Economic Pragmatics

Review of George Akerlof's *Explorations of Pragmatic Economics*

By Leeat Yariv, California Institute of Technology

The influential body of work produced by George Akerlof has turned him into an economist on the verge of a retrospective for some time now. *Explorations in Pragmatic Economics* provides that long awaited compilation of favorite hits by Akerlof and his co-authors. The underlying theme of the book is the interplay between micro and macro behavior. Minor defections from statistical sophistication, a small amount of stickiness in updating prices, or a slight tendency to hold self-confirming beliefs, are only some of the micro phenomena that are analyzed and shown to generate potentially significant macroeconomic consequences.

As a compilation of papers, the book is by nature somewhat eclectic. In fact, in analogy to Leibniz' *Monadology*, the book could be thought of as Akerlof's *Nomadology*, constituting of papers journeying from area to area in economics. While it is not structured as a text book, it could certainly be a natural accompanying text for various advanced graduate classes. It is also interesting from a "history of thought" point of view. Indeed, the recent behavioral up rise has introduced and reintroduced many of the phenomena the articles in the book suggest (e.g., the ideas that agents hold self-confirming beliefs or have a taste for immediate gratification). In that respect, some of the ideas presented throughout the book will appear astonishingly familiar even to those who have not been weaned on the articles themselves.

The wonderful introductory chapter is useful in summarizing and linking the different papers. It also spells out Akerlof's dictum that economists should subject their beautiful theories to sprinkles of empirics and loitering with facts regarding the details of microeconomic behavior. Certainly, when one goes through the articles, one is left with the sense that empirical work served as a trigger or motivation for much of the (alas, parsimonious) formal modeling. For the reader who is short on time, I highly recommend the introduction as a stand alone piece.

The book is divided into segments broadly categorized as micro- and macroeconomics, each presenting several conglomerates of related papers. In what follows, I shall try to briefly describe to the aspiring reader each of the major pieces presented in the book.

The microeconomic part of the book starts with a discussion of information asymmetries and presents one of the most notable (and literal) exercises in

turning lemons into fantastic lemonade, "The Market for Lemons." This important paper introduced the idea that asymmetric information may cause some markets to disappear in the absence of long-term guarantees. Indeed, if a commodity's quality is known only to the seller but not to potential buyers, the seller has incentives to pass off a low-quality good (a "lemon") as a higher-quality one. Sophisticated consumers take these incentives into account. Thus, the mere fact that a commodity (say, a used car) is on the market suggests its potential undesirability (its potential for constituting a "lemon"). Consequently, in the absence of long-term guarantees by the seller, consumers may be quite wary of purchasing such commodities, and the corresponding markets may be restricted or vanish altogether. This idea has been applied to numerous realms ranging from used cars to capital markets to online dating. Beyond introducing a new methodology to the bastion of economics of complete information, the paper is also a professional exemplar for the jaded. This mighty piece has apparently fallen several times through the cracks of refereeing processes at a few of the top journals until it finally got published in the distinguished *Quarterly Journal of Economics*. It is possibly the most influential paper (as of yet) appearing in the volume.

The sequence of papers that follow do not directly tie to the lemons paper (as Akerlof admits, partly because of that paper's rocky reception), though follow themes in their own right. In particular, the second theme of the book, presented in Chapters 2-4, deals with issues pertaining to identity and their importance to economic phenomena. In two papers, the reader finds the "dent" in "identity" in the form of discrimination. In these papers one's identity with a group (a caste) may lead to economically sub-optimal equilibria. Individuals may be willing to obey the caste codes because of sufficient punishment norms for defection within the caste. Thus, the notion of "caste equilibrium" is coined and two important macroeconomic implications are analyzed. First, caste equilibrium can entail a gap between supply and demand that explains what would appear as discriminatory unemployment. Second, the models help analyze the type of codes that can be sustained by castes.

The third paper under this theme ("Economics and Identity," co-authored with Rachel Kranton) provides a more general framework for thinking about identity in economic contexts. It draws on insights from sociology, and illuminates the important aspects of identity formation, as well as makes the case that thinking about identity is crucial for understanding a plethora of economic symptoms across fields, particularly in labor economics (e.g., why women (men) are not supposed to engage in male (female) type jobs, how racial discrimination occurs, and so on).

The third set of essays, Chapters 5-7, studies income redistribution and family structure, and utilizes some of the adverse selection techniques that were pioneered in the lemons paper. "The Economics of 'Tagging'" points to the difficulties stemming from asymmetric information in the US welfare system. Since the government does not know incomes a-priori, it "tags" groups of people who are particularly likely to be needy. This policy has many unfortunate consequences and the paper argues for earned income credits as an alternative policy. Low skill, misfortune, and family structure, are a troika of significant components in the determination of economic neediness, and the papers that follow tackle the endogenous formation of impoverished groups by studying the last of the three.

Empirically, the introduction of oral contraception and legalization of abortion in the late 60s and early 70s was accompanied by significant declines in the rates of "shot-gun" marriages occurring during pregnancy. Akerlof's economic brethren have argued that the changes in that time empowered women , and made a woman's pregnancy less of the "man's fault." Consequently, out-of-wedlock births became more common, their associated stigma weakened, and a curious feedback loop was created. Nonetheless, as Akerlof and co-authors point out, these arguments are confounded with another historical transition -- the secularization of sexual relations -- that may have trumped the custom of marriage upon conception. The consequences for welfare, especially in view of "tagging" policies are dramatic. Indeed, restricting assistance to single mothers would hardly affect the scope of out-of-wedlock births, but would seriously decrease the income and welfare of unfortunate mothers and children. The analysis crystallizes the interplay between norms, identity, and social tagging.

The fourth group of papers, presented in Chapters 8-10, considers the wide paradigm of economics and psychology. In two of the papers the underlying tradeoff is between holding beliefs (e.g., regarding safety measures on the job or financial returns) that are accurate and holding beliefs that are pleasant. Even a slight taste for self-comforting beliefs may have dramatic effects in various contexts. This is especially relevant for collective decision settings. Each atomic individual has little influence on outcomes and therefore may as well select beliefs that are affirming rather than correct, but the aggregate effect may be substantial. These two papers have a clear link to the identity papers, the latter suggesting a potential channel by which (possibly erroneous) beliefs are formed.

The idea that people exhibit a taste for immediate gratification is now part of the standard discourse of economics and psychology. It is thus befitting for the volume to contain a paper studying the implications of present biases and issues of self control. Again, the paper builds up on a slight taste for immediate

gratification and illustrates its potentially grand effects on procrastination, notably important for saving behavior.

The microeconomics section of the book concludes with a paper on financial mischief. In "Looting: The Economic Underworld of Bankruptcy for Profit," co-authored with Paul Romer, one particular managerial malady is identified. Accounting rules permitting, managers and owners may have incentives to loot a company (pay excessive dividends) in one period if they know the firm will declare bankruptcy later on. Indeed, the return from a marginal dollar once a firm is bankrupt is zero, and a "morbid" equilibrium exists. Following the general theme of the book, a small divergence between accounting and economic definitions, may have great impacts for the survival of firms.

The macroeconomics half of the volume comprises four topics. The first, appearing in Chapters 12-14, illustrates the impacts of small frictions on the economy. It starts with the maxim of monetary neutrality - expected changes in money supply are classically anticipated to be accompanied by matching changes in wages and prices that leave real variables unchanged. However, if, for instance, wage or price settings are staggered, the neutrality result may evaporate. This is illustrated in a few contexts. In the first paper firms simply alternate in introducing price changes. In the following few papers, banks use target-threshold rules, which connect money demand and the flow of funds. Furthermore, target-threshold demands for money explain why both fiscal and monetary policy are effective in changing aggregate demand in the short run, turning (to the paper) "Irving Fisher on His Head."

The second set of papers, Chapters 15-17, deals with unemployment and the ultimate question of why involuntary unemployment exists. Indeed, a classical economist would expect wages to equilibrate demand and supply of labor so that those who want to work, will work, albeit for a possibly very low wage. In "Jobs as Dam Sites," a simple response a-là Ricardo is given. Workers with sufficiently low skills, even if willing to work, would make employment, even at zero wage, potentially non-economical. Just like the construction of a low quality dam, cheap as it may be, at a prime site, may be non-economical.

In the papers that follow an alternative style of explanation for voluntary unemployment is given. Namely, the idea that firms may be reluctant to reduce wages below a certain point caring about workers' morale, as a consequence of fairness, or a reciprocal gift exchange norm (i.e., the experimentally grounded idea that paying workers well will make them exert effort in return) vis-à-vis the workers. These "morale hazard" explanations for wages that exceed market clearing levels have strong conceptual ties to the microeconomic papers dealing with identity. They both stress one's internal psychological ideals as opposed to pure economic considerations.

The penultimate suite of papers, appearing in Chapters 17-19, combines some of the previous ideas regarding sluggish adaptation and analyzes the nature of macroeconomic equilibria. Classical economics adheres to the idea that changes in money supply should have no effect on economic equilibria, in particular on output or unemployment. However, a sluggish response by firms (or workers) may result in significant changes to the equilibrium at play and push money neutrality into a very dusky horizon. Similarly, a small amount of money illusion derived from, say, firms' response to workers' dislike of wage cuts, can produce an interesting tradeoff between inflation and unemployment even in the long-run, and cause the prevailing Phillips curve to be non-vertical, contrary to classical economics' credo. These papers illustrate, yet again, the significance of micro-level reactions to macro-level end results.

The closing paper of the book is Akerlof's 2001 Nobel Lecture, "Behavioral Macroeconomics and Macroeconomic Behavior," that argues for the natural appeal of behavioral elements in macroeconomic analysis. Ironically, Keynes' *General Theory* is filled with psychological explanations of observed phenomena. The economics' weapons of math destruction have tamed Keynes' contributions and transformed it to what is known nowadays as classical economics. The chapter illustrates how behavioral explanations can fill important empirical gaps using psychological observations on reciprocity, fairness, loss aversion, herding, etc.

To conclude, the book compiles some of the most innovative articles written in the past few decades. It is a must read (or at least, a must skim) for any economist, be it a micro, macro, behavioral, or misbehavioral one.