The Core of the Economic Method and Some Implications

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Introduction

• The Bank’s revised approach to economic analysis of projects:
  – What is the project’s development impact?
  – Is public sector provision or financing the appropriate vehicle?
  – What is the rationale for Bank involvement?
Introduction

• We will be drilling down into the detail of these issues over the next two days.
• What I would like to do in this talk is to provide a perspective from 30,000 feet on that detail, by considering the defining features of economic analysis—of the economic method.
• I will also from time to time link the core of the economic method to the specifics of the Bank’s work and to Human Development.
Some Readings

What is Economics?

• John Kenneth Galbraith

  – Economics is extremely useful as a form of employment for economists.
What is Economics?

• Thomas Carlyle

  – It's easy to train economists. Just teach a parrot to say ‘Supply and Demand’.
What is Economics?

• Art Buchwald

  – An economist is a man who knows a hundred ways of making love but doesn’t know any women.
What is Economics?

• Edmund Burke (on Marie Antoinette’s Execution)
  – I thought ten thousand swords must have leaped....to avenge even a look that threatened her with insult. But the age of chivalry is gone; that of sophisters, economists, and calculators has succeeded, and the glory of Europe is extinguished forever.
What is Economics?

• John Maynard Keynes
  – The master economist must possess a rare combination of gifts. He must be a mathematician, historian, statesman, philosopher--in some degree. He must understand symbols and speak in words. He must contemplate the particular in terms of the general, and touch abstract and concrete in the same flight of thought. He must study the present in the light of the past for the purposes of the future. No part of man's nature or institutions must lie entirely outside his regard. He must be purposeful and disinterested in a simultaneous mood; as aloof and incorruptible as an artist, yet sometimes as near the earth as a politician.
What is Economics?

• John Maynard Keynes

– If economists could manage to get themselves thought of as humble, competent people on a level with dentists, that would be splendid.
What is Economics?

• John Maynard Keynes

  – The theory of economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, an apparatus of the mind, a technique of thinking....
What is Economics?

• Gary Becker

  – The combined assumptions of maximizing behavior, market equilibrium, and stable preferences, used relentlessly and unflinchingly, form the heart of the economic approach.
What is Economics?

• Ravi Kanbur (2002). Elements of the Core of Economic Method
  – Core I: Voluntary Transactions Beneficial
  – Core II: No Market Power
  – Core III: Efficiency and Distribution Separable
Core I: Voluntary Transactions Beneficial

• Milton Friedman

– “…the elementary—yet frequently denied—proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed.”
Core I: Voluntary Transactions Beneficial

• This core principle, of voluntary and informed transactions being mutually beneficial, is the strength as well as the weakness of economics.
• It forms the basis of mainstream economist’s instinctive position that interfering in such transactions prevents mutual benefit.
• And when the mutual benefit is large, attempts to prevent such transactions will never succeed completely.
• The transaction will occur in another guise, where the benefits to the transacting parties will be smaller, but where it may have socially negative effects (e.g. when activities are driven underground).
Core I: Voluntary Transactions Beneficial

• Example: Foreign exchange rationing in Ghana (and other countries).
Core I: Voluntary Transactions Beneficial

• One implication of the benefit from voluntary transactions—specialization according to tastes/productivities.
• I can have both more oranges and apples than you, but taste difference can still lead to exchange.
• I can be more productive than you at producing both wine and cloth, but differences in our relative productivities can lead to exchange of cloth for wine.
• In other words Comparative Advantage.
Core I: Voluntary Transactions Beneficial

• The principle of Comparative Advantage emerges as a core of the economic method.

• Question: Is it the Bank’s comparative advantage to be involved in this range of activities? Is it relatively better at it than the alternative sources of finance and knowledge?
Core I: Voluntary Transactions Beneficial

- In other words, not just whether the value added of the Bank in A or B is positive (we hope it is), or how it could be improved (we should take recommendations on board).
- Not even whether the Bank is better at A than B is an absolute sense.
Core I: Voluntary Transactions Beneficial

• Not even simply whether the performance of the Bank in A or B is better than that of an alternative entity (private sector, official agency, government itself), although this is a good start.

• Rather, the question for a country with limited access to Bank resources should be: would the performance of the Bank in A compared to the performance of the best alternative entity, be better than this ratio for B
# WB and MICs (16)

Bank vs Others by Fit, Responsiveness and Access

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<thead>
<tr>
<th></th>
<th>Worse</th>
<th>Same</th>
<th>Better</th>
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<tbody>
<tr>
<td>Quality</td>
<td>7%</td>
<td>34%</td>
<td>60%</td>
</tr>
<tr>
<td>Fit to country needs</td>
<td>18%</td>
<td>39%</td>
<td>43%</td>
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<tr>
<td>Responsiveness when country needs change</td>
<td>28%</td>
<td>34%</td>
<td>38%</td>
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<tr>
<td>Ease of access to support</td>
<td>32%</td>
<td>37%</td>
<td>31%</td>
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WB and MICs (15)
Bank vs Official and Bank vs Private

<table>
<thead>
<tr>
<th></th>
<th>Less Effective</th>
<th>Same</th>
<th>More Effective</th>
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<tbody>
<tr>
<td>WB vs RDBs &amp; Bilaterals</td>
<td>21%</td>
<td>33%</td>
<td>45%</td>
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<tr>
<td>WB vs Private Capital</td>
<td>43%</td>
<td>20%</td>
<td>37%</td>
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## WB and MICs (17)

**Bank vs Others for Knowledge Services**

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<th>Less effective</th>
<th>Same</th>
<th>More effective</th>
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<tbody>
<tr>
<td>Bank vs RDBs and Bilaterals</td>
<td>10%</td>
<td>35%</td>
<td>55%</td>
</tr>
<tr>
<td>Professional advisers such as consultants and academics</td>
<td>24%</td>
<td>31%</td>
<td>45%</td>
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Core I: Voluntary Transactions Beneficial

• Case Study: India
  – SBL on IBRD; Phasing out of IDA.
  – In a constrained resource environment, what should the Bank offer its resources for, and what should the GoI use the Bank’s resources for?

• I have argued (Kanbur, 2010) that in India the Bank’s Comparative Advantage is in Lagging States and Social Sectors, not in High End Infrastructure and Finance.
Core I: Voluntary Transactions Beneficial

• The core instinct on voluntary transactions is the bedrock of the strength of the economic method, but it is also its weakness.
• But where the assumptions of voluntarism and information are weak the instincts of economists will be found wanting.
Core I: Voluntary Transactions Beneficial

• “Just between you and me, shouldn't the World Bank be encouraging MORE migration of the dirty industries to the LDCs?.....I think the economic logic behind dumping a load of toxic waste in the lowest wage country is impeccable and we should face up to that.”

— Lawrence Summers, World Bank Chief Economist
Core I: Voluntary Transactions Beneficial

- I have argued (Kanbur, 2004) that three features distinguish “obnoxious exchange” from the normal variety:
  - Possibility of extreme outcomes
  - Weakness of agency
  - Underlying inequality
Core II: No Market Power

• James Galbraith
  – “The prevailing theory is the idea that price and quantity are set in free competitive markets through the interaction of supply and demand. It is this idea, and no other, that lies at the core of the economist’s way of thinking. And it is also the source of the profession’s problem in getting almost anything important right...
Core II: No Market Power

• Supply, Demand, Markets and Equilibrium are the great strengths and also the weakness of economics.

• They provide powerful organizing principles, and powerful engines of analysis, but sometimes the engines are set to run on entirely the wrong tracks.
Core II: No Market Power

• Economists’ formulation of phenomena in terms of markets and equilibrium means that they instinctively look for what was there before an intervention, and what will be the reaction of the economy to the intervention.

• These are good instincts to have, even if implementation of those instincts often falls short.
Core II: No Market Power

• Thus, for example, there is usually rudimentary health provision through a private market even in the remotest areas.

• Leaving to one side the case for or against intervention, when intervention does take place, this will change the conditions for the pre-existing market, which will in turn affect the final outcome.

• The economist will instinctively ask for an analysis of these knock on effects, which will in turn require baseline information for a before/after comparison.
Core II: No Market Power

• Further, the attention the core method gives to the interaction of markets, to the general equilibrium of markets, inculcates an instinct to look for knock on effects, and spillover effects beyond the intervention, including questions of financial and fiscal sustainability.
Core II: No Market Power

• As a second example of the power of the core method, I take the much maligned supply and demand structure of analysis.
• It provides a systematic way of thinking about different influences on an outcome—even if there is no actual market.
• Example: education supply and demand when there is only state education. The usefulness of supply constrained versus demand constrained regimes.
Core II: No Market Power

• For me, perhaps the biggest danger in this powerful engine of analysis unleashed by the competitive markets framework is the unthinking acceptance of the assumption of perfect competition.

• More specifically, the assumption that no agent has market power over another. This assumption, while it strips away complications and generates our best known predictions and conclusions, is one of the biggest reasons for disconnect between economics and other disciplines and civil society.
Core II: No Market Power

- For Economic Analysis at the Bank, the implication is to keep a sharp lookout on whether the assumption of competitive markets, in labor or otherwise, is satisfied. (eg Malaysia NLTA on minimum wage)
Core III: Efficiency and Distribution Separable

• The third core of the economic method as I see it is to do with distribution and efficiency.

• The issue is NOT, as many non-economists and civil society activists would have it, that economics is unconcerned with distribution.

• Rather, the issue is somewhat different and a lot more interesting.
Core III: Efficiency and Distribution Separable

• At the core of the economic method is an instinct to *separate out* efficiency from distribution; to deal with each nexus separately.

• The real characterization of mainstream economics along this dimension is not insensitivity to distribution. Rather, it is the instinctive position that preventing mutually beneficial transactions is an inefficient way of improving distribution—that there has to be a better way.

• From this flows the policy instinct of using direct redistributive measures rather than market interventions to achieve distributional ends.
Core III: Efficiency and Distribution Separable

More than 25 years ago, the late James Meade, Nobel Laureate in economics and an egalitarian of note, wrote a pamphlet entitled “The Intelligent Radical’s Guide to Economic Policy.”

In Meade’s characterization the Intelligent Radical is “radical” because of a strong preference for equity, and “intelligent” because interference in markets and mutually beneficial transactions is eschewed in achieving this goal.

This separation is captured and crystallized formally in the Fundamental Theorems of Welfare Economics, and it is these theorems, with their implications of the separation of “efficiency” from “equity”, that form this aspect of the core of mainstream economics.
Core III: Efficiency and Distribution
Separable

• “In a competitive system those citizens who are well endowed from birth with in born capacity or inherited wealth and social contacts and who are favored by the luck of the market may earn much higher incomes and accumulate much higher properties than the less fortunate members of society.

• The intelligent radical does not draw the conclusion that the competitive market should be abandoned, but rather that far reaching direct fiscal measures should be taken by budgetary taxes and expenditures to moderate high, and to supplement the low, income and properties....

• In general...the intelligent radical will advocate more direct general measures for the redistribution of income and properties in preference to particular interventions in particular markets for this purpose.”
Core III: Efficiency and Distribution
Separable

• This separation once again a strength and a weakness of economics.

• The strength comes in breaking up the public policy problem into the “market failure” part and the “distribution” part and handling each in a focused way.

• The weakness is just the flip side of this coin.
Core III: Efficiency and Distribution Separable

• To be fair, recent years have seen tremendous advances in research and in mindset in linking these two dimensions—eg recent IMF work has argued that inequality is detrimental to growth.

• This changing mindset has allowed, for example, gender equity or human development interventions to be presented not only as equitable but also as “smart economics” (the phrasing itself reveals the legacy of separation efficiency from distribution)
Core III: Efficiency and Distribution Separable

• However, I contend that the core of the economic method still relies on this separation—the detailed write up of the economic analysis guidelines also show their roots in Core III.
Core III: Efficiency and Distribution Separable

• Final but very important point on the focus on efficiency and distribution. The focus is on interventions to “correct” market failure or distributional outcomes.

• The debate between efficiency and distribution, while important, takes attention away from intervention failure, or “government failure.”
Core III: Efficiency and Distribution Separable

• On this issue, economic analysis has had very little to say to guide intervention, despite the recent burgeoning of the “new political economy” literature.

• How is the core of the economic method to be applied in a practical way, analogously to standard cost-benefit analysis, to reform of public institutions?

• I contend that we simply do not know.
Summary

• Economics is a method, a way of thinking.
• At its core are three elements which structure the economic method: (I) Voluntary Transactions Are Beneficial, (II) There is No Market Power, and (III) Efficiency and Distribution are Separable.
• The very strengths of the Economic Method carry the seeds of its weakness. The weakness is often the flip side of the strength.
• Perhaps the greatest weakness of economics as a discipline is that, despite its magnificent strengths, it does not have a full appreciation of its weaknesses.