

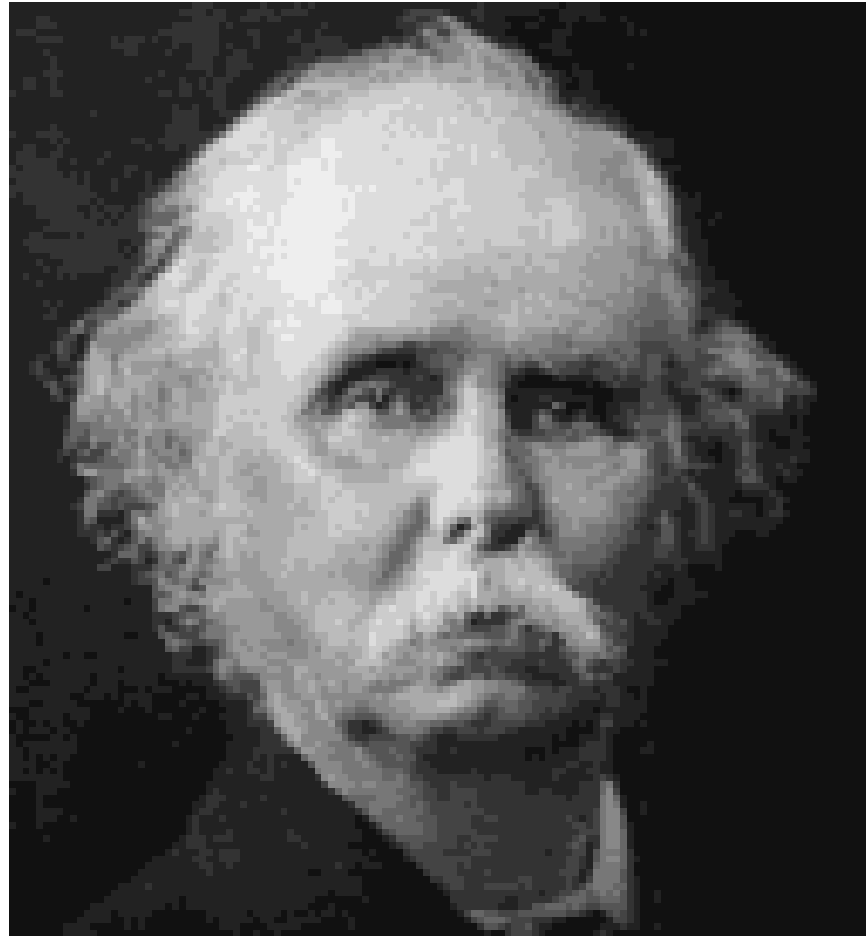
7. lecture

Neoclassical economics

Neoclassical economics (1890s – 1930s)

- Two founders of neoclassical economics:
- Alfred Marshall (1842-1924), *Principles of economics*, 1890
- Leon Walras (1834-1910), *Elements of pure economics*, 1874

Alfred Marshall (1842-1924)



Alfred Marshall

- Father of modern orthodox microeconomic theory (neoclassicism) along with L. Walras
 - Structural basis of undergraduate economic theory (Walras more adequate for graduate classes)
 - Translated Ricardo and J.S. Mill economics into mathematics

Alfred Marshall's approach

- Marshall – inclined to give balanced judgements and therefore perceived often as vague, indecisive or imprecise.
- Marshall's views on the proper subject of economics
 1. responsible for introduction of 'economics' in place of 'political economy'
 2. economics is „*a study of mankind in the ordinary business of life; it examines that part of individual and social action which is most closely connected with the attainment and with the use of the material requisites of wellbeing. Thus it is on one side a study of wealth; and on the other, and more important side, a part of the study of man*”
 3. elimination of poverty is the ultimate task of economists

Marshall's views on the methodology of economics

- The right method is the proper combination of mathematical theory and historical analysis.
- Views on the use of mathematics:

"I have a growing feeling that a mathematical theorem dealing with economic hypotheses is very unlikely to be good economics, and I go more and more on the following rules -

1) Use mathematics as a shorthand language rather than as an engine of inquiry.

2) Keep to them until you have done.

3) Translate into English.

4) Then illustrate with examples that are important in real life.

5) Burn the mathematics.

6) If you don't succeed in 4, burn 3. This last I often do."

Reasons for the supposed 'indecisiveness' of Marshall's economics

-
- The study of the economy is very difficult, because:
 - the economy is very complex, everything seems to depend upon everything else – complex and subtle relationships between variables
 - time is extremely important in economic analysis: it takes time to work out full effects of economic causes
- This explains also why he was cautious with respect to the use of mathematics in economics

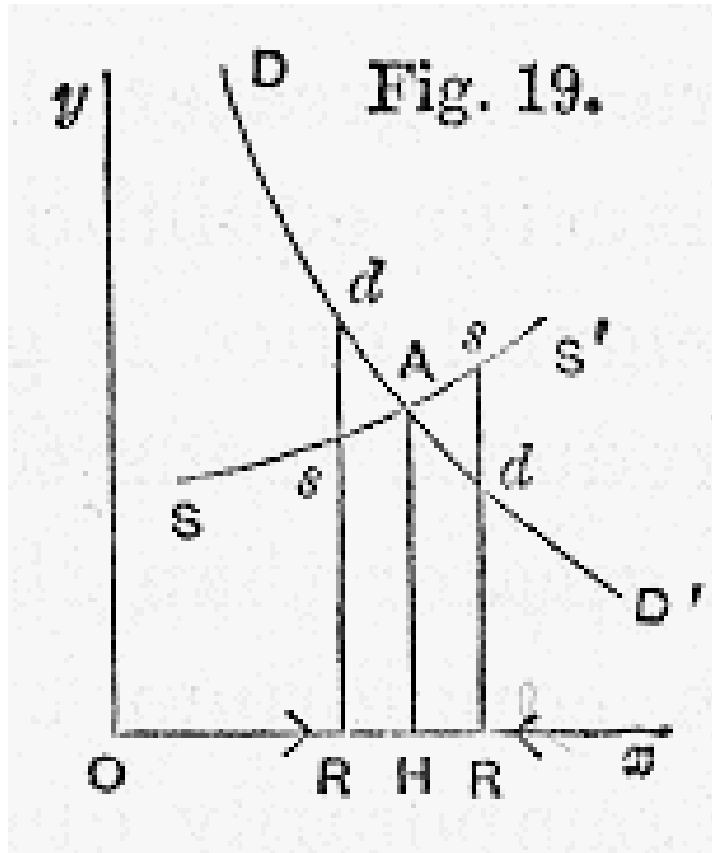
Marshall's approach

- To cope with those problems developed a method called partial equilibrium analysis.
- To solve a complex problem you have to isolate a part of the economy for analysis, ignoring but not denying the interdependence of all parts of the economy.
- It provides a first, inexact but valuable approximation of the likely effects of a given economic cause.
- Marshall's procedure – start in a very narrow partial equilibrium framework and later broaden the scope of analysis slowly and carefully by including more and more markets.
- Example: explaining demand for orange juice

Marshall on the equilibrium concept

- *When demand and supply are in stable equilibrium, if any accident should move the scale of production from its equilibrium position, there will be instantly brought into play forces tending to push it back to that position; just as, if a stone hanging by a string is displaced from its equilibrium position, the force of gravity will at once tend to bring it back to its equilibrium position. The movements of the scale of production about its position of equilibrium will be of a somewhat similar kind*
- *But in real life such oscillations are seldom as rhythmical as those of a stone hanging freely from a string; the comparison would be more exact if the string were supposed to hang in the troubled waters of a mill-race, whose stream was at one time allowed to flow freely, and at another partially cut off. Nor are these complexities sufficient to illustrate all the disturbances with which the economist and the merchant alike are forced to concern themselves. If the person holding the string swings his hand with movements partly rhythmical and partly arbitrary, the illustration will not outrun the difficulties of some very real and practical problems of value. For indeed the demand and supply schedules do not in practice remain unchanged for a long time together, but are constantly being changed; and every change in them alters the equilibrium amount and the equilibrium price, and thus gives new positions to the centres about which the amount and the price tend to oscillate.*

Market equilibrium according to Marshall



Marshall on time in economics

- To cope with the problem of time in economic analysis Marshall defined four time periods:
 - Market period - the amount of time for which the supply of a commodity is fixed.
 - Short period (or short run) - is the time in which the supply can be increased by adding labor and other inputs but not by changing factory size or building another factory.
 - Long period (long run) – here the factory size can vary, can be changed (all factors of production are variable).
 - Secular period – permits technology or population changes.

Marshall on exchange value (price)

- Before Marshall we had the controversy between the classical economists and the marginalists concerning the relative importance of demand and supply in value theory.
- Classical economists - supply determines value,
- Marginalists - demand is the most important factor explaining values and prices.
- Marshall believed that this controversy can only be resolved if we correctly understand the interdependence of economic variables and the influence of time in the economy.

Marshall's theory of value

- **Marshall maintained that in general case marginal utility, cost of production and value or price of a commodity are interdependent and are mutual causes of each other.**
- There is no single cause for price or value of a commodity.
- Marginal utility, cost of production and price of a good mutually determine their values at the equilibrium point in market.

Other contributions of Marshall to microeconomics

- 1) introduced the concept of price elasticity of demand (a kereslet árrugalmassága)

A kereslet árrugalmassága azt méri, hogy a termék iránti kereslet mennyire érzékeny az ár változásaira.

- 2) Popularized the concept of consumer's surplus (fogyasztói többlet)

Egy [jószág](#) megvásárlásakor fellépő *nettó fogyasztói többlet* – vagy egyszerűen fogyasztói többlet – annak a maximális [pénzösszegnek](#), amit a vásárló ([fogyasztó](#)) a jószágért még éppen hajlandó megfizetni, valamint a jószág tényleges vételárának a különbsége.

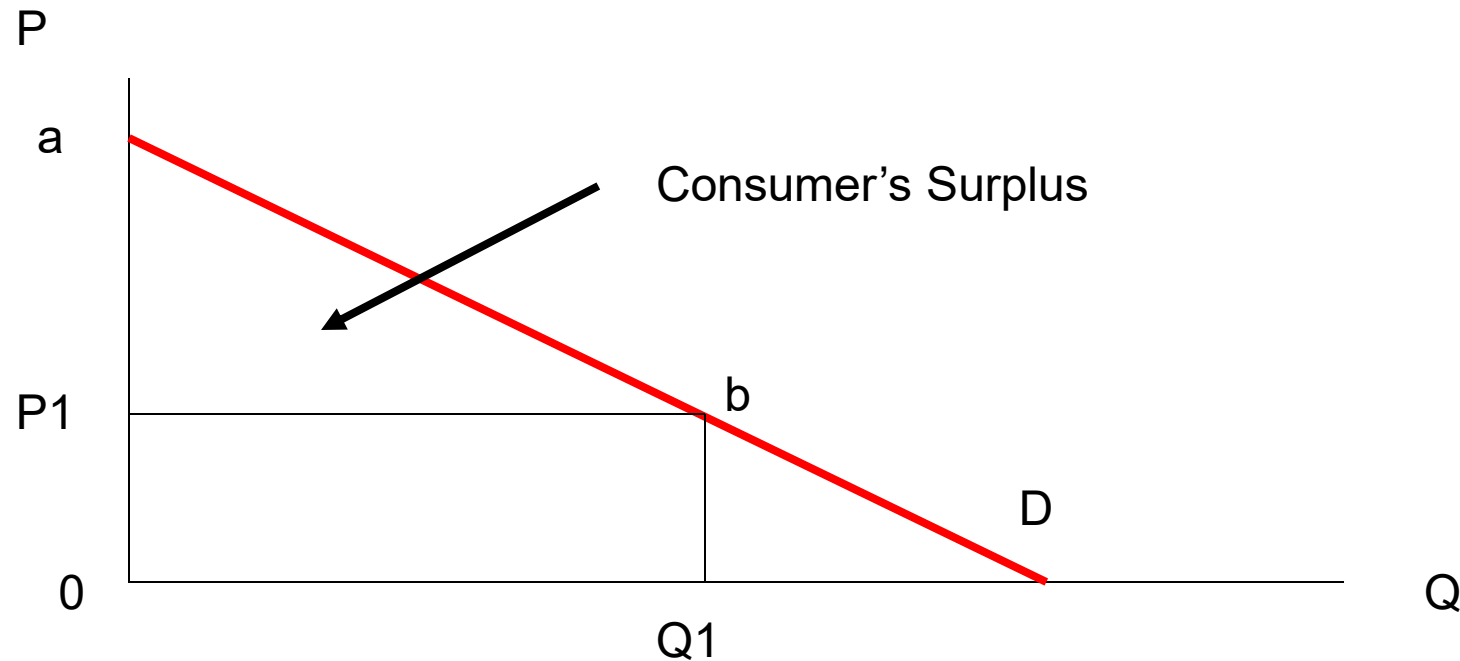
Elasticity of demand

- Marshall invented the elasticity as a measure of the responsiveness of demand to changes in price
- Percentage or proportional change in Q demanded divided by the percentage or proportional change in P
- Unit free measure of responsiveness
- Elasticity and relationship to total expenditure on the good (E is maximized when $E_p = -1$)

Consumer's surplus

- Demand curve shows that consumer is willing to pay more for the first few units of a good than for subsequent units
- If the consumer pays a single price for all units bought (market price) then the total willingness to pay for those units will exceed the amount actually paid
- This is consumer's surplus

Consumer's surplus



Total willingness to pay for Q1 = $0abQ1$

Amount actually paid = 0P1bQ1

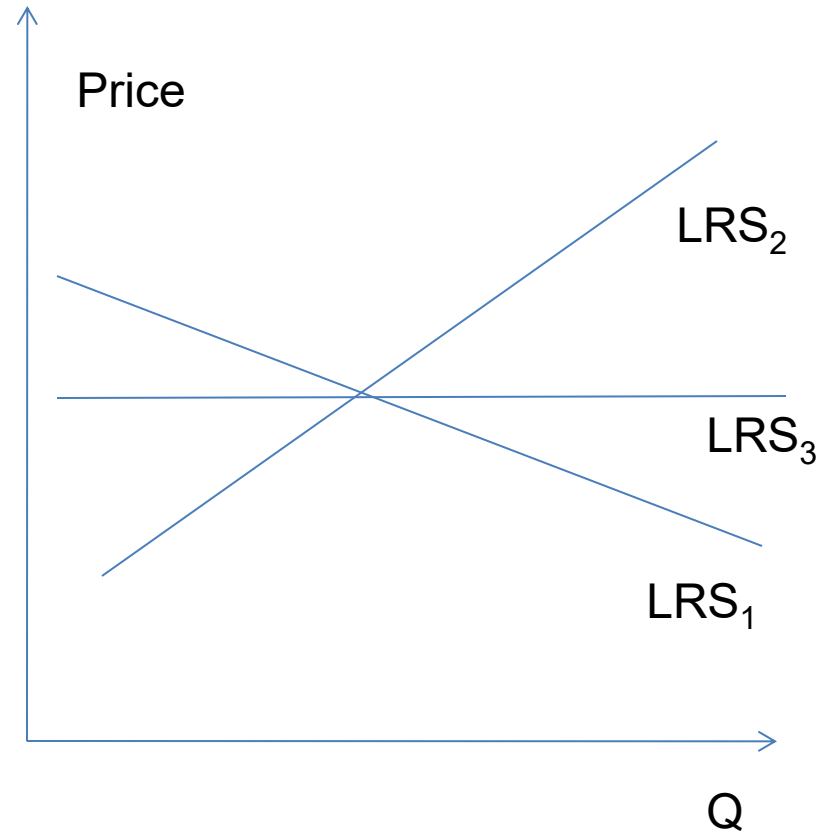
Consumer's surplus = $P1ab$

Marshall on production in the long-run

- In the long run firms can change scale (all factors are variable= and the size of the industry can change)
- Marshall thinks in terms of the costs of the representative firm (access to average technology)
- In long run equilibrium the representative firm must be at least covering total costs (fixed and variable) – no loss
- If the representative firm is not covering total cost the industry will shrink in size
- If the representative firm industry is more than normally profitable the industry will grow in size

Marshall on production in the long-run

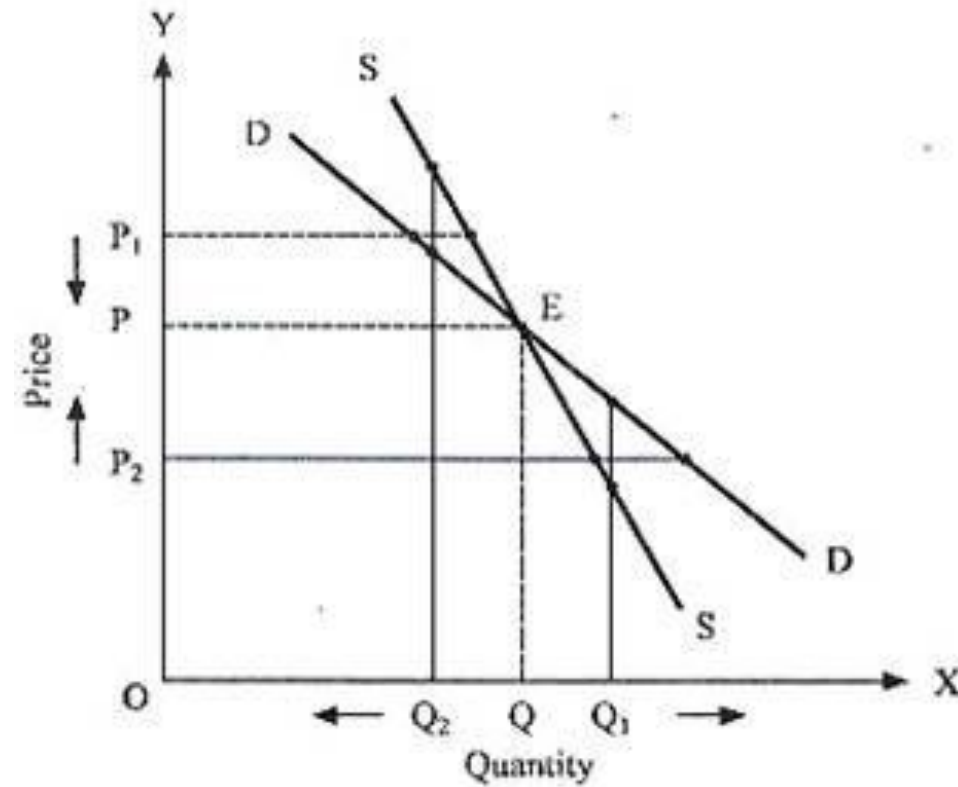
- Internal vs external economies of scale
- What happens to the costs of a representative firm as the industry changes in size?
- In industries where *external economies* dominate *external diseconomies*, growth in industry size will lower the costs of all firms
- Long run industry supply curve will be downward sloping (decreasing cost industry) (can result in an unstable market) (LRS_1)
- If external diseconomies dominate, industry growth raises costs for all firms
- Long run industry supply curve will be upward sloping (increasing cost industry) (LRS_2)
- If external economies and diseconomies just cancel each other out : LRS_3



Marshall on production in the long-run

- Marshall thought that most industries other than natural resource industries had declining long run costs
- That is external economies dominate external diseconomies
- What might these external economies consist of?
- Close localization of firms in a industry might cause them to share their ideas about production and management.
- It also brings cost-saving subsidiary industries – leányvállalatok - (that deliver intermediate products for the industry)
- and skilled labor has the incentive to locate in the area.

Marshall's unstable equilibrium



Marshall on macroeconomics

- Accepted that capitalism is stable on the macro level - the depressions are not very deep and long-lasting – so he accepted the Say's Law.
- But of course, temporary economic fluctuations did happen in capitalism in Marshall's times and he explained them with the reference to the notion of business confidence.
- In the boom, when the production is increasing, business confidence is high and credit expands rapidly, during the depression business becomes pessimistic and credit rapidly contracts.

Marshall on macroeconomics

- Marshall suggested that to avoid depressions and unemployment you should do two things.
- Control credit markets, so that credit is not over-expanded in period of rising business confidence because it may lead to depressions;
- In depressions, the government can help restore business confidence by guaranteeing firms against risks.

Summary of Marshall's economics

- Father of modern orthodox microeconomic theory (neoclassicism) along with Leon Walras
- Initiated not just modern economics but THE PROFESSION:
 - Students: J.M. Keynes and Joan Robinson
 - Contributed to the institutional foundation of economics (resources, departments, etc.)
 - Textbook legacy

Max Weber (1864 – 1920)

- The big problem:
 - What caused the rise of capitalism in early 19th century England?
 - Proximate causes of growth & development (i.e. capital – A. Smith) and deep/fundamental/ultimate causes



Weber's main arguments

- The big problem:
 - What caused the rise of capitalism? (With its rapid economic growth, global poverty reduction, huge rise in the standard of living)
 - Why Industrial Revolution happened in Britain and not China, or Poland, or France?
 - Was capitalism caused by economic factors?
 - Natural resources richness (coal)
 - Shortage of labour that caused relatively high wages in England, which led to more innovation (replacing labor)
 - High level of human capital
 - Or maybe the causes of capitalism rise were non-economic, for example, cultural, religious, etc.
 - Weber's main thesis: **capitalism has religious and cultural origins**
 - Heavily broadens and deepens the economic analysis

Weber's argument

- Capitalism developed because the Protestant (especially Puritan) ethics became popular in England and made a large number of people to behave in a capitalist way (profit-seeking is ethically good and even desired by God)
- So capitalism is unplanned effect of the Protestant Revolution
- A big change in the world of ideas/values/preferences caused (partially?) a big change in the (material) economic world
- Weber was vague on whether Protestant ethics was the only cause of the rise of capitalism, or if it was one among many other causes
- Weber contra Marx's historical materialism

What was the Reformation (or Protestant Revolution)?

- A schism in Western Christianity in 16th century Europe
- Martin Luther (1517), John Calvin and others
- Causes?
- Dissatisfaction with the hierarchical structure of Roman Catholic Church (power of the Pope) and the Catholic Doctrine (sale of indulgences, belief that salvation comes from following the Church's authority, etc.)
- The lower classes were unhappy about the enormous wealth of the Church, and its perceived corruption (buying your way into salvation)
- The rich were jealous of the power and influence that the Pope and clergy held in society

Major elements of Puritan/Calvinist ethics

- Doctrine of predestination – your salvation is already decided by God
- God's will can not be known or interpreted by priests
- Purpose of this-world activities is to serve God diligently
- To convince yourself and others that you are selected you need to work hard, be successful, etc.
- Idea of the calling – work hard in a calling/a vocation, job for which you were chosen by God; frequent changes of jobs are suspect or wrong
- Financial success is a sign of being chosen for salvation (megváltás)
- It's good to be rich, but you should spend little. Asceticism should be practiced, restricting consumption, saving is good, self-control, avoiding distractions from work, luxury, etc.
- Are these claims present in the doctrines of Roman Catholicism or in other religions?
- How these religious guidelines translate into economic advantages?

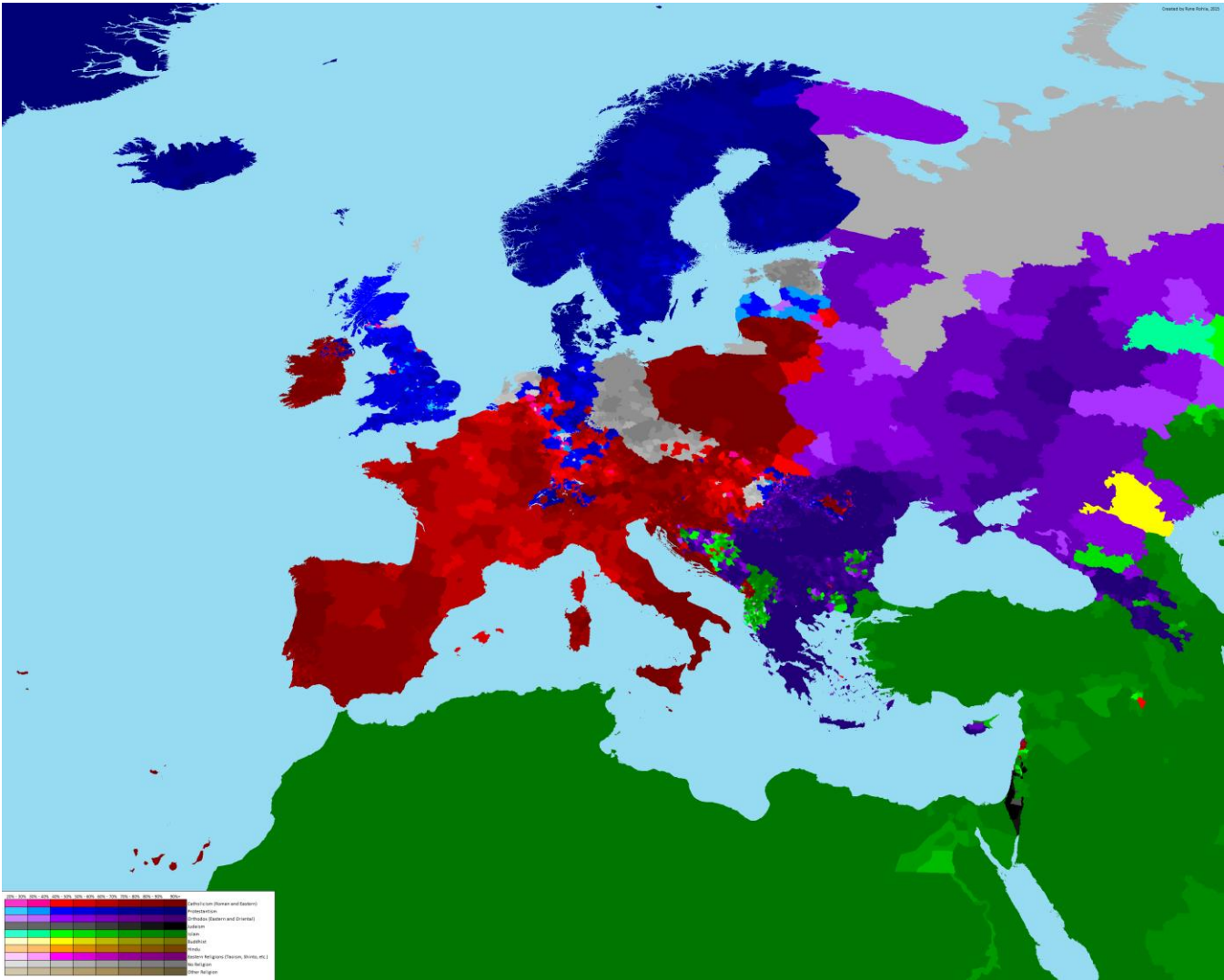
Weber's argument in economic language

- Working hard => longer working hours
- Idea of a calling/vocation => labor specialization, more division of labor => higher productivity of labor
- Asceticism = > higher savings, more capital accumulated
- All contribute to higher economic growth according to classical economics' theory of growth (Adam Smith and others)

What is capitalism?

- Standard definition
- Markets as allocation and distribution mechanisms and...
- Accumulated stock of capital (sufficiently high)
- Weber's approach
- Capitalism = pursuit of profit by means of rational (calculating) behaviour
- "Spirit of capitalism" = 1) the calling to make more money as an end in itself, 2) working hard (work ethic) for its own sake as a sign of salvation; 3) being ascetic
- New psychological dispositions, attitudes, new set of values, motivated first religiously (Protestant Revolution), next secularized (internalized by more and more people in secularizing societies)

- Is Weber's theory correct?



Criticisms of Weber's thesis

based on Becker, S. O., Pfaff, S., & Rubin, J. (2016). Causes and consequences of the Protestant Reformation. *Explorations in Economic History*, 62, 1-25.

- Didn't capitalist institutions like banking and credit exist before the 16th century?
- They did since 15th century in Italy, southern Germany, and Flanders (Tawney 1926)
- Is it possible that relatively small savings obtained through ascetic way of living could generate huge capital needed for capitalist breakthrough?
- Not likely (Samuelsson 1957)
- Isn't it the case that long-run growth depends rather on innovation than on capital accumulation?
- Likely
- Is there any element of the Protestant religious doctrine that encourages innovation?
- Praising profit-seeking and being rich – maybe, but indirectly

Weber right, but for different reasons?

- Could Protestantism contribute not only to forced savings and capitalist work ethic but also to other growth-stimulating factors?
- How about human capital (education, experience, knowledge)?
- According to Becker and Woessmann (2009), Protestantism encouraged literacy, because Luther wanted all Christians to read the Bible
- With low literacy around 1500, Protestants needed to provide universal schooling in their areas
- Using data from all 452 counties in 1871 Prussia, Becker and Woessmann show higher literacy rates (and smaller gender gaps) where Protestant shares were higher.
- The raw difference in literacy rates between all-Protestant counties and all-Catholic counties is 8 percentage points - a substantial difference since in the average Prussian county literacy rates were 87.51%
- So it is possible that Weber was right, but the mechanism was different:
 - Reformation encouraged growth through human capital accumulation, not through capitalist work ethic or physical capital accumulation

The human capital approach as complementary to Weber's arguments

- However, that does not necessarily mean that a Weberian Protestant (work) ethic thesis is outright wrong.
- In fact, there is evidence for Germany and Switzerland, as well as from cross-country regressions, that Protestants:
 - work more hours,
 - have less of a preference for leisure
 - suffer more displeasure when they are unemployed,
- All of which are consistent with the idea that Protestants (want to) work harder.
- Also Protestants in Catholic-dominated regions are 5 percentage points more likely to be entrepreneurs than Catholics in Protestant-dominated areas.

Lessons

- Religion (or more broadly culture, ideology, etc.) can influence important long-run economic outcomes such as growth, human capital, entrepreneurship, work ethic
- It is not possible to understand long-run successes and failures of countries (or civilizations) without taking religion and culture into account
- Interesting to study now how various religion-related factors (secularization in the West, the rise of Islam) affect present-day economic outcomes – growth, propensity to innovate, etc.

7. practice

- [Every Major Economic Theory Explained in 20 Minutes](#)
- [SOCIOLOGY - Max Weber](#)
- [Karl Marx Versus Max Weber | Who is Right | Sociology](#)

Lecture 8.

John Maynard Keynes (1883-1946)

- No theory of business cycles in economics before Keynes
- One of the most important figures in the entire history of economics
- Revolutionized macroeconomic theory and practice of economic policy in the 20th century

John Maynard Keynes (1883-1946)

- Main work: *The General Theory of Employment, Interest and Money*, 1936
- Son of John Neville Keynes, British economist
- Educated at Cambridge
- Not only an economist, held several government posts; also engaged heavily in drama and literature

John Maynard Keynes (1883-1946)

- Invested in stocks privately – went from near bankruptcy in 1929 to the wealth of ca 13.5 million US dollars (current prices) in 1940s
- Policy-oriented economist
- Published two books on the economic consequences of peace and war
- Represented Britain at the peace conference after The First World War

John Maynard Keynes (1883-1946)

- In 1926 published *The end of laissez-faire*, in which he rejected Smith's vision of the invisible hand of markets.
- In 1944 contributed to the establishment of IMF and the World Bank
- In *General theory...* Keynes argued that classical and neoclassical macroeconomic theories are special cases in his more *general* framework.

Keynes's methodology in *General Theory*

- Avoided mathematics (worked in Marshallian tradition)
- Complex, ambiguous, imprecise work
- There are multiple interpretations of the *General theory*
- Here only a conventional account of it will be offered

Keynes vs. Neoclassical economics

- Neoclassical economics assumed that in the long-run equilibrium at macro level can be achieved only at full employment of resources, especially labour.
- Deviations from equilibrium (recessions) are possible (even likely) but they will be temporary and short-lived
- So in the long run unemployment is either voluntary (people don't want to work at market wage), or it is caused by government intervention (for example minimum wage legislation).

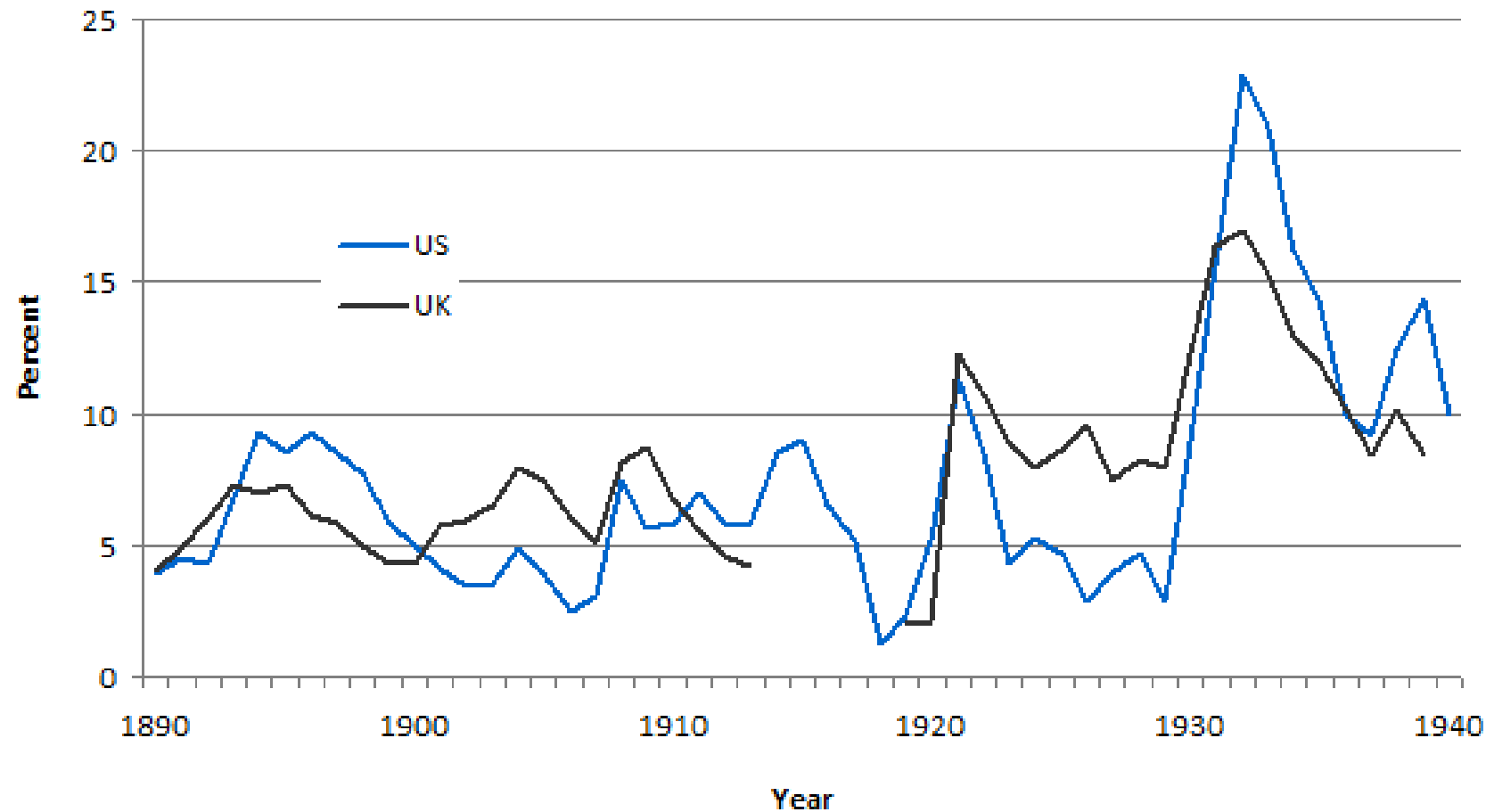
Keynes vs. Neoclassical economics

- For Keynes, equilibrium at less than full employment can exist for a long period. Full employment of resources (esp. labour) is very special and not very likely case.
- Keynes rejected the view that capitalism is a stable and self-adjusting economic system (with respect to unemployment at least).
- He thought that (neo)classical economics was unable to explain such facts as high and long-lasting unemployment, business cycles, severe depressions etc.

The Great Depression of 1930s

- Worst economic slump in history
- Unemployment rate rose in the US from 3% in 1929 to 25% in 1933
- US production level dropped by about 30% in 1929-1930
- Occurred in all industrialized countries
- Lasted for about a decade

Unemployment in the US and the UK during the Great Depression



(Neo)Classical Macroeconomics

- Economic perturbations are short-lived
- Markets operate relatively quickly and restore full employment equilibrium
- Government intervention is neither necessary nor desirable – could only generate greater instability
- Assumptions:
 - Economic agents are rational and maximize (profits or utility)
 - Markets are perfectly competitive (agents are price-takers)
 - Agents have perfect knowledge and stable expectations

(Neo)Classical Macroeconomics

1. Output (national income) is determined by real factors (stock of capital, quantity of labour, technology)
 2. Quantity theory of money (monetary policy affects only level of prices and not the real output)
 3. Say's Law operates – supply creates its own demand; production creates income and purchasing power; so demand is always sufficient to purchase all output which is produced
- In other words, there is an automatic tendency for full employment of resources (esp. labour)

Keynes's economics

- Keynes constructed a new basis for macroeconomic theory
- He rejected classical concept of Say's Law – supply creates its own demand.
- Keynes argued that it is not production which generates demand, but it is rather that production adjusts to demand.
(Turned classical theory upside down)
- Production and employment (Y and L) are determined by the so called effective demand, that is the sum of investment and consumption expenditures by firms and households: $E = I + C$
- The last statement is Keynes's principle of effective demand:
 $E \rightarrow Y$, and $L=f(Y)$

Keynes's effective demand

- Most powerful implication of this principle is that the level of production determined by effective demand is at equilibrium point, but this equilibrium does not have necessarily to be at full employment of resources (e.g. labour).
- This occurs when effective demand is too small.
- In such a situation we face involuntary unemployment – people want to be employed at the market wage rate, but can not find jobs.
- But why effective demand can be insufficient to generate full employment of labour? What is the reason for inefficiency of capitalism in terms of unemployment?

Why effective demand can be insufficient?

- Keynes focused on investment spending.
- Investments, for Keynes, depend on the interest rate and MEC (marginal efficiency of capital).
- MEC is expected (by businesspeople) rate of return on capital (expected profits)
- MEC estimates are based on expectations about the future, which are influenced by psychological, irrational factors.
- Those expectations are volatile, change quickly and irrationally.
- This way he rejects the (neo)classical assumption of (perfect) rationality of economic agents (here business owners)

Keynes on investment decisions

- Investors' moods, irrational waves of optimism or pessimism, states of confidence and 'animal spirits' govern investors' decisions.
- By animal spirits Keynes meant intuitive, unconscious mental actions, irrational actions, not based on economic calculation.
- Investment decisions governed by animal spirits are therefore not fully rational.
- And therefore, effective demand, in a part, also depends on uncontrollable, and extremely unstable factor – animal spirits.
- Investment decisions are not rational → unstable investments → unstable effective demand → unstable levels of production and employment (**that is why business cycles occur**)

Keynes on (in)stability of free markets

- So, there is a possibility of crises (increasing unemployment) because of a rapid fall in investments
- But why there is no automatic tendency to recover to full employment as postulated by classical theory ?
 - Classics: if r goes up – savings (S) go up, consumption decreases;
when r goes down - savings go down, consumption increases
- According to classics, $I=S$, so interest rate (kamatláb) must have fallen (because investments are down) and consumption has to rise -> E does not change -> no recession
- But in Keynes's system:
 1. Consumption does not depend on the interest rate (but on income)
 2. Interest rate is determined outside savings and investments market
- Therefore a fall in investments cannot decrease an interest rate and encourage consumption

Keynes on the neutrality of money

- Classical theory: QTM implies that money is neutral with respect to real variables (e.g. national income, unemployment etc.)
 - $M * V = P * Y$, (with $Y=f(K, L)$, V - velocity of money)
 - A rise in M leads to a proportionate rise in P , no real effects
- In Keynes's system:
Increase in money supply ($M/P \uparrow$) $\rightarrow r \downarrow \rightarrow I \uparrow \rightarrow E \uparrow \rightarrow$
 $\rightarrow Y \uparrow$ and $L \uparrow$
- So, money is non-neutral for Keynes – income and employment can be increased through this mechanism
- Potentially, expansionary monetary policy can bring back the full employment of resources in the economy

How unemployment can be automatically cured in Keynes's theory?

- If there is a crisis and growing involuntary unemployment, then theoretically the following mechanism automatically restores full employment of resources:

Employers cut down nominal wages ($w \downarrow$) $\rightarrow P \downarrow \rightarrow$
 $(M/P) \uparrow \rightarrow r \downarrow \rightarrow I \uparrow \rightarrow E \uparrow \rightarrow Y \uparrow$ and $L \uparrow$

- This mechanism is known as 'Keynes effect' – shows how market forces could bring back macroeconomic equilibrium with full employment in Keynes's theory

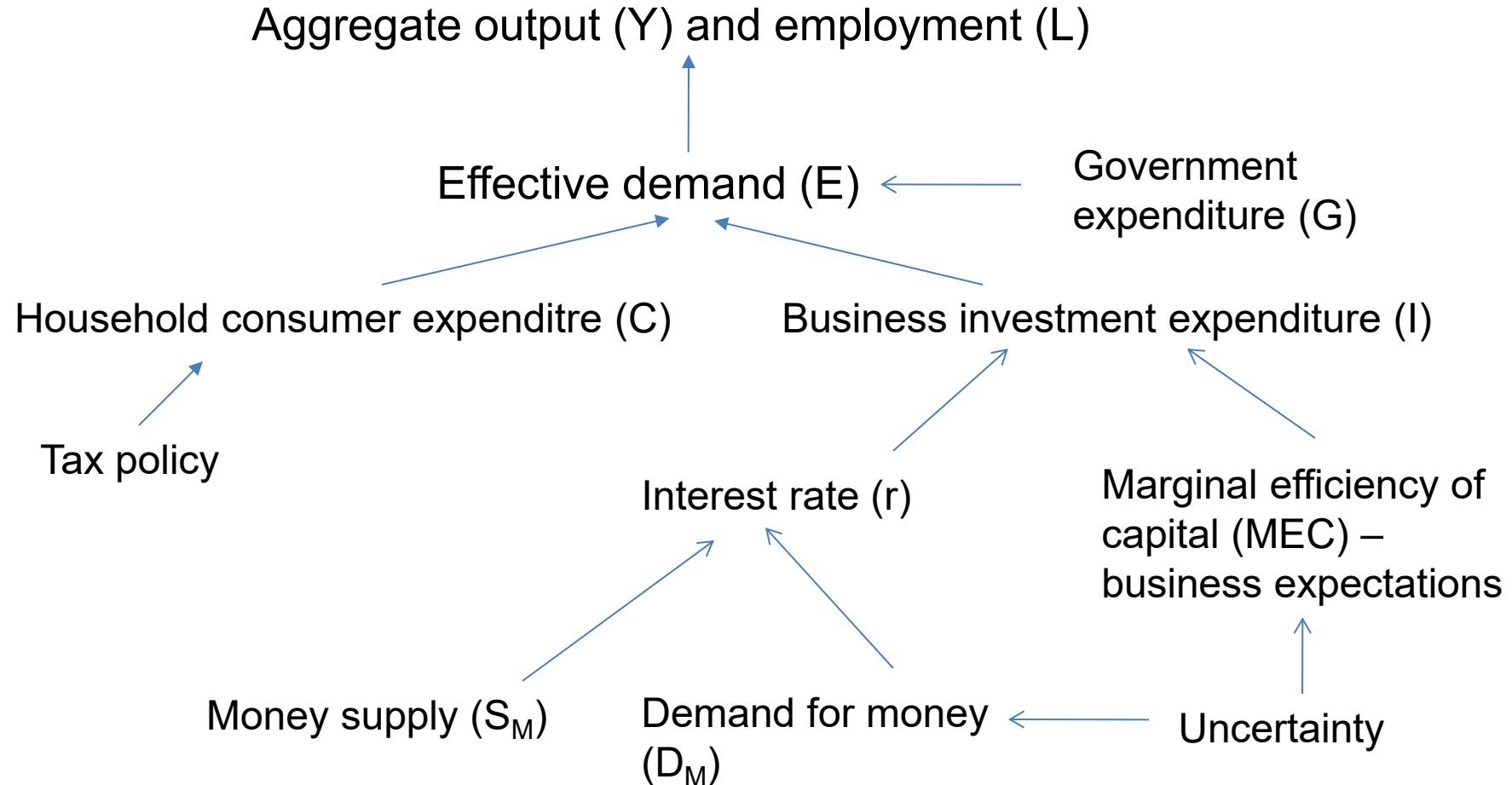
When Keynes effect does not work?

- But, of course, Keynes wanted to show that markets fail to provide full employment of resources
- So, he had to show that 'Keynes effect' sometimes (or rather often) is unable to deliver its promise
- Keynes introduced two reasons why 'Keynes effect' might fail:
 - 'liquidity trap'
 - Interest-inelastic demand for investments

How to achieve full employment when Keynes effect fails?

- In presence of any of those two situations, market forces will be too weak or inefficient – aggregate demand (E) will not be sufficient to produce full employment
- The only solution is stimulate E ($E = C + I$):
 - (a) directly through encouraging investment (I) *by increased government expenditure (G)*; so in fact: $E = C + I + G$
 - (b) indirectly by lowering taxes that stimulate consumer spending (C) through rising households incomes

Determination of output and employment in Keynes's system



Economic policy according to Keynes

- In *General Theory* presented extreme opposition to laissez-faire policy
- Advocated extensive, active and permanent government interventionism
- Specific policy obligations of governments in Keynes' vision:
 1. control the level of interest rates, tending to lower it in order to increase investments
 2. socialization of investment (to stabilize levels of employment and production).
 - Probably meant some kind of public (or public-private) investments in the economy in times of recessions
 3. use fiscal policy to lower economic inequalities (in incomes and wealth)
 - „the euthanasia of the rentier"

Economic policy according to Keynes

- Keynes was accused of being socialist, but himself thought that he was rather conservative.
- Not aimed at radical changes, only wanted to get rid of two biggest evils of capitalism for him: unemployment and inequality.
- Thought that his proposals would leave the biggest advantages of capitalism – like personal liberty, private property – intact.
- Thought that the continuation of laissez-faire policy would lead to revolt, socialism or totalitarian state.
- Rejected socialist and totalitarian visions of economic system.

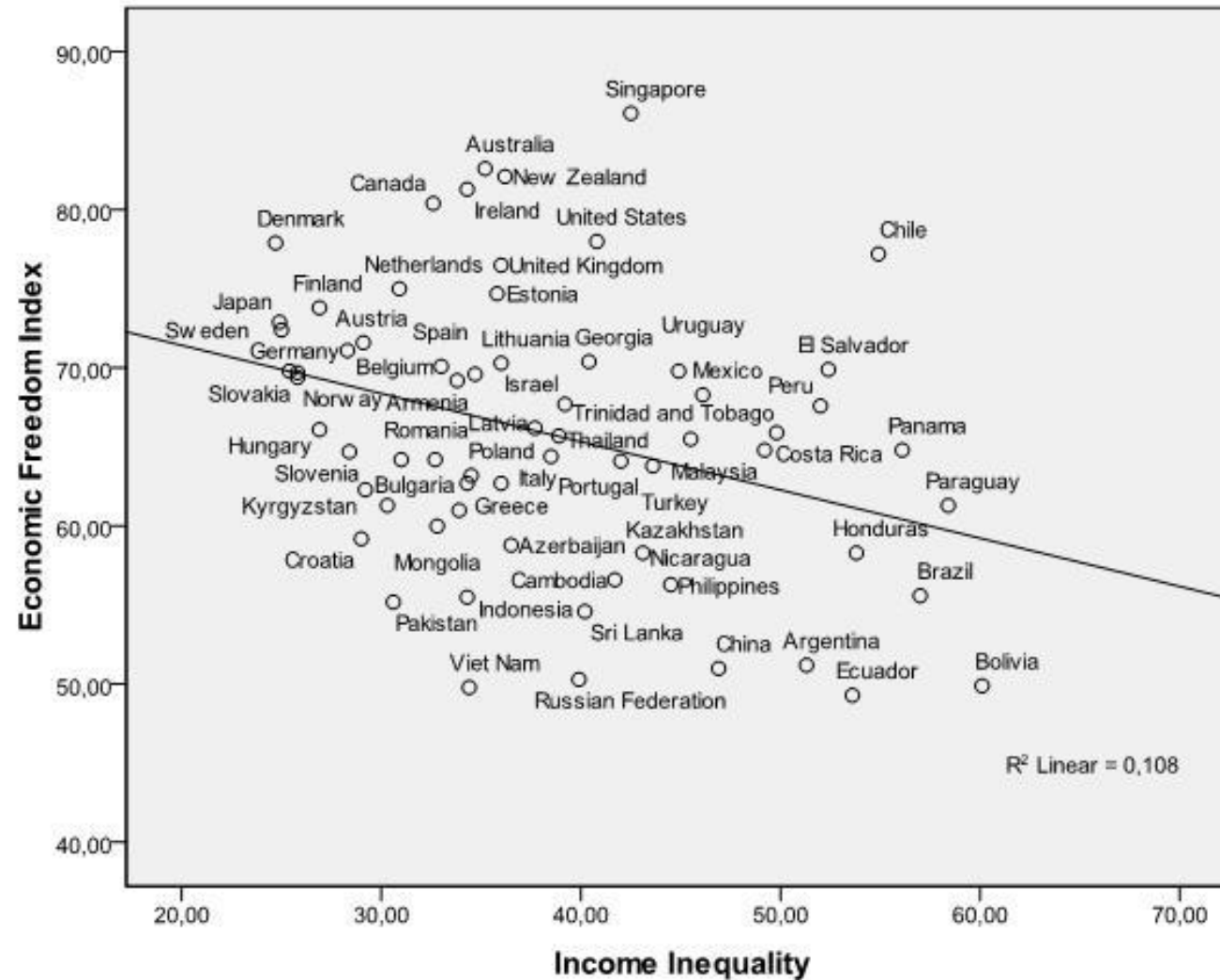
Economic policy according to Keynes

- Argued that personal freedom and private property associated with capitalism produce in general economic efficiency, innovative economy, variety of life etc.
- In general, Keynes can be called a proponent of a third way between capitalism and socialism, an advocate of refined capitalism (without involuntary unemployment and big inequalities)
- Was against laissez-faire policy, but was rather liberal, not radical or socialist.

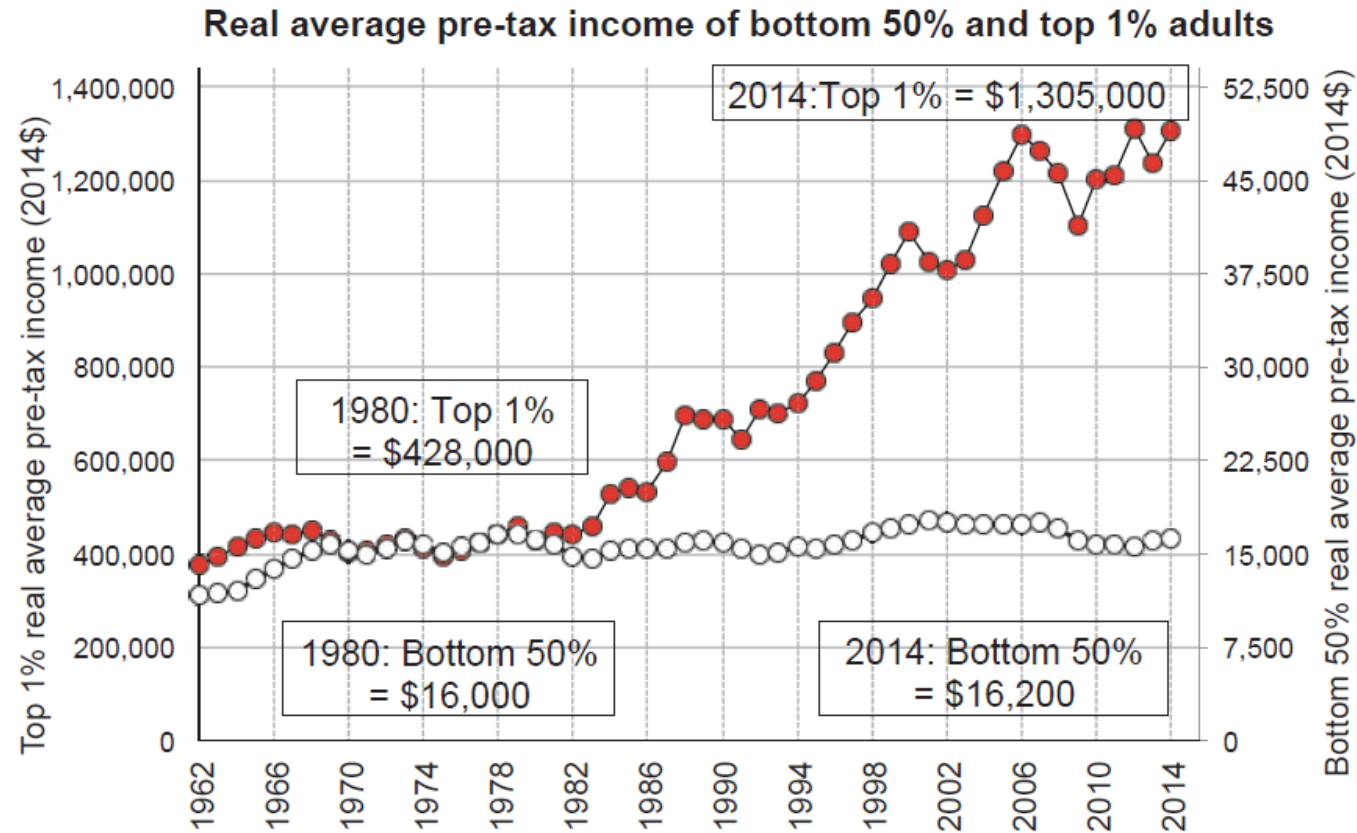
2018 *Economic Freedom of the World Index*^[1]

Rank ↕	Country ^[2] ↕	Score ↕
1	 Hong Kong	90.2
2	 Singapore	88.8
3	 New Zealand	84.2
4	 Switzerland	81.7
5	 Australia	80.9
6	 Ireland	80.4
7	 Estonia	78.8
8	 United Kingdom	78.0
9	 Canada	77.7
10	 United Arab Emirates	77.6
11	 Iceland	77.0
12	 Denmark	76.6
13	 Taiwan	76.6
14	 Luxembourg	76.4
15	 Sweden	76.3
16	 Georgia	76.2
17	 Netherlands	76.2
18	 United States	75.7
19	 Lithuania	75.3
20	 Chile	75.2
21	 Mauritius	75.1
22	 Malaysia	74.5
23	 Norway	74.3
24	 Czech Republic	74.2
25	 Germany	74.2
26	 Finland	74.1
27	 South Korea	73.8

Source: <http://economynepal.com/concerned-about-the-wealth-gap-spread-economic-freedom/>

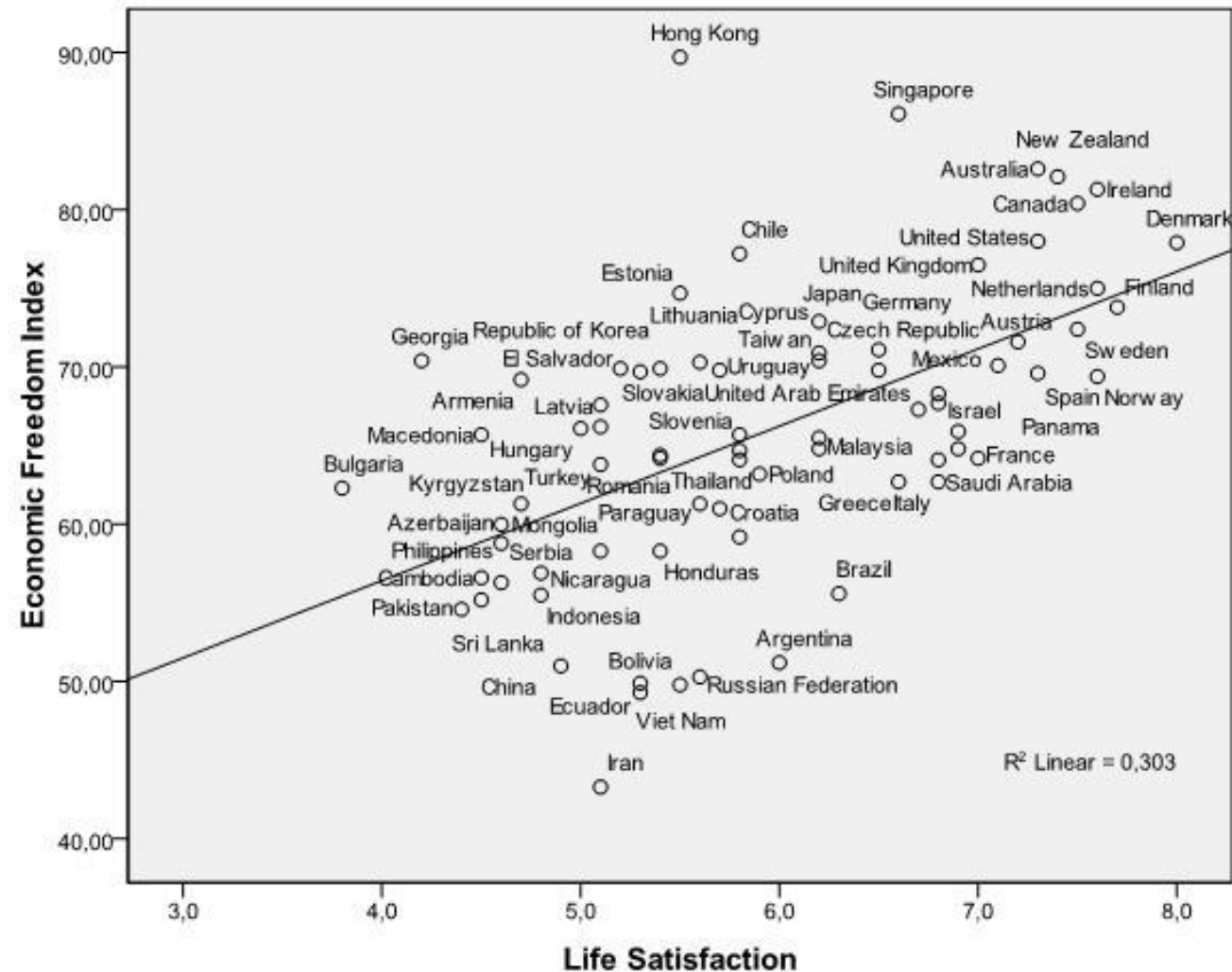


Piketty, T., Saez, E., & Zucman, G. (2016). Distributional national accounts: Methods and estimates for the united states (No. w22945). National Bureau of Economic Research.



Source: Appendix Tables II-B7 and II-B10

<https://www.theatlantic.com/international/archive/2010/04/free-tolerant-and-happy/39127/>



New Institutional Economics

- Much of economics takes preferences, technology and institutions (market structure, laws, regulations, political systems, policies) as given.
- But different laws and regulations, and different political systems have a major effect on investment, education and allocation decisions and thus on economic development.
- Why do societies choose different institutions?
- And what are institutions anyway?

What are institutions?

- Douglass North (1920-2015; Nobel prize in 1993):
- Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.
- They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights).
- What about morality, social norms, culture?
- Key points: institutions are
 - are humanly devised
 - set constraints
 - shape incentives
- Economic institutions - rules of the game in the economic world
 - degree of property rights security and enforcement
 - set of contracts available to businesspeople
 - Rules and regulations determining economic opportunities open to agents (tax law, labor law, competition law, regulations concerning starting new businesses, etc.)
- Political institutions - rules of the political game
 - constitution
 - democracy versus dictatorship,
 - electoral laws,
 - constraints on the government from the parliament, judiciary, the public
 - Checks and balances (e.g. constitutional tribunal can block unconstitutional bills passed in the parliament)

How institutions affect growth & development according to D. North?

- Institutions arose to give “a guide to human interaction” and “reduce uncertainty by providing a structure to everyday life” (North, 1990a: 4).
- By making human behavior more predictable, both formal and informal institutions reduce the cost of transacting (*transaction cost*) with others.
- As North puts it, because institutions permit *impersonal* transactions between *strangers over time and at a distance* even where neither self-enforcement by the parties (personal transactions) to the transaction nor “trust” are viable ways to enforce rules they are “the basic determinant of the performance of an economy”
- Absent third-party protection (institutions), parties of the transaction could easily be cheated
- This limited trade to transactions or trade between merchants who repeatedly interacted (i.e. personal, not impersonal, exchange).
- To expand trade from personal to impersonal transactions, many institutions appeared (legal system, information sharing networks among merchants, fairs, merchant guilds, etc.)
- Institutions were critical in supporting the transition from personal to impersonal trade.

Big differences in economic and political institutions across countries.

- Enforcement of property rights.
- Legal systems.
- Corruption.
- Entry barriers.
- Democracy vs. dictatorship vs. authoritarianism vs. illiberal democracy
- Constraints on politicians and political elites.
- Electoral rules in democracy (who can vote, how votes are marked, cast and counted, majoritarian vs. proportional voting, etc.)
- How to measure institutions?

Sources of prosperity

- Vast differences in prosperity across countries today.
- Income per capita in sub-Saharan Africa on average 1/20th of U.S. income per capita
- In Mali, Democratic Republic of the Congo (Zaire), and Ethiopia, 1/35th of U.S. income per capita.
- Why?
- Standard economic answers:
 - Physical capital differences (poor countries don't save enough)
 - Human capital differences (poor countries don't invest enough in education and skills)
 - “Technology” differences (poor countries don't invest enough in R&D and technology adoption, and don't organize their production efficiently)

Sources of prosperity (2)

- These are, however, proximate causes of differences in prosperity.
- – Why do some countries invest less in physical and human capital?
- – Why do some countries fail to adopt new technologies and to organize production efficiency?
- The answer to these questions is related to the fundamental causes of differences in prosperity.
- Potential fundamental causes:
 - Institutions (humanly-devised rules shaping incentives)
 - Geography (exogenous differences of environment, climate, land fertility)
 - Culture (differences in beliefs, attitudes and preferences)
 - Biology (genetic differences)
- New institutional economics (D. North, D. Acemoglu, many others) argue that institutions are the major factor responsible for long-run prosperity.
- The impact of other factors (like geography) disappears or become very small when one accounts for differences in institutions between countries