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Positive economic incentives New behavioral economics and successful economic transitions

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Abstract

The core hypothesis of this paper is that, despite adverse economic effects of custom, tradition, command economies and their aftermath, implementation of well-considered macroeconomic policies has rapidly generated successful economic transition—and conversely. The hypothesis has been tested for Russia, East Germany, selected countries in sub-Saharan Africa, and in the Western Hemisphere. Key factors of behavioral economics have helped to explain results that are often different from those of neo-classical analysis. It has been shown that relations between the presently evolving global economy and national macroeconomic policies have had fundamental effects on the propensity of economic entities to utilize positive incentives for optimal economic outcomes.

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1. Introduction

Since the time of Adam Smith, and even earlier, economists have concentrated on analyzing the conditions of economic equilibrium in a given political and economic context. They have

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also examined the necessary conditions for restoring economic equilibrium. Understandably, until recent years, practically no attention has been paid to the problems of a nation transforming its economy from one politico-economic context to another. The innovation of this paper – in line with the evolutionary approach of behavioral economics – is to examine the recent economic transitions in Russia, East Germany, selected countries in sub-Saharan Africa, and in the Western Hemisphere. The core objectives are to show the relations between the presently evolving global economy, the implementation by a nation of well-founded macroeconomic policies, and the propensity of individual economic entities to utilize positive incentives for optimal economic outcomes. The paper is in three parts. Part I (Section 2) extends the analysis of Theodore W. Schultz and his students on transforming traditional agriculture to modern transition economies. Part II (Section 3) presents the relevant key aspects of the new science of behavioral economics. Part III examines the necessary conditions for successful economic transition.

2. Extending Schultz's analysis

First, I would like to draw attention to the unheralded triumph of economics over custom and tradition. But I must be careful not to be misunderstood. It is not that these factors are unimportant in economies, but if their effects can be explained in economic terms, they can be tested and established on a more solid footing. Moreover, it has often mistakenly been claimed that custom and tradition would make unlikely, or even impossible, a rapid and successful economic transition, or that they were the major causes of economic failures. But recent experience has shown that a nation's success in transforming itself into a healthy, developed and industrial economy depends, primarily, on its government's adherence to robust macroeconomic policies and that such policies prove more significant than purported national weaknesses of character and mindset.

Schultz famously demonstrated that traditional farm people, for all their established ways, nevertheless responded realistically to the economic cues of the marketplace; they could see what was advantageous to them, and they acted accordingly—adjusting their economic behavior to prevailing costs, prices, and other variable parameters. Fundamentally, they were in a state of economic equilibrium in the sense that, under the conditions they faced, they were optimizing their economic activity (Schultz, 1970). It is my objective to extend this insight by generalizing the analysis to non-traditional economies of the 21st century. Prior to Schultz's research, it was generally held that traditional farm people were poor because they were bound by custom, innately lazier and more backward than non-farm people. Presumably, they lacked incentives to work harder to improve their and their families' well being. Schultz and his students showed that these assumptions and conclusions were erroneous.

Schultz himself, by implication at least, drew attention to several necessary conditions for traditional economies, to break out from their underdevelopment. Producers, guided by intuitive beliefs and preferences, would have to operate in an environment where incentives existed to discover, develop, produce and distribute new factors of production. Demanders, in turn, would have to operate in an environment where they had incentives to search for information about the new factors of production and the attendant new goods and services. Such developments could be analyzed in a cost-and-revenue frame of reference. It will be shown that two new phenomena are helpful in extending the analysis. First, as shown in Fig. 1, world GDP has been moving toward synchronized rates of economic growth. This trend has been associated, in most industrial countries, with a reduction in economic volatility, especially lowered rates of inflation