Development, Happiness,
and the End of Naive Neoclassical Policy

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Introduction

In the early twentieth century form of Neoclassical Economics, for example in the work of Lionel Robbins (1935), historical forces of technological change, institutional formation, and unstable and evolving values were edited out. These "very long run" Marshallian factors were considered "fixed". Profound change in these fields of consideration over recent decades has rendered early twentieth century, naive Neoclassical analysis less than adequate as a basis for policy. The result has been the branching of Economics into history, psychology, and game theory, A currently prominent example is the burgeoning of Behavioural Economics, but the root elements in that departure from naive Neoclassical analysis have been strong in the evolution of Economics in general over the past thirty years. The implication for policy is departure from recent Neoconservative assumptions about the omni-competence of market forces.

Happiness Economics

Having been adopted by a newly elected President of the United States, Behavioural Economics, a policy oriented application of the Economics of Happiness, has become a celebrity among the branches of Economics in that country. Books in the field multiply[1]. The essence of the thing is simple, but it has broad implications. It goes beyond "standard" Neoclassical Economics by refusing to accept the "rationality" of individual's decisions: "rationality" in this instance signifying an informed correctness in the judgment that individuals act upon in the pursuit of self interest. With this refusal the behavioural approach replaces the recently famous assumption of "rational expectations", and opens the door to societal manipulation of individual's choices.

Behavioural Economics has its limitations (Johns and Omerod, 2008) and dose not displace Neoclassical Economics. Rather, it offers a justifiable reach beyond Neoclassical Economics in an attempt to inform the implementation of public policy.

With sound intuition and growing, though incomplete, empirical support, Behavioural Economics asserts that individuals generally do not do what is in their own best interest, let alone what is good for the economy as a whole. They make bad choices because their process of choice is flawed. They are ignorant, impulsive, short sighted, and prejudiced. Accordingly, Behavioural Economics argues that there is a place for a knowing and judgmentally correct agent who can present choices in such a way that individuals are "nudged" into choosing what is good for themselves and for society.

Behavioural Economics clearly has strong implications for economic policy. Dating from before the Enron scandal, the Savings and Loan debacle, the Dot Com stock market slump, and the 2008 general economic slump, it is a soft return from the heyday of deregulation to social control of market forces. In practice, Behavioural Economics is a well informed list of tricks that the good and wise implementor can use to ensure that, even in a society in which judgement is an individual prerogative, behaviour will conform to politically established norms.

Behavioural Economics and its implications for institutions of social control, may or may not be a good thing, but that is not the point here. The point here is that it is one manifestation of a path enthusiastically taken in by some economists over the past thirty years. The enthusiasm will pass, of course, and it will be found that the Neoclassical Economics has not been abandoned. Rather, it will have been supplemented with adjustments in the preconceptions on which it is based. Naive Neoclassical Economics presupposed fixed technology and institutions, and, indeed, fixed "sovereign" consumer preferences. It was in that that it was naive. Post Naive Neoclassicism presumes that technological change is at the core of economic activity, and that the institutions of economic agency are constantly adapting to this. It presumes unstable and evolving entrepreneurial and consumer judgements. Accordingly, the logical core of Neoclassical theory has been left intact, but the policy conclusions to be drawn from it have not. For example, admission that comparative advantages in trade change with changing technology does not negate the proposition that trade is efficiently based on comparative advantage, but it changes policy from acceptance to positive action.

Over the last half of the twentieth century, economics in Canada became a local manifestation of a continental, if not, a Euro-American discourse, so examples of the emergent approach to economic theory and policy can be drawn from its expression by members of the Canadian economics profession.

The Game Theory Paradigm

In the latter half of the twentieth century, Game Theory emerged from an explicit attempt to overcome the naivety of Neoclassical Economics (Shubik, 1982; Mirowski, 1992; Shotter, 1992). Game Theory was constructed on the assumption that the information shaping entrepreneurial decisions and the institutions in which those decisions were made, were, respectively, an uncertain and unstable consequence of a designated, changing technological context. It conceived an equilibrium (a Nash Equilibrium) apart from the efficiencies associated with informationally and institutionally static, naive Neoclassical competitive conditions.

The Implications for Public Sector Economics and Policy

According to Robin Broadway, late twentieth century Public Sector Economics, in its most advanced expressions, had adopted a game theoretic "information approach" that attempted to penetrate the processes of preference formation in the general public (Broadway, 1997). At one point he stated, "If imposing distortionary taxation is an efficient way of relaxing the self-selection constraints, perhaps other forms of distortion, such as quantity controls, might be efficiency enhancing as well" (Broadway, 1997, p. 760), At another point he characterized the results of such

government intervention as only second best; affirming that "... the use of distorting taxes expands the economy's second-best efficiency frontier" (p. 761). Still, at yet another point he wrote that such interventions "... move the Pareto-Efficiency Frontier outward".(Broadway, 1997, p. 761; see also p. 769, para 1); and still later, he referred to "the old second best theory that [the new information approach] has partially displaced." (Broadway, 1997, p. 769).

The concerns and methods of Game Theory also had immediate implications for Industrial Organization Theory and the reform, if not elimination, of competition policy (Green, 1986). In game theoretic Industrial Organization Theory high concentration ratios were associated with dynamic improvements, that is Very Long Run efficiencies due to economies of scale and scope associated with technological advance and organizational adaptation. With this approach, conceptualization moved from a former "mainline", normative, structure-conduct-performance, naive Neoclassical paradigm to a more positive, strategic-response-contestable-market game theoretic paradigm.

Acceptance of a game theoretic approach entailed denial of the empirical relevance of the First and Second Theorems of Neoclassical welfare economics[2] for practical policy (Blackorby, 1990: Broadway, 1997). Among the consequences of this view was acceptance by those who were most aware of the change in paradigm that the primary function of government was redistribution rather than efficiency simply taken. Accordingly, Richard Musgrave's separation of the allocation and distribution functions of government was thought to be not representative of government behaviour.

The Implications for Trade Theory, and Commercial Policy

Early in the period Richard Harris introduced economies of scale into a computable general equilibrium model and used the model to predict gains from free trade between Canada and the United States (Harris, 1984). It was a sophistication, though much that was naively Neoclassical remained in his presentation. Other works took a look inside the putatively empty boxes of Naive Neoclassical theory, but no more than a look. According to Tim Hazeldine, the models of Richard Harris and David Cox, like those of most Canadian economists, continued to rely on much that was naively Neoclassical (Hazeldine, 1989, p. 453.) Harris himself, however, in an exhaustive review of the evolution of trade theory and the contributions of economists in Canada to that evolution (Harris, 1989), seemed to be saying that Game Theory had substantially altered the traditional international trade paradigm, and that the alteration had come in the form of recognition of the extent to which changes in technology and institutions qualified Neoclassical analyses (See also Melvin, 1990). Evidently there was a paradigmatic shift, and as Hazeldine, himself, pointed out, computations of the benefits of free trade differed depending on whether assumptions were Neoclassical or game theoretic (Hazeldine, 1990).

The Intrusion of Feminist Economics

Toward the very end of the twentieth century the arrival of Feminist Economics fulfilled its promise by placing a new emphasis on distribution, by forcing consideration of the 25% of the population that falls below the age of seventeen, and by taking a fresh look at theory. Feminist

economics was rooted in a less naive approach. According to Shelly Phipps,

> The 'utility' approach is problematic for a study of the well-being of children because at the level of theory, there is the problem that utility functions are typically assumed to be 'given', yet children's preferences are clearly in the process of forming, indeed 'growing up' is the defining characteristic of childhood (Phipps, 1999, p. 1142)..

At a theoretical level Feminist Economics attempted to get inside what it called Becker's "black box model" of the family (Phipps, 1999, p. 1154. See also, Currie, 2004.). But questioning the relevance of accepted theory for one quarter of the population moved beyond filling up a particular theoretical vacuity to filling up a more fundamental empty box of neoclassical analysis, because it asserted that Amarta Sen's concept of personal maximization and the instability of preferences was also relevant for those over the age of seventeen (Phipps, 1999, p. 1145). The feminist concern was not with the fact of maximization, however, its concern was the nature of informational and institutional constraints in the context of which "*homo economicus"* took into account the measure of relative scarcity (Samson, 1995, p. 145). In light of these considerations Feminist Economics suggested that policy was well advised to look beyond the traditional concept of consumer sovereignty to its unstable underpinnings.

The Intrusions of Historically Sensitive Growth Theory

Abandoning the Naive Neoclassical foundation of growth theory took a long time and was not universal. Where it was abandoned it terminated in "historically sensitive" growth theory and its associated literature (for example, Hodgson, 2002; Helpman, 2004; and Warsh, 2006), but it started much earlier. Indeed there were some who, along with Harry Johnson (see Neill, 1991, p. 184), never accepted the abstractions of either Neoclassical or Western Marxist growth theory.

Historically sensitive growth theory's roots lay in the debate over Keynesian and New Classical general equilibrium models – their seeming empirical failure to account for growth – and the consequent emergence of endogenous growth models in which the second principle of naive Neoclassical economics, diminishing returns, is held in abeyance. It roots notwithstanding, the evolution of growth theory also was based on advances in Industrial Organization Theory and Trade Theory as influenced by Game Theory (Howitt, 1994, p. 771).

Historically sensitive growth theory began with an early twenty first century comment on the problem of using Neoclassically defined Total Factor Productivity to measure technologically generated improvements in productivity and living standards. Lipsey and Carlaw pointed out (1) that a production function such as that used by Solow [Y = f(K, L)] to measure total factor productivity assumes the Neoclassical long run condition of zero technological change; (2) that a function of this sort assumes aggregation of the microeconomic production functions of individual firms in equilibrium in single product, competitive industries; (3) that the Cobb-Douglass version of this Solow-type aggregate production function ignores variations in macroeconomic capacity utilization; (4) that these constraints on theory are acceptable approximations only in the "short" or "medium" term when the Marshallian Long Run growth rate of total factor productivity is the growth rate of

some index of total output less the growth rate of some index of total inputs, and (5) there is no reason to question the formation of the indexes. Such theory, they asserted, tells us nothing about the effects of technological change or any associated evolution of industrial organization (Lipsey and Carlaw, 2004). In short, they were asserting that a production function of this sort is naively Neoclassical.

The contribution of "historically sensitive growth theory" to the reduction of naivety in Neoclassicism is most evident in *Economic Transformations* (Lipsey, Carlaw, and Bekar, 2005), in which theory is reduced to historical thesis, and in which it is implicitly but definitely recognized that in the Very Long Run we are very much alive. Its policy implication is that conditions fostering economic growth cannot be reduced to the assumed conditions of Neoclassical "free enterprise perfect competition".

The Passing of Naive Neoclassical Policy, or Not.

In general, the problem for Naive Neoclassicism is its structural inability to discern the effects of advancing technology, evolving values, and changing institutions. Confronted in the past thirty years with economic activity driven by profound technological developments, adjustments in values, and reorganization associated with increasing globalization of markets (Melvin, 1990: Brander, 1992), it simply failed the test of applicability. On evidence drawn from the evolution of Economics in Canada, it would seem that this problem has been faced in theory. The empirical base for the implied necessary revision of policy has yet to be definitively established, and policy itself has yet to substantially conform to the reformation of theory. The depressed and unstable conditions that appeared throughout the global economy in 2008 will be a catalyst in this respect.

There are, however, at least four ways in which naive Neoclassicism, apart from Neoclassically based policy, has not passed. (1) It has been supplemented, not negated. (2) There are those who still hold to it in its naive form. (3) There are those who still are ready to mix it with other approaches as a base for policy. (4) The spirit of Neoclassicism, a reluctance to assume that government intervention can improve on any situation that has been produced by the "natural" forces of history, is still very much alive.

Notes

1. For example, Dan Ariely, *Predictably Irrational: The Hidden Forces that Shape our Decisions*, Harper Collins, (2007). Bruno S. Frey., *Happiness: A Revolution in Economics*, MIT Press, (2007). Daniel Kahneman, Paul Slovic, and Amos Tversky (eds), *Judgement Under Uncertainty: Heuristics and Biases*, Cambridge University Press, Cambridge, 1982. Richard H. Thaler, *Nudge: Improving Decisions about Health, Wealth, and Happiness*, Yale University Press, New Haven, 2008.. Richard H. Thaler, . *The Winner's Curse: Paradoxes and Anomalies of Economic Life,* Free Press, New York, 1992 Helen Johns and Paul Omerod, "The unhappy thing about happiness economics", *Real-World Economics Review,* no. 46, pp. 139-146. Extended lists of journals articles are available on line. For a list of references to the broader field of the Economics of Happiness see Carol Graham, "The Economics of Happiness", forthcoming in Steven Durlauf and Larry Blume, eds. *The New Palgrave Dictionary of Economics,* Second Edition.

2. The First and Second Theorems of Neoclassical Welfare Economics are here taken to be the following: (1) under standard competitive conditions economies are Pareto efficient, and (2) any of many Pareto efficient solutions can be achieved by a suitable reassignment of endowments among households.

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