

Why Analysis of Economic Policies Needs Institutional Economics, and Why This Economics Needs to Admit Unequally Rational Individuals and Comprehend Economic Change

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The outline

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- 3 Streamlining IE for analysis of economic policies: Economic IE based on the IF-ON conceptual model
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- 6 Extended Economic IE: the main implications for analysis of economic policies, with new answers to four old policy issues

Basic references

1 – INTRODUCTION: TWO INTERTWINED AIMS

(I) **Advance theory:** extend IE to make it able to

- deal with unequally rational individuals
- comprehend different dimensions of economic change ('evo-devo')

(both extensions based on my earlier published research)

(II) **Improve analysis of economic policies:**

- enable it to deal with deep non-cyclical crises
- diminish its production of misleading results

Results of (I) will be used for (II), and results of (II) will justify the usefulness of (I):
the analysis will be shown to need IE, and IE will be shown to need the extensions

2 - ANALYSIS OF ECONOMIC POLICIES: ITS TASK AND ITS USERS

Here: only analysis that is non-normative and value-free: no policy objectives prescribed, no policy choices made (yes, this is possible!)

The task: help people with own values and own objectives to make for them the right policy choices, by informing them on

- the choice sets
- the consequences of specific choices

The users:

- the government (actual policymakers)
- other citizens, whose return for individual effort depends on the actual state of the economy, and thereby on the actual economic policies

Economic policy choices:

(1) of **policy objectives**

(2) of **policy means**

- (a) of **legislative economic policies**, including the definitions of executive policy instruments
- (b) of **executive economic policies** = the uses of the defined instruments

How analysis of economic policies can help policymakers

- with choices (1): to see the feasibility frontier, and thus make the policy objectives feasible and internally consistent
- with choices (2a): to see the feasible variety of effective legislation, and to predict the consequences of its different variants, including different policy instruments, at least comparatively
- with choices (2b): to see the possible uses of the legislated policy instruments, and to predict the consequences of these uses, including no use, at least comparatively

3 - STREAMLINING IE FOR ANALYSIS OF ECONOMIC POLICIES: THE IF-ON CONCEPTUAL MODEL

Economic IE and Political IE, the two main branches of today's IE, but:

- not always conceptually clear: different more or less clear definitions of the term "institutions"
 - much of IE not directly helpful for any policy analysis
- three steps:
- basic conceptual clarifications → institutional rules and frameworks
 - most helpful to analysis of economic policies: Economic IE
 - an operationally clear conceptual basis: the IF-ON model

Choosing the terminology

The term “institutions” remains ambiguous: not always clearly seen, often includes “organizations” → not useful for precise analysis

“**institutional rules**” = “institutions” in the sense of North (1990) = roughly: humanly devised rules that shape (constrain, guide, enable) human interactions (“rules of the game”) – in part formal, defined by legislators, in part informal, outcomes of sociocultural evolution

“**institutional framework**” (**IF**) = all institutional rules of an economy

“**organizational network (ON)**” = all the markets and organizations, both private and governmental, of an economy (cf. Williamson 1975)

Today's IE: its central task and its main branches

The central task: understand the **effects** of an economy's **IF** on its **performance**, including the distribution of resources, in both ways:

- from the performance to its causes in the **IF**
- from the **IF** to its impact on the performance

Two main branches:

- **Economic IE** (North, Williamson, ...)
- **Political IE** (Acemoglu, Johnson, Robinson, ...)

Economic IE vs. Political IE: similarities and differences

Formally about the same '**IF → performance**' effects, but:

- **Economic IE:** from **economic IFs** (e.g. market vs. government) → *the behaviors of people as economic agents* → **the performance**
- **Political IE** from **political IFs** (e.g. democracy vs. dictatorship) → the behaviors of people as political agents → the government with policy objectives (e.g. inclusive or extractive) → the **economic IF ...** → *the behaviors of people as economic agents* → **the performance**

Note: the same end, but differently remote beginnings

Which IE can help with what?

Political IE → the choices selecting the government

can be made by the citizens at large (not in dictatorships) and/or the incumbent government (not in democracies)

Economic IE → the choices of economic policies

always made by government, whatever its origins

Helping the government make these choices, and the citizens critically evaluate them, is purely a matter of **Economic IE** (and not Political IE)

Building a conceptual basis for Economic IE: the IF-ON model

- IFs' effects pass through **individual behaviors** → the model must be **microeconomic**:
- the mainstream skeleton: **an economy** = a set of **interrelated individuals**, who use their **rationality** to pursue their **preferences** under a number of **constraints**
- but not the mainstream simplifications: e.g. no assumption of perfect rationality of the individuals, nor convexity of the preferences

IF and ON: the two institutional parameters

The individuals are interrelated:

- **institutionally**, by sharing the same **IF** – although different individuals may directly be concerned by different subsets of its rules
- **organizationally**, by their jobs on the markets and/or within the organizations of the **ON** – the outcome of their job-designing and job-assigning, for themselves and/or for others

Note the synthesis of North's and Williamson's approaches

The IF-ON model → three layers of economic processes

- (I) **Resource-allocation** – including production, exchanges and consumption – within a **given ON**, guided and constrained by a **given IF** (the usual)
- (II) **Development of ON** – including entry, growth or exit of firms, opening and closing of markets, and growth or shrinking of government – all this guided and constrained by a **given IF** (cf. Schumpeter's creative destruction)
- (III) **Evolution of IF** – including changes of formal institutional rules by known legislators and/or judges, and changes of informal institutional rules by anonymous sociocultural innovators and imitators (cf. e.g. Hayek and North)
 - Note 1: (I) & (II) = institutional statics; (III) = institutional dynamics
 - Note 2: economic evolution distinguished from economic development
 - Note 3: iff interested in biology, note the *logical* correspondence (with *quantitative* qualifications): "IF-ON \longleftrightarrow genotype-phenotype"

4 - THE NEED OF ANALYSIS OF ECONOMIC POLICIES FOR ECONOMIC IE

All economic policy choices involve some institutional rules:

Choices of policy objectives → the formal institutional rules that shape the constraining tradeoffs (e.g. forms of taxation → equality-efficiency)

Choices of legislative policies → all formal institutional rules, their consequences and feasibility (this analysis is 100% IE)

Choices of executive policies → the formal institutional rules that define the **permissible policy instruments** (→ legislative policies)

NB: before optimizing the use of any policy instrument, Economic IE must check whether to use it at all! Misleading: finding an optimal use in theory for a policy instrument bound to cause harm in practice

→ all analysis of economic policies needs some Economic IE → aim (I) attained

A complementary argument: two kinds of failures and their remedies

- **Macroeconomic failures:** macro disequilibria → cyclical and/or chaotic and/or chronic → **remedies:** **macro-policies** (fiscal and/or monetary) chosen by the **executive** (e.g. austerity or QE)
- **Microeconomic failures** → inefficient individual behaviors → **inefficient IF** = hindering efficient behaviors and/or rewarding inefficient behaviors → **remedies: institutional reforms** chosen by the **legislature** (e.g. more or less free markets, more or less of government control)

Both failures are critical and analysis of both needs Economic IE:
institutional reforms obviously; macro-policies for estimating their effectiveness, possibly much spoiled by **IF-inefficiencies** (e.g. well-known by IMF)

5 - THE NEED OF ECONOMIC IE FOR TWO EXTENSIONS: ADMITTING UNEQUALLY RATIONAL INDIVIDUALS, AND COMPREHENDING ECONOMIC CHANGE

Any theory, to **reliably** help, and not mislead, choices of actions in practice, must meet two necessary conditions:

- **No wishfulness about initial conditions:** no condition on which the success of the actions depends may be assumed more favorable than it is; if uncertain, it must prudently be assumed less favorable
- **Comprehensiveness of predictions:** the actions' consequences must be predicted comprehensively enough not to omit any undesirable side-effects

These conditions may never be fully met, but theories for practical applications must strive to meet them, keep repairing emerging failures

Economic IE: its actual state and its need for extensions

Today's Economic IE frequently fails to meet both these conditions:

- **No Wishfulness Condition** – when adopting the perfect rationality assumption: many policies may appear successful under it, and crash in the real world of **boundedly rational individuals**
- **Comprehensiveness Condition** – when not paying enough attention to economic change: policies successful in the short run may seriously harm **ON-development** in the long run

Economic IE, to help and not mislead analysis of economic policies:

- must admit unequally rational individuals (Pelikan 2007, 2010)
- must deepen its understanding of economic change (Pelikan 2011)

The IF's effects: from the known to the extensions

The **IF → performance effects**: multiple more or less long channels

The so far best known:

- through transaction costs and other incentives (e.g. property rights)
- through the availability of information (e.g. its asymmetries)

The two extensions:

- through dealing with unequally rational individuals
- through shaping of economic change

Note: the channels are partly overlapping: e.g. economic change also depends on transaction costs, but far from only on them

Admitting unequally rational (competent, talented) individuals:

A step beyond Simon, Kahneman and Tversky → admit human rationality not only bounded, but moreover unequally so → becomes a scarce resource in need of efficient allocation (Pelikan 2007, 2010)

The importance of admitting bounded rationality

Efficient incentives and available information may not suffice if the decisionmakers' rationality is too bounded → the need to admit it → IF needs to cope with it

The importance of admitting unequally bounded rationality:

Only some may suit the top jobs in an efficient **ON**, while many err in complex consumer choices → IF needs to cope with both

Unequally bounded rationality → the main challenges for IFs

- **In production:** keep selecting some of the best for the tops of organizations (e.g. entrepreneurs, investors, managers); resist competence-difficulty gaps by adjusting job-designing to job-assigning
- **In final consumption:** protect little-rational individuals from harming themselves and/or others by incompetent consumer choices
- **In policymaking:** keep policy instruments simple enough not to overtax the policymakers' relevant rationality, and thus avoid the particularly costly government competence-difficulty gaps →

Cf. J.S. Mill (1861) in Considerations on Representative Government:

“The positive evils and dangers of the representative, as of every other form of government, may be reduced to two heads:

first, general ignorance and incapacity, or, to speak more moderately, insufficient mental qualifications, in the controlling body;

secondly, the danger of its being under the influence of interests not identical with the general welfare of the community.”

Different views of government in a nutshell:

J.S. Mill: admits Low Relevant Rationality & Selfish Motivations

Classical economists: assume High-RR & Pro-Social-M (naïve)

Public Choice: assumes High-RR & expects Selfish-M (cynical?)

Unequally Bounded R: Low-RR, but the benefit of the doubt about M

Comparing IFs for their dealing with unequally bounded rationality: some preliminary results (Pelikan 2007, 2010)

Top decisionmaking in production:

- The IFs allowing markets and protecting market competition → the potential to converge towards selecting some of the best – faster with financial markets than without, and with LFT than with HFT (!)
- The IFs using government selection likely to stagnate slightly above-the-average (far from the worse and far from the best)

Decisionmaking in final consumption:

- Advantage to mildly paternalistic IFs: governments' slightly above-the-average relevant rationality → the potential to help a majority of consumers (strengthens Thaler and Sunstein)

Comprehending processes of economic change:

A step beyond Schumpeter: from “creative destruction” in standard capitalism to other types of **IFs** (Pelikan 2003, 2011)

The importance of comprehending economic change:

- Adaptive efficiency of **ON**-development is more important than static efficiency of resource-allocation → the need for **IF** that can make and keep **ON**-development adaptively efficient
- Even the most excellent **IF** cannot be implemented by policy without respecting the principles of, and the constraints upon, **IF**-evolution

Economic change → the main challenges for IFs

Unknown future → both ON-development and IF-evolution need variation & selection (“trial & error”), but:

- the **ON**-developmental selection (e.g. market selection) is endogenous, shaped by the **IF** = not “natural”
- the **IF**-evolutionary selection is exogenous: natural & economic environments require static & adaptive efficiency; socio-cultural environment requires limited inequalities

To succeed in evolution, each **IF** needs a doubly efficient ON → must shape **ON**-development accordingly → must allow & encourage large variety of trials & rapid correction or elimination of errors

Comparing IFs for their dealing with economic change: some preliminary results (Pelikan 1988, 2003, 2011)

- Some capitalist IFs that admit private and tradable ownership of capital outperform all of the non-capitalist IFs that require this ownership to be collectivist (government, compulsory cooperatives)
→ why: more entrepreneurial trials & faster correction of errors
- But a capitalist IF may fail:
 - If ON-development allows “too big” firms → fewer entrepreneurial trials & slower correction of errors → loss of adaptive efficiency
 - If economic inequalities exceed the sociocultural tolerance limits

Link to rationality-allocation: ON-development proceeds by tentative job-designing & job-assigning = allocates unequally bounded rationality!

Extra attention

- **Adaptive efficiency** → markets are less self-correcting in **ON**-development than in resource-allocation → more market failures (e.g. too-big-to-fail firms) → more demand for government policies ... **BUT:**
- **Unequally bounded rationality** → more government failures → fewer instruments that government can handle without doing more harm than good → cannot play industrial or financial champions, but may, and may have to, help markets keep selecting them

6 – THE EXTENDED ECONOMIC IE: MAIN IMPLICATIONS FOR ANALYSIS OF ECONOMIC POLICIES, WITH NEW ANSWERS TO FOUR OLD POLICY ISSUES

Extended Economic IE → more problems for analysis of economic policies:

Choices of policy objectives: the equality-efficiency tradeoff enlarged by adaptive efficiency; the redistribution problem enlarged by the side-effects on rationality-allocation qua **ON-development**

Choices of policy means: longer checklists for the causes of failures and the effects of proposed policies: (1) macro-variables → (2) property rights → (3) incentives → (4) information → (5) **job-assignment** → (6) **job-design**

- Problems (2) to (4) → basic Economic IE
- Problems (5) & (6) → Extended Economic IE → competence-difficulty gaps → rationality-allocation by **ON-development** (NB: includes the design of executive policy instruments)

Example 1: the sustainability of socialist IFs

Classical arguments: focus on allocative efficiency = on providing assumedly top performing production units (firms) with sufficient information and incentives – e.g. by incentive-compatible and informationally-decentralized planning

The extended Economic IE: focus on ON-development = on how to make and keep the **ON** populated by top performing firms, in the face of variable environments, requiring production of, and adaptation to, many kinds of innovations

→ in ON-development: no one knows for sure *what* is right and *who* is right → need for trial-and-error → without financial markets for private and tradable ownership of capital (excluded from all socialist **IFs**), both fewer entrepreneurial “trials” and less rigorous correction of wasteful “errors”

→ All socialist IFs are bound to suffer from less developed and less adaptable ON
→ sooner or later bound to fail (e.g. the enormous productivity differences between East German and West German firms in 1990)

Example 2: Selective industrial policies

Frequent argument: selection by product markets is too slow, prevents future winners to grow fast enough, and allows future losers to keep wasting resources too long → the need for industrial policy, to accelerate the growth of the winners and the exit of the losers.

The extended Economic IE: distinguishing future winners from future losers is not easy → no one can do it perfectly, but politically selected industrial policymakers are likely to do it less well than private investors (“risk-capitalists”) selected by competitive financial markets.

→ **the best policymakers can do:** make and keep financial markets competitive enough to keep selecting the right investors

Example 3: The social efficiency of very large firms

Classical argument: hostility to large firms because of the welfare losses due to their expected over-pricing

Transaction-costs argument: more hospitality, large firms defended if such losses are over-compensated by their savings on transaction costs

The extended Economic IE: back to more hostility – “too big to fail” firms harm **ON**-development by hindering market competition and selection, hiding inside their possibly growing competence-difficulty gaps, and sending the bills for their errors to the taxpayers

Example 4: Government regulations of the financial sector

Classical view: financial markets = efficient devices for allocating investment

The extended Economic IE: the financial markets are moreover devices for selecting the investors, and may not be efficient:

- The selection may be hindered by financial firms grown “too-big-to-fail,” able to hide and protect their possibly growing competence-difficulty gaps
- The incentives and selection criteria may be disconnected from social efficiency, rewarding and promoting socially less valuable investors – e.g., high-frequency traders rather than fundamental investors
- Government not competent enough to meddle into details of investment banking, but may split too large banks, and redress incentives and selection criteria by a small FTT (“to calm the rich, not help the poor ...”)

Summing up: how the Extended Economic IE can improve analysis of economic policies

- **Extends the analysis to include deep, non-cyclical crises:** if the macroeconomic “austerity vs. QE” controversy is sterile → basic Economic IE (= property rights, incentives, information), if this fails → Extended Economic IE (UBR-allocation, **ON**-development)
- **Prevents theoretical models of policy optimization from misleading practical policymaking:** drops the models’ idealizing assumptions, admits the true incentives, information, and rationality bounds of both the policymakers and the market participants, and takes into account the long-term effects on **ON**-development

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