Þjóðmálastofnun Háskóla Íslands

Inventing Imaginary Societies:
On the Assumptions in Standard Economic Theories

eftir

Pär Gustafsson

Rannsóknarritgerðir / Working papers; nr. 2 2009

ABSTRACT

Standard economic theories rest on behavioural assumptions that stem from the great Scottish philosopher and economist Adam Smith's The Wealth of Nations *(1776), which marked the emergence of classical economics. These assumptions are based on the idea that individuals are autonomous, rational and driven by economic self-interest to create a better life for themselves. Adam Smith stated that prices are determined by production costs (rather than by demand): the neoclassical economists,by contrast, stressed that prices are the result of the willingness of economic actors to buy at a particular price level. Thus, the neoclassical version of economic theory,while using Adam Smith's behavioural assumptions, explained the role of the market in terms of the interplay of supply and demand for goods and services. This essay argues that the excessive attention paid to the price mechanism and the treatment of Adam Smith's behavioural assumptions as unassailable truths, has had the undesirable consequence of barring potentially decisive variables from entering mainstream economic analysis. In other words, economists tend to invent 'imaginary societies' with little or no similarity to the real world. For instance, the implicit assumption of social harmony gives the impression that conflict between interest groups is either non-existent or unimportant. Another consequence of the assumption is that commercial conflicts between firms are viewed as a marginal issue and, consequently, the role of the law and the judiciary in economic processes becomes difficult to comprehend and possible to ignore given the seemingly over-riding importance of the price mechanism.*

ÚTDRÁTTUR

Ríkjandi hagfræðikenningar byggja á fyrirframgefnum forsendum um mannlegt atferli sem rekja uppruna sinn til kenninga Adams Smiths. Umræddar forsendur eru að einstaklingar hafi sjálfsforræði, séu skynsamir og drifnir áfram af eiginhagsmunum og efnahagslegri ásælni sem miðar að því að skapa sér sem best líf. Nýklassísk hagfræði byggir á þessum sömu forsendum en þar sem Adam Smith taldi að verðmyndun stýrðist af framleiðslukostnaði telja hagfræðingar samtímans að hún stýrist af samspili framboðs og eftirspurnar. Í þessari ritgerð eru færð rök fyrir því að ofuráhersla á verðmyndun og ógagnrýnin nálgun á atferlisforsendur Adams Smiths blindi hagfræðingum sýn á ýmsar mikilvægar skýringabreytur. Hagfræðingar hafa tilhneigingu til að skálda upp "ímynduð samfélög" sem svipar lítið til veruleikans.

UM HÖFUND

Höfundurinn lauk doktorsnámi í félagsfræði frá Háskólanum í Oxford og starfar nú við Háskólann í Växjö í Svíþjóð. Ábendingar of fyrirspurnir má senda á: paer.gustafsson@vxu.se

Inventing Imaginary Societies:
On the Assumptions in Standard Economic Theories[1]

1. INTRODUCTION

Those who are critical of standard economic theories are often treated as 'rogue scholars' [2] by those who belong to the mainstream of the discipline. An established economist, [3] invited to give a lecture to undergraduates at the Department of Economics at the esteemed University of Uppsala in Sweden, compared standard economic theories with an alternative theory that stressed the earth's limited natural resources. The students left the lecture theatre confused as to whether the economic theories they had been taught during the past academic year really were sound. The department dealt with this precarious situation by not inviting the lecturer to repeat the same lecture in the following year[4]. (Lagerlöf 1995:68-69) The fate of a Swedish economist whose research fell outside mainstream economics is of course just an anecdote which might be told differently if we asked the course provider in Uppsala. Yet it might also illustrate the tip of an attitudinal iceberg in mainstream economics. Those who have anything negative to say about standard economic theories and their behavioural assumptions are typically not welcomed by fellow economists.

The discipline of economics lives in "a self-conscious isolation from the other social sciences and from most philosophical controversies of the twentieth century" (Lindberg 1982). Most economists are content with the assumptions they hold about human nature and are not prone to change. Students of economics are encouraged to view the behavioural assumptions of classical economics as unassailable truths and to believe that economics has tools for

---

[1] I would like to thank Kolbeinn Stefansson, Rickard Ulmestig and Maria Wolmesjö.
[2] I am not referring to the mainstream economist Steven D. Levitt (2005) who dubbed himself "rogue scholar" for extending standard economic thinking into virtually every aspect of human affairs, but to critics such as Hazel Henderson (1978) who questioned the foundations of economic theory, and Joseph Stiglitz (2002) who criticized the extreme neo-liberal economic theory used by the advocates of rapid market reform in Russia and elsewhere in the 1990s.
[3] Peter Söderbaum gave his first and last lecture at Uppsala in spring 1991.
[4] This is the explanation he was given by the department, according to Lagerlöf (1995).

analysing most aspects of human affairs. The expansion of neoclassical economic thinking into the Swedish health-care sector (Hugemark 1994; Nordgren 2003) is a consequence of this tendency. But other reflective mainstream economists have noted that undergraduate courses present economics as a “dead science” which has answers to every question (Schotter 1997: xix), that private-sector and academic economists alike are trapped in an iron cage of behavioural assumptions and statistical techniques unfit to assess real-world financial risks (Taleb 2007) and that the particular mode of analytical thinking encouraged by standard economic theories is undermining all forms of community, except the modern nation-state (Marglin 2008).

This essay argues that the excessive attention paid to the price mechanism and Adam Smith’s behavioural assumptions has had the undesirable consequence of barring potentially decisive variables from economic analysis[5].

2. THE ORIGINS OF STANDARD ECONOMIC THEORIES

If an economist’s mind is a perpetual feast, when did this idea begin to take hold? Economists became increasingly satisfied with the foundation of their theories during the 19th century. The behavioural assumptions postulated by Adam Smith in 1776 remained uncontested and the term ‘interest’ (which previously had been used to denote both social, cultural *and* economic interest) was increasingly monopolised by economists who defined it solely as ‘economic interest’ (Swedberg 2004). In other words, there is a significant historical continuity from Adam Smith’s classical economics of the early 19th century to contemporary mainstream economics. The sources used in this section are Smith (1776), Sandelin, Trautwein & Wundrak (2003) and Oser & Blanchfield (1975) unless otherwise stated.

The classical tradition began when the Scottish-born scholar Adam Smith (1723-1790) published his monumental work *An inquiry into the Nature and Causes of the Wealth of Nations* (1776). Adam Smith’s starting-point was a

[5] The reader should note that I am aware of but not concerned with institutional economics (e.g. North 1990) in this essay.

particular conception of the human nature. He famously stated in *Wealth of Nations* (1776) that individuals are driven by egoism, strive for self-betterment, have a tendency to trade and barter, and are born with unequal abilities. These claims are the basic and explicit assumptions of human nature in classical economics.

Classical economics expressed optimism in the sense that it assumed a constantly improving world. It stressed the importance of macro economic growth and long-term development towards equilibrium. The prices of goods and services were treated as a consequence of production costs rather than of demand. Classical economics proposed that the economy was governed by a mechanism, Adam Smith's famous "invisible hand", that would work smoothly if undisturbed.

David Ricardo, in contrast to Adam Smith, was a pessimist. He stressed the negative consequences of population pressure brought on by the industrial revolution. People would be pushed to use poorer soil than previously and till better soil more intensively. Ricardo believed that technological progress would not be able to offset this effect. His theory on land rent and the law of diminishing returns became one of the key ideas of neoclassical economics.

The neoclassical breakthrough came towards the end of the 19th century with the works of Jevons, Menger and Walras. Neoclassical economics, or marginalism, focussed more on the individual and the firm than classical economics had. Building on Adam Smith's assumptions about human nature, neoclassical economists assumed that individuals were utility maximizers and that firms always maximize profit. Thus the concept of the 'free market' was central in neoclassical economics. Prices were seen as the mechanism of allocation of labour, land and capital. Consumer demand determined prices, but this was modified later on and production costs were introduced into the analysis. While classical economics had not distinguished between scholarly research and political recommendations, neoclassical economics was an attempt to do so. The name of the discipline changed from "political economy" to "economics", which is more familiar to modern ears.

Although the scholarly focus shifted from macro to micro, the behavioural assumptions in neoclassical economics were the same as the assumptions formulated by Adam Smith in 1776. Neoclassical economics reigned uninterrupted until 1936 when Maynard Keynes, who held a favourable attitude towards state interventions in the economic sphere, delivered a powerful critique of the way neoclassical economics worked. Neoclassical economics and Keyneseanism co-exist until this day, but the former dominates mainstream economics. Adam Smith's assumptions about human nature are still used in the standard economic theories of today, and are often summarised by the use of the term *Homo economicus,* or economic man.

3. CONTEMPORARY STANDARD ECONOMIC THEORIES

The price mechanism is a core notion in the body of standard economic theories and, as I have demonstrated, builds on behavioural assumptions that stem from Adam Smith. Mainstream economists treat these assumptions as unassailable facts, although they are known to stand on shaky empirical ground (Lauterbach 1950; Heinrich 2004; Clark 2005; Marglin 2008). Below I examine both explicit and implicit assumptions in contemporary standard economic theories. The purpose of this section is not to refute the assumption(s) or the methodology of positive economics but to create a conceptual frame for a discussion about the exessive attention paid to the price mechanism. I conclude this section with a discussion of the implications of this phenomenon for the relation between neo-liberal policies and empirical evidence in Russia's market transition in the 1990s.

Let the spotlight shine on the theory's protagonist: *Homo economicus* or economic man. Contemporary standard economic theories explain the economic markets in terms of supply and demand for goods and services that are produced, bought and sold by *Homo economici* who are rational, autonomous, wealth-maximizing actors driven by economic self-interest. This is mainstream economics in the past century or so in a nutshell. I illustrate this with examples of accounts of standard economic theories of the market-place in three undergraduate textbooks. Each quotation is used as a starting-point for comments on the explicit and implicit assumptions in standard economic theories such as the price mechanism.

3.1. Explicit assumptions

Any given theory rests on explicit and implicit assumptions. The explicit assumptions are those that are consciously stated. The behavioural assumptions, economic man, in standard economic theories were explicitly stated by Adam Smith. A recent example of scholarship with clear references to Adam Smith's legacy is Johan Norberg's (2001) *In Defence of World Capitalism*. Norberg's thesis is that prosperity and freedom is increasing and the world has become a better place to live. He argues that this outcome is no coincidence but an inherent trait of capitalism. Johan Norberg clearly joined forces with the optimist Adam Smith.

The textbook quotations (in this section) illustrate how the foundations of standard economic theories are taught today. There are, of course, more complex models of the market in textbooks for advanced students but this does not change the fact that they build on the model presented above – at least as long as we are talking about mainstream economics and not about new and still marginal sub-disciplines such as behavioural economics.

Various critics have pointed to the problem of unrealistic behavioural assumptions in standard economic theories (Veblen 1898; Ayres 1918; Lauterbach 1950; Lindberg 1982; Clark 2005; Lapavitsas 2005). And indeed, the theory's advocates readily admit that assumptions either should be, or at least can be, unrealistic without justifying a rejection of the methodology of positive economics (Friedman 1966[1953]; Nagel 1963; Hill 1968; Boland 1979; Ng et al 2008).

Milton Friedman (1953) outlined the methodology of positive economics in a seminal paper and paved the road for an expansion of quantitative methods in economics. Friedman propagated a view of 'theory' which belongs to the instrumental philosophy of science. In line with this philosophy, basic assumptions (in this case, assumptions concerning human nature) do not have to be realistic. The reason is simple: a theory is not used to describe the empirical world accurately and in detail but to generate testable and fruitful hypotheses about the empirical world. A considerable part of the value of a theory is its capacity for generating useful hypotheses, according to Friedman's argument. This is the predominant use of the term 'theory' in economics today.

Below I illustrate the Smithian assumptions of autonomous actors, rationality and self-interest with quotations from undergraduate textbooks in economics:

> *Economics for Business. 4th Edition*. (Sloman et al 2007:62)
> In a free market individuals are free to make their own economic decisions. Consumers are free to decide what to buy with their income: free to make demand decisions. Firms are free to choose what to sell and what production methods to use: free to make supply decisions. The resulting demand and supply decisions of consumers and firms are transmitted to each other through their effect on *prices*: through the price mechanism.

Autonomy is a key element; indeed, social atomization is a precondition for perfect competition (Smith 1776 in Swedberg 2004). The assumption of autonomous individuals has been criticized by the sociologist Mark Granovetter (1985) on the grounds that there are many instances in which social networks impact on an individual's economic behaviour.

> *Microeconomics. A Modern Approach. Second edition*. (Schotter 1997:16)
> It should be noted here that the person we are discussing in this and later chapters is homo economicus – economic man (person). This fictional individual contains many qualities that we share but is characterized primarily by a dedication to the principles of rationality.

Rationality is another explicit assumption, and the theory assumes (in this standard version) that everyone has access to all information in the market. Perhaps the most common objection to the body of standard economic theories among sociologists is that it rests on bizarre and unrealistic assumptions about human nature. *Homo economicus* was never admitted to the exclusive club of sociologists. A source and illustration of this aversion to the assumptions in standard economic theory is Thorstein Veblen's (1898) famous rejection of the neoclassical assumptions about human nature:

> The psychological and anthropological preconceptions of the economists have been those which were accepted by the psychological and social sciences some generations ago. The hedonistic conception of man is that of a lightning calculator of pleasures and pains who oscillates like a homogeneous globule of desire of happiness under the impulse of stimuli that shift him about the area, but leave him intact. He has neither antecedent nor consequent. He is an isolated definitive human datum, in stable equilibrium except for the buffets of the impinging forces that displace him in one direction or another. (Veblen 1898)

Veblen suggested that as well as being hedonistic, standard economic theory is teleological and taxonomic: teleological, because it suggests that there are inescapable ends (equilibrium) and fails to explain how market institutions emerge; taxonomic, because it is based on a set of non-evolutionary concepts such as 'natural rights' and 'utilitarism' (Gosh 1984). A more recent appraisal of the neoclassical school was conducted by Amitai Etzioni (1988). He argues that the behavioral assumptions in standard economic theory are unsubstantiated or contested by empirical research. Standard economic theory is, according to the likes of Veblen and Etzione, a colossus with feet of clay.

Self-interest. It is also assumed that the rational individual is motivated by economic self-interest (selfishness). Recent cross-cultural experimental evidence suggests that the selfishness assumption in standard economic theory does not hold in the real world because people often make economic decisions based on social norms and values that contradict economic calculative rationality (Heinrich et al 2004).

The assumptions outlined above are explicit behavioural assumptions in standard economic theories, but there are also implicit assumptions.

3.2. Implicit assumptions

Implicit assumptions are derived from explicit assumptions and the proponents of the theory are not always aware of them, or the consequences of such assumptions for the way we analyse the world and solve problems.

An important but often overlooked implicit assumption stems from the tendency to reduce the markets of the empirical world to a mechanism for resource allocation in which the deciding factor is price. Prices in standard economic theories reflect the willingess of economic actors to buy a good or service at a particular price level, which is not an inherent value of the product. This theory of value belongs to the so-called Austrian school or neclassical tradition. By focussing on the price mechanism and idealized markets of perfect competition, the possibility that humans occasionally experience tension and conflict among themselves is glossed over. In fact, the elimination of social relations from economic analysis led to the disappearance of the problem of order from conventional economic analysis (Granovetter 1985).

Another way to express this idea is to say that standard economic theories assume *social harmony*. The assumption of social harmony has at least two layers. Firstly, on the macro level it implies an absence of interest conflict between social groups (Myrdal 1965). Secondly, on the micro level it implies that economic actors do not experience commercial conflicts with other economic actors. Ormerod (2005) has pointed out that standard economic theories aim at explaining success and ignore the prevalence of failure, such as “disruptive commercial conflicts” (Gustafsson 2007), in the business world. One way to make sense of this assumption is to seek its roots in “the philosophical inspirations of political economy – the philosophy of natural law and its English branch, utilitarianism – (which) stem from a belief in social harmony, and (whose) practical recommendations presuppose such harmony” (Myrdal 1965: 193-94).

Neither Ormerod nor Myrdal extensively examine the consequences of this implicit assumption in standard economic theories on how we understand the role of law and legal institutions. One important consequence of this implicit assumption is that the role the legal apparatus is allowed to recede into the shadows. This is understandable. It is almost impossible to assess the role of legal institutions such as courts and the police for economic development with the help of standard economic theories, because the standard economic tool-kit only contains tools for tinkering with the price mechanism. To paraphrase a slogan from Bill Clinton's presidential campaign: *It is the price mechanism, stupid!* Markets are about determining the price, according to standard economic theories, not about whether an economic transaction will be conducted in the first place, or whether the buyer will pay and the seller will deliver. This is illustrated in the textbook quotations above. In addition, the following quotation indicates the implicit assumption that economics is a discipline that examines more than the sphere of business and commerce.

> *Economics. Sixth Edition.* (Begg et al 2000:29)
> Society has to find *some* way of deciding what, how, and for whom to produce. Western economies rely heavily on markets and prices to allocate resources between competing uses. The framework of analysis is very general. It can be applied to the market for cars, haircuts, or even footballers. In each case, the interplay of *demand* (the behaviour of buyers) and *supply* (the behaviour of sellers) determines the quantity of the good produced and the price at which it is bought and sold.

'Society' must make allocative decisions and standard economic theory offers a seemingly neutral algorithm for doing so. An analogy has been made between the discipline of economics and mathematics to show that the former discipline is (like mathematics) free from normative bias in the manner it solves problems[6]. This conception of economics can, no doubt, partially explain its attractiveness to policymakers. The expansion of neo-liberal economic thinking

[6] For an example of this kind of analogy see e.g. Ng and Tseng (2008).

and management speak to the public health sector in Sweden is an illustration of this (Hugemark 1994; Nordgren 2003). In contrast to this tendency, Myrdal (1965) argues that it is problematic to assume that economics is a neutral discipline since economic theories are in fact normative. For instance, neoclassical mainstream economics posit that full employment is a natural condition which is disturbed when labour-markets are subjected to external interference by the state. This notion is normative, according to Myrdal, who argues that the scientific process can never determine what our preference for the future state of society ought to be. Normative preferences can only be determined through political debate, not logically derived from theories or determined by empirical research.

Further illustration of the impact of the implicit assumptions in standard economic theories on social and economic processes can be found in Russia's market transition of the 1990s. The dissolution of the Soviet empire and the ensuing attempts to transform the planned economic system of the Soviet bloc into a market-based system, was perhaps the most momentous event of the postwar era. A neo-liberal economic transition was on the agenda as soon as Boris Yel'tsin seized power in the autumn of 1991.

The assumption of social harmony and the belief that economics can decide what is 'best for society' because it is a neutral algorithm for decision-making, contributed to the outcome of the attempt at a transition from Soviet planning toward a market-economy in Russia post-1991.

The task of managing the unprecedented situation was formidable. No theories of transition of planned economies toward market-economy systems existed. Advocates of the neo-liberal transition project believed that it was better to do what one *could* do, rather than wait indefinitely for social science to catch up with history. However, in acting as advisors in the reformers, they clearly left their ivory tower and entered the shadowland between academia and politics. The price mechanism (which embodies Smithian behavioural assumptions) in mainstream economics provided a rhetorical figure for defending neo-liberal economic policy advice to the Russian government.

Transition optimists in Russia often used a rather messianic tone in their arguments. The goal of the reform could apparently justify a great deal of suffering among the population in the short run. Blejer and his co-authors suggest that it was necessary to keep the goal of the transition in mind and not be distracted by problems along the road, because you would inevitably see obstacles when you took your eyes off the goal (Blejer et al. 1997). The parallel between the messianic neo-liberal reformers and the equally messianic Bolshevik revolutionaries of 1917 is noted by several critics of the transition (Stiglitz 2002). There is no point in blaming this entirely on standard economic theories; such an attempt would be rather bizarre. However, it is worth noting that the view of the price mechanism as the over-riding factor did fit very well into the agenda of the Russian reformers and their US educated advisors. When faced with obstacles – and there were plenty of obstacles to the social, economic and political transformation of Russia – transition optimists could simply follow Blejer's advice and focus on the goal on the horizon. In fact, it was a mentality that echoed a subversive Soviet-era joke about the futility of striving toward communism:

> In the lecture theatre at the Institute, the lecturer explains: "The Soviet Union has successfully created socialism and is rapidly moving toward the horizon where communism is emerging!" A student asks: "What is the horizon?" The lecturer clarifies: "The horizon is the point where the sky and the land meet, and it has the quality of moving further away from a spectator who tries to approach it."

Russia's ardous market transition was plagued with massive obstacles, yet hailed as a success by the economist Anders Åslund (1995) in *How Russia Became a Market Economy*. Åslund was one of the advisers to the Russian government and used a neoliberal version of standard economic theory to back up his policy prescriptions. He supported the price-liberalisation introduced on 1 January 1992, which led to the onset of hyperinflation. The hyperinflation eroded the life-savings of millions of Russian households within less than a year. A rapid privatization of state enterprises, the so-called voucher-privatization, began in

1994. Every Russian citizen received a voucher which gave them a stake in the state-controlled economy. Privatization tenders were held in which state enterprises were sold and paid for in vouchers. It is widely recognised that voucher privatization was severely biased by unscrupulous economic actors, of which some used threats, bribes and criminal methods to aquire large number of vouchers. The voucher privatization campaign coincided with the rise of organised criminal groups in Russia. (Reddaway et al 2001; Varese 2001) Anders Åslund (1995) was upbeat despite this backdrop, and proclaimed that Russia had been transformed into a market economy by the end of 1993. Richard Layard and John Parker's (1996) *The Coming Russian Boom* is another example of optimism in the face of grim reality. Layard and Parker boldly predicted that the Russian economy would be set for rapid economic growth and prosperity if President Yeltsin were re-elected in 1996. Yeltsin defeated the communists and the stock market boomed, but the economy did not boom until the world-market price of oil went through the roof in the early 00s. The oil-fueled Russian economy was (and still is) in need of structural reform: corruption, bureaucratic inertia and an ineffective judiciary remain central obstacles for economic development in Russia.

The belief in economics as a discipline which provides the key to explaining almost everything is not restricted to the field of transition economics of the 1990s; it has been dispersed to a wider audience in recent years. International bestsellers such as *Freakonomics* (Levitt et al 2005) and *The Economic Naturalist* (Frank 2007) have applied standard economic thinking to a wide range of phenomena with or without any relation to the sphere of business and commerce. Such attempts at popularization (Levitt and Dubner's book has sold at least three million copies worldwide according to the *Freakonomics Weblog*), gives the impression that economics have something to say about every aspect of human affairs.

The implicit assumption of social harmony (discussed above) in standard economic theories gave economists the impression that conflict between interest groups is either non-existent or unimportant in comparison to factors that directly impact supply and demand. Another consequence of the assumption of social harmony is that commercial conflicts between firms are viewed as a marginal issue and, consequently, the role of the law and the judiciary in economic processes becomes difficult to comprehend and possible to ignore with reference to the over-riding importance of the price mechanism. Transition optimists in Russia also relied on the Coase theorem to explain why it did not matter that the voucher privatization programme (above) became a vehicle for state-employed directors of inefficient Soviet enterprises to seize control of those companies with more or less shady methods (Black et al 2000). Coase theorem is notoriously difficult to interpret, but one interpretation is that it does not matter who controls companies: Bad owners will have incentive to sell their shares to good owners who will create long-term value. Thus, resource allocation will move towards efficiency and equilibrium. This, however, rests on the assumption that an adequately efficient and fair legal system is in place, which was not the case in the Russia of the 1990s. Transition optimists used Coase theorem to justify the privatization programme but failed to see that what happened in the real world was that bad initial owners looted their enterprises and corrupted the government in the process (Ibid 2000: 1802). In other words, the transition optimists invented a neo-liberal, Coasian 'imaginary society'[7] with little or no similarity to the conditions in Russia of the 1990s. The absence of an efficient legal system is a striking indication of this.

In the neo-liberal, Coasian imaginary Russia, judicial reform was considered less important than rapid market reform. Anders Åslund (1995) was initially dismissive of the calls for more focus on judicial reform, claiming that adequate measures had been taken, the police had been given better equipment and more lawyers were being trained. His over-riding priority was the speed of the transition, which would allow the price mechanism to emerge. However, the textbooks do not discuss how to transform a planned economy into a market-based system and they also assume, just as Adam Smith did, that there is social

[7] The task of economists, according to Myrdal (1965), is to invent "imaginary societies" (theoretical models).

harmony. Åslund and other transition optimists largely turned a blind eye to the problem of criminality and corruption in the 1990s. In later years, especially after the shocking events in the conflict between the Yukos oil-company and the Russian state which ended with the destruction of the corporation and the imprisonment of its CEO, Åslund modified his argument. Examining his opinions pieces published in *The Moscow Times* and international newspapers during the conflict, it is apparent that his model for analyzing the events was flawed. He still argues that Russia was succesfully transformed into a market economy by 1993 but now recognises that the fragile judiciary was a major problem. Åslunds blames the lack of attention to the judiciary on the virtual absence of international funding for judicial reform in Russia. (Åslund 2007)

Not all economists, however, were in favour of the neo-liberal transition in Russia. Joseph Stiglitz is a Nobel-prize winning economist and a leading critic of the neo-liberal project of transforming planned economies into market-based economies. Stiglitz damns the market transition in Russia after 1991 as a failure because the one-eyed focus on rapid liberalisation and the use of economic incentives did not produce the intended effect, but a number of serious undesirable side-effects (e.g. 2002). The rise of organised crime, rampant corruption, increasing poverty as well as adverse effects on public health are usually listed among the negative effects of transition in the 1990s. Stiglitz, it should be stressed, is not critical of the market system, or standard economic theory, as such. Rather, he is critical of the extreme neo-liberal version of standard economic theory and especially its use by policy-makers in the economic transformation of former socialist countries after 1991. The body of standard economic theories were used as a guiding principle for an economic transition it was never intended to explain. Transition optimists such as Anders Åslund, Jeffrey Sachs and Richard Layard used standard economic theories to justify a rapid market transition in Russia. Their views resonated with the view common among Russian politicians that the Russian people must be pushed into the future for their own good (and for the good of their rulers). This tendency was not unique for Russia of the chaotic 1990s but can be traced through Soviet and

Russian history. Ironically, the body of standard economic theories and the way western neo-liberal economists thought about society, fitted the agenda of the Russian reformers who feared a genuine grass-roots revolution (Reddaway et al 2001).

4. WHAT SHOULD BE DONE?

I suggest that a weak spot in standard economic theories is *not* the existence of unrealistic behavioural assumptions, but the very fact that they are treated as permanent elements of the theory (see above). Economists give undue attention to the price mechanism as an explanation of market processes and do not question the behavioural assumptions that stem from Adam Smith. The latter are treated as unassailable principles or 'truths'. This unfortunate amalgamation influenced the transition from Soviet planning toward a market-based system in Russia by barring potentially important variables (such as the judiciary) from the analysis. It seems that the root of this problem lies in the explicit and implicit assumptions in the body of standard economic theory.

So, what should be done? According to the realist philosophy of science, held by most sociologists, theories should be faithful to reality at all levels, from basic assumptions about human nature to empirical implications. One option is to reject standard economic theories on the grounds that the assumptions are unrealistic and bizarre, because they tend to partially or wholly contradict contemporary psychological, sociological and economic experimental research. Marxist-oriented scholars who hold a realist philosophy of science have rejected standard economic theory lock, stock and barrel in this manner (e.g. Clark 2005; Lapavitsas 2005). Clark (2005) finds it problematic that standard economic theories are based on unrealistic assumptions and asserts that "modern economics is not a scientific discipline but the systematic elaboration of a very specific social theory" (ibid 2005:50). Not only Marxist-oriented scholars are critical of unrealistic assumptions. A prominent sociologist (Hedström 2005:66) argues forcefully against "knowingly accepting false assumptions". Sociology is, however, a diverse discipline and a closer look reveals that the idea that a theory's behavioural assumptions must be realistic is not endogenous to the foundations of the discipline. A prosaic objection to the criticism of unrealistic assumptions is that a theory, assuming it is aimed at explanation rather than mere description, is always an abstraction which per definition is faithful only to a slice of the empirical world (Homans 1951; Stinchcombe 1968). However, many sociologists lean toward a realist philosophy of science and consequently maintain that a theory's assumptions need to be realistic. Kanazawa (1998), in contrast, argues that behavioural assumptions are and ought to be unrealistic.

Kanazawa (1998) argues that assumptions *should* be unrealistic (a position he shares with mainstream economists such as Friedman [1953]) and that this view is not incompatible with a realist philosophy of science (a position held by many sociologists such as Hedström [2005]) as long as two conditions are met: 1) 'unrealistic' is interpreted as 'empirically incomplete' rather than 'untrue', 2) the concept of 'theory' is used in the meaning "causal explanation of an empirical phenomenon" (Hechter 1987 in Kanazawa 1998)[8]. Assumptions, according to Kanazawa, cannot be derived from any other part of the theory (or other theories). Empirically testable hypotheses, on the other hand, are deduced from the set of assumptions of a theory.

> ..the [highly unrealistic or incomplete] assumption set captures a very narrow slice of the empirical reality, but it is a true reality nonetheless. If such a theory can still produce a large number of hypotheses that are accurate descriptions of a wide range of the empirical world, then the theory is simultaneously true (in the sense of being acceptable to philosophical realists), fruitful (in Jasso's sense because "it explains much by little", to use Friedman's words) and incomplete (in the sense that its assumption set is highly unrealistic). (Kanazawa 1998: 200)

If Kanazawa's argument (1998) is correct then behavioural assumptions can be unrealistic (i.e. empirically incomplete) but they certainly cannot be permanent fixtures in a set of theories. Thus, a scholar dedicated to intellectual flexibility

[8] This definition of theory is consistent with the mechanism-based sociology of Gambetta (1998) and Hedström (2005).

ought to formulate and try out various different behavioural assumptions that are slices of the empirical world – aspects of the reality that are selected and highlighted – but not complete empirical descriptions. Note that there is no reason why Adam Smith's selfishness axiom should be damned and discarded on principle. But its status should be changed to that of a *potential behavioural assumption* among other potential assumptions, because the fact "that material interests, sexual drives, and the quest for power have often been over-estimated as human motives is no reason to deny their reality" (Wrong 1961:191). This approach might encourage intellectual flexibility, rather than a dogmatic stance in the search for knowledge.

Mainstream economics is dogmatic because the behavioural assumptions in standard economic theories are treated as permanent fixtures. So, I would suggest that an important weak spot in standard economic theories is not the unrealistic behavioural assumptions but the very fact that they seem to be carved in stone.

Hedström (2005:66) argued forcefully against "knowingly accepting false assumptions" but conceded that "theories by their nature always are descriptively incomplete" and stressed that the actor's desires and beliefs are key components in sociological explanations. I suggest, assuming that 'unrealistic' means 'empirically incomplete' rather than 'false' or 'untrue', that Kanazawa's and Hedström's views on assumptions are not incompatible, despite Hedström's rejection of the use of "wildly inaccurate assumptions" (Friedman 1953)[9].

5. CONCLUDING REMARKS

Standard economic theories rest on fixed behavioural assumptions about the motivations for economic and social behaviour. The main problem of the behavioural assumptions in standard economic theories is that they are permanent features which gives the impression that they represent the ultimate truth about the human nature. Behavioural assumptions are treated as

[9] Hedström stresses the impact of social interaction on collective outcomes, but this difference between the two scholars is largely irrelevant for this essay.

unassailable dogmas. The permanency of such elements in the foundation of economic theory contributes to a number of problems.

Firstly, permanent explicit behavioural assumptions may make life seem simpler from the point of view of undergraduates learning economic theory, but block out the influx of potentially important behavioural assumptions that would result in the formulation of new and evocative hypotheses about market processes.

Secondly, some problematic implicit assumptions are related to the explicit ones, and encourage economists to turn a blind eye to variables that may have a decisive effect on economic processes. An example of this is that the implicit assumption of social harmony gives the impression that conflict between interest groups is either non-existent or unimportant in comparison to factors that directly impact supply and demand. Commercial conflicts between firms are viewed as a marginal issue and, consequently, the role of the law and the judiciary in economic processes becomes difficult to comprehend and possible to ignore given the over-riding importance of the price mechanism. Nowhere has this unfortunate effect been more pronounced than during Russia’s transition from Soviet planning toward a market-based economic system in the 1990s. Domestic and foreign advisors to the Russian reformers alike were using an extreme neo-liberal version of standard economic theory to justify their policy prescriptions. The policy prescriptions were focussed on bringing the economy on its feet and turn it into a market-economy overnight. Thus, an exaggerated attention was given to factors that would impact supply and demand decisions (i.e. the price mechanism) while the fundamental absence of a fair and efficient legal system was overlooked, or deemed to be of lesser importance. Organised crime, corruption and embezzlement thrived under such conditions when the Soviet planned economic institutions had been destroyed. Of course it would be bizarre to blame standard economic theories for the momentous failure to bring capitalism and enduring democracy to Russia. Nevertheless, the role of standard economic theories in how ideas, debates and transition processes were shaped is worth consideration.

REFERENCES:

Ayres, C.E. (1918) The Function and Problems of Economic Theory. *The Journal of Political Economy*, Vol. 26, No.1 (January), pp 69-90.

Åslund, A. (1995) *How Russia Became a Market Economy*. Washington, D.C.: Brookings Institution.

__________ (2007) *Russia's Capitalist Revolution. Why Market Reform Succeeded and Democracy Failed.* Washington, D.C.: Peterson Institute for International Economics.

Begg, D., Stanley Fisher and Rudiger Dornbush. (2000) *Economics. Sixth Edition*. London: McGraw-Hill.

Black, B., Kraakman, R. and Anna Tarassova (2000) Russian Privatization and Corporate Governance. What Went Wrong? *Standford Law Review*, Vol. 52 (July), pp 1731-1808.

Blejer, M.I. and Marko Škreb (1997) *Macroeconomic Stabilization in Transition Economies.* Cambridge: Cambridge University Press.

Boland, L.A. (1979) A Critique of Friedman's Critics. *Journal of Economic Literature*, Vol. XVII (June), pp 503-522.

Clark, S. (2005) The Neoliberal Theory of Society, pp 50-59, in *Neoliberalism: A Critical Reader*, edited by Alfredo Saad-Filho and Deborah Johnston. London: Pluto Press.

Etzioni, A. (1988) *The Moral Dimension: Toward a New Economics*, New York: The Free Press.

Frank, R. H. (2008) *The Economic Naturalist: Why Economics Explains Almost Everything*, London: Virgin Books.

Freakonomics Weblog. Internetadress: http://freakonomics.blogs.nytimes.com/ Downloaded: January 2009.

Friedman, M. (1966) The Methodology of Positive Economics, in *Essays in Positive Economics*, Chicago: University of Chicago Press.

Gambetta, D. (1998) Concatenations of Mechanisms, pp 102-124, in *Social Mechanisms: An Analytical Approach to Social Theory*, edited by Peter Hedström and Richard Swedberg, Cambridge: Cambridge University Press.

Gosh, S. K. (1984) On the Validity of Veblen's Criticisms of Economic Orthodoxy: An Analysis of His Positions in the Light of Current Conditions and Economic Thought. *American Journal of Economics and Sociology,* Vol. 43, No. 2 (April).

Granovetter, M. (1985) Economic Action and Social Structure: The Problem of Embeddedness. *American Journal of Sociology*, Vol. 91, No.3 (Nov.), pp 481-510.

Gustafsson, P. (2007) Commercial Conflict: The Case of Russia's Contemporary Economy. D.Phil Thesis in Sociology, University of Oxford.

Hechter, M. (1987) *Principles in Group Solidarity*. Berkeley: University of California Press.

Hedström, P. (2005) *Dissecting the Social. On the Principles of Analytical Sociology.* Cambridge: Cambridge University Press.

Heinrich, J., Robert Boyd, Samuel Bowles, Colin Camerer, Ernst Fehr and Herbert Gintis (2004). *Foundations of Human Sociality: Economic Experiments and Ethnographic Evidence from Fifteen Small-Scale Societies,* Oxford: Oxford University Press.

Henderson, H. (1978) *The Collected Writings of Hazel Henderson: Creating Alternative Futures – The End of Economics*. New York: Perigree Books.

Hill, L.E. (1968) A Critique of Positive Economics. *American Journal of Economics and Sociology*, Vol. 27, No. 3 (July), pp 259-266.

Homans, G.C. (1968 [1951]) *The Human Group*. London: Routledge & Keegan Press.

Hugemark, A. (1994) *Den fängslande marknaden. Ekonomiska experter om välfärdsstaten* [The Captivating Market. Economists on the Welfare State in Sweden]. Lund Studies in Social Welfare VII. Lund: Arkiv.

Kanazawa, S. (1998) In Defense of Unrealistic Assumptions. *Sociological Theory*, Vol. 16, No.2 (July), pp 193-204.

Lagerlöf, K. E. (1995) *Demokrati. Berättelser, minnen, essäer*. [Democracy: Stories, memories, essays.] Eslöv: Carlssons förlag.

Lapavitsas, C. (2005) Mainstream Economics in the Neoliberal Era, pp 30-40, in *Neoliberalism: A Critical Reader*, edited by Alfredo Saad-Filho and Deborah Johnston. London: Pluto Press.

Lauterbach, A. (1950) Psychological Assumptions of Economic Theory. *American Journal of Economics and Sociology*, Vol. 10, No. 1 (October), pp 27-38.

Layard, R. and John Parker (1996) *The Coming Russian Boom. A Guide to New Markets and Politics.* New York: The Free Press.

Levitt, S.D. and Stephen Dubner (2005) Freakonomics. A Rogue Economist Explores the Hidden Side of Everything. New York: William Morrow.

Lindberg, L.N. (1982) The Problems of Economic Theory in Explaining Economic Performance. *Annals of the American Academy of Political and Social Science*, Vol. 459, Government and Economic Performance (January), pp 14-27.

Marglin, S. A. (2008) *The Dismal Science: How Thinking Like an Economist Undermines Community*, Cambridge, Massachusetts: Harvard University Press.

Myrdal, G. (1965 [1953]) *The Political Element in the Development of Economic Thought*, London: Routledge & Kegan Paul Ltd.

Nagel, E. (1963) Assumptions in Economic Theory. The American Economic Review, Vol. 53, No.2, Papers and Proceedings of the Seventy-Fifth Annual Meeting of the American Economic Association (May), pp 211-219.

Ng, Irene and Lu-Ming Tseng. (2008) Learning to be Sociable: The Evolution of Homo Economicus, *American Journal of Economics and Sociology*, Vol. 67, No.2, (April), pp 265-286.

Norberg, J. (2001) *Till världskapitalismens försvar* [In Defense of World Capitalism]. Timbro förlag.

Nordgren, L. (2003) *Från patient till kund. Intåget av marknadstänkande i sjukvården och förskjutningen av patientens position* [Patients Turned Into Customers. The Expansion of Economic Thinking to the Health-Care Sector and the Changing Role of the Patient]. Lund: Lund Business Press.

North, D.C. (1990) *Institutions, Institutional Change and Economic Performance.* Cambridge: Camridge University Press.

Oser, J. and William C. Blanchfield. (1975) The *Evolution of Economic Thought. Third Edition.* New York: Harcourt Brace Jovanovich, Inc.

Reddaway, P. and Dmitri Glinski. (2001) *The Tragedy of Russia's Reforms: Market Bolshevism Against Democracy.* Washington, D.C.: United States Institute of Peace Press.

Sandelin, B.; Trautwein, H-M and Richard Wundrak (2003) *Det ekonomiska tänkandets historia* [A History of Economic Thought], Stockholm: SNS-förlag.

Schotter, A. (1997) *Micro Economics: A Modern Approach*. New York: Addison-Wesley.

Sloman, J. and Kevin Hinde (2007). *Economics for Business. 4th Edition*. Harlow: Prentice Hall.

Smith, A. (1975 [1776]) *The Wealth of Nations*. London and Toronto: Dent & Sons.

Stiglits, J. (2002) *Globalization and its Discontents*. New York: W.W. Norton & Norton Company.

Stinchcombe, A. L. (1968) *Constructing Social Theories*. Chicago: University of Chicago Press.

Swedberg, R. (2003) *The Principles of Economic Sociology,* Princeton and Oxford: Princeton University Press.

Taleb, N. N. T. (2007) *The Black Swan. The Impact of the Highly Improbable*. London: Penguin Books.

Varese, F. (2001) *The Russian Mafia. Private Protection in a New Market Economy*. Oxford: Oxford University Press.

Veblen, T. (1898) Why is Economics not an Evolutionary Science? *The Quarterly Journal of Economics,* Vol. 12. Website: http://etext.virginia.edu/toc/modeng/public/VebEvol.html Downloaded 4/2/2009

Wrong, D. (1961) The Oversocialized Conception of Man in Modern Sociology, *Americal Sociological Review,* Vol. 26, No. 2 (April), pp 183-193.