B) will avoid disclosing what presumably provides it with a competitive advantage. Furthermore, following the takeover, firm (A + B) may have less incentive to innovate since it can outcompete other firms through lower transaction costs, without any need to focus entirely on a nevertheless risky qualitative upgrading of its products and/or production processes. It may remain competitive, but in the context of a “low road” to development (Sengenberger, 1992; Milberg, 2005).

The above considerations apply even if we accept the (mostly implicit and rather unrealistic) assumption that markets are impersonal. Economic actors, however, do not merely react to prices. They purposively interact - through rivalry, cooperation, imitation, predation – in order to change not only prices but the bargaining power between firms and workers as well as among firms within the production chain. As a result they preclude the ideal competitive environment where relative prices ought to carry out their coordinating function. Indeed, the firms who act this way affect the decisions of other actors, so that they exert a coordinating action which cannot be separated from other transactions-centered relations. This effect is, generally, greater as their size increases.

An important implication is that markets are not independent of the action of the firms. They may well operate as selection mechanisms but the nature of such a selection depends on the action of those very firms that should be selected (Ramazzotti, 2002). Markets do not provide an independent terms of reference to assess whether what firms do is efficient or not for the economy as a whole. Both the distinction between the market and institutions and the distinction between efficiency-centered and strategizing behavior turn out to be impracticable, under these circumstances.

While the Coase-Williamson tradition focuses on institutions that make up for the inefficiency of the market, North (1990; 2005) focuses on extra-economic institutions such as, for instance, religion. It is these institutions that, in his view, may be a major cause of inefficiency in terms of low rates of growth. The reason is that they may provide behavioral rules that preclude maximizing behavior. Since these institutions are strongly related to beliefs, changing them is not an easy task.

Both of these New Institutional accounts of the role of institutions assume that the market is the logical point of departure for any inquiry. Institutions may increase or reduce its efficiency and this is how their economic relevance is assessed. An alternative strand of thought, centered on Original Institutional Economics, but which can be traced back to Adam Smith and his theory of moral sentiments, denies this centrality of the market. It argues that, historically, not all types of economy have been coordinated through contracted exchange and the relative prices that it leads to. Quite to the contrary, since all economies are a sub-system of society, they are all regulated in one way or another. They all need some kind of institutional setup to coordinate activities, with or without the concurrent action of relative prices (Polanyi, 1957).

Following this perspective, let us consider the economy we live in. No price system may exist unless it is backed up by a set of rules that allow it to function. More specifically, all sets of relative prices depend on some legal-economic nexus (Commons, 1924; Schmid, 1987; Bromley, 1989; Samuels, 1994; Samuels, 1997). Property rights need to be assigned, appropriate behavior – hence, also misbehavior – among actors must be defined, possible sanctions must also be identified, and some organization has to inflict those sanctions. Furthermore, the very extension of coordination by relative prices has to be decided. For instance, human beings as well as parts of their bodies may or may not be subject to contracted exchange.

The above institutions require some ethical system to exist, i.e. criteria that determine how they are to regulate (economic) activity. For instance, the assignment of property rights may be based on efficiency criteria – however defined – but also on distributional equity, or historical accident, war, force and fraud. The extension of the price mechanism may depend on the importance assigned to alternative criteria in the production and distribution of resources, as in the case of the welfare state. The organization of production may depend on what is most profitable but other criteria may hold: Consider the protection of social rights as they appear in a range of important charters such as the Universal Declaration of Human Rights (1948).

There would seem to be a common ground for discussion between those New Institutional scholar who, like North, emphasize the importance of beliefs – and, more generally, mental models (Denzau, 1994; North, 2005) – and Original Institutional scholar who stress the relevance of ethics. Indeed, these appear to be different ways to look at the same phenomenon (Dequech, 2002). What beliefs, ethics and institutions in general imply for the functioning of the market should be clearly stated, however. They determine rights for someone, thus duties for someone else (Commons, 1990). They determine the choice sets of economic actors, thus what they can do and what they cannot do. Precisely because they determine “who may do what to whom” (Bromley, 1989, p. 49), they are a pre-requisite for the market, thereby undermining the latter’s presumed centrality. Truly, a given institutional set-up may deter economic growth. But the contention that this is tantamount to inefficiency reflects an implicit assumption: that growth is more important than the institutions that “constrain” the market. While the value judgment underlying this assumption is legitimate, it is no more so than the value judgments underlying the establishment of the “growth-deterring” institutional setup. It is indeed a consequence of the systemic openness of the economy that such a clash in value judgments may occur.

Systemic openness implies that the economy does not just reflect the institutional setup determined by society. It also feeds back, thereby affecting society and how it changes over time. The output produced, the techniques used, the labor relations established: These and other circumstances affect the organization of society, how it functions and how it pursues both its economic and not economic ends. Thus, how people work – the number of hours, the stress, the safety conditions – as well as the income they receive, affects how they live in general, how they take part in other dimensions of their societal life, how they understand the world that surrounds them and that they are a part of (Scott, 1995; Dequech, 2014)². This understanding, in turn, feeds back on how people deal with that world, i.e. the extent to which they (intend to) accept it as it is

² Needless to say, advertisements are another important example in that they do not merely inform but exert their power of suggestion, they act upon the perception that people have of (sections of) reality and, consequently, the interpretations and explanations they subsequently elaborate.

or, alternatively, attempt to change part or all of it. Ultimately, it affects the way they contribute to the formation of the institutions that guide their lives (Hodgson, 2002).

This leads us to the conclusion that the beliefs people have, their understanding of the world they live in and the ethics that derives from this understanding affect the institutional setup that underlies the economy. Knowledge in this broad sense is as much a coordinating instance as the ones mentioned above. It is not independent of them, however, since the economy affects how people behave, what they choose and how they learn.

The above discussion stresses that coordination in the economy we live in involves markets, institutions and knowledge. This is generally consistent with the so-called micro-meso-macro framework, whereby “we define micro as the level of individual agents and their interactions. As soon as some ‘structure’ (institution) has emerged that exists independently from individual agents, we understand this to belong to the meso level if a ‘meso’-sized ‘carrier group’ has been co-evolving with that structure. A meso-sized group, in turn, is defined in our model as any group of a size smaller than the whole population involved. The latter, finally, may be considered then to reflect the macro level, mirroring the real-world ‘national’ level mentioned (considered as the space of more formal institutions and agency).” (Elsner, 2010, p. 449). The distinction between these three levels may be useful from a heuristic point of view. It has also been used to provide an account of coordination that would support a *general* theory of economic evolution (Dopfer, 2009). It is therefore important to assess whether and how the framework actually provides insights on coordination.

Let us focus on the micro level. Two apparently opposite features have to be pointed out. The first one is that, in so far as economic actors pursue their specific goals, they are likely not to appreciate what happens at the macro level. A typical example is the paradox of thrift whereby, if individuals attempt to increase their savings, the aggregate outcome is a fall in output but no change in overall saving. This unawareness of the consequences of one’s individual action accounts for the independent status of the micro level. It also justifies the existence of an agency that operates at the aggregate level.

The second feature is that economic actors may well be aware of potentially undesired outcomes. They may consequently act in order to avoid them. They may act in two distinct ways. The first one is to adapt to circumstances in order to achieve a better outcome. This is what underlies a lot of game theory. As Loasby (1991, p. 44) points out, however, “Nash equilibria constrain each individual as tightly as perfect competition, and have the advantage that the discovery of such equilibria apparently requires neither an auctioneer nor any transactions which might disturb the outcome, but simply individual ratiocination. All actions are therefore equilibrium actions, as a rigorous insistence on optimization demands. However, each Nash equilibrium requires all players to be smart enough to work out the implications of the rules of the game, but not smart enough to recognize the potential advantages of varying them. They are only boundedly rational after all.” The second type of conduct, therefore, is to proactively change those very circumstances, that is, to vary the rules of the game.

In terms of the micro-meso-macro framework, economic actors may not only abide by the existing rules of the game and, through interaction, generate new rules. They may also purposively act on the trajectories that allow a rule to spread out in the economy. A meso level – where such trajectories occur – must obviously exist but the rules that will eventually prevail and play a significant role at the macro level will not necessarily result from an unintentional diffusion. Single

actors may play a coordinating role that interferes and downplays the impersonal one that independent actors would allow for.

Independently of how they behave as economic actors, individuals are not only that. Because of systemic openness, they can hardly be reduced to that feature. As mentioned above, they are able to transcend their conventional economic goals when it comes to assessing their quality of life and the quality of life of the people around them. For instance, although, based on their specific economic activity, they may be unable to understand the causes of such appalling circumstances as unemployment or poverty, they may nonetheless feel that something is going wrong and think about how to fix the situation. They may therefore act as citizens – as opposed to single economic actors – so that a public agency may take appropriate measures. Little matters that the measures they ask for may be successful or not. What is relevant is that individuals may broaden the scope for institutions: The meso need not be conventionally economic.

Since the set of institutions that emerge at the meso level may or may not fit together, the macro level should ensure an adjustment process. Economic activity cannot be isolated from the rest of human concerns, however, so institutions have to do with many, if not all, of such concerns. There is no a priori reason to believe that they will eventually fit together. The typical Hayekian contention that markets self-organize is of little use here, not only because self-organization cannot be taken for granted but, above all, because markets are intermingled with a great many other societal variables.

These features allow us to look at the macro level as the outcome of a range of actions that often are proactive, may be strategic and are not necessarily restricted to conventional economic variables. Consequently, coordination cannot be restricted to the economy – not to mention the market. It has to do with whatever individuals deem so relevant that it affects their actions. Furthermore, it occurs not only in a bottom-up fashion – from the micro to the meso and, finally to the macro – but also the other way round, in a top-down fashion.

Summing up, there are various coordinating instances that act upon the economy and the society it is a part of. To some extent, this accounts for the complexity described in the first section of this paper. On the other hand, owing to some balance of power or temporary convergence of interests, some dominant institutions may emerge and ensure an order out of what would otherwise be total chaos. This may account for the persistence of the institutional setup that is generally labeled “capitalism” as well as for the persistence, within capitalism, of periods of relative stability. A full picture, however, requires us to look at the last coordinating instance: government action.

Given the above discussion on complexity and coordination, two issues should be pointed out. First, just as economic actors try to influence the way they are supposed to interact, so may a government. The second issue is that, whatever the ends government action pursues, policy-makers must somehow make sense of a complex environment. These issues are discussed in the section that follows.

Public action

The discussion of complexity and of coordination leads to the conclusion that there is no general law that we can rely on when we try to describe the economy and the society we live in. The attempt to somehow regulate or direct the evolution of the economy is just as problematic. This does not mean that the conclusions lead us nowhere, however. It simply tells us that no mechanistic description or policy is available (Sotolongo, 2004).

One key point that arises from the discussion is that coordination occurs in at least three distinct, but interactive, ways: through prices; through institutions; through the proactive and strategic action of single actors. Institutions and the structure of knowledge consist in enabling constraints for economic actors. They provide for some stability in the economy because they usually tend to change slowly. The conditions they determine allow actors to choose according to relative prices. It is precisely because of their enabling and constraining function, however, that actors often try to change them: The evolution of financial markets in the USA over the past decades is a case in point (Varoufakis, 2011). Coordination is a contested process: Different economic actors try to direct the economy in one way or other. They do so within an institutional setup that reflects but also feeds back on that interaction.

Can a policy-maker act in a consistent way upon this complex reality? Can she make sense of economic change? Doubtless, the issues discussed above provide tools for the economist's toolbox but they do not provide an explanation. Indeed, if the term "explanation" refers to a fairly accurate description of the economy and of how it evolves, a range of problems arise.

The systemic openness of the economy raises a key issue. How should the economy be circumscribed? What does it consist of? Is it the market as it is described by standard microeconomics textbooks? Is it the market plus government agencies and, perhaps, nonprofit organizations? Does it include unions, lobbies, political parties, religious organizations? Openness implies that we cannot trace a once and for all boundary. It also suggests that when we do trace a boundary – possibly because we choose to focus on a specific issue - we are not only leaving some variables out of our inquiry; we are assuming away possible interactions between what we include and what we leave out. Only to some extent can we rely on a subsequent extension of our model and inquiry. As the boundaries change, the nature of the interactions – not just their extension – may change as well. Complexity hardly allows for reductionist practices that merely add up the results of distinct inquiries.

Given their different concerns and their bounded rationality (Simon, 1976), economic actors are likely to formulate different assumptions with regard to the boundaries of the economy. Thus, in order to plan its business activities, a local construction company may focus on information concerning local income growth and on what building areas will be made available by local authorities. A local importer of foreign cars and a multinational company are likely to be less concerned about how those authorities manage the local territory than about changes in the exchange rate, thus about monetary policy. All these companies, however, share a common goal: making money. There are different ways to go about doing this but the goal is fairly clear.

Individuals may want to make money just like any economic actor but, unlike business, they may pursue other goals as well. As we mentioned above, the quality of life may involve more than money. Given these premises, their notion of the economy is less straightforward than that of businesses.

Policy-makers try to make sense of reality in much the same way as individuals. They must decide what their policy goals are. They must subsequently understand how to achieve them. As far as the first issue is concerned, systemic openness suggests that no once and for all distinction is possible between economic and non-economic ends and that there is no reason to give precedence to conventionally economic ones. There is a broad range of policy perspectives that governments can choose from. Which one they do choose depends on the ultimate end that they pursue. Examples of such ends include Sen's (1999) development as freedom, Layard's (2005) and Kahneman's (1997; 1999) notion of happiness, the forceful establishment of the institutions

required for a neoliberal market (Foucault, 2004; Brown, 2005; Ramazzotti, 2014a) or the straightforward protection of some vested interest. Choosing among these and other options obviously involves moral value judgments: deciding how the economy and society should be, i.e. what values should be assigned a priority.

Given an end, how can policy-makers choose the appropriate policy? In order to deal with this question it is necessary to qualify the economy they are referring to. The issue is not only that, given systemic openness, everything is connected to everything else. The issue is that it is necessary to decide what is deemed constant and what is deemed subject to change. Consider, for instance, a Prisoners' Dilemma. The decision to identify and pursue the appropriate way to achieve a Pareto optimal outcome sounds reasonable. It implicitly assumes, however, that the payoffs are given. In broader terms, here, just as in any case where the goal is a Pareto improvement, the extant distribution (usually, the endowments) is taken as given. This is a legitimate value judgment but nothing else. One might just as well consider the possibility of changing the existing distribution.

A decision such as this one – whether distributional conditions are potentially subject to change – actually involves two different interconnected value judgments. The first one is whether such an action is feasible, i.e. whether there are institutional, political or other circumstances that preclude such a change, at least in the time interval that is relevant for the policy-maker. The second one is up to what point policy should attempt to change a given situation. Since it is generally the case that someone benefits from a policy but someone else is damaged, when is this policy deemed appropriate?

Although the two value judgments are linked, the first one relates to how the economy is understood to be structured and to function whereas the second one has to do with how costs should be shared within society. The first one is a cognitive value judgment whereas the second one is a moral value judgment.

The two steps outlined here – identifying a goal and circumscribing the economy – are not the end of the story. Once the economy is properly depicted, only a proper inquiry will provide an understanding of whether and how the goal may actually be achieved. In turn, the resulting knowledge may lead to a reassessment of the goal, thus to a reassessment of the boundaries of the economy, and so on in an iterative process.

There is more to the value judgments discussed so far. Leaving aside the restrictive case of Pareto optimality, consider a policy – e.g. the introduction of a new technology - that is expected to make everybody better off, independently of any ceremonial valuation. The problem is how this specific end in view – making people better off – relates to the ultimate ends outlined above. If the new technology increases the income available to everybody but reinforces an undesirable division of labor among genders or among social classes, should it be valued positively in instrumental terms? The answer cannot be given a priori. It involves answering a question concerning the possibility to actually change – possibly with some alternative policy – the existing division of labor. We are back to the combination of moral and cognitive value judgments.

The objection that the answer depends on what people want, thus in deliberative democracy, is not a convincing one. As Sen (1999) argues with his example of the Indian woman – who is unaware that her subordinate position in the family and in society precludes her from living a better life – people may well internalize the values underlying the organization of the economy and of society. What is at issue is that any instrumental valuation reflects the *status quo*. More specifically, as Samuels (1977: 882) argues, “‘Efficiency’ is a function of power and the valuational

process (governing whose interests count) which operates through the power structure.”. Thus, no instrumental valuation is possible unless one clearly distinguishes what can and should change from what cannot and/or should not.

On more methodological grounds, what I am suggesting is that, while it is reasonable to conceive of models that focus on specific aspects of reality and deal with them according to whatever tools the scholar deems appropriate, the true issue is how and where to identify and circumscribe them. Conventional economic analysis conceives of the economy as a closed system. It starts out with a set of axioms and elaborates on them by deducing economic laws and applying them to general and special cases. The complexity discussed so far, however, suggests that you cannot proceed this way. An alternative approach, therefore, consists in formulating a discretionary judgment concerning what is relevant, quite independently of axioms³.

Relevance, here has two interdependent dimensions. The first one is that the questions underlying the inquiry should be made explicit⁴. They include the ultimate end pursued which, when we focus on a policy perspective, inevitably involves a moral value judgment. The second one is that the categories used and the theory they lead to must be grounded in a methodologically rigorous procedure. By this I mean that it must be possible to understand the assumptions – as well as the arguments - underlying the inquiry⁵. This involves another type of value judgment – a cognitive value judgment - which has to do with the general idea one has of how the economy is and of how it should be investigated⁶.

Although complexity hardly allows for clear-cut economic laws, the above approach does allow the tools in the economist’s toolbox to grow and to provide insights. These insights may not lead to a full-fledged theory but they may reduce the degree of uncertainty that any policy decision involves.

I already pointed out that, contrary to conventional views, policy is not constrained by relative prices alone. It is constrained by the institutional setup, which determines how transactions occur and how relative prices are determined. It is also constrained by the conduct of other actors and by the patterns of change this conduct may determine. Policy has to cope with actors who contrast any measure that clashes with their, actual and potential, vested interests as well as with their views of what is appropriate. From this perspective, policy cannot be envisaged as a set of fixed institutions and incentives that allow the market to operate successfully, thereby making economic actors behave in a desired fashion. Rather, it is a continuous process where vested interests try to contrast public action, thereby forcing government to counter-react, only to be followed by a new reaction, etc.. Public action obviously involves recourse to the economist’s tool box, with a clear understanding of the cognitive value judgments that underlie it. It also involves an ongoing interaction with other actors since, as Stanfield (2009, p. 11) points out, “[w]hile it is true that any regulatory scheme tends to bring forth efforts to evade control, this only means that regulation must be continuously reformed not that it must be abandoned.”.

The denial of a mechanistic account of how the economy works suggests that, as a general rule, policy cannot consist in switching a structural model of the economy into its inverse reduced form.

³ A more detailed discussion of these themes is in Dow (1996, 2008).

⁴ This a key theme in Myrdal (1978, 1998²).

⁵ This issue is at the origin of Delorme’s (2010) discussion of deep complexity and how it can be anchored.

⁶ A more detailed discussion of moral and cognitive value judgments is in Ramazzotti (2014b).

This difficulty arises because any (structural) model is not only an approximation in the sense that it abstracts from trivial issues, i.e. issues that are not important for a correct understanding of a core issue. It is an approximation because – owing to complexity - it cannot definitely distinguish core issues from trivial ones⁷. This approximation can be improved upon but it cannot be overcome. The gap between a model and reality is not filled with more information. It requires greater understanding. Contrary to what is likely to occur in a closed system, uncertainty does not necessarily fall as you increase the available information. Uncertainty may increase because the new information suggests that aspects of the core issue were not taken account of. The decisions concerning the boundaries, the heuristics and the time devoted to the inquiry may prove to be inappropriate, thereby undermining the previous understanding.

Concluding remarks

Contrary to the impression that one might get from a cursory look at the previous sections, the aim of the paper is not to argue that any policy is doomed to failure because of the absence of appropriate terms of reference such as a clear-cut theory of how the economy is coordinated. It is that policy-makers should free themselves of the bounds that a simplistic view of the economy suggests. By simplistic view I refer to the belief that there is an automatism that coordinates the conduct of economic actors. The complexity of the economy depends on the co-existence of diverse, and sometimes inconsistent, coordinating instances. This results in economic and social outcomes that most often reflect the predominant role of sectional - vested – interests. It also results in a difficulty – for all actors - to single out a pattern of behavior and performance of the economy, i.e. to formulate reliable expectations about the future.

The policy implications are that the pursuit of some sort of social welfare implies dealing with the strategies of the sectional interests as well as reducing the degree of uncertainty in the economy. The actual policies, however, cannot be devised in the conventional way, which consists in taking a model from political economy and identifying the appropriate objective and instrumental variables. The reason for this is that an important gap exists between any model and historical reality.

To some extent this is consistent with David Colander's (2014) claim that "policy search requires a practical sense of real-world institutions, a comprehensive knowledge of past literature, familiarity with history, and a well-tuned sense of nuance." (*ibid.*, p. 489). My point, however, is that, economic knowledge depends on the questions we ask and on the assumptions we make concerning what is given and what can be changed. Policy-makers cannot simply add extra-economic knowledge to (neutral) economic models.

In a general context of uncertainty policy-makers must formulate a decision concerning what societal problems should be addressed. This involves asking whether a change is possible that solves those problems. In turn, this leads to the use of the economist's toolbox in order to frame the problems in an account of how the economy is working. The resulting account of the economy allows the policy-maker to assess the original problems in the light of what appears to be possible. The assessment is the starting point for a recursive process which eventually will allow the policy-maker to formulate an educated guess over what to do.

⁷ Following Musgrave's (1981) taxonomy, it is not possible to properly distinguish between "domain" and "heuristic" assumptions.

Complexity involves that the economic and extra-economic dimensions cannot be conceptually separated. Consequently, the scope of economic knowledge cannot be defined *a priori*. It is the result of a sequential interaction between the identification of the ends to be pursued and an appropriate understanding of what issues, boundaries, variables and forms of interaction are relevant to those ends.

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