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The behavioral economics of George Akerloff and Harvey Leibenstein

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Abstract

Behavioral economics is now receiving greater acceptance in the economics profession. One illustration of this acceptance is the Nobel Prize awarded to George Akerloff in 2001.

Akerloff's work included issues of rationality, work norms, and asymmetric information in both more and less developed countries. Leibenstein was one of the first economists in recent decades to explore behavioral economics. This was accomplished through his development of X-efficiency theory, but not exclusively through X-efficiency theory. This paper will show similarities in the work done by Akerloff and Leibenstein, and cite examples of how Akerloff extended some of Leibenstein's work, leading to Akerloff's much deserved Nobel Prize.

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1. Introduction

Recently, three economists were given the Nobel Prize for their work in behavioral economics: George Akerloff, Daniel Kahneman, and Joseph Stiglitz. Behavioral economics has now received much greater acceptance in the economics profession than it had in 1983 when the first conference on behavioral economics was held at Princeton University. Yet, the recognition it received in 1983 was a large multiple of what it was in 1971 when the *Journal of Behavioral Economics* (now the *Journal of Socio-Economics*) was started by Richard Hattwick at Western Illinois University. Even the *New York Times* has hailed behavioral economics. The problem is, in their February 11, 2001 article, "Some Economists Call Behavior a Key," the Times claimed that 1994 will be remembered as a "momentous" date in the history of economics (Uchitelle, 2001). The reason it is momentous is that it was the

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year in which David Laibson received his Ph.D. Laibson's work may one day earn him a Nobel Prize. But if it does he will be standing on the shoulders of the pioneers of behavioral economics, people such as Akerloff, Kahneman, Stiglitz, and Herbert Simon, all winners of the Nobel Prize, as well as George Katona, Richard Thaler, and Harvey Leibenstein.

The focus of my paper is Leibenstein and Akerloff, specifically, how Akerloff's work extended Leibenstein's. In the next section I present a very short discussion of the salient characteristics of Leibenstein's X-efficiency theory. This is followed by a discussion of some of Akerloff's work. Finally, I present some extensions of Leibenstein's work contained in Akerloff's research.

2. X-efficiency theory

The development of the theory of X-efficiency began as the result of an intuition. Leibenstein was teaching at Berkeley where he had a graduate assistant whose effort and performance varied considerably week-to-week. It was only during one meeting with his graduate student that it suddenly occurred to him that perhaps efficiency in the form of effort and actual performance varies considerably across individuals, firms, or industries. He began searching for data. There were three types of data which were significant. First, data from more (U.S. and England) and less developed countries (India, Burma, Indonesia, Thailand, Pakistan) showed that simple reorganizations of manufacturing plants or changes in management–labor relations, or changes in incentive systems, with capital and labor inputs constant, resulted in relatively large changes in labor productivity. Clearly, there were forces at work determining total output and labor productivity other than the traditional inputs—quantity of labor and capital. Second, data showing that gains in allocative efficiency from increased competition was extremely small, usually no more than one-tenth of 1% of output. Why the small estimates? Because the estimates assume that firms purchase and use all inputs efficiently and hence that they are operating on their production and cost functions. In other words, without the opportunity for changes in organization, broadly defined, the only efficiency gains possible are the net marginal effects of price and quantity changes. The third type of data is related to Robert Mundell's (1962) response to the estimates of only very small gains in allocative efficiency. Robert Mundell lamented that small gains in allocative efficiency could be interpreted that there are only small efficiency losses due to market power and hence neither economics nor economists were of much importance. Mundell called for a rethinking about how the estimates of allocative efficiency gains are constructed. Leibenstein's response to small estimates of gains in allocative efficiency was different. He had already envisioned a different type of efficiency at work, and so *initially* he chose to leave the estimates of allocative efficiency alone. Since the type of efficiency he was thinking about was not well understood by economists, including himself, he simply choose to refer to it as X-efficiency. His first statement of allocative and X-efficiency appeared in the June 1966 issue of the *American Economic Review* (Leibenstein, 1966).

In one his early post-1966 articles, Leibenstein, in a co-authored paper with William Comanor (Comanor and Leibenstein, 1969), addressed the size of potential gains in allocative efficiency, showing that gains in X-efficiency increase the size of allocative inefficiency. In Figure 1, begin with monopoly price and cost equal to P_m and C_m , respectively. Monopoly

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