

The Dahrendorf hypothesis and its implications for (the theory of) economic policy-making

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ABSTRACT. In his recent writings, the sociologist Lord Ralf Dahrendorf suggests that the year 1989 has marked the end of any fundamental debate on economic systems. According to Dahrendorf, a principal commitment to the market order and to an open society protecting individual liberties is largely undisputed today, at least in the western hemisphere. This, however, does not result in a convergence of economic policies towards some common ideal model. On the contrary, he states that “*diversity is [...] at the very heart of a world that has abandoned the need for closed, encompassing systems*” (DAHRENDORF, 1999: 15). It will be shown that the Dahrendorf hypothesis is difficult to reconcile with orthodox economic approaches to economic policy-making. Nevertheless, it will be argued that if the scope of analysis is extended to epistemological problems, then a decentralised experimentation with policies can be reasonable. Given the fact that selection mechanisms are imperfect and that diversity can be sustained, a dilemma may occur for neoclassical economics: if individuals internalise preferences for inefficient policy measures, a decision between the sovereignty of individual preferences and efficiency may have to be made.

JEL-CLASSIFICATION: B52, D72, D78.

KEYWORDS: diversity; evolutionary political economy; economic policy-making.

1. INTRODUCTION

If what is today considered to represent the modern theory of economic policy concerns itself with diversity in economic policies (which it seldomly does at all), it usually displays a rather hostile and sceptical attitude towards diverse policies. The primary interest of a neoclassical theory of economic policy is to identify optimality conditions and to propose measures that improve the economy into the direction of those conditions. Once Pareto efficiency as the relevant criterion against which real world allocations ought to be evaluated is agreed upon, there is no obvious reason why heterogeneity of policies should be advocated: As far as the matter of political institutions, i.e. of constitutional choice, is concerned, the problem is merely one of mechanism design, and the optimal constitution is the one that solves the problem of incomplete and asymmetric information between voters and representatives the most convincingly.¹

When we are interested in policies directed at improving allocative efficiency, the same is true: there are universal principles of allocative efficiency, attainable by employing a clearly defined set of policies, that are supposed to ensure that a competitive equilibrium can be achieved. Whenever an efficient competitive equilibrium cannot be achieved, standard policies in order to correct for inefficiencies are supposed to be used as remedies: externalities are internalised by efficient taxes or subsidies, pure public goods are provided according to the Samuelson conditions and so on. From a microeconomic perspective interested in allocative efficiency, there is very little scope for diversity in economic policy.

Since it is well known that generally, infinitely many different Pareto efficient states of an economy are conceivable, one might expect diversity to enter through the backdoor of distributive policies. People in different places may consider different distributions of income and wealth as justified, and by choosing different initial distributions, they will eventually also end up with different, albeit all efficient, allocations. In practice, however, this scope is limited by the allocative side-effects of the politics of redistribution. As soon as the fact is acknowledged that an initial distribution cannot be simply chosen but has to be installed by using distortionary systems of redistribution, the pursuit of the optimal

¹See, for instance, the elegant constitutional economics of LAFFONT (2001).

level and means of redistribution is opened – and diversity, if it implies the employment of suboptimal distributive policies, is considered irrational once again.

With this being the situation when mainstream economics theorises on economic policy, DAHRENDORF (1999: 15) proposes that “*diversity is [...] at the very heart of a world that has abandoned the need for closed, encompassing systems*” and goes so far to state that diversity, also in economic policy, is indeed desirable and ought to be defended against attempts to level out regional or other distinctions.² It would be easy to dismiss such insisting on the relevance of diverse economic policies: an economic science that perceives itself to have the expertise to phrase clear cut prescriptions for rational economic policy does, after all, have no reason to promote diverse policies, but to promote *the* rational policy.

This paper will discuss the prerequisites that are necessary to argue in favour of heterogeneity in economic policy-making. The argument will proceed as follows: in the following section, a brief survey of the relationship between welfare economics and heterogeneity is given, which is extended to Social Choice and Public Choice in Section 3. In Section 4, it is argued that inescapable model uncertainty is one argument to support diversity and in Section 5 the possibility that individuals have pure policy preferences is introduced to support the case for diversity. Finally, Section 6 offers some conclusions.

2. THE TIEBOUT MODEL: POLICY HETEROGENEITY ENTERS NEOCLASSICAL ECONOMICS

The idea that heterogeneity in economic policy may make sense entered neoclassical economics as early as 1956, with the seminal paper on “A Pure Theory of Local Expenditures” by Charles Tiebout. The paper intended to propose a mechanism through which public goods could be provided efficiently through an invisible hand mechanism resembling the efficient provision of private goods on competitive markets. Not unlike Walrasian general equilibrium theory, most of what would have been interesting to theorise upon was kept exogenous: Tiebout assumed an exogenous supply of possibly infinitely

²See DAHRENDORF (1998).

many jurisdictions, so that every individual blessed by costless mobility and perfect information is able to find a jurisdiction whose supply of public goods suits exactly his preferences. If there are also sufficiently many individuals on the demand side and the local jurisdictions set non-distortionary head taxes just high enough to attract exactly that number of individuals where local public goods can be provided at the cost-minimal level, then an efficient solution results.

What is particularly interesting about this model is which questions Tiebout chooses not to pose, and certainly not to answer. It may, for instance, occur that the efficient equilibrium is not attainable simply because there are not enough individuals for each jurisdiction to reach its cost-minimal population, i.e. to exploit all economies of scale in the provision of local public goods. If individuals nevertheless have heterogeneous preferences for public goods, the Tiebout model cannot give us normative counsel on whether heterogeneity ought to be sustained or given up in favour of cost efficiency. To date, the possible trade-off between diversity and cost-efficiency is almost completely a blind spot in the economics of fiscal federalism.

Another blind spot is the question where the heterogeneous supply of local public goods comes from – and why local jurisdictions should have an incentive to cater them efficiently. The occupation of public entrepreneurship is not explained within the framework of the Tiebout model and its successors. A simple thought experiment can illustrate that this is indeed a problem: Following Tiebout in presuming that there is no inefficient slack and every existing jurisdiction has exactly that population which exploits economies of scale efficiently, this equilibrium would be associated with the problem that no individual has a place to leave for. Since every other jurisdiction supplies a bundle of public goods that the individual considers inferior, he has only imperfect substitutes to choose from. Thus partially deprived of their “exit”-option once the initial sorting process of individuals to jurisdictions is over, the Tiebout equilibrium leaves individuals vulnerable to fiscal exploitation by local Leviathan governments. Even more important, once every jurisdiction shelters exactly that number of individuals where the surplus of tax revenue over costs of public goods provision is maximised, it will deter any additional individual by setting prohibitively high taxes – the “exit”-option de facto degenerates even further.

It is evident that analysing endogeneous policymaking within the framework of a Tiebout model is similar to opening Pandora's box. Working with standard public choice assumptions leads to local governments using their – still existing – monopoly power for fiscal exploitation by collecting tax revenue that is exceeding the costs of providing local public goods. Incentives to endogeneously provide heterogeneous policies are opaque. There are no channels of communication other than migration through which the public sector entrepreneurs learn, which local public goods mobile individuals want to have supplied. Therefore, the interesting task would not so much be to understand the sorting of individuals to given jurisdictions, but to understand the learning process that leads public sector entrepreneurs to supply the “correct” bundles of public goods. If such learning processes bear the risk of economic losses, which may for instance occur if a newly supplied public goods bundle accidentally deters taxpayers, one might wonder how willing public sector entrepreneurs are to embark upon such a risky learning process at all. The existence of equilibria, certainly of efficient equilibria, becomes doubtful.

It should have become obvious, that the Tiebout model and subsequent approaches to fiscal federalism have limited explanatory power. They do not offer satisfactory positive explanations of the economic processes that occur when decision-making on economic policy is decentralised and heterogeneous policies exist. Nevertheless, the model was a giant leap forward in supplying an analytical framework within which heterogeneity can be acclaimed from a normative viewpoint. Even if one has doubts about the proposition of efficient equilibria, one can still accept the core statement that heterogeneous policies can be approved of because individuals can have differing preferences for public goods. The problem is that, while to more recent generations of public finance scholars reading Tiebout this statement looks like a tiger, for Tiebout himself it was more probably the tail. He is interested in the efficiency of decentralised public goods provision, and what he needs to prove this is a convex relationship between the costs of public goods provision and the number of individuals in a jurisdiction, as well as the assumption that the number of individuals relates to the number of jurisdictions so that an efficient spatial distribution of individuals is possible. Heterogeneity of preferences (and of local public good bundles) is a nice example to illustrate the mechanism, but it is not necessary to make the mechanism work. A Tiebout economy with a number of identical jurisdictions, inhibited by identical

individuals, can be perfectly efficient – Tiebout can survive without heterogeneity, but collapses with global economies of scale in public goods provision.

It is instructive to see how this thread has been picked up by subsequent authors analysing fiscal federalism. For example, the groundbreaking and by now classical contribution by OATES (1972) sets its focus almost exclusively on issues of efficiency. What interests Oates is the efficient allocation of the powers of decision making on public goods to different levels of government, and as a pragmatic decision rule, he proposes his decentralisation theorem: If there is a perfect correspondence in the sense that exactly those individuals who gain utility from a public good also pay the taxes to finance its provision and if this can be done on a more decentral level at the same or lower costs as on a more central level, then the public good ought to be provided on the more decentral level. Once again, a potential conflict between heterogeneity and efficiency remains unresolved. Regionally differing preferences for public goods are one criterion for decentralisation, as decentralisation may induce perfect correspondence, but cost efficiency is a second criterion. If the status quo is a cost-efficient centralised regime without perfect correspondence, it is unresolved whether the decentralisation theorem warrants institutional change from a centralised regime to two or more heterogeneous, decentralised jurisdictions.

In his further theorising, Oates exhibits a bias towards questions of efficiency and more or less neglects the complications that are introduced with heterogeneity. In the same year as Oates' study, BUCHANAN/GOETZ (1972) have published a paper that carries the seeds of the bulk of neoclassical literature on decentralised economic policy. Buchanan and Goetz show that whenever an individual migrates from one jurisdiction to the other, her decision to do so will only depend on the private cost and utility of migration, while the social costs are not considered. Therefore, any migration is associated with externalities, such as the effect on the marginal productivity of labour and thus on the wage of other individuals or the effect on the tax base, which affects either tax rates or the quantity of public goods provided in the jurisdictions. Because individuals do not care for those externalities when deciding if they should stay or go, the level of migration will usually be inefficiently high or low, depending on whether the positive externalities outweigh the negative or vice versa.

Starting from here, the neoclassical literature on decentralised economic policy has asked, and often answered, plenty of original and important questions: Is efficient taxation possible when productive factors are mobile? Can redistributive policies be sustained under factor mobility? What are the efficiency and distributional implications of differential mobility of capital and labour? And so on. More often than not, the proposed remedy for allocative inefficiencies generated by factor mobility is to centralise policies, or at least to install complex systems of interjurisdictional redistribution in order to provide “correct” incentives to decentral decision-makers.

With this focus on efficiency, questions regarding heterogeneity have moved out of sight. The representative individual became a prominent feature of these models, so that Oates’ first criterion, that of perfect correspondence, became irrelevant and only fiscal externalities and the cost functions of public goods remained as the relevant criteria for (de-)centralisation decisions. Given this biased perspective at the outset, the resulting tendency to favour centralisation is certainly not too surprising. Regionally differing preferences for public and private goods, as one important rationale for heterogeneous policies, are simply not accounted for any more. Even if OATES (1972) has not convincingly treated the possible tradeoff between heterogeneity and efficiency, he at least recognised its existence. The more recent welfare economic literature, in contrast, is reluctant to acknowledge this problem at all.

Half a century after Tiebout’s seminal contribution, welfare economics finds heterogeneity of policies to be neutral at best, but usually to be a nuisance inducing factor mobility, which is associated with unpleasant, efficiency-degenerating side effects. But within this framework, there is hardly anything to be gained from diversity in the sphere of economic policy.

3. AVOIDING COERCION: THE RATIONALITY OF “EXIT” IN AN IRRATIONAL WORLD

It should have become clear in the previous section that welfare economics is not the right place to look for an economic rationale for policy heterogeneity. Given that their starting point is the heterogeneity of individuals’ preferences, social choice and public choice may be much more promising places to find such a rationale.

3.1. Diversity and collective irrationality. Social choice is known as one of the subdisciplines of the dismal science that regularly produces truly disencouraging results. This was not always the case, though. When the Marquis de Condorcet set out to show that democracy is a rational method of collective decision-making, some of the results he produced were not dismal at all. If all voters have the same objective and are uncertain about the correct means of attaining it, if the individual likelihood of making the correct choice between two alternatives is greater than $1/2$ and if the objective probability of each of the alternatives to actually be correct equals $1/2$, then under simple majority rule the probability that the electorate decides correctly converges towards one with a rising number of voters.³ As soon as more than two alternatives are given, however, the results of the vote are subject to cycles; the result depends on the pairing of the alternatives and consistent voting results cannot be expected. This problem may be mitigated by more complex voting rules, but the principal vulnerability of the result to strategic pairing of the alternatives remains.

When there is no consensus about the objective and voting takes place not only to solve conflicts of theory, but also conflicts of interest, the problems are reinforced. ARROW (1951) shows in his famous impossibility theorem that there is no mechanism of collective decision-making that satisfies four conditions: an unrestricted domain of alternatives (i.e., no alternatives to choose from are excluded from the choice process) is to be transformed into a rational social ordering, weak Pareto efficiency (i.e., if all individuals strictly prefer alternative A to B, then the mechanism must lead society as a whole also to prefer A), independence of irrelevant alternatives and nondictatorship. Arrow has shown that at best three of these criteria can be satisfied simultaneously. This implies that, once democracy and the Pareto criterion are agreed upon as indispensable, full collective rationality is impossible to be attained.

Thus, this world of collective irrationality is plagued by problems both from a positive and from a normative viewpoint. The existence of cycling leads to the prediction that stable majorities do not exist; an electorate that prefers *A* to *B* and *C* at one point in time may prefer *B* or *C* at another point in time, without any underlying change of individual preferences and only due to a different voting agenda. And from the normative

³See CONDORCET (1785).

perspective, the non-existence of a social welfare function satisfying the four restrictions mentioned above is a very troubling result, because the social welfare function ceases to have any practical relevance for the choice of the optimal allocation amongst the infinitely many Pareto efficient allocations.

If, contrary to the usual convention, the cycling of majorities is not thought to happen in time within the same jurisdiction, but rather simultaneously in various jurisdictions, then this means that due to the indeterminacy of the democratic process, the chosen policies in these jurisdictions are likely to differ. Even if the electorates are characterised by exactly the same distributions of preferences, a regional variation of the results of the voting processes is likely due to different political institutions or political traditions which, in the language of social choice, are simply different agenda setting mechanisms. Recognising the instability results of social choice is a first step to actually explain the diversity of economic policies.

Social choice, however, is unlikely to offer convincing normative foundations that would allow us to appraise diversity. Certainly, the absence of a consistent social welfare function also implies the absence of an unequivocally optimal allocation that ought to be pursued by economic policy. But this opens little scope for diversity in economic policy – after all, the welfare economic criteria for efficient allocations remain unaltered, and the only purpose of a social welfare function, would it be of practical use, would be to choose one among many efficient allocations. But even if welfare economics has little to offer in guiding this final choice, it can still insist that economic policy needs to ensure that Paretian marginal conditions are fulfilled, and it can usually offer some optimal measures to achieve this.

From this perspective, diversity, even if it is the outcome of the democratic process, is an objectionable deviation from an optimal policy. Preference aggregation through voting disappoints the welfare economist, because it does not reliably lead to an economic policy that maximises aggregate welfare. MIROWSKI (2002: 304) has made this point very convincingly in stating that to Arrow, “*democratic voting is an inferior type of computer for calculating the welfare optima already putatively identified by the Walrasian computer*” (accentuation as in the original). By approaching democracy with a Walrasian toolbox –

a toolbox in which, for instance, trial and error or individual learning had no place at the time and are still widely neglected today – Arrow’s research programme for social choice is led to denounce diverse economic policies as a symptom of the malady of collective irrationality.

3.2. Even more collective irrationality: public choice. Following our discussion of social choice in the above subsection, public choice must, candidly speaking, appear to be a progress in the sense that it is interested in real political processes, where social choice theorists are usually content to stay within a world of axiomatic thinking that bears little resemblance to politics as we know it. But with public choice, all the nasty and unpleasant features of real politics became subject of economic analysis – “economic” implying that analysis is founded upon the assumptions of rationality, self-interest and methodological individualism.

It is needless to mention that log-rolling, vote-trading, interest group activities and all their companions do not foster a belief in the efficiency of democratic decision-making. Nevertheless, a bottomline of public choice is that contrary to social choice, it can still argue in favour of democracy because its checks and balances still produce results superior to those produced by an unrestricted Leviathan. In applying the assumption of self-interest also to those who are governing, public choice became enlightened enough to know that neither the benevolent dictatorship nor central planning are bound to enforce optimal policies, or even policies superior to those approved by popular vote.

Once one accepts this result, diversity of policies is a necessary evil. It is one of the consequences of the famous claim made by DEMSETZ (1969) that the yardstick by which policies or institutions are measured ought to be other real policies or institutions rather than a fictitious nirvana solution. If there is no mechanism to install an optimal economic policy, then the mechanism that has the least potential for disastrous failure ought to be chosen. This does not imply, however, that taking a public choice point of view enables the economist to wholeheartedly applaud the existence of heterogeneous policies.

After all, as recent surveys such as MUELLER (2003) show, public choice is still deeply rooted in a very orthodox notion of rationality, which has no place for a clear distinction

between the objective world and the way individuals perceive it. While there are plenty theoretical approaches that account for asymmetrical information and/or incompletely informed individuals, public choice has little to say about what, in political science, RIKER (1986) calls heresthetics: the art of manipulating not only objective restrictions, but also the subjective perception individuals have of the world, in order to further one's self-interest. In other words, public choice so far is reluctant to incorporate the possibility of fundamental, theoretical errors in individuals' world views into its models. This should not be confused with the presumption of rational expectations, where a complete symmetry between reality, the economist's model of it, and the knowledge of the individuals acting within the models is assumed. But the relationship between both concepts of rationality is not too distant. In orthodox political economy, the economist knows that there are general conditions for an optimal solution, and would the costs of acquiring this information be sufficiently low, then the entire electorate would also know them.

Deficient knowledge about what is optimal is therefore not a general problem that concerns every human being – at least economic theorists are spared of this problem. When suboptimal policies are conducted, this is either due to incomplete information, which may principally be improved to the rational expectations level, or due to the failure of the invisible hand on the political market place. The peculiarities of decision-making within the political sphere may, after all, lead even completely informed, self-interested individuals to end up with collectively irrational decisions. The public choice theorist, on the other hand, is always aware of his optimality conditions and is unable to find anything positive in heterogeneous deviations of actual from optimal policies, besides that they are a necessary price to pay in order to escape the coercion exercised by an uncontrolled Leviathan.

4. ECONOMIC POLICY IN THE LABORATORY: DIVERSITY, SELECTION AND COLLECTIVE LEARNING

Following this brief and necessarily sketchy foray through orthodox approaches and their attitudes towards diversity in economic policy, it is now time to introduce some building blocks of an alternative theory of economic policymaking which is bound to comply with

the statement made by Lord Dahrendorf that the existence of a diversity of economic policies, or even a variety of capitalisms, is not only a fact, but also a praiseworthy fact. One might wonder why this should be a worthwhile effort at all, given the fact that much of economics, perceiving itself as the most advanced and precise social science, finds solid arguments to refuse such an appraisal of diversity. Therefore, a brief justification will be offered in the following subsection, before the argument itself proceeds.

4.1. The call for realism in economic science. The most fundamental, but at the same time most convincing, objection to the orthodox point of view is its lack of realism. Such an objection has been put forward many times, and its main arguments regarding economic theory are to found for instance in LAWSON (1997, chapter 8). According to this line of criticism, orthodox economic theory is able to pursue its research programme founded on axiomatic thinking and a high degree of formalism only by employing more and more specific assumptions, which in turn leads to a declining relevance of economic theory for real world problems. This is accompanied by a tendency to model the economy as a strictly deterministic system in which individuals lack any internal structure and are limited to behaviouristic responses to external stimuli and which is free of unexpected novelty. Given this characterisation, it is difficult to imagine how orthodox theory can claim to produce any policy proposals that are relevant to real economies.

Even for those who are reluctant to agree to such a harsh rejection of orthodox economics as a whole, there is a grain of truth in this fundamental criticism. Asked for their methodological background, most mainstream economists would subscribe to critical rationalism or one of its descendants, and these imply a competitive selection process among different theories. The problem is that, while every day they go to work, researching economists engage in this competition of theories, they act as if there was only one theory (usually, the one they adhere to themselves) when they are asked for policy proposals. But if economic policy proposals depend on theories, and if we subscribe to the fact that the degree of congruence between theory and reality is principally uncertain, then we also have to admit that there is an inescapable uncertainty concerning the question whether the policy we recommend is indeed optimal or not.⁴

⁴See also SCHNELLENBACH (2002).

This finding does allow an appreciation of diversity from an epistemological perspective. Heterogeneity of economic policies can be seen as a simultaneous test of hypotheses about which economic policy is ideal.⁵ But two questions remain unanswered so far: first, how well does this test of hypotheses work in practice, and second: if we deviate from the orthodox set of assumptions, do we arrive at any other convincing arguments in favour of diversity of policies? To answer both questions, it is necessary to first of all turn the attention to the building blocks of an alternative theory of economic policymaking.

4.2. Subjectivism and economic policy. In a much cited article, HAYEK (1942) asserted that every important advance in economic theory during the hundred years before 1942 owed its existence to the consistent application of subjectivism. This may have been true then, but the account of post-war economics given by MIROWSKI (2002) suggests that mainstream economics has increasingly looked at other places for inspiration. But modern criticism of the mainstream, especially of the modelling of individual decisions in an anaemic stimulus-response fashion, indicates that something may be won by re-introducing the concept of subjectivism.

There is, however, also an important pitfall: a subjectivism as in the more recent austrian economics tradition, associated with apriorism, would not be a progress compared to the rational expectations tradition. On the contrary, the habit of declaring every choice rational within the bounds of individual knowledge eventually amounts to a immunisation of theory against attempts of empirical falsification. In terms of explanatory power, there is nothing to be gained by giving up rational expectations and instead starting to search ex post for a stock of individual knowledge that, together with the observed choice, would lead us to be convinced that the choice was rational.

Instead of picking up this thread of neo-austrian hermeneutics, it shall simply be assumed here that subjectivism implies that there may be systematic differences between the objective world and the way it is perceived by the individual – by *any* individual, including those acting within the economic models, those who create the models and those who give advice on economic policy. Put in different terms, the scope of uncertainty is now

⁵See also KERBER (1997) for a proposal to interpret competition between jurisdictions as a test of such hypotheses.

wider compared to orthodox approaches; there is not only incomplete information about the parameters of a given model, but it is unclear which theoretical model gives the most appropriate approximation of reality.

If this is the case, then, as already mentioned above, one can argue in favour of diversity, as for instance OKRUCH (2002) does. But what may be surprising is the fact that diversity of policies makes sense even if the jurisdictions who conduct these policies are completely alike otherwise. There may be the same distribution of preferences within the electorate and they may have the same production functions, but in the face of uncertainty, diversity of policies does create the potential to engage in collective learning processes. In this context, the indeterminacy of democratic decision-making predicted by social choice may appear as a blessing. The efficacy of collective learning, however, is still subject to debate.

4.3. Selection mechanisms in collective learning. A very important issue is the willingness of individuals to revise a given stock of knowledge if there is reason to believe that they are wrong. This question would not be of too great concern if there were private profits to be gained from substituting a less for a more accurate belief – the incentives to learn in a private sector environment are much more obvious.⁶ When it comes to economic policies, however, the individual probability of having the decisive vote is almost zero. Behind this veil of insignificance, an individual does appear to have no incentive at all to incur the costs of voiding his given set of beliefs and of learning new, possibly superior theories. Following KURAN (1987), a change of mind on political issues may be more plausibly explained by herding behaviour, if the prestige of one individual depends on the concurrence between his beliefs and those of a larger group.

But the origin of such herding behaviour is nevertheless to be sought on the individual level. In their cognitive-evolutionary theory of economic policy-making, Alfred Meier and associate researchers suggest that the degree of actual uncertainty may have a decisive impact.⁷ In situations with little uncertainty, characterised for instance by a modest

⁶See KERBER/SAAM (2001) for a simulation model of private sector learning processes in a competitive environment.

⁷See for instance MEIER/METTLER (1985) and MEIER/HAURY (1990).

disappointment of expectations or a small gap between the own performance and that of a competitor, individuals tend to maintain their given stock of knowledge, ignore or repress evidence that suggests otherwise or look for auxiliary hypotheses that defend their given beliefs. For example, they may contend that there was some local temporary shock in their own jurisdiction that led to a comparatively lower performance. In situations of greater uncertainty, on the other hand, such a strategy is often not viable. Large and persistent performance gaps or disappointed expectations are difficult to reconcile with the stock of knowledge that has produced such expectations. In this case, cognitive dissonance may indeed lead to an individual willingness to revise given knowledge, and if this willingness is reinforced through communication with other individuals who have the same problem, collective learning may occur.

A different selection process may be migration between competing jurisdictions. If the relatively efficient jurisdiction is characterised by higher incomes, an inflow of individuals from the relatively inefficient jurisdiction may be expected. Given standard production functions with diminishing marginal productivity, however, this will produce perverse learning incentives, as the efficient jurisdiction experiences lower wages and the inefficient jurisdiction experiences rising wages through migration. If individuals act as satisficers and their ex ante income is their aspiration level, then the individuals who do not migrate and remain in the efficient jurisdiction may feel a need to revise their stock of knowledge, while the immobile individuals in the inefficient jurisdiction enjoy a windfall wage rise and feel their stock of knowledge to be affirmed by experience. The relevance of this problem increases if a relatively large group of individuals considers themselves to be generally immobile. These individuals have no incentive at all to inform themselves about the results of the other jurisdictions' policies. As a consequence, they observe only the change of their own income, but not the absolute difference between incomes in different jurisdictions.⁸

Finally, the selection process may be less demand-driven. It was implicitly assumed that if a sufficiently high number of voters change their minds, then a change of policy will follow. If, on the other hand, political control through voting is imperfect and the governing have enough leeway to pursue their self-interest, the situation may be different. When

⁸See SCHNELLENBACH (2003) for a more extensive treatment of this issue.

a representative in office can expropriate a fixed portion of the gross domestic product generated within his economy as a rent, then he clearly has an incentive to always choose the most efficient policy. But this produces new problems, namely problems concerning the distribution of the gains from a change of policy between the representative and his citizens. If democratic control is diminished enough to let the representative install efficient policies of which a majority of voters is not convinced, then it is doubtful that voters will profit much from the efficiency gains.

These considerations suggest that the selection processes concerning economic policies are far from perfect. If they were, diversity of policies would usually be short-lived, as all jurisdictions would quickly adopt the policy conducted in the jurisdiction that is the most efficient at any given time. From a point of view that favours such ex post harmonisation of policies, this may be disappointing. But this result also implies that diversity, once it exists, is probably sustainable.

5. FROM BELIEFS TO PREFERENCES

To make the point regarding a possible transformation of beliefs into preferences, we may assume that, at the outset, there is a great number of identical jurisdictions. Due to the imponderabilities of the process of democratic preference aggregation, they nevertheless conduct differing economic policies. And due to the imperfect selection mechanisms in interjurisdictional competition, diversity is sustained for a lengthy period of time. There may be some incremental, syncretic change, when one jurisdiction adopts some policy measure from another jurisdiction that is promising to enhance efficiency, but that fits within the broad outline of a given stock of knowledge. But nevertheless, there is still substantial heterogeneity between policies.

At this early stage, individuals are reluctant to change their minds and have a tendency to defend their given stock of knowledge because they believe that the policy measures implied by this stock of knowledge lead to the most efficient results. Given enough time, however, it may happen that individuals forget about the teleological aspect of producing efficient results and instead develop a preference for these policy measures. ELSTER (1983) explains how individuals internalise choices that they were initially forced to

make. Having at first chosen a certain behaviour to avoid punishment for non-compliance, individuals may develop a preference for this behaviour and maintain it even if the threat of punishment disappears.

If being punished may induce a preference, there is no a priori reason why punishing should not lead to the same result. A voter whose prime political objective is to vote off politicians who do not conduct the economic policy he deems efficient may do so initially because of the efficiency argument – but if he has put sufficient time and energy into defending a specific set of policy measures, he may forget about the efficiency argument and develop a preference for the policy measure as such. There is probably no efficiency argument in the world that can convince the german median voter of Thatcherism, and if the german social security system were efficient, a US median voter with a conservative-libertarian tendency could probably still not be convinced of adopting it.

What this implies is that individuals may establish a preference for a certain kind of policy, regardless if it is efficient or not. From an institutionalist perspective, a market as such does not exist. Rather, different institutions shape different kinds of markets, which yield different results.⁹ On what kind of market commercial exchange actually takes place is a problem that depends to a large extent on the culture or institutional framework in which a particular market is embedded. In neoclassical terms, they may prefer an economic policy that leads to a point below the production possibility frontier associated with the most efficient technology simply because they have a preference for this policy *as such*. In country *A*, individuals may have accomodated themselves to a large welfare state, which may lead to lower output growth rates compared to country *B*, where a more dynamic kind of capitalism is preferred. Nevertheless, it may be perfectly reasonable for the people in *A* to keep their institutional framework, not because the welfare state is efficient (that conjecture would have to be dismissed based upon the comparison with *B*) but because they have an institutional preference for their welfare state, even if it is relatively inefficient.

Put differently, economic policy becomes a matter not so much of choosing a point on the most outward production possibility frontier, which is associated with the most efficient

⁹See HODGSON (2001, pp. 253-7).

technology. Rather, from the perspective taken here it is a matter of choosing one of many production possibility frontiers that are all associated with different policies and different institutional frameworks. The “choice” that is made here, however, is not conducted by a representative individual, but essentially a choice made by chance and history, since both play the lead role in determining which pure policy preferences a majority of individuals internalises at a given time and place.

The diversity of economic policy becomes rooted within individuals’ preferences. If the old motto *de gustibus non est disputandum* still applies, then even an wholeheartedly neoclassical economist should be able to agree to heterogeneity of policies under these circumstances. The problem is only that his analytical apparatus is ill-suited to make that judgement. Individuals may have developed a preference for policy measures that are not efficient, i.e., that do not enforce Paretian efficiency conditions. From a neoclassical perspective, this leads into a dilemma: is it allowed to argue about preferences, after all, or shall we rather dispense of efficiency? Is it necessary campaign for an efficient policy, i.e. to enlighten individuals of their “true” self-interest?

From a more heterodox perspective, the picture looks a bit brighter: Sustained diversity, even if it can be sustained only due to imperfect selection mechanisms, still leaves some scope for learning from the policies conducted in other jurisdictions. However, these will be incremental learning processes, where small changes occur only within the bounds stretched by the beliefs, theories and preferences that are dominant within any one jurisdiction. There is no reason to assume that learning about institutions and policies as well as progress in their development does not take place. But they will often take place only insofar as a given system of policy-related beliefs, theories of preferences does not need to be abandoned as a whole, but can be varied in small steps.

6. CONCLUSIONS

It has been shown that the Dahrendorf hypothesis, stating that a diversity of economic policies is not only likely to exist, but also reasonable to be sustained, is difficult to reconcile with orthodox economic approaches to economic policy-making. Nevertheless, it

has been argued that if the scope of analysis is extended to the epistemological problem that economic theory and policy proposals derived from it are always vulnerable to be false, then a decentralised experimentation with policies can be reasonable. Given the fact that selection mechanisms are imperfect and that diversity can be sustained, a dilemma may occur for neoclassical economics: if individuals internalise preferences for inefficient policy measures, a decision between the sovereignty of individual preferences and efficiency in the neoclassical sense may have to be made. In a more broader sense, the universal neoclassical efficiency criteria become impossible to apply as soon as individuals have pure policy preferences, i.e. if they prefer a policy as such regardless of its impact on neoclassical efficiency. In that case, the statement by HODGSON (1999: 101) can be confirmed that *“although not all capitalisms are equal in performance, the advantages or efficiencies of one type of capitalism over another are typically dependent on their historical path and context and thereby none can be said to be ultimately superior to all the others.”*

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