

2.4. Theorisation and understanding of the reality

Two different approaches in economics

- (1) What is it for?
 - understanding
 - prediction
- (2) Requirements of a theory
 - logical consistency
 - relevance to reality

Prediction-oriented theorists

- “Truly important and significant hypotheses will be found to have ‘assumptions’ that are wildly inaccurate descriptive representations of reality, and, in general, the more significant the theory, the more unrealistic the assumptions.... the relevant question to ask about the ‘assumptions’ of a theory is not whether they are sufficiently good approximations for the purpose in hand. (continued)

... And this question can be answered only by seeing whether the theory works, which means whether it yields sufficiently accurate predictions. The two supposedly independent tests thus reduce to one test.” (Milton Friedman, *The Methodology of Positive Economics*, in Hausman 1984: 218)

→ criticism of ‘the theory of monopolistic and imperfect competition’

Realists

“... a body of theorems based on assumptions that are *empirically* derived (from observations) and which embody hypotheses that are capable of verification both in regard to the assumptions and the predictions.
(Nicholas Kaldor, *The Irrelevance of Equilibrium Economics*, in Tagetti & Thirlwall 1989: 373)

→ increasing complexity of theories

Methodenstreit: Historical School

- Empirical *apriorism*

"Descriptive economics provides the material for general theory. This material is the more complete the more fully the phenomena are described in all their actual characteristics, changes, causes, and consequences ...
(continued)

... [it is necessarily of primary importance] to increase, improve and make more accurate our empirical observation, so that with the aid of the better and more extensive descriptive material of every kind, classifications and definitions can be improved, and typical sequences and their connections, causes, and ramifications may be more clearly understood. If a science from time to time concentrates mainly on description it is by no means in neglect of theory, but to provide a necessary foundation for it". (Gustav Schmoller, Quoted in Eucken 1950: 59-60)

Methodenstreit: Theoretical School

- 'Dualism' between theory and history

"The phenomenal world can be regarded from two essentially different points of view: *either* as made up of concrete phenomena in their positions in space and time and in their concrete relations with one another, *or* as forms regularly recurring amid the changes of the concrete phenomena, the understanding of these forms being the object of science. (continued)

“From the former viewpoint study is directed at understanding the concrete, or rather the *individual*, and from the latter the *general* aspect of phenomena. Corresponding to these two main points of view we find two great classes of scientific knowledge, the former of which we may briefly call the individual, the latter the general". (Carl Menger, Quoted in Eucken 1950: 58)

Appraisal of the two schools

“Neither the Historical School nor the Theoretical School could provide a solution to deal with the tension between theory and reality *now*. The former put it off as a matter to tackle *later* only after empirical investigations. The latter excluded it from theory and was satisfied with remaining in what they think the realm of theory” (Shin).

Weberian resolution of the tension between theory and reality

(1) What is the 'understanding' of the reality?

→ 'causal imputation'

eg. Understanding the Industrial Revolution?

Weberian resolution of the tension between theory and reality

(2) Epistemological dilemma of human being

- 'infinite reality' vs. 'finite human mind'

"an *exhaustive* causal investigation ... in its full reality is not only practically impossible - it is simply nonsense".
For the human mind cannot contain the infinity. (continued)

"All the analysis of *infinite reality* which *the finite human mind* can conduct rests on the tacit assumption that only a finite portion of this reality constitutes the object of scientific investigation".
(Weber)

→ the principal source of tension
between theory and reality

Weberian resolution of the tension between theory and reality

(3) The working of human mind
: 'nomological knowledge'.

→ We are bound to think in terms of
models and regularities

- " ... a *valid* imputation of any individual effect without the application of '*nomological knowledge*' - i.e., the knowledge of recurrent causal sequences - would in general be impossible. Whether a single individual component of a relationship is ... to be assigned causal responsibility for an effect ..., can in doubtful cases be determined only by estimating the effects which we *generally* expect from it and from the other components of the same complex which are relevant to the explanation".

"Brain functions by fitting inputs against models"
(brain biologists, quoted in Gerschenkron)

Weberian resolution of the tension between theory and reality

(4) Ideal type and interpretative sociology

* 'Ideal type'

: a tool to limit our attention while giving guidance to 'causal imputation'

"It is a utopia. [It] ... approximates to or diverge from reality."

- ‘Heuristic device’ to facilitate research
“The ideal typical concept will help to develop our skill in imputation in *research*: It *is* no ‘hypothesis’ but it offers guidance to the construction of hypothesis. It is not a *description* of reality but it aims to give unambiguous means of expression to such a description.” (p. 90)

“Economics is a tool box.” (Joan Robinson)

- Value judgement (from the beginning)
 - inevitable ‘one-sidedness’ or ‘arbitrariness’

It is not value-free because "the very problems which define the objectives of interest are dependent on such presuppositions".

- "a phenomenon is 'economic' only insofar as and *only* as long as our *interest* is exclusively focused on its constitutive significance in the material struggle for existence".

Understanding 'configuration'

- The final objective of theory

[theory building] is a task of "very modest preparation" and "It is then the concern of history to give a causal explanations of these particular characteristics."

theory, not as the 'end', but the 'means' for historical analysis

- 'Interpretative sociology'

Our knowledge is advanced "by elucidating the degree of *approximation* to which a particular historical phenomenon can be classified in terms of one or more of these concepts [ideal types]"

eg. pool

Theoretical vs. historical question

- Theoretical simplicity vs. realistic complexity
- (1) theoretical (functional) questions: general relations
- eg 1. FX movement vs. growth
 - eg 2. R&D investment vs. growth,
 - eg 3. interest rate vs. bankruptcy
 - eg 4. path dependency and technical progress

Theoretical vs. historical questions

(2) historical (realistic) questions: looking at particular configurations

eg 1. Why did financial crisis happen?

eg 2. Why has Japan succeeded in catching up with the U.S.?

eg 3. Why were there sudden bankruptcies?

eg 4. Why the Wintel remain dominant in the world computer industry?

→ involves various functions. various causes

Level of abstraction and agenda for heterogeneous theories

- Abstraction is a necessary process in understanding reality
- It is important to which level one abstracts
 - dependent on research objectives
- Need for theoretical frameworks to view diversity
- Limitations of heterogeneous models
 - constrained by time and space (situational models)