STRAIGHT TALK

# Assume anarchy?

## Why an orthodox economic model may not be the best guide for policy

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INSTITUTIONS are all the rage. The absence of institutions—such as efficient and impartial judiciaries, legal systems to protect intellectual property, tax administrations that are efficient and free of corruption, and credible central banks—is offered as an explanation for some of the central puzzles in development economics, including why so many countries don't grow fast enough to vanquish poverty.

But, unfortunately, economic theory offers us little guidance on how strong institutions are created and nurtured. And, unless we develop a better understanding, simply reciting the mantra "institutions" offers little in the way of constructive policy advice to less developed countries, leaving the policy arena open to other, more dubious views. A tremendous amount of research is now being conducted on the provenance of institutions—including whether they are a proxy for deeper forces. But my focus here is on why mainstream economists have neglected this in the past. In particular, I want to ask how much blame for this neglect should be attached to the canonical model in economics: the complete markets model.

### Assume a perfect world

In this theoretical model, which every graduate economics student encounters in one form or other, everyone is fully informed; every eventuality is anticipated in contracts; all contracts are enforced by omniscient, incorruptible courts; and governments automatically take care of all the public goods and interfere in none of the private ones. Clearly, this is an abstraction even in relation to the developed world. Yet it is regarded as a useful starting point for a number of reasons.

First, it is argued, the model is, in important respects, a reasonable approximation of reality. Second, it usefully serves as a common point of departure, deviations from which—and the fewer the better—have to be justified. This approach disciplines research, preventing original but muddled thinkers from generating results simply by making unorthodox assumptions. It enables economists to talk to each other rather than past each other. It helps economists see the implications of their favorite deviation from the assumptions of the complete markets model by comparing the conclusions from the model incorporating that assumption with those of the complete markets model itself. And it enhances debate and understanding (and makes refereeing for scholarly publications easier). Third, the model is mathematically tractable and allows elegant theorems and proofs.

The point of building models is to learn about the real world by abstracting from details that are irrelevant to the issue being considered. Without models, we would just have descriptions. But while some abstraction is important, gross abstraction can make a model irrelevant. And for many situations, at least in the developing world, the complete markets model is too far distanced from reality to be useful.

Take, for example, armed conflict, which plagues many poor countries. It is usually viewed as wasting resources and, therefore, being economically inefficient. There is no room for conflict in the complete markets paradigm: with complete markets, we would simply anticipate all possible situations of conflict and contract them away. But, in truth, an important reason for continued conflicts in some countries is that there is simply no credible mechanism to enforce contracts. Warlords may sign peace treaties but, knowing they won't be enforced, exploit the ensuing peace to prepare for the next war. How to build commitment against predation and enforce contracts at the national level are first-order economic issues. Early economists, like Hobbes and Locke, reflected on them. But with a few notable exceptions, economists neglected them for many decades, in part, perhaps, because many were trained in developed countries, where the complete markets model is somewhat less absurd. Only recently have economists returned to these questions.

Although the model can be a useful abstraction in some circumstances, it is an intellectual straitjacket when applied universally, particularly because it ignores the costs of contracting and enforcement. Requiring card-carrying economists to stay within a few standard deviations of the model may greatly hinder their ability to focus on what is essential in environments different from the one that gave birth to the model. I say this even though several important breakthroughs in economics in the past three decades have come from one-step deviations, such as assuming that not everyone has the same information (known in the jargon as "asymmetric information") or that economic activity is carried out by organizations where employees may not share the goals of the organization (known in the jargon as "agency").

### A poor guide for policy

One problem with relying on models that are within a few standard deviations of the complete markets model to guide policy in poor countries is that solutions may seem far easier than they actually are. For example, in these countries some contracts are inflexible or don't exist. The facile policy prescription from the model is to advocate greater flexibility or create the missing contract. Yet there may be far deeper deficiencies that need to be addressed to rectify the problem.

For example, the inflexibility of labor contracts—particularly the difficulty of firing employees—is seen as inefficient because it doesn't permit firms to react quickly to business conditions. Often, these prohibitions are ascribed to overly strong unions that hold the economy for ransom. But if courts are slow and corrupt, so that a worker who is wrongfully fired has no redress, perhaps the prohibition on firing—because violations are so easily and publicly observable—is the only way to protect workers from arbitrary decisions by employers. Job tenure may also act as a form of social security, necessary because the government does a miserable job of providing a safety net and private insurance markets do not exist. Admittedly, these explanations are speculative, and the truth may lie elsewhere. But my point is that crude, inefficient prohibitions on firing may be a robust response to a number of deficiencies in the system, many of which reinforce each other in subtle ways. If so, unions may command strong popular support because of deficiencies in the system rather than be the cause of them. This is not to say that inflexible contracts are without cost but that altering them may require deep-rooted reform.

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Consider another example. Small entrepreneurs in developed countries often have to pledge property as collateral for a loan. The poor in developing countries often lack clear title to their assets—such as the land they occupy. So, some analysts suggest, a way to give them access to finance is to give them clear title. In practice, however, this suggestion is hard to implement when so much else doesn't work. For one thing, how is the tenuous protection of existing private property affected when squatters obtain property rights? How will informal ways of establishing ownership by determining the historical antecedents of a particular piece of property be misused when local thugs and politicians can coerce the citizenry? Instead of analyzing the effects of introducing contracts in a world where everything else works, a better approach might be to investigate the effects of introducing a legitimate contract in a world where nothing works. Our analysis would be better informed by assuming anarchy as a starting point rather than a pristine world of complete contracts.

I am not suggesting that policymakers do actually analyze problems with a complete markets model in mind. They do, of course, make adjustments for the world they confront. But their worldview is naturally influenced by the frameworks they were taught. And because those frameworks assume so much that is unrealistic, how confident can policymakers be in their recommendations?

Nor am I arguing for undisciplined economic thinking, for an "anything goes" school of theory. Economics has come a long way in the past half century, and much that we have learned is of great relevance. Respectable economists, such as Oliver Hart and Jack Hirshleifer, have escaped the straitjacket of the complete markets model without sacrificing sensible economics. But a sizable group of economists still thinks there is only one model, and complete markets is its name. One can only suspect that elegance rather than relevance is its appeal.

### Assume anarchy?

Institution building is one area where international financial institutions and policymakers have learned from experience and have used common sense to devise practical approaches, without much guidance from academia. And there is hope, supported by a growing body of research, that more students of development are realizing that a better starting point for analysis than a world with only minor blemishes may be a world where nothing is enforceable, property and individual rights are totally insecure, and the enforcement apparatus for every contract must be derived from first principles—as in the world that Hobbes so vividly depicted. Not only will this kind of work more closely approximate reality in the poorest, conflict-ridden countries, but it could also lead to more sensible policy. ■