

Session Two: Defining the Economic Realm

January 27, 2010

**THE NETWORKED
ECONOMY**



Where Do We Start?

- ❖ Our basic premise—there is something new about today's economy.
- ❖ Our failure to understand it is due not only to its increasing complexity, but also to our lack of theory about:
 - ❖ What constitutes the economy,
 - ❖ The role that networks (social structure) play in it, and
 - ❖ How technology and its architecture affects those structures.



Courtesy of Mikhaela

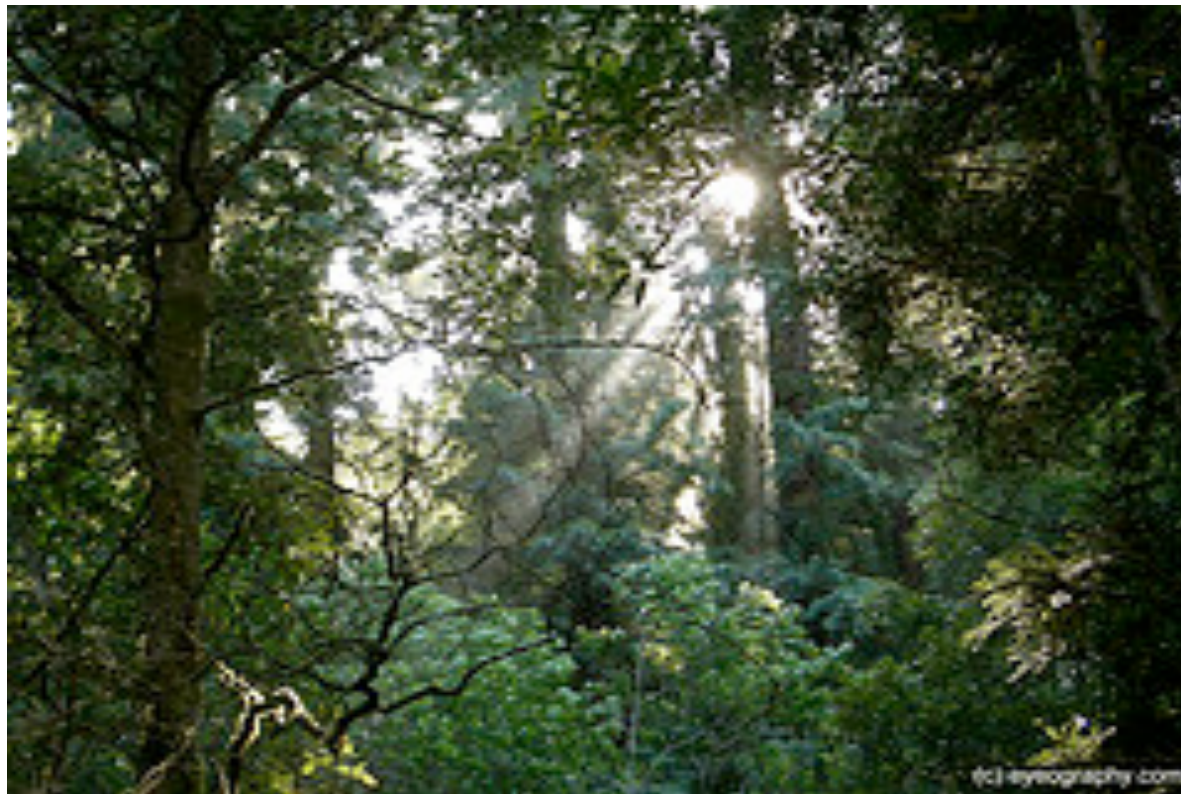
The Need for Humility!



Courtesy of Helder

Strengths & Weaknesses of Theories

Photo Courtesy of Bes Z



Seeing the Forest Through the Trees

Theories Are Also Historically Contingent.

- We draw upon metaphors from our day-to-day existence—the machine age.
- Theories evolve in the context of historical events, circumstances, and contests
- Disciplines try to reconstruct themselves, to take anomalies into account.
- Hence, new ideas often emerge at the interstices of old disciplines—socioeconomics.
- A good reason for interdisciplinary research.

In What Ways Was Classical Economics Contingent?

- The end of the feudal era, and an economy based on rights and obligations.
- The rise of British trade & the reaction to mercantilism.
- Adam Smith's *Wealth of Nations*.
- The Age of Enlightenment & the call for social 'science.'
- Harnessing rather than controlling man's passions.

The Fable of the Bees

Vast number thronged the fruitful hive;
Yet those vast number made 'em thrive;
Millions endeavoring to supply
Each others lust and vanity.

...Thus every part was full of vice,
Yet, the whole mass a paradise.

Then leave complaints: Fools only strive
To make a great {into} a hive.
To enjoy the world's conveniences,
Be famed in war, yet live in Ease,
Without great vices, is in vain.
Utopia seated in the Brain.



Bernard de Mandeville

The Evolution of the Classical Paradigm.

- **Adam Smith—A moral philosopher?**
- **Jeremy Bentham—pain/pleasure defined as utility.**
- **Karl Marx—the emphasis on production—the relationship between people and the relationship between things.**
- **Walras/Jevons—mathematical models drawn from physics.**
- **The *Methodenstreit*—end of the historical school and an emphasis on the market in the abstract.**
- **Alfred Marshall and utilitarianism—maximizing utility in the face of scarcity—the market as price maker.**
- **Neo-Austrian School—the spontaneously emerging market.**
- **Paul Samuelson—economics as the study of rational behavior.**
- **Oliver Williamson—all relationships can be viewed as being contractual.**

What Does It Mean to be a Market Economy?

- Are the economy and the market one and the same?
 - From marketplace to an abstract mechanism.
 - Exchange? What happened to production?
 - The formal definition—the logical character of the means-end relationship in economizing.



How Did the Formal Definition Lead to Reductionism?

- **The economy was equated with the market.**
- **Other 'factors' in the economy were ignored.**
- **The market came to be studied from a theoretical (mathematical) perspective as opposed to a real-world historical one.**
- **The economy was viewed as a closed system.**
- **The study of the market became the 'preserve' of the economic discipline.**
- **Methodological individualism.**
- **Other disciplines were colonized by economics via the rational actor model.**

As Hodgson has described:



“Elsewhere. . .a science is normally defined as the study of a particular aspect of objective reality: physics is about the nature and properties of matter and energy, biology about living things, psychology about the psyche, and so on. For many economists, in contrast, their subject is defined in terms of a single methodology and core theory, not as the varied study of a real object—the economy.”

Hodgson, *Evolutionary Economics*: 7.

How does a paradigmatic lock-in take place?

- Acceptance of a core set of principles.
- Formalization and closure to a new set of ideas.
- Explanation of anomalies are sought from within the existing framework.
- Problems that don't fit are considered outside the discipline.
- Paradigm is perpetuated through 'habitus'—those who define it discipline the others.
- Eg. Solow and Romer

What's Economic is What's in the Discipline!

As Duncan McRae describes:

The development of economics has thus led to the choice of problems internal rather than external to the discipline. Economists can turn more easily to clearly defined and neatly solvable problems in their field rather than to the problems of society—assuming that their colleagues, and eventually society at large will acknowledge the correctness of their choice. When they do venture into other subject matter, or into practical policy advice, it is with the aid of the conceptual machinery that their discipline has helped develop internally. (McRae:113)

Underlying Assumptions of the (neo) classical paradigm.

- ***The economy is separate*** from the rest of society, so that property rights, preferences, etc. are assumed to be given, and thus treated as exogenous variables.
- ***The market is self-regulated.*** Mediated by the price mechanism, it will come into general equilibrium, in which all resources are utilized in the most efficient manner. When changes do occur—as in the case of technology advance—the market will operate to restore order.

Assumptions (cont.)



- **Economic Man is 'rational'** insofar as he operates to maximize his own self interest, and has the information resources to do so.
- **Individuals are atomized.** *Their social and cultural ties have no effect on their market behavior.*
- **Economic actors operate as 'price-takers.'** They have no influence on the economic choices of others.
- **Economic interactions are 'events' in time rather than on-going processes over time.** Hence there is no feedback, externalities or increasing returns.

Assumptions (cont.)

- **The economy is frictionless**, in the sense that there are not transaction costs entailed in productive relationship or market exchanges.
- **The nation state is the 'natural' unit** for the organization of production and exchange.
- **Preferences are a given**; they cannot be changed.
- **The market clears, where supply meets demand**, given the law of diminishing returns, and the law of diminishing marginal utility.
- **The outcome is a Pareto Optimum**—that is all resources are optimally allocated from society's point of view.

What kinds of criticisms did the discipline encounter?

- Dickens was highly critical of the poor laws.
- Marx—while seeking scientific laws sought to demonstrate the inevitable exploitation of labor & the collapse of capitalism.
- Thorsten Veblen derided the notion of economic man and equilibrium outcomes. (cumulative causation)
- German historical school fought for historical contingency.
- Weber emphasizes power in competition among producers, followed by reciprocal exchange.

The Early Sociological Perspective



- Instead of focusing on individual behavior (methodological individualism), sociologists focused on groups & institutions.
- Behavior is not a given; it is partially constructed, and subject to 'habits, conventions, routines, and rules of thumb.'
- Substantively 'rational' individuals can pursue values such as loyalty, reciprocity, and equity.

Sociology Withdraws from the Scene— the legacy of Talcott Parsons



- Talcott Parsons—the father of American sociology.
- General theory of sociology (incorporating all the other disciplines)
- Sociology won support by renouncing economic questions.
- Attack from the left in opposition to the structural-functionalist approach.

The New Socio-Economics

- Building on a substantive definition of the economy—as defined by Polanyi—the interchange with the material and social world to meet material needs.
- The sociological perspective applied to economic phenomena.
- Bringing background factors into the foreground.
- Social structure matters; it is a formidable unit of analysis.

Re-embedding the Economy.



- In institutions.
- In culture
- In networks of social structure.
- In history.
- In the process of evolution.

Institutionalism—focus on the macro level

- Behavior driven by habit & routine, punctuated by acts of creativity & novelty.
- Institutional structures are emergent.
- The economy is an open evolving system in historical time.
- Individuals are situated in an evolving social culture, so preferences are not fixed.
- Technology is evolving and endogenous.
- Concern with the significance of the role of power.
- Indeterminate outcomes, multiple equilibria.

Limitations of the Sociological, Institutional Approach.

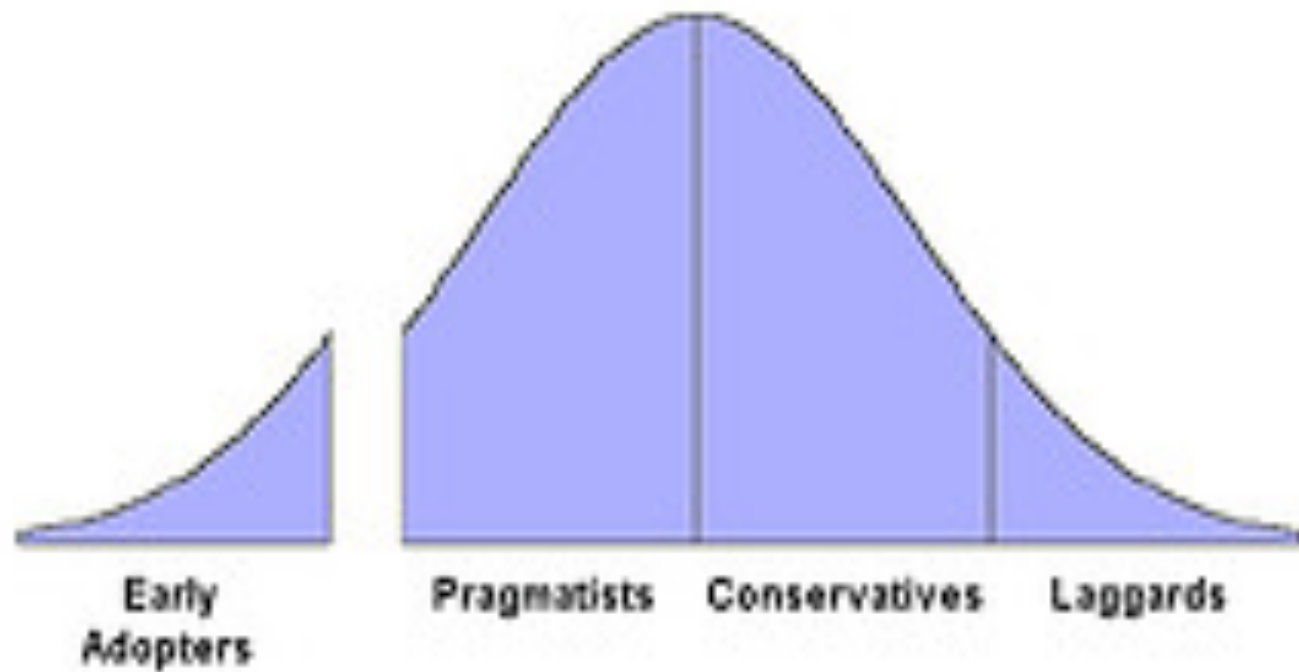
- The need to separate policy prescriptions from analytical critiques.
- The need to incorporate the notion of ‘individual agency.’
- The socioeconomics and the new institutionalism provide a sound critiques, but they do not offer an alternative, coherent theory.
- Quantifying social interactions.
- There is a need to theorize and specify the social mechanisms that link relationships among individual actors, institutions, social networks, and economic outcomes.

How to Proceed From Here? The Challenge of Complexity.



Courtesy of Jeremy Stockwell

The Problem With the Bell Curve



Courtesy of Pace 212

The Power Law



Source: Wikipedia

Uncertainty & The Black Swan



Courtesy of Hobbeskin

Emergence and Evolutionary Theory



Courtesy of C@rijones

The Promise of Social Network Analysis

