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★★★★★ **Best Book on Public Policy in Years**, May 24, 2014

By [Herbert Gintis](#)

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This review is from: **Complexity and the Art of Public Policy: Solving Society's Problems from the Bottom Up (Hardcover)**

I want to begin my review of this marvelous and compelling book by outlining what economists have known concerning public policy for at least fifty years. This is a prelude to discussing what is wrong with this received wisdom, and what is new in the complexity approach to modeling the market economy that is advocated and explained in this book.

I was taught public economics by Richard Musgrave, who in 1959 wrote the classic textbook on the subject, *The Theory of Public Finance*. Surprisingly, many prominent figures and public intellectuals today profess an understanding of the economy yet know nothing about public economics. They regularly assert the truth of principles that have been discredited for half a century. Colander and Kupers have very important corrections to the standard theory, but one must first recognize the status of standard public economics as the foundation stone on which complexity theory does, and must, rest.

Public economics analyzes the conditions under which market exchange leads to imperfect outcomes that might be corrected by non-market institutions and policies. Complexity theory has, to my knowledge, no quarrel with these principles. Rather, complexity theory alters our understanding of what forms of non-market economic interventions are likely to be effective in improving economic efficiency and promoting economic growth.

There are two distinct roles for economic policy: regulating market dynamics (e.g., stabilizing business fluctuations and preventing catastrophic breakdowns) and influencing the equilibrium allocation of economic resources (e.g., financing social infrastructure, providing public goods, and regulating industrial effluents).

The analysis of market dynamics is based on the so-called Walrasian market economy, in which there are households that own the factors of production (land, labor, capital, resources) and firms that rent these resources from households (e.g., they hire labor for a wage and borrow funds at an interest rate), and produce goods and services that they sell back to the households. In this model, the capital and resources owned by the firm are simply assigned to the firm's owners.

The Walrasian economy is in equilibrium when the price structure for goods, services, and factors of production is such that supply and demand are equal in all markets. In the 1950's, economists Gerard Debreu, Kenneth Arrow, and others proved the existence of general equilibrium, under rather mild assumptions. This means that there always exists a set of positive prices at which all markets clear. However, economists have been quite unable to develop a plausible model of how the market economy behaves out of equilibrium. Hence economists cannot say whether the market economy, under particular institutional arrangements, fragile or robust in reacting to such exogenous shocks as new technologies, financial speculation, and socio-political turmoil. For a discussion of the history of attempts to develop a dynamic model of Walrasian economy, see my paper "The Dynamics of Pure Market Exchange," which is available on my website: people.umass.edu/gintis.

Because of this stunning failure of basic economic theory, all of our understanding of market dynamics is based not on established analytical principles on smoke and mirrors, known as macroeconomic theory, and journalistic posturing. Macroeconomists do not like to admit this, but in fact we know nothing systematic concerning market dynamics.

Historically, the most important type of economic dynamics have dealt with the business cycle. Every market economy has regulations aimed at smoothing the business cycle, including monetary and fiscal policy (increasing government expenditure and reducing taxes during a downturn, and doing the opposite during an upturn), and automatic stabilizers (e.g., unemployment compensation, progressive taxation) that automatically move net government debt in the opposite direction as aggregate demand in the private sector. Because, as Colander and Kupers stress, the market economy is a complex nonlinear dynamic adaptive system, no one can prove that automatic stabilizers work, but they appear in practice to do for the economy what shock absorbers do for motor vehicles.

As I write, financial instability is the key dynamical instability problem facing advanced economies, and the standard economic models (Keynesian and rational expectations models) are incapable of handling the problem because the financial sector is simply not represented in the standard macroeconomic models. Of course, intensive work by economists is now under way to correct this problem, but it will be several years before an adequate model is developed. It is unlikely, for reasons explained by Colander and Kupers, that any model that ignores complexity will survive.

In the popular press, conservatives blame the financial crisis on over-regulation and liberals blame the crisis on under-regulation. The notion that the financial sector of a market economy needs little regulation and is robust in the absence of extensive intervention is simply an article of faith unsupported by theory or experience. I know only a handful of economists who embrace the free-marketeer's faith in the stability of unregulated markets, and they are all ideologically motivated thinkers whose arguments I find to be without merit. The notion that the financial sector may be under-regulated is probably false and is dangerous because simply slapping on

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intuitively desirable regulations threatens to dampen the financial sector's contribution to economic growth and technical progress. The correct position is that the crisis was due to improper regulation, itself in part a failure to understand the economy as a complex dynamical system.

If the traditional theory of business cycle regulation is a rather complete failure, the traditional theory of when markets produce the most efficient pattern of production inputs (resources, labor, and capital) and production outputs (consumption and investment goods) is much more successful. The basic question of when free markets are the most effective instruments of economic efficiency was worked out in the post World War II period, and remain valid today, a half century later. This theory is called the theory of market failure.

Market Failure I: Increasing returns to scale sectors. In some goods, the optimal efficient firm size is so large that competition is precluded. For instance, water to a city may be supplied by a single reservoir and a unified system of delivery and waste removal. There is simply no room for multiple firms to compete, so the service is supplied by the government. Many municipal services are of this form. The problem can sometimes be handled by requiring firms to share the resource that accounts for increasing returns, such as railroad tracks or an electric grid.

Market Failure II: Public goods. Some goods are non-exclusionary---they are consumed equally by many or all individuals (although they may be valued differently by different individuals). For instance, national defense protects all equally, and many forms of public health measures affect the incidence of diseases for the entire population. Public goods must be publicly provided in most cases.

Market Failure III: Externalities. Some goods are produced using technologies that release waste products into the environment at zero or low cost to the producer but that impose high costs on everyone else. Economic theory suggests that the costs imposed by these effluents be charged to producers, or in some cases that the release of effluents be prohibited by law (e.g., making it illegal to release chemical waste into a river or lake).

Market Failure IV: Ensuring product quality: In many industries in which the quality of a product cannot be ascertained until after purchase, and in which reputation effects are not sufficient to ensure a minimum quality level, quality can be maintained only by legal regulation. For instance, most countries have health standards for restaurants and quality standards for hotels (perhaps rated by one to five stars, or some such) that prevent an upstart from profiting at the expense of consumers and the high quality firms. Similarly, professionals may be licensed (e.g., medical and legal services), and pharmaceuticals may be regulated for safety and effectiveness.

Market Failure V: Merit goods: There are some goods that are not permitted to be bought and sold on markets for ethical reasons. Examples are votes and body parts.

Of course, just as there is market failure, so there is state failure, which means that the regulating agencies fail to operate in the public interest because of corruption, special interest lobbying, incomplete and inaccurate information, and the like. For this reason, is often better to leave imperfect markets unregulated, or lightly regulated, rather than regulate them heavily or replace them with government production.

The notion of state failure was completely ignored when I was a graduate student in the mid-1960's. I recall asking the famous Keynesian Nobel prize-winning economist James Tobin, at a talk to the Harvard economics department on business cycle stabilization, why the government could be expected to act the way his model suggested it should. I was treated as though I had transgressed the boundaries of propriety in posing such a question.

But the question was a fair and important one. State failure was stressed by Milton Friedman in his critique of Keynesian economics. Friedman argued that when a legislative body is called up to change the tax system, members will fight interminably over exactly who will bear the burdens and benefits of the changes, and by the time they have come to an agreement, the business cycle will have moved on to another phase.

But Friedman was a pariah at that time in Cambridge Massachusetts and most other economics departments. James Buchanan and Gordon Tullock introduced rent-seeking into the literature in their 1962 volume *The Calculus of Consent*, and Mancur Olson provided an economic theory of special interest pleading in *The Logic of Collective Action* in 1965, but the general notion of state failure was not recognized by economists until the mid-1970's, with the collapse and discrediting of Keynesian models of the macroeconomy.

The second major weakness of the neoclassical policy framework was its assumption, maintained to this day, that the government has at its disposal all the information concerning the operation of the economy that is available to private agents. In particular, the price system and production technologies were assumed to be public information. To appreciate how unrealistic is this key assumption of neoclassical economics, I might point out that in the great continental "Sozialismusdebatte" (socialism debates) of the 1930s, the market socialists Enrico Barone, Fred M. Taylor, Oskar Lange, Abba Lerner and others used the neoclassical general equilibrium model to argue that a state-run economy could at least be as efficient as a capitalist economy. All that was needed was for government planners to use the price system to simulate the role of Walras' auctioneer in setting prices to induce market clearing in the market economy. The state could then simply own all the property, hire managers to run firms, and instruct these managers to maximize profits. The return to capital could then be used by the state on behalf of its workers and citizens in an egalitarian and just manner. The opponents of the market socialists, members of the Austrian school of laissez-faire economics, led by Ludwig von Mises and Friedrich Hayek, were no match for this high-tech neoclassical-turned-socialist analysis, which convinced even so stalwart a champion of capitalism as Josef Schumpeter to predict the eventual triumph of state socialism. This indeed is the message of his famously misguided contribution *Capitalism, Socialism and Democracy* (1942).

His defeat at the hands of the market socialists convinced Hayek that neoclassical theory must be abandoned, for it was incapable of explaining why private property and entrepreneurial initiative were superior to centralized state socialism. He published his definitive break with neoclassical economics in his famous *American Economic Review* paper "The Uses of Knowledge in Society" (1945). In this paper he asserted that information is extremely decentralized in a private property

market economy, and a government agency simply will not have the information to perform the massive number and range of calculations necessary to run an efficient and innovative economy. Hayek wrote (p. 519): "What is the problem we wish to solve when we try to construct a rational economic order? If we possess all the relevant information, the problem which remains is purely one of logic. This, however, is emphatically not the economic problem which society faces. The problem of a rational economic order is determined precisely by the fact that the knowledge of the circumstances of which we must make use never exists in concentrated or integrated form, but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess."

I know that this has been an unusually long preface to the review of a book, but it does teach us some important lessons. First, neoclassically inspired public economics provides a very powerful and largely correct framework for analyzing when markets work well and when they fail. Second, markets are often fragile and easily destabilized unless properly regulated. Third, markets and regulating institutions are not alternatives but rather complements. Fourth, neoclassical economics cannot model state failure, and therefore overstates the latitude for government intervention in stabilizing the economy and correcting market failures. One reason for this failure is that government is subject to political forces that lead it to favor special interests rather than the general good. What Colander and Kupers tell us is that there is a second reason: the market economy is a complex, dynamic, and adaptive system more like a natural ecology than a man-made machine.

The complex economy cannot be controlled, as the planners would like, but it can be influenced by very carefully formulated and judiciously applied "rules of the game" that move market dynamics in preferred directions. In this respect, traditional planners are like the Queen of Hearts in *Through the Looking Glass* who cannot stand the fact that she cannot order the flowers in her garden to heed her bidding, and employs a bevy of "gardeners" to paint the flowers to her specifications. The situation is worse for an economy because there is no regulatory counterpart to painting the flowers. "The [effective] government does not impose norms, or even force individuals to self-regulate. Instead it attempts to encourage the development of an econstructure that encourages self-reliance and concern about others." (p. 9).

Complexity theory helps us understand that the moral rules that govern everyday life cannot be imposed, but must emerge from the dynamics of everyday life. Horace long ago noted that "laws without morality are useless." Some two thousand years later Colander and Kupers similarly write "A government... must be a moral strength... not a coercive strength that attempts to control." A great example of this insight is the life-work of the great Nobel prize winner Elinor Ostrom, who has shown that local community initiatives can effectively control common pool resources (e.g., the ecology of waters that provide sustenance to fishing communities, or forests to lumbering communities) where the market is no help and the central government is more often the exploiter than the preserver of such resources. The government can best achieve efficient resource use given the complexities of common pool resource management by setting conditions under which local community control can thrive.

Kudos to David Colander and Roland Kupers for this fine book.

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Initial post: Jul 7, 2014 11:28:54 AM PDT

S. Prewitt says:

If we view social systems as complex evolving systems, as the authors recommend, then one thing becomes abundantly clear: indiscriminate wealth transfers from winners (individuals, households) to losers essentially end learning by natural selection. In fact they do worse; they replace natural selection with dysgenic selection!

Such policies increase "utility" only from a very short-term point of view. Long-term they increase inequality, decrease cooperation and inevitably (it seems to me) cause societies to fragment and collapse.

Hopefully the authors of this book recommend a better way. Intelligent animals would be able to replace natural selection with compassionate selection, not dysgenic selection.

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In reply to [an earlier post](#) on Nov 25, 2014 8:37:13 AM PST

Arnie Kriegbaum says:

Ok. Yes. "Long-term they increase inequality". Probably. However, I am dubious that society would even make it to the "long-term" without wealth transfers in the near term.

Also, thank you for introducing me to the term dysgenic selection.

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Posted on Dec 17, 2014 8:48:27 AM PST

Roger says:

Reading Gintis' reviews is always a treasure. Thank you for this and all the great reviews to great books you provide.

[Reply to this post](#)[Permalink](#) | [Report abuse](#)Do you think this post adds to the discussion? In reply to [an earlier post](#) on Jan 4, 2015 9:21:16 AM PST
Last edited by the author on Jan 4, 2015 9:23:28 AM PST

M. Passey says:

Roger: I first came across Herbert Gintis when reading his review of Krugman's Conscience of a Liberal (in which he explains why Krugman's polemicist style isn't very helpful). I have since read most of his Amazon reviews and many of those reviewed books, including this one. I now find myself frequently responding to Progressives and Libertarians alike with the sentiment "Do your freakin' homework for heaven's sake. Read some Gintis." Start with Moral Sentiments and Material Interests. Then read A Cooperative Species (if you're a bit math smart). And everyone interested in evidence-based public policy must read Elenor Olstrom Governing the Commons, of whom I became aware through Herbert Gintis. As you state in your review of this book a complexity frame does not support political ideologies, Progressive or right wing. Herbert Gintis is someone who comes out of a more progressive temperament than I do. But because he is intellectually honest enough to state that the nature of human cooperation does not support the strong socialism some Progressives yearn for, he also has the credibility to push back against the strong Darwinian group-ism of the political right.

Herbert Gintis: You state: "Government policies can be used to tweak the system, shifting the point of equilibrium, but not replace the basic self regulation that occurs." It seems to me that this implies the same basic question you asked James Tobin in the 1960's, why should the governing class be expected to act the way the complexity framework suggests it should? Is the solution for complexity-aware people to get elected to public office? How do you escape the top-downism implied here?--- "If we were in charge this is how we would tweak the system. "

The problem I'm having here is the sense that very few people understand the profound implications of the formally complex nature of the human social and economic interaction landscape. And the people who do understand it might ignore it in their particular discipline because it makes problems mathematically intractable. So we have lots of action oriented, well-intentioned, smart people creating mischief by proposing public policy based on thought models (ideologies) or linear mathematical models feeble to the task.

So what is the alternative? When it comes to evidence based public policy, are we not still stuck in a heuristic epistemic Chesterton's fence?---first do no harm? The nature of empirical methods is that knowledge is negative; we learn by proving what is false, leaving us in the mode of operating by provisional truths. It just seems to me that the complexity frame implies that we are very far from escaping the current reliance on first principles that are provisionally true, because at least they are a de facto proven basin of attraction in a landscape of multiple possible dynamic equilibria. And the most robust first principles are those framed in the negative--- "do not do this". Thus the power for economic good in the rule of proscriptive law, such as the enforcement of contracts (Solomons Knot). Thus the power of constitutional democracy. The US Constitution is at its strongest in stating the negatives: the bill of rights, the separation and enumeration of powers. So back to Roger's impression in his review that the complexity frame (and the economics implications of evolutionary psychology for that matter) are rather inimical to agenda progressivism. Is it the case that "the facts of life are conservative"?---with a small c of course.

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Herbert Gintis says:

Political democracy is imperfect, but it does constrain governments. Over the years, we have come to understand a lot about socioeconomic policy. I think the journal The Economist gets it right almost all the time, and there is a general understanding among economists as to how to do economic regulation. Of course, this gets distorted through the ideological lenses of politicians and the bigoted "public economists" who make the op ed page of many newspapers.

I am not pessimistic at all about government policy. It is just a slow process of educating the public and doing really good quantitative research. Economists

are doing that right now---read some of the American Economics Association journals. They are first rate.

Real life is neither conservative nor liberal (in the American political sense), by the way. These ideologies I find quite amusing when they are not contemptible.

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In reply to [an earlier post](#) on May 2, 2015 2:56:56 PM PDT

Sevens says:

H. Gintis, I was surprised to find that this book is a rather superficial introduction with vast amounts of repetition. - Have you read Schuck's Why Government Fails So Often, Princeton UP, 2014? I found it more informative; its principles are build around case studies.

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