

Markets vs. Governments when Rationality is Unequally Bounded

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Abstract

It is now often recognized that human rationality has bounds, but less often that they are unequal across individuals. Recognizing also the latter, this paper treats unequally bounded rationality as a scarce resource, but finds it to be special, tied to individuals and *used for deciding on its own uses*. As a consequence, its allocation to uses in society involves a trial-and-error evolution. Important differences are found between the institutions (“the rules of the game”) that can shape this evolution on markets and the ones that can shape it within governments. The policy implications are politically mixed. For top jobs in production, competitive markets, especially when including financial markets, will in the long run vastly outperform any government. This strengthens the case against all national planning, selective industrial policies, and government ownership of enterprises, including commercial and investment banks. But the slightly above-the-average rationality that agents of democratic governments are found likely to have may allow policies to help large categories of consumers with complicated choices, which strengthens the case for some paternalism in final consumption.

.... Yet another problem is that allowing financial markets to select for relevant rationality may not suffice, as it is equally important to prevent them from selecting for other qualities, in particular dishonesty. While self-policing based on reputation effects is certainly necessary, it may not always be sufficient. Reputation is not always easy to acquire even on developed markets, and is definitely unavailable on the emerging financial markets in new market economies. Policies may therefore also have to help with the forming of institutions by which such deviant selection could be prevented, or at least rapidly disclosed and corrected.¹ The search for such policies involves the familiar problems of transparency, insider trading, corporate governance, and protection of minority owners, for which the use of legislation is often debated. Taking into account the need for forcing financial markets to select for high relevant rationality, and not for low ethical standards, often strengthens the case *for* this use.²

¹ What is rapid in this context can only be relative. Thus, the roughly two years that it took the US financial markets to disclose the scandalous mismanagement and enormous losses of Enron must be considered very rapid in comparison with the more than twenty years that it took to disclose the comparably scandalous mismanagement and enormous losses of the French bank *Crédit Lyonnais* when it was entirely government-owned.

² That neglecting such policies may cause serious social damages can be illustrated by the setback that hit in 1996 and 1997 the until then highly successful transformation of Czech economy towards modern capitalism. A rapid and relatively successful voucher privatization of most of the formerly socialist enterprises first allowed virtually all citizens to start trading on financial markets, either directly or through investment funds, which raised both hopes for personal success and enthusiasm for capitalism in general. Unfortunately, the neglect to provide the financial markets with a suitable legal framework, which would, among other things, offer a minimum protection to minority

owners (as has been standard in all modern capitalist economies), allowed extensive asset-stripping by dishonest managers of investment funds. This crushed most of both the hopes and the enthusiasm, and moreover caused the average level of honesty of the successful Czech capitalists selected by such markets to be low. Foreign investors started to avoid Prague and a large part of the electorate turned to capitalism-critical or even hostile political parties. Although since then, the institutional framework has been largely mended and many foreign investors have returned, the political damage and the low level of honesty are still far from repaired – as illustrated by the high popularity of the old communist party and the low ranking of Czech economy in the international corruption league.