

## Chapter 1 : Economic Behavior and Institutions

*An important new research program has developed in economics that extends neoclassical economic theory in order to examine the effects of institutions on economic behavior.*

Art and culture See also: However, these institutions may be considered private or autonomous, whilst organised religion and family life certainly pre-date the advent of the nation state. The Neo-Marxist thought of Antonio Gramsci, for instance, distinguishes between institutions of political society police, the army, legal system, etc. For example, in *Schenck v. United States*, the circumstance of which made that speech case special Informal institutions[ edit ] Informal institutions have been largely overlooked in comparative politics, but in many countries it is the informal institutions and rules that govern the political landscape. To understand the political behaviour in a country it is important to look at how that behaviour is enabled or constrained by informal institutions, and how this affects how formal institutions are run. For example, if there are high levels of extrajudicial killings in a country, it might be that while it is prohibited by the state the police are actually enabled to carry out such killings and informally encouraged to prop up an inefficient formal state police institution. An informal institution tends to have socially shared rules, which are unwritten and yet are often known by all inhabitants of a certain country, as such they are often referred to as being an inherent part of the culture of a given country. Informal practices are often referred to as "cultural", for example clientelism or corruption is sometimes stated as a part of the political culture in a certain place, but an informal institution itself is not cultural, it may be shaped by culture or behaviour of a given political landscape, but they should be looked at in the same way as formal institutions to understand their role in a given country. Informal institutions might be particularly used to pursue a political agenda, or a course of action that might not be publicly popular, or even legal, and can be seen as an effective way of making up for lack of efficiency in a formal institution. For example, in countries where formal institutions are particularly inefficient, an informal institution may be the most cost effective way or actually carrying out a given task, and this ensures that there is little pressure on the formal institutions to become more efficient. The relationship between formal and informal institutions is often closely aligned and informal institutions step in to prop up inefficient institutions. However, because they do not have a centre, which directs and coordinates their actions, changing informal institutions is a slow and lengthy process. Social science perspectives[ edit ] While institutions tend to appear to people in society as part of the natural, unchanging landscape of their lives, study of institutions by the social sciences tends to reveal the nature of institutions as social constructions, artifacts of a particular time, culture and society, produced by collective human choice, though not directly by individual intention. Sociology traditionally analyzed social institutions in terms of interlocking social roles and expectations. Social institutions created and were composed of groups of roles, or expected behaviors. The social function of the institution was executed by the fulfillment of roles. Institutions can be seen as "naturally" arising from, and conforming to, human nature—a fundamentally conservative view—or institutions can be seen as artificial, almost accidental, and in need of architectural redesign, informed by expert social analysis, to better serve human needs—a fundamentally progressive view. Adam Smith anchored his economics in the supposed human "propensity to truck, barter and exchange". Modern feminists have criticized traditional marriage and other institutions as element of an oppressive and obsolete patriarchy. Economics, in recent years, has used game theory to study institutions from two perspectives. Firstly, how do institutions survive and evolve? In this perspective, institutions arise from Nash equilibria of games. For example, whenever people pass each other in a corridor or thoroughfare, there is a need for customs, which avoid collisions. Such a custom might call for each party to keep to their own right or left—such a choice is arbitrary, it is only necessary that the choice be uniform and consistent. Such customs may be supposed to be the origin of rules, such as the rule, adopted in many countries, which requires driving automobiles on the right side of the road. Secondly, how do institutions affect behaviour? In this perspective, the focus is on behaviour arising from a given set of institutional rules. In these models, institutions determine the rules i. Douglass North argues, the very emergence of an institution reflects behavioral adaptations through his application of increasing returns.

For example, the Cournot duopoly model is based on an institution involving an auctioneer who sells all goods at the market-clearing price. While it is always possible to analyze behaviour with the institutions-as-equilibria approach instead, it is much more complicated. A " memetic institutionalism " has been proposed, suggesting that institutions provide selection environments for political action, whereby differentiated retention arises and thereby a Darwinian evolution of institutions over time. Public choice theory , another branch of economics with a close relationship to political science, considers how government policy choices are made, and seeks to determine what the policy outputs are likely to be, given a particular political decision-making process and context. Credibility thesis purports that institutions emerge from intentional institution-building but never in the originally intended form. In history, a distinction between eras or periods, implies a major and fundamental change in the system of institutions governing a society. Political and military events are judged to be of historical significance to the extent that they are associated with changes in institutions. In European history, particular significance is attached to the long transition from the feudal institutions of the Middle Ages to the modern institutions, which govern contemporary life. Theories of institutional change[ edit ] In order to understand why some institutions persist and other institutions only appear in certain contexts, it is important to understand what drives institutional change. Acemoglu, Johnson and Robinson assert that institutional change is endogenous. They posit a framework for institutional change that is rooted in the distribution of resources across society and preexisting political institutions. These entrepreneurs weigh the expected costs of altering the institutional framework against the benefits they can derive from the change. Lipsky argues that patterns of institutional change vary according to underlying characteristics of issue areas, such as network effects. This produces a phenomenon called path dependence, which states that institutional patterns are persistent and endure over time. Once a choice is made during a critical juncture, it becomes progressively difficult to return to the initial point where the choice was made. James Mahoney studies path dependence in the context of national regime change in Central America and finds that liberal policy choices of Central American leaders in the 19th century was the critical juncture that led to the divergent levels of development that we see in these countries today. Though institutions are persistent, North states that paths can change course when external forces weaken the power of an existing organization. This allows other entrepreneurs to affect change in the institutional framework. This change can also occur as a result of gridlock between political actors produced by a lack of mediating institutions and an inability to reach a bargain. North, Wallis, and Weingast divide societies into different social orders: Open access orders and limited access orders differ fundamentally in the way power and influence is distributed. As a result, open access institutions placed in limited access orders face limited success and are often coopted by the powerful elite for self-enrichment. Transition to more democratic institutions is not created simply by transplanting these institutions into new contexts, but happens when it is in the interest of the dominant coalition to widen access. This can eventually lead to institutions becoming stuck on local maxima , such that for the institution to improve any further, it would first need to decrease its overall fitness score e. The tendency to get stuck on local maxima can explain why certain types of institutions may continue to have policies that are harmful to its members or to the institution itself, even when members and leadership are all aware of the faults of these policies. Under this analysis, says Ian Lustick, Japan was stuck on a "local maxima", which it arrived at through gradual increases in its fitness level, set by the economic landscape of the s and 80s. Without an accompanying change in institutional flexibility, Japan was unable to adapt to changing conditions, and even though experts may have known which changes the country needed, they would have been virtually powerless to enact those changes without instituting unpopular policies that would have been harmful in the short-term. For example, Lustick observes that any politician who hopes to run for elected office stands very little to no chance if they enact policies that show no short-term results. Unfortunately, there is a mismatch between policies that bring about short-term benefits with minimal sacrifice, and those that bring about long-lasting change by encouraging institution-level adaptations. Lustick himself notes that identifying the inability of institutions to adapt as a symptom of being stuck on a local maxima within a fitness landscape does nothing to solve the problem. At the very least, however, it might add credibility to the idea that truly beneficial change might require short-term harm to institutions and their members. David Sloan Wilson notes that Lustick needs to more

carefully distinguish between two concepts: This may be relatively simple in evaluating the economic prosperity of a society, for example, but it is difficult to see how objectively a measure can be applied to the amount of freedom of a society, or the quality of life of the individuals within. Institutionalisation The term "institutionalization" is widely used in social theory to refer to the process of embedding something for example a concept, a social role, a particular value or mode of behavior within an organization, social system, or society as a whole. The term may also be used to refer to committing a particular individual to an institution, such as a mental institution. To this extent, "institutionalization" may carry negative connotations regarding the treatment of, and damage caused to, vulnerable human beings by the oppressive or corrupt application of inflexible systems of social, medical, or legal controls by publicly owned, private or not-for-profit organizations. The term "institutionalization" may also be used in a political sense to apply to the creation or organization of governmental institutions or particular bodies responsible for overseeing or implementing policy, for example in welfare or development.

## Chapter 2 : Behavioral economics - Wikipedia

*Economic Institutions* is one of 51 key economics concepts identified by the Council for Economic Education (CEE) for high school classes. *Economic Institutions* On this page: Definitions and Basics In the News and Examples A Little History: Primary Sources and References Advanced Resources Related Topics Definitions and Basics Institution, from.

**Abstract** An important research programme has developed in economics that extends neo-classical economic theory in order to examine the effects of institutions on economic behaviour. The body of work emerging from this line of inquiry includes contributions from various branches of economic theory, such as the economics of property rights, the theory of the firm, cliometrics and law and economics. The author proposes a unified approach to this research, integrating the work of various contributors and emphasising the common principles of inquiry that tie the work together. The theoretical discussion is accompanied by empirical studies dealing with a range of institutions and economic systems. This book will serve as the primary resource for economists and students who want to learn about this important branch of economic theory. Suggested Citation Eggertsson, Thrainn, To find whether it is available, there are three options: Check below whether another version of this item is available online. Perform a search for a similarly titled item that would be available. More about this item Access and download statistics Corrections All material on this site has been provided by the respective publishers and authors. You can help correct errors and omissions. See general information about how to correct material in RePEc. For technical questions regarding this item, or to correct its authors, title, abstract, bibliographic or download information, contact: General contact details of provider: If you have authored this item and are not yet registered with RePEc, we encourage you to do it here. This allows to link your profile to this item. It also allows you to accept potential citations to this item that we are uncertain about. We have no references for this item. You can help adding them by using this form. If you know of missing items citing this one, you can help us creating those links by adding the relevant references in the same way as above, for each referring item. If you are a registered author of this item, you may also want to check the "citations" tab in your RePEc Author Service profile, as there may be some citations waiting for confirmation. Please note that corrections may take a couple of weeks to filter through the various RePEc services. More services and features.

**Chapter 3 : Economic Behavior and Institutions by Thrainn Eggertsson**

*Program Goal To support rigorous and objective research projects on U.S. economic structure, behavior, and performance whose findings inform and strengthen decision-making by regulators, policymakers, and the public.*

Bronfenbrenner, Duke University Professor K. Prest, London School of Economics and Political Science The literature of economics is expanding rapidly, and many subjects have changed out of recognition within the space of a few years. Perceiving the state of knowledge in fast-developing subjects is difficult for students and timeconsuming for professional economists. This series is intended to help with this problem. Each book will be quite brief, giving a clear structure to and balanced overview of the topic, and written at a level intelligible to the senior undergraduate. The books will therefore be useful for teaching but will also provide a mature yet compact presentation of the subject for economists wishing to update their knowledge outside their own specialization. Other books in the series E. The compatibility of microeconomics and macroeconomics Dennis C. Public choice Robert Clark and Joseph Spengler: The economics of individual and population aging Edwin Burmeister: Capital theory and dynamics Mark Blaug: The methodology of economics or how economists explain Robert Ferber and Werner Z. Social experimentation and economic policy Anthony C. Resource and environmental economics Morton I. Kamien and Nancy L. Market structure and innovation Richard E. Multinational enterprise and economic analysis Anne O. Exchange-rate determination James W. Oligopoly theory Mark R. Labor supply Helmut Frisch: Theories of inflation Steven M. Rational expectations Sanford V. Berg and John Tschirhart: Subject to statutory exception and to the provisions of relevant collective licensing agreements, no reproduction of any part may take place without the written permission of Cambridge University Press. Introduction to the theory 1 Generalizing Neoclassical Economics: Property rights and economic outcomes 4 The economics of exclusive rights 4. Price theory or microeconomics, in its conventional form, treats organizations and institutions the same way as it treats the law of gravity: These factors are implicitly assumed to exist but appear neither as independent nor as dependent variables in the models. Such economy in model making can be eminently reasonable. It enables us to isolate critical relationships and simplifies the use of mathematical tools in the analysis. However, unlike the law of gravity, organizations and institutions are not invariant; they vary with time and location, with political arrangements and structures of property rights, with technologies employed, and with physical qualities of resources, commodities, and services that are exchanged. In fact, production involves not only the physical transformation of inputs into outputs but also the transfer of property rights between the owners of resources, commodities, and labor services. In the transfer of rights, whether within firms or across markets, agents maximize their objective functions subject to the constraints of organizations and institutions. Once our research questions involve variable organizations and institutions, either as exogenous or endogenous variables, conventional microeconomic analysis becomes a rather blunt instrument. Our traditional tools are not well suited for examining the xi xii Preface nature of the firm, the variation in industrial organization, institutional change in economic history, the organization of exchange in formal markets and nonmarket settings, or comparative economic systems. It was a logical development, which we have observed in recent years, that economics departments at various major universities gradually would give relatively low priority to fields of study that deal with organizations and institutions - fields such as economic history, comparative economic studies, the economics of growth and development, and various economic policy areas. This trend in priorities was also reflected in leading journals of economics. One could say that the structure of the economic system itself and of its parts was no longer a central focus of inquiry. In , I set out to investigate whether my demand for institutional analysis had created its own supply, whether the thesis of institution-free economics had created its antithesis. My working rule was to limit the study to contributions that did not alter the core of the economic approach, particularly the rational-choice model, and to seek a new synthesis of neoclassical and institutional economics. Neoinstitutional Economics is the term I use. The renewal of a scientific discipline usually does not originate at the center, and I found what I was looking for in various outlying branches of economics. Tremendously interesting ideas were being developed and discussed in subfields within economic

history, the theory of the firm, and industrial organization; in the new field of law and economics; and by political scientists who employed the rational-choice model. These contributions had in common the introduction of transaction costs to the analysis. The modern use of the concept of transaction costs originates in two articles by Ronald H. Coase. Transaction costs were used in the one case to show that if they are not included in the analysis, the firm has no purpose, while in the other I showed, as I thought, that if transaction costs were not introduced into the analysis, for the range of problems considered, the law had no purpose. In this instance, the study of political processes is of little interest for the student of economic systems. However, this generalization is not valid if we introduce transaction costs into the analysis of political exchange. The rational-choice model is now consistent with structures of property rights that fail to maximize the national wealth and may even bring economic decline, which we can interpret as organizational failures due to transaction costs. As I see it, there are several levels of analysis in Neoinstitutional Economics, depending on which variables are treated as endogenous. At the first level, the structure of property rights and forms of organization are explicitly modeled but are treated as exogenous, and the emphasis is on their impact on economic outcomes. At the second level, the organization of exchange is endogenized, but the fundamental structure of property rights remains exogenous. Exchange within firms, across formal markets, and in nonmarket situations is organized by means of contracts that constrain economic agents. For instance, the firm is defined as a network of contracts. At the third level, attempts are made to endogenize both social and political rules and the structure of political institutions by introducing the concept of transaction costs. My book is organized on the basis of these three levels of analysis. Its intended contribution is to bring together heterogeneous work by scholars in various fields in order to suggest a new research program. Most of the work I discuss is new; Neoinstitutional Economics as a unified research program took shape in the 1980s. I hope the book will convey a sense of the tremendous potential I see in the new approach that I predict will one day be referred to as *transaction cost economics*. The main contributors to neoinstitutional analysis usually operate at only one of the three levels of analysis that I have described, except for Douglass North. In fact, the turning point in my thinking was the chance discovery of one of his articles. He responded swiftly and generously to a letter from me and invited me to join his political economy group at Washington University in St. Louis for one semester. My debt to Washington University is great. I have been a visiting professor in the Economics Department, a visiting fellow of the Center in Political Economy, and a research associate of the Center for the Study of American Business. Of numerous friends at Washington University I would especially like to thank Wilhelm Neufeind, Murray Weidenbaum, and my friends and benefactors Lee and Alexandra Benham, who followed my work closely with sound advice, critique, and encouragement and helped me establish important contacts with leading contributors to Neoinstitutional Economics, which included a memorable evening with Ronald Coase in Chicago. Many of the scholars cited in this book have provided me with unpublished papers and manuscripts and read chapters relating to their work. I would especially like to mention Armen A. Alchian of the Norwegian School of Economics and Business Administration, which provided me with an office one summer, and Rognvaldur Hannesson, who read several chapters of my manuscript. I also thank Bo Gustafsson in Uppsala for commenting on my manuscript, and Johan Myhrman at the Stockholm School of Economics for both reading my manuscript and using it in one of his courses. At the University of Iceland I have received useful suggestions from Thorvaldur Gylfason and from Thorolfur Matthiasson, who carefully read the manuscript at one stage in its development. Gudmundur Olafsson gave valuable help with the indexes. The participants in the Economics Workshop of the University of Iceland made useful suggestions. None of these people is responsible for my mistakes. I thank the University of Iceland for financial support, including a grant from the University Research Fund. My thanks go also to three anonymous referees who were employed by my publisher, and to the excellent staff of Cambridge University Press in the United States. I mention especially Colin Day, who was editorial director at Cambridge when I made my initial contact with CUP and who supported my project from the beginning. Neoinstitutional Economics and the theory of production and exchange We are concerned in this book with recent attempts to extend and generalize the theory of price and apply it to economic and political institutions. Our focus is on a certain propensity in human nature, which Adam Smith pointed out - "the propensity to truck, barter, and exchange one thing for another" - and on the

consequences of these activities for the use of scarce resources and the creation of wealth. Adam Smith, in Chapter 2 of *The Wealth of Nations*, argues that it is this human propensity to exchange that gives rise to the division of labor. Oxford University Press, In his pioneering contribution to economics, Adam Smith sought to demonstrate how one specific set of rules contributes more to the wealth of nations than any other. The structure that Adam Smith recommended was one whereby individuals have exclusive private rights to economic assets. In spite of this simplification, the approach has been fruitful: In terms of both analytical power and empirical relevance it overshadows all other theoretical systems in economics and the social sciences. The theory of price microeconomic theory has provided valuable insights into the fundamental nature of exchange and resource allocation in decentralized markets and also tools that enable us to predict how equilibrium outcomes are affected by changes in the constraints that individual decision makers face. For some time now, the major implications of the basic model have been well understood, whereas the theory, without significant modifications, is unsuitable for examining a variety of important questions. Even when theoretical tools were available, the traditional model and the cumulative research tradition did not encourage certain lines of investigation. We can point to three areas of inquiry that until recently have been largely neglected by economists of the neoclassical school: How do alternative sets of social rules property rights and economic organizations affect behavior, allocation of resources, and equilibrium outcomes? Why does the form of economic organization differ from one type of economic activity to another, even within the same legal framework? In general, what is 2. For an introduction to the theory of price, see, for example, Hirshleifer, Jack *Price Theory and Applications*, 4th ed. Generalizing Neoclassical Economics 5 the economic logic of various contractual agreements, such as the firm, that are used for organizing production and exchange? What is the economic logic behind the fundamental social and political rules that govern production and exchange, and how do these rules change? Although it must be admitted that neoclassical economists at various times have touched on all three issues, usually the examination has been ephemeral, neither contributing new theoretical concepts nor generating sustained research programs. Since the late s, however, a good number of neoclassical economists have become interested in the structure of economic organization. A new research program has evolved that is aimed at generalizing microeconomic theory while retaining all the essential elements of the economic approach - stable preferences, the rational-choice model, and equilibria.

**Chapter 4 : Institutional and Behavioral Economics**

*The Center for Economic Behavior, Institutions and Design (CEBID) is dedicated to laboratory research in economics and related social sciences, with the broad aim of understanding economic behavior and institutions, disciplined by economic theory.*

Nudge theory Richard Thaler , winner of the Nobel Prize in economics Nudge is a concept in behavioral science , political theory and economics which proposes positive reinforcement and indirect suggestions as ways to influence the behavior and decision making of groups or individuals. Nudging contrasts with other ways to achieve compliance, such as education , legislation or enforcement. The concept has influenced British and American politicians. The first formulation of the term and associated principles was developed in cybernetics by James Wilk before and described by Brunel University academic D. Stewart as "the art of the nudge" sometimes referred to as micronudges [37]. It also gained a following among US and UK politicians, in the private sector and in public health. To count as a mere nudge, the intervention must be easy and cheap to avoid. Nudges are not mandates. Putting fruit at eye level counts as a nudge. Banning junk food does not. In this form, drawing on behavioral economics, the nudge is more generally applied to influence behaviour. In other words, a nudge alters the environment so that when heuristic, or System 1, decision-making is used, the resulting choice will be the most positive or desired outcome. Regarding its application to HSE, one of the primary goals of nudge is to achieve a "zero accident culture". These companies are using nudges in various forms to increase the productivity and happiness of employees. Recently, further companies are gaining interest in using what is called "nudge management" to improve the productivity of their white-collar workers. Ethicists have debated this rigorously. Similarly, legal scholars have discussed the role of nudges and the law.

Behavioral finance[ edit ] Robert J. Shiller , winner of the Nobel Prize in economics The central issue in behavioral finance is explaining why market participants make irrational systematic errors contrary to assumption of rational market participants. The study of behavioral finance also investigates how other participants take advantage arbitrage of such errors and market inefficiencies. Behavioral finance highlights inefficiencies, such as under- or over-reactions to information, as causes of market trends and, in extreme cases, of bubbles and crashes. Such reactions have been attributed to limited investor attention, overconfidence, overoptimism, mimicry herding instinct and noise trading. Loss aversion appears to manifest itself in investor behavior as a reluctance to sell shares or other equity if doing so would result in a nominal loss. Benartzi and Thaler, applying a version of prospect theory , claim to have solved the equity premium puzzle , something conventional finance models so far have been unable to do. Quantitative behavioral finance[ edit ] Quantitative behavioral finance uses mathematical and statistical methodology to understand behavioral biases. In marketing research, a study shows little evidence that escalating biases impact marketing decisions. One characteristic of overreaction is that average returns following announcements of good news is lower than following bad news. In other words, overreaction occurs if the market reacts too strongly or for too long to news, thus requiring an adjustment in the opposite direction. As a result, outperforming assets in one period is likely to underperform in the following period. They contend that behavioral finance is more a collection of anomalies than a true branch of finance and that these anomalies are either quickly priced out of the market or explained by appealing to market microstructure arguments. However, individual cognitive biases are distinct from social biases; the former can be averaged out by the market, while the other can create positive feedback loops that drive the market further and further from a " fair price " equilibrium. Similarly, for an anomaly to violate market efficiency, an investor must be able to trade against it and earn abnormal profits; this is not the case for many anomalies. It is argued that the cause is entry barriers both practical and psychological and that returns between stocks and bonds should equalize as electronic resources open up the stock market to more traders. Experiments include testing deviations from typical simplifications of economic theory such as the independence axiom [77] and neglect of altruism , [78] fairness , [79] and framing effects. Early attempts along these lines focus on the behavior of rats and pigeons. These studies draw on the tenets of comparative psychology , where the main goal is to discover analogs to human behavior in experimentally

-tractable non-human animals. They are also methodologically similar to the work of Ferster and Skinner. Recent studies have adopted a slightly different approach, taking a more evolutionary perspective, comparing economic behavior of humans to a species of non-human primate, the capuchin monkey. These studies looked at things like peck rate in the case of the pigeon and bar-pressing rate in the case of the rat given certain conditions of reward. Use of this laboratory is predicated on the fact that behavior, as well as structure, vary continuously across species, and that principles of economic behavior would be unique among behavioral principles if they did not apply, with some variation, of course, to the behavior of nonhumans. Labor supply[ edit ] The typical laboratory environment to study labor supply in pigeons is set up as follows. Pigeons are first deprived of food. Since the animals become hungry, food becomes highly desired. The pigeons are then placed in an operant conditioning chamber and through orienting and exploring the environment of the chamber they discover that by pecking a small disk located on one side of the chamber, food is delivered to them. In effect, pecking behavior becomes reinforced, as it is associated with food. Before long, the pigeon pecks at the disk or stimulus regularly. In this circumstance, the pigeon is said to "work" for the food by pecking. The food, then, is thought of as the currency. The value of the currency can be adjusted in several ways, including the amount of food delivered, the rate of food delivery and the type of food delivered some foods are more desirable than others. Researchers argue that this is similar to labor supply behavior in humans. That is, like humans who, even in need, will only work so much for a given wage, the pigeons demonstrate decreases in pecking work when the reward value is reduced. This means that as the price of a certain good increase, the amount that consumers are willing and able to purchase decreases. Researchers studying the demand curves of non-human animals, such as rats, also find downward slopes. Researchers have studied demand in rats in a manner distinct from studying labor supply in pigeons. Specifically, in an operant conditioning chamber containing rats as experimental subjects, we require them to press a bar, instead of pecking a small disk, to receive a reward. The reward can be food reward pellets, water, or a commodity drink such as cherry cola. Unlike in previous pigeon studies, where the work analog was pecking and the monetary analog was a reward, the work analog in this experiment is bar-pressing. Under these circumstances, the researchers claim that changing the number of bar presses required to obtain a commodity item is analogous to changing the price of a commodity item in human economics.

## Chapter 5 : Institution - Wikipedia

*On balance, however, Economic Behavior and Institutions is a fine point of entry into an active and even valuable field of research which, owing to its expository structure, should be accessible to anyone with a basic grasp of conventional microeconomics.*

In economics, rational choice theory states that when humans are presented with various options under the conditions of scarcity, they would choose the option that maximizes their individual satisfaction. This theory assumes that people, given their preferences and constraints, are capable of making rational decisions by effectively weighing the costs and benefits of each option available to them. The final decision made will be the best choice for the individual. The rational person has self-control and is unmoved by emotions and external factors and, hence, knows what is best for himself. Alas behavioral economics explains that humans are not rational and are incapable of making good decisions. Behavioral economics draws on psychology and economics to explore why people sometimes make irrational decisions, and why and how their behavior does not follow the predictions of economic models. Decisions such as how much to pay for a cup of coffee, whether to go to graduate school, whether to pursue a healthy lifestyle, how much to contribute towards retirement, etc. Behavioral economics seeks to explain why an individual decided to go for choice A, instead of choice B. Because humans are emotional and easily distracted beings, they make decisions that are not in their self-interest. For example, according to the rational choice theory, if Charles wants to lose weight and is equipped with information about the number of calories available in each edible product, he will opt only for the food products with minimal calories. Behavioral economics states that even if Charles wants to lose weight and sets his mind on eating healthy food going forward, his end behavior will be subject to cognitive bias, emotions, and social influences. If a commercial on TV advertises a brand of ice cream at an attractive price and quotes that all human beings need 2,000 calories a day to function effectively after all, the mouth-watering ice cream image, price, and seemingly valid statistics may lead Charles to fall into the sweet temptation and fall out of the weight loss bandwagon, showing his lack of self-control.

Applications One application of behavioral economics is heuristics, which is the use of rules of thumb or mental shortcuts to make a quick decision. However, when the decision made leads to error, heuristics can lead to cognitive bias. Another field in which behavioral economics can be applied to is behavioral finance, which seeks to explain why investors make rash decisions when trading in the capital markets. Companies are increasingly incorporating behavioral economics to increase sales of their products. Also, consider a soap manufacturer who produces the same soap but markets them in two different packages to appeal to multiple target groups. One package advertises the soap for all soap users, the other for consumers with sensitive skin. The latter target would not have purchased the product if the package did not specify that the soap was for sensitive skin. Notable individuals in the study of behavioral economics are Nobel laureates Gary Becker motives, consumer mistakes; , Herbert Simon bounded rationality; , Daniel Kahneman illusion of validity, anchoring bias; and George Akerlof procrastination;

**Chapter 6 : Thr jinn Eggertsson, Economic Behavior and Institutions**

*An important research programme has developed in economics that extends neo-classical economic theory in order to examine the effects of institutions on economic behaviour.*

The most basic generic paradigm in social science is that social and physical environments shape or at least influence human behavior and the resulting behavior of individuals interacting with the environment influences the performance of the unit of society under consideration. This essay is concerned with the problems of developing and using paradigms, theories, or simple beliefs about the relationships among institutions, behavior and performance, recognizing that behavior is never determined by institutions alone, but is always shaped and influenced by the environments of individual actors as well as by their physical makeup. Understanding these relationships is useful in predicting the consequences of actions given the matrix of existing institutions and the related patterns of behavior and in predicting the consequences of changes in the matrix of institutions. In order to make sense out of the almost infinite set of possible relationships, theories are developed. Three levels of theory are important in thinking about institutional analysis. There are meta paradigms which provided the basic framework for understanding political economic systems. These identify basic relationships, the questions which are appropriate to ask, and represent a general set of beliefs about how a system works and how it could work. Neoclassic economics could be an important part of be such a system, providing a particular way of looking at the economy. Second, there are what I will call theories of the case. These are theories about how a particular area of the economy works and could work. For example, institutional analysis of health care in Detroit would require a theory of how the matrix of institutions influences the behavior of different participants in the health care system and the consequence of that behavior in respect to important characteristics of performance, such as child mortality rates or costs of treating colon cancers. The observations made, the questions asked, the alternatives considered would be influenced by the more general paradigms of participant analysts. But the relevant theory for this case would need to take into account data from the unique situation. In the real world of policy and management, problems arise because different participants have quite different theories of the case. Third are the micro theories developed by all participants in the form of beliefs about reactions to and consequences of particular actions. For example, a Doctor might believe he would leave himself open to a malpractice suit unless he prescribed a number of screening tests. Data on the micro theories held by different classes of participants would be important empirical content of a theory of the case. Similarly theories of the case and meta paradigms influence the micro theories of individuals and thus influence their behavior. Institutions In this discussion institutions are taken to be the formal and informal rules which govern or at least influence the behavior of participants of a society as they interact in political and economic activities. The formal rules include laws and regulations as interpreted and enforced by political authority. The informal rules are the shared beliefs about acceptable and unacceptable behavior enforced by conscience, a result of socialization, based upon the actual and expected reactions of other members of the society. Both the formal and informal rules reflect or embody views about fairness, legitimacy, good and evil, right and wrong. Institutions are the product of collective action. They are the result of cooperation. Institutions both constrain and liberate individual behavior, may promote cooperation or conflict and have varying levels of support of the polity. A class of institutions provide order in every ones interest with little or no influence on the distribution of benefits and costs; for example, rules for driving on a particular side of the road. This illustrates one of the important general functions of institutions; they make the behavior of others more predictable and reduce mistakes and conflicts arising from unpredictable behavior. Many of the working rules for markets are similar to traffic regulations. They facilitate trade to both parties advantage. At the same time market rules defining property--rules which define what has to be taken into account in economic activity--greatly influence not only the organization of the economy, but also the distribution of benefits and costs from that economy. Institutional analysis is concerned with effects on performance of both existing and missing institutions. Analysis is complicated by the fact that behavior is influenced by a matrix of institutions, some formal and some informal. Formal rule changes intended to

change a particular performance may fail to produce expected results because of the informal institutions in the relevant matrix. It is generally the case that the political process is much more able to change the laws and regulations than to suppress or create customs and attitudes. The following is an example. Like many countries, Tanzania is in the process of moving from a planned socialist economy to one much more directed by people interacting in markets. Laws have been changed making it legal to own and use resources for private enterprises. Taking advantage of the change in formal property law, the privatizing of some land, a budding business man acquired some land and is considering establishing a dairy. He would produce milk with three cows and sell the milk at retail. His business analysis, based upon expected prices of inputs and outputs shows potential profits of 10 times the government civil service salary for a middle manager with a masters degree. However, he is faced with a number of institution related problems. A number of inputs are required and their availability at the time they are needed is uncertain. For example the market for feed is unreliable and there is no tradition of contracting. He has to find farmers with reliable feed production and develop a personal relationship with them. There is no firm with a reliable supply selling the needed inputs. He would have to make arrangements to have them imported. This, he claims, would require a personal relationship with a customs official to assure timely delivery. It would be much more efficient to have a firm specialize in importing and distributing these need supplies. But potential farmers would be reluctant to rely on them fearing "hold up prices" dealing with the single supplier when the supplier knows the farmer has a sick cow. Marketing the milk also has many problems. The most important is that, lacking either regulation or custom to assure sanitation, the buyers would insist on knowing the dairyman personally. In Cairo the extreme version of this problem is shown by observing herds of dairy cows in the streets moving to places where the buyers actually see their milk come from the cow. This is just a sample of the problems faced by a potential private entrepreneur in a country without a supporting set of institutions. The budding business man, a Ph. D economist, after two years has not found ways to deal with the institutional barriers to developing a three cow dairy enterprise. This is not a unique case, but rather illustrates a common situation. Behavior The generic paradigm of institutional analysis is that institutions have a strong influence on participant behavior and that the resulting behavior has a strong influence on economic performance. More particularly each participant faces and responds to a changing opportunity set, with institutions important in structuring the opportunity sets. Performance is strongly influenced by the sum of interactions of participant responses. The paradigm is dynamic if changes in opportunity sets and learning are taken into account as consequences of previous patterns of behavioral responses. This paradigm, taken at face value, would lead to the conclusion that institutional analysis is practically impossible. After all, the U. S economy alone is the result of the behavior of million or so individuals, each reacting to their perceptions of their opportunity sets based upon a unique set of experiences. Each individual is unique. A psychiatrist can spend years with a single client and still not understand their behavior. What possibility is there then to understand and predict the institution, behavior, performance sequence? There are several general approaches to this problem. One is to put behavior in a black box, making observations relating different patterns of institutions to different performance characteristics. It is assumed that it is not necessary, or not possible, to know what takes place in the black box, just as is unnecessary to know what happens inside a television to make comparisons of performance among brands. For example, judgements about the institutions of capitalism and socialism might be made by observing the differences in gross national product between countries with the two different systems. A few years ago a well known newspaper owner proclaimed that advertising was the major source of economic growth based on comparing levels of gross national product with levels of advertising. Such analysis leaves much to be desired to be useful in informing policy decisions, although much policy seems to be based on such observations. At the same time there are many examples of rules which can be evaluated concentrating on the association of the rule and the data of performance indicators. A second general approach to behavior in institutional analysis is to make broad general assumptions about behavior of participants and leave empirical questions about actual behavior in the black box. The two common assumptions in economics are that suppliers of goods and services do or attempt to maximize profits and that consumers do or attempt to maximize utility or satisfaction. Deductive models are then used to infer consequences of various changes in the opportunity sets

of producers or consumers. For example, if a rule restricts the availability of an input to an industry and firms maximize profits at least the direction of price changes of outputs can be deduced. While it is empirically the case that it cannot be proved that firms maximize profits, models based upon profit maximization may give useful inferences, approximations and suggest important questions because firm behavior often more or less corresponds to the assumption. Detailed knowledge would be needed to know under what conditions the assumption would be useful. The assumption of utility maximization is quite a different story. The assumption has no empirical counterpart in the real world. It is impossible to test if utility is in fact being maximized in any case. Nonetheless the assumption is used as if it is the basis of explanations of patterns of behavior and justification of conclusions about institutions related to that behavior. A third approach to behavior is measurement of particular responses to particular changes in the economy and using these measures in analysis. Supply and demand elasticities are good examples. These are measures of the responses to changes in prices in past periods. Supply-demand analysis can be very useful in estimating important effects of many policies. Policies effect prices and prices effect incomes. There are many technical problems in estimating such measures as elasticities. An understanding of the underlying behavior can help in the estimations. For example, taking into account the fact that consumers learn changes the procedures appropriate for demand analysis. The fourth approach to behavior in institutional analysis is more complex. The concept is to identify the relevant classes of participants, make informed assumptions about their behavior, testing the assumptions propositions to the extent possible both by direct observation and by inference from consequences of their behavior, and model the interactions among the participants and the pattern of institutions under consideration. In this approach knowledge of relevant classes of participants and their likely behavior becomes very important. For example, firms could be recognized as political and social organizations with internal interest groups with differing objectives, with ideologies, with standard operating procedures and with employees effort influenced by the political system of the firm. It would be recognized that individuals learn patterns of responses to similar situations. They develop techniques for coping with their uncertain world. The fact of limited information and general uncertainty would be recognized. It would not be assumed that individuals necessarily act in their long run interest; interests are uncertain and preferences evolve.

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*Furthermore, the behavioral revolution in political science, just like the field of economics, paid almost no attention to the structure of institutions and their restraining influence on behavior. This is now changing.*

Publicly regulated firm Akerlof-Johnson effect Public firm Chapter 6 The contractual nature of the firm Nature of the firm Right to smoke. The Economist articles on revisionist views of minimum wage legislation and rent controls. Chapter 7 The logic of economic organization Neoinstitutionalism holds that economics of organization is the economics of contracts. The relative economic advantage of alternative contractual forms is determined by transactions costs and cannot be explained by standard microeconomic analysis. Search goods versus experience or convenience goods. Search goods are ones whose quality can be determined by inspection whereas experience goods are ones whose quality can only be determined by consumption. Defines and enforces a system of property rights 2. Provide public goods; i. Reduces transactions cost by such things as standardizing weights and measures 4. However, when transaction costs are positive, then the distribution of power within a country and the institutional structure of its rule-making institutions are critical factors in its development. Rights were not exclusive. Hunting for trade was exclusive but hunting for personal consumption was allowed. Also the game animals could move so private property rights were only established upon harvesting of the resources. This led to an overhunting of the area and the end of the beaver populations. In the American west the invention of barbed wire drastically reduced the cost of enforcing exclusivity. Chapter 9 Property rights in stateless societies Group responsibility and vengeance as a substitute for the state. He developed a model to determine the size of the claims. North The resource endowment and stock of knowledge of a society determine a technical production frontier. The structure of property rights of a society determine how close it gets to this technical production frontier. The production possibilities curve for a given property rights structure is called the structural production frontier. Appropriate structures of property rights are required to reduce transactions costs to manageable levels and the state has a comparative advantage in supplying those structures. The factor  $p/G$  rises to a maximum and then declines. The socially efficient objective would be to choose  $G$  so as to maximize  $Y$ , but there are other considerations to be taken into account. If the state has to balance its budget then the government workers will have to be paid for by a tax. If it is an income tax and the tax rate is  $t$  then the cost of the government workers is  $tY$ . But the government workers pay is also taxable so when the state increases  $G$  the net cost is  $(1-t)w$ , where  $w$  is the wage rate. In a competitive labor market the wage rate in the government sector will be the same as in the private sector. If the wage in the private sector is based upon the marginal productivity of another worker then increasing government workers decreases the private sector workers and thereby increases the wage rate because the marginal labor productivity in the private sector will rise. This would be an impediment to policy that wanted to maximize  $G$ . Or the state could strive to maximize its wealth by choosing a level of government employment where the difference between tax revenues and costs is the largest, given an exogenously set tax rate. North argued that the development of representative democracy in western Europe may have been tied to advances in military technology. More advanced weapons required a larger budget which the aristocracy could get only by surrendering some of its prerogatives to the cities. Separation of powers and the financial revolution in England gave it an edge over France. Any actual public policy, be it fiscal, monetary, public welfare, international aid, unemployment, medical care, tax, drug, or transportation, is looked upon as an abomination to be considered briefly while holding the nose. As a consequence of this disdain of practice, economists spend most of their time fruitlessly considering optimal choices that ignore the organizational and political constraints on public policy choices. Harold Demsetz, in a different context, referred to this orientation as a nirvana complex. If economics is to have a positive marginal social product, economists must be cognizant of institutional frameworks and the constraints they impose. I propose that we light one candle by providing our students with a course which deals with these topics in a practical as well as an analytical way. There is, of course, an institutionalist school of hoary if not ancient tradition in economics. It has not had much of an impact on mainstream economics, perhaps because its proponents proposed to supplant

neoclassical economics rather than augment it. As so often is the case people go wrong intellectually not because their ideas are completely without validity but instead because they attempt to establish that their ideas are the total truth. This, of course, also applies to neoclassical economics. While the primary focus of the proposed course is not traditional institutionalist economics, it is appropriate to provide a survey of the teachings of Thorstein Veblen, John Commons, Alan Gruchy, Morris Copeland Flow of Funds Accounts and Clarence Ayres. There are also more recent proponents of an institutionalist focus who constitute the neo-institutionalist school such as Oliver Williamson and Douglass North who would also be covered. The neo-institutionalists, in contrast to the institutionalists, seek to generalize neo-classical analysis. There is also a school of thought within economics that sees social institutions as the outcome of economic processes such as Gary Becker, Friedrich Hayek, Ludwig von Mises and, of course, Karl Marx. Ronald Coase and the Law and Economics movement would also fit in here as well. It would be appropriate to give some time to these people in the context of how institutional structures affect economic decisions. There is a more recent field of economics that should also be covered. That is Public Choice Theory. I should note here that the word "institution" is used differently by different groups. For some "institution" refers to what might be called social institutions, such as private property. Others use "institution" to refer to organizational or political structure. Still others would refer to laws as institutions. The heart of the course should be case studies of legislative, executive, and regulatory organizations and their policy making. Often the outcome of the policy making these bodies is the creation of other governmental bodies such as urban planning departments and regulatory agencies. Economists should know about the operation of urban planning and its effects on cities. The course should also cover legislation such as those requiring environmental impact analyses for all major projects. This is quite important in the education of economists because they often are involved in research that stems from these regulations. Gary Becker, Human Capital, Gary Becker, A Treatise on the Family, Daniel Bromley, Economic Interests and Institutions, Robert Boyd and Peter J. James Buchanan et al eds. Toward a Theory of a Rent-Seeking Society, Feldman, Cultural Transmission and Evolution: A Quantitative Approach, Princeton, N. Princeton University Press, Harvard University Press, John Clammer, Anthropology and Political Economy, Diggins, The Bard of Savagery: John Kenneth Galbraith, American Capitalism: Wendell Gordon, Institutional Economics: The Changing System, Allan Gruchy, Modern Economic Thought: The American Contribution, Allan Gruchy, Contemporary Economic Thought, Allan Gruchy, The Reconstruction of Economics, Kuhn, The Evolution of Economic Thought, Richard Langlois, Economics as a Process: Essays in the New Institutional Economics, David Seckler, Thorstein Veblen and the Institutionalists, La Salle, Illinois, HB v66 S73 Technocracy Inc. Kelley, Bookseller, New York, Firms, Markets and Relational Contracting, Journal Articles Armen A.

### Chapter 8 : Economic Behavior and Institutions by Thrain Eggertsson

*An important research programme has developed in economics that extends neo-classical economic theory in order to examine the effects of institutions on economic behaviour. The body of work emerging from this line of inquiry includes contributions from various branches of economic theory, such as.*

### Chapter 9 : Economic Institutions, Behavior, & Performance

*A supply and demand diagram, illustrating the effects of an increase in demand.*