

10th IZA Summer School in Labor Economics
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**Schizophrenic Economics:
battling over the soul of market economies**

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Standard economic analysis stresses the positive and normative virtues of self-interested behavior in competitive markets in the absence of externalities. With no transactions costs, self-interested behavior can resolve the problems created by externalities through efficient bargaining per the Coase Theorem.

But generosity, cooperative behavior, bounded rationality decisions and out of equilibrium adjustments are also important in market economies, producing anomalies even in financial markets. Analyzes of prisoner's dilemma games, ultimatum games, public goods games, and measures of brain activity during decisions show that more is involved in many economic decisions and market outcomes than pure rational self-interest.

These lectures present on-going debates in economics as a battle between the vision of rational self-interested behavior in competitive market settings and the vision of other forms of behavior in those settings and in prisoner's dilemma games. I examine the theory and evidence behind the conflicting visions of economic behavior at the level of the individual decision-maker; within-firm management of labor; the role of institutions in markets, and at the debate over the relative merits of the US's relatively unfettered market capitalism and the EU's social dialogue welfare state version. I show that the different views underlie attitudes toward fairness and inequality, and toward trade unions; regulations, and the welfare state.

The scientific question that the lectures address is: which of these competing views – self-interested greed in competitive markets or cooperative behavior in a prisoner's dilemma world – best categorizes modern capitalist economies? The normative question is whether firms and capitalist economies perform better when people act as “greedy economic man” in unfettered matters or as “behavioral man” in institutional settings? The schizophrenia in the title reflects the problem in answering these questions.

Lecture—part 1): Rational Optimizer vs Imperfect Human: uses standard maximizing calculus to show how different maximands produce sometimes surprising predictions about the optimizing behavior of individuals and firms and reviews evidence that individual concern over fairness and altruistic behavior affect outcomes and are biologically based.

Weitzman, Martin, "The Simple Macroeconomics of Profit-Sharing" *American Economic Review* 75 (December 1985) pp 937-953.

Craig, B. and J. Pencavel, "The Behavior of Worker Cooperatives: The Plywood Companies of the Pacific NW" *American Economic Review* 82:5 (Dec 92) pp 1083-1105.

Kruse, Douglas L., “Profit-Sharing and Employment Variability: Microeconomic Evidence on the Weitzman Theory” *Industrial and Labor Relations Review* 44:3 (April 1991) pp 437-453.

Kahneman, Daniel, Jack L. Knetsch, and Richard Thaler "Fairness as a Constraint on Profit-Seeking: Entitlements in the Market" *American Economic Review* 76:4 (Sept) 1986: 728-741.

Sigmund, Karl, Ernst Fehr, Martin Nowak (2002). "The Economics of Fair Play" *Scientific American*, (Jan) pp 83-87:

Sanfey, Alan G., James K. Rilling, Jessica A. Aronson, Leigh E. Nystrom, Jonathan D. Cohen (2003). "The Neural Basis of Economic Decision-Making in the Ultimatum Game," *Science* Vol 300 (5626) p1755.

Green, Joshua D., R. Brian Sommerville, et al. (2001). "An fMRI Investigation of Emotional Engagement in Moral Judgement," *Science* 293 (September 14). Pp 2105.

Lecture – part 2): Managing labor examines incentives in tournament models and contrasts optimal inequality for productivity with socially desirable levels of inequality. It documents the use of team work and group incentives and analyses the role of worker monitoring of coworkers in reducing free rider behavior in these forms of production.

Lazear, Edward and Sherwin Rosen, "Rank-Order Tournaments as Optimum Labor Contracts" *Journal of Political Economy* 1981 89(5), pp 841-864

M Moldovanu, Benny and Aner Sela, "The Optimal Allocation of Prizes in Contests." *American Economic Review*, 91, 542-558 (2001).

Freeman, Richard and Gelber, Alex "Optimal Inequality/Optimal Incentives: evidence from a tournament" NBER WP 12588

Freeman, Richard, Doug Kruse, and Joseph Blasi "Worker Responses to Shirking"
<http://www.nber.org/~confer/2006/SCf06/freeman.pdf>

Lecture – part 3): Markets and Institutions contrasts the monopoly and collective voice faces of unionism. It shows that workers in diverse countries have similar desires for institutions to represent their economic interests and compares the differences in unionization and collective bargaining between the Anglo-American countries and the bulk of EU countries.

Freeman, R. and E. Lazear, "An Economic Analysis of Works Councils", in Joel Rogers and Wolfgang Streeck (eds) *Works Councils: Consultation, Representation, Cooperation*. (University of Chicago Press for NBER, 1995).

Fehr, Gächter, Kirschsteiger, "Reciprocity as a Contract Enforcement Device: Experimental Evidence," *Econometrics*_Vol 65:4 (July 1997) 833-860

Bennett, James T. and Bruce E. Kaufman. "What Do Unions Do? A Twenty-Year Perspective," Chapter 1 in James T. Bennett and Bruce E. Kaufman, eds. *What Do Unions Do? A Twenty-Year Perspective* (New Brunswick, NJ: Transaction Publishers, 2007). Also published in *Journal of Labor Research* XXV(3) July 2004, pp: 339-350

Blanchflower, David G. and Alex Bryson, "What Effect Do Unions Have on Wages Now and Would Freeman and Medoff be Surprised?" Chapter 4 in James T. Bennett and Bruce E. Kaufman, eds. *What Do Unions Do? A Twenty-Year Perspective* (New Brunswick, NJ: Transaction Publishers, 2007). Also published in *Journal of Labor Research* XXV(3) July 2004, pp: 383-414.

Hirsch, Barry T., "What Do Unions Do for Economic Performance?" Chapter 7 in James T. Bennett and Bruce E. Kaufman, eds. *What Do Unions Do? A Twenty-Year Perspective* (New Brunswick, NJ: Transaction Publishers, 2007). Also published in *Journal of Labor Research* XXV(3) July 2004, pp: 415-456

Addison, John T. and Clive R. Belfield, "Union Voice," Chapter 8 in James T. Bennett and Bruce E. Kaufman, eds. *What Do Unions Do? A Twenty-Year Perspective* (New Brunswick, NJ: Transaction Publishers, 2007). Also published in *Journal of Labor Research* XXV(4) Fall 2004, pp: 563-596.

"What Do Unions Do? The 2004 M-Brane Stringtwister Edition," Chapter 20 in James T. Bennett and Bruce E. Kaufman, eds. *What Do Unions Do? A Twenty-Year Perspective* (New Brunswick, NJ: Transaction Publishers, 2007). Also published in *Journal of Labor Research* XXVI(4) Fall 2005, pp 641-68. Also published as NBER WP # 11410 (June 2005).

"Open Source Unionism: Beyond Exclusive Collective Bargaining," with Joel Rogers, *WorkingUSA: The Journal of Labor and Society* vol 7:2 (Spring 2002), pp 3-4 (ME Sharpe).

OECD, *Employment Outlook*, 2004, chapter 3

Blanchflower, D. and A. Oswald, "An Introduction to the Wage Curve" *Journal of Economic Perspectives* 9 Summer 1995, 153-167

Lecture – part 4) Economic Systems examines the "war of the models" debate over the optimal way to organize a capitalist labor market and the strength of evidence on the OECD Jobs

Freeman, R. 2002. "Single Peaked vs. Diversified Capitalism: The Relation Between Economic Institutions and Outcomes" Chapter 8 in Jacques Dreze (ed) *Advances in Macroeconomic Theory* (London: Palgrave for the IEA, Conf. Vol #133). NBER WP

Freeman, R. "War of the Models: Which Labour Market Institutions for the 21st Century?" *Labour Economics* 5: issue 1 (March 1998) pp 1-24

Calmfors, L. and J. Driffil. 1988. "Bargaining Structure, Corporatism and Macroeconomic Performance (Centralization of Wage Bargaining:)" *Economic Policy*, no 6 (April).

Soskice, D. "Wage Determination: The Changing Role of Institutions in the Advanced Industrialized Countries" *Oxford Review of Economic Policy* 6:4 (Winter 1990)

Freeman, Richard B., "Labour Market Institutions Without Blinders: The Debate Over

Flexibility and Labour Market Performance,” *International Economic Journal RIEJ* 19:2 (June 2005) pp 129-145. Also published as NBER WP #11,286 (April 2005).

Ichniowski, Casey, Kathryn Shaw and Giovanna Prennushi, The Effects of Human Resource Management Practices on Productivity: A Study of Steel Finishing Lines,” *AER* 87:3 (June 97) 291-313.

Freeman, Richard B. “Searching for the EU Social Dialogue Model,” in Nicola Acocella and Riccardo Leoni (eds) *Social Pacts, Employment and Growth: A Reappraisal of Ezio Tarantelli's Thought*. (Physica-Verlag, Heidelberg, 2007, **forthcoming**). Also published as NBER WP # 12,306, June 2006.

Lecture – part 5: Analyzing the Schizophrenia counterposes artificial agent models in which zero intelligent agents give competitive market solutions when budget and profit constraints are binding against evolutionary game theory models that demonstrate the greater robustness of Tit for Tat style strategies – nice and retaliatory – over other strategies in games where cooperation pays off.

Gode, D.K. and S. Sunder. 1993. “Allocative Efficiency of Markets with Zero-Intelligence Traders,” *Journal of Political Economy* 101:1 (February) pp: 119-137

Bendor, Jonathan and Piotr Swistak “The Evolutionary Stability of Cooperation” *American Political Science Review*, Vol 91, no 2, June 1997, pp 290-307

Leombruni, Richiardi ”Why are economists sceptical about agent-based simulations? (con M. Richiardi), *Physica A*, Volume 355, Issue 1, 2005

Kandori, M., G. Mailath, and R. Rob, “Learning, Mutation, and Long Run Equilibria in Games,” *Econometrica* 61:1 (January 1993), pp: 29-56

Freeman, Richard B., "Spurts in Union Growth: Defining Moments and Social Processes," in *The Defining Moment: The Great Depression and the American Economy in the Twentieth Century*. Michael Bordo, Claudia Goldin, and Eugene White (editors). University of Chicago Press for NBER, 1998, pp 265-295; Also published as NBER WP #6012, May, 1997.