

Rational Choice and Political and Economic Institutions

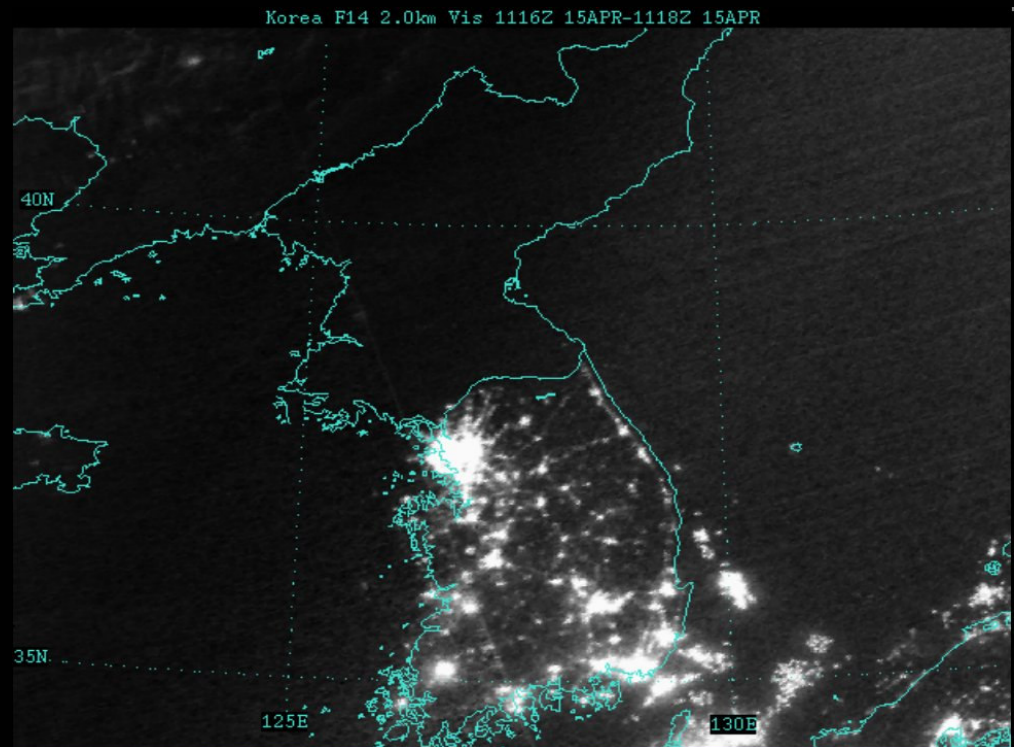
Presented by
Dr. Tom G. Palmer
Senior Fellow, Cato Institute
tpalmer@cato.org

What is Rationality?

- Minimal Criterion: Transitivity of Preferences
- If $A > B$, and $B > C$, then $A > C$
- If preferences were intransitive, then $A > B$, $B > C$, but $C > A$
- Such intransitivity leads to infinite choice loops: given a choice between C and A , the agent chooses C ; between C and B , the agent chooses B ; between A and B , the agent chooses A , thus returning to the starting point

Incentives and Institutions Matter

- Incentives give signals to rational actors about what will advance their purposes
- Institutions give form to incentives
- What incentives do different people have to create light?



The World Is **Not** Ruled by Magic

- It is ruled by cause and effect;
- In the world of human interactions, the scientific method asks about incentives;
- Incentives are given form by Institutions



Long Term Economic Growth is a Function of Not Only of Capital Accumulation, but of Innovation and of Institutions

- ◆ “If the only reason why Germany is richer than Zimbabwe today were that Germany possesses more useful knowledge, the difference might be eliminated in a relatively short time. If we were to ask, however, why Germany is richer today than it was in 1815, the importance of technology becomes unassailable—though better institutions might still be of importance as well.” Joel Mokyr, Northwestern University

There IS Good News

- ✦ “History shows that economies can grow faster by riding on the prosperity and technology of other countries. From 1780, it took England 58 years to double its wealth. A hundred years later, Japan did it in only 34 years, and another century later it took South Korea only 11 years.” Johan Norberg, *In Defense of Global Capitalism* (Timbro: Sweden)

Institutions Matter, but Beware of “Cargo Cult” Policy-Making

- In New Guinea and other islands in the South Pacific, cargo cults emerged after World War II. In order to lure the airplanes to return, they created wooden airplanes, landing strips, and control towers, all in the hope that the great silver birds would land again. They never came.



It's Better to Look at How Other Countries **Became** Rich....

- “The United States is not the model for Mexico or any of these countries.... take as your model the U.S. in its first hundred and fifty years.”
- Milton Friedman, Nobel Prize Winner, Mexico City, 1992

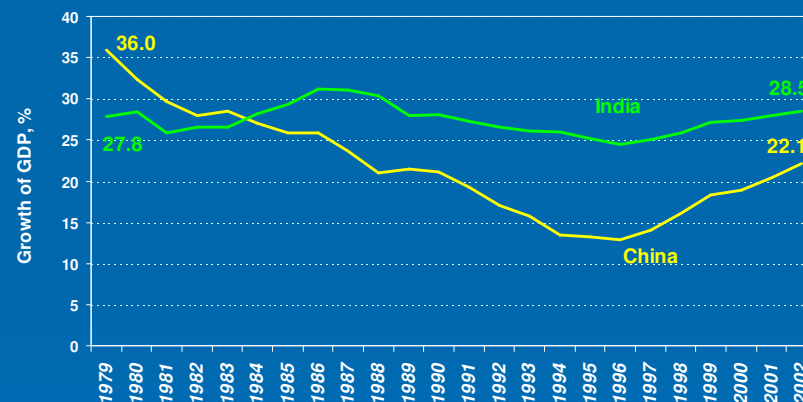
Complex Orders Require Simple Rules

- Clear Property Titles and Security of Ownership
- Simple Rules to Transfer Property or Make Agreements
- A Minimum of Bureaucratic Control
- Rules that Are Too Complex Create Opportunities for Corruption

The Size of Government Matters, Too

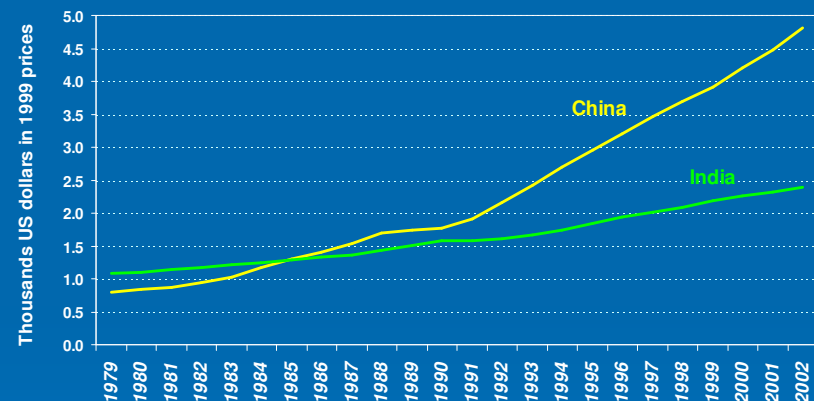
➤ Government Spending as % of Gross Domestic Product in China and India in 1979–2002

(Source: Institute for Economic Studies, Moscow)



Smaller Government Leads to Greater Wealth

➤ **Per capita
Gross
Domestic
Product in
China and
India
1979–2002**
(Source: Institute for
Economic Studies,
Moscow)



Natural Resources Alone Will Not Make Iraqis Prosperous, but Good Institutions Can

The Constitution
Creates the
Basic Rules

The Rules Create
the Incentives for
Freedom, Peace,
and Prosperity

