Pier Francesco Asso (1958) is Full Professor of History of Economic Thought at the University of Palermo. He has published on Keynes, Ricardo, Italian economic thought and the history of banks and monetary systems. Together with Luca Fiorito he has coauthored many essays on the history of American Institutionalism which have been published in leading international journals (History of Political Economy, Journal of the History of Economic Thought, Research in the History of Economic Thought and Methodology). He is the Managing Editor of Storia del Pensiero Economico and, since 2001, member of the AISPE Board. In 2004 he chaired the Organizing Committee of the VIII AISPE Conference.

Luca Fiorito (1967) is Associate Professor of History of Economic Thought at the University of Palermo.
CONTENTS

Foreword, by Pier Francesco Asso and Luca Fiorito pag. 7

I. The Institutional and Ethical Foundations of the Market

Between “Is” and “Ought”. Some Notes on the Evolving Relationship Between Ethics and Economics, by Lilia Costabile » 13

The Institutionalist Conception of Market as a Social Construction: A Political Economy of Institutions, by Laure Bazzoli and Veronique Dutraive » 28

The Notion of Market Power for the Italian Marginalists: De Viti de Marco and Pantaleoni, by Manuela Mosca » 47

Stackelberg: Oligopoly Theory and Industrial Policy, by Luigi Luini » 62

Retirement and Pensions as Social Institutions, by Sergio Cesariatto » 75

The Development of Macroeconomics and The Revolution in Finance, by Perry Mehrling » 107

Financial Markets and Human Behavior, by Gur Huberman » 115

II. Knowledge, Advocacy and Institutions

Central Banking in the History of Economics (with some considerations on the “case” of Luigi Einaudi), by Piero Barucci and Alfredo Gigliobianco » 133

Monetary Policy Controversies and the Creation of Economics Departments at Central Banks: The Case of Belgium, by Erik Buyst and Ivo Maes » 143
III. Institutions and Economic Theory

Thorstein B. Veblen in Italy in the First Half of the 20th Century: Historiographical Perspectives, by Tiziana Foresti
» 231

Paralipomena of the “Exogeneity” of Demaria: Institutions and Measure of Their Economic Effects, by Achille Agnati
» 259

Exogeneity in the Long View: Giovanni Demaria’s Economics of Institutions, by Francesco Boldizzoni
» 271

Routine, Creativity and Leadership in Schumpeter and Von Mises’ Analyses of Economic Change: A New Look at Recent Debates on Routines, by Agnès Festré and Nathalie Lazaric
» 295

Institutional Economics and the Substative Approach, by Marco Rangone and Stefano Solari
» 317

IV. Institutions and the Spread of Economic Thought

Political Economy and Republicanism in Late Eighteenth Century Spain: R. De Salas’ “Apuntaciones” to A. Genovesi’s Lezioni di commercio, by Jesús Astigarraga and Javier Usoz
» 343

Pablo Olavide (1725-1803) a Spanish-American Economist at the Service of the Institution, by Fernando Ciaramitaro
» 368

The “Società Economica” of Catania (1832-1866), by Adriano Di Gregorio
» 389

The Role of the Rockefeller Foundation in the Training of Italian Economists, by Domenico da Empoli
» 406

Overseas Pioneering Specialization in Economics in the 1920s: The Case of Luigi De Simone, by Daniela Parisi
» 415
Are we all institutionalists now?

In these days there seems to be a general consensus among scholars about the relevance of institutions in economic analysis. After all, we may say, “institutions matter” to any economist. It goes without saying that the so-called old American institutionalists can claim some sort of priority in this connection, let alone the contribution of the classical and pre-classical thinkers. However, it now appears that any school of thought in the discipline – from Post-Keynesians to Austrians, from Marxists to Neoclassicals (whatever this term may mean at the dawn of the third millennium) – acknowledges the role of institutions both at the micro level, in shaping individual behavior, and at the macro level, in affecting the performance of the economy as a whole. In other words, the pendulum of economics seems now to swing towards broader institutional perspectives, including either reemphasis upon, or rediscovery, of the institutional dimension of many masterworks of the past – Smith’s *Wealth of Nations*, just to cite one of the most significative examples.

Still, in spite of such a general consensus, the term “institution” often remains vague and unclear. Douglass North, founder of the New Institutional Economics and winner of the Noble Prize in Economics, has devoted much of his study of economic history to the evolution of institutions. North defines institutions as “humanly devised constraints that structure political, economic and social interaction.” This is another way of saying that institutions set the framework of rules and incentives that affect how people rationally utilize resources in political and economic decision-making. In a quite different fashion, John Roger Commons, one of the leading figures of the old institutionalism, conceived institutions to be “collective actions in control of individual action.” Institutional adjustment, he believed, involved changing the working...
rules that ordered the provisioning process. What the rules specified were the
terms and patterns of rights, duties and options in the actual exchange of
ownership. Such exchanges were termed transactions which specified the
terms of interaction between and among individuals.

This lack of coherence becomes even wider once one considers: that Aus-
trians see institutions as responses to strong versions of uncertainty or, fol-
lowing the Schumpeterian tradition, emphasize the technological aspect of
economic institutions; that Post-Keynesians focus on money as a particular
form of institution and on the actual institutions which govern monetary and
banking policy; that Marxian and Neo-Ricardians insist on the institutional
structure of production and labor relationships, and so on.

These are, of course, overgeneralizations. Still they provide a rough pic-
ture of the complexity of the situation we are facing now. In other words,
paraphrasing a famous sentence of the late 1960s, we can claim “we are all
institutionalists now,” but no agreement seems to emerge on the meaning and
analytical relevance of the term “institution”.

**The aim of the book**

Therefore, the essays collected in this volume are not to be intended sole-
ly as excercises in the history of institutional economics in the various expres-
sions, aspects and nuances sketched above. Surely, some of the essays deal
with the evolution of the several brands of institutionalism. However the
scope of the conference, where these papers were presented in the Fall of
2004, was wider, and, in many respects, deeper.

The conference was held at the University of Palermo, Faculty of Political
Sciences. It was intended, in fact, to stimulate the presentation of original
contributions on the mutual interrelationship between economic theory and
the real functioning of economic institutions in historical perspective. The
organizing Committee set three main fields of inquiry which regarded,
respectively: i. the influence of economic ideas or of single economists upon
the creation and the governance of specific institutions; ii. the way the actual
working and organization of institutions may have influenced the growth of
economic theory and knowledge; and, finally, iii. the economic theory of
institutions in historical perspective.

The final programme included the presentation of more than one hundred
papers, twentytwo of which have been selected for publication in these pro-
ceedings. As far as the structure of the present volume is concerned, we
decided neither to follow the chronological order of the subjects dealt with by
the papers, nor to group the contributions according to their “national origin,”
i.e. with a section devoted to American institutionalism, one to Italian eco-
nomic thought, and so on. The complexity and heterogeneity of the themes
discussed in the Conference induced us to follow a more comprehensive approach, namely to trace four major threads and divide the contributions in 4 sections.

The first section, “The Institutional and Ethical Foundations of the Market,” includes those papers which emphasize how markets, to work as they should, need institutions. Defining the rules of the game, institutions consist of the constraints, formal and informal, on economic and political actors. Market institutions – among other things – serve to limit transaction costs, to organize production, to cope with uncertainty, to negotiate agreements, to monitor performances and to settle disputes.

The second section, “Knowledge, Advocacy and Institutions”, focuses on how economic theory influenced the actual working of institutions, here meant as established organizations or foundations, especially those dedicated to the economy, education, public service, or culture.

The third section, “Institutions and Economic Theory,” explores with several versions of institutional economics ranging from Veblen’s “old” institutionalism, to the more recent evolutionary approaches proposed by the neo-Schumpeterian school of Nelson and Winter.

Finally, the fourth section, “Institutions and the Spread of Economic Thought,” studies how certain academic institutions – from research institutes or universities to foundations or economic societies – played an active role in channelling the evolution of economic thinking, both in terms of its theoretical and policy-making influence and international diffusion.

This book owes a great deal to the advice and encouragement we have received from our colleagues, from the participants to the 2004 AISPE Conference on Economics and Institutions and from the AISPE Board, Professors Piero Bini, Marco Bianchini, Ferruccio Marzano, Manuela Mosca, Riccardo Realfonzo, Gianfranco Tusset.

Professor Giuseppe Silvestri, President of the University of Palermo, and Professor Carlo Argiroffì, Dean of the Faculty of Political Science, deserve special thanks for their steadfast belief in the realization of this project.

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I. The Institutional and Ethical Foundations of the Market
1. Introduction

This paper explores the relationship between ethics and economics by focusing on how alternative economic models of social interaction accommodate ethical standards and norms of moral behaviour.1

In recent years, the relationship between ethics and economics has undergone a deep change, as the conditions, consequences and implications of moral behaviour, a subject voluntarily neglected by economists for most of the 20th century, has become a lively field of economic research. The reasons for this change have certainly to do with the decline of Positivism from its dominating position as the paradigm of economic science. In their “Introduction” to Philosophy and Economic Theory, which was published as late as in 1979, Frank Hahn and Martin Hollis argued that the Positivists tenets were still dominating the economic profession, and that “The upheaval caused by Quine’s pragmatism, Kuhn’s paradigms and more recent bouleversements has yet to send more than a tremor through the temple” (Hahn and Hollis 1979: 1).

One consequence of the state of affairs described by Hahn & Hollis was that the claim to ethical neutrality, which many economists advanced for their science, found strong epistemological underpinnings in the positivist “fact/value dichotomy” (Putnam 2002; Walsh 2003). Robbins (1935) Essay is the classic locus for this approach. Since this book has shaped the profession’s view of the relationship between ethics and economics for many decades, it is the natural starting point for my analysis. Section 1 evaluates Robbins’s contribution, and provides an interpretative hypothesis concerning his methodological systematisation, and the underlying model of social interactions.

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* Dipartimento di Economia, Università di Napoli Federico II.
1 This analysis of economic approaches to moral behaviour is far from exhaustive. I have studied other approaches to institutions and norms of behaviour in Costabile (1995; 1998 and 2003).
This paper then raises the following questions concerning the more recent evolution: what has happened to the relationship between ethics and economics now that “Positivist epistemology has lost its charms” (Hahn and Hollis 1979: 16)? Has “the temple” included the principles of ethics within its boundaries, as susceptible to rational discourse? And in which way? Sections 2 and 3 try to answer these questions. This is done by illustrating and discussing a bifurcation, which has emerged in the literature, between the “evolutionary” approach and a different line of thought, stressing “critical reflection” (Sen 1999) as a means for evaluating economic arrangements and devising just rules of behaviour and just institutions. These two approaches assign different meanings to what I have labelled “rational discourse”, which is respectively intended as rational explanation in the former approach, and, in the latter, as rational selection. Therefore, in order to answer the questions raised above, it is necessary to understand the implications of these alternative points of view.

This paper reviews some parts of the literature on ethics and economics, by adopting as an interpretative criterion the time-honoured, Humean distinction between indicative propositions (of the form “is” and “is not”) and statements which rely on an entirely different “copulation of propositions” (Hume 1738, II: 3,3), of the form “ought” and “ought not”. It argues that the “tension” between “is” and “ought” is still partly unresolved, at least in some part of the relevant literature.

2. Robbins on the ethical neutrality of economics

Ethical neutrality\(^2\) is famously associated with Lionel Robbins’s distinction between positive and normative propositions, and his ascription of the propositions of economics to the former category: “Propositions involving the verb ‘ought’ are different in kind from propositions involving the verb ‘is’”. “Economics deals with ascertainable facts; ethics with valuations and obligations” (Robbins 1935: 148, 149).

These statements can best be understood if taken in conjunction with Robbins’s definition of economics as “the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses”. Robbins himself, and a long series of interpreters after him, argued that this definition, coupled with the notion that economics takes ends as given, implies the positive nature of economics.

\(^2\) An interesting discussion of the debate on Wertfreiheit in economics, focussing on the Austrian School is in Kirzner (1976b). Kirzner (1976a) provides a detailed discussion of Robbins’s Essay and the related literature.
At a first approximation, we may interpret the notion of “given ends” in two ways: firstly, and weakly, as a “ceteris paribus” assumption, implying that ends are not allowed to change in the time span relevant for analytical purposes; secondly, as a stronger assumption implying the proposition that the content of these ends “is completely irrelevant to the economic aspect of the act and hence to economic analysis” (Kirzner 1976b). Under the second interpretation, ethical neutrality can be defined more precisely as “neutrality towards ends”.

In order to clarify this distinction, consider that, while many other ceteribus paribus assumptions have been made in economics, either for purposes of definition or as simplifying devices, they have rarely been taken as basic constitutive elements of economics. As an illustrative example, consider Marshall’s definition of “periods”. In Marshall’s analysis, the capital stock is taken as given in the definition of the “short period”, but the analysis is subsequently expanded to cover the “long period”, by taking the stock of capital as an endogenous variable, and studying the forces and incentives that determine its change. In this example, the ceteris paribus assumption plays the role of a definitional device, but is obviously no part of the definition of economics as a science, i.e. of its epistemological statute. Such a weak interpretation was adopted, for instance, by Hahn and Hollis in their exposition of the postulates of economic theory in the essay referred to above, where they argued that “preferences, although mutable, change slowly in relation to the endogenous variables of economic models. Therefore it does no arm to the rest of the analysis to treat them as exogenous (and unexplained)” (Hahn and Hollis 1978: 8). On such a weak interpretation, one may take “ends” as given for some analytical purposes, but allow them to change for other purposes, or in some other subfields of economics. But this is not what Robbins argued. In his view, considering ends as given is, so to speak, a “constitutional principle” in the scientific statute of economic science. It is the second, stronger version that is really relevant to Robbins’s definition: “Economics is neutral as between ends” (Robbins 1935: 147).

What was his justification for according “ends” the privileged status of a postulate of economic theory? According to Robbins, the postulate of given ends shares with other postulates of economic theory the quality of “obviousness”, which results from its correspondence to some “simple and indisputable facts” of everyday experience. In other words, the postulate that ends are given, as any postulate of economic theory, is self-evident: “The propositions of economic theory, like all scientific theory, are obviously deductions from a series of postulates. And the chief of these postulates are all assumptions in some way simple and indisputable facts of experience relating to the way in which the scarcity of goods which is the subject-matter of our science actually shows itself in the world of reality. The main postulate of the theory of value is the fact that individuals can arrange their preferences in order, and
in fact do so” (Robbins 1935: 78). For this reason, he argued, the postulates of economics do not need to be discussed or tested by means of “controlled experiments” (as is the case, for instance, with physics). This would happen because, in our science, we have the opportunity for direct observation. Preference ordering (as the other postulates of economic theory) is “so much the stuff of our everyday experience that they have only to be stated to be recognized as obvious” (Ibid.: 79).

A long-standing methodological debate has developed concerning the status and functions of “postulates” in scientific practice. For our present purposes, without entering this debate, suffice it to say that if, as Robbins argues, the validity of scientific propositions in economics rests on the “self-evident” nature of the postulates from which they are derived, the answer is that, as many economists have pointed out, the postulate of preference ordering is far from self-evident. For instance, it has been argued that this postulate denies the consumer “the privileges of random variability in consumption, as well as its opposite, the comforts of consumption habits somewhat rigidly maintained under varying circumstances” (Koopmans 1957: 137). It has also been observed that consumers do not engage in endless comparisons of relevant alternatives for every state of nature (Hahn and Hollis 1978: 10-13). And, as a matter of fact, the postulate has been considered as unrealistic at least since the publication of Simon’s book on “bounded rationality” (Simon 1957). More generally, with reference to Robbins’s postulates, it has been argued that “since they are disputable, they are not self-evident. Since they can be reasoned about, they are not introspectible” (Hollis and Nell 1975: 55).

In addition to these considerations, we may add that Robbins’s contention that the epistemological statute of economics rests on the assumption of given ends has not been confirmed as a necessary postulate of economic science: in subsequent developments, theoretical models of changing and endogenous “ends” (tastes, preferences) have been produced by economists such as Yaari (1977), and have been accepted as perfectly legitimate pieces of economic analysis. Even more important from our present perspective is the circumstance that individual ends are evaluated, and aggregated by giving them appropriate weights for purposes of Welfare economics. Finally, economists like Amartya Sen have argued that “ends” can be discussed, and that some preferences (as, for instance, racist preferences) are illegitimate. Thus, “positive” historical analysis of what economics actually is does not confirm Robbins’s definition of economics as a science which takes ends as given.

Thus, both from the logical and the historical points of view, it is not obvious that the assumption of given ends is confirmed as a basic, constitutional principle of economics. If, in line with these arguments, we recognise that the assumption of given ends is neither a self-evident truth nor a necessary assumption, we are naturally led to ask what may have guided Robbins in choosing it as the “main” postulate of economic theory. One possible answer
is that this choice may reflect Robbins's view that the ends of individuals should not be discussed, and should consequently be taken as given, because they reflect the individuals’ autonomous choices, and these choices should not be interfered with. In this interpretation, the “neutrality towards ends” of economic science would ultimately rest on the more basic idea that economics should simply accept consumers’ ends as a datum: and the reason is that individuals are, and should be treated as, sovereigns with respect to their ends. If this suggested interpretation is correct, we would expect Robbins to argue that economic science should not engage into an evaluation of ends because they reflect the valuations of individual agents. And, indeed, Robbins’s claim to ethical neutrality rests precisely on this notion, as he himself made clear: “As we have just seen, economic analysis is wertfrei in the Weber sense. The values of which it takes account are valuations of individuals. The question whether in any further sense they are valuable valuations is not one which enters into its scope” (Robbins 1935: 91).

This point of view expresses the most important assumptions (given preferences, given resources and, in Robbins’s own words (Robbins 1935: 76), a “given initial distribution of property”) and results (competitive prices as indexes of preferences and relative scarcities) of general equilibrium theory, whose research program can be summarised as follows: if, reflecting the sovereignty of individuals with respect to their ends, preferences are assumed as exogenous, and their ordering complete; if resources and technologies are also assumed as given; and if another conspicuous set of assumptions is added (such as perfect and symmetric information; absence of externalities, etc.), which decision making mechanism would attract resources towards an optimal allocation? The elegant theorems of general equilibrium show that the price mechanism is such an optimal device. The market mechanism delivers an allocation of resources which is optimal in Pareto’s sense, because it reconciles the ends of many individuals among themselves, and with natural scarcities.

Thus, the market mechanism has a moral dimension to it: this is so because competitive prices automatically produce “the required incentives so that individuals behave in a socially desirable way” (Frey 1992: 153). This belief was the basis of the assumed ethical self-sufficiency of competitive market economies. This moral dimension is the maximum compatible with the requirement of “null interference” with individuals’ ends, and with a given initial distribution of resources. It was, admittedly, a modicum of ethics, an exiguous morality: but one which was sufficient to satisfy the economic profession for many decades.

Robbins’s essay, as a methodological systematization of general equilibrium analysis in the Thirties (Napoleoni 1963: 37), incorporates in its “main postulate” of given ends the implicit moral commitment to individuals as sovereigns with respect to their ends, and as the ultimate guide to resource allocation.
Summing up, my argument thus far is as follows: the claim to “ethical neutrality”, in the version proposed by Robbins, was built on a value judgement and an ethical commitment. This expunction of ethics from the realm of rational economic discourse rested on a definition of the “economic aspect of human behaviour”, and hence of “economics”, as the science which embodied the “moral” postulate of null interference with individual choices in the form of the assumption that ends should be taken as given, and not subjected to any investigation. One form of social interactions, i.e. market interactions via competitive prices, was then shown to be the only compatible with these premises. Thus, we may conclude that Robbins’s definition of economics as “the Science which studies human behaviour as a relationship between ends and scarce means which have alternative uses” (Robbins 1935: 16) was built on a value-judgement. In other words, Robbins derived an “is” — his definition of economics as a *wertfrei* science — from an “ought”: the idea that any evaluation of individuals’ ends should remain outside the scope of economic science.

3. Morality in the approach of “spontaneous order”

The ban on ethical discourse, imposed in the days when Positivism had not “lost its charms” yet, has been lifted in subsequent developments of economic science. To-day, many economists discuss the conditions, origins and implication of moral behaviour. Thus, ethics and economics is now a lively field of economic analysis. However, although ethical issues have now become an “admissible” subject for economists, and a large literature has been produced in this field, no consensus exists as yet concerning how economics should deal with ethical issues. Economics is facing a bifurcation between two competing paradigms, proposing “spontaneous order” and “critical selection” as alternative routes to ethics. In this section, I deal with the “spontaneous order” approach, while the other approach will be considered in section 4.

Different brands of models rely on evolution as a foundation for moral behaviour: in addition to conventionalism, which I consider below, behaviouralist approaches to morality are also gaining consensus among economists (Bowles, Boyd, Fehr and Gintis 2005; Gintis 2005). In the limited space of these notes, I will refer to conventionalism which, in my opinion, is the most loyal to the spirit of “spontaneous order” underlying much of the evolutionary approach to ethics.

3 I refer to Robert Sugden’s version of conventionalism (Sugden 1986). I have considered other aspects of Sugden’s model (particularly his requirement that asymmetries be cross-cutting) in Costabile (2003).
Morality as the product of spontaneous evolution, rather than rational design, was a concept anticipated by Hume and Hayek, but it has been recently rejuvenated by the adoption of game theory (particularly in its evolutionary version) as a tool of economic analysis. The basic idea unifying the evolutionary approach is that social interactions can best be represented as games among individuals (whether self-interested or “affected” by some degree of “altruism”). In the games that they play, individuals solve problems of coordination, when their interests converge (as in the traffic game), and problems which also include an element of conflict (as, for instance, when they establish exclusive property rights over scarce resources). Through repeated interactions, individuals spontaneously learn the most convenient strategies, given the strategies played by the other players. Equilibrium strategies are rules of behaviour to which all individuals converge when anyone chooses his/her action in such a way as to adapt to the expected actions of other individuals.

Generally speaking, there are many equilibria in a game. It is for this reason that any established equilibrium strategy is a “convention”: what distinguishes a convention from any other self-enforcing rule is precisely the circumstance that another convention might have emerged instead. For instance, in the traffic game, driving on the left and driving on the right are both equilibria. The established convention favours “right” in most countries, but the “left” convention was a possible alternative (and was actually established in Britain). In more technical language, a convention is “any stable equilibrium in a game that has two or more stable equilibria” (Sugden 1986: 32).

Because there are multiple equilibria, the interesting question is: why does one equilibrium, and the sustaining convention, prevail over conceivable alternatives? In technical language, what is the equilibrium selection mechanism? Different answers to this question have been advanced by different authors within the evolutionary approach.

Conventionalism proposes the principle of “salience” or “prominence” as the equilibrium selection mechanism. The concept of salience is illustrated by a game of “heads” or “tails”, originally set by Schelling (1960). Although there is no rational presumption in favour of either answer, the great majority of people, taken two by two, participating in the game (36 out of 42) gave the answer “heads”. Why would most people call “heads” in the first place? Because “heads” struck their imagination as “salient”. While in the game just described the players had common interests (because they were promised a prize if both gave the same answer), “salience” is also used to explain conventions which regulate conflicting interests, as “conventions of property”. Salience, in this case, is associated with asymmetries. The idea is that conventions of property emerge as salient, and therefore as a solution towards which the competing parties are attracted, because they exploit an asymmetry
between the parties. More precisely, in asymmetric games, “they exploit an existing association between claimants and objects. Such conventions inevitably tend to favour possessors, since to be in possession of something is to have a very obvious association with it” (Sugden 1986: 89).

According to conventionalism, the answer to the question why egalitarian property rights are not observed is that the selection mechanism does not favour this distributive rule, as it is not “salient”. I observe that an “inevitable” association between property and possession cannot be taken for granted. In reality, while this association is indeed found in some animal species, in others the opposite rule, i.e. one that favours the “intruders”, is observed in other species (Grafen 1987, quoted by Bulmer 1994)⁴. Thus, “isomorphism” (Sugden 1986: 32) with animal behaviour may be a counterproductive argument for supporters of the conventionalist interpretation of property rights.

In our present perspective, it is of interest to notice that the conventionalist approach claims that conventions come to form the basis of our systems of morality. This would happen because, once established, a convention becomes self-enforcing, as it is in each individual’s interest to follow it, “provided that everyone else, or almost everyone else, does the same” (Sugden 1986: 32). The grounds for the opinion that conventions acquire the status of moral principles are these: because everybody is expected to follow the rule which everyone else in that community respects, people internalise these conventions as the appropriate norms of moral behaviour. And, if a different rule were followed in the community, then everybody would be expected to follow this alternative rule. Morality has a purely conventional basis.

A critic of conventionalism may argue that these foundations are very arbitrary for a system of morality. The conventionalist’s answer is that he is merely making an “is” and not an “ought to” argument. But this retreat into indicative propositions presents the following problems.

Firstly, the proposed “is” (i.e. that people internalise conventions as the appropriate norms of moral behaviour) is actually not an uncontroversial “is”: many conventions are disputed, particularly in democratic societies. Diversity and contestation within each culture and each society exist (Nussbaum 2000: 41-49). The conventionalist idea that conventions acquire the status of moral norms, and that, moreover, these moral norms become inviolable, is an undemonstrated proposition, and one that is falsified in many cases.

Secondly, the conventionalist approach is “backward looking”: paradoxically, it does not contemplate evolution from one system of morality to

⁴ Among spiders called Oecibus civitas, it is not the possessor, but the intruder who consistently plays “hawk” rather than “dawn”. The intruder has a good reason to do so: the hawk strategy displays a high payoff (a high increase in its reproductive fitness, which is very low if he is excluded from the contested territory). This species does not consider the association between property and possession as salient.
another. Since contestation is not recognised, then a coherent conventionalist should regard any change in conventions as impossible. But we know that many conventions have disappeared, just because they were opposed by some members of the society where they had been originally established. One may think, for instance, of several conventions concerning “appropriate” “feminine” behaviour as cases in point. In many cases, people opposing the established conventions appealed to alternative moral principles. Consequently, it is plausible to conceive of our system of morality as an evolving system, with diversity and contestation being the driving forces of change. If this alternative point of view is accepted, evolution may come to be seen as an open-ended process, rather than as a process which comes to a full stop when one convention is established, as the conventionalist approach seems to imply. Another consequence is that evolution from one convention to another may not be a spontaneous process; rather, it may require “critical reflection” in the process of devising the new norms of behaviour. This is the point of view proposed by the alternative approach, to be considered in next section.

Thirdly: if, for the argument’s sake, we accept as an “is” the propositions that “people are expected to follow the rule which everyone else in that community respects”, and that they internalise conventions as the appropriate norms of behaviour, then we are led to enquire more deeply into the nature and objectives of the conventionalist research program.

No doubt, this research program marks a progress in the route towards the integration of ethics and economics, because it includes ethical principles within the boundaries of economic analysis. By contrast, as we have seen before, this integration was made impossible by Robbins’s definition of economics. Yet, in spite of this progress, the conventionalist’s claim to be making an “is”, rather than an “ought to” argument raises the question whether he may not be still adhering to the Positivist fact-value dichotomy. In the new context, this dichotomy would imply that economics, while now allowed to deal with ethical principles, should nevertheless be confined to a description of the existing system of morality, and to an explanation of how it came to be established: but it should not include any critical discussion and/or ethical evaluation of this system. *A fortiori*, economics should not contribute to selecting moral principles on the basis of rational discourse, or to devising “just institutions” (Rawls 1971). Consequently, economists interested in ethical issues should be content to register where spontaneous evolution has led us. In other words, economics, having included ethical issues in its territories, should retain a “positive”, rather than a “normative” approach to morality.

But, if we take this claim seriously, we soon realise that the conventionalist economist runs into a logical problem. This happens because the indicative propositions that he proposes – his “is-ses” – have normative implications; and conventionalism subscribes to them. One such implication, for instance,