

Paola Palminiello

# An Attempt to Provide a Non-Circular Explanation of Economic Reforms. Elements for a New Individualistic Theory of Institutional Change

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# An Attempt to Provide a Non-Circular Explanation of Economic Reforms

## Elements for a New Individualistic Theory of Institutional Change

by Paola Palminiello

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### Introduction

The following considerations stem from what originally was an explanatory project: to explain from an individualistic standpoint, and using therefore the notions, categories and generalisations typical of such an approach, the neoliberal economic reforms introduced in Italy and Europe since approximately the early 1980s – to clarify, for example, what led even countries with a high inflation rate to adopt and pursue, after 1987, a restrictive monetary policy; how and why political powers gave their central banks political and operational independence; what led them to privatise their then numerous State-owned companies or what, furthermore, persuaded them to gradually deregulate their labour markets and downsize their welfare systems.

Over the next pages, however, I shall not dwell at any length on these specific issues.

Indeed, in the first part of this essay I shall be examining the structure of rational-choice explanations of institutional change,<sup>1</sup> and I shall attempt to show that, though such explanations are viewed as prototypes of individualistic research programme<sup>2</sup> and are actually the codifiers of the categories about institutions included

<sup>1</sup> And, more specifically, explanations that follow what Buchanan [1990] calls the maximization paradigm. Contractualist explanations are therefore excluded.

<sup>2</sup> For instance, compared to so-called analytical sociology, which, with the exception of Elster (but see further down for a few clarifications), tends to propose a rather weaker interpretation of

in the toolbox of this approach, they cannot in fact lay claim to any such title, nor can their notions profess unquestionable validity. More specifically, I shall support the view that researchers who refer to this research programme break in fact the fundamental principle of methodological individualism. In the belief that institutions are the means by which social systems achieve increasing levels of social welfare, they fail to look at (and define) phenomena to be explained (institutions, in this case) from the point of view of the individuals who produced them, and instead replace this point of view with a characterization of those phenomena as they may appear from the perspective of that external and supra-individual aim. The problem lies in the fact that no external – or even transcendent – characterisation of actions or their outcomes can help explain these actions themselves. And indeed, all such explanations appear to be both “distorted” in order to prove the *explanandum* (in ways the authors themselves would have considered unacceptable had they taken the trouble to make use of a significant advantage of intentional explanations), and, in many cases, narrowly enclosed in a functionalist, and therefore holistic and tautological, framework.

I shall maintain, in conclusion, that there is only one way to avoid these sorts of circularity, and it consists in keeping to the principle of looking at, and defining, the phenomena to be explained strictly from the standpoint of the individuals in some way involved in producing them, a thesis that I shall defend also as the main objection to be made against all holistic approaches.<sup>3</sup> I will argue, to sum up, that any move away from the agents’ standpoint – whether intentional, as in holism, or unintentional, as perhaps is the case of at least some of the economists’ contributions – will only involve replacing that point of view with the observers’ own ideas and opinions, ideas and opinions that are entirely irrelevant in terms of providing an explanation.

The second part of this essay will therefore be devoted to illustrating the core elements of a new theory of institutional change, developed by seeking to meet the above methodological requirements. It is made up of a bargaining model, partly based on Schelling’s works [particularly Schelling 1960], in which parties do not negotiate

the individualistic research programme. This is clearly shown by the very notion that there exist two separate levels of reality – the level of macro phenomena and the microlevel of individual actions and interactions –, and therefore that the main challenge is finding out the possible causal connections between the two. It’s the idea illustrated by the widely referred-to diagram of the so-called Coleman Boat. See Coleman [1990] and, among others, Hedström and Swedberg [1998], and Borlandi and Sciolla [2005].

<sup>3</sup> And consequently, being themselves objectivist, also against both the so-called weak individualisms – institutional or structural –, and the various possible forms of “assignment of a meaning”, about which, anyway, I will say nothing here. For the definitions of weak, institutional and structural individualisms, one can see in particular Udehn [2001]. For the idea of searching for a meaning, see Elster [1983], who maintains however, in [2007a], that social sciences are nowadays much less afflicted with essentialism than in the past.

over the division of the gains of a bargaining situation already given (as supposed by traditional bargaining theory), but rather over defining and establishing a cooperation scheme that will enable them both to achieve some of their respective goals.

I shall illustrate this model very schematically.

In this part of the essay, I shall occasionally also refer to neoliberal reforms and the economic debate that preceded and accompanied their introduction, however my aim will be to illustrate some of the model's features rather than actually attempting to explain those measures. One of the main ideas, for example, is that the recipes of neoliberal economists have actually been implemented because some social groups saw in them ways of reorganizing socio-economic cooperation more profitable for them than the existing one, and at the same time acceptable to their counterparts too, though only as preferable to non-cooperation. And in the third section, I shall also suggest an explanatory hypothesis for both the introduction in Europe, in 1978, of the European Monetary System and the subsequent convergence on low inflation rates also on the part of formerly internally unstable countries.

It is in any case a fact that the categories suggested by this new theory of institutional change only constitute a small part of the toolbox that needs to be reconsidered and reassembled. A number of notions have yet to be revised and reformulated before a satisfactory explanation of neoliberal reforms can be provided. I shall briefly refer to some of them in my conclusions.

## **1. What Rational-Choice Explanations of Institutional Change Really Are**

The advantage of intentional explanations mentioned in the previous section consists in this: that, by viewing social phenomena as the result of actions of individuals and, consequently, attempting to explain such phenomena by the actions carried out and these actions by the beliefs, motivations and intentions of the agents who performed them, these explanations resort, in developing the explanatory hypotheses, to reconstructions of psychological processes (belief formation, choices, etc.), to data and information that can be subjected to plausibility checks first of all by introspection. For example, is it acceptable to assert that individuals can come to believe X because by believing X they can tackle situations that would otherwise be intolerably uncertain? Does it make sense to claim that agents always misrepresent their motivations when they refer to them in public and at the same time affirm that agents never apparently trust what others declare?<sup>4</sup> Is it reasonable to believe that

<sup>4</sup> And if one holds this views, does it make sense to carry out or make use of surveys and opinion polls?

politicians sensitive to popular pressure decided to introduce a budget constraint into the constitution so as to isolate themselves from such pressure? Is it appropriate to explain a certain action by the intention to produce a particular outcome if, in fact, the allegedly desired outcome can be generated only if the counterpart is irrational? Examining and correcting the initial explanation based on a preliminary interpretation of the *explanandum* will lead to a new way of reconstructing the agents' point of view and, consequently, of considering and defining the *explanandum* itself. And this new reconstruction of choices and new definition of the *explanandum* may, in turn, provide the explanatory effort with renewed momentum.<sup>5</sup> The possibility of resorting to this kind of plausibility check is an advantage of intentional explanations because, as I shall try to illustrate more clearly further on, holistic explanations have no internal verification tools.<sup>6</sup> Rather, they consist in applying the chosen substantial theory to the specific phenomenic domain considered, and, therefore, in developing or expanding that interpretative hypothesis through both the definition of the *explanandum* and the construction of the *explanans*.

As we shall see, all rational-choice explanations of institutional change,<sup>7</sup> if examined on the basis of the plausibility of the decision-making processes imputed to agents, turn out to be totally unconvincing. As indicated above, the *explanans* appears to be constructed ad hoc to prove the definition of the *explanandum*: rather than implying it, it is implied by it.

This outcome, however, cannot be considered entirely surprising. The explicit purpose of these explanations is not in fact to explain the introduction of some specific institution by considering the beliefs and intentions of the agents to some extent involved in its establishment and thus viewing such an institution as a means for them. Their aim is rather to explain in terms of rational actions the birth and development of institutions conceived in the same way as the institutions that are the subject of positive and normative economic analyses, i.e. institutions that are seen and defined from above or outside, and, more precisely, on the basis of the efficiency results for society as a whole. One may define them as sets of constraints and incentives which are thought to be able to organise (or align, as it is often said) the actions and interactions of individuals.

<sup>5</sup> von Wright has written [1971, 155]: "There were demonstrations, turmoils, strikes, terrorist attacks, etc. Does this situation have to be considered a 'civil war' or a 'revolution'? One doesn't have to classify it according to predetermined criteria, nor to decide on the application of a particular term. It's rather a matter of understanding [...] what is going on."

<sup>6</sup> Empirical checks – statistical for example – are no such tools, considering that it is confidence in the main hypotheses developed that in actual fact makes these checks appear to be conclusive, rather than vice versa. Elster, for example, supports a similar view [2007a].

<sup>7</sup> The ones analysed in this essay and the others more generally.

And more. In so doing, they also call upon the additional and definitely stronger idea that institutions exist precisely because they guarantee gains in terms of social welfare in a number of different ways. Although decentralized and exclusively self-interested, individual actions lead to socially optimal results on the market, thanks to the information provided by prices; however, the efficient functioning of markets depends in turn on the existence of many other institutions, both private and public, from the police to the cadastre; both the market and the State can moreover encounter many kinds of failures, and other institutions are then needed to provide solutions; and so on. Explaining any such institution involves, therefore, identifying the specific benefits it has ensured (or the problem it has solved) and, proceeding from there, reconstructing the rational choices that can be attributed to the individuals thought to be involved in its introduction. Firms or hierarchies would have arisen as attempts to economise on transaction costs connected to market exchanges; the separation of the judiciary from the executive would have provided the latter with the ability to control its own propensity to behave arbitrarily; without quality brands some particular markets wouldn't exist; without property rights a number of species would have become extinct a long time ago; and so on.

But indeed: proceeding from an external definition of the *explanandum*,<sup>8</sup> and more specifically from a “characterisation” of it in terms of a goal concerning society taken as a whole and considered from above, is not compatible with the provisions of methodological individualism.<sup>9</sup> It is, rather, a sort of finalism. More precisely, given this specific external definition of the *explananda* (institutions viewed as the instruments for achieving increasing levels of social efficiency), the reconstruction of individual choices can be “made to fit” or “stretched” fundamentally in two ways.<sup>10</sup> The first is effected by those “explanations” that present the institutions to be accounted for as the fulfilment of some alleged requirement of the socio-economic system. And it consists in trying to transform this positive result defined from outside the system or, we might say, presented as “objective”, into the motivation of choice of the agents to whom the introduction of that institution is attributed, and a somewhat stronger

<sup>8</sup> And abiding by it strictly.

<sup>9</sup> Udehn [2001], in some ways, takes the opposite view. He believes that economic theory has gradually moved away from the individualistic tradition by selecting institutions as the privileged object of analysis and attributing to them the role of exogenous variables, while the attempt to explain these institutions in terms of rational choice could be seen as an attempt to reconfirm the individualistic research programme. That the external definition in terms of some sort of positive consequence is an obvious violation of the principles of individualism and will inevitably compromise the success of individualistic explanations is not at all recognized. See also Rutherford [1989].

<sup>10</sup> For similar considerations but in connection with *explananda* defined in terms of mathematical functions (and therefore once again from an external point of view), see Schelling [1998].

motivation of choice, apparently, than the one it would have the task of rectifying and that is supposed to have originated the system requirement now finally met. This is without doubt the most frequently encountered type of “stretching”.<sup>11</sup> I will describe it in detail by analysing a well-known paper by Giavazzi and Pagano [1988] about the European Monetary System (EMS) and the adoption, through it, of monetary restraint rules, i.e. about institutions generally thought to be neoliberal. However, many explanations of institutional change entail this kind of stretching, for instance the explanations of political constitutions as pre-commitment devices “imposed by Peter when sober on Peter when drunk,” and all those explanations actually in rational-choice terms<sup>12</sup> developed by the economics of contracts. Although never with reference to works on institutional change, Elster [2007a, 53-54] calls this kind of explanation “rational-choice functionalism.”

In the explanations characterized by the second kind of stretching alluded to above, on the other hand, the adoption of new institutions is attributed to agents who are themselves considered directly and explicitly interested in realizing, by means of those institutions, welfare increases for society as a whole. In other words, social welfare is seen here as a subjective goal instead of an objective positive result. What in any case makes these agents absolutely atypical is not really their alleged benevolence. Imputing a goal to them that the rational-choice theorist her/himself is the first to consider the highest or even the only one to pursue, this theorist goes so far as to present these agents as some sort of angels, i.e. as agents located outside institutions

<sup>11</sup> For a critical analysis of it similar to the one proposed further on in the text, see Elster [2007a, 209-210], who however fails to see this kind of “stretching” in economic explanations of institutional change.

<sup>12</sup> There are, however, actually not very many of them. In fact, the great majority of positive analyses worked out by contract theory simply aim at showing that certain rules, institutions or organisations can be seen as devices that eliminate or cut down transaction costs, and therefore as the objects of possible contracts or agreements thought up and underwritten by the parties because they are in the interest of both. These analyses, in other words, just illustrate or describe the parties’ advantages, in the imagined *status quo*, of reaching those hypothetical agreements, and therefore cannot be considered more than merely speculative or, more precisely, counterfactual. One can have a different opinion only if one is willing to be satisfied with purely or merely functionalist explanations, that is with the kind of “explanations” – which I’ll criticize just below in the text – that consist in simply alluding to the alleged benefits granted by the chosen *explanandum*, on the hypothesis that those very benefits could explain its presence on the stage. In actual fact, once the parties’ interests in coming to an agreement and therefore adopting the institution, rule or organization under examination have been illustrated, the problem is accounting for the real existence, at some time in the past, of the transaction cost that in the meantime would have been eliminated or reduced because of those interests – that is, leaving room for change itself. In fact, one can say that transaction costs exist only if no party has any incentive to propose an agreement to eliminate them. So, in the few analyses that really try to account for an institutional change, the leading party can actually manage to have a new contract only by binding itself in order to change its own incentives and induce itself to cooperate, precisely as in Giavazzi and Pagano [1988].

or even transcendent to the world, instead of agents who, in the pursuit (perhaps) of social efficiency, that is a good which is weighable only from outside the society, consider *themselves* as such. The fact is that these angels or supernatural beings are also required, as we know, to act on or modify this society, a society which is obviously conceived as regulated by the principle according to which everybody responds to incentives. That these angels are doomed to fail should not therefore come as a surprise. I will describe this second type of stretching analysing the work – quite famous among political scientists – that Dyson and Featherstone [1996] devoted to the Maastricht Treaty. In any case, this is not the only explanation that alludes to the intervention by agents of this kind – again, agents whom the researcher presents not only as personally persuaded that they represent the general interest, but actually involved in this pursuit and in this sense almost as her/his messengers among human beings. For just an example, we can think of the (outlined only) explanation by Elster [2007b] of the French decision to keep electoral laws out of the constitution.

In any case, an only apparently obvious point is that, once the rational-choice accounts have proved to be unsuccessful in their attempts to support the view that society moves towards efficiency, it is certainly out of question that one can rely on merely functionalist “explanations” – for instance, the “explanation” whereby formal organisations mirror the attempt to reach efficiency in coordination and motivation [Milgrom and Roberts 1992]; or the idea that the safeguard clauses set out in the Tokyo Round of Gatt were not in fact an authorisation to defect but rather an efficient response to the weaknesses and rigidity of previously established conciliation mechanisms and the sensible acknowledgement that self-enforcing cooperation has its limitations [Dixit 1996].

That point is only apparently obvious because, while it is true that all economists or political scientists reject this kind of thesis as bad logic [Fiorina 1990; but, for a few examples, see also Williamson 1990; Przeworski 2003; Elster 1984; 2000; 2007a], it is at least equally true that absolutely all economists or political scientists use, and widely, precisely this type of thesis, to begin with the one according to which institutions exist because they are needed to overcome collective-action problems. Or, for instance, just to mention another few of these theses, the idea that collective decisions are made when collective action fails; that civil service law is needed to stabilize political deals [Williamson 1990]; that parliamentary debates are open to the public because this sets boundaries to political intrigue and promotes the common good [Elster 2007a]; that one of the main points of bargaining is to make joint ventures possible by enabling the parties to agree on the division of gains to be made from cooperation [Elster 1989], or else, that resorting to routines helps save resources, although it can lead to decisions less good than the one that would be taken if the



problems in hand were analysed thoroughly [Milgrom and Roberts 1992; see also North 1990]. Or, finally, one might think of the essays in which the mere mention of efficiency problems to be tackled suffices to evoke the day they will be solved [for an example see *Epilogue* in Przeworski 2003].<sup>13</sup>

There are three reasons why, on the contrary, these “explanations” cannot be taken seriously as reliable representations of the way the world works. Because they are statements of principle or, at the very best, tautological explanations – what is good to happen happens because it’s good it happens: what has been introduced in the definition of the *explanandum* reappears in the construction of the *explanans*.<sup>14</sup> Because they are made up of theses that, if true, no one could actually state them, starting from the basic one that individuals always pursue their own interests within exogenously given constraints. But above all because, in providing a description of the kinds of relationships between individuals objectively needed to increase efficiency as these relationships would appear from a point of view external to society, those explanations, like all other theses of an objectivist nature (holistic or maybe behaviourist), do not answer any question of a scientific nature but, rather, only satisfy what is primarily an ethical or political need: to uphold one’s own beliefs concerning the best way to organise social life or see it organised as objectively true (true from a standpoint that is external to society) and a criterion of truthfulness in the examination of agents’ opinions and evaluations.<sup>15</sup> Note the following: researchers never recognize the existence, within the field they study, of social factors, structures or teleologies that they consider unacceptable.

To see this clearly – i.e. that objectivist theses do not reflect any ontological reality, and that the interests they serve are political or ethical instead of scientific – suffice it to consider that there is no statement concerning the existence of an objective order or structure to be grasped by placing oneself above society or behind individuals, that does not also involve (or that does not also respond to) the establishment of two radically different communities. One of them is the community of the agents observed, i.e. a community made up of individuals who are considered capable of intentionality within the context of institutions but certainly not of controlling that

<sup>13</sup> Barbera and Negri [2008] also emphasize the functionalist structure of many economic explanations of institutional change.

<sup>14</sup> Functional explanations are often characterized (and criticized) by insisting on the need to indicate feedback mechanisms from the consequences imputed to the phenomenon being analysed to the phenomenon itself, if those consequences are to explain what is allegedly their cause (see, among many, for example Elster [2007a]). By presenting them as tautological I shift the focus to the perspective from which a given consequence is considered positive.

<sup>15</sup> So, it is true: the “individualism” of the new institutional economics is in fact “ethical” (see, among the many, Basu [2011]), but because this theory is in fact holistic rather than individualistic.

context or even clearly understanding it. The other is the community made up of the observer and the receivers of his/her analysis, suggestions and recommendations, that is to say of individuals who are considered, unlike the agents, as having not only intentionality but also the ability to effectively and meaningfully affect the social reality described to them by the observer, and for reasons that may even be noble and inspired by justice. And indeed it is exactly this way that these receivers conceive themselves and the researcher: as unconstrained or in any way limited by institutions, social structures or the design of history, which, rather, fully satisfy their desires. In fact, what can it identify this second community if not precisely this?

Giavazzi and Pagano [1988] is a fairly well-structured and detailed example of essays that, having defined the institution to be explained from an external point of view as a solution to a previously existing inefficiency problem, aspire nevertheless to explain its introduction in terms of individual actions, and attempt to do so by attributing to some agent an intention to, one might say, “self-correct”. The institution in question is the European Monetary System, or rather Italy’s decision to join this system. Giavazzi and Pagano propose to explain it as the set of commitments, rules and constraints to which Italian policy-makers would have submitted (or some policy-makers might have submitted) to make their own promise to cooperate with their counterpart (trade unions, as I shall explain) really credible, and so succeed in achieving the optimal result, i.e. cooperation, rather than the sub-optimal one of non-cooperation. Looking at the problem rather than the solution, the idea is that an agent (say agent I) who, at  $t_0$ , promises to agent II to cooperate at  $t_2$  in return for what agent II will have done at  $t_1$ , will in fact have an incentive not to cooperate, when his/her turn comes: clearly his/her promise will not then be credible and therefore the outcome will be sub-optimal.

As everybody can see, the model is the one originally developed by Kydland and Prescott [1977] and referred to by a number of authors under the heading of strategic time inconsistency [see for example Bicchieri 1993; Dixit 1996; Elster 2000; Przeworski 2003]. As Kydland and Prescott had done, Giavazzi and Pagano use it mainly to prove the optimality of an irreversible commitment to a restrictive monetary policy: the correlations between employment and inflation highlighted by Phillips could be exploited effectively by government to increase jobs if trade unions weren’t able to recognize the government’s own incentives. The problem is that they would be: wage claims triggered by fear of monetary expansions would neutralise policy-makers’ efforts to increase employment, contributing only to increasing inflation. From the government’s point of view then, it would be better to strictly pursue a zero inflation policy. This is a fundamental measure of the neoliberal programme. The following critique shows that it cannot have been adopted in the way suggested

by Giavazzi and Pagano, but it obviously says nothing about its goodness or badness from the economic standpoint.

Two main problems arise from the point of view of psychological plausibility of the decision-making processes imputed to agents. In this context, the first one is of secondary importance. I will mention it only briefly. It has to do with the alleged rationality or optimality of the monetary expansion policy (or the defection strategy), that is to say, with the objective existence, from the government's point of view, of incentives to adopt it, and in consequence of which it would have precisely to tie its hands.<sup>16</sup> Kydland and Prescott [1977] present this policy as optimal also with regard to the situations in which policy-makers would adopt it absolutely ignoring the possibility that trade unions react to it out of self-defence, i.e. in which they would consider them as nature. However, in this kind of circumstances, this is clearly not the case: it is not rational to act in a strategic context as if it were parametric.<sup>17</sup> But, one may also wonder whether, once all agents have come to view each other as rational, it is still reasonable for policy-makers to adopt policies that, in seeking to achieve the desired goals, will harm their counterparts and that these counterparts are in a position to neutralise.<sup>18</sup> Obviously, if it isn't, no time inconsistency problem will ever arise.

The game of promises seems to give some plausibility to the idea that policy-makers retain the incentive to defect (that rationality dictates to them this strategy) and therefore cannot avoid the problem of strategic time inconsistency.<sup>19</sup> Among other things, this game would be a unilateral Prisoner's Dilemma (PD), and in PDs defecting is, one generally assumes, a dominant strategy. Yet, as one can easily see, policy-makers would actually have this incentive if and only if trade unions were to cooperate, that is to say only if they were irrational. And this is something they clearly are not, as policy-makers themselves obviously well know. So, doesn't nurturing the hope of taking advantage of the cooperation of others go against precisely the thesis of rational expectations?

Anyway, in this context, this issue is, as already said, of secondary importance. Let it be assumed, therefore, as in Giavazzi and Pagano [1988], that policy-makers have an incentive to defect and so that the problem of time inconsistency is real. Thus, since trade unions recognise that policy-makers have incentives not to cooperate and moreover know that, if they themselves were to cooperate, the authorities would not,

<sup>16</sup> This is, of course, a widely debated issue in the context of rational-choice theory. For an in-depth analysis, with a wealth of bibliographical references, see Sugden [1991].

<sup>17</sup> Elster [2007a] has coined the definition of younger sibling syndrome to indicate our alleged tendency to consider others less rational than we are.

<sup>18</sup> This is the position upheld in Elster [2007a], but not the one presented in Elster [2000].

<sup>19</sup> Oddly (see the previous footnote) according to Elster [2007a] too.

they do not cooperate as well, and the end result is much worse for both sides than it would have been if the government's promise had been credible and cooperation feasible.

The idea that policy-makers might avoid this outcome by deciding to tie their own hands presents however a number of problems. In fact, if agents have an incentive to behave in a given way (if, to them, this is the rational action to be pursued), then it is impossible for them to also have an incentive to do the opposite (to pre-commit or tie their own hands).<sup>20</sup> Or: agents who have no incentive to behave in a specific way, don't have any incentive to give themselves that incentive either.<sup>21</sup> And indeed, the idea that they might succeed in pre-committing derives from the illegitimate introduction of a kind of rationality that is quite different from the subjective one of rational-choice theory, i.e. the objective rationality of complying with the efficiency requirements of the social system as these requirements may be grasped by an external observer. But it is a rationality that, one might even say, is without a subject or belongs to the system and, precisely for this reason, cannot have any motivational power. Many explanations of institutional change are similar to Giavazzi and Pagano's and therefore exposed to analogous objections, for example, Dixit's account of the introduction of fixed rules as responses to ex-post opportunism [Dixit 1996]; Przeworski's discussion of constitutional constraints as solutions to the principal's moral hazard [Przeworski 2003], and more generally the analyses of many pre-commitment devices (delegating, constitutional clauses, separation of powers, reputation-building, etc.) as checks or constraints to free-riding and therefore prerequisites of cooperation. The idea of constitutions as ties by means of which societies would bind themselves to hold out against their passions supposes a decision mechanism which is implausible in two senses: because it refers to a unitary subject, instead of a collective and probably divided one [Elster 2007a; 2007b], and because it presumes, again, that someone who is motivated by a passion can desire to oppose this same passion.<sup>22</sup>

<sup>20</sup> Or moving, for another example, to the problem of reforming political institutions, how can the institutions required to regulate the political process so that it may make appropriate decisions be introduced before they have been introduced, i.e. before the political process has acquired the qualities that are essential if it is to make wise decisions?

<sup>21</sup> Elster [2007a] acknowledges this in the analysis of Becker's thesis according to which individuals could win their inability to defer gratification for example by trying to continue their studies, but not in his analysis of promises and threats.

<sup>22</sup> As Przeworski and Limongi [1993] note, Ulysses decides to tie himself before he hears the Sirens; societies in the grip of passions are already listening to them. Self-binding can be a subjectively rational choice, rather than "rational" from the point of view of external observers only, if the passion to be counteracted is impulsive rather than enduring. Tending to yield to the former kind of passion is in fact a classical example of weakness of will, a type of irrationality that we generally recognize and try to overcome. However, applying these ideas to the explanation of constitutions implies, again,

While according to the kind of explanation just examined individuals are, so to speak, the executors of a process the direction of which they do not control (and it is precisely for this reason that the decision-making processes attributed to them turn out to be implausible), according instead to the one suggested by Dyson and Featherstone [1996], but also by Putnam [1988], Moravcsik [1993], Dixit [1996], and Vreeland [1999], the aim of promoting social welfare by choosing and adopting the proper institution is entrusted directly to specific social agents – in Dyson and Featherstone’s essay, to the small technocratic elite that played a primary role in the bargaining that led to the Maastricht treaty; in the other contributions mentioned, to a number of European and non-European governments. So, the action – the introduction of an institution viewed as a means by which to ensure social welfare – would appear to be explained, here, exactly in the way suggested by individualism, i.e. by looking at the agents’ prior beliefs and motivations.

Obviously, the hypothesis that there are or might be agents interested in realizing welfare increases for society as a whole plays only a secondary or minor role in the context of approaches to institutional change in terms of rational-choice theory, and it is hard not to consider it as being ad hoc. Anyway, the really important question is instead that, as already noted above, in endorsing that hypothesis, the authors of this kind of explanations impute to the agents they are considering a goal that they themselves consider the highest. And this is why those agents turn out to be not engaged in the pursuit of their particular aim among other actors equally committed to promoting their own, but rather absorbed in the making of the one and only good for society, against and in spite of other social groups, who are themselves supposed to be motivated by personal interests only; or, in other words, are conceived as members of an elite which is undoubtedly very generous, but is at the same time also superior to all the other social groups, and, unlike these groups, located above society, or outside its constraints and incentives. As Przeworski [2003] writes with a degree of self-mockery, and as we stated above, these agents are in fact similar to angels;<sup>23</sup> in some papers, they are presented as “politicians autonomous”. The problem is that, in a world conceived as entirely identified by the web of constraints and incentives, their location outside society is, on the one hand, absolutely necessary in order to make room for institutional change itself; and, on the other, an insuperable obstacle

supposing either that society is a big individual, or that all its members are liable to the same passions and in identical circumstances, and fear their effects to the same extent.

<sup>23</sup> It is precisely the way in which economists – apparently without any shame – see themselves in relation to us. More generally, we can say that we here encounter two groups of agents who are quite similar to the two communities created or established by holistic researches: the set of agents whose actions are to be regulated or organized by means of institutions, and the élite group of the agents who can care for the welfare of the whole society and are located beyond its constraints.

to it. Or even: an agent in that position could succeed in realizing her/his aims only by having the particular omnipotence of the benevolent and omniscient dictator of the old welfare economics or, which is the same, the powers of a wizard.

The basic idea suggested by the above-mentioned authors is – to be more specific – that when groups of internal opponents hinder the introduction of policy provisions presented as in the interest of society by the government (or any of its components), the latter can take part in or even launch international negotiations in order to prevail over such groups and succeed in gaining approval for its policies. More specifically, by binding itself to the external counterparts, such a government (or its components) would succeed in uniting the fate of the policies it supports to the fate of the international agreement, thus raising the cost of non-approval. According to Putnam [1988], this would provide an explanation, for instance, for the 1978 agreement subscribed at the Bonn summit, and for the 1974 and 1977 negotiations between Italy and the IMF, which some Italian conservative political groups would have exploited to promote policy measures that would otherwise have been rejected. Moravcsik [1993] explains along these lines a number of free-trade treaties, and some European agreements used for domestic purposes in particular by Spain and Italy. Quoting Putnam but also Dixit [1996], Vreeland [1999] seeks to prove that several governments resorted to the IMF exclusively to silence their own internal opposition and have policies unsuccessfully supported for a long time at last “imposed” upon them. That is to say, they would have resorted to the IMF and signed an agreement with it although they had absolutely no need for its financial support. As for Dyson and Featherstone, their thesis is that, by the Maastricht Treaty, the small technocratic elite in charge of negotiations would have managed to subject the corrupt and incompetent Italian political world to an “external constraint”, and so get approval for policies that were as opposed as imperative.

Clearly, for the negotiations and the connected agreement with the external counterparts to work in the way just described, it is crucial that at least internal groups hostile to the government’s policies and supposed uninterested in the good of the country nonetheless attach importance to what is at stake in the negotiations themselves, for example to Italy’s participation in the Monetary Union or the loan promised by the Monetary Fund. It is a requirement that is not, in truth, perfectly consistent with their alleged opportunism. The key question, at any rate, is whether or not what has been promised by foreign counterparts (or by the Fund) in return for what they have asked for, is considered important or valuable by benevolent groups or governments too.

In fact, these groups or governments can get the foreign countries or the IMF to impose to them exactly the policies they appreciate if and only if they are not in

any way dependent on these countries or the Fund, i.e. only if they need nothing from them except a signature on the agreement. Only this way can they claim to have imposed an external constraint on the country without they themselves being bound by it. Vreeland explicitly presents this requirement as met. The problem, however, lies in this: that if the Fund's loan and the process of European integration are not considered important by anyone except the internal oppositions, then the agreement signed by benevolent authorities will not be binding for anyone at all (repudiating it wouldn't involve any loss), and the explanation would miss its target.

## **2. Explaining Institutional Change. A Bargaining Model**

### *2.1. Institutions in the Perspective of Individuals*

Imagine a relatively large group of people who, in exiting the subway, make use of the escalator, placing themselves indiscriminately on both the right and left sides of the stairs. Those who are in a hurry and want to move up the stairs will discover their dependence on the travellers ahead of them, and begin to think about a rule which addresses this reciprocal dependence in such a way as to be advantageous to them but also, obviously, acceptable to others, given their differing objectives.

Cholera made its first appearance in Europe around the middle of the nineteenth century. Passing beyond India's borders in 1818, it spread without obstacle throughout south-eastern Asia all the way to China and Japan. Travelling over the Arabian Sea, it reached East Africa, passing into the Middle East, in Syria and Palestine, and finally in 1822 it arrived in southern Russia.

Exploding with another major outbreak in India, the epidemic of 1826 reached eastern Russia in 1827. Notwithstanding the great quarantine measures adopted, by 1831 no one of the major cities in the country was unscathed by the epidemic. Russian soldiers carried the disease with them to Poland, and from there it spread into Germany, Hungary, and Austria; in 1832 it reached Paris. Muslim pilgrims returning from Mecca transported it into Egypt and all of North Africa. In October of 1831, a ship from Hamburg brought the contagion to England, and from here, in 1831, it crossed the Atlantic and reached Montreal. By 1832 cholera had arrived in New York, and by 1834 had devastated New Mexico. The first European-wide efforts to organize a system of international cooperation to combat the spread of infectious diseases began in the aftermath of this epidemic. Over the years, this cooperation passed from an exchange of information to the adoption of shared definitions and health standards, from debates about what national policies to undertake to international

coordination of interventions, until, finally, joint action under common direction and shared expenses [Cooper 1989].

The bargaining model proposed in this section represents a possible way of explaining the type of institutions referred to in these examples.

More precisely, supposing that coordination-type institutions exist as well, I define the type of institutions which I intend to explain as repeated (or set up to exist through time) cooperation schemes planned out by individuals (groups or parties) as the best means, given the specific situations of mutual dependence in which they find themselves, to reach some of their objectives, and adopted in mutual agreement with others involved in those dependences because they are convenient for them too.

Examples of this type of institutions are a taxation system; a pension system; the set of economic and political institutions necessary to achieve an efficient society; the whole of economic and political institutions able to realize a social-democratic society; corruption relations such as *Tangentopoli*; State or public solutions to the tragedy of commons (taxes and subsidies), market or private measures (assignation of property rights), or finally decentralized solutions (agreements between users) to this kind of problems; the organization of the euro zone; the system of crowd-funding as both a solution to the problem of scarce public resources and an alternative to the market; the informal regulations adopted by the first private radio stations; the creation of a local currency; a rationing system; a national wage agreement; a company salary agreement; an industrial district, etc. There are therefore cooperation schemes that either involve the whole society or are merely “local”; devised for the realization of goals either perceived as merely self-interested or recognised as moral or ethical (rights; the equal possibility to realize one’s own plan of life; with the clarifications suggested later on, the goal of efficiency; etc.); agreed upon by homogeneous parties or vice versa by heterogeneous ones; by few agents or many, etc.<sup>24</sup>

## 2.2. Assumptions Underlying the Suggested Notion of Institution

In attributing to individuals the ability to devise, in situations of mutual dependence, a cooperation scheme fit for the achievement of their own purposes but welcome to others too, given the goals of their owns, I support Schelling’s thesis

<sup>24</sup> Ostrom [1990] too sees institutions as individuals’ tools instead of means of the goal of efficiency. In particular, she analyses in that terms the institutions devised by appropriators and users of common pool resources to make it possible the reproduction of these resources and therefore ensure access to them to everyone. However, Ostrom suggests this way of interpreting institutions as it was suitable only for the arrangements supplied by appropriators and users, that is, as if the State and the market solutions to the tragedy of commons were not planned by individuals as well.



[1960] according to which, with the exception of situations of exchange (whose starting point is the *status quo*), it is up to individuals to create the so-called bargaining situations.

According once more to what can be deduced from Schelling [*Ibidem*], attributing to individuals the creation of bargaining games means recognizing them three different capabilities:

a) the ability to understand that there are circumstances in which the best way to realize one's own purposes consists either in proposing to those with whom one is linked to by the relevant (in respect to those goals) mutual dependence a different way of organizing that dependence which could be beneficial for them too, or in creating a radically new situation of mutual dependence in which cooperating could be convenient for others too;

b) the ability to have, given these beliefs, the intention to cooperate and/or to create the dependence perhaps needed, and finally,

c) the ability, given a) and b), to signal in a credible way to the counterpart one's own intentions, or, in the words of Schelling himself, the ability to change the game: to sum up, to influence what this counterpart will do by influencing primarily her/his expectations about the way in which one intends to act. It is the topic of strategic moves, that is to say of the many possible ways in which one can take on commitments which are truly binding and regarded as such also by others.<sup>25</sup>

As Schelling himself recognizes, the idea that an individual may wish to change the game to "win together with others" is not compatible with the basic assumptions of "traditional" or "merely formal" game theory. For a restatement of the standard thesis, one can look at what Binmore [1993] writes against Gauthier: the awareness of the benefit of cooperation cannot by itself make a commitment self-enforcing; to make a player to keep his promise there has to be a device that somehow penalizes the betrayal; but either this mechanism is already part of the game, in which case the player will certainly cooperate, thus succeeding in bringing home his/her share of cooperative surplus, or it is not, and in that case, no individual can establish it anew by virtue of a piece of his/her own reasoning. This is not, however, an unquestionable thesis. As it was noted in the first section, what indeed excludes that a player can have an incentive to betray his/her promise is actually the rationality of his/her counterpart.

<sup>25</sup> The point is anyway the following: that an agent pre-commits himself not to change his incentives, as neo-institutional explanations contradictory state, but to communicate to others the kind of interests he intends to satisfy.

That is to say, the idea that an agent can succeed in betraying her/his promise appears itself to be illusory.<sup>26</sup>

What has been said so far can be considered the core of a theory of bargaining in sharp contrast to the traditional one (or to common points of the many versions of this). I will now try to state two further aspects of this new theory, only the second of which made explicit by Schelling.

1) While in traditional bargaining theory parties are supposed to negotiate on the division of the gains from a cooperation whose characteristics are assumed as given, in what follows – with the only exception, once again, of exchange situations (whose starting point is already given by the status quo) – by bargaining it will be meant either the set-up, and establishment, of a scheme of cooperation as the best way of fulfilling the common interests of the parties and, through such interests, their diverging goals, or, in the event that the proposed schemes are more than one, the choice of the scheme to be adopted. When bargaining concerns one-shot schemes (as in the kidnapping game, for example),<sup>27</sup> it is in the interest of the party whom the proposal is addressed to (in the example, the kidnapper)<sup>28</sup> to verify the adequacy of the scheme. When bargaining concerns a repeated (or multistage) scheme, it is up first of all to the proponent to verify its adequacy and keep to it (ripping off an advantage now would harm future interests). In other words, each bargainer's share of benefits is settled by the requirements of the scheme "functioning" or effectiveness with respect to its aims, and nobody has anything to gain by modifying these requisites.

2) According to traditional game theory, coordination between players is made possible by common knowledge of rationality, so that the so-called transparency of reason could be said to be the result of the possibility of ascribing one's own rational reasoning to the counterpart. On the contrary, as just pointed out, according to Schelling, players coordinate their behaviour by means of strategic moves, i.e. by

<sup>26</sup> Ostrom [1990] explains cooperation between appropriators or users of common-pool resources citing the operation of social norms, the rationality of cooperative strategy in indefinitely repeated PDs, and the establishment of mutual monitoring devices that everybody trusts. Although upholding the rationality conception of traditional game theory, Elster [2007a] acknowledges that there are situations in which, in failing to conform to the predictions of game theory, people appear to be more than rational (or "reasonable") instead of less than rational. More precisely, they would prove to be able to "transcend the traps of rationality – to concentrate on the fact that both players can gain while ignoring the best-response logic."

<sup>27</sup> Proposed by Schelling. There are a kidnapped and a kidnapper, and the ransom has been paid. The kidnapper would prefer not to worsen his situation by committing a murder in addition to the kidnapping, but knows that the kidnapped will go to the police if he releases him. Nevertheless, the kidnapped could find a way out, with advantage of both parties, by making himself too dependent on the kidnapper or blackmailable by him, for example by confessing a crime he committed.

<sup>28</sup> He would have to verify the truthfulness of the kidnapped's confession, and possibly evaluate the actual seriousness of the crime "praised" by him.

moves to be meant as means of communication of credible information explicitly addressed to one's counterpart, and an answer, therefore, to the need of both sides to establish a contact between their respective thoughts.

### 2.3. *A Bargaining Model Over Repeated Cooperation Schemes*

The aim of the model presented below is to defend the plausibility of the assumptions just proposed – and in particular, of the definition of bargaining over repeated schemes introduced by point 1) – by proposing a detailed description of the kinds of actions we suppose are undertaken in bargaining.

Bargaining tools, and therefore instruments of coordination, are:

- elaboration of correct beliefs (or the search for truth);
- necessarily sincere arguing about *a*) the desirability of the goals that each scheme promises to achieve, in particular from the point of view of the parties other than the proponent, and *b*) its capability to function or work, that is to realize those objectives;
- sincere communication of one's own intentions (strategic moves), and finally,
- voting (necessary in certain specific situations).

Bargaining, therefore, does not refer to having recourse to threats and promises as opposed to arguing and voting as qualitatively distinct mechanisms, as in Elster [2007a], but reaching an agreement by using the actions listed here above.

I will explain the way in which these tools are used in relation to three possible types of bargaining.

In fact, bargaining can mean:

- devising and adopting a cooperative scheme; or
- choosing between alternative cooperative schemes, which can differ *a*) either because they are based on different factual beliefs, although means for all the proposers of the same purposes, *b*) or because they are means of realizing different purposes for which the parties have contrasting preferences (see for a summary table 1).

#### 2.3.1. **Bargaining Over One Cooperative Scheme**

The contracting parties are most probably homogeneous; if heterogeneous, only one party will propose a scheme suitable for the achievement of his/her objectives (and therefore, first of all, form the beliefs necessary to devise it).

Examples of this type of schemes are: a workers cooperative; a decentralized solution to the tragedy of commons; a mutual aid society; the informal rules of the

first private radio stations, etc. Where a certain economic policy is almost unanimously considered only as a technical matter and its proponents are therefore considered no more than “technicians”, presumably only one cooperative scheme has been proposed.

Leaving aside the strategic moves necessary to signal the intention of cooperating, the bargaining tools are essentially two, in this case: the formation of hopefully true beliefs and sincere arguing.

Formation of beliefs: in shaping them one aims at truth: it must be true (or it is necessary to believe it is) that the devised scheme is *a*) achievable or feasible, and *b*) will function or work, that is will be able to satisfy common interests of the parties and, through them, the diverging ones.<sup>29</sup> Therefore one searches for truth in particular about:

- a) the interests of the parties to which the cooperation scheme is proposed: it has to be true that cooperating is convenient for them too;<sup>30</sup>
- a) the effectiveness of cooperation with respect to parties’ common and conflicting interests, which in turn depends upon:
  - a) the technical characteristics of the situation;
  - a) the causes and effects of relevant actions undertaken by agents different from the cooperators and whose behaviour must be taken therefore as given; and
  - a) the means-ends relationships between the cooperation tasks established by the scheme and the objectives of the parties.

As an example one can think about the data and the information necessary to set up the rules of a mutual aid society (for instance, to determinate the amount of monthly subscriptions), about those necessary to devise a system of self-regulation in situations of common-pool resources, etc. It is clear, in any case, that the cognitive capabilities ascribed to the agents are the same that an economist would attribute to her/himself.

<sup>29</sup> Getting to correct (or so considered) beliefs is of vital importance both for understanding the exact nature of the mutual dependences discovered, and for devising the scheme with which to deal with or to utilise them. According to Cooper [1989], what had impeded for a long time international cooperation in controlling the spread of infectious diseases was disagreement on the mechanisms of disease transmission. See also Ostrom [1990].

<sup>30</sup> Or in other words: it is necessary that proposer and recipients have common interests. One can obviously be wrong about this as well. For example, in 1878, during the V International Sanitary Conference, the American delegation, mistrusting the health inspections on ships leaving the Far East destined for US ports, asked that functionaries from the countries of destination conduct the inspections, rather than personnel from the ports of departure. This proposal was denied. No poor colony had motive to doubt the strictness and scrupulousness of the American inspectors on ships leaving American ports, but very strong reasons to fear the suspension of maritime traffic, so important for their economies, in the event of discovery of cases of yellow fever [Cooper 1989].

As mentioned above, where bargaining involves repeated (instead of one-shot) cooperation schemes, it is of utmost interest to the proponent to form true beliefs: only if the proposed scheme works<sup>31</sup> over time, will cooperation be useful to her/him and the best way of achieving her/his objectives.

On the other hand, since the parties' shares of cooperation benefits depend on the working requirements of the scheme, it is in the interest of the proponent not only to know the truth but also to stick to it: trying to obtain an immediate advantage (a higher share of benefits than would be correct) will jeopardize future gains.

Sincere arguing: the reason why debating is at least sometimes indispensable has to be found in the possible complexity of the means-end relationships in question; the reason why it is necessarily sincere (or lying inconvenient) lies in the repeated (or multistage) nature of the cooperative schemes considered; it concerns:

- the desirability or convenience of the scheme for receivers of the proposal too;
- its good working or functioning.<sup>32</sup>

Supposing that the proposed scheme appears potentially advantageous to the receivers too (and in particular, that no one of them succeeds in devising a different scheme that is more advantageous for themselves), it is in the latter's interest to pay attention to what the proponent maintains about the efficacy or ability to function of the cooperation suggested. On the other hand, if the receivers, in evaluating the information given them, get to differing opinions, it is in their interest to communicate these to the proponent, and in the interest of the proponent to pay attention to them. No one can benefit from ignoring the truth.

### **2.3.2. Bargaining as a Choice between Schemes which Differ Being Based on Contrasting Beliefs although Means for All the Proposers for Achieving the Same Goals**

For an example, one can consider the positions taken up recently respectively by the ECB and the Bundesbank concerning the best possible response to the Euro

<sup>31</sup> Worrying about the proper working or functioning of a scheme is equivalent to worrying about its technical or productive efficiency. Worrying about efficiency in the meaning of the previous section means, vice versa, looking at the scheme from the point of view of a benevolent and impartial observer external to society. Given a scheme which is efficient in the first meaning, i.e. capable of realizing the objectives of both the proponent and his/her counterpart, a benevolent observer might ask, in light of his calculations in terms of utility, for a reframing of the scheme in order to ensure any possible gains of social welfare, regardless of whom these gains might favour.

<sup>32</sup> For a comparison with the thesis that, from the point of view of any single agent, the rational thing to do is on the contrary lying about everything (a thesis which supposes that agents have conflicting interests only), see, among many, Austen-Smith [1992]; Elster [1994; 1998; 2007a]; Gambetta [1998]; Przeworski [1998].

crisis: according to several comments, the common interest to be pursued would have been the same for both – i.e. saving the Eurozone as a market economy able to compete globally – but the proposed courses of action significantly different, being based on diverse diagnoses of the problem to be tackled. More specifically, according to Weidmann, the European bond spreads of the period were the effect of the irresponsible budgetary policies implemented by Mediterranean countries for a number of years. Therefore, unburdening them (with the ECB purchasing their government bonds) would not have solved the basic problem and in the end, on the contrary, slowed down the introduction of the required reforms. Draghi's explanation was different: according to him, the crisis was not associated with the debt of individual countries, but rather with the risk of an overall collapse of the Euro. Investors would have demanded punitive interest rates from Italy and Spain because they feared the two countries were about to leave the Euro, and that they would therefore eventually be reimbursed in lira and pesetas. Hence, the ECB needed to prove that the Euro is "irreversible". Had it failed to do so, the panic would have spread, precipitating the situation towards the end of the common currency.

Seeking the truth: it is undeniable that there are cases in which searching for the truth, though obstinate and rigorous, is unable to lead to convergence.

Still, disagreement over facts can lead to scheme models that, though means to achieve the same objectives, distribute costs and benefits of the proposed cooperation in different ways more or less favourable to the parties involved. Compared to the course of action proposed by Weidmann, the authorisation obtained by the ECB to buy the Southern countries' government bonds is likely to reduce the costs of Eurozone recovery borne by these countries.

Sincere arguing: in these cases, searching for the truth and arguing cannot by themselves lead to an agreement by definition.

Yet, as long as each contracting party is persuaded to be dealing with a counterpart as interested in the matter in discussion as itself, arguing is always sincere, provided that, anyway, it involves bargainers only. Since the chances of achieving one's own goals depend, for both parties, on the choice of a truly functioning scheme, in bargaining with the other, each of them has an interest both in presenting its best arguments and in paying the utmost attention to the other party's objections and to its reasons for upholding a different scheme. Following Schelling [1960],<sup>33</sup> one might define these factual arguments as warnings: the conveyance of truthful information

<sup>33</sup> But not Elster [1994; 2000], who by warning means a statement on facts that the agent who delivers the statement does not control.

favourable to both sides, and the purpose of which is to avoid an unwanted result by improving the understanding of the second player.<sup>34</sup>

However, supporters of one front or the other not directly involved in the bargaining often tend to ascribe to their opponents interests other than those they profess. Usually, they are prompted to do so by the different “distributive” effects of the opponents’ scheme. According to a few Italian commentators, both Weidmann and Merkel allegedly pursued their own electoral interests on a number of occasions.

How are agreements reached: the ECB and Bundesbank reached an agreement by voting. In fact, from the point of view of two parties equally interested in achieving a given purpose but holding different beliefs as to the most effective cooperation scheme, giving in to the other side’s proposal means endorsing a course of action “known” to be disastrous. The majority rule makes it possible to identify a decision that will be binding for all without requiring dissidents to converge on the successful position.

In some cases, however, a party may come to believe, as time passes, that its counterpart either does not have (as it should) the same deep interest in the issue to be addressed (a difference which, in its opinion, could perhaps explain also their disagreement over facts) or pursues goals that are different, at least partially, from the ones it has professed. The side that comes to a conclusion of this sort can impose its chosen scheme on the other by signalling its unwillingness to abandon it through a strategic move.

### **2.3.3. Bargaining as a Choice between Schemes which Differ as They Are Means of Achieving Different Goals on which the Parties Have Contrasting Preferences**

Both sides prefer cooperation to non-cooperation, but the scheme proposed by A ensures to her/himself the achievement of goals that she/he appreciates more than the goals offered by the scheme proposed by B, and to the latter, goals that she/he (B) appreciates less than the goals offered by her/his own scheme (B’s). So, A and B both prefer their own scheme out of interest (in the broader sense) and neither of

<sup>34</sup> It is worthy of note, in this context, that either the notion of incentive-based threat coincides with that of warning, means therefore sincere communication of true information, and is as such in no way threatening (in fact, in everyone’s interest), or it is empty. Indeed, if a party’s threat is actually based on incentives, than either the counterpart already fully acknowledges both the existence of these incentives and the accord of its own conveniences with the first party’s ones (in which case the “threat” proves to be totally unnecessary), or this counterpart imputes to itself and the first party different incentives, that is to say, it disagrees about facts, and precisely, as it is said in the text, about the exact features of the scheme that is most effective in achieving the desired goals.

them would gain any real benefit from participating in the other's one, unless it turns out to be the only feasible one.

Conflicts of interest thus return to the foreground, but not in the shape of a conflict over the division of the gains of the cooperation to be started (or of a conflict between separate individual – or group – interests), but rather in the form of a conflict over the cooperation scheme to be adopted.

Examples: the set of political and economic institutions needed to bring about results of social efficiency, as opposed to the set of institutions needed to implement the principles of a social-democratic society; an earnings-related pension scheme as opposed to a contributions-based pension scheme.

In referring, in the following pages, to the goal of efficiency, it should be kept in mind that, unlike the goals agents may seek to pursue through a cooperation scheme convenient also for others, this one does not concern individuals as such but rather society as a whole. Prompted by benevolence, agents who pursue it tend to place themselves, so to say, outside society or above it. One might even say that they evaluate cooperation schemes devised by “lay-persons” in order to realize their own goals, by considering whether or not these schemes waste resources from the point of view of social welfare for the community as a whole, and then indicate the institutional changes possibly needed to fully exploit opportunities for improvement in this regard. However, in trying to explain the adoption of such institutional solutions, it is assumed that at least some receivers of the economists' reform proposals see in these proposals the frames of a cooperation scheme with others that could be useful to achieve their own goals (and possibly even the most useful, in the absence of alternative theories as to what should be done).<sup>35</sup> In fact, in recommending the appropriate policy solutions, economists themselves often suggest, in defence of their proposals, arguments not centred on efficiency, for instance in terms of fairness, freedom of choice, accountability, modernisation, etc.

Searching for the truth: as in the previous cases, each proposer wants her/his proposal based on beliefs she/he considers true, so that she/he can feel certain, or at least sufficiently secure, that her/his scheme is both desirable (or at least acceptable)

<sup>35</sup> Thus, institutions consistent with welfarist and consequentialist theories (one of which is certainly the neoliberalism of the maximisation paradigm) would be actually introduced in a contractualist way, being anyway out of question that they could be adopted in the ways analysed in the previous section. Hume assumed that, faced with institutions able to maximise the public good, each of us, being benevolent, would acknowledge their social usefulness and, therefore, would approve and support them. But this is direct utilitarianism, which requires the world to be populated entirely by utilitarians instead of by selfish individuals. Actually, according to Kymlicka [1990], the idea that utilitarianism constitutes a principle of choice should be rejected. We should consider it simply an evaluation criterion.



also to others (and therefore feasible)<sup>36</sup> and truly able to function or achieve the desired goals.

Arguing: each proposer expresses his views on the desirability and effectiveness both of his own and the other side's scheme.

Statements in favour of the effective functioning of one's own scheme are clearly always sincere, and for the same reasons already mentioned more than once. Yet, the same certainly holds true as well for arguments about the characteristics of one's own scheme, in itself or in comparison with the opponent's one, in terms of impartiality and social justice. Indeed, within the framework of this third kind of bargaining, proposing or upholding one scheme against another means favouring one's own goals instead of those of others. It is a sort of battle that one can fight determinedly and boldly only if considers oneself being in the right.

It is possible to differentiate at least some of the arguments used in bargaining by looking at the components of each cooperation scheme which they refer to, first of all, achievable goals and cooperation setup (institutional rules).

For instance, the cooperation schemes consistent with the indications of neoliberal theory have been upheld by imputing to them, at socio-economic level, amongst others, the goal of freeing the economic system from State control or State fetters; of saving citizens from the State's organised theft; of giving back to individuals the freedom to choose one's fate; of offering everybody the opportunity of self-realization, or, further, of modernising society, ensuring freedom of choice, and finally of supporting families; and, on the political level, for instance the aim of making it possible to introduce "bold" or "unpopular" reforms (or also of "keeping governments from blindly following the inclinations of the people"); of preventing the political game from deteriorating into "Guelphs against Ghibellines" rivalries, or, further, of harnessing politicians' opportunism, cutting the costs of politics, etc.

While neoliberal economists view the institutional rules they have developed as means by which to achieve the supra-individual and benevolent aim of social welfare, to the proponents of a given cooperation scheme these institutional rules define the arrangement of the cooperation to be introduced in order to achieve their own goals (they fight for themselves) and that is also convenient for others, given these latter's goals. The arguments about the ability of a scheme to work (i.e. to realize the desired

<sup>36</sup> As pointed out above, one can make a mistake also in this regard. For instance, we can perhaps explain this way the first Berlusconi government's failure to change Italian public pension scheme. When the plan was presented (under the 1995 finance bill), workers and trade unions reacted with a long series of spontaneous and formal initiatives (strikes, demonstrations, rail and road blockades, a general strike and eventually a successful unitary demonstration) until, in the end, Berlusconi gave in on December 1st, 1994.

goals) concern precisely this relationship between rules of cooperation and goals to be achieved: as repeatedly pointed out above, the purpose of these points is to prove to others that the proposed organisation of the cooperation scheme will succeed in realizing what has been announced.

Nevertheless, it is a fact that, in negotiations of this third kind, the many cooperation rules proposed over time are quite often presented, above all, as being consistent with principles of justice – for instance, principles of equality or of equity. Some neoliberal reforms of the welfare system have been advocated, for example, in terms of actuarial equity (the transition to a public contribution-based pension scheme), intra-generation equity (again the move to this kind of pension system), inter-generation equity (the overall restructuring of the welfare system to the benefit of the young and households), and equality of opportunities and merit (active labour policies, reorganisation of the educational system).

Once again: while neoliberal economists take the view that these principles have instrumental value only<sup>37</sup> and therefore mention them mainly in view of the importance some social groups attach to them,<sup>38</sup> proposers of cooperation schemes seem to impute to them intrinsic value. To explain this apparent paradox – i.e. that cooperation rules set up to achieve specific goals are viewed, at the same time, as consistent with inalienable principles –, one can perhaps suggest the hypothesis that coming up with justice arguments that are persuasive first and foremost to oneself is essential for at least two reasons: to justify the demand that one's own scheme be adopted instead of the one proposed by others, and first of all to value the effects of a given mutual dependence as negative and therefore to be removed. It is possible, i.e., that the ability to develop moral justifications that are convincing at least from one's own point of view acts as a constraint on the identification of one's own interests.

All these arguments are offered to whoever is allegedly interested in the goals or principles professed; it is not assumed that they will succeed in persuading everyone (proponents of cooperation schemes do not hold the same, possibly illusory, ambitions of the authors of justice theories).

Thanks to the arguments supporting the desirability for others of the proposed scheme, a proponent may succeed in involving in negotiation agents and groups

<sup>37</sup> More specifically, equality of resources is considered a means, under specific circumstances, to satisfy some preferences for public goods; principles of equity a basis for incentive schemes. According to Elster [2007a], if thus conceived, these principles would be forward-looking instead of backward-looking.

<sup>38</sup> In interpreting these principles, such groups would be backward-looking instead of forward-looking. Thus, in proposing such arguments, economists would exploit the so-called overdetermined nature of some efficient solutions, i.e. their ability to meet “locally”, that is, given a certain *status quo*, other values as well [Elster 1992].

with partially different goals, or even in facilitating the formation of new bargaining parties. For instance, on the basis of arguments provided by neoliberal theory, some groups of tax-payers may become convinced, and therefore assert, that one has to pay taxes only in return for a specific equivalent; consumers may emphatically demand the liberalisation of taxi and notary services, etc. As indicated by these examples, the possibly assembled coalition will not therefore be held together by beliefs and normative principles unanimously shared (which is rather what Elster claims with regard to arguing and justice theories wish for), but rather by the convergence on the same basic institutional solutions of different social groups, each motivated by goals and beliefs partially different from those of others.

However, the reasons presented by proponent A in defence of her/his scheme will not persuade either proponent B or the individuals or groups that, in the choice between the proposed schemes, share the latter's preferences. The only kind of argument by A that can be effective from B's point of view is the one according to which A's scheme is the only one actually able to function. If it is true that only her/his scheme will work, then it is also true that it is the most convenient one not only for A and the individuals and groups who share her/his preferences, but for everyone.

It is a sort of arguments widely used ("considering demographic ageing;" "given the constraints introduced by the Maastricht Treaty;" "under the new circumstances created by global competition," etc.),<sup>39</sup> and each side (being sure of the effectiveness of its scheme) has always, in principle, an interest in presenting them. The question is, then, whether in these cases arguing is insincere.

Although, with the exception of the staunchest proponents or advocates of the rival scheme, everyone has a strong interest in paying heed to this kind of argument (the danger is taking a stand in favour of a scheme desirable by not actually effective), whatever proponents state in support of the effectiveness exclusively of their own scheme and the ineffectiveness of the rival one is not generally reliable or truthful, at least because the actual functioning of the latter (the rival scheme) is evaluated not in terms of the goals pursued by its advocates, but rather on the basis either of an incorrect re-interpretation of those goals or of one's own.

Yet, contrary to what is stated by advocates of the rival scheme, it is not actually a matter of lies. It is likely, rather, that the limited reliability of this kind of theses is a consequence of the dissimilarity of the two parties' perspectives: the counterpart's

<sup>39</sup> Or an entrepreneur might state, for instance, that "Economic growth is the last, best hope both for the poor and for the rest of us. Sheer redistribution of income cannot do the job. We must create a steady larger income pie. This can be done only through economic growth. And only profitable private businesses can make the capital investments that produce economic growth and jobs and tax revenues" (from a Mobil Oil advertisement, quoted in Przeworski [1998]).

goals appear to be too uninteresting and distant from one's own viewpoint for their feasibility to be seriously analysed.

And since, after all, proving the effectiveness of a scheme, perhaps under new circumstances, is mainly a business of its proponents, one is tempted to conclude that if a given proposal "wins" in public debate it is first and foremost because of the weakness of the theory supporting the rival scheme.

How are agreements reached: for the reasons repeatedly illustrated above (the need for a scheme to be effective), the agreement cannot be the result of a compromise. Parties will agree on either one scheme or the other.

While in bargaining of the first and second type the problem of coordination is to a great extent solved by a sincere exchange of beliefs considered to be true, given everyone's awareness of each side's willingness to cooperate, in bargaining of the third type it is on the contrary absolutely real or authentic. There are at least two possible solutions: each side definitely prefers its own to the other side's one; however, since it also prefers cooperating in the way chosen by the other party rather than not cooperating at all, it is also willing to give up. Which solution will be chosen is decided by the party that is better able to communicate its own choice to the other in a credible manner: being entirely persuaded of the rightness of its goals and legitimacy of its interests, it indicates in a reliable way – by a strategic move – its unwillingness to cooperate with the other in the mode this latter would have preferred.<sup>40</sup>

For a few examples of a strategic move, one might consider Napolitano's decision to appoint Mario Monti as Senator for life; Cameron's decision to hold a referendum on the UK's permanence in the European Union shortly before bargaining was to begin over the Union budget; and the success of a new party in political elections.

Coordinated by such a move, all parties underwrite the agreement,<sup>41</sup> but they do so each for a different reason (because the scheme adopted is both the most convenient and also the fairest; because one has been defeated and has no choice, etc.), and expecting the achievement of diverse goals (those of A and its allies and those of B).

The agreement is self-enforcing: it survives as long as all parties' interests remain unchanged, i.e. as long as neither the As, nor the Bs, nor other groups succeed in finding more advantageous ways of cooperating with their counterpart (or counterparts).

<sup>40</sup> That is to say, it is possible that we use moral or justice arguments more to reaffirm to oneself the moral appropriateness of one's own claims than to persuade those who are motivated by opposite interests.

<sup>41</sup> It is not necessarily a matter of jumping on the bandwagon; one simply takes a stand in a new context.

TAB. 1. *Types of Bargaining and Bargaining Tools*

Types of bargaining	Bargaining object	Bargaining tools	
Search for truth	Sincere arguing	Vote (or any other mechanism considered impartial)	
1st type	Bargaining over one scheme (design and adoption of a scheme)	Mainly about facts; ethical convictions are shared and taken for granted. Necessary but not sufficient.	Mainly about facts. Necessary but not sufficient.
2nd type	Bargaining over alternative schemes based on different factual beliefs	Mainly about facts; ethical convictions are shared. Necessary but not sufficient.	Mainly about facts. Necessary but not sufficient.
3rd type	Bargaining over alternative schemes as means for achieving different goals	About facts and ethical values and principles. Necessary but not sufficient.	About facts and ethical values. Necessary but not sufficient.

*Source:* Author's Elaboration.

### 3. The European Monetary System: an Explanatory Hypothesis

The following short reconstruction of the negotiations that led, in 1978, to the introduction of the EMS is a first attempt to use the model illustrated above to explain a real institution. Its aims are limited: to identify the problem of interdependence that France and Germany – the main players in this and other circumstances of the European integration history – planned to tackle through their respective agreement proposals, given their distinct interests; to identify the most important characteristics of the two cooperation schemes presented (the objectives of the proponent country and the objectives envisaged for the recipients); to present some of the normative and factual arguments used in negotiations; and, lastly, to prove that, in bargaining of the third kind, the “loosing” side can abandon its own scheme and accept an unwelcome agreement only if it can in any case count on the achievement of some of its own goals, i.e. only if that agreement is truly preferable to non cooperation.<sup>42</sup>

<sup>42</sup> It might be worth pointing out that, from the methodological point of view, the explanatory hypothesis presented here is opposed not only to the many economic explanations that follow the one provided by Giavazzi and Pagano and analysed in the first section, but also to explanations, they too fairly common, that suggest conspiracies. These explanations link the entrance of Southern European countries into the EMS – a system considered here harmful rather than beneficial to high-inflation countries – to the determination of Northern countries, in particular Germany, to advance themselves only: the purpose of the fixed (or almost fixed) exchange rate system would have been to keep to a minimum the competitive devaluations on the part of high-inflation countries to

From the substantial point of view, the main idea I will suggest is that gradual convergence on low inflation rates also on the part of the less stable countries was a result not so much or not only of the EMS, as maintained on the contrary by the wide majority of explanations,<sup>43</sup> but rather of two subsequent negotiations: of the external one on the exchange rate system, undoubtedly, but also a negotiation internal to each of the high inflation countries, it too of the third kind, between enterprises and workers. From this perspective, the 1987 Basel-Nyborg agreement could be viewed as a sort of promise made by Southern countries to Germany to comply with the cooperation rules always preferred by the latter, in return for an increase in exchange opportunities.

One can define the EMS as a system with fixed but adjustable exchange rates; with ECU as a pivot but bilateral intervention limits and therefore asymmetric to the benefit of the countries economically stronger and whose currency is expected to appreciate; that commits the monetary authorities of all countries whose currencies would reach their respective fluctuation margins to intervene on currency markets to uphold the established parities, also resorting, in particularly difficult cases, to credit facilities; but one that, lastly, also allows countries with serious imbalances to turn to realignments.

One can identify it with the cooperation scheme devised by Germany to confront the more negative mutual dependences arisen after the collapse of Bretton Woods, and that it proposed to other countries – and in fact got it adopted in the place of the French one – as the most advantageous for itself but also for all other Member States (from its own point of view).

In particular, the introduction of a fixed exchange rate system as an alternative to the often dirty fluctuations associated with the flexible exchange rate regime would have provided all countries with an opportunity to satisfy a number of common interests and, through them, specific diverging ones:

a) firstly, the opportunity to have some checks or guarantees over the monetary policies of the other Member States, a goal considered important by both low-infla-

the advantage of the Northern ones (see, as an example, some of the essays collected in Moss and Michie [2000]). One might say that the *explanandum* of these explanations is the “EMS as a plot concocted to damage me or my side.” However, it is obvious that no country can sign an agreement without hope to gain some advantage. To explain its choices, one has to seek first of all common interests.

<sup>43</sup> All the explanations that view the EMS as a device to sanction inflation.

tion countries threatened by the possible competitive devaluations of others,<sup>44</sup> and those with high inflation rates but involved in internal stabilisation plans;<sup>45</sup>

b) secondly, as a result of stability in exchange rates, a more favourable environment for exchanges and investments, a condition always considered important by EEC countries,<sup>46</sup> but one that could also provide some support or reward for stabilisation efforts on the part of high inflation countries; and lastly and above all,

c) the possibility for Germany itself, on the one hand, to lay the foundations, through this redesigning of interests, for a common European policy in respect of the dollar, and, on the other, thanks in particular to the realignment option, to enjoy the benefits listed above while maintaining for itself, though consequently for all other countries too, the right to implement, within the established constraints, the monetary policies of its choice. In particular, it is essential for Germany to keep the option of practicing its low inflation policy, even avoiding, when necessary, the obligation to support excessively weak currencies.

So it is incorrect to attribute to Germany a primary interest in avoiding devaluation in high inflation countries.<sup>47</sup> It is true that the EMS, unlike the Snake – which, according to Gros and Thygesen [1992], turned into a mostly unilateral system in the last years of its existence –, subordinates realignments to the consent of the countries involved, at least in principle. However, according to a number of authors, Germany allegedly clearly stated from the start, though not publicly, that in case of a conflict between external and internal stability, the latter would have had priority over the first. More than realignments or their excessive frequency, Germany would have feared resistance to accepting them.

Although Germany's determination to pursue, first and foremost, domestic price stability can be taken as a sign of a substantial indifference to the fate of other countries,<sup>48</sup> forced to choose between chasing a probably increasingly strong mark and yielding to instability in exchange rates, it is at any rate a monetary

<sup>44</sup> This is proven, among other things, by the Duisenberg Plan, drawn up in 1976 by the then Dutch Finance Minister. Prompted by the sharp depreciations of the lira and sterling in the first half of 1967, it envisaged the creation, in addition to the Snake, of a so-called *target zone* within which floating countries too would have had to contain their effective exchange rates.

<sup>45</sup> Caffé [1984], Cooper [1999], and Fitoussi [1995] in particular emphasize countries' fear of the often manipulated or in any case manipulable fluctuations of the flexible exchange rate system.

<sup>46</sup> As to the importance of fixed exchange rates in this respect for EEC countries, see Gros and Thygesen [1992, in particular chapter 1], and Krugman [1994]; on the same topic in principle, see Frieden [2002] and Wyplosz [2006].

<sup>47</sup> As done on the contrary, for example, by Fitoussi [1995], Acocella [2001] and many others, but not, for instance, by Simonazzi and Vianello [1994].

<sup>48</sup> This will be done in particular by those who tend to impute to disinflation policies considerable costs – perhaps unjustified – in terms of unemployment and stagnation.

strategy that Germany has always openly upheld from at least two points of view: on the one hand as the only appropriate policy, and therefore impossible to abandon, for the development of an economy organised around the full utilisation of entrepreneurial skills and the free use of one's gifts and talent; and, on the other, as fair towards the other Community countries and, in the long run, beneficial to all.

It is supposedly the most appropriate monetary strategy because the best way of ensuring employment and well-being would consist in relying on healthy and competitive enterprises, and so, above all, on price containment, production cost reduction, increases in productivity, product and process innovations, investments, sound budget policies, etc. In this regard, it should be opposed to the attempt to increase employment and stimulate growth through expansionary policies, that is through policies that would be, on the contrary, the main cause of both inflation and balance-of-payments imbalances.

On the other hand, despite the tensions it could cause given the heterogeneous nature of countries involved in terms of inflation, competitiveness and economic weight, the monetary cooperation ensured by the EMS would be nonetheless fair towards the other economies precisely because neither binding, thanks to the realignment option, nor penalizing of the correct political strategies. On the contrary, from this point of view, it would be rather the prefiguration of the sort of economic integration most profitable for all, and in this sense already beneficial to everybody. Germany's arguments on its correct interpretation of the very rules of the Snake [Gros and Thygesen 1992] and urges to other countries to – so to say – put their house in order [Caffè 1984] should be seen in this light.

The monetary cooperation scheme advocated by France can be considered in continuity with the Fourcade plan presented to the Ecofin Council in September 1974, with the proposal developed in 1977 by the European Commission presided by Jenkins, and lastly, but from some angles only, with the 1970 Werner plan.<sup>49</sup> Like the Fourcade plan, it requests in particular a correction of the Snake's asymmetry that favoured Germany, i.e. that fluctuation margins be set according to the average trend of the Community currencies given their weights as fixed by the Ecu basket, instead of in terms of bilateral parities.<sup>50</sup> And like the Commission's proposal and

<sup>49</sup> Only from some angles because the problems to be tackled are significantly different in the two periods: in 1970, Bretton Woods is still in force, the economies of European countries are fairly similar, akin the economic policies adopted and exchange rates generally stable. In 1970, the monetary plan involves a single currency in a context of substantial stability; in 1978, the aim is to regain some of the past stability.

<sup>50</sup> In essence, once adopted this standard of reference, any departure of a currency from the



the Werner plan, it envisages the introduction of forms of financial aid for countries facing particular difficulties, and an enlargement of the Community's allocative and redistributive role. A thesis was that, with the Ecu as pivot of the system and a more generous European budget, exchange rate stability would have been a goal all countries, without exception, could have achieved and, to the benefit of each of them, at a lower cost [Gros and Thygesen 1992].

Why France aims to correct external effects different from and even in conflict with the ones considered crucial by Germany is explained by the goals it intends to pursue and by the fairness criteria it considers appropriate to both its domestic organisation and the Community context. Although it is centre-right and for some time committed to fighting inflation, the French government identifies the interests of its economy according to the domestic cooperation scheme then considered as the only one effective by many of the European countries, that is the scheme organised around the aim of jobs for all and a degree of equality in social rights and income, and coordinated by demand policies [Moss and Michie 2000]. According to the French scheme, that is, not only is there a genuine trade-off between employment and fighting inflation (pursuing one of these goals entails costs in terms of the other), but the first objective needs to prevail over the second [Krugman 1994].

As to inter-European relations, in fact, by proposing Ecu as pivot of the EMS, France requests that the arrangement of European cooperation be determined by the actual choices of the majority of countries' between competitiveness on the one hand, and jobs and citizen equality on the other, that is basically by their choices on the level of inflation on which to converge. And for their part, the enlarged Community funds would have supported and encouraged the contribution of each country to European and possibly international monetary coordination any time market adjustment mechanisms might have been ineffective or untimely.

The main features of the EMS preferred by Germany and finally adopted were defined in the course of the negotiations that took place between the Bremen Council of July 1978 and the Brussels Council of December. Concerning the issue of asymmetry, French authorities would have given up as early as September, during a meeting with the German Chancellor. With the Brussels compromise, they obtained that Ecu fluctuation margins were used as indicators of alarming divergences deserving joint discussion and analysis, but absolutely not as thresholds automatically triggering compulsory interventions. It is indeed possible that Germany's outright unwilling-

average performance of Community currencies would have been considered a deviant behaviour, regardless of its direction.

ness to take into consideration the French scheme had been somehow clear for some time, given, among other things, its reactions to the Fourcade plan.

On the other hand, from the point of view of weaker countries, rejecting the German proposal would have meant relinquishing any kind of protection from the capriciousness, not determined exclusively by market forces, of the flexible exchange rate system, that is of a system-non-system [Caffè 1984] able to neutralise in a few instants any economic or monetary strategy. France was probably motivated to accept German proposal also by the failure of its many attempts to find a satisfactory solution to this kind of problems at a global level. But a primary role must also have been played by the option of realignments, i.e. by the possibility to opt each time either for external stability or for employment according to one's own hierarchy of goals. Some Italian newspaper articles emphasize the importance of exchange rate stability mainly as a precondition for a desired intensification of both exports and investments in Italy, presenting then this intensification as a support and at the same time a possible result of the disinflation envisaged by the Pandolfi plan.

As a number of authors have pointed out, after a few rather turbulent years marked by several realignments (between 1979 and 1982), the inflation rates of the less stable EMS countries began to drop considerably and exchange rates stabilized. Between 1982 and 1987, parities were revised only twice, and never between 1988 and 1992.

However, the above explanation of the EMS and, in particular, the description of Germany and France's stands cannot account for this disinflation result: indeed, according to these explanation and characterisations, the EMS is not a device to penalise inflation, from either the German or the French point of view. Given the suggested account, it seems necessary to make room to a passage or change in particular, i.e. France's decision to set aside the goal hierarchy that, until 1982-1983, had kept it from achieving the disinflation results it would have pursued, on the contrary, later.

A possible conjecture is that the EMS did actually play a role in reversing attitudes toward inflation, but not so much as a device to penalise inflation, as suggested by most of the available explanations, but rather as a precondition, recognised by some social groups, for an attractive reorganisation of first the domestic and then the European cooperation. One can suppose, more precisely, that entrepreneurs confident in their actual or potential competitiveness have recognised in the ongoing European integration and in a possible reinforcement of it the external support, in the guise of an intensification of exchanges, to their activity by which to replace the domestic ones provided by the State and main causes of inflation. In other words, they may have seen the process of European integration as the foundation on which

to start building a new cooperation scheme that could be a way out for all from the existing growth problems, and at the same time a profitable opportunity for themselves, at least once taxation had been lowered, welfare system downsized, industrial relations radically changed, labour cost reduced, etc. It can be observed that, given a similar scheme, it's true that expansionary policies are ineffective if not in fact seriously damaging, but at the same time also false if the scheme and goals are different.

In Italy, the often-mentioned March of the forty thousand in 1980 and the 1985 referendum on the wage indexation system may have acted as strategic moves of the domestic negotiation just hypothesized. As to the strengthening of the EMS in 1987, one should then see it not as a crucial stage of a plan devised as early as 1978 or maybe even 1970 through the Werner plan, but rather as the outcome of twofold bargaining: the above-described bargaining (of the third type) within each of the countries previously characterized by high inflation rates, and a European negotiation between parties moved by then by the same objectives (a bargaining therefore of the first type).

Contrary to what is supposed by, among others, Krugman [1994] and Dyson and Featherstone [1996], it is only when the new scheme is fully operational and citizens finally persuaded (in a way rightly so, given the unwillingness of many to cooperate in other ways and the incentives generated by new institutions) that being bound to Europe is of crucial importance, that governments, parties, etc. can invoke compliance with agreements on exchange rates to justify very harsh policies.

#### **4. Conclusions**

Maybe it has always been mostly or primarily orthodox economic theory that has identified the individualistic approach to the explanation and, with it, its basic notions, generalisations and pieces of social theory.

However, as already noted, confidence in the ability of market choices to produce efficient results, at the core (or roots) of this theory, has soon been replaced by the acknowledgement that “deviant” conduct can cause inefficiencies, and therefore by the building of buttresses to support or uphold the “spontaneously” ordered arrangement of those choices. However, more buttresses have had to be added on, for instance to integrate the “basic” market with special markets for specific goods or to make room for the production of public goods and the correction of negative externalities, and then yet more fortifications to protect the market so re-organised from opportunistic interventions on the part of politicians of democratic societies; and, again, still more buttresses to make it possible for citizens to cast their vote rationally. And so on.

That is to say, the idea that the organisation of economic and social life tends naturally or spontaneously towards social efficiency appears, on closer inspection, for what it is. On the one hand, a partisan dogma – that there exist such a thing as a “free market”, although it is actually individuals and groups external to the market and beyond the reach of its rules who establish what it should involve and what regulations should govern it.<sup>51</sup> On the other, the cause of crucial methodological mistakes.

These are the mistakes I tried to describe in the first part of this essay. When the phenomena to be explained are examined from the outside in terms of the efficiency results for the whole society, individualism is transformed into functionalism, and the notions of its toolbox are turned into elements of an objective teleology. A theory of strategic interactions based on the concept of interest devised to analyse the market cannot but attribute to agents a halved rationality.

The bargaining model presented in the second part of this paper as the core of a new theory of institutional change has been developed seeking to comply, as strictly as possible, with the individualistic prescription of looking at the phenomena to be explained only from the standpoint of the agents who have produced them. Obviously, it represents only a small part of the methodological individualism to be constructed. Yet, to my mind, it does already succeed in presenting a picture of the social and economic reality quite different from the one offered by orthodox economic theory and concisely illustrated above. I will confine myself to indicating three ways of seeing this.

1. Firstly, if it is true, as claimed above, that individuals can change the game, then the order of priority too between the so-called parametric behaviour and the strategic one must be reversed: in fact, if this is how things are, it is in the latter rather than in the former that one has to identify the more general decision model. As to parametric rationality, a hypothesis is that one can see it as an appropriate description of the behaviour one adopts once a given cooperation scheme has been introduced and the parties involved have begun to consider its rules as given and for the time being not modifiable – some parties because they view those rules as consistent with “justice”, others because, though they wish perhaps for more favourable terms of cooperation, are unable to present this aspiration as legitimate or devise a new cooperation scheme. Yet, nothing in the parametric way of behaving can prove that

<sup>51</sup> And before them economists who oppose to economists, none of whom though sees himself, so that the market they have constructed or “put together” as the “real” free market can continue to appear to be the referent for what they state and the evidence of the objectivity of their theories. (According to Arrow [1974], “Economists are educated to be considered the caretakers of rationality, who ascribe rationality to others, and prescribe it to the social world”).

the framework within which decisions are made and actions taken is fixed for ever, and that the actions of one party have no influence over the actions of the other and the aggregate result.

2. If it is conceived as a cooperation organized in conformity with the rules and terms of the cooperation scheme adopted in a given time, the economic and social system no longer appears to be something one can qualify merely as efficient or inefficient. We can rather consider it as something that can be organised in a number of different ways depending on the kinds of goals to be achieved. Each economic theory could then be distinguished from the others not as a possibly true representation of a single reality that is objective in the same way as nature, but rather as a description of the manner in which the socio-economic system can be organised or reorganised in order to realize specific goals.

3. On the other hand, claiming that individuals are able to change the game means supporting the view that they themselves introduce their own “constraints” on the basis of their own interests, rather than constraints establishing what such interests should be. Thus, complying with the requirement of looking at phenomena to be explained strictly from the standpoint of agents seems to lead to an individualism according to which these agents do not represent only the elementary units of explanations, but rather are considered as having freedom of choice and being able, each of them, to “make a difference”. Bernard Williams defines this kind of individualism as ethically substantial [1984-85]; Udehn [2001] calls it “strong”.

At any rate, the suggested model undoubtedly identifies one kind of interaction only and the notions revised (those of institution, bargaining, arguing, warning, threat, pre-commitment, etc.), though important, are only a very small part of the toolbox that needs to be reassembled. I shall not try to list the many categories to be reviewed (from market to constitution; from vote to misrepresentation; from social norms to altruism; from trust to backward induction, and so on). I shall only refer to, without illustrating them, two more general problems.

a) Once the concern for efficiency has been set aside, it doesn't really make sense to distinguish between truthful manifestations of one's own preferences and misrepresentations of such preferences. What needs to be done is, rather, to explain each choice, statement or stance in itself, in the light of the ongoing interaction.<sup>52</sup> In bargaining over repeated cooperation schemes, each party knows that the other is sincere; those who follow negotiations without being involved in them consider

<sup>52</sup> Elster [2007a] follows the first strategy in the section *A Hermeneutic Dilemma*, but appears to go in the direction of the second in the chapter *Persons and Situations*, if it were not for the way, on the whole objectivist, in which these situations are conceived.

themselves and their allies as moved by impartial motivations, but accuse the other side of pursuing only its own interest. Why?

b) Although they are undoubtedly benevolent and probably consider themselves as such, economists tend to attribute to agents personal interests only. They accept the opposite thesis only when comforted by the results of behavioural economics. Elster [2007a] adds to interest two more kinds of motivations: reason and passions. Yet, not only is the juxtaposition between consequential, and therefore rational, ethics on one hand, and irrational moral norms on the other not clear at all, and certainly dubious the idea that strong reciprocity induces behaviour similar to kicking the stone one has tripped over in order to take revenge of it. As suggested in illustrating the model, even distinguishing interest from morality (or reason) in a sharp way may be questionable.

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## **An Attempt to Provide a Non-Circular Explanation of Economic Reforms**

### Elements for a New Individualistic Theory of Institutional Change

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Abstract: Rational-choice explanations of institutional change are generally considered the prototype of the individualistic research programme. The first aim of this essay is to demonstrate that this claim is not warranted. It is not so if the phenomena to be explained are defined from the external point of view of social efficiency: in this case, individualism is transformed into functionalism and the notions of its toolbox are turned into elements of an objective teleology. When considered from the point of view of the individuals involved in their construction, institutions can be conceived as repeated cooperation schemes devised by some of these individuals (the proposers) as the best means to tackle the mutual dependences in which they find themselves and achieve some of their goals, and adopted in mutual agreement with their counterparts (the receivers) because convenient for them too, given their own particular interests. The second aim of the essay is to develop a bargaining model based upon this idea. The proposed model shows, among other things, that when bargaining concerns the adoption of repeated cooperation schemes (i.e. of institutions, according to my definition), it is in the interest of the proposers to get to correct (or so considered) beliefs and to communicate them to the counterpart sincerely. Moreover, when bargaining consists in choosing one scheme among others, it is possible that some will agree to it despite the fact that they are not better-off with respect to the initial situation. The third aim of the essay is to show that the model proposed can highlight the process that has led to adopt important institutions such as the European Monetary System.

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*Keywords: Institutional Change; Rational-choice Explanations; Social Efficiency as an Externally Defined Explanandum; Weak/Strong Methodological Individualism; Bargaining.*

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Graduate in Philosophy, **Paola Palmiello** was a temporary research assistant at the Rimes Department at the University La Sapienza of Rome, and got a PhD in Economics and Sociology. She currently collaborates with various research centres and works as a translator for several Italian publishing companies. She is now working on rational-choice theory.