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## Social costs and normative economics

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Quaderno di Dipartimento n. 66

Febbraio 2012

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### Abstract

The aim of the paper is to assess the notion of social costs from an evolutionary institutionalist perspective. It argues that: social costs can be defined as the difference between the actual outcome of a historically defined capitalist market economy and the outcome desired by the members of society; markets are only one of the possible coordinating instances in such economies, albeit the prevalent one, the others including non-profit organizations, the welfare state, households, etc.; under these circumstances, the assessment and organization of economic activities requires a meta-coordinating instance; the extension of capabilities, as theorized by Amartya Sen, may provide such an instance. The paper begins with a brief discussion of the themes of, and problems related to, the conventional theory of social costs. It then specifies the context of the discussion by situating it in a historically defined economy: a capitalist market one. It contends that the rationale of such an economy involves treating labor, nature and money as "fictitious commodities", and that the existence of social costs ultimately depends on this central feature. Based on this approach, it discusses Kapp's suggestion that policy should focus on minimal social requirements. It points out, in this respect, that a broader criterion is required. Drawing on Sen, the paper stresses that choices cannot be reduced to a single dimension - such as (economic) welfare - and that the economic context may preclude the freedom to choose how to conduct one's life. The implication is a qualification of social costs: they are determined by economic activities that prevent people from achieving the capabilities they need. The public policy implications of the above approach are that many alternatives to the status quo are possible. In the light of these features, the discussion reasserts the need for a normative approach to economic inquiry.

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A preliminary version of this paper was presented at recent EAEPE, STOREP and AISSEC Conferences. I wish to thank all the participants who commented on it. I also wish to thank Michele Cangiani, Wolfram Elsner, Vinicio Guidi and Pietro Frigato for their comments. The usual disclaimer applies.

# 1 Introduction

The aim of the paper is to assess the notion of social costs from an evolutionary institutionalist perspective. It argues that: social costs can be defined as the difference between the actual outcome of a historically defined capitalist market economy and the outcome desired by the members of society; markets are only one of the possible coordinating instances in such economies, albeit the prevalent one, the others including non-profit organizations, the welfare state, households, etc.; under these circumstances, the assessment and organization of economic activities requires a meta-coordinating instance; the extension of capabilities, as theorized by Amartya Sen, may provide such an instance.

The paper is organized as follows. The section that follows briefly recalls some of the themes of, and problems related to, the conventional theory of social costs. It stresses that the theory's exclusive focus on the market neglects important issues concerning how the market is arranged in the first place. It points out that, for these issues to be properly treated, it is necessary to draw on external – with respect to the market – assessment criteria and rules.

The subsequent section specifies the context of the discussion by situating it in a historically defined economy: a capitalist market one. It contends that the rationale of such an economy involves treating labor, nature and money as 'fictitious commodities', and that the existence of social costs ultimately depends on this central feature. Based on this approach, it discusses Kapp's suggestion that policy should focus on minimal social requirements. It points out, in this respect, that any policy that does not aim merely to constrain the market but wishes to take account of the criteria underlying other coordinating instances – such as the welfare state, non-profit organizations, families, etc. – must consider that each one functions according to a specific metric. Thus, a meta-metric is required to assess the economy as a whole and to coordinate the interaction among the different coordinating instances.

The fourth section, on social costs and society, discusses the nature of the required meta-metric. Its point of departure is Sen's presentation of the different criteria people resort to when they must choose. The discussion stresses that choices cannot be reduced to a single dimension – such as (economic) welfare – and that the economic context may preclude the freedom to choose how to conduct one's life. The implication is a qualification of the definition of social costs: they are determined by economic activities that prevent people from achieving the capabilities they need to choose how to conduct their lives. In this perspective, capabilities can be conceived of as a meta-metric to assess the performance of the economy.

The section on compatibilities and economists discusses the implications that an open systems approach, such as the one the paper leads to, has for public policy and for scholars wishing to devise the required measures. It contends that systemic openness is likely to involve more alternatives to the status quo than systemic closure. At the same time, it makes their identification difficult, owing to the complexity of the interdependence among sub-systems. In the light of these features, the discussion reasserts the need for a normative approach to economic inquiry. The final section draws the main conclusions.

## 2 Social costs and 'the market'

The conventional approach to social costs was to consider them as externalities. In so far as the market did not register all the effects of economic activity, some of these effects remained external to it. Externalities were the result of an imperfect price mechanism. The implication therefore was to make up for this failure. Whereas the Pigouvian solution consisted in government action to correct prices, given that they did not function properly, Coase argued that the market could be made to work properly.<sup>1</sup> The reason why the market did not work was that some property rights were not assigned. Once this problem was solved – i.e. once property rights were assigned – the market could

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<sup>1</sup>Aguilera Klink (1994), however, argues that the antagonism between Pigou and Coase is overstated and should be traced back to how Coase's followers interpreted his views.

resume its key function.<sup>2</sup>

This solution raised a problem, however. Who was to obtain the property rights? One answer was that they were to be assigned in order to achieve the most efficient outcome. Obviously, this answer would not make any sense in a perfect Walrasian market because any initial endowment allows a Pareto optimum to be achieved. In other terms, it would not make any difference to assign a property right to one agent rather than another because efficiency would always follow.

Truly, owing to transaction costs, markets were claimed not to be perfect.<sup>3</sup> Given this imperfection, how can the potentially most efficient outcome be assessed? How do we know whether the output achieved through one solution will be higher than the one we would have achieved through an alternative one? The answer would seem to be that you assess efficiency according to existing relative prices. But those relative prices are biased. They reflect the inefficient allocation of resources achieved by an imperfect market, so they do not provide an appropriate criterion. In other terms, when the allocation mechanism is imperfect, it is conducive to prices that provide inadequate information, and you cannot rely on them to correct the mechanism.

This problem was dismissed by stating quite simply that you should not try to fit actual markets to some ideal. In other terms, it would be pointless to rely on what Demsetz (1969) labeled the ‘Nirvana approach’.<sup>4</sup> What you could do was ‘use an ideal norm to provide standards from which divergences are assessed for all practical alternatives of interest and select as efficient that alternative which seems most likely to minimize the divergence’ (Demsetz 1969: 1). While this sounds reasonable, it does not say anything about what the ideal norm is or is supposed to be. If the norm still refers to the same notion of optimal allocation that is under attack, with the mere proviso that ‘perfection is not of this world’, this sounds sensible but it sure is not a theoretical innovation: anything is justifiable on these grounds. Conversely, if that notion of optimal allocation is discarded altogether, what are the grounds for a claim such as: ‘the foundation of a private-ownership, market-based economy is its generally superior ability to work with resources as compared with central planners’ (Demsetz 2008: 116), or even: ‘the state has a role to play’ (*ibid.*)?

In the absence of an appropriate criterion, pragmatic reliance on ‘relative’ efficiency turns out to have no meaning whatsoever. Plausibly, it will refer to the mere convenience of self-interested agents, but such a criterion is not an alternative to the Nirvana approach: it simply denies that any phenomenon other than the immediate convenience of single agents is relevant. Paradoxically, the ultimate implication is that there simply is no scope for social costs: ‘Society might be better off if the “problem” of social cost had never been discovered.’ (Rowley 1978: 13).

The above approaches are centered on the assumption that social costs exist because some things do not have a price tag. There are two reasons that may account for such a situation. The first one, which underlies the above approaches, is that the market does not function properly. The second one is that the market is simply unable to register some phenomena. An important example of this case occurs when some circumstances transcend the very rationale of the market. Consider human rights. Although we may conceive of a market where children are allowed to work so that a price (a wage) is determined for the ‘child work force’ commodity, this situation clashes with the generally acknowledged right of children not to work. Thus, even though a price tag exists, it is still possible to claim that the way the market is arranged leads to a specific social cost on the grounds that child labor is inconsistent with social values.<sup>5</sup>

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<sup>2</sup>Even when this was not possible, institutional setups were to reflect the market requirements of the actors involved. Cf. Coase (1988a).

<sup>3</sup>‘What I showed in ‘The Problem of Social Cost’ was that, in the absence of transaction costs, it does not matter what the law is, since people can always negotiate without cost to acquire, subdivide, and combine rights whenever this would increase the value of production. . . . Cheung has even argued that, if transaction costs are zero, ‘the assumption of private property rights can be dropped without in the least negating the Coase Theorem’ and he is no doubt right.’ (Coase 1988b: 14-15).

<sup>4</sup>In practice, those who adopt the nirvana viewpoint seek to discover discrepancies between the ideal and the real and if discrepancies are found, they deduce that the real is inefficient. Users of the comparative institution approach attempt to assess which alternative real institutional arrangement seems best able to cope with the economic problem.’ (Demsetz 1969: 1).

<sup>5</sup>Passas and Goodwin (2004) provide an extensive treatment of situations such as the ones discussed here. The title of their book – *It’s Legal but it Ain’t Right* – vividly stresses the inconsistency between various economic practices and the values of society.

Whether child labor is allowed or not, the market functions subject to rules concerning the overall setup of the economy: some transactions may be forbidden, some property rights may be denied, some other rights may be acknowledged. These rules underlie the legal-economic nexus which determines the boundaries and the specific features of the market.<sup>6</sup> Under these circumstances, there actually is no market as such, but a wide range of possible markets, each one defined by its legal-economic nexus. Furthermore, whatever the criterion used to define allocative efficiency, the latter will depend on the specific characteristics of the market as they are determined by the nexus. You cannot compare the efficiency of these different market setups just as you cannot compare consumer choices associated to different lexicographic preferences. Another way to state this is that you cannot assess the efficiency of resource allocation independently of value judgments concerning the way that allocation should be arranged.<sup>7</sup>

While the more conventional views attach social costs to the malfunctioning of a given market, the approach outlined here stresses that the latter must meet requirements that are defined by society, i.e. that are independent of the market as such. In the traditional approach, social costs occur because of imperfections within the market; in the legal-economic nexus approach they occur because the external criteria that determine the way the market is arranged do not adequately reflect social values. Let us see why this may occur.

### 3 Social costs and the capitalist market economy

*What market?*

What metric do markets use? In general, markets tend to be considered coordinating instances based on relative prices. Even when we refer to markets in terms of contracted exchange, however, relative prices need not be the only possible, or indeed the actual, metric used. In order to continue our discussion, we therefore need to specify what kind of market we are talking about.

In what follows we refer to a capitalist market economy. In such an economy commodities are produced in order to obtain a money profit. Businesses acquire money that they use to pay for the materials and labor force required for production. Their aim is to sell the resulting commodities in order to gain an amount of money greater than the one originally advanced.<sup>8</sup> Businesses must make money. What they do with the money they gain is a secondary – and in the first instance, irrelevant – issue: indeed, the main goal is to increase the value of existing capital, not that of gaining access to ever more consumption goods.

Since the ultimate goal is to achieve a money gain, a commodity must be profitable to manufacture and sell: it must have an exchange value, which is conceptually distinct from its use value. If a commodity ceases to be profitable – if its exchange value is inadequate – it eventually will stop being produced. It is no surprise, therefore, that people may lack nutrition, shelter or health. Basic goods required to ensure these conditions may not be supplied because, although they may be desperately needed, it just may not be profitable to produce and sell them.

Three key commodities in capitalist economies – labor, nature and money – do not match this requirement: their supply does not reflect their profitability.<sup>9</sup> When the availability of workers exceeds their demand from businesses, workers do not cease to be produced and the price for labor

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<sup>6</sup>‘There are no absolute or given costs, only a cost-price structure which is a function of the interplay of demand and supply, which in turn is a function of the opportunity-set structure which in turn is a function of the power (rights) structure.’ (Samuels and Schmid 1997: 234; see also Bromley 1989).

<sup>7</sup>Based on this view, the reason why the assignment of a property right was problematic in the Coasian case was that no such value judgment was formulated.

<sup>8</sup>Marx referred to this as an expanded economic reproduction, i.e. one based on an M-C-M’ (Money-Commodity-Money+surplus) process. You begin with money that you use to buy commodities which will have to be transformed into new commodities. These will eventually be sold in order to obtain a greater amount of money. This process is contrasted to simple reproduction, i.e. a C-M-C process, where commodities are turned into money only to obtain other commodities. Note that a third process is also possible where production is left out because the ultimate goal of making money may be achieved without it. The process then becomes M-M’, financial speculation being a special, if prominent example. A major implication of these qualifications is that the goal that business pursues is not profit alone but wealth, where the latter includes all other money gains that are not associated to production.

<sup>9</sup>K. Polanyi (1944) refers to them as ‘fictitious commodities’.

may drop below subsistence or, alternatively, unemployment may ensue. The case may be that the economy's overall wage bill is not sufficient to pay for the subsistence of all available workers. Under these circumstances three situations may occur: people live in dire conditions and may even starve to death; they disrupt society in order to survive, or; society somehow bears the cost of their subsistence. In the latter case there is a gap between the wage bill and the (overhead) cost that society must bear (Clark 1923; Stabile 1996). Obviously this would be labeled a social cost and it is no surprise that on many historical occasions the effort was made to restrict the 'allocation' of people as if they were a commodity.

Similar considerations apply to nature and money. Because the supply of natural resources is not determined as for normal commodities, their prices may lead to the irreversible depletion of the environment required for survival. Society will inevitably suffer the feedback of nature's disruption by bearing a cost that the economy does not take into account. Finally, the price of liquidity – thus, not only money but also financial assets – is often characterized by positive, rather than negative, feedbacks: as prices for these assets go up, their demand does not drop but rises along with supply, leading to the financial bubbles that have become so frequent over the past decades. The consequences may be both the over- or under-production of financial assets, and the resulting financial instability (Minsky 1957) will produce social costs such as lower incomes and unemployment.

Another feature of a capitalist market economy is worth pointing out. The pursuit of money gains involves a continuous innovative activity. Innovation concerns production – e.g. in achieving economies of scale or scope, as well as gaining strategic control over the high value added phases -, technology – through process and product innovation -, marketing – through the identification of unsatisfied wants as well as through their very creation -, finance – through the creation of new financial instruments, often with the aim of circumventing extant regulations<sup>10</sup> - and the 'rules of the game' underlying the legal-economic nexus. While innovative activity qualifies our discussion of how social costs arise, what is most important about it is that it continuously changes the boundaries of specific markets and of the market as a whole. Business constantly redefines not only property rights but the overall features of the legal-economic nexus.<sup>11</sup> It is therefore somewhat of an understatement to consider social costs as the consequences that bear on society because of economic activity. It is more appropriate to consider them as resulting from the specific features of the money-making rationale of the capitalist market. They are not just determined by the (insufficient or inappropriate) assignment of property rights or by an inadequate recognition of distributional issues by the legal-economic nexus. They result from the inconsistency between the constant attempt by business to maintain the commodity status of labor, nature and money and the persistence, over time, of a socially inclusive society. This is why Kapp's book deals with the social costs of *business enterprise*.

#### *Business and minimal social requirements*

Given these general premises, however, how are we to deal with the social costs that a capitalist market economy leads to? Kapp's (1978) suggestion is to define minimal social requirements that act as constraints on market practices. In practice, this prescription remains important and viable even though many oppose it on strictly ideological grounds. It suggests that the definition of a legal-economic nexus that avoids social costs basically is a matter of ethical choice.

On more general grounds, however, this suggestion may require a few qualifications. What are the minimal social requirements for pollution, for instance: the probability of any minor affection or the probability of serious illness? Are only human affections taken into account or should other forms of life be considered? What are the relevant probability intervals to decide when there actually is a risk? These are not strictly technical issues; they involve a value judgment, and who is to decide

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<sup>10</sup>Innovation in production is generally associated to the pursuit of profit through changes in technology and in the impact of transaction costs. An insightful alternative approach, from a business-oriented perspective, is provided by Jacobides and Winter (2007) who stress that money profit is only one possible type of money gain and that the pursuit of rents may be much more important than action on technology and costs. As for innovation in finance see Minsky (1957).

<sup>11</sup>Under these circumstances, reliance on ex ante restrictions reflects a substantial neglect of the key role that innovation has in modern capitalism.

over these matters is a critical issue.

How to decide about these issues is no less a problem. Consider, for instance, the income-related cost of being unemployed. This can be dealt with in a variety of ways: workers may enjoy some type of private – for profit - insurance; the welfare state may provide them with subsidies by redistributing income; their families may support them; they may be assisted by some charitable – nonprofit – association. Each type of solution affects the size and the arrangement of the market. When the scope of the market is restricted – i.e. when it does not coordinate all economic activities - alternative forms of coordination are required, based on criteria different from those underlying the market: families and charitable organizations generally operate on the basis of solidarity; welfare states may operate on the basis of solidarity and/or equity; central planning may resort to some notion of efficiency. Each type of coordination, in turn, requires an appropriate metric.

Although the market has a dominant role in a capitalist market economy, if other coordinating instances are assigned specific tasks, the issue arises of how these coordinating instances relate to each other. Obviously, if the goals pursued – and the criteria to assess them – differ, it is not appropriate to compare different coordinating instances. Thus, while it may be sensible to compare a private and a government-owned company in terms of their profitability when the sole task they are assigned is to make a profit, the same comparison is misleading if the two companies are assigned different tasks, for instance, if a government-owned company is assigned the task to establish an infant industry that a private, profit-pursuing one would not deem convenient to set up. In the unemployment-related example above, while the company that provides private insurance needs to be profitable, a public agency may need, at the very least, to balance its budget and, under some circumstances, may even be a channel for a deficit-spending fiscal policy.

The relevance of this issue emerges especially when different goals – associated to different metrics – clash.<sup>12</sup> Indeed, a great deal of opposition to non-market coordinating instances is that they preclude the proper functioning of the market: consider, for instance, Okun's (1975) open bucket metaphor whereby there is a trade-off between equity and efficiency.<sup>13</sup>

A more relevant case is provided by Kalecki (1943), who argues that full employment policies eventually undermine the bargaining power of capitalists, thereby leading to negative expectations and a drop in investment. Whether the choice is between the desired goals (private profitability and full employment) or between alternative solutions to the clash, a criterion is required to choose. Granted that the clash arises because the goals pursued are based on different coordinating criteria and metrics, a meta-metric is required to judge what the best way to proceed is. In the limit case where no solutions to the clash exist, the choice may be between private profits (with unemployment) and full employment (with socialized investment).<sup>14</sup> The conventional view is to use the market metric as the meta-metric, which would lead to the choice of private investment. But while the choice of this metric is legitimate, it is neither the only one nor, *a priori*, the best one.

The clash between the rationale of the market and societal values is a distinctive feature of K. Polanyi's studies and of his notion of the double movement. According to Polanyi (1944; 1957), the self-regulating mechanism of contracted exchange renders the market autonomous relative to the society it is a part of. This autonomy eventually leads to the subordination of societal values and to a situation where the market is not embedded in society anymore; quite to the contrary, it is society that is embedded in the market. The autonomy of the market determines a reaction from within society and the attempt to restore the subordination of the former to the latter. In some instances, this attempt may produce a stalemate that disrupts the polity and society. Although the implication is that the above problems tend to be less economical than political, some specifically

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<sup>12</sup>Different goals and different coordinating instances need not clash, as I will argue in Section 5. Such a circumstance, however, is not warranted.

<sup>13</sup>Despite its importance in the literature and its intuitive appeal, the metaphor is based on an assumption that is seldom made explicit and that greatly reduces its generality: While different goals may happen to be mutually inconsistent – or at least, they may cause friction – the notion of a trade-off implicitly assumes that the metric required to assess the problem is relative prices. It therefore takes the extant distribution as the terms of reference, whereas what the equity issue suggests is that it is precisely that specific distribution which is at the root of the problem.

<sup>14</sup>On strictly economic grounds, private profits would be enhanced by a higher level of aggregate demand, so that there would seem to be no reason to claim that full employment clashes with private profitability. This is why Kalecki specifically refers to these issues as *political aspects* of full employment.

economic considerations may be worth focusing on.

As I mentioned above, Kapp's (1978) and Polanyi's (1944) suggestion is that there are commonly accepted social priorities which should not be subordinated to the rationale of the market. They are not reducible to the money metric, so that economic accounts, whether of micro units or of a country as a whole, are inadequate when it comes to assessing social welfare. Indeed, if we think of nutrition, shelter or health, this would seem to be reasonable, although even these fundamental living conditions are far from being generally acknowledged to be social priorities.

This is where our discussion of the meta-metric is important. A criterion is required to identify societal priorities, i.e. what is wanted and what is not. It must not be bound to specific coordinating instances but it must take account of their existence. It must acknowledge that societal priorities may constrain the functioning of the market to the point that a clash is envisaged between the market metric – money profit - and non-market constraints. The function of a meta-metric, therefore, is to assess the overall priorities in the light of the different goals that markets and society pursue.

A meta-metric also allows the assessment of priorities when – as envisaged by Kapp - distinct social requirements are identified and co-exist, each one dealing with a specific issue. This is particularly important when we take into account issues that are not strictly related to basic goods or elemental living conditions, such as urban congestion or car accidents.

As I shall argue further on, the systemic openness of the economy does not warrant a mechanistic view of the market, whereby social constraints either allow or preclude its ability to coordinate some activities. Nonetheless, a coordination of different coordinating instances – e.g. markets, welfare state, non-profit organizations, households, etc. – is important to achieve consistency for the economy as a whole.

From the perspective here outlined, social costs can be depicted as the effects of business-related activities that are not only unwanted – according to some societal criterion – but also avoidable. The problem is how to assess what is unwanted and whether it is avoidable. I will discuss these issues in the following and the subsequent sections, respectively.

## 4 Social costs and society

### *Economic agents or members of communities?*

In conventional theory social costs may be deemed unwanted if a gap exists between individual and social welfare. Although it may be difficult, in practice, to measure these two types of welfare, they are conceptually clear in so far as they reflect utility maximization with given preferences.<sup>15</sup> While the origin of such preferences remains an open issue, the true problem with this approach is the restrictiveness of the assumption that only preferences matter for choice.

Sen (1982; see also Sen 1993, 1999) argues that there is no reason to believe that individuals choose on the basis of their preferences alone. Other criteria act upon choice. Thus, whereas I may want to smoke, so that utility maximization would require me to do precisely that, I may also be concerned that it is bad for my health or that it may be inappropriate to force other people to breathe my smoke.

Sen (1982) points out, in this respect, that individuals may be egoistic but they may also be concerned about other people's conditions. One type of concern is sympathy, which involves that the individual's personal welfare is directly affected by those conditions. In order to increase her personal welfare, the individual will behave so as to increase/reduce the welfare of the people she likes/dislikes. Another type of concern is commitment. In this case, the individual's personal welfare is not directly involved. Her behavior depends on what she deems appropriate, independently of whether it will affect her welfare in one way or another.<sup>16</sup> This means that her general views of what

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<sup>15</sup>I do not wish to downplay the difficulties associated to the dramatic conclusions of Arrow's Impossibility Theorem. What I wish to argue is that major problems lie elsewhere.

<sup>16</sup>Sen (1982) provides the example of torture. If we are against it because we suffer for the people we are tortured, that is sympathy. If we believe that torture should be banned because it is wrong, even though we may not be affected by what tortured people must bear, that is commitment.



is right and what is wrong may make her behave in a way that is inconsistent with her personal welfare.

Sympathy involves caring about others. Some people may care about humanity as a whole, while others may care for nobody at all. In general, however, it is likely that sympathy will depend on how many people someone is in touch with, i.e. the number of people in her family, at work and in the other communities – religious, political, recreational, etc. – she is a member of. It will also depend on the intensity of her interaction with those people. Thus, her ‘sympathetic’ – as opposed to strictly egoistic – behavior will depend on the network of social relations that she is embedded in.

Commitment involves a less emotional relationship between the individual and her surrounding environment. She need not care about other people but she does judge whether the world she lives in meets her moral expectations. Whatever her views of how things should be, they affect her behavior. In other terms, once commitment is a possible feature of behavior, the individual inevitably chooses – explicitly or implicitly – whether to take account of circumstances that transcend her personal welfare. Commitment, however, depends not only on the moral conceptions of the individual – thus her views concerning how things should be – but on her understanding of how things actually are. For instance, her commitment against on job mortality is likely to depend on how informed she is about such phenomena, thus on the availability of information and on her degree of literacy. Interaction with others – communication, dialogue, etc. – is also likely to affect her views. Just as for sympathy, her behavior depends on the social environment she is embedded in.

Given the above depicted features of individual behavior, the criteria people resort to in order to assess the economy may depend on their egoistic wants but also on their views concerning what is appropriate for them (their needs), for their acquaintances or for society as a whole. Following the textbook representation of consumer behavior, for instance, a hungry individual may choose whether to eat meat or vegetables according to her taste for these types of food and to their (relative) price. She may also wish to take account of their nutritional characteristics, however, which means that, although she likes one type of food more than the other, she may eventually choose the other because it is healthier. On similar grounds, the consumer may like one type of food very much but may feel concerned, on humane or moral grounds, about working conditions in that industry: for instance, she might prefer to eat junk food because of its organoleptic qualities but she chooses not to eat it because the companies that supply it operate like sweatshops.

Thus, the consumer may choose in relation to quite a few variables. Depending on which variables she deems important, she may rank all her actions in more than one way. In other terms, what she chooses to do depends not only on her preferences but on her meta-preferences as well.

Let us continue to look at our consumer. Given her moral views concerning how workers are treated, her behavior need not be restricted to the choice between eating junk food or substituting it with some other food. In order to make sure that the food people buy meets her humane requirements, she may choose to involve public opinion. She may also act in order to have new laws passed against working conditions she deems unacceptable.

The same applies to a worker. She may bargain over the money that the firm must pay her but she may also be concerned about the real value of her wage, with all that this implies in terms of business strategy as well as industrial and macroeconomic policy. Her concern may even transcend her direct gain and include what the firm does: whether the products it manufactures are safe; whether it carries out strategies that may be harmful to the community (e.g. the way it builds and manages an oil rig in the Gulf of Mexico); whether it invests in oil-derived fuels rather than in less polluting types of energy.

This leads us to the conclusion that the classical separation between the individual as a consumer and the individual as a citizen does not hold. When people do not like a commodity simply because it does not meet their preferences, they choose not to buy it. When they believe that that same commodity may be harmful for the health of the community or that it may clash with the moral concerns of others, they may well choose to inform and convince others not to buy those goods. In this case they are neither just voting with their money, i.e. by buying one good rather than another, nor are they (necessarily) acting through the polity, that is, choosing policy-makers who will eventually change the market according to what meta-preferences – i.e. values, in this case – prevail. They are conducting direct actions to promote a different understanding – and, eventually,

a different arrangement - of the economy. They are disrupting the conventional separation between economy and polity.

Three points are worth noting, here. First, since individuals choose according to different criteria – strict self-interest, sympathy, commitment – it is not possible to draw conclusions concerning their personal welfare from what they buy. Furthermore, precisely because they may be concerned about circumstances that lie beyond the price and quality of the goods they can buy - when someone thinks about switching the television on in order to relax, she may also be concerned about whether the required electricity is generated with a polluting technology – their choices may involve more information than the market is fit to supply. Extra-market information is just as important as market information. In fact, in many cases people not only need information *from* the market, they also need information *about* the market.

The second point is that, since people cannot formulate satisfactory decisions on the basis of preferences alone, the very criteria underlying choice need not be mutually consistent,<sup>17</sup> so that there is more to choosing than just processing information in order to achieve maximization. It is no wonder, therefore that, according to Sen (2004: 4) ‘Rationality is interpreted here, broadly, as the discipline of subjecting one’s choices – of actions as well as of objectives, values and priorities – to reasoned scrutiny.’. This ‘loose’ conception of rationality implies that people may have a bounded understanding of the world they live in, especially if their social and institutional environment prevents them from taking advantage of all possible opportunities.

An extreme case of bounded understanding is provided by Sen’s (1999) example of a woman who, having internalized her subordinate role in society, cannot imagine that an alternative to the status quo is possible: she will be content with what she has rather than lamenting the situation she is in. Truly, she does not suffer any dilemma. She is unaware of her unawareness. But this is not the outcome of a choice of hers: her bounded understanding prevents her from identifying an appropriate choice context.

It is important to consider that the same type of problem may prevent people from identifying social costs, i.e. they may be unable to realize that some unwanted effects of business-related activity are also avoidable: whether an individual is obliged to take the status quo for granted or is able to conceive of possible alternatives depends on her capabilities, i.e. on the set of possible combinations of actions that she can take.

The final point is that the conceptual distinction between the economic and the ethical dimensions does not mean that they are separated in practice. Business does not just comply with the wants of its customers. It also tries to change those wants by acting on how customers understand their choice context. In so far as it wishes to direct the polity to its advantage, it acts on the ethical and political views of the citizenry. More generally, people – be they businessmen or plain citizens - do not only vote for policy makers so that the latter set the rules of the game that those same people will eventually play as economic agents. People interact by communicating, discussing and scrutinizing each others’ views in order to assess whether the economy – and the polity – match their overall views and concerns. They may act directly to change the existing setup of the economy, in its factual if not legal aspects. The distinction between ‘rules of the game’ and ‘game’ should not be mistaken for a separation: the rules of the game are determined *while* the game is played, sometimes by *how* the game is played. They may reflect egoism, sympathy, commitment.

These three points are different ways to look at one same issue: markets are not systemically closed and what economic agents do cannot be understood independently of the more general (historical, social and natural) environment they are a part of. The relevance from the perspective of social costs is that these costs cannot be identified in terms of market-related welfare as in the conventional approach. Pigou’s (2009 [1932]) original distinction between economic and general welfare is misleading even as a working hypothesis. What people view as their welfare depends on how they relate to the world they live in.

### *Capabilities and social costs*

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<sup>17</sup>As Hirschman (1984) points out, an individual’s views on some action – say smoking – generally reflect different types of judgment.

This leads us to a rather important conclusion. The definition of social costs, in terms of a gap between potential and actual welfare, implicitly acknowledges that, as I mentioned above, they must be unwanted and avoidable. But in order to be unwanted, they must be identified, and in order to be identified people must have the appropriate capabilities. So, along with the social costs Kapp and Polanyi had in mind, which were basically related to elemental living conditions, a new category emerges from the above discussion. Social costs include the lack of capabilities that prevents people from being aware of possible welfare improvements. We might refer to them as the lack of capabilities that prevents people from being aware of that very lack of capabilities.

When people have the capabilities that allow them to find out what their potential welfare is, another category of social costs can be identified. These costs are associated to negative effects that were not previously perceived or that were considered as the inevitable side effects of some desired goal. Let us consider these in greater detail by going back to a question asked before: are car accidents a social cost?

From a conventional perspective, it is possible to argue that the probability of a car accident can be computed or, at least, figured out. Whoever chooses to use a car therefore knows that she is taking that risk and is, even if implicitly, assessing the costs and benefits of such a choice. In other terms, she is aware that, although cars have (potentially) negative effects, it may nonetheless be worthwhile to use them. The question this approach does not address is whether an alternative is possible. Are less dangerous cars possible? Could public transport substitute private transport and reduce the risk of accidents?

Obviously, I am not concerned with these questions as such. What I wish to point out is that people need not be – and often are not – concerned with the ‘here and now’ alone. They may want to think about possible alternatives and pursue them. Under these circumstances, even though people currently use cars and, given the present circumstances, would not think of doing without them, it makes sense to ask whether some different arrangement of economic activity would be more desirable. If we acknowledge that cars have negative effects and that some envisaged alternative may be less damaging, then it is appropriate to classify car accidents as a social cost: the envisaged alternative may change people’s views as to the inevitability of their use.

Truly, alternatives that appear to be better than the status quo may eventually turn out not to be so. Decisions are taken *ex ante*, which always implies some degree of uncertainty. This applies in all cases, including the choice of maintaining cars rather than opting for the alternatives. What is important, however, is that people must be able to question the status quo, seek alternatives, assess them in terms of a meta-metric they deem appropriate, and finally choose how to proceed. The identification of these types of social costs, therefore, is the outcome of a deliberative process. People must be able to understand what is at stake and to judge according to their value systems. In this sense, while the previous types of social cost can be classified as ‘basic’ social costs, in that they preclude the very possibility to choose how to conduct one’s life, this type of cost can be classified as a ‘freedom-related’ cost, in that it emerges as a result of the freedom that people have.

The distinction between these two types of social costs may give the impression that they can be dealt with independently of one another and, possibly, that the ‘freedom-related’ ones are not as important as the basic ones. The fact is that basic social costs can be identified precisely because they prevent people from choosing how to conduct their lives. In other terms, they prevent the identification of freedom-related social costs. In this perspective, the freedom to choose how to conduct one’s life – and to identify freedom-related costs – is an end in terms of which it is possible to identify basic social costs. It is a terms of reference to assess the performance of the economy and of economic policy.

The removal of social costs requires a decision concerning which coordinating instance is more appropriate to carry out each type of economic activity. The decision does not involve a mere reorganization of the market but a redefinition of the relation between the market and other components of the economy such as the welfare state, non-profit organizations, families, etc. By defining the boundaries of the market and how it must interact with these other components, it therefore determines what is deemed the appropriate degree of systemic openness of the market. In Polanyian terms, this involves determining not only whether but also *how* the market must be embedded in society. In so far as the removal of social costs affects the way that distinct components of society

interact, it impacts on the social, as well as on the material, reproduction of society.

## 5 Compatibilities and economists

In the previous section I tried to argue that it is possible to decide whether and how some features of the economy are unwanted. Let us now consider whether they can be deemed avoidable.

Economic theory has long discussed about the failure of a capitalist market economy to achieve desired goals such as full employment, growth stability, a socially just distribution of income and wealth, ecological sustainability, and other aspects of economic welfare. In most instances what emerged was that public action was required and that, in some instances, it led to positive sum outcomes: full employment policies would provide more jobs to workers but would also raise the profits of firms; welfare provisions improved the living standards of people but, in so doing, increased social cohesion, thereby leading to higher productivity and to positive expectations by investors. In many cases, the relationship between efficiency and equity turned out to be a synergy rather than a trade-off. Market-centered criteria were consistent with the ends derived from other, non market, criteria.<sup>18</sup>

Granted that these issues are very important, it is also important to consider that social goals may be more far reaching and/or that, in some instances, they may be inconsistent with market goals. What conventional economists connote as trade-offs do occur. What is wrong with the notion of trade-off is not that different goals may clash but the *a priori* pretence that the choice between them should be based on relative prices, i.e. on a market metric.

The theoretical suggestion underlying the approach of this paper is that social accounting should be based on a criterion – the social inclusion and empowerment of all the members of a community – that is distinct of the conventional market-centered one. More specifically, the key contention is that social costs arise precisely when the use of the latter criterion contrasts the goals that the former would put forward. It is not possible to separate the areas that these criteria refer to because, although, as I argued above, a capitalist market economy has a rationale of its own, it is nonetheless part of an open (nearly decomposable; Simon 1981) system and, in one way or another, interacts with the other sub-systems. What is at issue, therefore, is - following Polanyi (1944) - what kind of interaction should prevail, i.e. whether social priorities should subsume the economy or the other way round.

The conventional view considers that some problems may be solved either by constraining the economy (usually at a cost) or by relying on the resources that the economy makes available. Systemic openness,<sup>19</sup> on the other hand, suggests that this mechanistic view is misleading, and that the economy may be arranged in a variety of ways. It suggests that we may grasp a broader view of how the economy affects the social and natural environment. An economic system is open because it interacts with its surrounding environment, through the exchange of matter, energy or information. Consequently, the economy affects the quality of life not only through prices and the supply of goods and services. It also affects it through the feedbacks of the social and natural environment. Racism, as Myrdal (1962) pointed out years ago, is an economic phenomenon not just because it reflects the way the economy is organized but also because it feeds back on the quality of life either by acting on strictly economic variables such as prices and the provision of goods and services or by determining undesired consequences such as a shorter life expectancy. The same applies to completely different phenomena such as the depletion of the ozone layer or what is generally called international peace keeping.

Precisely because of systemic openness, the effects of economic policy may affect the overall quality of life. Given the strong relation between the material and the social reproduction of society, it is most likely that different arrangements will affect sections of society in different ways.<sup>20</sup> Negative

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<sup>18</sup>One of the reasons why Italian industrial districts intrigued many scholars is that they seemed to allow for the convergence of interests between a community of people and a population of firms (Becattini, 1990). The fragility of this convergence is discussed in Ramazzotti (2010).

<sup>19</sup>See Kapp (1976) for a discussion of ‘The open-system character of the economy and its implications’.

<sup>20</sup>As Etzioni (1988) points out, conflict is indeed possible but, while it does lead to change, it need not be disruptive of a social community: ‘We see room for conflicts *within* a community; classes *within* society. And while any other

reactions to change are definitely possible. Actions that aim to protect vested interests, however, should not be confused with technical impediments to change. The dynamic nature of a capitalist market economy implies that whenever business is constrained it seeks new ways to achieve its money gains. In some instances they consist in new economic activities that overcome the constraints, in others they consist in rent seeking to bypass them. The evolutionary nature of this process entails that there is no arrangement that avoids social costs once and for all but, as Stanfield and Carroll (2009: 11) point out, '[w]hile it is true that any regulatory scheme tends to bring forth efforts to evade control, this only means that regulation must be continuously reformed not that it must be abandoned.'

A critical issue, however, is whether – quite apart from social and political reactions - technical impediments to economic change exist and what they consist in. In order to clearly understand what is at issue, note that the openness of the economy involves a myriad of possible variables which may or may not interact in a variety of ways at any given moment. In other words, the openness we are concerned with is characterized by complexity,<sup>21</sup> whereby '[a]n open system is one where not all of the constituent variables and structural relationships are known or knowable, and thus the boundaries of the system are not known or knowable.' (Dow 1996: 14).

This specific aspect of systemic openness provides quite a few insights. First, since the boundaries of a system are never given once and for all,<sup>22</sup> it is not possible to provide a once and for all assessment of how constraining a given structure actually is. More specifically, in so far as the system is engrained in a historical process, these boundaries are subject to change in rather unpredictable ways. As Schumpeter (1911) argued a century ago, capitalism involves a process of creative destruction, that is, a constant rearrangement not only of how available resources are used but also of how they are produced. Although his analysis was restricted to business in a capitalist market economy, it does suggest that change occurs, and sometimes in most unpredictable ways. Indeed, the a priori assumption that technical impediments cannot be overcome is at odds with the historical record of the evolution of technology.

Second, aside from how it affects a system's boundaries, it is the very nature of novelty that is unpredictable. The learning process, whereby the structural relationships become knowable, is itself an open system. This means that human learning allows people to identify connections, relations and potential innovations as it proceeds. Human learning need not be bounded by the extant boundaries of the economy, it may transcend them, thereby affecting society as a whole. Market-oriented entrepreneurs need not be the only innovators. What appears to be an impediment today may turn out not to be so in a subsequent period.

Third, systemic openness involves the need to establish heuristic boundaries in order to make sense of reality: Although everything is connected to everything else, you must eventually choose when to conclude – if momentarily - your inquiry, thus what will fit in and what will be left out of it. Hence, when you choose to investigate an issue and you attempt to identify what is relevant to that end, you can never be sure that you are not missing something. Models that depict the economy are possible only in so far as they formulate assumptions on some structural features of the economy. These assumptions allow us to grasp aspects of the economy but the extent to which we should take them for granted depends on how far we are willing to go in order to achieve our goals. In other terms, while in a closed system one may expect no other structure to be possible, in an open system such a belief would be unwarranted. The acceptance of a given structure – which ultimately means that one chooses to abstain from further investigations on possible alternatives - is discretionary: it is a matter of value judgment. It depends on the questions we ask and the priorities we set. It ultimately reflects our (moral) value judgments, concerning what we wish to achieve, and our (cognitive) value judgments,<sup>23</sup> concerning how we expect to grasp the reality we

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societal structure or equilibrium may be upset, society as a community needs to be maintained as a context for the particular collectivities, to encapsulate conflict, to avoid total war. In short, structures may be changed but society cannot be avoided.' (216; emphases in the original).

<sup>21</sup>'Roughly, by a complex system I mean one made up of a large number of parts that interact in a nonsimple way.' (Simon 1981: 195).

<sup>22</sup>'An open system is one where not all of the constituent variables and structural relationships are known or knowable, and thus the boundaries of the system are not known or knowable.' (Dow 1996: 14)

<sup>23</sup>A discussion of these two types of value judgments is in Ramazzotti (2011)

live in: ‘Valuations are always with us. Disinterested research there has never been and can never be. Prior to answers there must be questions. There can be no view except from a viewpoint. In the questions raised and the viewpoint chosen, valuations are implied.’ (Myrdal: 1978: 778-9).

Systemic openness suggests that alternatives to the status quo may exist, but the very nature of openness prevents us from identifying them in terms of an organic and consistent arrangement. Owing to the great many interdependences there are in a society, a new societal setup may be difficult, when not impossible, to envisage.

In most instances the existing organization of the economy and of society simply does not allow people to envisage possible changes, thereby leading to a view of the world which very much resembles that of the subordinate woman discussed by Sen. Even if we leave aside this extreme case, it is worthwhile to recall that the above discussion of sympathy and commitment emphasized that these types of behavior – thus, the choices they involve – depend on the social environment individuals are embedded in. This embeddedness, in turn, depends on the capabilities that the environment warrants.<sup>24</sup>

Viewed from this perspective, social costs are not the peculiarities or theoretical conundrums that lie at the margins of economics. They are the key issues for whoever investigates the economy in order to establish a more humane society. They have to do not with marginal changes in an otherwise ‘well behaved’ economy but with issues such as unemployment, lack of basic education, unhealthy living conditions, on job accidents, lack of proper housing, unfair income and wealth distribution<sup>25</sup> that prevent people from choosing how to conduct their lives.

Efforts to remove social costs and the structural constraints that are associated to them greatly depend on the willingness of scholars to consider these issues as the points of reference for any change in the direction of a more humane society. In other terms, only a normative approach to economics will allow scholars to go beyond the boundaries that conventional knowledge sets and to deal with Keynes’ remark that ‘The difficulty lies, not in the new ideas, but in escaping from the old ones, which ramify [...] into every corner of our minds.’ (Keynes 1973 [1936]: xxiii).

## 6 Conclusion

The notion of social cost is still open to debate. Different theoretical approaches tend to look at the issue in different ways. This would not be a problem if it testified to the liveliness of economic thought and debate. Unfortunately, this is not always the case. The variety of treatments of the social cost issue reflects the neglect of some approaches, thus the persistence of open issues. It is somewhat daunting that Kapp’s work should be ignored by well known scholars, despite his important contribution to this topic.

The paper has tried to put together some of the key issues that emerge from the literature. It did not pretend to provide a full-fledged survey. It did try to point out some major shortcomings in the theoretical debate which remain to be discussed. The key issue that the paper focused on is the need for a criterion to assess the performance of the economy. Given the internal inconsistencies of the mainstream approaches outlined at the outset, it focused on the contributions of Kapp, Polanyi and Sen. It pointed, out that while it is important to understand how markets function in a capitalist market economy, the latter cannot be reduced to them. Economic activity is coordinated by a range of other sub-systems, each one according to its priorities and criteria. This raises coordination problems for whoever wishes to carry out a policy that avoids social costs. It also raises the question: what are the priorities of society as a whole?

Amartya Sen’s notion of capabilities provides important insights on what public policy should be concerned about, which provides the basis for a depiction of social costs as the negative effects that the capitalist market economy has on capabilities. This notion of social costs encompasses Kapp’s, and in practical terms, it would be difficult, today, to distinguish the policy implications that the two approaches would have for most countries. It goes beyond Kapp’s notion of minimal social

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<sup>24</sup>This issue is stressed from a different but interesting perspective by Davis (2009).

<sup>25</sup>In a nutshell, one could simply refer to the Universal Declaration of Human Rights, especially from art. 20 onwards. Cf. United Nations (1948).

requirements, however. On the one hand, it suggests that the struggle against social costs should not consist only in constraining markets but that it involves an active coordination of the economy as a whole. On the other, it suggests that, given the present economic and environmental crises, a clearer view of what the policy objectives are – from the social cost perspective – will contribute to the avoidance of the dramatic stalemate – pointed out by Polanyi – that the clash between market requirements and societal values may lead to.

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