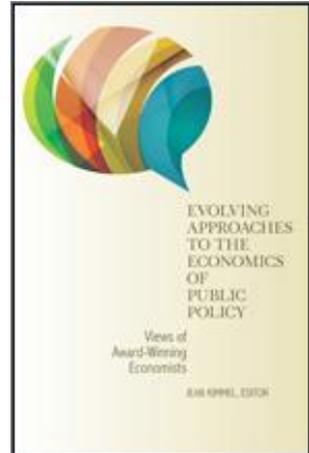


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## Introduction

Jean Kimmel  
*Western Michigan University*



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**Evolving Approaches to the  
Economics of Public Policy**

**Views of Award-Winning Economists**

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*Editor*

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# 1

## Introduction

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In the academic year 2013–2014, the Department of Economics at Western Michigan University in Kalamazoo, Michigan, commemorated the fiftieth anniversary of the Werner Sichel Lecture Series with a series organized by this author and titled “Award-Winning Economists Speak on Contemporary Economic Issues.” The annual Sichel series, sponsored jointly by the Economics Department and the W.E. Upjohn Institute for Employment Research, is named for Dr. Sichel, a longtime Western Michigan University economics professor and former department chair who retired in 2004. The success and longevity of this series is a testament to his vision and guidance.

All five authors represented here who participated in this anniversary series, although they are at different points in their accomplished careers, have achieved substantial national and international notoriety for their research accomplishments. While each speaker discussed a specific subject, they all adhered to the series theme of highlighting the various ways that economics can assist policymakers in the development and evaluation of public policy. The topics were wide-ranging: microfinance, human capital, worker motivation, societal institutions, and workplace regulation. In all, five of the six presenters from that year prepared chapters from their presentations for inclusion in this edited volume.

Chapter 2, “Microfinance: Points of Promise,” stems from the lecture by Erica Field of Duke University, who was the recipient of the Elaine Bennett Research Prize in 2010. This prize is awarded by the American Economic Association’s Committee on the Status of Women in the Economics Profession to the top young female economist who completed her doctoral dissertation within the past seven years.

Field’s lecture and the corresponding book chapter, jointly authored with Abraham Holland and Rohini Pande, both of Harvard University,

contain a nicely written description of microfinance, a popular anti-poverty tool used most often by developing nations. In place of the requirement of collateral to ensure repayment, it relies on small-group social pressure. The chapter includes a comprehensive discussion of its early implementation and the ways it has evolved over time. Much of this evolution, at least in recent years, has been in response to rigorous economic analysis. Most interestingly, the chapter includes a thoughtful discussion of what is meant, generally, by policy success or policy failure, and how economists ought to evaluate policy, followed by an application of this evaluation strategy to microfinance.

Oftentimes, when researchers talk about microfinance, they speak of it in glowing terms, implying that it offers the promise of great success with little downside. Field, Holland, and Pande relate the microfinance “narrative” to that of penicillin, which preceded it by many years. Penicillin is often spoken of as a miracle drug that arose seemingly from nowhere. In reality, it was developed and brought to market over many years with much trial and error, and less than 30 years after its introduction physicians began observing occurrences of drug-resistant bacteria. Penicillin’s glory days were short-lived.

This first section of the chapter makes clear that while microfinance has enjoyed explosive growth, there is limited evidence of “success” when focusing on outcomes closely tied to the likelihood that households will be extremely poor. The next section of the chapter looks at the nitty-gritty of the policy details, with the goal of identifying specific policy components that show the greatest promise. The authors present evidence that, if microcredit’s impacts are to be enhanced, microfinance contracts need more flexibility, particularly in the grace period between loan initiation and the start of repayment, as well as in the frequency of loan repayments. The authors themselves have been involved in the design and implementation of policy experiments that manipulate various loan details incrementally to determine the impact of specific changes. In one study described in this chapter, Field, with her coresearchers, shows that extending the grace period not only has a substantial positive impact on small business formation but also results in an impressive accompanying increase in household income. Another experiment focused on varying the frequency of repayment; the results were impressive, with substantial increases in household income and business profits along with no increase in default rates.

In their description of the origins of microfinance, Field, Holland, and Pande lay the framework for the interdisciplinary discussions that occupy the remaining chapters in this edited volume. It is clear from their description that the origins of microfinance were based on a realization of the ways that sociology and psychology can offer insight into the dilemma of how to provide credit to populations that simply cannot access traditional bank loans. Reliance on group pressure to repay the microloans reflects an appreciation for the way that culture is manifested in social behavior: in developing nations, extended families and their local communities tend to be very tight-knit, making it possible to rely on these social connections in developing alternative loaning mechanisms.

In Chapter 3, Nancy Folbre, emerita professor of economics at the University of Massachusetts Amherst, writes about “The Once (But No Longer) Golden Age of Human Capital.” Dr. Folbre, a MacArthur Fellow in 1998, devoted her career largely to the study of the interface between political economy and feminist theory, with an emphasis on the value of unpaid care work. Her chapter describes the evolution in how economists talk about human capital (specifically, college education) as an investment, and the empirical evidence regarding the labor market return to that investment. Until somewhat recently, a college education produced a fairly reliable return relative to a high school diploma; thus, many economists viewed inequality as a problem that could be addressed primarily by improving access to higher education. Unfortunately, as Folbre explains, this optimistic view ignores the interaction of both supply and demand factors in market determination of wages; the very nature of markets puts much of wage determination beyond individuals’ control. Economists have struggled to use standard models of discrimination to explain differences in wages by race and gender, and these differences have been made more striking by growing wage inequality among white men. Folbre’s analysis of discrimination relates to her human capital theme because of the link between differences in human capital investment and wage inequality. Interestingly, over the years, the very existence of standard “Mincer” earnings equations has implied that, to the extent that wage differences can partially be explained within a regression framework because of differences in human capital, then somehow these wage differences are acceptable. But in recent years, as the reliability of the linkage between educational

attainment and wages has weakened, concerns have grown both about the economists' human capital narrative and about the implications for educated workers struggling to adapt to a changing world.

The chapter provides a sweeping overview of the way that economists have talked about human capital throughout history and across types of human capital, leading to a discussion of the role of government in encouraging and financing such investments. This link to government is critical, given the final portion of Folbre's chapter: it focuses on what could be considered the alarming consequences of recent technological advancements, particularly with regard to information technology, which has weakened the link between a college diploma and high lifetime earnings. Not only is this link weakened, but, now more than ever, for those with college degrees, variation in the *type* of skills developed during school leads to substantial variation in earnings. This development ought to imply a revision in public attitudes toward higher education and a resultant overhaul of government policies. According to Folbre, the demise of the societal promise of reliable returns to a college degree may lead these workers to "identify themselves as members of a working class that is collectively disadvantaged by technological change and globalization," potentially leading to a new, strong political voting bloc.

Avner Greif, cowinner of the MacArthur Foundation Fellowship with Folbre in 1998, is professor of economics and Bowman Family Endowed Professor in Humanities and Sciences at Stanford University. His areas of research include European economic history and the historical development of economic institutions, including their interrelations with political, social, and cultural factors and their impact on economic growth. In Chapter 4, "Society and State in Determining Economic Outcomes," Greif analyzes the relationship between social structures and government institutions, on the one hand, and economic outcomes on the other. He explains that, in general, sociologists tend to emphasize the role of culture and social structures in determining economic outcomes, while economists tend to emphasize governments and markets; the latter emphasis results in behavior based on formal-rule-driven behavior, while the former implies culturally driven behavior. His chapter is a rather technical historical narrative of this discussion, with well-placed examples to which the reader can relate. For example, Greif talks about drivers of automobiles: how their rule-following

behavior evolves from social expectations, possibly influenced by the threat of the force of law. He concludes with a thoughtful description of the manner in which the two approaches are interrelated.

Greif talks extensively about rule formulation and the circumstances under which social rules can be formally institutionalized into rules enforced by the state. He returns to the example of automobile drivers to characterize the manner in which socially appropriate behavior is best achieved when the goals of social behavior can be individually internalized. For example, individual automobile drivers follow rules of the road, in part, because they know that it is important to them that others follow those rules as well. He extends this discussion to include morality as a force behind individual behavior that may be socially appropriate. In this way, his chapter is perhaps the most interdisciplinary of the ones included in this edited volume, with its intertwining of economics, sociology, psychology, and even theology.

Greif's chapter contains a detailed description of the nature of institutions as reflecting a collection of rules and contracts, as well as a description of the nature of institutions as dynamic, in the sense that they evolve over time. Finally, the chapter concludes almost where it began, with explicit comparisons between formal rule-driven behavior versus culturally driven behavior, from static as well as dynamic vantage points. Greif displays his vast appreciation for history with his varied examples, including late medieval Genoa, which produced a largely individualist society; a comparison of the way that different cultural beliefs in America and Germany led to the development of very different institutional structures in the nineteenth century; and a comparison of the timing of the elimination of institutionalized slavery in Christian versus Muslim societies. Greif refers to his theory of institutions and their evolution over time as a theory of action, explaining that the theory does not presuppose that behavior is rule-driven (i.e., driven by the state) or behavior-driven (i.e., driven by society). "From this perspective, asking whether society or the state is more important in determining economic outcomes understates the complexity of studying the sources of economic behavior," he writes. "Society and state intertwine in generating behavior. . . . It is sufficient to note that a functioning state is an outcome, and its ability to formulate rules depends on the cultural beliefs of various groups regarding not only their interests but also the goals and expected behavior of other groups."

David M. Kreps is the Adams Distinguished Professor of Management in the Graduate School of Business at Stanford University; he also holds a courtesy appointment as professor of economics, also at Stanford. In 1989, he was awarded the prestigious John Bates Clark Medal by the American Economic Association. This medal is awarded to “the American economist under the age of 40 judged to have made the most significant contribution to economic thought and knowledge.” His research applies theories of dynamic choice behavior to economics with a wide variety of applications, including human resource management and noncooperative game theory. Kreps’s submission, Chapter 5, is titled “Motivating Consummate Effort.” As suggested by an earlier working title (“The Economics and Psychology of Worker Motivation”), this research lies at the nexus of two areas in labor economics: industrial relations and industrial organizational psychology. Kreps’s contribution to this volume lies primarily in his expansion of the previous authors’ focus on economics as the primary analytical tool into a more fully interdisciplinary approach. Additionally, his chapter serves to demonstrate to the reader the reach of economics: his theoretical sophistication is clearly well informed by his professional proximity to the real business world.

Kreps begins by defining terms: “consummate effort” is “effort undertaken by a worker within an organization that goes well beyond any nominal job description, in a manner that is desired by the organization.” Kreps is referring to jobs that he labels “Type-K” jobs, in which K stands for Knowledge: high-skilled jobs that require a great deal of worker independence, creativity, and multitasking, and that feature vaguely defined tasks and a great deal of cooperation with coworkers. According to Kreps, traditional theory of worker motivation rooted in economics is not particularly useful for Type-K jobs because it relies on “reward for performance,” but in Type-K jobs, worker performance quality can be difficult to assess.

As a starting point, Kreps uses results from a survey that he administered to participants in the 2013 Stanford Executive Program (SEP), an annual six-week general management program serving top-level executives from around the world. In this particular summer, there were 158 program participants, of which 124 responded to the survey. Of the respondents, most were male, having an average age of 45, and about half were chief executive officers (CEOs), chief operating offi-

cers (COOs), or other very senior executives. The survey asks what motivates the respondent to exert consummate effort and offers a variety of possible responses (tangible rewards such as higher pay, better promotion opportunities, higher status; nontangible rewards such as work that is interesting and exciting, organizational success, and social importance). Then the respondent also reports what he believes motivates those who report directly to him (so-called direct reports). Kreps notes that current economic theory is most appropriate when tangible rewards motivate effort. His results show, however, that much motivation is driven by *nontangible* rewards. Kreps analyzes other survey questions as well and mines the data for differences by age, gender, and country of origin, noting that “Europeans perceive themselves as less self-motivated by tangible rewards and more by organizational success than do U.S. citizens and Canadians, with East Asians in the middle.” Overall, the survey shows that worker motivation is far more nuanced than current economic theory can accommodate, but it fits well within the social psychology construct.

Kreps moves on to present a broad overview of the social psychologist’s accounts of worker motivation, revealing that it includes the above-noted nuance, permitting more of a place for how workers perceive themselves and their roles within their organizations. He describes two different case studies: first, he describes nursing at Beth Israel Hospital and how it evolved from “primary nursing” in the 1970s to its current “floor nursing” model. In the 1970s, Beth Israel became the leading hospital in the Boston area by following the primary nursing model, in which each patient is assigned a primary nurse who is responsible for coordinating all care for that patient. However, in the ensuing years, as cost pressures mounted—partially because of changes in the nature of insurance reimbursement—care decisions became less driven by “what is best for the patient” and more driven by “what is cost-effective.” Care decisions now became jointly determined by the nurses on the hospital floor. The result, unfortunately, was a decline in nurses’ work satisfaction along with a decline in Beth Israel’s standing in the hospital community. The reaction on the part of the nurses can be described in theoretical terms as an evolution from intrinsic motivation to extrinsic motivation.

The same motivational issue is described in Kreps’s second case study, which looks at Company Z, a tech start-up in which the founding

tech workers were motivated intrinsically. As the company grew, salespeople were hired, and these new employees were motivated extrinsically by being offered performance incentives with tangible rewards (i.e., higher pay and bonuses). As might have been predicted, having tech workers who were expected to continue to be motivated intrinsically while they now were working alongside those being motivated monetarily resulted in tech-worker performance problems.

Kreps concludes his manuscript with a long, imagined conversation between a psychologist and an economist in which the two discuss the issues and evidence presented thus far. The section concludes with Kreps's admission that his sympathies lie with the psychologist, largely because of the difficulty that current economic modeling has in incorporating changing worker preferences. But Kreps remains convinced that economists are up to the task of developing better models, and in his conclusion he asserts that economists should embrace the psychologist's ideas.

The final chapter, Chapter 6, "Efficient and Effective Economic Regulation in a Confusing Technological Environment," comes from Michael J. Piore, the David W. Skinner Professor of Political Economy, Emeritus, at the Massachusetts Institute of Technology (MIT). Piore was awarded the MacArthur Foundation Fellowship in 1984. He is director of the MIT-Mexico Program and faculty cochair of the Industrial Performance Center at MIT. His chapter presents a thorough historical analysis of the role of government and regulation in a market-based economic system, providing illumination through several very different real-life examples involving the administration of labor market standards and the organization of product design and product development. As explained by Piore, the modern literature on this subject begins with the onset of much new government intervention in the private sector, which proliferated as a response to the Great Depression of the 1930s. Attitudes toward government regulation have ebbed and flowed since that time, with a strong push toward deregulation taking hold under then-President Reagan in the 1980s. According to Piore, however, while attitudes may shift, the arguments for and against government regulation remain consistent, with those who favor deregulation emphasizing the benefits of freely adjusting prices in response to scarcity. Piore focuses this chapter on work regulation, which is opposed by antiregulation adherents because of concerns that government labor-market interfer-

ence, with resulting wage rigidities, can produce inefficient allocation of labor across sectors. These concerns have become more focused in recent years in light of technological advancements that some believe have made existing regulation inappropriate.

Piore's contribution to this discussion is driven by his international expertise; thus, while there may be some truth to the more dire predictions arising from technological change within the administrative system of work regulations as they exist in the United States, Piore explains that systems of workplace regulations vary significantly worldwide; generally speaking, workplace regulation in the United States is inflexible because it is more specialized and focused on sanctions, while the administrative structure more common in France and much of southern Europe, as well as in South America, is much more flexible, thus more able to adapt to changing technological environments. Piore refers to this alternative administrative structure as the Franco-Latin system of work regulation, which he defines as being built on a conciliation/remediation model. In other words, compliance is monitored by administrators who have a more personal relationship with the proprietor and a more specific understanding of the particular production process, and these inspectors have more individual control over how to address violations. "The emphasis on compliance should lead the inspector to look for the underlying causes of the violations and seek remedies in managerial practice or technology that actually address the problem at its root," Piore writes. "In this way, the system encourages inspectors to look for support from other government programs that address these problems, such as manufacturing extension programs or employment and training. The U.S. system, by contrast, leads the inspectors to focus narrowly on what are, in effect, symptoms of the way the company does business. It is like the difference between a doctor focusing on the symptoms and one focusing on the disease."

Piore broadens his discussion of the manner in which the street-level inspectors are trained and managed in the Franco-Latin system of work regulation to a more general concern: how does regulation evolve in the first place? He outlines various models, with a focus on one in which each of the different actors in the puzzle communicates well with the others, thereby permitting regulation to evolve in an effective and efficient way. This discussion is informed by the author's studies on new product development—specifically, studies of the way in which

new products can pave the way for the development of more efficient, flexible government regulation. The primary example is the development of the cellular telephone. The development of this product draws from both radio and telephone technologies; thus, the ability of experts in both fields to communicate well with each other was paramount to the success of this important product development effort. According to Piore, “the cellular phone as it exists today emerged out of what I term in my organizational research an ongoing conversation, a conversation not only among the disparate engineers and managers who ultimately had to collaborate to produce the new product, but also between the producers and consumers who would ultimately purchase and use it.” At its core, successful product development requires enormous flexibility and communication, and these things also lie at the root of the success of the Franco-Latin system of work regulation discussed earlier.

Following the other chapters in this volume, particularly that of Kreps, Piore’s discussion of both regulation and product development extends explicitly beyond the traditional economics narrative to incorporate contributions from sociology and psychology. As Piore explains, this is by necessity—if economists are to improve upon their ability to contribute to the ongoing public policy debate on critical issues relating, for example, to workplace safety, then economists need a broader-based analysis.

The five chapters that follow this introduction, although focusing on very different subjects, share more than the general theme of the role of economics in public policy. Each chapter reflects, to varying degrees, the evolution of traditional economic approaches toward more interdisciplinary ones that blend economic theory with that of psychology and sociology. Whether this interdisciplinary result is discussed explicitly by the author (e.g., Kreps) or simply implied (e.g., Field, Holland, and Pande), each chapter displays the broader movement of applied economics toward this more inclusive and thus real-world approach.