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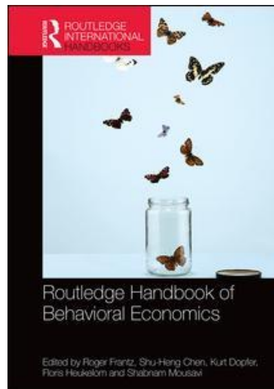

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24 BEHAVIORAL POLITICAL ECONOMY

Gigi Foster and Paul Frijters

Introduction

A major element in the success of economics is its production of simple ideas to describe many complex phenomena. Crudely speaking, mainstream economists view the world as made up of optimizing actors looking to become as wealthy as possible within the rules of the game set down by a political process. Consequently, approximating perfect markets as closely as possible is the means by which a society can achieve the greatest overall welfare from the natural competition between individuals. Economists, therefore, analyze situations in terms of their divergence from perfect markets; for example, because of asymmetric information, missing markets, returns to scale, limited property rights, and/or market power. Economists then rely on implicit rules of thumb about what can be done to overcome market imperfections, such as 'seek to reduce entry barriers', 'promote public access to trade-relevant information', and 'avoid concentrations of market power'. Feasible interventions based on such rules of thumb might include public oversight over natural monopolies, contract enforcement, managing interest rates and the money supply, setting up new property rights, creating markets, and so forth.

Policy is frequently informed by these core ideas and rules of thumb: modern societies feature state production of public goods (such as education and a national currency) and a plethora of regulatory institutions largely concerned with spotting and alleviating market imperfections. It is no exaggeration to say that the utopian vision of mainstream economics has become the 'main vision in town' as to how welfare can be improved by politicians and other social actors. As a result, economists enjoy a standing in the policy community unparalleled by that of any other social science, as well as an enviable academic position relative to other social sciences (Fourcade, Ollion & Algan, 2014).

Behavioral economics has in recent decades extended the mainstream *Homo Economicus* model of microeconomic behavior to 'explain' aspects of the wider economy that were previously mysterious. This approach has given us useful working paradigms, such as Robert Shiller's 'bubbles' arising from Keynesian 'animal spirits' (Shiller & Akerlof, 2009) and the idea that 'warm glow' effects underpin more giving behavior than greed would imply (Kolm, 2013). Yet the connection of such additions as animal spirits and warm glow to general economics is still shallow, in the sense that the picture of the individual lying at their base is not well-developed or integrated with the institutions and patterns observed in our broader society.

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More broadly, the discipline has blind spots in its image of society as a whole, and opponents of economics have repeatedly pointed them out. For example, the scope of the state's ability to improve matters is not well understood. How do the rules of the democratic game actually come about? And how robust are they? Which behaviors of market players can realistically be monitored or enforced by the state? For that matter, why would one trust any state official to enforce anything that goes against his own personal interests? Despite a large body of work in institutional economics, and whole literatures in sociology and political science describing the state as the winner of an evolutionary struggle for supremacy (and thus as an institution with strengths and weaknesses), mainstream economic textbooks do not seriously consider the nature of the state and individuals' relation to it.

Ironically, an entire integrated set of blind spots in economics concerns trade—arguably the activity that the discipline is best known for championing. How prices are actually formed, what is involved when an agent searches for trading partners, and the role of trust in key aspects of the system underpinning trade (specifically, money, the division of labor, and the rule of law) remain strikingly absent from the mainstream economics curriculum. This makes it hard for economists to view recessions as anything other than mass holidays in which potential workers are simply not willing to accept wage reductions. Many reflective and experienced economists (e.g., Larry Summers and John Maynard Keynes) have understood that in recessions, workers are willing to work and firms have things they want to sell, but these two sides cannot find each other and get organized quickly enough to trade, and that this leads to unemployment and bankruptcy. Yet this description of what goes on during recessions can be viewed with incredulity by freshly minted PhD economists, as they will often never have encountered such a notion during their training.

There is also no guidance provided by the 'microeconomic foundations' approach, behavioral or otherwise, about which core ideas should be used in modelling any concrete problem. Is a particular policy scenario best modelled as a public-goods problem, or as a problem of barriers to entry? Externalities, or fixed costs? Structural inefficiencies, or returns to scale?

We submit that to fill in these blind spots, it is preferable 'to consider whole clusters of ideas rather than to target just one at a time' (Frijters, 2013: 342). Taking Daniel Kahneman's cue to move beyond rational economic man, we propose in this chapter a more integrated picture of not only the individual, but also his groups and his institutions. While we cannot solve all of the problems that modern mainstream economics leaves unsolved, we aim to show how expanding economists' view of individual and group processes, by accommodating more behavioral realism and directly modelling processes traditionally considered the purview of social psychology, can yield an improved understanding not only of microeconomic behavior but of the broader political economy in which we operate.

The individual and the greed–love dichotomy

Modern mainstream economics depicts a person as an 'individually rational agent', seeking to attain maximum personal gain from scarce material resources. This stylized individual simply takes resources and dominates others whenever he can in the pursuit of more wealth. Yet moral philosophers, including many modern economists, know that this is not a realistic depiction of human behavior: people's behavior reflects not only their search for money and status but also their love for their children, their love for their gods, and their commitment to notions of right and wrong. Yet how can we make our view of the individual more realistic without sacrificing the simplicity and tractability of the *Homo Economicus* model? A workable alternative should retain the elegance and the myriad contributions of the old model lest we fall into the trap of throwing away a very successful model just because it does not explain everything. Yet, the call to jettison

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what has been learned because of what is not yet explained is made by many (see, for example, Hodgson, 2013). Sensing the threat of admitting that the standard model fails to address important economic phenomena, economists have offered ever more fanciful rationalizations for retaining the old model, including such behaviors as voting (Downs, 1957), paying taxes (Allingham & Sandmo, 1972), and giving away money (Tiehen, 2001).

Significant mental gymnastics are required, however, to rationalize why a wealth maximizer would agree to serve his country as a front-line soldier; why a voter would expend effort to vote even though his chances of changing the outcome of the election are minimal; or why any one of us should be a tax-paying, law-abiding citizen when the probability of getting caught engaging in tax avoidance or petty crime is minimal. Either an individual must be stupid, uninformed, deluded, or unseen strings must be attached in order for mainstream economics to make sense of behavior that appears to be misaligned with the material interests of the individual. Perhaps our care for our children is the clearest case of the limits of the explanatory power of wealth-maximization: you would have to believe very unlikely arguments, such as that the only reason parents buy things for their children is so that the parents themselves look good in front of their friends and thus get more status, or that parents secure the highest possible income in adulthood for their children, the better to then beg, borrow or steal some of it for themselves.

Cognitive limitations, habits, and poor information (Pingle, 2010; Fehr & Zych, 2008; Altman, 2012) have frequently been offered as justifications for 'suboptimal' behavior, with some *ad hoc* acknowledgment of the possible contributions of true generosity or love. Variants of 'altruism' have been observed in many settings, in the lab and elsewhere (e.g., Andreoni, 1995), but this phenomenon has not been theoretically integrated into the economic model of decision-making. Even the motivating ideals of economics as a science and a profession are mysterious from the point of view of the very *Homo Economicus* lying at the discipline's heart, who cares nothing for helping society as a whole, searching for 'the truth' or helping 'his colleagues'.

While we freely acknowledge the greed of people and their willingness—seen in examples throughout history and around the world—to lie, cheat, steal, and kill in order to amass more for themselves, we think it is impossible to fully explain human behavior solely by greed. To dismiss the many situations in which people give freely of their resources with no personal material reward as merely unusual-looking attempts to dominate requires too many acrobatic flips of logic and suspensions of disbelief. Taking a serious alternative stance, however, requires an objective examination of what 'non-greed' really is.[1]

What the economist requires is a simple statement of the truly non-greedy side of human motivation that makes sense from the evolutionary and economic perspectives, fits most observed behaviors stemming from something other than greed, and is also flexible and general enough to inform and be woven into a larger story of how individuals interact.

Our main argument is that the non-greedy side of human motivation, which we call interchangeably love or loyalty, can be seen as a resource-acquisition strategy based on submission: an individual gives up part of his current identity and resources to a person or entity in the hope of a return favor.[2]

When do we use this strategy? Crucially, as it is impossible to consciously choose to love or stop loving something or someone, something uncontrolled by our conscious will must be at work in determining whether or not we will use this 'non-greedy' submission strategy in a given situation. For lack of a better word, we refer to this part of the mind as the 'unconscious.'

We propose that love is initialized in the unconscious mind because of a combination of desire (the lover must desire something from the loved object) and power (the lover must perceive the loved object as so powerful that it cannot be directly dominated). We thus contend that objects, ideals or people are loved when have been assessed by those beholding them as possessing

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something of value, but as being unable to be forced into surrendering it. Love is then essentially an implicit offer of care made by the unconscious mind towards the loved object, made in the hope that the loved object will reciprocate by providing the lover with what he wants. Once ensnared by this offer, the lover's conscious mind becomes bound to its promise, and treats the loved object as an extension of himself, irrespective of whether the hoped-for reciprocation happens.

We contend that economic agents act under the influence of greed when they consciously try to get the most for themselves by taking it or trading for it, and that they act under the influence of love or loyalty when they give towards others (people, objects, gods, or ideals) when there is no material reward for their generosity. There may be a hoped-for material reward, and there is also a true reward for seeing the loved entity thrive, but these are only perceived inside the mind of the lover. Figure 24.1, reproduced from Frijters (2013), provides a simple schematic of the two different strategies: greed, based on the domination response; and love or loyalty, based on the submission response.

It is hard to overstate the policy relevance of this mechanism. If loyalty is the outcome of beholding a power that is deemed to control something desired, then those with actual power can use this mechanism to create loyalty towards themselves and their ideals. Hence, nation states can create loyalty to themselves by means of national curricula, national armies, national festivities, and the national media. Through its power over the next generation in schools, army institutions, universities, and ministries, the nation state molds its citizens into loyal subjects who then man the state institutions and organize the loyalty formation of the next generation. In a similar way do academic disciplines and large corporations influence new recruits towards adopting new ideals and goals. Simply put, the love mechanism provides a natural means for the creation of group loyalty and hence for the creation and maintenance of groups themselves.

Naturally, some people pretend to be acting out of loyalty when in actual fact they are merely being calculating (i.e., greedy). This situation normally requires a social component, since pretense is normally a social activity. Hence, to further explore this and other consequences of our enhanced view of the individual, we must proceed to examine a higher level of aggregation than the individual himself: groups of people.

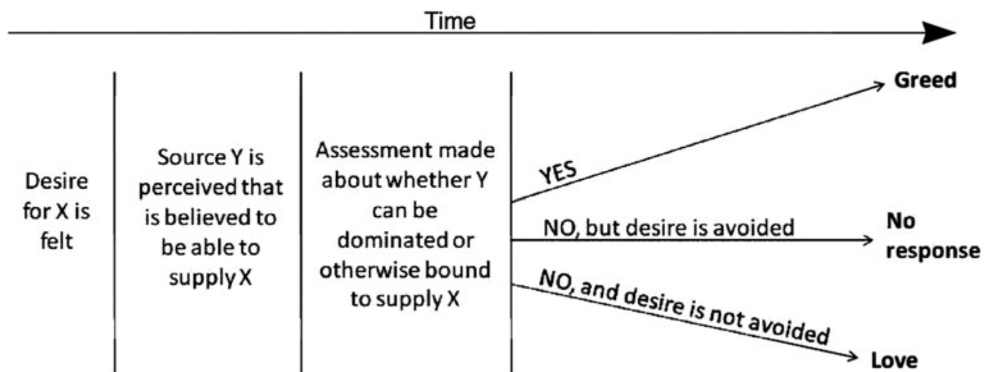

Figure 24.1 The stylized dichotomy between the strategies of dominance and submission

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Groups

We now put forth a view of human groups that is consistent with the above view of the individual, and that can underpin an understanding of the wide array of economic and social institutions that we see today and have seen throughout history.

We draw inspiration in this section from studies in sociology and social psychology of how people interact in different types of groups. The Milgram studies (Milgram, 1974), for example, demonstrate our high degree of willingness to follow orders from a figure of authority when we are in the role of an underling. Other studies in psychology also show how a particular interpretation of reality can be upheld through social pressure within a group of relative equals (Asch, 1956) and how groups can form quickly where there are clear and immediate returns to being part of a group rather than on one's own (Peters, 1971). Like love, groups clearly matter for how we behave, meaning again that economists require a simple, tractable understanding of them that can be integrated with the discipline's existing models of behavior.

Our proposal is that every human group and organization is made up of elements of two core archetypes: hierarchies, and what we will call circles of reciprocity. Hierarchies feature clear lines of authority, with one person or group of people 'in charge' and others playing the role of followers. The number of hierarchical layers may vary, but the distinguishing feature is that orders of the leaders must be obeyed by the followers, whether or not these orders make sense to the followers. People operating in archetypical hierarchies are not motivated by any abstract common purpose shared by everyone in the hierarchy, other than the simple desire to amass wealth or status. The hierarchy is the social group type most associated with greed, as it operates on the basis of cold calculation by everyone in the hierarchy that their best chance to get ahead—possibly by rising in the ranks of the hierarchy itself—is to continue to be part of the hierarchy, whether as a follower or as a leader.

The other group archetype that we propose is characterized by the absence of lines of authority. A pure circle of reciprocity consists of people who see themselves as equals. The group runs not on the basis of its members' conscious pursuit of more for themselves and obedience to authority, but rather through the existence of abstractions in everyone's minds to which all members contribute. Due to the exceptional power of the human mind to conjure up and be motivated by unseen things, the abstractions defining a circle of reciprocity need not be specified exactly in order to perform the function of coordinating the group's actions. Such vague notions as 'fairness', 'our nation', 'my family', 'the school', or 'our ethnicity' are perfectly serviceable, even if what is meant by each of these things is subject to personal interpretation. Some fraction of the members of any circle of reciprocity will sacrifice towards the ideals of the group out of true loyalty to those ideals (one might call these members 'true believers'), where that loyalty has developed over time following the process sketched previously. Others in the circle may not be truly loyal to the ideals but nevertheless wish to benefit from membership in the group, and hence will play along.

A hierarchy offers high returns for those at the top, and each individual member must only monitor the activities of underlings one layer down. Hence, hierarchies naturally attract ambitious people, and are efficient ways to organize large-scale, generic activities whose successful performance requires only minimal (i.e., one-layer-down) checking to ensure that orders are being followed. The main economic cost of a hierarchy is that its members are not loyal to a group ideal and are continuously looking to benefit personally at the expense of other members. In modern societies featuring nation states with monopolies on violence, individuals can usually just walk away from hierarchies, which means that a successful modern hierarchy must obtain a rent to share among its members. This rent might be an effective monopoly, generated via a patent

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or returns to scale, or a political rent, in the case of a hierarchical ministry established by the political system.

The economic advantage of a circle of reciprocity is that its members are motivated to advance the interests of the group even when unmonitored. This makes circles of reciprocity the preferred group type with which to organize activities that require the coordinated activity of many individuals whose choices are based on locally available information and are complementary with other individuals' choices. This is partially why schools, army units, and teams operate as circles of reciprocity. Activities of the productive members of these groups amplify each other in production: successful performance of the group goal requires coordinated effort at myriad local levels contributed by willing cooperators.

Circles of reciprocity can be usefully subdivided into small ones—where all members are personally known to all others—and large ones. Both types feature individuals sustaining mental relations with the group abstraction: one's relation with 'Russia', 'Hinduism', or 'sociology' is equivalent for our purposes as one's relation with one's mother or one's neighbors. Yet small circles of reciprocity involve a cost, borne by members, of keeping mental score sheets as to who has contributed what. Even when there is a core of 'true believers', this score-keeping is required in order for circles of reciprocity to prevent and punish the free-riding of those who are not true believers, and thereby to maintain behavioral commitment to the joint group ideal. The cost of mutual monitoring goes up quadratically in the number of group members, which limits the size of small circles of reciprocity. In large circles of reciprocity, such as a religion or a nation state, the required monitoring happens instead via dedicated institutions. Members of a large reciprocal group do not personally know all of the group's other members, but everyone shares a similar understanding as to how the 'group-as-a-whole' rewards and punishes each member. Cohesion is maintained via formal institutions that indoctrinate new members, reward faithful service to the group, and punish conspicuous deviants—in line with that shared understanding and essentially following the recipe for generating loyalty in our love/greed theory above. Of course, the monitoring of large circles is not perfect, and individuals may compete for control of the common understanding or 'story' of what it means to be a 'good' member of the group.

These core archetypes are rarely seen in their pure form: most real human groups are patchworks of hierarchies and circles of reciprocity. Nonetheless, the nation state is the best modern example of a large reciprocal group. It wields the greatest power over us in many ways, including in terms of taxation and military potential, and even in terms of our self-image.

We propose that an economist can better understand the incentives faced by people, who are invariably members of multiple groups, when he first determines what lines of authority exist and what abstractions are at play in those groups. Any individual behavior that the economist would like to understand better can be viewed in the context of those group pressures most relevant to the individual at the time. For example, a father teaching his small child arithmetic will respond very differently to his child's questions than he would have responded earlier that day in response to questions from his marketing colleagues around the boardroom about his most recent proposed initiative to increase sales. This is because he is facing different powers in the two situations. With his child, he is motivated mainly by love, together with a mild sense of being in a position of authority over the child; in the boardroom, he is motivated by a desire to be seen to be trying to advance the financial interests of the company, and also to be seen as a valued member of his group of marketing colleagues who view each other roughly as equals sharing a particular outlook on the world. His answers to his colleagues' questions would, therefore, be framed in terms of financial benefit to the company and adherence to principles of marketing; his answers to his child would be framed in terms of information provision and training (possibly both about math and about obedience) that will best assist his child to learn and feel good.

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Power

Power is a very slippery term. Our working definition of power is that it is about the believed potential to call upon resources in service of an objective. The power faced by underlings in a hierarchy is wielded mainly by their overseers, who can call upon their own physical force, and ultimately the physical force of others of higher rank, in order to ensure compliance with orders. The power faced by a member of a circle of reciprocity is not only that wielded over him by his unconscious mind if he is a true believer, essentially telling him that he himself will ensure his compliance, but also ultimately—for true believers and others alike—the power of the entire group. Every member of a circle of reciprocity is bound to adhere to the ideals of that circle in part because he believes those ideals to be backed up by the potential of everyone in the group. This is why, when decisions about the strategic objectives of a circle of reciprocity (such as a nation) are taken by one person or a small group of people (such as a president, or a cabinet of ministers) who temporarily hold the potential of all the members of the circle in their hands, it is common to talk of that person or small group as having a lot of power. In reality, the elite that is temporarily in charge of guiding a circle of reciprocity is almost as tightly constrained as any ordinary member by adherence to the group's ideals. Straying too far from those ideals will result in the ousting of a temporary leader from headship of a circle of reciprocity, and the consequent loss of virtually all of his 'power'.

We propose that power almost always derives from group roles; that it is about believed potential to draw upon resources; and that it is created in greatest measure by large circles of reciprocity. Much of the power wielded in smaller groups and hierarchies is derivative of the rules agreed upon centrally in our large circles of reciprocity, such as family law, contract law, labor law, and general expectations of proper behavior.

Networks

The final element that we propose here operates, like hierarchies and circles of reciprocity, at an intermediate level of aggregation—yet it differs from the two above-mentioned group archetypes in that there are no group-derived behavioral expectations. No lines of authority exist that are expected to be respected by members, and no ideals exist to which members are expected to show allegiance. People are instead allowed and even expected to behave in an entirely self-promoting fashion, with no one in a position to tell anyone else what to do. This interactive realm is what we refer to as a trade network.

The basic building block of a network is a trade relation, also called a link or a business relation, which is in essence an expected trade between two entities over some period of time. The expectation can be formal, such as when a worker holds an employment contract with a firm, or implicit, such as when a shopkeeper rationally expects to be able to sell his goods to one in twenty of the tourists in his part of town. The trade can be one-off or sustained, specialized or generic, and may involve prior investments. At the macro level, the aggregate concept of 'networks in the economy' is very similar to the concept of aggregate demand and aggregate supply, but we speak in terms of individual trade links at the micro level in order to support a conception of networks at the individual, firm, industry, and country level.

Like power, a trade link exists as a believed potential rather than necessarily a tangible, easily quantifiable object, even though many links will be expressed in quantifiable and tangible formats (such as delivery contracts). When someone says that his 'network' is large, it means that he believes he could call upon (and expect to receive an answer from) a large number of people in regard to a new opportunity. For example, a baker might notice that his new millet rolls are selling

well, and might call his 'network' of suppliers to find out who can quickly increase their supply of millet flour. A chemist might hear about a new drug at a conference, and later contact his 'network' of suppliers to find out who can sell him the drug; he might also promote the drug among his 'network' of clients and even among other chemists in his professional 'network'. The expected response from a member of someone's network to information about a new opportunity is to be interested in the potential to achieve some type of personal gain from that opportunity. Still, the value of a network is often recognized by its members, which somewhat constrains their behavior: people do not routinely defraud other people in their networks, even if they are presently competing with them, since those same people may be of use in a future period. More important for our view of the aggregate economy, a network's members are constrained by the rules and behavioral expectations that accompany the hierarchies and circles of reciprocity to which those members belong.

Within this view, an unemployed person is someone without a particular type of link, that is, someone with no partners with whom to trade his labor. Job search consists of looking for partners with whom to enjoy the benefits of trading on the basis of comparative advantage. Private firms are primary bundles of networks, both among workers inside a firm (who are sorted into functional units and teams) and between any given firm and its external clients and suppliers. Bankruptcy is often caused by the collapse of these trading ties: that is, the reneging on explicit or implicit expectations of intentions to buy or sell particular goods at particular prices. The strong interdependence of network-related decisions taken every moment by actors in the modern economy has immediate implications for how to conceptualize economic downturns. As we discuss in more detail below, the links of trade and expectations defining an economy can suffer rapid and catastrophic destruction due to the externalities that accompany every decision in a given network. Once existing trade links break, it takes time for all directly affected parties to find new partners—something already recognized in existing search models—but our model predicts the cost of this search to be even higher because of the negative externality of others' links having also been broken. In this way, the interconnectedness of trade networks that characterizes a modern, advanced economy leads to protracted periods of economic doldrums after catastrophic crashes.

Networks have been identified by some economists as important catalysts for trade (Coase, 1937; Calvo-Armengol, 2004), but in our view they are more than that. They are a necessary input for trade and ultimately for economic growth. It is via networks that opportunities are broadcast, new combinations of inputs trialed in production processes, and innovations spread. It was not only through war, migration, and theft but also via trade networks that spices were brought to Europe, horses to America, and cotton to Africa. Traders have a keen interest and economic stake in preserving their autonomy—only a free hand can capture opportunities when they arise—and we contend that this dynamic in the longer run shapes the political systems under which we live, since many of the large circles of reciprocity that now dominate the political landscape started out as ideas bandied around in trade networks (Frijters, 2013).

Implications

We now combine the above ingredients to offer a behavioral interpretation of the structures of modern society, maintained not only by greed, but also the conditioned loyalty of individuals towards the abstractions supporting the circles of reciprocity in the economy. We first examine important components of the wider economy, and then offer observations about economic crises such as the GFC.

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The legal system

The structure of laws and courts underpinning our economies is an outgrowth of the ideals that define the large circle of reciprocity that is the modern democratic nation state. The idea of 'the rule of law' precedes the nation state, but its current form is as an instrument, serving the goals of the country as a whole. The legal system is seen as an efficient means of guaranteeing desirable outcomes, such as the separation of powers and the ability to plan for the future on the basis that the rules of society in the future will be upheld much as they are today.

Ideas like human rights, egalitarian treatment, fairness, and justice are by implication only as powerful as they are today due to the power of the nation states with which these ideas are aligned. Those who operate within our legal system, including lawyers, judges, and bureaucrats, are beholden more or less to those nation-state ideals, but also hold other loyalties and face other material incentives. For example, the standing of lawyers is heavily influenced by what other lawyers think of them, which in turn is influenced by factors such as whether they are perceived to know their case law or to be effective arguers. Their ideals are partially shaped in law school as young, aspiring lawyers wanting something from the legal profession (i.e., a job and social standing) and judging unconsciously that submission to the ideals of that profession was the optimal strategy for satisfying those desires.

At the same time, lawyers face opportunities for personal material advancement that exploit their reputation but do not actually further the ideals of either the nation or their profession. Hence, lawyers and judges—like many other professionals in society—constantly balance a tension between their impulse to dominate and acquire more wealth while secretly disregarding the ideals that support their role and reputation in the economy, and 'toeing the line' in regard to those ideals. This tension is of a different caliber for those legal professionals who have developed true loyalty to the ideals of fairness and justice, but even those who have not are constrained by what they believe to be the ideals of others. Those legal professionals who are seen to use their position to further their own ends (e.g., by taking bribes, or devoting insufficient effort to determining 'fair' sentences) without regard to the ideals of their profession may find themselves out of a job.

Central banks

Central bankers are also part of the machinery of the nation state and are hence somewhat beholden to the ideals that it promulgates. In this case, however, the ideal most relevant to their professional decisions is not fairness or human rights, but the growth desired by the state.

Growth requires stability and predictability. This is because people will not plan or make long-term investments in the areas of their comparative advantages (i.e., they will not specialize) unless they are relatively sure that later possibilities for trade with other specializing people will materialize. Ultimately, the ability to create the circumstances in which economic growth occurs is a large part of what lends the nation state its perpetual pull on people's loyalty: this is a power that pushes citizens into adopting a submission strategy rather than a domination strategy when interacting with 'the nation'. Central bankers operate as a group with growth as the guiding ideal, following particular notions of what the group is supposed to do, such as maintaining purchasing power stability through setting appropriate interest rates.

As with judges, temptations arise for bankers to stop subjugating themselves to this ideal and instead to exploit their positions for personal benefit, and such temptations are easier to resist the stronger the true loyalty of bankers to the economic success of the nation state. Again, this loyalty is developed over time, in proportion to bankers' perception of the nation as a powerful force that

offers benefits. With a measure of independence from the government bureaucracy, central bankers can distance themselves from the fiscal realities of everyday government, giving them more freedom to act in accordance with their ideals but also some independence from bureaucratic oversight, opening opportunities for corruption.

The independence of both the legal system and the central bank from the main political actors in the nation state (e.g., parliament and the political executive, such as a cabinet or president) is not inevitable, but is rather the outcome of a learning process regarding how to efficiently organize institutions that support the nation state. Distance between the politicians and these groups is, in the dominant nation-state vision of today, believed to be in the interests of the members of the nation state. Whether that is actually true, and whether better mechanisms are possible, are both subject to debate.

Government ministries

The nation state's daily operations are overseen by a vast patchwork of small circles of reciprocity (the elite groups in charge of government ministries) that dominate and direct the large hierarchy of the national bureaucracy, which in turn dominates and directs both smaller hierarchies (e.g., at the state level) and the small circles of reciprocity that direct them. The small circles of reciprocity at the top of ministries—like those at the top of any hierarchy, even an autocratic one—are essential, for without them the leaders of the hierarchy would not achieve the level of cooperation required to ensure the effective functioning of the entire (ministerial) hierarchy. Each of the small circles at the top is in part dependent for its existence upon its reputation for advancing the nation as a whole, but also acts to promote its own interests, such as when it tries to grab resources and administrative oversight from other ministries. The arguments made in any such attempts at domination and subgroup advancement will be made in terms of the interests of the whole nation or its ideals, rather than in terms of advancing merely the interests of the subgroup. Here again, the ideals upheld by the larger circle of reciprocity act to restrain the personal greed of those operating within it.

Watchdog groups

Competition watchdog groups, such as the Fair Trade Commission, are also outgrowths of nation-state ideals. They are staffed by professionals bound not only to the ideals of the nation state but also to their professional ideals, lest they lose their posts. An economist who takes a five-year job with a watchdog group and is seen by his peers during that time not to have upheld the ideals of the profession of economists—namely, to seek higher social welfare and efficiency, and to push markets towards the perfect-competition, laissez-faire ideal—will likely find himself out of a job once his term ends. The prospect of this reputation damage constrains the behavior even of similarly drafted economists who believe in neither the ideals of the nation state nor the ideals of economics. The same can be said of economic advisors to governments or non-governmental organizations.

Corporations and their lobby groups

Corporations are primarily wealth-maximizing hierarchies that can, in our modern societies, gain financial advantages by latching onto the ideals of various circles of reciprocity, and even by pretending to be circles of reciprocity. They can only exist because the nation state reinforces their hierarchical elements with contract laws and enforcement mechanisms (e.g., police, courts, and habits of obedience taught at school). Within a corporation, as within the government bureaucracy itself, lie many small circles of reciprocity, often organized around productive

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units—Accounts Payable, or the Board of Directors—that seek gain for themselves but are constrained by the need to be seen to adhere to the objectives of the whole corporation. The more that the corporation's employees have developed true corporate loyalty, the less direct monitoring from the top is required. Corporate lobby groups, which represent the interests of corporations to the government, are institutionalized rent-seekers. Playing the system by appealing to nation-state ideals while really having only partisan interests at heart, lobby groups are a good example in the modern world of a wolf in sheep's clothing: an entity that is powered by greed but that relies for its own productivity on appeals to loyalty. This view accords with what is known as 'capture theory' in political economy (Stigler, 1971; Peltzman, 1976), although unlike ours, that theory does not provide an explanation for the countervailing force of nation-state ideals in the decision-making of the government officials who are lobbied.

Economic crises

Through the lens of our theory, most economic crises are due to stagnation in the creation of new trade links together with the destruction of existing trade links, often through bankruptcies and lay-offs. The resultant crumbling of networks leads to idle labor (unemployment) and idle capital (unused buildings and machinery). Trade links, which take time to rebuild, are broken in rapid cascades because the destruction of any individual link creates externalities on the trading partners of those previously linked. This is why economic busts in our theory are predicted to be rapid but followed by long periods of slow recovery, in which capacity continues to be under-utilized. By contrast, most traditional economic theories, such as theories of unemployment that rest on sluggish price movements, understate the difficulties of finding trading partners and overstate the ease with which information and opportunities are available and recognized.

Business cycles result in our theory from interconnected trade networks combined with the agency problem afflicting large hierarchical organizations, like banks. Like other professionals, bankers face a constant temptation to gamble with the resources of their organization in order to achieve private gain. When there is substantial discretion on the part of a bank's top brass and technical decision makers (e.g., key investment managers), one should expect unproductive networks to be formed during the boom phase of the economic cycle. This is because those professionals who are neither true believers nor closely monitored will hire their friends as suppliers, waste money on trades that only benefit themselves and their cronies, package bad loans in complex and non-transparent ways so investors can be fooled into buying them and thereby taking on excessive risk, and so on. Similar things will happen in other large hierarchical organizations. Once these bad investments become visible, a period of stagnation in new link formation ensues in which large organizations switch to 'no risk' mode as managers try to learn more about what they actually invested in, and organizations pay off their accumulated debts and collect on outstanding debts.

A type of endogenous regime-switching ensues, where a regime is described by the degree to which the more entrepreneurial actors in large organizations find themselves able to set up new networks. In 'normal times', the limited liability of these decision makers gives them an incentive to invest in new projects and gamble with the resources of their organizations and investors. The investments and projects that are undertaken by such actors are interconnected and complementary to one another. This results in phases in which many projects are successful, and lead to more investments, until there is a conspicuous failure that leads to an initial destruction of business links, at which point the general expectation switches. This switch then causes many investments existing at that moment to fail, and throws up blockades against new investments. Because of the interconnectedness of investments via trade links, what starts out as a small shock can grow into a

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large cyclical slow-down involving the destruction of many networks without the creation of new networks to replace them.

Even large organizations that do not themselves enter a 'no risk' mode once the switching point arrives face the problem that when many others do enter that mode, new ventures will be more likely to fail: chains of trade links are required to make new ventures productive, and many parts of each chain will experience knock-on effects from the decisions made in other parts.

This interpretation of recessions, fairly close in spirit to the views of Keynes, explains why large volumes of government and private debt can prevent new economic activities from being started and funded. The difficulties of servicing large debts when other organizations are also reducing their activities lead many organizations into 'no risk' mode, which implies that they are unavailable—at least temporarily—for the creation of new links. Other organizations in the economy then face higher costs of finding new connections. In a recession, the chances that something new will fail are much greater than in normal times because new connections must be formed by many different players in order to make new ventures productive—and in a recession, many players are unavailable.

Observations on the Global Financial Crisis

The Global Financial Crisis of 2008–13, also known as the Great Recession, involved many elements relevant to our theory. For the sake of brevity we enumerate and explain below a few aspects particular to the GFC that are not recognized in standard economic discussions and that underscore the importance of groups, links, and loyalty in society.

Debt and the move from informal to formal links

The rise of household indebtedness that accompanied the property bubble, whose bust is a core characteristic of the GFC, is a measure of the entanglement of claims among individuals due to the fact that one person's loan is another's investment. One might argue that having more debts makes an individual more vulnerable to shocks, since people who cannot pay back their debts thereby sever many trade ties with investors who in turn might well sever some of theirs. This may be true, but why did debts rise so much in the first place? Put differently, what did the larger and larger debts observed in recent times replace?

Pre-GFC, the level of household debt had grown over a long period in both the US and, even more noticeably, in the richest countries of the EU. Figure 24.2 (reproduced from Weisenthal (2012)) shows a time series of debt-to-disposable income percentages for the US that climbed steadily from the mid-1980s through the start of the GFC. Figure 24.3 shows a rise in the same measure starting from the mid-to-late 1990s, using similar data for many EU member states.

Part of the explanation for the slow rise in normalized debts pre-GFC is that economic relations gradually changed in the twentieth century from being strongly mediated by families and small communities (small circles of reciprocity) to being reflected in anonymous, trackable trades (anonymous networks). Instead of living in their parents' house that they would inherit when the parents died, partially in exchange for looking after the parents in their dotage, younger people started owning their own homes and insuring themselves against health shocks, unemployment, and old age via anonymous financial markets. The Netherlands and Denmark, which saw the greatest rise in debts as shown in Figure 24.3, not coincidentally also had the largest assets in the form of huge public pension funds. Households had both debts and large pension assets, both operating via formal, visible financial institutions. Thus, what were previously invisible debts and implicit rights inside households and communities—informal links—became openly visible links,

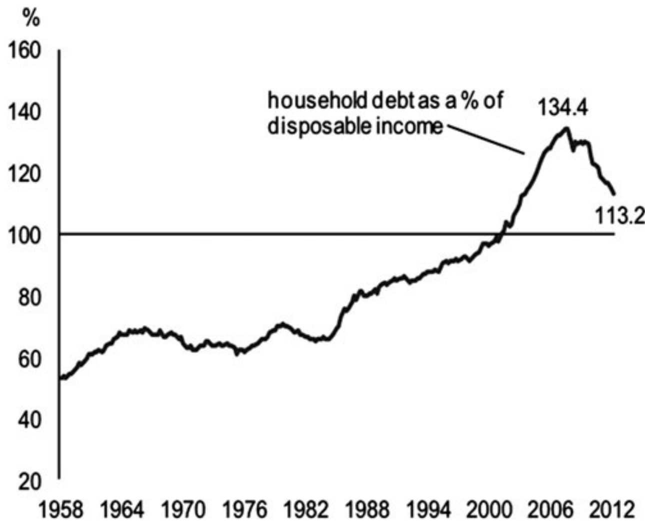

Figure 24.2 US debt to disposable income

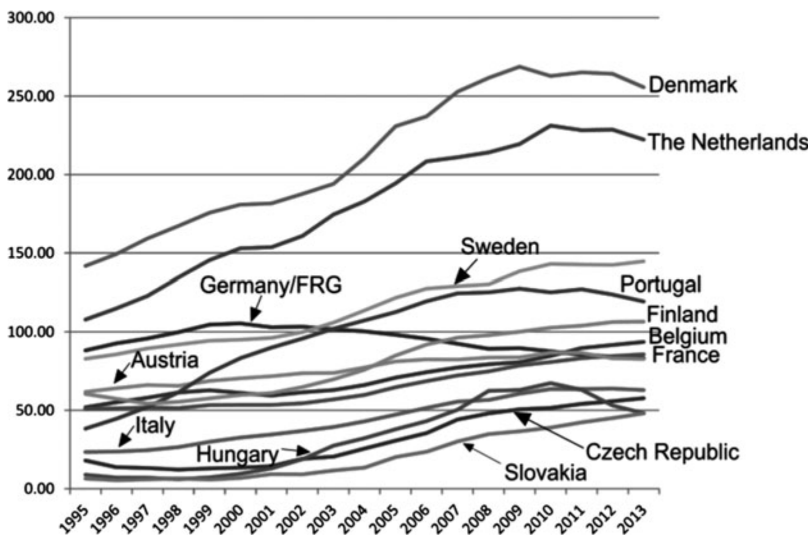

Figure 24.3 European debt to disposable income, in percentages

Source: Eurostat.

whereby the relatively young and poor borrowed money from the relatively old and rich via banks, insurance companies, and pension companies.

Because the unraveling of implicit debts and rights inside less visible small circles (families and communities) has gone unmeasured, it is not obvious whether the increased formal debt levels replaced equal, lesser, or greater amounts of previously invisible debts. Measures of changes in the hidden insurance and wealth claims within families and communities would be needed in order to gauge whether there are more claims on the average young person today than in the past.

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Nation-state identities and accountability I: the Fed versus the ECB

The US Federal Reserve reacted to the GFC more quickly and in a different fashion than the EU financial institutions, notably the European Central Bank. The Fed was able to buy up large amounts of US treasury bonds and bad loans made by US financial institutions, and to make cheap loans available to banks so as to increase the money supply (a policy known as 'quantitative easing'). In contrast, the ECB could buy up only a very limited number of member states' government bonds, and could not directly buy up bad loans.

The difference arises because the United States is a nation state, with the nation-state ideals and members' loyalties that come with that, and the EU is not. Decision makers within the Fed have the explicit mandate from the whole of the United States to ensure price stability and to try to prevent and ameliorate recessions. The ECB by contrast only has a mandate to ensure price stability, and must also navigate the conflicting interests of member states, which made it unable to buy bonds and engage in quantitative easing on the same scale as the Fed. During the crisis, member countries with divergent financial interests have effectively vetoed expansions in the ECB's minimalist mandate. A recent report financed by the Bruegel Foundation (Mody, 2013) summarizes the financial events in the European Union thus:

> Five years of crisis have pushed Europe to take emergency financial measures to cushion the free fall of distressed countries. However, efforts to turn the crisis into a spur for 'an ever closer union' have met with political resistance to the surrender of fiscal sovereignty. If such a union remains elusive, a perpetual muddling ahead risks generating economic and political dysfunction.

By comparison, the Fed's behavior shows the advantages of being a fully integrated nation state.

Nation-state identities and accountability II: people, power, and politics

During the crisis, all players focused on the decisions taken by the institutions of nation states. This is a clear demonstration of the true underlying distribution of power. Populations, banks, and investors all knew on which side their bread was buttered, and lobbied governments for favorable treatment—governments, not banks, investment agencies, or mortgage holders. Virtually no one saw the point of appealing to the generosity of bankers or homeowners. Why? Because it is well understood by most economic agents that, as our theory proposes, the private sector and financial institutions aim to make money and are hence not likely to be responsive to moral requests, whereas nation states, and their politicians and representative institutions, are in part accountable to their citizens. The citizenry voiced its concerns within the frameworks that organize political power in nation states: by appealing to the politicians, the ministries, and the representative institutions (like the Fed) for solutions. Whether the entities receiving these appeals were to blame for the problems, or even whether they had any idea how to solve them, was immaterial: as the current wielders of the power of the group as a whole, politicians and institutions were expected to deliver a solution.

Many accusations were made (and often proven) about how small vested interest groups had taken advantage of society's trust by means of securing subsidies or favorable legislation before the GFC (such as the repeal of the Glass–Steagall act in the United States that made high-risk investments easier for banks to take). This type of ex-post accusation is further proof of the power of the story of the nation state, that is, the story of what is in the interests of the population and what, in hindsight, should have been done to serve those interests. Institutions and ministries

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eventually suggested new mechanisms to prevent another GFC, for example by increasing the capital requirements of banks and by having a bank watchdog inside the ECB. In sum, the GFC provided the population with a focal point as to what it did not want, after which the politicians were forced into promising to learn lessons and improve regulation. This very interaction demonstrates the faith by citizens in the long-run oversight provided by the institutions of their nation states.

Trade links and personal incentives in hierarchies with limited monitoring and liability

The high degree of risk-taking inside financial and commercial institutions (which also borrowed heavily) is a key feature of the pre-GFC 'Keynesian boom.' We see such booms as inevitable because of a central trade-off in the economic and legal institutions that surround risk-taking behavior: limited liability versus limited appropriability.

The legal institution of limited liability supports stock-traded companies in which others can invest, but whose managers are not personally responsible for company losses. The worst that can happen to such managers is that they are fired by the stockholders: there is no grand moral ideal they must be seen to uphold for the sake of their reputations. This legal institution has many advantages, including that managers need not be rich and that investors need not be particularly knowledgeable (only enough to smell a rat), but there is a natural disadvantage: the managers will take excessive risks with other people's money, since they stand to share more in gains than in losses. This description applies to a whole layer of decision makers in society, leading them to be optimistic and risk-taking. Because of the interconnectedness of business links, the system as a whole will be swept along with this optimism in good times.

At the societal level, the benefit of this risk-taking comes from the widespread existence of limited appropriability: the benefits that flow from investments and inventions that work out cannot be entirely appropriated by the organization doing the investing or innovating. Inevitably—again because of interconnected business links—the clients and suppliers in the instigating firm's network benefit too, and often whole countries can benefit from new inventions and technologies that were originally the product of some single company or ministry. Those individuals who made the initial investment decisions can only cash in to a limited degree, since intellectual property cannot be perfectly monitored or guarded. As usual in economics, these externalities should lead to under-provision, or in this case under-investment in projects by individuals whose personal gain upon the project's success is less than the social gain.

So, on balance, over-optimistic limited-liability managers finance innovation that they would not finance with their own money, with the social benefit that if things work out, others gain from the new project and technology. The balance between the forces of limited liability and limited appropriability, coupled with imperfect monitoring, makes cycles virtually inevitable in our theory: during booms, societies enjoy the spillovers of successful investments and feel optimistic without knowing the full details of all investments made, and in busts, societies discover the extent of the over-optimism which they could not know beforehand because of the imperfect monitoring of each individual actor in the network, and then become pessimistic.

While we can only guess at whether the balance between these forces is optimal at the moment, it would not surprise us if it were socially optimal to have even more risk-taking on average than we see presently. It may be also turn out to be optimal for our societies to introduce more liability and less risk-taking in some areas (e.g., mortgage markets) and more in other areas, depending on just how important the positive spillovers from limited appropriability are in that area compared to the negative consequences of a cascade of broken links due to over-investment.

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Conclusions

The political institutions that support our economies are outgrowths of hundreds of years of social evolution in which the nation state, nurturing a large private sector, has emerged as the currently best vehicle for producing mass loyalty and economic growth. It is clear that national institutions have a great deal of influence on the functioning of our economies, but capturing that influence in a simple way that can be integrated with standard mainstream economic thought has so far eluded the discipline. To fully understand modern political economy, we argue that one must first understand its structures in a way consistent with an expanded view of individuals that includes not only their greedy nature but also their submissive side: how people behave with respect to their groups, and how they respond—and particularly, how they develop loyalty—to power.

We began this chapter by proposing to offer both a way of expanding the core ideas included in the umbrella of economics, and an explicit heuristic for deciding which ideas apply to which particular scenarios. The heuristic that we propose—reflecting facets of both behavioral economics and social psychology—is grounded in an understanding of not only the material aspects of a particular situation, but of the groups, loyalties, and networks relevant to the people operating in that situation. While a full exposition of this heuristic is beyond the scope of this chapter, interested readers can find such a description together with several detailed applications showing its value in our recent book, Frijters (2013). In simplified form, we suggest that instead of asking merely—cui bono? —the behavioral political economist should also ask himself or herself: 'Where have I seen this problem before?', 'Which big groups are involved?', and finally, 'Who faces which powers?'.

Notes

1 Research in behavioral finance has sometimes pointed to fear as an additional non-greedy motivation for behavior (Lo, Repin & Steenbarger, 2005), but we contend that fear of wealth loss (often termed loss aversion) can still be understood as greed, since it derives from the same goal—that is, maximizing wealth.

2 We are less interested in describing the feelings involved in love, as already done in social psychology (Rubin, 1970), but more in offering an explanation about why and how love afflicts an advanced social animal with highly developed survival strategies. We talk at great length in Frijters (2013) about how the 'love program' described here could arise and be evolutionarily stable.

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