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Cambridge University Press
978-1-107-02627-8 - An Economic Theory of Greed, Love, Groups, and Networks
Paul Frijters with Gigi Foster
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Introduction and preview

Introduction

Society routinely asks broad questions of economists and expects fairly all-encompassing answers. Are trade barriers good or bad? What is the role of private enterprise? How involved should government be in regulating industry? A reasoned yet simple answer to any of these questions must depend on some aggregate view of how a country works. Whatever the particulars, each question is a "system" question that touches upon so many aspects of the whole economic and political system that its answer inevitably requires some explicit or implicit overarching story.

For example, one cannot answer the question on trade barriers without some implicit equilibrium framework in mind, together with an implicit understanding of how trade barriers come to be politically sponsored. Likewise, one cannot provide the *raison d'être* of private enterprise without a fairly complete picture of the roles of other actors in the economy, such as consumers and government, and the dynamics in operation between these different actors. Policy makers and students routinely present economists with simply stated questions that nonetheless have only imprecise answers, due to being underpinned by a plethora of implicit ideas and possibilities. The reasonableness of any simple answer to such a question depends upon the reasonableness of the answerer's underlying aggregate view.

The goal of this book is to offer such an aggregate view. The starting point of the book is to take the principles of mainstream economics at face value. Layers of selected ideas are then added and integrated with the mainstream economic view, relating to the roles of loyalty, groups, power, and networks. What results is an enhanced view of how society works that increases the number of phenomena covered, and deepens the existing story.

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The groundwork laid by economics

The dominant aggregate view of economists is roughly as follows. Humans are primarily motivated by greed, and competition between greedy individuals leads each of them individually to specialize in doing what they do best. At the aggregate level, this dynamic leads to a condition of balance, in which all opportunities for mutual advancement have been depleted as long as some benevolent rule-setter forces people to abide by property rights and contract law. Competition amongst a large number of individual actors within such an institutional framework produces an optimal outcome for society as a whole in terms of productive efficiency, and therefore should be encouraged on the grounds of maximizing social surplus. The very structures of society itself, such as our parliaments and our notions of fair play, can likewise be seen to have survived a long-fought competition – not amongst individuals, but amongst institutions and ideas, in which those that were more appealing to the innate wishes of the population as a whole survived.

Relying on this overall view of society allows economists to abstract from specific situational factors and deliver simple, fairly general answers to the broad questions they are routinely asked. Trade barriers, most economists would claim, give a monopoly to domestic suppliers at the expense of domestic consumers, and deliver aggregate efficiency losses. Private enterprise exists so that greedy individuals have incentives to discover the most efficient means of producing existing goods and discovering new goods. Government should regulate industry when market imperfections, such as entry barriers, information asymmetries, or externalities threaten the ability of the unimpeded market to deliver the socially efficient allocation of resources.[1]

[1] I here temporarily ignore concerns about the trade-off between efficiency and equality (cf. Okun 1975). It is true that economists often make the theoretical distinction between maximizing the size of the economic pie (termed "allocative efficiency") and distributing it, where the latter is seen as a normative issue that could potentially be addressed via taxes and transfers (preferably nondistorting ones). Yet, while economists often pay lip service to the possibility of transfers to losers from policy changes, such that everyone would benefit from increases in the economic pie (i.e., so that such increases are Pareto-improving), full transfers seldom occur in reality. It would be fairer to say that economists worry mainly about the size of the economic pie, while leaving its distribution to politics. In this book, this political process is itself taken as part of the subject under study.

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The holder of such a stylized "mainstream economics" view will advocate those forms of competition that lead to optimal specialization, and will advocate mechanisms that allow for orderly transitions of institutions along the lines of optimal fitness. The holder of such a view will analyze the material incentives of every actor involved in a problem, and will generally try to solve the problem by realigning those individual incentives with what is optimal for society as a whole, often through exploiting the power of greed-based competition amongst individuals. The policy advice of the economist boils down to a set of answers to the following sequential questions: "How does the socially optimal outcome differ from what we have now; who currently benefits materially from which aspects of the current situation; and whose material incentives can we change such that their individually optimal choices will coincide with what we want them to do from a social welfare perspective?"

This is a powerful and intuitive way of looking at any problem. It is also a view that has been highly successful in influencing thought in both the public and private sectors, as witnessed by the dominance of the language of economics in policy circles, international institutions, and business. In terms of the ability to generate simple stories that can be grafted on to many different situations to deliver simple advice, it is hard to think of a more successful and useful view that has come from the social sciences.

The mainstream neoclassical view of economics sketched above depicts "Homo Economicus" (economic man) in isolation, living each day only to satisfy his greedy desires through the pursuit of material wealth. This atomistic and materialistic view of humanity has, over its long life, come under fierce criticism for being demonstrably simplistic. Economic insiders know that people do not just care about money; they know that people are not always experts at calculating what is in their own best interests; they know that historical accident has as much to do with existing institutions as those institutions' supposed "economic fitness"; and they know that competition does not just happen in a vacuum, but requires the existence of quite culturally specific institutions in order to appear. The main task in this book is not to remind the reader of all the inadequacies of the stylized mainstream economic view. Rather, I want to recognize its great value in providing people with simplified stories and solution strategies, and then to expand the mainstream view by adding important elements not currently included.

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Loyalty and groups

The first element I wish to add to the mainstream economics view is an understanding of the crucial role of love and loyalty in generating behavior, both at the micro-level and the macro-level. This will require offering a working definition of loyalty, and then asking why people are loyal – considering loyalty to families, countries, clans, and other groups as all essentially the same type of phenomenon.[2] This question is critical if we are to make sense of why people care for their children, fight for their country, do not coordinate on defrauding the tax authorities, by and large follow the constitution, and so forth. It is contended in this book that economics has not incorporated satisfactory answers to any of these questions into its mainstream view, notwithstanding the economic literature on altruism and groups.

The inclusion of love and loyalty will lead more broadly to a consideration of how the power implicit in social groups can influence behavior. I will illustrate how groups form initially, and how they manage to create the incentives for group members to abide by group norms. This again is an area that traditional mainstream economics has been unable to illuminate, yet it is demonstrably important in influencing the behavior of groups of people in aggregate. This analysis ultimately seeks to explain and thereby predict the existence and behavior of important groups in modern economies, including the "citizens" of the nation state, the "faithful" in religions, the self-identifying members of ethnicities, unions, and other clubs, and so on.[3]

[2] Many authors have used the word "altruism" to describe the behavioral reflections of love and loyalty. As Ackerman (1996) argued in her review of attempts to incorporate altruism in economic analyses (p. 701), "Altruism . . . cannot be understood within the standard economic framework. Theoretical progress requires a richer conception of individual utility functions and a base in cognitive psychology that incorporates the power of ideas and emotions in motivating behavior." I fully agree with this statement, and use the word "loyalty" to denote the abstract foundation of altruism as typically understood. In this book I also address "loyalty" directly rather than "altruism" because this offers broader conceptual scope: people can be loyal to abstract ideas (as well as people), whereas the notion of "altruism" typically is associated only with loyalty to people.

[3] These behaviors were squarely in the realm of what many early contributors to modern economic science (e.g., Adam Smith) considered worthy of attention; see Harcourt (1995) for further discussion.

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Trade networks

The first observation I make about trade networks is that they are a crucial component of the modern economic system of production and exchange. While this idea is accepted in some economic circles, standard economic practice – often stated as part of an assumption of zero transaction costs – is to presume that everyone can instantaneously trade with anyone else and can switch trading partners at zero cost. Reality is more complicated. People and organizations live, produce, and exchange in trade networks of limited size, where relations are specific and where one cannot exchange one relation for another without significant cost. For instance, a car company relying on a trade network of suppliers that deliver different automobile components cannot instantaneously obtain, say, its windshield wipers from an alternative supplier. Such a change would take time to implement, since it would require that alternative supplier to develop specific knowledge in order to suit the customized requirements of the car manufacturer: that windshield wiper has to be made of specific material, must conform to specific standards, and must fit onto specific components made by others. It takes time and resources to comply with such demands. Similarly, consumers, financiers, doctors, and any number of other professionals depend upon the individuals and organizations in their current network when making their production and consumption decisions.

Even if they were not a crucial element in the economy, trade networks are a particular type of social group, and therefore should be included in this book for the sake of providing a complete treatment of groups and their dynamics. Yet there is also one remaining, more insidious reason to include an analysis of trade networks. Such networks form the main conduit between changes in the material circumstances of individuals and in their behavior as political actors in other existing groups. As such, an understanding of trade networks will be a crucial element in answering the questions of how and when major political and economic institutions emerge.

Organization of the book

This book is organized to follow the train of thought shown above. The preview following this introduction provides an illustrative summary of where the book is heading, by presenting a set of stylized questions that

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will be addressed. These questions range from those that mainstream economics already considers "core business" to questions that lie at the periphery of present-day mainstream economics.

In Chapter 1 of the book, I review in more depth the mainstream story of economics. This chapter outlines the main overall story that "we" economists teach our students, and illustrates its great relevance in generating implications for how the world is run and how it should be run. This first chapter paves the way for the ensuing chapters by noting contentious areas where extensions to the existing aggregate story might be fruitful.

Chapters 2 through 4 then delve into the main concepts with which the economists' story outlined in Chapter 1 will be enhanced. Chapter 2 explores the concept of loyalty, also termed love. Chapter 3 considers questions relating to groups and power. Chapter 4 analyzes network formation, drawing on the collapse of networks in the wake of the dismantling of the former Soviet Union in order to illustrate the economic and political role of networks.

Chapter 5 draws the strands of the previous chapters together and presents an augmented overall story of how our economic and political systems work. This chapter includes a novel heuristic for tackling socioeconomic questions based on this augmented story. This heuristic is then applied to the questions introduced in the book's preview. The book concludes by reviewing what has been added to the aggregate view of economists, as well as noting some elements of socioeconomic life that are still not well integrated.

To the best of my knowledge, with one exception,[4] none of the specific observations or individual theoretical arguments in this book is new. Each can be found in some other discipline and/or in some previous time period, which are duly referenced. The novelty of the book is in the explicit attempt to bring many diverse strands of thought together to form a single overall view. In that regard, each of Chapters 2 through 4 is in itself a novel perspective on one aspect of the problem, while the main point of innovation is the synthesis in Chapter 5.

[4] I believe that the unified description of the nature of love and loyalty, embodied in the Love Principle presented in Chapter 2 – while derived from observations many have made previously – is itself new.

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Preview

In this Preview, I first describe the context from which this book emerges, to clarify its scope and intended aims. Several applications are then introduced that can be directly analyzed through the lens of the unified view that will ultimately emerge. This is followed by a reflective discussion of the methods applied in order to construct and arrive at this unified view, and a final statement of purpose for the book as a whole.

The view of economics in this book is as a discipline ultimately driven by the need of policy makers and the rest of society for advice on how to deal with perceived problems.[5] By "problem," I mean a facet of economic, social, or political life in which different decisions can be made that may lead to dramatically different outcomes in terms of overall social welfare. What policy makers or society consider to be an "economic problem," and therefore one for which they turn to economists for advice, is itself the outcome of perceptions and competition: self-interested economists plying their trade will naturally seek to expand the set of problems about which they dispense advice, and thereby gradually encroach on the territory of other social scientists, such as anthropologists, psychologists, or sociologists. Social scientists from other disciplines will naturally do the same. The question of what is an "economic problem" therefore has an answer that shifts with the political winds.

To determine what should count as the main territory of economists, I reviewed the surveys of professional economists run over the years, with a particular focus on the surveys of members of the American Economic Association with which many economists, both American and non-American, are affiliated. In addition, I reviewed the twenty-five most popular introductory textbooks in economics currently available, as selected by Lopus and Paringer (2011) for their chapter on economic textbooks in *The International Handbook on Teaching and Learning Economics*.

The textbooks unanimously agree that the modern "territory" of economists minimally includes problems surrounding material

[5] This is similar to the view espoused in Harcourt (1982).

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trade-offs. Typical examples of trade-offs presented to students are whether to fund policy A or policy B, or whether to consume X or Y. This consensus is at the forefront in the three most popular textbooks: Mankiw's (fifth edition) first and fourth principles of economics are that "people face trade-offs" and "[p]eople respond to incentives." The first chapter of McConnell et al., which apparently is the most widely sold economics textbook ever and is now in its nineteenth edition, is similarly about scarcity and choices; Samuelson and Nordhaus (nineteenth edition) also name scarcity and trade-offs as belonging to the central concepts of economics. New textbooks run the same line: Stone (2011) proffers (p. 12) as key economic ideas that "choice and scarcity force tradeoffs" and that "opportunity costs dominate our lives." Textbooks of intermediate vintage (e.g., Boyes and Melvin [eighth edition]) similarly place scarcity and choice at the center of their definitions of economics.

These economic textbooks, as well as the questions posed in the surveys of economists, address trade-offs concentrated in the wealth-generating part of the economy: production and exchange. The dominance of these domains as the source of the typical decision problems on which economists are consulted means that, by and large, policy questions in these domains define mainstream economics.

Under each ensuing subheading in this Preview, I provide a brief sketch of a problem – whether residing in or out of the traditional "territory" of economics – and then give a quick summary of how mainstream economics would view and then proceed to solve the problem. In each case, I then sketch the augmented view of the problem that subsequent chapters will work towards. These problems are only briefly introduced here, but will resurface again throughout the book. They range from those that will be intimately familiar to any practicing economist to those that, while amenable to economic arguments, will not be easily recognized as traditional economic problems.

International trade

A key question facing policy makers is whether they should catalyze or hinder international trade. This is the main question addressed by Adam Smith in his most famous book, published in 1776. This book, *The Wealth of Nations* (Smith 1776), directly addresses the political

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question of whether government should interfere in agricultural trade – wheat, in particular.

Hindrances placed on trade by policy makers can take the form of tariffs on imports or exports, quotas on the number of goods that are allowed into the country, or quality requirements on imports that effectively block them. The archetypal situation is that policy makers in a particular country are asked by that country's domestic producers to protect them from cheaper imports via implementing one or more such hindrances. Typically the argument made by the domestic producers is that this interference by policy makers will "save jobs."

The mainstream economic answer to the question of whether to implement such hindrances is a resounding "no," regardless of the type of hindrance. As Winters, McCulloch, and McKay (2004) observe (p. 72) in their review of trade liberalization, "[m]ost economists accept that, in the long run, open economies fare better in aggregate than do closed ones, and that relatively open policies contribute significantly to development."

The main argument behind this stance is that in any voluntary trade, both trading partners know what they are doing and therefore are both benefitting from the exchange. In the case of international trade, the importing consumer gets the good at a better price than he would otherwise have to pay (or a higher-quality good at an equal or lower price), while the exporter also receives a better price than he could get elsewhere. Any alternative price that could be gotten elsewhere is interpretable – under the assumption of competitive markets – as the cost that others would face in order to produce the same good. The very observation that consumers prefer a cheaper foreign supplier therefore signals that domestic producers' actual comparative advantage lies elsewhere than in producing the good in question.

Economists who observe domestic suppliers lobbying policy makers for protectionist policies view this situation as an opportunity to create additional social surplus by rearranging the economy. The domestic economy could grow larger in the long run if suppliers currently making tradeable goods that cannot compete with foreign imports would stop making them, and would instead produce those goods in whose production processes they have a comparative advantage. Through this lens, hindrances to imports merely impoverish one's own country in the long run, both by preventing domestic consumers from getting a better deal, and by preventing domestic producers from

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reorienting themselves towards production processes in which they have comparative advantages.[6]

Naturally, mainstream economists admit some exceptions to the standard case above, mainly to do with failures of perfect competition. We know that trade barriers can be beneficial to the domestic country if the foreign competitors in question have a large degree of market power, and domestic demand is somewhat elastic; we know it is possible, in a situation with large upfront costs, that temporary trade barriers might give the domestic industry a required window of opportunity in which to establish itself as the world leader in an industry and reap monopoly rents itself; and so forth. Chang (2010) provides an entertaining review of such exceptions, for this case as well as other policy areas addressed by mainstream economics.

Despite these exceptions and many others for which economists have fully developed models, economists make up a solid bloc in favor of freer international trade, and as such applaud free trade agreements, unilateral reductions in tariffs, harmonization of tax rules in order to facilitate free trade, and similar initiatives. Working towards freer trade is an activity that occupies many policy economists inside trade ministries, foreign affairs ministries, and international organizations. There are of course economists working for the "other side," i.e., economists who argue against trade liberalization, either because their employer requires them to argue against freer trade or because they genuinely think that one of the exceptions applies.

However, surveys amongst American, English, and Australian economists show that freer international trade is something that the vast majority of economists applaud. In the original survey of American Economic Association (AEA) members in 1977 (Kearl, Pope, Whiting, and Wimmer 1979), some 97% of the responding economists agreed with the statement that "tariffs and import quotas usually reduce general economic welfare," and only 16% of those who agreed did so with some provisions. Fifteen years later, a general survey (Alston, Kearl, and Vaughan 1992) of American economists, including those in business, academia, and government positions, found that 93.5% agreed

[6] Although not the central goal of domestic policy makers, foreign suppliers' welfare is also higher in the absence of import restrictions. Symmetrically, domestic suppliers are better off in the absence of export restrictions.

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