EVOLUTION OF ECONOMICS THROUGHOUT THE YEARS

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Abstract: The paper discusses some seminal papers in the field of economics from some of the very eminent researchers. They have played a major role in shaping the economics that we study today. The papers that I have discussed here include "The Use Of Knowledge In Society" by FA Hayek, "The Market for "Lemons": Quality Uncertainty and the Market Mechanism" by Gerorge A. Akerlof, "Rationality in Psychology and Economics" by Herbert A. Simon and "Job Market Signaling" by Michael Spence. The papers discuss concepts such as the system of open markets, information asymmetry, bounded rationality and signalling. These concepts are the foundation of the some of the most widely used theories today in the field of economics and business.

Introduction

This paper discusses some seminal papers that have played a major role in the development of the economic research. In this paper, I have tried to summarize and review the works of some of the very well-known researchers in the field of economics and management. They include: Hayek, Akerlof, Simon and Spence. I have discussed their seminal works, i.e., the papers that have helped in building the foundation of some of the most widely used theories and are the basis of many theoretical models used these days.

1945 – Open Market by Hayek

The Use of Knowledge in Society by FA Hayek

The first paper that I am discussing here is "The Use of Knowledge in Society". It is authored by FA Hayek. It was published in the September 1945 issue of The American Economic Review.

Hayek wants to address the problem of rational economic organization through this paper. He brings out the question that who should be responsible for doing the economic planning? Should it be done centrally by some authority? Or should it be delegated to the people who directly deal with the problem? In other words, should it be decentralized? He is essentially discussing the benefits of an open market vis-à-vis a centrally planned economy. He also highlights the benefits of the dynamic nature of price fluctuations.

The problem with delegating the economic planning to a central authority is that, that it is not aware of the day to day activities and struggles that are faced by industries. They see things at a very macro level. They tend to take statistical aggregates which do not aptly reflect the frequent changes that occur in the industry. Hayek, here refers to the kind of problems/changes that cannot be expressed mathematically and hence, more often than not, can't be communicated to the central authority. Since, the central authority is not even aware of these changes, it can't possibly make use of it during economic planning.

So, through these arguments, Hayek says that according to him, it is probably best that economic planning is decentralized (open market type of economy).

But, on the other hand, economic planning can't be left to the person who is directly dealing with the problem at hand. He may not be aware of the causes and long-term repercussions of the decision that he is about to make. He is not equipped with the proper knowledge of making such a profound decision.

According to Hayek, "economic proper calculus helps us to see that how this problem can be solved using the price system". By attaching a numerical index (that reflects the whole "means-end structure") to each resource is a plausible solution. So, a person while taking an important decision, will just have to consider these numerical indices (i.e., the price) which have all the relevant information. Consequently, based on this an individual with limited knowledge can make an intelligent and correct decision.

He also mentions towards the end of the article that now the people are more receptive to the idea of decentralization. There is not much of a political pressure against it now, but more of methodological differences, which keep people from fully accepting this idea.

1970 – Information Asymmetry by Akerlof

The Market for "Lemons": Quality Uncertainty and the Market Mechanism by Gerorge A. Akerlof

The second paper that I am discussing here is titled “The Market for "Lemons": Quality Uncertainty and the Market Mechanism”. It is written by Gerorge A. Akerlof. This paper was published in August 1970 issue of The Quarterly Journal of Economics.

This paper talks about how the quality of goods in the market can worsen in case of information asymmetry between buyers and sellers.

He explains it taking automobiles as an example. Broadly speaking, there are two types of cars in the market: new and used. And within each of these two categories, we can have good quality as well as bad quality cars (referred to as lemons). In the case of used cars, the sellers generally have information whether the car is a good one or a lemon; while the buyers do not have this information.

Let us assume that the seller expects $100 for a lemon and $200 for a good quality car, while a buyer is willing to pay $120 for a lemon and $240 for a good quality car. But the buyers are unaware that the car they will buy will turn out to be a good quality car or a lemon. So, on an average the buyer will want to pay $180 for a car since he is not aware of the quality. At this price, the sellers will only want to sell the lemons. Had the buyer been assured of the fact that the car he is about to buy is not a lemon, he would be willing to pay as much as $240. But since, he is not aware of the quality of the car, he won't take such a risk and hence this transaction will not take place. At $180, which the buyer is willing to pay, only the lemons will be sold. So, the lemons (inferior goods) are driving out the sales of good quality cars when the information supply in the market is asymmetric (only the seller is aware about the quality of the used car; while the buyer is not). As the author says, this is related to Gresham's law: "bad money drives out good money through mechanism of exchange rates".

Another example that the author talks in his paper is of Insurance. According to him, if the price of the insurance/premium is high, then only those who think that they are likely to fall sick, will be the only ones opting for insurance. In other words, as the insurance price rises, the medical health of the people who opt for insurance falls.

Another example that the author states is of markets which have both honest and dishonest dealings - which is generally the case in developing and underdeveloped nations. Applying the above principle, dishonest dealings will drive out the honest dealings from the market.

Another example that the author takes is of credits markets in underdeveloped countries. In these countries, the local moneylenders lend money only to those people who they personally know or when the contract can easily be enforced. It is not based on the credit worthiness of the clients or their financial history. The people are also willing to pay higher interest rates since they know that the moneylender is available at all times, there is no cumbersome paperwork involved, all the legalities can be skipped and they share an amicable personal relationship with the money lender.

As the author says, there are some "counteracting institutions as well". When the product carries a guarantee or a warrantee along with it, then the "risk is borne by the seller than by the buyer". Also, in case of brands, the buyers are assured of the quality that comes with the brand name. And if they find any defect, they will stop purchasing that product in the future. Similarly, in case of chains (hotel and restaurant chains) and licenses granted by licensing authorities, the buyer is assured of the product quality.

1986 – Bounded Rationality by Simon

Rationality in Psychology and Economics by Herbert A. Simon

The third paper that I discuss here is “Rationality in Psychology and Economics”. It is authored by Herbert A. Simon. The paper was published in October 1986 issue of The Journal of Business.

Simon, in this paper, has discussed about rationality of economics (substantive rationality) and rationality of psychology (procedural rationality). He has essentially introduced, discussed, and propounded the concept of bounded rationality in this paper.

While making a decision, we can safely assume that the decision maker is not aware about the complete reality but just a part of it. So, it becomes imperative to differentiate between the real world and how the decision maker sees it and makes judgments/decisions accordingly. There is no empirical foundation on which the neoclassical economist may base his decisions. The author states that most of the decisions made by the neoclassical economist are based on factual assumptions and not on assumptions of optimization. Hence, it is necessary to put these factual assumptions to some empirical tests.

He talks about "the opportunities to children". He says that programs that support children's education cause the parents to invest the funds that they would have otherwise invested in the child's education somewhere else. Taking another example - increasing employment of women in labour force. Becker said that this trend was observed due to an increase in the earning power of women. This was based on the factual assumption that as the earning power of woman increases, she would rather work than stay at home to tend the children. This would in turn decrease the demand for children. As we can see, the assumptions in both the examples are factual rather than being based on some empirical tests. The possibility of an increase in the utility function of women caused an increase in the supply of women in the labour market.

Then the author talks about attention and representation. He exemplifies to explain that "focus of attention is a major determinant of behavior". He explains it through an example of flood insurance. He says that according to neoclassical economics, the people who expect the damage to be greater than the premium are more likely to buy flood insurance. But what happens is that the people who have suffered from the damage caused by floods or know someone who has suffered through such a damage purchase flood insurance.

Simon says that the neoclassical theory cannot explain the business cycle. People do not base their decisions on rationality, rather on what they think will happen in the future. So, in this case, understanding the procedure by which people think about future events is better used to understand the business cycle.

Another example that the author takes is of distribution of executive salaries. He says that neoclassical theory would say that the salaries are determined according to their managerial abilities. When the executives are hired, their ability to get managerial work done is uncertain. So, in this case it is important to understand the reasoning behind the people who hire people at managerial level. The decision is not based on some empirical tests. Another way to look at distribution of executive salaries is to explore the number of people reporting to the manager. Generally all organizations have a hierarchical pyramidal type structure. So by determining the number of subordinates of the manager we can accordingly proportionate the salaries. This explanation has some rationality behind it. But neoclassical economists are against this explanation.

The author says that "neoclassical economics has been observed to be essentially tautological and irrefutable". The neoclassical economists overlook the environment and the surrounding conditions which highly influence the decision of a person. According to Simon, the procedural theory of rationality (the procedure that one goes through while making a decision) better explains decision making in economics than the neoclassical theory.

1993 – Signalling by Spence

Job Market Signaling by Michael Spence

The last paper that I am discussing is titled as "Job Market Signaling". It is written by Michael Spence. It was published in August 1993 issue of the Quarterly Journal of Economics.

In this article, Spence is talking about markets where "signaling takes place and in which the primary signalers are relatively numerous and in the market sufficiently infrequently".

He explains this through taking an example of hiring which he says is an "investment under uncertainty". This is so because when the person is being hired, the employer is not certain of his capabilities. Only after he has spent some time in the job can his capabilities be assessed and then only can we get to know that whether hiring the person was a good decision or not. The author compares the uncertainty experienced during hiring to lottery.

Spence says that before a hiring decision is made, the employer tries to assess the potential employee based on some indices ("unalterable attributes", e.g., race, sex, etc.) and signals (characteristics that can be altered, e.g., education). Based on these signals and indices, the person will have a marginal product that is decided by the employer and is paid to him in the form of wage.

Since, signals can be altered, the potential employees try to alter their signals in such a manner so as to increase the wage that will be offered to them. In doing so, they may incur some cost that is referred by Spence as the signalling cost (e.g., cost incurred for education). An individual is most likely to put in efforts to maximize the difference between signalling cost and the wage offered to him. So, he will choose such signals that are profitable for him.

After some time, the employer also starts to get some feedback regarding the people he hired on the basis of certain signals and indices. Based on that feedback, he can further refine his hiring process (including the signals and indices he is looking for in a candidate and their wages as well). This is referred to as informational feedback in the job market and this goes in a loop and keeps on repeating itself. In equilibrium, the cost of signalling should be lower for a good worker and act as a signal to the employer to pay a higher wage. The state of equilibrium is reached when the employer beliefs are confirmed in the first hiring cycle and he does not have to change anything in the next hiring cycle.

Conclusion

In this paper, I have tried to include some of the pivotal and ground-breaking researches in the field of economics. Every student, researcher and all the people working in academia should be very well acquainted with these authors and their influential works. This was an attempt to familiarize the budding academia community in the field of economics and management with some of the journal papers that were the source of the basic fundamental theories that they use in all their research work.

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