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

1 Introduction: two intertwined aims
2 Analysis of economic policies: its tasks and its users
3 Streamlining IE for analysis of economic policies: Economic IE based on the IF-ON conceptual model
4 The need of analysis of economic policies for Economic IE
5 The need of Economic IE for two extensions: admitting unequally rational individuals, and comprehending economic change
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 $\rightarrow$ performance’ effects, but:

- **Economic IE**: from economic IFs (e.g. market vs. government) $\rightarrow$ the behaviors of people as economic agents $\rightarrow$ the **performance**

- **Political IE** from political IFs (e.g. democracy vs. dictatorship) $\rightarrow$ the behaviors of people as political agents $\rightarrow$ the government with policy objectives (e.g. inclusive or extractive) $\rightarrow$ the economic IF ... $\rightarrow$ the behaviors of people as economic agents $\rightarrow$ 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 ↔ 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
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 effectivity, possibly much spoiled by IF-inefficiencies (e.g. well-known by IMF)
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 \(\rightarrow\) admit human rationality not only bounded, but moreover unequally so \(\rightarrow\) 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 \(\rightarrow\) the need to admit it \(\rightarrow\) **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 \(\rightarrow\) **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-desiging 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 \(\rightarrow\) 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 \(\rightarrow\) 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 \(\rightarrow\) 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-desiging & job-assigning = allocates unequally bounded rationality!
Extra attention

- **Adaptive efficiency** $\rightarrow$ markets are **less self-correcting** in ON-development than in resource-allocation $\rightarrow$ **more market failures** (e.g. too-big-to-fail firms) $\rightarrow$ **more demand for government policies** ... **BUT:**

- **Unequally bounded rationality** $\rightarrow$ **more government failures** $\rightarrow$ fewer instruments that government can handle without doing more harm than good $\rightarrow$ **cannot play industrial or financial champions**, but **may, and may have to, help markets keep selecting them**
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
Basic references


