48 pieces on economics (old and new) updated 16-11-2020

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Introduction

Here I give a series of critical discussions of economics. It includes a review of different approaches and schools of thought in economics. It is based on my own experience with research on topics that do not sit easily in the body of mainstream economics, such as innovation, collaboration, and trust. And I make extensive use of the philosophical reflections in this philosophy blog. Related disciplines are sociology, (social) psychology, political science, philosophy, law, history, and cognitive neuroscience.

The context for the series is an ongoing debate in which I am involved, concerning a transformation of economics, among others a project for changing the economics curriculum in secondary education in the Netherlands, run by professor Lans Bovenberg at Tilburg University.

The motivation for the series is a growing protest against economic science, after the financial crises since 2008. It emerges in the 'Occupy' movement, in a protest against 'autistic economics', e.g. in France, a movement of 'rethinking economics' among young Dutch economists, to name a few movements. Even more or less orthodox economists are becoming open to criticism that a few years back they would have ignored.

There is an important economic aspect, concerning globalization and free trade, and an ideological aspect, concerning neo-liberalism, in the present populist revolt, on the political left (Bernie Sanders, Jeremy Corbyn) as well as on the right (Le Pen, Trump).

In the course of the series, the following questions stand out. What economics are we talking about. What is the core of it. What would need to be changed. Could that be done within economics, or would economics then fall apart. Would a new social science of relationships, in markets and society more widely, be needed. What would the core of that be?

A fundamental issue in all this is as follows. A consensus among many economists would be that economics is aimed at optimal allocation of scarce resources, given preferences. For that it is oriented at rational choice, calculating an optimum, and at a utility ethics. The point now is that in much criticism of economics and markets there is a plea to move from transactions to relations, and relations are most of all processes, which are mostly uncertain to the point that no optimum can be calculated. Can economics cope with that?

This relates to the issue of emergence, discussed in the preceding items in this blog. Certain phenomena within economics, such as innovation, are not subject to intelligent design, but are emergent processes. So are relationships. This relates to the other fundamental issue, of uncertainty, in the emergence rather than prior presence of preferences and resources, that precludes optimization on the basis of probabilities.

The step to relationships brings in the old theme from philosophy of the relationship between 'self and other', raising issues of altruism and free will., discussed earlier in this blog.

A second fundamental issue is one of ethics. Oriented towards optimal outcomes, economics is based on a utility ethic that looks only at outcomes, not intentions or processes. Therefore I have been pleading, as discussed in preceding items of this blog, for a step towards a virtue ethics.

Among other things, I will indicate different schools of thought in economics, the 'core' of mainstream economic theory, in the form of explanatory and methodological principles, objections to it, and possible alternatives, and their implications.

However, iconoclastic as this endeavour may seem, I will retain may notions from economics, beyond those fundamental explanatory principles, in the 'nuts and bolts of analysis' that remain useful.

387. The programme of economics   published 8-9-2018

As in other sciences, in economics there are diverse schools of thought: neo-classical, which is the mainstream, evolutionary, institutional and post-Keynesian economics. Here, I give an introductory survey. In subsequent items, I will discuss things in more detail. First, I focus on the mainstream.

How does one represent a school of thought? Imre Lakatos[i] proposed the notion of a *research programme*. That has a 'core' of fundamental principles, assumptions and directions for research, which must be protected from falsification at all costs, by means of a 'protective belt' of subsidiary assumptions that supplement or implement the core principles. When something comes up that falsifies the whole, it is attributed to the subsidiary assumptions, and a replacement is sought there to make the core work better.

Isn't such tenacity to a core unscientific? There is an argument for it. If something has performed well you will not give it up at the first sign of imperfection. That is an economic argument, but also an epistemological one. All theory is abstraction, imperfect and incomplete. It is by sticking to a programme, and milking it for all it is worth, that one discovers where its real limits lie, and finds indications for improvement. It does constitute a form of conservatism, but if someone is dissatisfied, he can start a new, competing programme. And that is again an economic argument: the argument for competition. As I proposed in this blog: imperfection on the move.

This conservatism can derail into dogmatism, and that happened to mainstream economics. One reason for it is that unlike natural sciences, the falsifiability of economics is dubious. I will discuss that in another item.

There are two dominant characterizations of economics: optimal allocation of scarce resources, and exchange (through markets). In mainstream economics, the core assumptions are: rational choice by autonomous agents, in the calculation of optimal choice, and the operation of markets that yields equilibrium between supply and demand. The protective belt gives subsidiary assumptions of legal conditions (e.g of ownership), technology of production, infrastructure, the role and availability of information, etc.

Research seeks 'forbidden events' (falsifications), to repair and improve the subsidiary assumptions. The process entails what Thomas Kuhn called 'normal science', solving puzzles within the programme, such as, in economics, finding yet another, more sophisticated 'production function' to model production technology.

Game theory brought a major transformation, as a tool to model strategic interaction between agents, with the central notion of a Nash Equilibrium: an outcome of interaction that is stable, in that every player wants to maintain its present strategy, as the best in view of the strategies adopted by the others. It is a useful device, but the basic principle of optimal choice remained the guiding principle. It is assumed that the set of strategies players can chose from, as well as the 'pay-offs' of combinations of the strategies of players, are given.

A later, more fundamental change, towards 'behavioural economics' allowed a relaxation of the principle of optimal rational choice, in allowing for decision heuristics from social psychology that are not substantively rational, not yielding optimal outcomes, though they may be rational in the face of conditions. A methodological advantage was that experiments could be made in laboratory settings, often with students of the researcher. However, it sits somewhat uneasily in the research programme of mainstream economics, as a more or less separate appendage. In a collaboration in this between economists and applied psychologists, a complaint of the latter is that the former cannot desist from forcing the heuristics back into optimal choice.

In economics, a distinction is made between risk and uncertainty. With risk one knows what can happen, and one can then append probabilities to calculate optimal choice, such as the one with highest expected outcome (outcomes multiplied by their probabilities). Under uncertainty, by contrast, one does not know all that can happen: that is not given prior to choice but emerges after choice, in action.

There, economists stand empty-handed, cannot ply their trade of calculation, so they ignore or neglect uncertainty. However, in innovation and relations uncertainty is routine. Radical innovation is uncertain, and the most fruitful relations are the most uncertain: they yield the surprise of novelty that goes beyond present insights. One engages most fruitfully with others who bring in things one could not before have imagined. One does not know in advance even of oneself how one will respond to unforeseeable events. There, also game theory falls short. In technical terms: there is no longer a matrix of strategies of agents and the values of outcomes of their combinations, because those mostly emerge during strategic interaction.

Here, economics short-changes itself. If the most valuable relations are the most uncertain, incalculable in advance, then shying away from them for that reason foregoes opportunities for value, which is an uneconomic thing to do.

An exception is Keynes, who recognized uncertainty and used it to explain herd effects in the economy that produce booms and busts: if one cannot calculate optimal choice, then it is reasonable to follow choices others are making, especially others who claim that they know what they are doing, even if they don't. Keynesian economics has not replaced the mainstream, but it remains as a minority stream, in post-Keynesian economics.

Mainstream economics is focused on optimal outcomes, not on processes that may or may not yield those outcomes. Evolutionary economics recognizes uncertainty and models economics as an evolutionary process of more or less random initiatives, selected by markets and institutions, and transmission of what survives.

Institutional economics recognizes that markets do not work automatically and require institutions to function, and, more fundamentally, deviates from the assumption of autonomous individuals, recognizing that they develop their knowledge and their preferences in interaction with their environment.

388. A methodological sleight of hand published 15-9-2018

Mainstream economics is based on the following three basic assumptions: economic agents are autonomous, have given preferences, and make rational, optimal choices between alternative ways of spending scarce resources.

This is not an ontological claim: good economists readily admit that these agents do not exist. In fact agents are limitedly rational, and routinely do not make optimal choices. The assumption is fictional, according to a methodology of *instrumentalism*: they serve as instruments for parsimonious, rigorous deduction of explanations of phenomena. It saves the enormous, complicated effort of explaining processes of decision making of individuals, which is the field of psychology, between individuals, which is the field of sociology.

Instrumentalism is not nonsense. In seeing the world one cannot see everything at the same time. Every view is conditioned, enabled and at the same time constrained by a perspective, a way of looking. The justification of counter-factual assumptions 'as if' is that they should lead to predictions that can be tested empirically.

The scientific scandal of economics is that this can hardly be done. The reason is twofold. First, predictions affect the choices that produce outcomes, and this can be self-fulfilling or self-defeating.

Second, in an economy there is little opportunity for controlled experiments, where one controls the factors that affect outcomes, next to the factors adduced from the theory. Society cannot be handled as a laboratory. As a result, predictions turn into retrodictions, tested after the fact, in retrospect, on the basis of statistics, in econometrics, where control of other factors, not part of the theory, is exercised with data on them. Great ingenuity has been exercised to develop ever more sophisticated tools for this. However, there still is the problem concerning the *ceteris paribus* assumption that factors other than those included in the process 'remain the same', as well as the causal structure, the logic of explanation.

Also, many relevant variables have not been and sometimes cannot be measured. Measurement being methodologically sacrosanct, research proceeds with what can be measured. This yields the cliché of the joke of the drunk man leaning against the lamppost at night: 'Why are you standing there, at the lamppost?' 'I am looking for my car keys'. 'Did you lose them here?' 'No, but this is where the light is'.

A deeper problem, discussed in the philosophy of science, is that facts are 'theory laden': the terms and conditions of observation and measurement are formed according to the forms of understanding: the basic, often tacit, taken for granted, assumptions and meanings, of the theory. That, however, is a problem for all sciences.

Next, and here lies the scandal, economists conduct a methodological sleight of hand. They begin with the admission that their assumptions are not realistic, they cannot perform strong empirical testing, and then, as if the assumptions have nevertheless been proven justified, they deduce recommendations of policies from them as if they are scientific.

For that they employ the following, impressive, strong logic, as the core of economics. Going back to Adam Smith, the idea is that of the *invisible hand* of the market. Each consumer seeks to satisfy its own preferences, this creates demand for products, and when supply cannot cover it, prices rise, which draws producers to that product, until supply and demand are in equilibrium, and thereby scarce resources are directed automatically to where they have the most utility, in satisfying demand.

This is so appealing that, regardless of any lack of empirical tests, policy is invariably slanted in favour of the market. And so the market expands in all directions.

Another rationale that has been used for the instrumental assumption of rational agents making optimal choices is illustrated by the following metaphor. From Chicago (the crucible of market economics), cars randomly move out in all directions. There are gasoline stations only along a few of the roads. After a large number of kilometres there are cars moving only along the roads with gas stations. It is as if those drivers rationally chose the roads with gas stations.

The idea is that since markets select out inefficient firms, we observe only efficient outcomes, as if the agents made the optimal choices, so that is how we can proceed, explain phenomena as if choices were optimal.

The response to this has been[ii] that if the argument is in fact one of selection, as in evolution, one should conduct the study in that way: model markets as eco-systems. This gave rise to the birth of *evolutionary economics*. One should see, and model, how efficient markets are in fact, in selecting out suboptimal choices.

However, that becomes complicated, since it requires the modelling of a process, which depends on many subsidiary assumptions, and thereby economics loses its crystalline clarity and rigour that is its pride, the pride of a myth of equilibria of outcomes without an account of how they may or may not be achieved.

389. Locality and flexibility published 15-9-2018

In mainstream economics, next to the assumptions of rationality and autonomy of the individual, the focus on optimal outcomes, and the neglect of uncertainty, a further problem is the assumption that local roots of people and communities hinder the flexibility that optimal allocation of resources requires. That is related to the assumption that the individual is autonomous.

The human being derives its identity from interaction, and that works best in local contacts of some duration. Some time is needed to get to know each other, cross cognitive distance, and to build trust and shared conventions, taken for granted habits and orientations. Human beings require a certain amount of community.

I don’t want to idealize such communities. The sharpest of conflicts and excesses of rivalry, jealousy, and revenge, developing into feuds, can arise there. To prevent such festering and stagnation, loosen dependencies, and obtain fresh ideas, there must be variety and room for entry and exit, and outside contacts.

Also, local bonding can increase what I discussed in this blog as ‘parochial altruism’, with altruism within the group and discrimination of outsiders, further worsening its isolation.

Nevertheless, some continuity and locality of relations in communities is needed. Formerly, people found community in religious associations and bonds of neighbourhood, school, sport, pubs, etc. And in a job, in the community of a firm, often on the basis of teams. For the lower educated, all these bonds have largely disappeared, as a result of increase of scale, resulting in concentration outside local communities, move to low wage countries, and spatial development of roads, office blocks, and shopping malls that destroyed social infrastructure.

And some of what remained of facilities went with priority to immigrants who needed to integrate; at least that is how it was perceived. More highly educated and mobile people found community of some sort in departments and teams in larger firms or professional bonds, which did not depend on geographic locality. But that now is also crumbling through individualization of work and shorter and more flexible employment.

These losses have been an important part of the feeding ground for populism.

The dominant stream in economics, excluding spatial economics and economic geography, had no eye for this. On the contrary: the central dogma was that of ‘comparative advantages’ and maximum flexibility, needed for the optimal allocation of resources. Locally one should engage in activities in which in comparison one was best, and other things needed to be acquired in trade with others. Labour and capital should not be locally bound but maximally flexible, to move to where their yield was greatest.

Local roots were seen as causing rigidity, and that, the suggestion is, is always bad. That is part of the rhetoric of maximal flexibility. The more the better. But that is often counter-productive, also from a purely economic perspective. That applies to both local communities and firms. It is good for both the firm and for the people working in it that one invest in knowledge and capabilities that are specific to the firm, yielding higher profits with specialties and novelties. That requires sufficient continuity of jobs and teams, because otherwise such investments are not made since they require continuity for them to be recouped. That lack of specific investments lowers quality of products, and the intrinsic quality of working in teams.

The goal should not be maximal but optimal flexibility: sufficient duration of location and relation without yielding rigidity. That is to be part of a new economy.

390. Forms of efficiency published 24-9-2018

In economics efficiency is defined purely in terms of costs of input relative to output. Contribution to quality of process, such as labour, or virtues, such as justice, do not count.

Economics recognizes three forms of such efficiency: allocative, productive and dynamic. Allocative efficiency forms the core of market thinking: scarce resources are optimally allocated to where needs are highest. Productive efficiency concerns the use of resources for production. That depends on a number of factors, such as economies of scale. Dynamic efficiency concerns efficiency in innovation. All three are desirable, and are adduced as arguments for markets, but in fact they obstruct each other.

Increase of scale can yield higher productive efficiency but tends to reduce competition, lowering allocative efficiency. Concentration in large firms allows firms to hinder entrance of to the market of new competitors, yields powers of lobbying for advantage, and can slow down innovation by obstructing its development. There is the incentive to protect existing investments and prolong their life. Small innovators may be bought to slow down the further development and introduction of their innovations.

Dynamic efficiency is the most difficult because of the uncertainty involved, which economics cannon well deal with, as discussed in a preceding item in this blog. Because of uncertainty, one needs reserves to absorb misfiring innovation, but for allocative efficiency there should be no such reserves.

In the literature on innovation there has been a long discussion whether large or small independent enterprises are the most innovative. Large firms have the advantage of more financial reserves, spreading risks across a portfolio of products, cross-subsidization of weak products by strong ones, lobbying power to affect the choice of projects for subsidy and its acquisition, and the establishment of technical standards and standards for safety, and that again reduces allocative efficiency.

Small firms have advantages of speed of development and flexibility to change direction when needed, due to less bureaucracy, more motivation to succeed, since success yields the entrepreneur's income, and closer proximity of management to the market and to incoming technology. They can suffer from high costs of small scale, lack of specialized support, difficulty of attracting finance, which all reduce productive efficiency.

Which form of efficiency deserves precedence? In fact, there are often combinations and compromises between them.

Concerning strengths and weaknesses large and small business are complementary. For example, in biotechnology small firms invent and develop new active substances or new processes of production which are then taken over by large firms with advantages for further development, testing, regulatory approval, and large scale production, distribution and brand name of products.

With digitalisation and informatisation, effects of scale in innovation have decreased, since production is now more virtual than physical, machines are replaced by computers, large production facilities are no longer needed, production can be better automated, and testing can often be virtual rather than physical, in computer simulation. On the other hand, new effects of a scale have come up, as in the large internet platform companies where volume of customers is part of the business model.

391. Ethics in economics published 6-10-2018

Economists claim that they do not make value judgements, but only indicate the economic consequences of policy. But the theory they use does implicitly harbour an ethics, even though many economists are not aware of it. Of what sort is that ethics?

There are several systems of ethics. Liberalism, and with that economic science, rests on utility ethics. That only looks at outcomes of choice and action, in this case utility, in the form of the greatest good for the greatest number of people. The ethical quality of other considerations, such as honesty, justice, forbearance, solidarity, etc. are irrelevant. 'Greed is good' as long as it leads to a higher level of prosperity, and the equity of its distribution is less relevant.

That stands in sharp contrast with duty ethics (going back to the philosopher Kant), where the issue is the ethical quality of motives of action, regardless of their consequences in terms of utility. The claim is that moral rules are universal, valid under all circumstances. The central principle is the ancient *golden rule:* One should (not) treat others as one would (not) want to be treated oneself. Here, that became the *categorical imperative*: an act is good if you would want to raise it to a universal rule. Lying is good if you would want everyone to do it. You don't want that, so you should never lie.

I don't go along with that because what is good or bad depends on circumstances. And what I find good for myself is not necessarily good for another: needs and demands vary.

A third system is virtue ethics, going back to the philosopher Aristotle. Virtues are character traits, dispositions to conduct. Many virtues are eligible, depending on circumstamces. The classical 'cardinal' (pivotal) virtues are: reasonableness (or prudence), courage, moderation, and justice. There is nothing wrong with pleasure, but it should be in combination with moderation and justice. That is missing in present theory and practice in economics.

Resistance is increasing against the conduct of a number of large firms, such as banks and pharmaceutical companies, those firms are suffering from that resistance, and they come up with plans for self-regulation. The key question is whether when push comes to shove and this leads to less profit it will be accepted by shareholders.

For this I give an anecdote. Two years ago I was asked by a colleague in Scotland if I would want to take part, as advisor and possibly as a teacher, with a bank, in the teaching/training of employees in trustworthiness. Trust is one of my subjects, so I accepted. The first step was a skype meeting for an exploration of ideas. We agreed that I would develop a proposal. In the discussion of that, in a second meeting, I asked whether it was part of the plan to educate employees to be trustworthy also to customers, not to sell them opaque products that work out to their disadvantage, as was customary among banks in the crisis of 2008. 'Of course', they answered. 'But what if that leads to foregoing opportunities for profit, would that be accepted by shareholders?'. I received no answer and the meeting was abruptly ended. I tried to get in the comment that if you are the only bank that can make good on the promise to such trustworthiness, that might be very profitable, but it could no longer help.

In the course of the present series on economics, in this blog, I will argue for a transformation of economics, with as the most fundamental part replacement of utility ethics by virtue ethics, where utility still counts, but next to considerations of moderation and justice. That is needed for justice but also for protection of the environment, which under the present regime of economics seems unattainable.

392. Greed and urge to manifestation published 13-10-2018

Theories of capitalism usually depart from the assumption of greed: the urge towards profit and income. People are driven to pursue them to survive, in a job or in a market, under the regime of competition, in shareholder capitalism.

But perhaps more important than greed and survival is the urge to manifest oneself: to ‘make a difference’, to be noticed, acquire attention or power. Salaries are not only sources of income but also signals of success in a power game.

The philosopher Plato spoke of reason as a charioteer that tries to reign in two horses: one of *eros,* desire, and one of *thymos,* the urge to self-manifestation. The philosopher Spinoza called it *conatus.* The philosopher Nietzsche claimed that the urge to power is stronger than the urge towards survival.

One can appreciate that: it is also the urge of ambition, to ‘make something of your life’, and to ‘make a contribution to society’. That is also, more than profit, a drive for independent entrepreneurs. And they feel wronged when set aside as mere money grabbers.

An outcome of a mountain of research on happiness is that happiness consists of a combination of ‘pleasure and purpose’, in giving ‘sense’ to life. That concerns something bigger than yourself, or *transcendence.* That can be vertical, towards a God or heaven, but also horizontal, towards society. Not one’s own immortality but a contribution to what you leave behind at death. And if in that you make the best use of your talents, that can be pleasurable.

Then the drive to manifestation can be a virtue, and virtue ethics makes room for it, provided it is accompanied by, or is held in check, by the charioteer, in virtues of reason, moderation and justice.

However, success often leads to a neglect of such virtues, in self-aggrandisement, a feeling of being superior, elevated, ‘beyond the law’.

Money and manifestation are both addictive, not only for managers but also for stars in thirst for applause, and for scientists in search of publication scores and citations.

In capitalism, both greed and the urge for self-manifestation have become institutionalised, ingrained, in business culture, fed by managers having followed courses in economics in which they were told that self-interest rules supreme, as the motor of the economy. It has become an internal ethic that drives careers, salaries, and bonuses.

When confronted with increasingly vociferous critique from society, the inmates of these institutions honestly feel treated unfairly: they are only doing what society needs. Even supervisory boards of firms, having the task to correct management, go along, because those boards are recruited from the wider population of managers of other firms, sharing the same internal ethics and habits of thought.

So, part of the change needed is to compose such boards differently, with people not only from other firms, and not only as representatives of shareholders, but also from other groups of 'stakeholders', such as employees, customers, suppliers, local communities, and society at large, in particular with a view to the longer term future, in the interests of future generations and the environment.

394. Rationality and heuristics published 27-10-2018

How could one still maintain, as economic theory did, that people make rational decisions? Already long ago (in the work of Herbert Simon), theory took bounded rationality into account, but only in a limited sense. The idea was that the capacity for rational thought is limited, and should be used where priority is highest.

A distinction was made between substantive and procedural rationality. Procedurally, it is rational not to evaluate everything in a substantively rational mode. That makes sense and still applies. One encounters it again in Kahneman's distinction between 'system 1 and system 2'. The first is based on unreflected routines where one acts without conscious deliberation, while the second entails conscious, critical reflection.

Without routines, life would not be practically viable. Imagine that in walking, or driving a car, one must reflect on it. Then one would not have attention to where one needs to go, and why, and to talk with another passenger.

But there is more, as understood in more recent 'behavioural economics', which has adopted insights from social psychology, in the form of decision 'heuristics', shortcuts for fast decisions, which are procedurally but not substantively rational. Here is a survey of some of them.

The heuristic of 'availability' is that people pay attention to what is 'available', in the sense of forcing attention, being emotionally laden, as a threat or opportunity. That can go wrong, in an excess of impulse, neglecting less salient but still important issues, but it helps in setting the agenda for scarce attention. Also, the danger of routines is that they are also practised where they do not apply, and then emotion of danger or opportunity is needed to catapult one into critical awareness.

Another well-known heuristic is that of 'loss aversion': a perspective of loss ('loss frame') weighs more heavily than that of gain ('gain frame'). One goes to greater extremes of conduct to keep what one stands to lose than to gain what one does not yet have. In evolution, that contributed to adaptiveness: loss leads sooner to death or harm than gain does. This has a stabilising effect on relationships: the one who wants to break the relationship does it to gain, the other stands to lose, and will go to extremes to prevent it.

Another heuristic is to raise incidents tot the level of laws: 'You always with your …..', while it happened only once or twice. That is unreasonable, but can have survival value to respond in time to threats.

A fourth heuristic is that of 'escalation of commitment': the more loss one has incurred in a certain position, the more one commits to it, since 'otherwise the losses would have been in vain'. That is not rational: the past is water under the bridge and cannot be changed; one should look only at possible further losses in the future. That heuristic also works in favour of the continuation of a negative relationship. A classic example is that of George Bush, for whom it was difficult to withdraw from Irak, because then all the American deaths 'would have been in vain'. It would also amount to an admission of having made a mistake, in entering. A new president, Obama was needed for withdrawal, and then he made the same mistake of increasing the commitment in Afghanistan.

A fifth heuristic is that of engaging only upon incremental deviations from existing policy, even if the initial position does not make sense, and a radical turnaround is needed.

A sixth is 'cognitive dissonance' or 'confirmation bias', where after a choice one only has attention for information that confirms that it was a good choice, not to what denies that. In a difficult to end relationship one only wants to hear the good things of the partner, and when one has broken the relationship only the bad things.

395. Individual and social published 3-11-2018

The theme of self and other has been discussed extensively in this blog, and a bundle of items on that theme can be downloaded from my website www.bartnooteboom.nl A combination of elements from the blog and my 2012 book 'Beyond humanism: the flourishing of life, self and other', *and my 2015 book* 'Beyond nihilism: imperfection on the move', *and an essay with the title* 'Beyond nihilism: self and other between Nietzsche and Levinas' *which can also be downloaded from that website. Here I give only a brief summary.*

The human being is individual but not autonomous, as economists would have it. It is socially constituted, on the basis of interaction with others, and shared culture. Culture here is anthropological: habits and customs, but also an ethic and morality. While those may be shared, what is made from it becomes individual, along a personal path of life.

That yields diversity, or what I called 'cognitive distance', and that may hinder mutual understanding but also offers an opportunity, to learn, and to escape, more or less, from personal prejudice and myopia. For this, one needs to develop the ability to understand people who think differently, intellectually and morally. That also yields economic advantage, in a better ability to innovate by combining different ideas.

For its development, the human being needs recognition, acceptance and respect, in local communities with some stability, needed also to develop and maintain trust, but those communities also need some external contacts and some entry and exit of inhabitants, not to get mired in rigidity, myopia and prejudice.

Strong bonds of interaction and mutual understanding are difficult to achieve on a national level. That requires decentralisation of governance to municipalities or city neighbourhoods, with an elected mayor, council and citizen panels, with or without political parties. That carries problems, as discussed earlier, but those are not insuperable (see item 347 of this blog).

A second need is to put an end to the present excessive flexibilization of work, with more continuity of work and teams. That is good for the quality of labour and the quality of products, which require 'specific investments' in mutual understanding and trust, for which some continuity of relationships is needed, in order to recoup those investments, which otherwise would not be made.

For this, and for innovation, the environment, and a just future for the young, a perspective of the long term is needed. No longer the obsession with profit in the next quarter. If shareholders cannot muster this, then they should not have a majority in supervisory boards. Those would also contain membership from employees, customers, suppliers and the local community. The latter especially with a view to protection of the environment.

Economists will comment that then the price of capital will increase, because opportunities for profit are foregone, which would lead to lower prosperity. Yes: that would have to be accepted: a bit less prosperity for the sake of a more humane and sane society.

396. From optimal to adaptive published 10-11-2018

The assumption, in economics, that people exhibit rational choice that leads to optimal outcomes yields an excuse not to look at processes that may or may not yield optimal outcomes. That may contribute to simplicity, avoidance of complexity, but also leads to neglect of important realities, of actual decision making, conduct, market imperfections, and differences between industries. And when optimality is impossible, due to uncertainty, one needs a different, adaptive stance.

It is needed, for government and management of firms, to act on the basis of insight in those realities. There is a myth afoot that for management it does not matter where you are manager, because it supposedly is the same everywhere, and that is not the case. Economic variables such as economies of scale, concentration, integration in mergers/acquisitions or alliances, entry barriers to markets, transaction costs, transparency of product quality, technology, knowledge intensity, uncertainty of markets, investments and their lead times, type of labour, importance of teamwork, fluidity of knowledge, etc. vary with industries.

On the macrolevel it is useful to see the economy and industries as evolutionary systems of variation, selection and transmission of what survives. State interference is then seen as exerting influence on those processes, rather than direct interference in conduct, though the latter may have to be part of it. In any case, an evolutionary, adaptive approach is modest concerning planning, especially planning of innovation. That would be as if evolution planned, designed new species. There is little scope for ‘intelligent design’, as in biology.

In economies, variation arises from entrepreneurship and invention, selection is performed by markets and institutions, and the transmission of success lies in growth of successful forms, imitation, publication, and teaching. One can influence variation by enabling entrepreneurship, with financial and fiscal measures, and employing it in the innovation of public policies and services. One can further the selection by markets by preventing monopolies and oligopolies, entry barriers to markets, and other conservative ploys of existing firms. One can improve transmission of success with policies concerning communication, information, education and training.

In the further filling in of the processes of variation, selection and transmission, important differences arise in comparison with biological evolution. There is artificial variation in combining genes other than by breeding, in genetic manipulation. Firms can influence selection by markets and institutions by political action, such as lobbying. They can test products before they are brought to market. Invention still involves trial and error, but it is not entirely random, as variation is in biology, because it is fed by learning, logics of inference and science.

The logic of adaptation in evolutionary systems avoids the problem of rational choice, on the basis of calculation, with probabilities attached to possible outcomes, that it cannot deal with uncertainty that is 'radical', in the sense that one does not know all that can happen. Given the impossibility to predict, due to uncertainty, and the consequent impossibility to find an optimal strategy, one can make use of scenario's, alternative imagined possible futures, and seek a strategy that performs reasonably well across them, without optimality in any single one of them. One can use computer modelling, simulation, for this. In the development of products one can mimic evolutionary processes of variation and selection, as happens, for example, in the development of robots and algorithms.

On the level of the individual also, uncertainty has its implications, requiring adaptiveness. One should grow up to be robust under unforeseeable setbacks, be resilient, learn to fall and stand up, have reserves to fall back on, and be flexible and creative in taking new directions when needed, even when they are not known in advance.

397. Power, dependence, control and trust   published 17-11-2018

Economists shy away from discussions of power, because power should not play a role in supposedly anonymous market forces. Economists do talk of market power as a disturbance of markets by monopolies, oligopolies and firms erecting entry barriers to markets. That is to be fought by competition authorities. But power is more widespread. Power creates dependence. But it can also be positive. Even monopoly can be beneficial.

I use the (customary) definition of power as having influence on the choices of others. It can be positive, in an extension of options for choice, and freedom of choosing from them, or negative, in reducing them.

If for choice one is dependent upon another, than he/she has power over you. One can avoid or reduce that by avoiding him/her or by creating counter-power, by constraining the actions of the other. Trust is leaving room for conduct for others, control is constraining it. Control can result in a vicious circle of accumulating mutual constraint. A danger looms of excessive oversight and control.

What forms and sources of dependence are there? One is that the other has a unique offer, with few adequate alternatives. That is the power of monopoly. Or there is no way out, no exit: you are locked in. That is the power of enforcement. Or there are incentives to submit to power, for the sake of income, position, protection or prestige.

How to deal with power?

One can fight negative power by constraining the room for power play, and punishing it by means of contracts, legal coercion. However, the specification of activities, rights and duties constrains action, and can act as a straightjacket that inhibits innovation. Contracts are also costly and may be difficult to enforce, particularly if it is difficult to monitor the partner's conduct.

One can also exert direct hierarchical control by taking over the partner, becoming his/her boss. That is a cop-out: one does not face the challenge of collaboration between independent partners.

One can also employ a reputation mechanism, where the partner will not cheat for fear of losing his reputation. Or one can use a hostage, in the form of some commercially sensitive information one has of the partner, with the threat, often implicit, not pronounced, to divulge it when the partner misbehaves. The hostage may also take the form of a package of shares that one has in the partner's business that one can sell to someone with the intent of a hostile take-over of the partner.

There are also more constructive, benevolent ways of dealing with power.

In relations of collaboration there is the following 'paradox of specific investments'. To create unique novelties, in innovation, connecting each other's competences, one typically needs 'specific investments', dedicated to the relation, that have no use elsewhere. That makes dependent: if the relation breaks, the investment is rendered useless. If the investment is asymmetric, mostly on one side in the relationship, dependence is one-sided. On the other hand, if the investment makes you special, offering something unique, that gives countervailing power. A monopoly, in fact. This can generate a race not to the bottom but to the top: partners keep investing in themselves to maintain a unique offer.
Another possibility is to demand shared payment and ownership of the specific investment. Yet another is to make the partner dependent in some other way, by offering some other unique benefit, such as access to a market, a brand name, special knowledge, technology, or a patent, or to some other resource (a lobby, perhaps).

One may also rely on other sources of reliability that are not oriented towards control, such as trust based on ethics or personal bonds of friendship, family, clan, or custom.

With the latter, however, one can get caught in systems of paternalism and enforced loyalty that does not allow for exit, thus imposing another constraint from power. Obligatory bonds limit the variety and freedom of outside contacts needed for learning and innovation.

Sometimes there is no alternative to such personal bonding, as in countries where there is no institutional basis outside personal relationships, such as a legal system to support contracts, reputation systems, or a shared ethic and morality. I found that to apply, for example, for different reasons, to Japan and the Ukraine.

In Japan the reason is a strong tradition of family values, which is now weakening. In the Ukraine the reason is widespread corruption and lack of a reliable legal and democratic order and justice.

398. A paradox of international trade published 24-11-2018

There is a long tradition, since Plato at least, to reach for pure, fixed universals that transcend the messy, shifting variety of particulars experienced in the world.

On the other hand, since Aristotle there is an appreciation of the variety of particulars that appear in reality, emerge, realize their potential and decay.

The opposition between the two is reflected in a long line of contestation within religions: in Catholicism, Protestantism, and the Islam, between two streams: the strict, orthodox, intolerant universalists, and the more lenient, tolerant, liberal particularists.

The opposition is also reflected in a difference between relatively lenient, tolerant cultures in cities that are based on international trade, and more rigid cultures in internally oriented, craft based communities. The rationale for this difference seems clear: tolerance of variety is needed to conduct international trade. An example of a port culture is Amsterdam, which has been a hub of trade for four centuries. One would expect something similar in other port cities.

However, current globalisation is borne by a universalist market fundamentalism, an ideology of the market as a pure universal, the same everywhere, that will automatically establish itself if only one abolishes all the obstacles of intervention by states.

In reality, markets require institutions to work, and markets vary greatly between industries, due to differences in factors that shape markets, such as economies of scale, degree of concentration, monopolisation, technological change and resulting uncertainty, entry barriers to markets, transaction costs, including different degrees to which users can judge the quality of products, switching costs between products from different producers, separability or complementarity of products and production processes.

The focus of the development of the EU lay on the internal market as a universal good that would develop automatically as soon as different government rules were dismantled, in what has been called 'negative integration'. The expectation was that this would eradicate complexities of rules and regulations, and that prosperity and goals of employment, living conditions, labour conditions, and the abolishment of exclusion would automatically follow.

It did not work out that way. As markets spread across different sectors of society, in drives of liberalisation and privatisation, complexity of rules and regulations did not decrease but increased, because of the imperfections of markets and differences between those sectors.

This unexpected complexity became one of the sources of irritation and opposition towards the EU as an excessive regulator, constraining freedom.

Meanwhile, the dream of the market as a magical source of prosperity and quality of life and society also was not realised. The exclusive focus on the internal market was seen not to fulfil social goals but to thwart them, and now the EU belatedly has to take a more socially oriented turn.

In sum, there is a paradox of universalist ideology versus particularistic reality of markets, and society has suffered again from the illusion of universalistic dreams.

399. Old and new economics published 1-12-2018

In item 387 in this blog I used Imre Lakatos'[iii] notion of a *research programme* to characterize mainstream economics. To recall: such a programme has a 'core' of fundamental principles, assumptions and directions for research, which must be protected from falsification at all costs, by means of a 'protective belt' of subsidiary assumptions that supplement or implement the core principles. When something comes up that falsifies the whole, it is attributed to the subsidiary assumptions, and a replacement is sought there to make the core work better.

That notion arose from a debate, in the philosophy of science, on the falsifiability of science. Popper had demanded falsification as the central purpose of scientific conduct, but then, in a famous article 'Two dogmas of empiricism', the philosopher Quine proposed that a theory is never tested as a single proposition, but as a system of propositions with main assumptions plus subsidiary assumptions and principles (e.g. about the direction and method of research, measurement), which is falsified as a whole. Then the question is which assumption or principle to consider falsified and in need of replacement. According to Lakatos' scheme the core assumptions are to be held on to, and revision is sought in the 'protective belt'.

I now present the core of a new programme of economics, to replace the old one. The cores of the old and the new are compared in the table below. Criticism of the old and arguments for the new were presented in preceding items in this blog.

Old and new economics

Old	New
Rational actors	Limited rationality, decision heuristics
Autonomous individual	Socially constituted individual
Optimal outcomes	Processes of adaptation and development
Competition	Competition and collaboration
Risk	Uncertainty
Utility ethics	Virtue ethics

The table shows a virtual reversal of core assumptions, from the old to the new. That illustrates how fundamental, radical, my proposal is. The components were discussed in preceding items in this blog. Here I recall some of the main connections.

A key feature is uncertainty, going beyond risk, formerly recognised, in economics, by Keynes (and Frank Night). With risk one knows what can happen, so that one can append probabilities and calculate an optimum expected outcome. With uncertainty one does not know what might happen, and options for choice emerge from action rather than being given in advance. That has a number of implications. Since optimal outcomes cannot be calculated in advance, that perspective of economics drops out, and one falls into the need to analyse processes of adaptation, to emerging outcomes, possibilities and options.

The most interesting and innovative relationships are the most uncertain. That requires trust, as a leap of faith across a gap of uncertainty. In contrast with earlier economic thought that trust cannot survive in competition because it requires giving without being able to count on receiving, the proposition is that in present economies next to competition firms also need to collaborate for innovation, which entails uncertainty, so that to survive one must handle the art of trust (without trust thereby becoming blind).

A switch is needed from the utility ethic underlying mainstream economics, looking only at the utility of outcomes, to a virtue ethics, looking also at virtues, not only of reason, and courage, but also of justice and moderation. Justice is needed for pressing social and political reasons, and moderation especially for saving the environment.

Relations also need to have some stability and some local roots, without falling into rigidity, and without surrendering international trade, but with necessary regulation of it. That is required for justice, political recognition of locality, and by an economic need for collaboration that also requires trust.

How realistic is this shift? I don't know, but in view of present populist revolt and the climate crisis, something has to change radically, or society will be destroyed.

I do not want to claim that the old economics is always wrong. It still applies under the following, clear conditions: the values involved can be measured, preferences and all options for choice are known, plus the possible outcomes ('pay-offs'), for oneself and any others one is dealing with. Then one can calculate an optimum, or equilibrium (in game theory), and it would be silly not to use that opportunity. If, on the other hand one or more of those conditions are not satisfied, under uncertainty, and preferences, options or outcomes are emergent rather than being given in advance, then one should shift to the new economics.

This goes back to an experience I had, when working for Shell in London, in the 1970's, as a project leader in the computing centre, where we used optimization techniques for the scheduling of refineries, routing of ships, location of gas stations, and design of loading stations for natural gas. For strategic planning, however, given the uncertainties involved, we developed scenario analysis, where we did not optimize, which was impossible, but used simulation to analyse the robustness of policies across different possible futures.

406. Why capitalism is unbeatable published 19-1-2019

In spite of a number of crises, capitalism is still thriving. How come? Does it satisfy more than material needs?

The human being is confronted with a range of antagonisms: the sacred/eternal and the profane/temporal, heaven and earth, body/matter and soul/spirit, desire and contentment, the universal and the particular, self/individual and other/collective, unity and variety, true and false. How can one deal with these? One needs a combination of fooling oneself, in 'cognitive dissonance', denial of the tension, and having an eye only for one side of an antagonism, with ideology that enshrines one's preferred option. Capitalism does both superbly.

It opts unequivocally for the self and denigrates the social, communal and local. It even proves (mathematically!) that greed is good, produces the highest possible level of prosperity. What is more alluring than that? It appeals to natural urges towards greed and self-manifestation, in both production and consumption. Opposition from altruism is blocked because that cannot survive in markets.

Its individualism is sanctioned by the Christian belief in individual, immortal souls. The magic of markets is that they offer variety, but under unity of universal market principles.

It appeals to the unquestionable, universal truth of markets, in a mystique of the automatic force of the 'invisible hand' of Adam Smith. 'Laissez faire': the magic will work itself. No counterforce can rival it. And no developing country must close itself off from international markets (while developed countries did that in their infancy).

In going for the individual it obstructs collective forces that may curtail it, such as unions, consumer societies, and ecological societies. It does constitute an interest group in itself. It lobbies for advantage, but not overtly, in secrecy, and denied when publicized. It is in the guilty interest of government to contribute to its secrecy, enhanced by revolving door careers between business and government.

In the stimulus of unending consumption, with new desires, it helps keep the boredom at bay that follows the satisfaction of desire. Shopping then becomes a way of life. The opposite of Buddhism, one could say.

It appeals to two forms of Romanticism. One, going back to Rousseau, is that of the free, autonomous individual against the coercion, manipulation and distortion of society. 'There is no such thing as society', was the motto of Margaret Thatcher. Breaking out of plodding mediocrity.

The second form of Romanticism is that of the transgression of boundaries: of the discoverer, the imperialist, the heroic entrepreneur, and the heroic scientist, breaking old constraints and opening new avenues to untold power, insight, pleasure and convenience. According to Harari[iv] it is the combination of capitalism, the scientific spirit and credit (to finance expansion and growth) that has produced European prominence in the world. And now Europe is being taken over by others imitating that perspective, first in the West (the US) and then in the East (China). They now practice capitalism in a purer or more complete form than Europe. Europe began to have qualms about capitalism, in communism, socialism and humanism, and now has lost its position of power.

It is Nietzschean, in its creative destruction, breaking up the old, not letting oneself be held back in power by the mediocre, with their jealousy, grudges and slave mentality. However, in large part this is myth. Large capital focuses on incremental innovation that leaves sunk investments intact for as long as possible, prolonging their life to save capital and squeeze it for profits. The most radical innovations are conducted by smaller firms, which then get bought by the large ones, to be frozen for as long as possible.

Ethical objections, and pleas for justice and benevolence, are waved off with the liberal claim that morality is a private matter, for behind the front door. The ruling ethic is that only outcomes count, in terms of utility, measured as prosperity. It considers instrumental, extrinsic quality of tools, capital and actions, not the intrinsic quality of processes (work), conditions and intentions. Justice beyond prosperity is not on the agenda. Of the classical virtues of reason/prudence, courage, moderation and justice, capitalism satisfies reason, in pursuing science, and courage, in crossing boundaries, but it violates the virtues of moderation and justice.

It pursues the truth of pragmatism: truth is what works. No nonsense, not the airy idealism and speculation of stuffy, ivory tower idealists.

Finally, while once upon a time the expectation was that capital would be overwhelmed by the power of labour, now with globalization the power of capitalism has only increased, and subdues labour, with the threat of capital to move its employment elsewhere if it does not get its way, in tax evasion, low cost, and low security and intrinsic quality of labour, subsidies for energy, and lenient environmental restrictions.

407. Growth and the good life

published 26-1-2019

What is the value of economic growth? It is needed to achieve enough prosperity, but why seek ongoing, endless growth beyond that? Why should we go on generating more wealth instead of working less, with more leisure to spend on other pursuits than consumption and material acquisition? This question was asked in a book 'How much is enough?' (2012), by Robert and Edward Skidelsky. They eloquently argued that ongoing growth is not conducive to the good life. There, as I do in this blog, they employ an Aristotelian virtue ethic, to replace the utilitarian ethic that rules economic science and from there politics.

The most fundamental point is that the good life entails a number of disparate dimensions that are incommensurable, cannot be added and subtracted in a single measure of value (see also item 79 of this blog). This upsets the paradigm of utility maximization that rules economic thought. There is not one single value to be maximized.

The literature offers a variety of lists of the good things in life, such as: health, courage, freedom or autonomy, love and friendship, empathy, material well-being, pleasure, moderation, prudence, security, intrinsic value of work, leading a useful life that contributes to society and nature, and more. Incommensurability entails that they cannot easily be traded off. How can I trade off love of knowledge and of my children, seeking satisfaction and contributing to society, self-interest and altruism? They are qualitatively different. And many of the goods of life are not tradeable.

Why does economic growth crowd out many aspects of the good life? One factor is the insatiability of human desire. Schopenhauer, for example, argued that satisfaction of one want evokes new wants and if satisfaction were ever achieved it would generate insufferable boredom.

The Skidelsky's recognized further factors. It is often the satisfaction not of wealth itself but of having more than others that drives acquisitiveness. An institutional factor is that with growth the poor can be pacified with the prospect of rising income, reducing the need for the politically tougher measure of more re-distribution of wealth, against the powerful lobby of the rich.

Implicitly or explicitly, economics, basing itself on liberal ethics. has made a fundamental moral assumption. It is not up to government but to citizens to determine what the good life is and how it is to be achieved. Governments should be neutral with respect to values, preserving freedom and avoiding coercion and paternalism.

There are two faults with this view. First, governments do in fact, and necessarily, make moral judgements in protecting the poor, sick and unemployed, fighting crime, promoting security, protecting the environment, and promoting health, education and culture. If in fact policy is value driven, it is better to make that explicit and bring it into debate.

Second, it is an illusion to think that consumers are autonomous in their preferences. They are affected by advertising and other actions that fuel desire, acquisitiveness, and spending.

Third, goods are produced with built-in obsolescence. For example, the software of old hardware, in computers and phones, is no longer supported, which forces people to buy ever-new hard- and software with features they do not need.

The underlying error of economic thought is two-fold. First the idea that preferences are given, not affected by options of choice and processes of choice. In fact, particularly from the pragmatist view set out in this blog, ideas, including preferences, develop in interaction with the social and natural environment. That also upsets the assumption that economic agents are autonomous.

So, economics is fundamentally misguided, and we must look how preferences are fed, formed and mobilized or ignored, and how that affects the good life.

408. How universal is the good life? published 2-2-2019

The great power of economic thought is five-fold. It is simple and parsimonious, it is amenable to technocratic calculation, satisfying urges towards rational choice and design, it is purported to be universal, applying always and everywhere, it conveniently avoids difficult ethical questions, and it supposedly promotes freedom. As argued earlier, concerning capitalism, in item 406, this makes economics virtually invincible, and its corrosive effects on the good life may be inevitable.

An approach from an Aristotelian consideration of the good life has corresponding weaknesses. It is complicated, discursive rather than calculative, difficult to universalize, and hence complicated and expensive, and it is to a greater or lesser extent paternalistic. It reigns in opportunities for further economic growth and concentration of wealth. As a result it can expect powerful opposition from an unholy alliance of the wealthy, established interests of industry and commerce, libertarians, technocrats, gluttons and consumption zombies.

Dare we proceed? Let us take it bit by bit.

One serious drawback to consideration of the good life is that it seems subjective and relativistic, flying off in all directions, depending on the identities, preferences and positions of individuals and the social and economic environments they are in.

In their book ‘How much is enough’ (2012), Robert and Edward Skidelsky try to remedy this. They first specify what conditions elements of the good life should satisfy, and then proceed to give their list of the good things. Much as I sympathise with their endeavour, I think they go wrong at the first condition they specify, that the good things should be universal. I disagree: the list of goods depends on taste and conditions.

This immediately shows up in their list, which next to health, respect, personality (autonomy), friendship, and leisure (absence of external compulsion, intrinsic value of activity), includes security (especially in income). I disagree with an unqualified good of security, which to me smacks too much of avoidance of risk. In the vein of Nietzsche I value the taking of risk for a flourishing life, at the pain of pain and loss that it involves.

Incidentally, in an attempt to regain voters in upcoming elections, he Dutch labour party recently launched a guiding motto of 'security'. I think that is a bad choice. Insecurity is un uneliminable part of life. Such a promise cannot be fulfilled and evokes a further fall of trust when it turns out not to be fulfilled. And it is counter to the interest of citizens. It would be better to help them accept insecurity and deal with it.

For Aristotle the good life consists in development of the potential one has, especially spiritual potential, and the striving for excellence in the realization of potential. I fully endorse that. Material conditions and pleasure are also part the good life, but in moderation. Aristotle's list included courage, moderation, generosity, justice, and wisdom, and the external goods necessary to realize them.

So how relativistic is the good life? Between the extremes of universalism and individualism there are intermediate forms of unity in diversity. There can be community without equality or any shared essence.

Music varies enormously but it always uses tone and pitch. The variety of gables along canals in Amsterdam is unified in the use of the golden ratio between the heights of windows on successive floors. Why could humanity not have a similar variety in views of the good life and yet have some form of resemblance in common?

Wittgenstein offered the notion of *family resemblance*: A has features in common with B who has features in common with C while A and C have nothing in common. What families share is chains or networks of resemblance without any clear familiar essence. Views of the good life might be like that.

But the most important thing, I think, is this. For Aristotle the overarching virtue, in common between all lists of goods, was *prudence* as the ability to deal with the variety and frequent contrariness of the other goods, in trying to find a good 'middle'. For example, courage as a 'middle' between recklessness and cowardice. One can seek some middle between risk and security, self-interest and altruism, spiritual and material goods, between work for money and for its intrinsic worth (of enjoyment, social relations, value to society, …..).

The kind of economy, and of politics, we should be looking for is one that caters to this.

409. Revival of risk and variety published 9-2-2019

The Dutch political scientist Paul Frissen proposed that a number of countries (he pointed to the Netherlands) are caught between a *cramp of control* and a *cramp of conformity.* The cramp of control arises from the modernist, technocratic dream of a society that is rationally designed, and where all risks and contingencies are under control. The cramp of conformity arises from a romantic populism of national spirit and culture that are to be kept pure and uncontaminated by foreign influence.

This is a disastrous situation. Especially for a country (such as the Netherlands) that used to derive its strength from pragmatic improvisation and tolerance of the foreign. Attempts to eliminate risk yield a glut of regulations and restrictions that squeeze out all *room* for novelty and creativity, and produce an explosion of cost. Xenophobic elimination of difference kills the variety that is a *source* of novelty and creativity. Together, risk avoidance and xenophobia suffocate society. The first halts breathing and the second takes away the oxygen.

How to get away from this? How to regain room and incentives for risk taking and variety? Those are precisely virtues of markets. I am deeply critical of market ideology, but instead of eliminating markets, if anyone were to plead for that, I advocate to harness their power while bending it and preventing perversities.

In this blog I discuss economics and markets. I argue that the core virtues of markets are that they allow for and utilize diversity, variety of local ideas and initiatives, while efficiently selecting out ventures that are not viable. This selection of course entails risk of failure, the risk of entrepreneurship. Not many people would want to take such risks, but entrepreneurs do. The virtue of markets is that they privatize risk. Risk are not imposed on unwilling taxpayers but on entrepreneurs, who take them voluntarily. But then they must be allowed to reap the advantages of profits when those occur, at least up to a point. And obstacles from institutions and vested interests must be eliminated to give them room.

In a perverse effect of markets, the conduct of bankers led to the reverse, the socialization of risk: private risks of banks were hived onto the public.

There are complications. Entrepreneurial innovation entails *creative destruction*, eliminating old technologies, industries, skills and employment. Unjust consequences for the victims are to be compensated by schemes of re-training and of social security for those who cannot catch up.

This is my not so new plea for an apparently neglected combination of markets and social security, in a society that is open to diversity and to risk and compensates for the latter’s injustices when those arise. We had that to some extent in past capitalism, but have somehow lost it.

410. Conditional goods published 16-2-2019

In what way is the good life not universal but *contingent*, dependent on conditions, in economies? For at least some actions, goodness is not absolute, universal, but depends on conditions. Consider the sticky issues of environmental protection, world trade, child labour, slave trade, trade in babies, and trade in organs.

This view follows from my Aristotelian stance of finding the good in between extremes, in *phronesis*, the practical wisdom of judging according to context.

It is easy to say that poor people should not, and should not be allowed to sell their organs. What would you do if that were the only way to save your sick child? It is too easy to simply forbid and prevent it everywhere. One should first create economic conditions where people are no longer forced to do it. A similar point applies to child labour. It does not necessarily improve matters to simply take the children out of work. Again, conditions should first be created to do so, in employment of parents and availability of affordable schooling. Surely, one might say, we would draw the line, as something never to be tolerated, at slave trade, and in particular trade in babies, which do both occur. But even there, what would you do as a single mother who can only feed her several children by selling one?

Is it reasonable to demand that developing countries levy the same taxes on pollution, reducing their opportunities to catch up, while developed countries pollute much more due to a higher level of production?

Is it reasonable that developed countries that became prosperous by protection of home industries now deny the right to emerging economies?

In this vein the good is subject to debate that takes conditions into account, and recognizes the contingency of goods, in a *debatable ethics*, as I argued in item 118 of this blog. What about the case of the mother selling one baby to save the others? We would see if that really were the only option, rather than taking on some nasty job that would still not be as bad as selling a baby.

In item 79 of this blog I recognized that incommensurability, the condition that not all values can be brought under a common measure, requires debate and that this can become very costly. Therefore we should try to make calculative trade-offs whenever that is warranted, i.e. does not do too much violence to incommensurability.

For economics there is no problem in any of these issues. Whatever people do, within the law, is an expression of their preferences, which they are free to satisfy. Moral constraints are up to laws and regulations that should apply equally to all, to ensure a 'level playing ground' for competition, regardless of considerations of justice, history, compassion or any aspect of the good life apart from satisfaction of wants.

Amartya Sen and Martha Nussbaum go further, with a *capabilities approach* that wants to ensure that people have access to the means needed to make a free choice. For the Skidelsky's, in their book 'How much is enough' (2012), this does not go far enough. It is still too much based on a liberal idea of autonomy. The question should not only be what people are capable of but what they actually achieve. What Sen and Nussbaum call capabilities, such as knowledge, access to jobs, to social relations, etc. are not mere *instruments* for the good life, but *constitute* the good life. However, the Skidelsky's do maintain that 'on any reasonable definition, the good life is an autonomous, self-determined one' (2013 version of the book, p. 149)[1].

I want to stretch it a little further. In this blog and elsewhere (Nooteboom 2012)[2] I argue that to achieve the highest level of freedom, which includes freedom from one's own prejudice and errors of thought, one needs opposition from the other, and for this one needs to develop openness and empathy. Autonomy is self-defeating.

411. Possible ends of capitalism published 23-2-2019

Karl Marx predicted that capitalism would break down in revolution. To maintain capitalist profits, a shrinking class of superwealthy would increasingly exploit labour, until the

[1] Robert and Edward Skidelsky, *How much is enough?,* Penguin, 2013.

[2] B. Nooteboom, *Beyond humanism: The flourishing of life, self and other,* Palgrave MacMillan, 2012. *It can be downloaded from my website www.bartnooteboom.nl*

populace rose in revolt. What Marx did not take into account was that innovation, in technology, markets and organization, continually raised labour productivity, which allowed for wage increases without affecting profits. The working class was sucked along in compulsive consumption that further fed profits.

Yet the current situation does resemble Marxist crisis. The ‘occupy’ movement is a manifestation of accumulating frustration and anger concerning the untrammeled, immoral acquisitiveness and opportunism of the 1% richest people, in particular in the financial sector, which makes increasingly disparate gains at the cost of citizens, who carry the risks that banks hive off onto society. Governments allow themselves to be taken hostage by business interests.

The movement seems to have petered out, and there are signs that the financial sector is ready to persist along its path of social destruction. As I indicated before, the alliance between economic logic, vested power interests, and governments that are taken hostage, is difficult to break through.

One scenario now is that tension and popular anger will keep on building up until it indeed does break out in revolution. Present populist protests may augur that.

A second scenario is a crumbling of central government and large business in decentralisation and localization of economic activity, social action, and finance. Such localization has been likened to the Middle Ages (by Alisdair Macintyre).

In finance we see it in the growth of crowd funding, of economic, social and cultural small scale activity, and in ‘Fintec’, the rise of small entrepreneurial activity outside the purview of banks, using new opportunities of digitalisation. Local providers of capital are beginning to deal directly with local entrepreneurs. Any resulting economic disadvantages of small scale, in lesser spread of risks and opportunities, may well be offset by lower risks of default due to local reputation effects and social control.

In social activities we see it in people organizing their own day care for children, care of the homeless and poor, and home care of the old and ill. People cook for people also outside the family. Unemployed set up repair shops. People set up systems for the exchange of used goods. Sometimes services rendered yield credits that can later be used to buy services. These are ways to bypass, to circumvent centralized powers that have gone haywire.

However, we should not romanticize this. There will be increasing inequality between different communities with different intellectual, financial and social capital. The poor communities may be tempted to come and rob the rich ones, which would then set up defences. Perhaps not unlike medieval fortified cities. Local bonzes may accumulate and misuse power, perhaps not unlike medieval barons.

Some remaining central government would be needed to provide safety, control power, and mitigate inequalities. It might be chosen on the basis of representation of local communities, not unlike the ‘states’ of old.

A third scenario is that present capitalism and economic theory be drastically reformed ‘from inside’, from within the system, to stop market corrosion of the untradeable elements of the good life, break down concentration of economic power, reduce complexity of the system by uncoupling and decentralization, establish a new balance between risk and security, and between autonomy and sociality. However, what earlier (in item 109) I called *system tragedy*, with established powers of business and institutions holding each other in the deadlock of prisoners dilemmas, on different levels, makes such change from within unlikely.

So, the most likely end is some form of 'creative destruction', in revolution or emergence of new forms outside the dominant system, emerging on a small scale, in a variety of forms that sooner or later will settle down in new dominant forms that are difficult to foresee.

How is capitalism defined? If we define it as markets plus private ownership of capital, new forms are likely to be new guises of capitalism.

412. Identity in economics published 2-3-2019

Earlier in this blog (items 8, 9, 10, 265) I noted that identity is personal as well as social/cultural. I also proposed that both individually and culturally identity is not single but multiple, and that it is not fixed but subject to development. There is no given, fixed essence that constitutes identity.

Socially, identity arises, in particular, from one's being held accountable for one's actions and utterances. Individually, identity develops from interaction with others, with their contrasting ideas and actions.

David Hume argued that there is no coherent personal identity; only a buzz of experience without coherence or stability. In item 8 of this blog I used the work of Antonio Damasio, arguing that the brain develops representations, embodied in neural connections, first of internal, endocrinal processes, in the body. Those, in turn, are regulated by means of such representations. Next, there arise representations from sensory impressions from outside, coalescing into concepts.

According to Gerald Edelman, concepts arise in analogy to evolution, in 'Neural Darwinism'. In mutual competition between emergent mental structures, those that produce success, in satisfying urges and passions, are reinforced at the cost of others. Such processes can produce a multiplicity of selves.

Is Hume, right, then? Is there no coherence in some sort of identity, even if multiple? I proposed that some coherence arises from the fact that what emerges in the brain is connected with survival of the body in which it forms thought, because that survival requires functional coherence, and that constitutes identity. Individuality is next produced by the assimilation of experience, and accommodation to it, along one's individual life trajectory.

How does all this sit in economic theory? It doesn't. In economics, identity is only individual, not social, and it is assumed as given, in sets of preferences. To include identity, economics needs to include preference formation. For that, it would need to include the interaction between people by which preferences and identity are formed. For that, economics would have to integrate with sociology and cognitive science.

Liberal individualistic market theory prides itself on yielding the widest possible scope for individual freedom. But, as I argued in item 49 in this blog, the highest form of freedom is freedom also from one's own prejudices, and for that one needs the opposition from others. To profit from that, one needs to develop empathy: understanding what makes other people tick.

For partnership in development one also needs trust. The most fundamental reason for this is that the development of identity, and of relations needed for it, entails radical uncertainty: one does not know in advance how even one's own preferences and options for choice will develop, and this renders calculative rational choice concerning relationships inoperable. One has to dare the leap faith of trust or forego the social and cultural sources of the development of identity. However, in economics trust that goes beyond rational control, in the exercise of hierarchy, contracts or incentives, cannot exist.

In sum, for an answer, the apparently simple question of identity in economics requires a fundamental revision of economic theory. The crux of it lies in the social and cultural sources of identity, and the radical uncertainty involved in identity formation.

In present times of 'filter bubbles' or 'echo chambers', many people take note only of opinions similar to their own, in social media. That robs them of the opposition from contrasting views, as a source of identity development. That development will then be stunted.

With its view of the individual as autonomous, economics has contributed to this.

409. Revival of risk and variety published 9-2-2019

The Dutch political scientist Paul Frissen proposed that a number of countries (he pointed to the Netherlands) are caught between a *cramp of control* and a *cramp of conformity.* The cramp of control arises from the modernist, technocratic dream of a society that is rationally designed, and where all risks and contingencies are under control. The cramp of conformity arises from a romantic populism of national spirit and culture that are to be kept pure and uncontaminated by foreign influence.

This is a disastrous situation. Especially for a country (such as the Netherlands) that used to derive its strength from pragmatic improvisation and tolerance of the foreign. Attempts to eliminate risk yield a glut of regulations and restrictions that squeeze out all *room* for novelty and creativity, and produce an explosion of cost. Xenophobic elimination of difference kills the variety that is a *source* of novelty and creativity. Together, risk avoidance and xenophobia suffocate society. The first halts breathing and the second takes away the oxygen.

How to get away from this? How to regain room and incentives for risk taking and variety? Those are precisely virtues of markets. I am deeply critical of market ideology, but instead of eliminating markets, if anyone were to plead for that, I advocate to harness their power while bending it and preventing perversities.

In this blog I discuss economics and markets. I argue that the core virtues of markets are that they allow for and utilize diversity, variety of local ideas and initiatives, while efficiently selecting out ventures that are not viable. This selection of course entails risk of failure, the risk of entrepreneurship. Not many people would want to take such risks, but entrepreneurs do. The virtue of markets is that they privatize risk. Risk are not imposed on unwilling taxpayers but on entrepreneurs, who take them voluntarily. But then they must be allowed to reap the advantages of profits when those occur, at least up to a point. And obstacles from institutions and vested interests must be eliminated to give them room.

In a perverse effect of markets, the conduct of bankers led to the reverse, the socialization of risk: private risks of banks were hived onto the public.

There are complications. Entrepreneurial innovation entails *creative destruction*, eliminating old technologies, industries, skills and employment. Unjust consequences for the victims are to be compensated by schemes of re-training and of social security for those who cannot catch up.

This is my not so new plea for an apparently neglected combination of markets and social security, in a society that is open to diversity and to risk and compensates for the latter's injustices when those arise. We had that to some extent in past capitalism, but have somehow lost it.

410. Conditional goods published 16-2-2019

In what way is the good life not universal but *contingent*, dependent on conditions, in economies? For at least some actions, goodness is not absolute, universal, but depends on conditions. Consider the sticky issues of environmental protection, world trade, child labour, slave trade, trade in babies, and trade in organs.

This view follows from my Aristotelian stance of finding the good in between extremes, in *phronesis*, the practical wisdom of judging according to context.

It is easy to say that poor people should not, and should not be allowed to sell their organs. What would you do if that were the only way to save your sick child? It is too easy to simply forbid and prevent it everywhere. One should first create economic conditions where people are no longer forced to do it. A similar point applies to child labour. It does not necessarily improve matters to simply take the children out of work. Again, conditions should first be created to do so, in employment of parents and availability of affordable schooling. Surely, one might say, we would draw the line, as something never to be tolerated, at slave trade, and in particular trade in babies, which do both occur. But even there, what would you do as a single mother who can only feed her several children by selling one?

Is it reasonable to demand that developing countries levy the same taxes on pollution, reducing their opportunities to catch up, while developed countries pollute much more due to a higher level of production?

Is it reasonable that developed countries that became prosperous by protection of home industries now deny the right to emerging economies?

In this vein the good is subject to debate that takes conditions into account, and recognizes the contingency of goods, in a *debatable ethics*, as I argued in item 118 of this blog. What about the case of the mother selling one baby to save the others? We would see if that really were the only option, rather than taking on some nasty job that would still not be as bad as selling a baby.

In item 79 of this blog I recognized that incommensurability, the condition that not all values can be brought under a common measure, requires debate and that this can become very costly. Therefore we should try to make calculative trade-offs whenever that is warranted, i.e. does not do too much violence to incommensurability.

For economics there is no problem in any of these issues. Whatever people do, within the law, is an expression of their preferences, which they are free to satisfy. Moral constraints are up to laws and regulations that should apply equally to all, to ensure a 'level playing ground' for competition, regardless of considerations of justice, history, compassion or any aspect of the good life apart from satisfaction of wants.

Amartya Sen and Martha Nussbaum go further, with a *capabilities approach* that wants to ensure that people have access to the means needed to make a free choice. For the Skidelsky's, in their book 'How much is enough' (2012), this does not go far enough. It is still too much based on a liberal idea of autonomy. The question should not only be what people are capable of but what they actually achieve. What Sen and Nussbaum call capabilities, such as knowledge, access to jobs, to social relations, etc. are not mere *instruments* for the good life, but *constitute* the good life. However, the Skidelsky's do maintain that 'on any reasonable definition, the good life is an autonomous, self-determined one' (2013 version of the book, p. 149)[3].

I want to stretch it a little further. In this blog and elsewhere (Nooteboom 2012)[4] I argue that to achieve the highest level of freedom, which includes freedom from one's own prejudice and errors of thought, one needs opposition from the other, and for this one needs to develop openness and empathy. Autonomy is self-defeating.

411. Possible ends of capitalism published 23-22019

Karl Marx predicted that capitalism would break down in revolution. To maintain capitalist profits, a shrinking class of superwealthy would increasingly exploit labour, until the populace rose in revolt. What Marx did not take into account was that innovation, in technology, markets and organization, continually raised labour productivity, which allowed for wage increases without affecting profits. The working class was sucked along in compulsive consumption that further fed profits.

Yet the current situation does resemble Marxist crisis. The 'occupy' movement is a manifestation of accumulating frustration and anger concerning the untrammeled, immoral acquisitiveness and opportunism of the 1% richest people, in particular in the financial sector, which makes increasingly disparate gains at the cost of citizens, who carry the risks that banks hive off onto society. Governments allow themselves to be taken hostage by business interests.

The movement seems to have petered out, and there are signs that the financial sector is ready to persist along its path of social destruction. As I indicated before, the alliance between

[3] Robert and Edward Skidelsky, *How much is enough?,* Penguin, 2013.
[4] B. Nooteboom, *Beyond humanism: The flourishing of life, self and other,* Palgrave MacMillan, 2012. *It can be downloaded from my website www.bartnooteboom.nl*

economic logic, vested power interests, and governments that are taken hostage, is difficult to break through.

One scenario now is that tension and popular anger will keep on building up until it indeed does break out in revolution. Present populist protests may augur that.

A second scenario is a crumbling of central government and large business in decentralisation and localization of economic activity, social action, and finance. Such localization has been likened to the Middle Ages (by Alisdair Macintyre).

In finance we see it in the growth of crowd funding, of economic, social and cultural small scale activity, and in 'Fintec', the rise of small entrepreneurial activity outside the purview of banks, using new opportunities of digitalisation. Local providers of capital are beginning to deal directly with local entrepreneurs. Any resulting economic disadvantages of small scale, in lesser spread of risks and opportunities, may well be offset by lower risks of default due to local reputation effects and social control.

In social activities we see it in people organizing their own day care for children, care of the homeless and poor, and home care of the old and ill. People cook for people also outside the family. Unemployed set up repair shops. People set up systems for the exchange of used goods. Sometimes services rendered yield credits that can later be used to buy services. These are ways to bypass, to circumvent centralized powers that have gone haywire.

However, we should not romanticize this. There will be increasing inequality between different communities with different intellectual, financial and social capital. The poor communities may be tempted to come and rob the rich ones, which would then set up defences. Perhaps not unlike medieval fortified cities. Local bonzes may accumulate and misuse power, perhaps not unlike medieval barons.

Some remaining central government would be needed to provide safety, control power, and mitigate inequalities. It might be chosen on the basis of representation of local communities, not unlike the 'states' of old.

A third scenario is that present capitalism and economic theory be drastically reformed 'from inside', from within the system, to stop market corrosion of the untradeable elements of the good life, break down concentration of economic power, reduce complexity of the system by uncoupling and decentralization, establish a new balance between risk and security, and between autonomy and sociality. However, what earlier (in item 109) I called *system tragedy*, with established powers of business and institutions holding each other in the deadlock of prisoners dilemmas, on different levels, makes such change from within unlikely.

So, the most likely end is some form of 'creative destruction', in revolution or emergence of new forms outside the dominant system, emerging on a small scale, in a variety of forms that sooner or later will settle down in new dominant forms that are difficult to foresee.

How is capitalism defined? If we define it as markets plus private ownership of capital, new forms are likely to be new guises of capitalism.

412. Identity in economics published 2-3-2019

Earlier in this blog (items 8, 9, 10, 265) I noted that identity is personal as well as social/cultural. I also proposed that both individually and culturally identity is not single but multiple, and that it is not fixed but subject to development. There is no given, fixed essence that constitutes identity.

Socially, identity arises, in particular, from one's being held accountable for one's actions and utterances. Individually, identity develops from interaction with others, with their contrasting ideas and actions.

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In present times of ‘filter bubbles’ or ‘echo chambers’, many people take note only of opinions similar to their own, in social media. That robs them of the opposition from contrasting views, as a source of identity development. That development will then be stunted.

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429. Why is it impossible to integrate economics and business?

Published 29-6-2019

Here I recount a personal experience. In the 1990’s, I was charged with the task of setting up a research institute integrating faculties of economics and business, at the university of Groningen, the Netherlands.

That ended in failure. In the end we had erected a nice semblance, a stage set of unity, but behind that everybody went on with their own sweet old practice.

It was, however, an interesting failure: why was integration so difficult, seemingly impossible? There is of course a simple behavioural factor: people don’t like to be pushed away from their routine. But there are also more substantive reasons. It took me some years to figure this out.

Earlier in this blog, in items 387 and 421, I discussed scientific schools of thought in terms of Imre Lakatos’ notion of ‘research programmes’, which are characterized as having a ‘hard core’ of fundamental principles of theory and method.

For economics, this included an orientation towards optimal outcomes, regardless of processes by which they may or may not be achieved. Second, aiming at optimal outcomes, it was oriented at rational choice. Third, choices are made by autonomous agents. Fourth, economics deals with risk, where one does not know what *will* happen but does know what *can* happen, but cannot deal with uncertainty, where one does not know the latter either. Fifth, the approach in terms of optimal outcomes offered the opportunity for mathematical calculation of optima and equilibria, and mathematical modelling became part of the core.

Business organization, by contrast, is oriented at processes, of production, development, decision making, which seldom achieve optimal outcomes. Second, it cannot ignore the limited rationality of choice, of people and organizations. Third, it cannot assume autonomy of agents, with which organizations could not function. Fourth, it cannot ignore uncertainty, with the reality that often options and contingencies of choice and action emerge after choice rather than being known in advance. Processes and uncertainty precluded calculation of optima. Some change is now occurring, with agent-based simulation of economic processes, which lends some of the reputation of mathematics.

Therefore, integration of the two faculties of economics and business would require either of the two to drop its core and allow oneself to be assimilated into the core of the other.

I had hoped to use, as bridgeheads for connecting the two disciplines, areas of non-orthodox economics that could be rhymed with the logics of business and organization. Those were evolutionary economics, which is process-oriented, institutional economics, which recognizes that agents are socially, institutionally constituted, enabled and constrained, and post-Keynesian economics, which follows John Maynard Keynes as one of the rare economists who recognized and incorporated uncertainty. Alas, those side-lines of economics were not present at this particular economics faculty. The economists present were purist mainstream economists.

Out of frustration with this impossibility, and the scheming that went along with it, I left the university.

Later, I heard, the two faculties were merged, and this was realised by assimilating business studies into economics, surrendering its core.

From colleagues I hear that this issue arises in many places, world wide, usually with economics winning out.

442. Economic freedom and trust published 27-9-2019

Do economic freedom and trust help or oppose each other? I come to this question from an article by Johan Graafland, who investigated the issue empirically.[v] Economic freedom consists of property rights, freedom of competition (free entry into markets), small government, and low taxes.

That is mostly 'negative freedom': absence of interference, no constraint on action, as opposed to 'positive freedom', which entails access to resources.

Trust yields a constraint on action, not to cheat, not to lie and make promises one cannot keep, not to take unfair advantage of people, to be loyal, and thus by definition limits economic freedom.

Now, are economic freedom and trust complements, reinforcing each other, or substitutes, replacing each other?

The institutions of economic freedom, such as property rights, legal contracts, access to courts, access to markets, do contribute to trust. Also contributing to trust is access to courts at low cost, and intelligibility of legal process and communication. All these provide 'institutional trust', a basis for trust to build on.

There are more institutions that support trust. Trust entails positive expectations, and fake news undermines expectations and thus hinders trust. Reliable news is thus needed for trust. So do reputation mechanisms..

Economic freedom is regularly limited by limits to competition. When left unchecked, markets develop into their antithesis, with entry barriers to markets, created by monopolies and oligopolies. By way of economies of large scale, concentration arises in large firms, which then exercise lobbying on government for advantages. This reduces economic freedom and creates distrust. Oversight by a competition authority and countervailing power of government to curtail economic power are needed for trust.

On the other hand, institutions can never be complete, to foreclose all the opportunities for coercion, cheating, lying that inhibit freedom of choice. Contracts can never be complete, must leave things to be taken for granted. Then, trust is needed to fill the gaps, so to speak.

Alternatively, one can try to fill the gaps with oversight by institutions, such as a competition authority, a consumer authority, a health authority, an education authority, a central bank, etc. but that can constrain freedom too much. Such efforts tend to accumulate and stifle freedom of action, in excess of control from the perceived need to close off all loopholes, which is impossible. Every time a new breech or work-around is invented, a new regulation is heaped onto the stack. If trust can come in its stead, it helps economic freedom.

Also, it is often expensive to make contracts as complete as possible. Trust can allow for more limited contracts, thus reducing 'transaction costs'.

Trust is more needed to the extent that contracts and control are more difficult, and that is the case, in particular, under the uncertainty of innovation, where by definition one does not know what will happen or even what can happen, so contracts cannot be specified.

Trust fosters collaboration, and that can lead to obstruction of economic freedom. But sometimes relationships require a certain stability, also for economic reasons, when jointly produced added value demands investments that are specific to the relation, for mutual understanding and adjustment, specific installations, instruments or training, and for building trust, and require a certain duration of collaboration to make the investments and recoup them. But for the duration that by definition excludes other participants, and hence limits competition. In other words, sometimes institutions for economic freedom need to be relaxed for economic reasons.

And, finally, apart from economic value, trust-based relations can have intrinsic value that merit a bit less economic value, if needed. They may enhance social conditions and personal satisfaction.

So, in conclusion, economic freedom and trust are both substitutes and complements, and need to be carefully mixed.

443. Freedom, economy and basic income published 4-10-2019

A virtue of liberal society is freedom of choice, or part of it. Such freedom requires two things: freedom to make a choice, selecting from options, with little constraint, in 'negative freedom'. It also requires that one have a choice, options to choose from, and the means to realise them, in 'positive freedom'.

A familiar idea of economics is 'quid pro quo': to get something you must give something. To have money one must earn it. There is no free lunch. The idea of an unconditional basic income (BI), with no condition of work and no obligations, seems to go against that principle.

That is no doubt part of the deeply rooted political resistance to a BI, as inimical to a market-based, liberal society. But it is not.

For poor people, however, the virtue of a BI is that it frees people from the stranglehold of poverty, with constant worry about food, ability to pay for bills, educate children, sapping opportunity. strength and initiative to get out of ‘the poverty trap’.

A BI increases negative freedom, from the shackles of poverty, as well as positive freedom, in lending some access to resources for improvement. But why not use the usual avenue of loans to set up enterprise? That should be promoted, as is happening with ‘micro credit’, but a problem remains that the poor lack ‘collateral’ to cover the loan, and in case of default the pit of poverty would deepen.

Time and again, experiments or practice of basic income, unconditional but often only for some, the trapped poor, and for some time, show that it works. There is evidence from Brazil, India, Rwanda, Ghana, Ethiopia, Kenia and Malawi. People receiving the benefit generally do not spend it on consumption but on some investment to improve their economic position. It is also used to get children to go to school who before had to contribute child labour for the family to survive. They use it to buy a sewing machine to make clothes to sell, a fishing net, or boat, or to sink a water well, together with others. So, here we have a non-economic thing with beneficial economic as well as social outcomes. A BI is a means to economic development.

But at the same time, there must also be economic freedom, in absence of corruption, access to markets, ownership rights, and fair legal process, for people not to robbed of the investments they make, and to earn their returns.

A BI is also an efficient means of development aid, more efficient than aid in the form of goods produced elsewhere and shipped and distributed in developing countries, often on the basis of ill-informed guesses about needs, costs of transport and distribution, and with spillage in corruption.

The BI can efficiently be allocated through cell phones that are now available everywhere, also in developing countries.

And concerning ideology: it is not that the recipients do not do something for the BI, it is just that they do it after, not before receiving it.

In sum, economy and basic income can go well together, complementing each other. Institutions of economic freedom are needed for BI to have its positive effect, with the negative freedom of preventing constraints for enterprise, while BI provides the positive freedom of access to resources for it.

445. The dogma of efficiency published 18-10-2019

The good thing about institutional economics is that it does not take markets for granted but investigates how institutions may enable, disable or pervert markets.

Institutions can be formal and written, such as property rights, access to markets (competition law), and a variety of government regulations (for the environment, advertising, labour conditions, etc.). There are also unwritten, informal, cultural effects, such as norms and customs of behaviour, with underlying ethics and values. Language is an institution that enables communication.

There still is, even among institutional economists, the dogma that all institutional analysis should be based on the assumption of efficiency, as recently propounded by Douglas Allen, in a book 'Research agenda for New Institutional Economics'.[vi] Allen defined efficiency as the outcome of the maximization of a utility function under constraints. If an institution appears inefficient, that is because one has neglected some part of he utility function or some side condition.

This is in itself an institution, stating the rule of the game for institutional economists to belong to the tribe.

Here, Allen quotes Coase, one of the founding fathers of institutional economics as saying that '.. to not appreciate that institutions are efficiently chosen is to end up doing welfare economics that "ultimately dissolves into a study of aesthetics and morals"'.

Now, I would not claim aesthetics as a basis for the study of institutions, but I would certainly include morals as perhaps the most important aspect of the role of culture in the making of institutions. Trust, for example is based, in part, on morals. It is risible to denigrate morals in the way that Coase did.

There are two problems with the dogma. The first is methodological. The claim that institutions are efficient is taken to be true by definition, therefore is not falsifiable and therefore not scientific.

The second problem is substantive. The assumption of efficiency appears to ignore the vast evidence that people routinely make decisions out of ignorance, mistake, impulse and irrational shortcuts to decisions (called 'heuristics'). Developed in social psychology, all this is now part of behavioural economics.

Now, the response to this criticism of the dogmatic economist would be that this conduct only seems irrational, inefficient, because one has not included the proper goals or constraints of conduct. But that only confirms, or deepens, the methodological problem. All conduct becomes rational even if it is not rational.

The solution of the dogmatist would be to rationalize the heuristics by including in the objective function the cost of mental effort and delay of rational analysis. In this way one can rationalize any conduct, no matter how absurd, by including the assumption that this what people want. The point is, of course that no matter how you twist it, the fact remains that the conduct is irrational.

A whole industry of 'nudging' is developing, where policymakers or business strategists develop ways to improve the rationality of conduct, by affecting ('nudging') preferences and habits, the way heuristics work, to improve their optimality, by showing how choice can be improved, or by sheer manipulation.

This requires the recognition of inefficiency and irrationality.

446. How rational is altruism?

Published 26-10-2019

In this blog I discussed several aspects of altruism. How would an economist deal with it? Altruism, recall, is defined as making a sacrifice to someone else without counting on an adequate benefit from it.

What an economist would probably say first, as has indeed been claimed, is that under the pressure of competition one cannot afford it. To survive one needs to grasp every possible opportunity for profit. In fact, the pressure of competition is often not so sharp, with firms doing all they can to soften it, in limits to competition.

However that may be, suppose that nevertheless altruism is observed? The economist, seeking to explain everything on the basis of the maximisation of some 'objective function' under constraints, would say that then it must be rational, and that it can be reconstructed by including in the objective function a reward in the form of feeling good about making the sacrifice.

The problem with this is as follows. Assuming that the sacrifice is material, i.e. monetary, in the form of profit foregone, the benefit is not material but ….., yes what? Is it a feeling of moral duty, or a personal sense of empathy, or friendship, or love (agape), or response to a need, or a habit, or a favour in return to a favour received, or creating a good reputation?

Is it clear to the decision maker himself which is at issue? Is he honest to himself about the motive? Recall the issue of limited freedom of the will, according to which many, perhaps most decisions are made subconsciously, by impulse, which then are often rationalized afterwards. Could one still call that rational?

And suppose he knew which motive was at play, how measurable would its benefit be? The 'value' of it would be uncertain, dependent on contigencies the decision maker cannot fathom. If the party the sacrifice is made to also has limited freedom of the will, who can say how he will respond? How measurable is all this? If not, what remains of the notion of maximizing an objective function?

One should recognize that here, as in many other cases, there is uncertainty in the sense that one does not know all the things that could happen, and what the costs and benefits would be. Then, one cannot calculate and be rational in that sense. One operates by hunch or guess, or more or less at random. Not knowing what the outcome will or even can be, one needs the courage of making a leap of faith, relying on one's intuitive hunches and impulse.

Research shows that often decisions made that way are surprisingly effective. It is just that one cannot explain how. After all, we operate subconsciously but effectively on the basis of routines in so many everyday activities.

Algorithms operated by 'platform businesses' such as Google and Facebook can predict your choices better, on the basis of masses of data collected on your conduct and choices, than you can yourself. Could one still maintain that our choices are rational?

447. Does China need democracy for growth? Published2-11-2019

This is a third piece on dogmatism in economics. I discuss an article by Cheryl Long in a recent volume on ‘A research agenda for New Institutional Economics’[vii]. It raises the familiar issue whether ‘ultimately’ economic growth requires the liberal democratic economic institutions familiar in the West: universal laws concerning property, access to markets, low government interference, especially in business, and low taxes.

In China things are different. Instead of universal laws of property, supported by an independent judiciary, there is decentralization to regions in the scope allowed for regulations and interference by local government and its collaboration with business, in expropriation and allocation of locations, tax, and the granting of permissions, and with an opaque sharing of interests and deals of give and take. Also, instead of legal ordering, activity to a large extent rests upon ‘guanxi’, networks of family members and partners supporting each other on the basis of reciprocity, reputation and trust. Long calls these ‘substitutes’ for Western institutions, implying that they compromise what is taken to be the ideal, i.e. the Western institutions. This raises doubt concerning Chinese perspectives for continued growth.

Yet, China has had an ongoing record of growth, and still continues to grow, albeit less, ostensibly due to trade conflicts with the US. So, perhaps one should consider the possibility of other paths to growth than only Western institutions. What might be the rationale for that?

The diversity of associations between local government and business, in China, yields competition between regions that may stimulate growth. It also turns the country into a huge laboratory of experiments in economic arrangements that may be a source of innovation. And after all, in other countries there have also been experiments with public-private enterprise.

Second, concerning the guanxi, in Japan also, trust networks of family and associates play an important role in business.[viii] That has the possible downside of locking activities into the network, closing it off to possibly more productive alternatives and inspiration from outside. On the other hand, the alternative of extensive contracting, via the law, carries high transaction costs. As argued elsewhere in this blog, innovation is a crucial source of growth, and under the uncertainty of innovation trust is needed as a ‘leap of faith’, backed up by relational goods. And apart from its instrumental value, trust may also yield a higher intrinsic value of relationships.

Third, concerning government involvement, much of economic growth in the West has also arisen from government initiatives and subsidies, i.e. in defence industries and its spinoffs. The EU offers large subsidies to a variety of projects in research and development. Japan also has based its prosperity partly on large government planned and financed projects.

So, it may not be good news politically, but a sense of realism compels one to recognize other paths to growth than democratic institutions.

454. Beyond utility published 27-12-2019

In his recent book ‘Is there a future for heterodox economics?’, Geoffrey Hodgson, a well known heterodox economist, characterized orthodox economics as maintaining the approach of ‘utility maximization’ or ‘Max U’. He criticized that, as I did in previous items in this blog. The principle of Max U is unfalsifiable, since utility cannot be measured.

One of the reasons that a one-dimensional measure of utility is assumed, is that it enables simple mathematics, and math rules as the paragon of ‘scientificness’.

When people say that human conduct entails more than self-interest, such as the interests of others, or other moral values, one can simply add corresponding variables. Hence, the principle of Max U is unfalsifiable. Here, I reiterate the problems I noted in previous items in this blog, and add an insight from Hodgson. The problems with Max U are as follows:

First, as mentioned, utility is not observable, and the principle of Max U is unfalsifiable, while that is one of the criteria of a theory being unscientific.

Second, there are different dimensions of utility that are not ‘commensurable’, cannot be subsumed in one variable of utility.

In particular, moral values are of a different order from economic ones. Buying a house one cannot afford is not of the same category as not killing someone. It is unconditional, imperative, and not a matter of self-interest. Likewise, the being of another, in his/her dignity is not an economic value to be bargained with. Not everything can be subsumed in self-interest. Kant already argued this. You Follow moral rules not for pleasure or other utility, but because following the rule constitutes who you want to be.

Jobs, and perhaps relations have extrinsic, instrumental value, for achieving some purpose, but can also have intrinsic value, value by themselves, and moral principles certainly do.

In other words, the other person and moral values cannot be subsumed under ‘utility’.

In a recent book, entitled ‘Uprooting economics’, I pleaded to replace ‘utility ethics’ with the ‘virtue ethics’ of Aristotle. The first looks only at outcomes, for example in the form of utility, and ignores intentions and morals. The second includes consequences but also looks at intentions, morality. The classical virtues are: reason, courage, moderation and justice. They are connected. For example: one needs moderation for justice. Also courage to make sacrifices for the sake of another, or resist temptations to violate a moral stricture. In this way, morality may not only be incommensurable, of a different order from economic value, but may go against it, in moderation and justice.

Third, the future can be uncertain, in distinction with calculable risk. This disables Max U.To deal with uncertainty, one needs trust, and courage to make a leap of faith, be vulnerable.

Liberalism excluded morality, discussions and expressions of faith from public debate, and relegated it to religion, behind doors of the private sphere. But that was in the effort to avoid religious wars, which were rampant in the past. Now, with the need for environmental protection, excesses of inequality of income and wealth, there is a need for public debate on it, on morality.

Social psychology teaches us that much of our decision making, choice, is made subconsciously, impulsively, not subject to deliberation, let alone Max U. This was adopted in economics, as ‘behavioural economics’, but a psychologist trying to collaborate with economists on this reported that those keep on trying to fit this in max U, and this is reported also by Hodgson. But how can you talk of maximization when it is not deliberate?

Behavioural economics was already considered by Herbert Simon 60 years ago. He proposed that people ‘satisfice’: stop doing Max U from a certain point. That can easily be incorporated in Max U by assuming that there is a psychic cost of rational calculation. Thus it is much less fundamental than choice being subconscious.

An alternative to Max U is adaptation, as in Evolutionary Evonomics, as discussed in item 396 in this blog. Much has already been written about evolution in this blog (items 27-30, 46, 82, 161, 195, 205, 279, 376. These 11 items were collected in a bundle, presented on my website bartnooteboom.nl). It is similar to the satisficing advocated by Herbert Simon, in that one can stop when survival is assured.

456. The meaning of rationality published 4-1-2020

In item 394 of this blog I discussed rationality and non-rational decision heuristics. Here I return to the subject, from a different angle.

What does ‘rationality’ mean? It can mean the use of logic, facts and their combination in the ‘scientific method’ of hypothesis and empirical test. Logic then requires that scientists seek to falsify their theories (Popper). In fact, scientists seek confirmation, to protect their reputation and gain attention and resources. Criticism and falsification are up to competition in the scientific community, not the individual.

Sometimes, especially in economics, ‘rationality’ means doing what is ‘good’, in agreement with goals, maximizing utility. The question then is who determines that. It is known, in social psychology, that often choices, decisions, are not made ‘rationally’, with the use of reason, consciously and deliberately, but unconsciously and impulsively. That is not always bad, in situations that one has often experienced, as in walking and driving a car, things fir which you have developed a routine.

Sometimes, however, they go against ‘optimality’. Use is made of non-rational decision heuristics, as discussed in item 394. That has led to ‘nudging’, where impulsive or routine behaviour is used to steer decisions in the direction of optimality. An example is the ‘opt-out’ in insurance, or the donation of organs, where you indicate if you don’t want it, instead of the earlier ‘opt-in’, where you indicate it if you want it. That employs the inertia or unwillingness to choose, whereby people remain underinsured or donate organs too little. The ethics of nudging is that it may only be done in the interest of the people involved. One can see that as benevolent guidance, but also as manipulation. That is not new: it has been happening for long in advertising, but not always in the interest of the consumer. It happens in the use of ‘algorithms’, on the basis of data of conduct as collected via Facebook, Google of Amazon. Those ‘know you better than yourself’ in your subconscious conduct. Is that rational? No, because it does not make conduct more ‘optimal’, but is to the benefit of those who do the manipulation. Yes, maybe, if it is used for nudging.

In Object oriented philosophy (OOO) Harman claimed that an object cannot be fully known, in all its features, but is partially ‘withdrawn’, with features that are inaccessible, because hidden or caught in an incomprehensible code or structure, or are not(yet) there. Bhaskar and

DeLanda proposed that objects have potential to produce features, depending on circumstances. Then they are not yet present and hence unknowable.

Rationality, the use of reason, is a virtue, but has its limits. We do some things without rational deliberation, in routines, as mentioned above, and some things can only bed grasped by hunch. Also, emotions set the agenda for rational thought.

And then there is morality: rules for conduct that are not rationally deliberated, subjected to calculation, but adopted and followed unconditionally, having intrinsic value of a different order than interests.

457. Issues for change in economics published 11-1-2020

The criticism of dominant, orthodox economics, and demands for its change, have intensified since the financial crisis in 2008. Sources of those protests are heterodox economics, such as post-Keynesian economics, evolutionary economics, (new) institutional economics. and social economics, and the international movement of young economists with the name ‘Rethinking economics’.

Some of the criticism and proposals for change were given in previous items of this blog, collected in a bundle posted on my website bartnooteboom.nl. They were also elaborated in a recent book[ix]. Here I review them and make additions. The order is arbitrary, does not signify priority.

1. The issue of uncertainty. Keynes was one the few economists to take it seriously and see its consequences. Under uncertainty one cannot calculate, and calculative rationality is a cornerstone of orthodox economics. The results are bandwagon effects and hypes, as Keynes recognized.
2. The issue of maximizing a utility function. People are not only limitedly rational (see below), but things of value cannot all be subsumed under a single utility. They can have intrinsic value next to extrinsic, instrumental value. That applies to work, as a source of income and a source of satisfaction, in giving pleasure or a sense of accomplishment, and social recognition. It applies, in particular, to moral values that one does not always practise for their utility, but because they constituted what one feels one should practise, and that is who one wants to be. That can apply also to trust, which can be useful, as a ‘lubricant for relations’ but also has intrinsic value. Another problem of utility is that it is purely conceptual, and cannot be observed directly. Utility maximization is unfalsifiable: one can always conceive of some utility function whose maximization reproduces observed behaviour. That makes it scientifically dubious.
3. The already present ‘preferences’ that underlie choice are partly formed, or adjusted, in the process of choosing and acting upon it. .
4. Due to the role of subconscious processes of choice, as taught in social psychology, people are limitedly rational: do not always make rational choices. That can be very effective, in routine conduct, but it does not satisfy the assumption, in economics, of rational choice.
5. Transaction costs, such as caused by imperfect information, cause ‘market failures’, of misjudging quality and reliability, the incompleteness and cost of collecting information, making contracts or other agreements and controlling their execution.

6. The condition that relations imply ‘specific investments’ that have value only, or mostly, in that relationship, which make one dependent, and create a need for the relationship to last some minimum tie, to recoup that investment. This pleads for ‘optimal’, not maximum flexibility.
7. The human need for local roots, which obstruct the economic credo of maximum mobility of resources, including labour, which in globalisation erode local communities and work relations, and sources of respect and reputation.
8. The self is not autonomous, as assumed in economics. One does not only need the other for the advantage of division of labour, but one is constituted in action in the world, in interaction with others. Opposition by others yields the highest form of freedom: freedom from prejudice.
9. The need for trust, for agreeable relations and the economy. Some economists claim that trust cannot survive in markets, due to competition, but competition is not always so strong as to prevent some slack for sacrifices for trust, and, more fundamentally, in so far as survival requires innovation, that brings uncertainty, which requires the ‘leap of trust’, and therefore I turn it around: in markets one needs trust.
10. In so far as economists take into account issues of information and knowledge, they take it for granted, tacitly most of the time, that in relations there should minimum of ‘cognitive distance’, difference in ideas. But such difference also has value, as source of innovation. Rather than minimum difference there should therefore be ‘optimal distance’, in a trade-off between distance as an obstacle for understanding and as a source of difference for innovation.

Most of these points entail a ‘paradigm shift’, and one can ask if this is still economics. That is probably why they tend to be ignored or neglected by economists.

458. Markets: What to make of them published 18-1-2020

In debates concerning markets, in the wake of the recent financial and economic crises, there is considerable confusion among policy makers and the general public, and even among economists, on what markets are, how they function, how they fail, what they contribute to society, and what the alternatives are. Related confusion arises in debates concerning deregulation and privatization of public or semi-public services, such as utilities (gas, water, electricity, telecommunication), transport (train, bus), infrastructure (road, rail, waterways), health services (care and cure), education and schooling, safety and security, prisons, etc. State bureaucracies are not attractive, but markets are taken to promise beneficial effects that are often not achieved or are overruled by negative effects.
Here I start a series of items to contribute to insight in markets that may help people to form an opinion. I derive it from a book on markets that was published by Edward Elgar in 2014.. The title is the same as of this item.

In the widest sense, *Markets* are processes of *supply and demand* on the basis of private choice and initiative that yield selection of success by competition and institutions. *Market places* are places where supply and demand meet. A meeting of supply and demand is needed to enable division of labour, needed as a source of prosperity.

A narrow notion of markets is the economist's traditional, idealized model of *perfect competition*, where a mere mechanism of prices, without any government intervention, in *laissez faire*, yields an optimal allocation of scarce resources. It was an intellectual challenge to prove that analytically Adam Smith's idea of the *invisible hand* could work. However, it has little, if anything, to do with reality. It is a fairy tale. I call it the *mythmarket*.

When one criticizes market ideology, targeting the myth, the idealized fairy tale, the answer from economists is that in modern economics the market is seen more broadly, and with more nuance, in a wider notion of markets. In fact, surreptitiously they still pursue the fairy tale that has been lodged in their minds in economics classes. In other words, the narrow view is taken as a guide (*theory in use*) but the broad view is wielded as an excuse *(espoused theory*).

In valid criticism of market ideology, radical critics, on the other hand, make the mistake of also throwing away a wider notion of markets that I think we cannot do without. So I need a new terminology to denote a variety of wider notions of markets while making it clear that I reject the fairy tale.

Earlier, in item 86 of this blog, I already discussed several wider notions of markets, in which there is collaboration next to competition, and competition is imperfect, yielding room for ethical conduct, a certain amount of altruism next to egotism, and a wider ethics, going beyond the *utilitarianism* of traditional economic theory, in a *virtue ethics* that also accords *intrinsic value* to economic activities and virtues.

The already existing notion of *regulated market* indicates that markets require institutions and government intervention to work and to redress perverse effects. That applies to all the markets indicated above, except the mythmarket. Competition is imperfect in many ways and requires a variety of government intervention. Markets do not satisfy all social goals and seriously damage a number of them. Most economists recognize this. Behind supply and demand there are social and psychological processes of choice and processes of production and innovation. Much of that requires collaboration, next to competition, and they limit each other. Many economists recognize this (e.g. in *transaction cost economics*).

Still crucial, also in the wider notions of markets, is the idea of maximum freedom, and hence variety, of choice and initiative. That is what makes it different from central planning. That element of ideology remains.

In the present series I will first specify in more detail the mythmarket *of perfect competition, and criticism of it. Next, I will go more deeply into the philosophical roots of markets and market ideology, and I will consider alternative roots for alternative views. I will also go a little more deeply in to the question how markets work and fail. I will show that in practice there are mixes of markets and government regulation, and I will give some examples. Finally, I will look at newer developments, and at possible alternatives to markets, in communities.*

459. Market ideology: freedom published 25-1-2020

Many good economists grant that the model of the mythmarket, with perfect competition, is unrealistic. That applies even to the original makers of the model (Arrow and Debreu). Some say that it was never meant to approximate reality. Others say that it presents a benchmark against which real markets may be assessed. However, a line of highly vocal economists, from Hayek and Friedman through *rational expectations* economists, in *the new classical economics*, were convinced that this Utopia could and should be realized, and many policy makers followed their gospel. The illusory ideal of perfect competition still forms the basis for a market ideology, often hidden, sometimes made explicit, that sees ‘the market’, i.e. the mythmarket, as a universal panacea.

I quote Cassidy (2009: 345): ‘Even today, all too many economists see their primary role as defending the market system against possible encroachments. Privately, they are often willing to acknowledge that a particular industry is wracked by market failure and needs reforming. Somehow, though, these individual flaws don’t add up to an overall critique’.

‘The market’ came to be taken for granted, as a law of nature, inexorable and inevitable, and economic ‘crises’ were and still are made to sound like natural disasters, like hurricanes, that happen to us, while in fact both markets and crises are of our own making.

Behind the model lie deeper, tacit, implicit views, mostly from the Enlightenment, concerning the rational, autonomous individual; freedom; an ethics of utility; the virtue of self-interest, universal principles and laws, and the rigours of mathematics. Here I discuss *freedom*, here freedom of choice for consumers and producers, which is arguably the most powerful driver of market ideology. That is why ‘the market’ is associated with ‘the free world’, and any compromise on the operation of markets is a compromise on freedom, and therefore unacceptable, or so the rhetoric goes.[5]

[5] A great impulse for this lay in Friedrich Hayeks *Road to serfdom* and Milton Friedmans *Capitalism and freedom.*

In real economies, freedom of choice is often severely hampered by lack of alternatives to choose from (in monopoly), the difficulty to judge differences in quality between competing goods and services, and high costs of switching between them.

Nevertheless, the claim of freedom, though imperfect, for markets is valid, and indeed one of its strongest points, but it does depend on what notion of freedom one endorses (see item 49in this blog). What applies here is so-called *negative freedom* or freedom from constraint or interference. But there is also a notion of *positive freedom* or freedom of access to resources, knowledge, abilities, networks and the like, and here markets perform much less well.

Few economists include this (Amartya Sen is an exception). To the extent that competition approaches what economists call ‘perfect’ indeed there is little room to make any compromise on maximum profit, but in fact that is seldom the case, due to market imperfections, arising from economies of scale, product differentiation, lack of information, transaction costs and other factors, to be discussed later in this blog. While ‘imperfect competition’ is a vice for economists it can be a virtue for the good life, and thereby I reverse the famous dictum that private vices (of cupidity) are public virtues (of economic efficiency): economic virtues can be public vices.

460. Market ideology: variety published 1-2-2020

A second strong argument for markets, next to freedom but related to it, is that in contrast with central planning they give room for *variety* and *variability* of local, idiosyncratic tastes and ideas of consumers and producers, and tap into them. That is important especially for innovation. This idea goes back to the economist Friedrich Hayek, one of the godfathers of neo-liberalism, and on this point he was right. Centrally planned economies are unable to plan and innovate production and allocate resources in a manner that fully mobilizes variety and variability of choice and enterprise. Hayek went overboard, however, in assuming that markets incorporate all relevant information efficiently in prices, to automatically produce an optimal allocation of resources.

In item 57 of this blog I discussed variety of cognition, in *cognitive* distance, as both a problem for mutual understanding and an opportunity for innovation by *novel combinations.* To profit from the opportunity of innovation one must learn to cross cognitive distance. A central challenge for entrepreneurs and firms is to develop the ability to collaborate with others who think and perceive differently.

There are now three paradoxes of variety. The first is tension between variety and the efficiency that is claimed for markets. With variety in the form of product differentiation not all information relevant to the individual is included in the price. It increases transaction costs in the form of search costs. Consumers are not always able to fully perceive and assess differences in products. At the same time, product variety reduces the pressure of price competition that is supposed to yield allocative efficiency. Also, differences in composition and quality of goods and services entail that when one chooses one product as the most preferred one, then to switch to another, different product one incurs *switching costs* in making a compromise on what is most desired. That switching cost for consumers allows producers to raise price above production cost.

The second paradox is as follows. While perhaps the strongest argument for markets is that they tap into the variety of individual, local knowledge, ideas and preferences, in industrialization increase of scale and concentration of activities into fewer, bigger organizations have led to a reduction of variety, in mass production. The mythmarket is one of *homogeneous products,* and *optimal production technology* accessible to all. In facilitating markets there is talk of creating a *level playing field.* In fact, competition is mostly about being different, in differentiating products and technology, and creating new playing fields.

The third paradox is as follows. Without institutions markets cannot work. Institutions are not just laws and their enforcement. They are, much more widely, durable social (humanly devised) habits and rules that both enable and constrain behaviour. This includes ethics and morality. They form the basis for predictions and agreements about future actions. Institutions vary among countries. Now, the claim for efficient markets is that they are universal, to be applied everywhere, regardless of varieties of institutions, resulting from differences of culture, history, political conditions, stage of economic development, and available resources.

In sum, to profit from the variety of markets one must accept that competition is imperfect, operates not only on price but also on quality, and that markets vary with institutions.

462 Philosophy of economic science published 18-2-2020

A famous defence of the unrealistic mythmarket of perfect competition is that theory requires abstraction and cannot and should not try to reproduce reality. The question is only whether the theory yields accurate predictions when we look at reality 'as if' the model applies. This is the famous *instrumentalist* argument of Milton Friedman. In fact most evidence has contradicted the theory.

Karl Popper proposed that a theory cannot be proven true but can only be falsified by evidence against it. A problem there is that in economics theory is hard to falsify because one can take shelter in the fact that there are so many other, uncontrollable conditions that can upset predictions, other than limitations of the theory.

Therefore, the argument for validity, or *warranted assertibility,* if not truth, on the basis of empirical validation may work for physical science, but for economics it does not fly, but flutters like a lame stork.

In fact, economists perform a sleight of hand here. While granting that assumptions are not realistic, and are made only 'as if', economists next give excuses why predictions cannot be rigorously tested, and then fall back on the theoretical assumptions anyway, no longer only 'as if' they apply, but also in deriving policy implications, claiming that markets should be left alone because they are efficient. But that remains to be demonstrated. The snake bites its tail. At first, markets are taken only 'as if' they are efficient, this is never convincingly corroborated, and then for policy implications they are taken to be efficient. It is admitted that the model is a Utopia but since it cannot be falsified it is taken to be real.

Traditionally, science aimed to 'save the phenomena': a theory should be able to explain accepted observations or facts. In economics the principle is 'save the theory'. If things claimed by the theory cannot be observed, occult, unobservable entities are posited by which they exist anyway.

There are several examples but I will discuss only one. In economic theory rational choice rests on the assumption that people have preferences that satisfy certain axioms (such as transitivity: if A is preferred to B and B to C, then A must also be preferred to C). These preferences cannot be observed, indeed in psychology they are found not to exist as postulated. In fact, much choice arises from unconscious impulse. And now comes the economists' sleight of hand again, the reversal of logic: since people do make choices, preferences must exist; they are *revealed* in the fact that choices are made. What is wrong with this is that it neglects the possibility that choices are made differently. Intransitive preferences have been shown to occur, when choices have to be made among options with several dimensions of utility that are not *commensurable*, i.e. cannot be added and subtracted (see item 79 on incommensurability).

But then, if people are unable to arrive at a consistent, rational evaluation, how are choices made? If people are unable to consistently add and subtract different dimensions of utility, the choice may be determined by whim and impulse. Producers exploit this in advertising. Not knowing how to trade off different dimensions of utility consumers decide on something often small but salient, with simple, emotional appeal, such as the design of the dashboard As they also do in politics.

Also, preferences often are not given beforehand but develop when things are tried out, arising after rather than prior to choice and action.

463. Human nature published 22-2-2020

Economists adopt a limited, highly stunted view of *human nature*, even while not actually believing in it. They are geared to think in terms of rational choice between alternatives, but people are very limited in their rational evaluation, for good cognitive reasons. Recent debates on the limits of free will, or even its absence, indicate how limited the rationality of our choices is. See also the previous item in this blog.

Economists further assume that people are driven only by self-interest. Many economists recognize that in markets there is collaboration next to competition, but here collaboration is still driven by self-interest, though this includes *enlightened self-interest* in which one makes sacrifices for others as long as in the end it yields net advantage for oneself. There is still no room, most economists think, for altruism, which may be detrimental to material self-interest. The argument is that competition is too harsh, too 'perfect', as economists would call it, to allow for any compromise on maximum profit or minimum cost. The firm would not survive if it did not grasp every opportunity for higher profit. I disagree.

As I argued in preceding items in this blog (e.g. 46), the human being has an instinct for both self-interest for the sake of survival, and altruism for the sake of social legitimacy and cohesion, with a corresponding 'moral' sense of normativity next to self-interest. Furthermore, competition is seldom so harsh that survival requires maximum possible profit. Product differentiation, segmentation of markets, innovation, and durable competitive advantage due to specialized, difficult to imitate knowledge and other assets, yield some slack to take other objectives into account.

The conduct of people is also determined, to a large degree, by behavioural phenomena of social interaction such as studied in social psychology. *Group cohesion* can have both beneficial and detrimental effects (see item 48 on immorality of the group). Time and time again economists, except Keynes, also neglect other sociological effects such as *herd conduct*, which leads to bubbles and their burst and indeed was a major factor in the current financial crisis.

I propose that for a proper understanding of markets we must include insights into the limits of rationality, psychology and sociology, processes that entail radical uncertainty, and the role of institutions. To some extent these can be found in *non-standard economics,* such as behavioural economics for limits of rationality, evolutionary economics for processes that are not based on rational foresight, and institutional economics. However, for sufficient depth and coherence of insight we must move beyond economics into the areas of cognitive science, social psychology, sociology, and philosophy rather than having heterodox economists re-inventing wheels in primitive ways, in those areas.

The partnering of economics and psychology is not new: it was there in the early economics of Adam Smith, who in his work on morality recognized an inability of people to focus on the long term, a concern for the well-being of others, in what he called sympathy, a tendency to overestimate one's own abilities, and an inclination to underestimate risks. Let us return to this wider view of human conduct.

464. Evolutionary economics published 27-2-2020

Perhaps the most fundamental problem for rational choice arises when *uncertainty* is radical, i.e. when we do not know in advance what all the options for actions are and what their consequences may be. Often options arise in the light of the outcomes of actions rather than being given in advance. Also, the preferences that are supposed to form the basis for rational choice are often formed in action rather than being given before it. I will argue that an evolutionary perspective of innovation, which avoids 'intelligent design', yields a more useful perspective.

The basic principles of evolution are *variety generation*, *selection* and *transmission* (of what survives selection). In item 30 of this blog I discussed evolution in society. Here I focus more on the economy. Variety generation arises from innovation, selection is performed by markets and institutions, and transmission of success occurs in firm growth, imitation, education and training.

However, in item 30 I warned against going too far in adopting a biological analogue of evolution. In society, variety generation, selection and transmission take their own forms, which are quite different from biology. Innovation is not the same as mutation of genes and crossover of chromosomes. The selection environment of markets and institutions can be manipulated by political influence. Transmission entails communication, which entails interpretation, which entails transformation, so that it is at the same time not only transmission but also a source of variety.

Evolution provides an alternative to market logic including freedom and variety as well as selection. There is freedom in a variety of ideas put up for selection. Struggle for survival includes competition, but also symbiosis. Survival, in adaptiveness to the selection environment, is not necessarily rational or optimal. In innovation it is often not the best product that wins, but the one that manages to conquer the market first. Most important, evolutionary theory recognizes radical uncertainty that limits intelligent design.

It is often adaptive, good for social survival, to go along with majority opinion, against one's own views and convictions. This is connected with *group think* in organizations, *herd conduct* in markets, and *immorality of groups* (see item 48). Policies are designed and adopted that are illogical, not optimal or even detrimental, for the sake of political expediency.

Paradoxically, this can lead to policies that satisfy old, erroneous intuitions of rational design, thwarting the dynamics of evolution. An example is innovation policy, as adopted in the Netherlands, in the form of planning innovation in committees for selected industries. It goes against the logic of evolution, and indeed the logic of markets, in reducing variety and selection. It yields an obstacle for the crossing of boundaries between industries and technologies that generates innovation. However, there is an erroneous, adaptive political rationale. Such policy avoids the risks of real innovation that parliament finds hard to stomach for its 'failures' to succeed, it gives vested interests in big business an opportunity to lobby for their interests to limit innovation to incremental innovation that does not upset existing investments and markets too much. This yields a powerful political force to adapt and conform to current standards that sweeps along even scientists who know better.

Is there no evolution or market mechanism to penalize this? Yes: it is manifested in new emerging countries less caught in habits and regulation that win out in innovation.

465. Market failures

> There is a range of market failures and here I can only review a few. Perhaps the most perverse failure is when the two core virtues of markets are destroyed: freedom and variety of choice and initiative, and selecting out failures. Destruction of freedom occurs in *monopolies* and in the *command economies* of large firms. Persistence of failures occurs, for example, with large banks that are 'too big to fail', and in large corporations where top managers are 'too megalomaniac to fail', impregnable and intolerant to criticism, keeping failures hidden or propped up with internal cross-subsidies.

A widely known failure lies in so-called *externalities*, such as environmental degradation and damage to health (*negative externalities*) and so-called *public goods*, such as parks and street lighting (*positive externalities*). One reason why they are difficult to include in markets is that they are *non-excludable*: it is difficult to exclude users who do not pay. An example is roads, but here, with toll roads one can restrict use to those who pay, at the cost of constructing tollbooths at limited entry and exit points.

There is a range of problems that violate the assumption in market theory of full information and rationality, and independence between autonomous agents and their choices and actions. In preceding items I discussed limits to rationality, as in *framing*, and problems of *herding*, which yield financial and other *bubbles* that burst, and in *prisoners' dilemmas* in which economic actors lock each other up in conduct that yields adverse effects (as in too risky investments).

In particular, there are problems of limited or *asymmetric information.* An important case is the phenomenon of *adverse selection.* This arises prominently in insurance, when risks are hard to judge by the insurer, such as a risk of skiing, say. The people most at risk have the highest need for insurance. Knowing this, the insurer could raise his premium, but then most seekers of insurance drop out, leaving only the worse risks. The result is that there is no price at which buyers and sellers can agree. Either the risk for a number of cases or the premium is too high.

A requirement for perfect competition is the absence of *economies of scale*, by which larger firms produce more cheaply than small ones. In fact, such effects are ubiquitous, in various forms, and they give an impulse to concentration of markets in a small number of large firms that can limit competition.

On a global scale, there are *exploitation* of labour and adverse economic and societal *structural effects* on developing countries. National policies for justice and human rights lack grip because multinationals are footloose, able to migrate to where conditions are least restrictive. Corporations far outrun the capability of governments to restrain them. Markets unleash forces that can become impossible to control.

Another adverse effect is that expectations on capital markets impose a *short term* perspective, and a focus on the interests of *shareholders*, whereby long term interests and public interests such as protecting the environment, are neglected. Investors and managers squeeze too much from the firm, reducing spending on innovation, to increase cash flow, which reduces innovative capability.

In the following item in this blog I will discuss the important problem of *transaction costs.*

466 Transaction costs published 14-3-2020

Transaction costs are the costs of markets: costs of *contact, contract* and *control*. Costs of contact lie in searching for buyers/suppliers, evaluation of the quality of their products, their reliability, etc. Costs of contract lie in coming to some form of *governance*, in reaching an agreement, negotiation, contracting, and costs of organization (division of labour, collaboration, and exchange). Costs of control lie in monitoring performance, adjustment of agreements, haggling, conflict resolution, litigation, if it comes to that, and costs of separation.

Governance needs to deal with relational risks. A central notion here is that of *relation-specific investments*: investments whose value is partly or wholly limited to the relation, and is largely worthless outside the relationship, and therefore entail *switching costs*: costs of switching to another buyer or supplier. The possible loss of such specific investment constitutes a risk, in that the partner can threaten to break up the relationship at the cost of that loss. As a result, such investments cause dependence that can be used as leverage in the distribution of jointly produced added value. A condition for making a specific investments is that one can expect that the relationship will last long enough, or will yield a sufficient volume of transactions, to recoup the investment.

Why incur such problems and not avoid specific investments? Often, most value is added, and most profit made, with specialized, differentiated products that distinguish themselves from the competition. That is mostly achieved by combining complementary resources from different firms (knowledge, technology, skills, market access, …) into novel, unique combinations of features. However, that requires relation-specific investments. So, one incurs the problems of dependence to utilize an opportunity for profit. As a result, collaboration is as much part of markets as competition is.

There is a dominant rhetoric of maximum flexibility to ensure maximum efficiency, in hiring and firing workers, in buying and selling parts of firms, and in beginning and ending relationships of collaboration. The logic of specific investments goes against that. Instead of maximum flexibility one should go for optimal flexibility, with relationships that are durable enough to elicit specific investments but not so fixed that they yield rigidities in the inability to adjust to novel conditions or opportunities.

There are also implications for choosing between on the one hand markets and on the other hand integration within a large organization. When the costs of the market exceed a certain limit, its motivational advantages, in partners being independently responsible for their own survival, becomes less than the costs involved in exchange and governance, and it is more efficient to integrate.

The standard theory proposes that the greater the uncertainty the higher relational risks and hence the greater the preference for integration. However, that is not quite right. It is useful to distinguish between behavioural and technical/commercial uncertainty. The claim applies for behavioural uncertainty, as when motives and capabilities are difficult to judge or when there is a low general level of trust. Under the technological and commercial uncertainty of innovation, on the other hand, outside, independent partners contribute more to the necessary variety of knowledge and the flexibility and scope of a variety of relationships. So there the prediction is the reverse: more uncertainty pleads for less integration.

467. A different view of markets published 21-3-2020

In view of all the problems of markets as envisaged by economics, discussed in preceding items in his blog, in summary I propose a view of markets that is different, indeed more or less the opposite to the model of *perfect competition*. My eight basic assumptions, replacing those of that model, presented in item 458, are the following:

1. Actors are *limitedly rational*. Though rational reflection does have an effect on choice, the latter is largely dictated by unconscious impulse, as recognised in behavioural economics.
2. Knowledge is biased by forms of thought that have developed during life, on the basis of genetic endowments, and vary between people to the extent that they have developed in different environments (*cognitive distance*).
3. People have *no fixed, prior identity*. Ideas are pragmatic and preliminary, and develop on the basis of success and opportunities in practice. As a result, *preferences are limitedly stable* and shift in the process of choice and action.
4. Especially in innovation there is *radical uncertainty* that precludes prior intelligent design. The development of novelty has the basic characteristics of *evolution*, with selection from trial and error and transmission of success.

5. People are not autonomous in their knowledge and preferences, which arise from *social interaction*. Markets are not only about competition but also about *collaboration*, to utilize complementarities in competence.
6. In markets there are *transaction costs* of contact, contract and control.
7. Products are *differentiated* to a greater or lesser extent. As a result, competition is seldom pure price competition and profits routinely exceed costs.
8. By nature, people are *self-interested*, but they are also oriented towards *social legitimation,* by which they also have a natural though limited capability to trust. Next to private motives people are entangled in group interests. Collective and individual interest are obstructed by both individual and collective egotism and deadlock (such as *prisoner's dilemmas*).
9. Ethics is more than only a consequentialist ethics of utility, to include *virtues* of justice, moderation, and solidarity. These values are not all commensurable, cannot always be brought together in calculative trade-off, in an objective function.

Clearly, all this leaves much more complexity than the economists' view of efficient markets. This is a deliberate methodological choice for *finesse rather than geometry* in human affairs. Given new technologies of computing and software there are novel ways of analysing complexity (e.g. in *agent-based simulation*). Evolution provides a theoretical framework for modelling such complexity, with markets interpreted as selection mechanisms, together with institutions, as well as sources of variety and discovery, and transmission devices.

The assumptions entail central importance of institutions, descriptively to understand individual and collective behaviour, and prescriptively to enable markets, to constrain perverse effects, to try and prevent their failure, to enable collaboration next to competition, and to ensure minimal standards of justice. But institutions need to be supported and complemented by ethics, which has the advantage of being voluntary and open to personal variety, interpretation, and circumstance.

As a result of all this, markets can never 'be left to themselves', in 'laisser faire'. It is misleading to speak of 'market failures', which suggests that as a rule they do not fail, while as a rule without proper institutions, interventions and ethics they cannot function. Markets always suffer failures to be redressed.

468. Markets and government published 28-3-2020

It is difficult to find an industry where markets are completely free, without regulation or intervention. The very notion of 'free' is problematic. Institutions are required not only to correct but also to *enable* markets.

In the most general terms, conditions for markets are conditions for the freedom of choice for users and freedom of enterprise for producers. To the extent that these freedoms are constrained, which is *always* the case to a greater or lesser extent, markets function only to some extent.

A question then is when we reach a point that regulation dominates freedom to such an extent that we can hardly still speak of markets. The question then becomes when regulations to channel and restrict the operation of a market go so far that it might be more efficient to take the alternative approach of public planning, which of course requires its own correction mechanisms. The question is not regulation or not, but how much regulation is needed.

Between 'pure' market, if that notion makes sense, and 'pure' public administration there is a range of forms with more or less public participation and regulation.

John Groenewegen identified several categories of public-private hybrids. In the first category *the state owns and manages* the assets, though it can by contract allocate the decision rights to a public agency or corporatized public entity. We may find that in the infrastructure of network industries, such as, for example railways, energy, water supply. Since there are no competing producers one can hardly speak of a market. However, the government can impose benchmarks that show the best performance achieved to challenge producers, or use them to set ceilings to costs. Sometimes the mere threat of privatization may stimulate efficiency. Also, producers may hive off part of their activities to markets, by outsourcing activities other than their core activities to commercial suppliers.

In the second category, *Public-Private-Partnerships* (PPPs), there are different distributions of ownership and decision rights. Private parties take risks in the supply of capital and responsibility for operating them. In return, they claim rights in the commercial supply of the service, a right to operate, and the right to design, build and operate the asset. Government maintains property and decision rights to the extent needed to guarantee a minimum level and quality of service. In some PPPs ownership is public and 'peripheral parts' are privately owned, and in others the building and maintenance of assets is private but the government is responsible for its design. Here, there is the possibility of concessions sold to private operators for a limited period, after which the rights are returned into public hands. Here we can think of the concession of rail and bus services.

The third category is *regulated industries*, where sector-specific regulators can by law intervene in the structure of the market or directly in the behaviour of the private actors. Here we find the telecom market, for example, where the government can intervene in tariff structures, for example. In case of a *natural monopoly*, where cost considerations, such as avoidance of any duplication of investments, such as with railway tracks or water or gas ducts, dictate a monopoly, there may be regulation concerning access to the infrastructure, quality, and price caps. We find this, for example, in energy pipelines.

472. Markets for health care? Published 26-4-2020

After an intermezzo on the Corona crisis, I resume a series of items on markets.

Health care used to be fully public, based on a budget system, but recently in the Netherlands attempts have been made to make it operate as a market. This is a complex case and I can only highlight some key points.

In health care there is separation between the user (the patient), the one who decides (the doctor) and the one who pays (in many cases the insurance company). The separation of use, decision and pay is an invitation of problems for the operation of a market.

The clever idea that emerged was to put the one who pays, the insurance company, in the position to judge quality of health providers, such as hospitals and clinics. The idea was that health providers would compete for the favour of the insurance companies, and insurance companies would compete for customers. The prime aim of the exercise was to cut the costs of health services, which were rising out of control due to ageing of the population and ever new possibilities generated by medical science and technology.

A problem then was that the insurance company cannot (yet) adequately judge the necessity of treatments. It is easily predictable that in a market regime, even if there arises competition on price, the providers of cure still decide the necessity of some treatment and can raise the volume of treatments to increase their income, which increases the cost of health care instead of decreasing it, as was the intention. One of the ironies of this case is that while under the old budget system there was undertreatment, resulting in waiting lists, now there is overtreatment. In laying a limit the old budget forced providers to make priorities in allocating limited capacity. Under the new system, insurers will have to develop some method of judging the need for treatments, taking into account the specific conditions of a given patient at a given time and place. The doctors know but they don't tell.

To make quality and cost judgement by insurance companies possible, health care was regimented in 30.000 *Diagnosis-Treatment-Combinations (DTCs).* This contributes to costs of transaction and administration while the aim of the exercise was reduction of costs. A second problem is that often professional work cannot be adequately captured in such codified protocols, so that their imposition would reduce the scope for case-sensitive professional judgement.

Finally, here is the paradox. One of the two fundamental merits of markets is that they allow for freedom of choice and initiative, but here in the name of markets freedom of choice of patients and freedom of professional practice of doctors is reduced. This move was made to engineer competition between hospitals. The freedom of markets was constrained to create the selection in markets. Now either the DTCs serve their purpose of monitoring and control but then constrain medical practice and yield de-professionalization, or they leave sufficient room for professional judgement and variety, in which case they do not achieve their purpose of monitoring and control.

473. Markets and communities published 2-5-2020

Market theory focuses on impersonal price competition between independent, anonymous, rival producers for the custom of independent, anonymous users. But in fact in markets much is going on in personal relations with a certain continuity. Producers try to build relations with their customers, and they collaborate among each other in more or less ongoing partly personal relations.

Users may collaborate among each other, as in buyer cooperatives. Producers may collaborate among each other, e.g. in setting standards, sharing resources (for example: distribution channels, knowledge), or, less positively, engaging in cartels (fixing price or dividing a market). And, most importantly, there may be collaboration between users and producers. In all or most of these many cases of collaboration the mechanism is not primarily, and sometimes not at all, a price mechanism, but a mechanism of utilizing complementary resources and capabilities, in mutual dependence. That dependence may not be symmetric, and rivalry and conflicts of interest arise. This yields risks that need to be managed in some adequate *governance mechanism.* The added value of collaboration is worth the efforts and costs involved.

Next to their role in creating economic value, relations also have intrinsic value. In early capitalism markets were largely local, with exchange being conducted in personal interchange. Consumers were acquainted with their butcher, baker and shoemaker. As economies of specialization and scale led to increasing concentration, distance between consumer and producer grew, both in space and socially. In economic expansion and industrialization, production became concentrated in large factories, business in large corporations, and public administration in large bureaucracies, and schooling in learning factories. There was an uncoupling in space between living, working, and schooling. There was a proliferation of highways and cars, disappearance of local shops, and concentration of people in large cities. This has led to a society where people do work they don't like to earn money to buy products they don't need to impress people they have no affinity with.

At several places in his blog I claimed that people are not autonomous but are socially constituted, develop their identity and cognition in interaction with others. Essential in that is interaction, action and reaction, expression and response, rejoinder, discussion, debate, give and take. In other words *voice.* That requires personality. If markets lack voice then they fail to offer an essential quality of the good life. But if markets can be transformed to function in communities again, perhaps they can still be saved. And if that is successful, traditional markets may shrink, losing business to local communities, and large, centralized firms will need to develop better ways to interact with their customers, with an eye for their differences.

I see a potential and a desire for a re-emergence of communities at least in some activities. The ICT revolution and other technological developments yield a host of instruments for enabling this. But not everything can be produced locally. Electricity can be, with windmills and solar cells, but oil refining for petrol cannot be. One can provide care locally but not specialized surgery. One can grow crops locally but not their processing into foods and derivatives. There are still economies of specialization and scale that require a certain amount of concentration. However, The Corona crisis shows how vulnerable we can get in breaking up production in parts and spreading those parts across the world, where they are most cheaply produced. Less vulnerability to that, with more local production, will lead to higher costs.

474 Nudging published 10-5-2020

Social psychology has demonstrated that people are very imperfect in their decision making, with routinely non-rational, non-optimal choice resulting from 'decision heuristics', inertia, 'framing', 'anchors', and lack of self-control, discussed elsewhere in this blog..

This discovery has stimulated a movement towards 'nudging', which aims to reduce these imperfections by 'nudging' people towards choices that are better for themselves or third parties, or public interest. Even libertarians argue for 'libertarian paternalism', defined as nudging which is to the benefit of the subject itself (paternalist), while leaving open the choice to accept the nudge or not (libertarian). It is libertarian 'benevolence' if it is in the interest of third parties or the collective.

Nudging can take many forms. One example is the use of nudging to get people to adopt a more healthy life style, in healthy food and more exercise, to avoid obesity. The idea is that people suffer from lack of self-control and lack of a long term perspective, by which they harm themselves (paternalism) or create high collective costs of medical care (benevolence). The nudge might be a higher health insurance premium for unhealthy life styles (premium selection).

One argument for nudging is that it is inevitable, happens in any case, whether intended or not, and then it is better to do it deliberately, in the most beneficial way, rather than ignoring it.

An important case is the question of 'opt-in' or 'opt-out'. For example, in organ donation, the 'default' may be that it is not permitted, unless one gives explicit permission, or, the other way around, one is assumed to give permission unless otherwise indicated. The latter yields more donation than the former, mostly as a result of inertia: one does not want to take the trouble of making an explicit decision and falls back on the default on offer. Another possibility is to force people to make an explicit decision: for or against, and then specify that (e.g. on one's driver's license).

I think that much of this makes sense, but not all of it. In this essay, I give some critical reflections. My target of this is, in particular, a paper arguing for libertarian paternalism by Cass Sunstein and Richard Thaler, published in 2003[x].

Proponents of nudging claim that there is no alternative, but there is. It is to try and build intrinsic motivation of people by convincing and coaching them. I propose that that is ethically, intrinsically preferable to nudging, as more humane, and is likely to be more stable and self-generating, and then also cheaper, more efficient, than extrinsic material incentives.

Take the case of obesity, with the nudge of insurance premiums. Proponents of nudging claim that there is no alternative. But there is. For obesity the alternative is for doctors or councillors to try and convince people to engage in a different life style, and to train and coach them in it. That could be promoted with insurance companies paying for it. When it succeeds the effect is more durable than the material incentive of an insurance premium, which lasts only as long as it is maintained. People then don't act in a certain way because they are rewarded for it but because they think it is better.

475. Markets and industries published 16-5-2020

Markets require a diversity of government intervention, and which measures are required depends on the industry. There is not one single industry policy that fits all. Previously, I discussed the market for hospital health care. Here I give a general survey of features of industries on which intervention depends. For a specific industry, one can pick up which features apply. As before in this blog, 'product' includes service: anything with 'added value'.

Concentration and economy of scale. Economies of scale (due to more of the same) and scope (due to combination of different things) yield lower costs and hence the possibility of lower prices, which yield fewer and larger firms, concentration, which can yield collusion, in price fixing or division of the market in different sections, reducing price competition, which increases prices. The effects can be of different kinds and can be large or small, in production, distribution or marketing, and depend on the technologies used. I will indicate what the various economies are in a separate item in this blog.

The degree of vertical integration of production, sourcing, distribution, servicing, and recycling

The degree and kind of ‘external’ costs of damage to the environment that are not included in the price of the product, such as pollution, safety and health hazards, messing up public space.

Transaction costs of different kinds:

- Costs and limitations for users to judge the nature and quality of the product (service of a repair shop, of a tax consultant, of a doctor, an insurance policy, medecine).
- Difficulty to craft a contract, in specifying punishments and rewards and their conditions.
- Ability to monitor performance, in a cooperative relationship, or other obstacles to enforcing a contract.
- ‘Specific investments’ that are worthless in different relationships than the one they are designed for. These can be investments in buildings (near the partner), training, machinery or installations, knowledge, familiarity as a basis for trust, agreements or contracts. When one-sided, they can yield dependence that can be used to wield power to impose limitations or sacrifices.

Transaction costs as costs of the market can also lead to more integration in big firms, limiting competition.

I may well have neglected some features, and in that case I invite the reader to notify me.

Mutual dependence between products and services (such as hardware and software) that can be used to package them and gain a monopoly.

The surreptitious use of price discrimination with artificial differences in the quality of a product (as with a paperback and hardcover version of a book).

Dominance by shareholders with a short term orientation towards profits, to the detriment of long term development such as innovation, and the duration that development takes (such as in the development of new medicines).

The power of firms to lobby and impose advanbtages for themselves. That depends on the ease of globalisation, moving employment elsewhere. The degree to which this will yield local hardship.

Opportunities for tax evasion, and the degree to which they are used.

The quality and justice of labour, wage and employment conditions

From these features one can cobble industrial policy.

I may well have omitted some features, and in that case I ask the reader to notify me.

476. Economies of scale published 25-5-2020

This is the last item of a series on markets, now containing 14 pieces. They have been collected in a bundle, posted on the blog page of my website www.bartnooteboom.nl

There are different kinds of economy of scale (producing more of the same) and economy of scope (producing different things).

A well known economy of scale is offered by specialisation, adduced already by Adam Smith, with his example of a pin factory, with some people drawing out the pin, others sharpening its point, others polishing it.

Another is in services where someone needs to be present to serve, during opening time, no matter how few customers visit. This yields an incentive for automated service or self-service. This applies to retailing, but also many other services, including that of a governmenmt office where people report or call in, or where the service provider needs to be present when the service is offered, as with a fire brigade, or 911. This effect also makes it relatively expensive in a small firm to employ specialist staff, because they would not be sufficiently occupied.

A customer also takes up space, no matter how little he buys. Now, in the policy against Corona, with the requirement to keep a minimum distance, this is intensified.

Many machines and installations, such as a refrigerator, have a minimal size, even if that is not fully utilised. In a series of machines it is the maximum minimum size that decides the issue.

In process industries, such as the chemical industry, and transport and acommodation (say of a hospital) there is the mathematical law that the surface of the space involved, say something globular, with a radius r, is proportional to the square of the radius, while its productive capacity that is proportional to its third power. Now, the surface determines the material costs and the effort of constructing the space, the costs of cleaning it, and the degree of temperature loss or gain in radiation, while the content determines maximum capacity for production, so that the ratio between output and costs is proportional to the radius. This also yields the phenomenon that some polar animals are large and rotund, such as polar bears, walruses and whales. Because then the ratio between the internal production of body temperature and radiation loss of heat through the skin is most efficient. A trick question then is why there are also large bulbous animals along the equator, such as hippos, rhinos, and elephants. The answer is that it is the difference between temperatures of the body and the outside that matters, and here with larger size the heating of the body is less. Why then the lean and thin panthers and antilopes? Because during the rush of pursuit of the one by the other body temperature is temporarily higher than that of the environment and cooling by radiation to the outside is needed.

The principle also applies to buildings and vehicles, say a jumbo jet. There, four effects of scale combine: more passengers per pilot, less air resistance in ratio to the body, less material cost per seat, and less propulsion energy per passenger. That is why ever larger airplanes are built.

In economy of scope efficiency is increased by the combination of different things, such as selling and reapairing cars. In small shops, it is efficient to have productive activity in the

absence of customers, such as a shoe seller also engaging in repairs. In the past, small shops survived with the owner living above it and engaging in household activities during quiet times, or children pitching in when a customer arrives.
Another example of scope is the grazing of sheep in between trees that must stand apart sufficiently for light and air.

There is also scope in time, as when an icecream seller in winter sells fuel, or a hotel outside the holiday season facilitates conferences.

One can sell different products under a shared brand name and advertising. One can transport different products in a lorry.

With many products or a product in many markets one can spread risks.

Serving many markets in many countries, for tax purposes one has more options to report revenues where taxes are lowest.

As a ‘platform’ company such as Facebook or Google one can offer more profiles and more extended ones, to the extent that sources them from more users. That is how they have grown so big.

Selling more products one can better source for suppliers, of inputs or new product variants. .

Being bigger, with more employment, one can exercise more lobbying power.

Often neglected, there are also disadvantages of scale. One is that with n people one can have n(n-1)/2 direct contacts, increasing quadratically with n. Such talking of everyone with everyone can crowd out work, and hence there was the invention of a pyramidal hierarchy, where one talks only with the next layer up or down. That yields the disadvantage of increased distance between management and shop floor. Another solution is a hub and spoke structure, where people do not talk with each other directly but only through the centre.

The Corona crisis showed how vulnerable we get when spreading production across the world, and the lesson is to maintain some production at home or keep more storage there.

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[i] Lakatos, *The methodology of scientific research programmes,* Philosophical papers volumes 1 and 2, J. Worrall and G. Curry (eds), Cambridge University Press.
[ii] I think the first was Sidney Winter, in his PhD study.
[iii] Lakatos, *The methodology of scientific research programmes,* Philosophical papers volumes 1 and 2, J. Worrall and G. Curry (eds), Cambridge University Press.
[iv] Yuval Noah Harari, 2011, *Sapiens; A brief history of humankind,* Penguin.
[v] Journal of Institutional Economics, …..
[vi] Douglas Allen, ‘Recognizing and solving institutional puzzles’, in: Claude Menard & Mary H. Shirley, *A research agenda for New Institutional Economics,* Cheltenham UK: Edward Elgar, 2018, p. 269-277.
[vii] Cheryl Long, ‘The China experience: an institutional approach’, in: Claude Ménard & Mary M. Shirley (eds.), *A research agenda for New Institutional Economics,* Cheltenham UK: Edward Elgar, 2018, p. 135-142.
[viii] Bart Nooteboom, ‘Uncertainty and the economic need for trust’, in Masamichi Sasaki (ed), *Trust in contemporary society,* Leiden: Brill, 2019, p. 60-76.
[ix] Bart Nooteboom, *Uprooting economics; a manifesto for change,* Edward Elgar, 2019.

[x] Cass R. Sunstein & Richard H. Thaler, 2003, *Libertarian paternalism is not an oxymoron*, The University of Chicago Law Review, vol. 70, no. 4, 1159-1202