

*Tomasz Żylicz\**

## WHAT ECONOMISTS ARE TO LEARN FROM THE ECONOMIC CRISIS?

There is a popular tendency to call for a radical change in economic theory in response to the economic downturn triggered by the collapse of the American real estate market. Also the most recent decisions of the Nobel Prize Committee to honour Elinor Ostrom and Oliver Williamson prompted some commentators to call for a “major rethinking” [see e.g. Gallagher, 2009].

Let us start with Elinor Ostrom. Her major contribution is demonstrating empirically that common pool resources – contrary to many conventional analyses – are not necessarily doomed to overexploitation. However, this is not a dissident view. Over the last several decades, economists developed the conceptual framework to analyze governance regimes that may either promote or hinder efficiency. Without exaggeration, one may claim that seminal contributions emerging from the study of asymmetric information [Rothschild and Stiglitz 1976], agency theory [Laffont and Tirole 1993], and transaction costs [Coase 1937, Williamson 1979] – many of which were already honoured with the Nobel Prize – paved the way for the work of Elinor Ostrom [e.g. Ostrom, 2005].

The main finding of Elinor Ostrom is not that there is something wrong with economic analysis, but rather that economists should constantly study real-world systems in order to understand how people behave. It turns out that people are more rational, that they trust each other more and that they more eagerly co-operate with each other than many of us expect. But this does not call for abandoning a “paradigm”. Although there may be some academics that miss the mainstream and stick to opinions that are not rooted in good scientific analyses, economics is well prepared to tackle problems we face.

Virtually all findings of Elinor Ostrom refer to what state-of-the-art economists analyze. Incentive structures, institutional arrangements, prospects for achieving

---

\* University of Warsaw.

efficiency – these problems have been studied in mainstream economics for many years now. What is novel is an empirical confirmation of adequacy of spontaneous institutional arrangements observed in many parts of the world. Without her research, analysts could have hypothesized whether or not, appropriate solutions require private or public property of resources. With the research, we know that the importance of formal ownership yields to the importance of decision-making rules based on shared values and tradition.

The Oliver Williamson's accomplishments are even more in line with textbook economic analysis. A follower of Coase, Williamson emphasizes the importance of transaction costs. More importantly, however, he raises a series of questions emerging from legal and policy experiences, in order to look for tractable theories that may provide answers to them. In particular, he looks at the American antitrust regulation, identifies populist motives and suggests solutions that have sound economic background. For instance, he observes that large corporations have abundant means to bribe politicians. Nevertheless, based on microeconomic modelling, one can conclude that it is better to fight pathological relationships directly rather than by limiting the size of corporations.

By no means is Williamson an economist who sacrifices scientific precision for political correctness. His analyses are rigorous and they often run contrary to the so-called common wisdom and conventional practices. Even though he can argue without referring to mathematics, he is one of the most sincere advocates of Industrial Organization, a branch of modern microeconomics which requires fluency in mathematics. Industrial Organization is perhaps one of the fastest developing fields in economics. At the same time, it is often criticized for its sophistication and reliance on mathematics. Oliver Williamson's work proves that a modern economist can combine an excellent appreciation of human and social factors with a rigour of scientific argument.

Oliver Williamson is also an economist who understands better than others the roles for a market, institutions and public policies. With respect to the economic downturn, he emphasizes the guilt of public policies and government failures rather than market failures. It is predictable that economic agents will always pursue their individual interests. Government regulations are to make sure that in doing so they increase rather than compromise social welfare.

Some people could have been surprised by the fact that banks might not served interests of their clients and firm managers did not act in the interest of shareholders. Nevertheless, for well educated economists this is not a surprise at all. Students of modern microeconomics do exercises in agency theory which address this very question; they analyze the architecture of contracts in order to determine their "incentive compatibility", i.e. a feature which binds interests of one party to these of another one. "Bursting bubbles" or bankruptcy scandals do not reveal anything that competent economists would not be aware of. Moreover, modern economic analysis provides tools to control these unwanted phenomena. If policy makers do not implement them, then economists to be blamed are those who provide wrong advice, not those who do their job competently.

An example of misplaced critique is observation that econometric estimation of parameters is often based on an unjustified assumption about the normal distribution of random terms. Indeed, some analysts – especially those who received poor training in mathematics – assume that the data they study are sampled from a normal distribution. If this underlying assumption is false, then the parameters estimated are wrong and so are the confidence intervals. However, this is not how a professional analysis should be carried out. Well educated economists know that one of the very first tasks is to verify the convenient normality assumption. If the verification turns out negative, then analysts should check other statistical distributions, and modern econometrics is ready to assist them with a number of tests. Therefore, while it is true that parameters can be estimated unprofessionally, it is unfair to blame economics for this.

Even though state-of-the-art economics has an adequate conceptual framework to understand the crisis, teaching patterns can be improved. In some universities economic students receive a solid dose of economic analysis, including Industrial Organization and quantitative methods, necessary to build effective predictions. Some faculties prefer their students to learn about social complexities and their impacts on economic policies.

Of course, the reality is complex and multifaceted, and calls for a holistic approach. Of course, there are no easy explanations for everything. Of course, people may behave irrationally and respond to accidental stimuli. Nevertheless, scientific methods require that the reality is simplified, and its components are analyzed by techniques appropriate for a given discipline. Economics is about how people make choices when their resources are too scarce to provide them with everything they want. Economics has gone a long way since Adam Smith directed its attention towards observing how individuals interact in markets. Economic life has become much more complex, and economic techniques have followed this evolution rather closely. Even though the reality is always more complex than models attempting to replicate it, there is no other way than to simplify things and then verify model predictions against empirical or experimental data. Thus students need to acquire skills necessary to simplify and analyze rather than to appreciate how complicated things are. Most people can understand Socrates' words "I know that I do not know" without too much effort. Energy thus needs to be spent to gain analytical skills rather than to learn how inadequate scientific knowledge is.

Economics curricula should reflect this. There are a number of courses that enhance students' analytical skills, such as Industrial Organization and Econometrics. At the same time, there are courses that explain how complex economic phenomena are, including psychology and anthropology, which are extremely interesting, yet of little value for professionals who would like to predict human behaviour and/or to design relevant economic institutions.

Emphasis put on enhancing analytical skills does not imply that economic students are to be separated from pressing issues such as psychological motivation, trust, or environmental constraints. They should be exposed to all challenges

brought by the present. Nevertheless it would be a bad service to train them in describing the problems without offering techniques to analyze these problems in a way that adds value to what other disciplines do.

There are numerous examples of how economists are involved in interdisciplinary work and provide insights into human behaviour that go beyond what can be accessed by means of other sciences. Gary Becker [1976] is perhaps the best known economist to explore the interface between psychology and economics that used to be considered as an area of “irrational” conduct. Bruno Frey [2008] has consistently argued that non-financial rewards play at least as important a role in motivating human behaviour as money. Oded Stark [2006] has repeatedly analyzed the link between international migration and poverty, paving the way for a successful empirical verification [Stark *et al.* 2009]. Many economists, including myself [Żylicz, 1994], have modelled institutions that take into account constraints posed by the availability of natural resources or environmental quality. These examples demonstrate how economists can contribute to solving pressing issues by using their concepts and methods rather than admitting that things are too complex to be modelled.

Having observed that modern economics does address global pressing issues, one should also admit that in many instances societies failed to implement appropriate solutions. The question is thus whether these failures occurred despite the availability of good economic expertise, or because of the availability of bad expertise. This is a difficult question, as perhaps both answers need to be accepted. An American proverb says: *There is no constituency for efficiency*. In other words, efficient arrangements may not have the support from constituencies. However, inefficient ones are often portrayed as fair or otherwise adequate, and there are some cynical or poorly trained economists who design them and present as “scientifically” justified. Therefore there is a case for some professional certification of institutional arrangements to replicate solutions in architecture, law or medicine where appropriate associations guarantee the professionalism of solutions. The design of such a system is, however, difficult to conceive.

To sum up, the recent economic downturn does not call for a new economic paradigm. While some economists should indeed learn from the facts, it would be unfair to claim that economics – as embodied in international refereed literature – is not prepared to analyze the observed phenomena. Nevertheless an open question remains how to promote efficiency in the real world.

## REFERENCES

- Becker, Gary S. [1976], *The Economic Approach to Human Behavior*, University of Chicago Press.
- Coase R. [1937], *The Nature of the Firm*, “Economica”, Vol. 4, pp. 386–405.
- Frey B.S., Neckermann S. [2008], *Awards: A View from Psychological Economics*, “University of Zurich Institute for Empirical Research in Economics Working Paper”, No. 357.

- Gallagher K. [2009], *Elinor Ostrom Breaks the Nobel Mould. The Economics Profession Needs to Be Shaken up. Ostrom's Nobel Prize Should Encourage Us to Take a Fresh Approach*, "Guardian", 13 October.
- Laffont J.-J., Tirole J. [1993], *A Theory of Incentives in Procurement and Regulation*, MIT Press, Cambridge (Mass.).
- Ostrom, Elinor [2005], *Understanding Institutional Diversity*, Princeton University Press.
- Rothschild M., Stiglitz J. [1976], *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, "Quarterly Journal of Economics", Vol. 90(4), pp. 629–649.
- Stark O. [2006], *Inequality and Migration: a Behavioral Link*, "Economic Letters", Vol. 91, pp. 146–152.
- Stark O., Micevska M., Mycielski J. [2009], *Relative Poverty as a Determinant of Migration: Evidence from Poland*, "Economic Letters", Vol. 103, pp. 119–122.
- Williamson O. [1979], *Transaction-Cost Economics: The Governance of Contractual Relations*, "Journal of Law and Economics", Vol. 22(2), pp. 233–261
- Żylicz T. [1994], *Improving Environment through Permit Trading: The Limits to a Market Approach*, in: E.C. van Ierland (ed.), *International Environmental Economics. Theories, Models and Applications to Climate Change, International Trade and Acidification*, Elsevier, Amsterdam, pp. 283–306.

## ABSTRACT

The paper discusses whether the current economic downturn calls for a “major rethinking” of economic theory. While it could have shocked some economists and prompted them to revise their views, it have not contradicted what modern economics – especially microeconomics – contains. Contemporary mainstream economics has been heavily influenced by so-called Industrial Organization which analyzes how economic agents co-operate in order to reach their objectives, and whether any optimality criteria are met in this process. Thus, for well-trained economists, it is not surprising that firm managers may not act in the interest of shareholders, or banks may consistently miscalculate the risk of financial operations. Also the 2009 Nobel Prize nominations suggest that the mainstream economics does not need to be revised in response to the turmoil in global financial markets. On the contrary, both Elinor Ostrom and Oliver Williamson’s works are deeply rooted in standard economic theories, and they prove that these theories, when confronted with empirical evidence, can convincingly explain development patterns. An open question, however, remains how to promote in the real world all the efficiency-enhancing solutions developed by economists.

**Key words:** mainstream economics, Industrial Organization, incentive compatibility, empirical foundations.

## CZEGO EKONOMIŚCI MOGĄ SIĘ NAUCZYĆ Z KRYZYSU GOSPODARCZEGO?

W artykule postawiono pytanie, czy współczesne załamanie gospodarcze wymaga „gruntownego przemyślenia” teorii ekonomii. O ile rzeczywiście mogło ono skłonić niektórych ekonomistów do rewizji poglądów, to nie obnażyło jednak żadnej sprzeczności w nowoczesnej ekonomii – a zwłaszcza w mikroekonomii. Współczesna ekonomia głównego nurtu rozwija się pod silnym wpływem tzw. organizacji przemysłowej, która bada mechanizmy współpracy pomiędzy podmiotami gospodarczymi i docieka, czy w trakcie tej współpracy spełnione są jakiegokolwiek kryteria optymalizacyjne. Dobrze wykształconego ekonomistę nie zdziwi więc fakt, że menedżerowie przedsiębiorstw niekoniecznie działają w interesie ich udziałowców, albo że banki mogą chronicznie źle kalkulować ryzyko swoich operacji finansowych. Również przyznane w 2009 r. Nagrody Nobla sugerują, że ekonomia głównego nurtu nie wymaga rewizji w obliczu załamania na światowych rynkach finansowych. Wręcz przeciwnie, zarówno prace Elinor Ostrom, jak i Olivera Williamsona są głęboko zakorzenione w standardowej analizie ekonomicznej i wskazują, że w konfrontacji z materiałem empirycznym owa analiza całkiem przekonująco wyjaśnia zjawiska rozwoju gospodarczego. Jednakże otwarte pozostaje pytanie, jak sprawić, by proefektywnościowe rozwiązania wypracowywane przez ekonomistów miały szansę praktycznego wdrożenia.

**Słowa kluczowe:** ekonomia głównego nurtu, organizacja przemysłowa, poprawność motywacyjna, podstawy empiryczne.