

A Comprehensive Conceptual Model for Analytical Institutional Economics

Pavel Pelikan

Department of Institutional, Environmental and Experimental Economics

University of Economics, Prague

The outline

- 1) Introduction: Analytical Institutional Economics (AIE) as the most directly applicable branch of Institutional Economic, but still in need of conceptual precision and a clear overview
- 2) Providing AIE with a solid conceptual basis: the IF-ON model
- 3) Refinement 1: Distinguishing types of institutional rules and frameworks
- 4) Refinement 2: Distinguishing layers of economic change and classifying economic analyses
- 5) How the IF-ON model brings together North, Williamson, and Acemoglu, Johnson and Robinson
- 6) A few lessons for comparative economics and analysis of economic policies
- 7) For interested economists only: how the IF-ON model leads to Generalized Darwinism and to the Mecca of Alfred Marshall

1) Introduction: Analytical Institutional Economics (AIE) and its two weaknesses

- IE: long history, now a rapidly growing and ramifying field
- Two weaknesses:
 - vagueness or ambiguity of some of the basic concepts
 - fragmentation: different specialized studies but no overall view
- The aim of this paper: to diminish these weaknesses for one special branch of IE, defined as Analytical IE (AIE), by means of a comprehensive conceptual model

Identifying AIE

Definition 1: an economy's institutional framework (IF) = all of its institutional rules, both formal and informal

NB: no use for the word 'institutions' - found irremediably ambiguous!

Three questions about IFs:

Q1: What are the effects of different **IFs** on economies?

Q2: How do **IFs** evolve?

Q3: How can the **IF**-evolution be influenced by policy?

Definition 2: **AIE** = all analyses seeking to answer at least some part of some of these questions

(**AIE** leaves aside critical, ontological, taxonomical and philosophical essays, but overlaps with Law and Economics, and Constitutional Economics)

2) Providing AIE with a solid conceptual basis: the IF-ON model

- Standard core: an economy = a collection of acting and interacting individuals, each pursuing certain objectives with certain rationality
- Less standard: the objectives may be changing & be partly altruistic; the rationality is unequally bounded across the individuals

Definition 3: An economy's Organizational Network (ON) = the collection of all of its markets and organizations, both private and governmental, with their individuals and their interconnections

Admitting unequally bounded rationality (competence, talents):

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

Why unequally bounded rationality cannot be ignored:

- Efficient incentives and available information may not suffice if rationality is bounded
 - Only some individuals may suit the top jobs in an efficient **ON**
 - Many may harm themselves and/or others by wrong consumer choices
- Solutions by **IF**, not by individuals (their rationality?)

The IF-ON model: the main chains of effects

- The actual **IF** → shapes the individuals' behaviors → they form & operate the **ON** → makes the economy perform → the actual output
- the actual output → the political support of the formal **IF** → withdrawn if government finds it too low and/or unacceptably distributed → a reform of the formal IF by legislation
- the effective new **IF** depends on the formal reform & the underlying informal IF
- the informal **IF** changes “spontaneously” by socio-cultural innovators and imitators, possibly influenced by the formal **IF** (but how?)

3) Refinement 1: distinguishing types of institutional rules and frameworks

Distinction A: an economy's IF vs. its organizations' internal IFs

- If the **ON** contains organizations → need to distinguish the overall econ-**IF** from the internal org-**IF** of each organization:

the econ-**IF** constrains the choices of the org-**IF** (e.g., corporate law constrains the forms of corporate governance, may even determine)

Distinction B: market-IF vs. executive government-IF

- **ON** with executive government → distinguish gvt-IF from mrkt-IF

the gvt-**IF** delimits the government economic agenda = allowed policy instruments with limits of their uses (from zero in a perfect laissez-faire, to all economic decisions in a fully command economy)

4) Refinement 2: Distinguishing layers of economic change and classifying economic analyses

Layers of economic change:

- (I) Resource-allocation – production, transactions and consumption – within a **given ON**, and a **given IF**
- (II) Development of ON – entry, growth or exit of firms; changes of technologies; opening and closing of markets; growth or shrinking of government within a **given IF**
- (III) Evolution of IF – changes of formal institutional rules by known legislators and/or judges & changes of informal institutional rules by anonymous sociocultural innovators and imitators

→ classification of economic analyses

- Analysis of (I) = institutional and organizational statics (most of standard analysis)
- Analysis of (II) = institutional statics with organizational dynamics (e.g., developmental analysis, Schumpeter's creative destruction)
- Analysis of (III) = institutional dynamics, evolutionary economics proper

NB: economic development distinguished from economic evolution
(→ Schumpeterian economics is developmental, not evolutionary)

5) How the IF-ON model brings together North, Williamson, and Acemoglu, Johnson and Robinson

- North mainly about econ-**IFs**: performance and growth of economies
- Williamson mainly on org-**IFs**: sizes of firms and corporate governance

Main link: econ-**IFs** constrain both the sizes of firms and their org-**IF**

Both belong to economic AIE: economic IFs → economic behaviors → the economy's performance (via incentives, esp. transaction costs)

- Acemoglu, Johnson and Robinson belong to political AIE: political IFs → political behaviors → the choice of the government → its choice of the economic IF → the economy's performance

The same end, but differently remote beginnings: political AIE includes economic AIE

Which AIE can help with what?

Political AIE → how to choose the government? → which political **IF**?

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

Economic AIE → how can government help the economy perform → which formal economic **IF**?

NB: Helping the government choose this **IF**, and the citizens critically evaluate it, is purely a matter of **Economic** (and not Political) **AIE**

But: what does economic **AIE** actually know? and what of this is known to the government?

→ Difficulties of Political AIE with accomodating Economic AIE

Acemoglu et al. (2005) : “Economic institutions determine the incentives of and the constraints on economic actors, and shape economic outcomes. As such, they are social decisions, chosen for their consequences.”

But 1: Economic “institutions” (= **IF**) are not simple decisions, but outcomes of a complex evolutionary process, only partly influenceable by policies

But 2: The consequences of policies may only be believed, but the belief may be mor or less wrong: depends on the state of the art of the Economic AIE and the knowledge of this knowleded by governments → assuming the consequences known makes Economic AIE jobless!

E.g.: Ignorant democratic governments that ruined their economy, and enlightened authoritarian rulers who helped → political democracy need not cause economic growth – contrary to the popular hypothesis of Political AIE

6) A few lessons for comparative economics and policy analysis

The main departure from standard analysis:

- An economy's **ON** is not an exogenous constant, possible to assume ideal (e.g., with perfect firms), but a variable depending on the IF
- For evolutionary sustainability, the **IFs'** effects of **ON**-development are much more important than their effects on resource-allocation within a given **ON**
- Given inevitable uncertainties, **ON**-development must proceed by trials-and-errors → the relevant rules of the **IF** influence the variety of possible entrepreneurial trials & the strictness of the correction or elimination of errors, including c-d gaps

Lessons for comparative economics

- The 'species' of economies (e.g., types of capitalism, socialism, welfarism) can more precisely be classified by their relatively more stable **IF** than by their endogenously changing **ON**
- Compare **IFs** not only for their effects on resource-allocation within an idealized **ON** (e.g., plan vs. markets), but also and above for their effects on **ON**-development, through the conditions of both entry and exit, including the defenses against c-d gaps (e.g., compare socialist vs. private ownership of capital)

Important case: The Final Answer to the Socialist Controversy

- for resource-allocation: plan can be as efficient as markets
- for **ON**-development: private and tradeable ownership of production capital is doubly superior to all forms of socialist ownership

Compelling empirical illustration: unification of German economies

- easy to replace plan by markets
- difficult to bring into being high quality firms: compared to West German firms, the East German ones developed into much larger sizes (in average more than 10x) and much lower productivity (< 25%)

Lessons for analysis of economic policies

For institutional policies (= legislation modifying the **IF**)

- Create and protect favorable conditions for entrepreneurial trials
 - Create and protect strict selection of socially efficient successes, and forceful correction or elimination of socially wasteful errors, including costly competence-difficulty gaps, including the government ones
- both may require antitrust, better approximate than none

For executive policies (= uses of policy instruments defined by the **IF**)

- Attention to their effects on **ON**-development (“adaptive efficiency”)
- Do not blindly optimize of the use of any policy instrument, without first checking its safety = its c-d gaps? its scope for corruption?

Example 1: 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 help the growth of the winners and the exit of the losers.

AIE/ON-development argument: 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.

→ Most promising policy: make and keep financial markets competitive enough to keep selecting the right investors (“industrial policymakers”)

Example 2: The social efficiency of very large firms

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

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

AIE/ON-development argument: 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

→ Most promising policies: antitrust slowing down M&A, cutting down too large firms – even only roughly, and not optimally

Example 3: Government regulations of the financial sector

Classical view: financial markets = efficient devices for allocating investment

AIE/ON-development argument: the financial markets are moreover devices for selecting the investors, and may not be efficient:

- The selection hindered by financial firms grown “too-big-to-fail,” allowed to grow inefficient, while hiding and protecting their internal c-d gaps
- The incentives and selection criteria may be disconnected from social efficiency, rewarding and selecting for socially less valuable investing – e.g., high-frequency trading rather than fundamental investing
- Government not competent enough for details of investment banking,
→ Most promising policies: antitrust for banks, and redressing incentives and selection criteria by a small FTT (“to calm the rich, not help the poor ...”)

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: warns against Low Relevant Rationality & Selfish Motivations

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

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

Unequally Bounded R: recognizes Low-RR, admits Pro-Social-M (diplomatic?)

7) For interested economists only: from the IF-ON model to Generalized Darwinism, and to the Mecca of Alfred Marshall

- the IF-ON model logically corresponds to the genotype-phenotype model of evolutionary biology → both are special cases of Generalized Darwinism:
 - Instructed self-organizing of basic interactors (molecules, individuals) that form and develop complex interactors (phenotypes, economic organizations) → generalized ontogenesis
 - imperfectly informed trial-and-error search (variation & selection) for the instructions (genomes, IFs) that can make the complex interactors evolutionarily successful → generalized phylogenesis
- But many quantitative differences: in relative speeds, in number of trials
→ The IF-ON model is a promising means for attaining the Mecca of Alfred Marshall: building economics as a biological science

Basic references

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