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# THE RESOLUTION OF ECONOMIC CONFLICTS: BEYOND THE ECONOMIC SYSTEM

*by*

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Economic conflict is the confrontation between two or more individuals (or groups) to defend their selfish individual (or collective) interests. There have been two extreme positions about economic conflict: I) For the neoclassical school, the confrontation is between individuals and the resolution is obtained by granting individual freedom. If individual freedom (which includes political freedom, freedom of expression and economic freedom) is granted, the economic conflict, it is argued, will be solved harmoniously by the free markets. According to this position individual freedom guarantees peace and progress. II) For the Marxist school the confrontation is between economic classes: proletariats versus capitalists. The resolution is obtained by the appropriation of the means of production by the proletariat (through a revolution); which conduces to the communist society in which peace and progress will be guaranteed. The communist society will evolve into a social humane society, in which all the individuals will be free, satisfying their true nature as species being.

None of these two extreme positions has been validated historically. In the real world, individual freedom in the West did not produce peace; economic conflicts often resulted in military confrontations. And individual freedom, while related to the economic progress of the West, did not produce progress in the developing economies, nor in the world at large. On the other hand, communist revolutions did not happen neither globally, nor in the developed countries, as Marxism forecasted; and in those developing countries where they were adopted, they did not produce neither peace, nor progress. Nor have these communist countries evolved into humane societies characterized by free individuals, in any sense of the word.

As we will show, there are no scientific bases to uphold neither the neoclassical nor the Marxist resolution of economic conflict. In here, we argue that economic conflict is consequence of the evolutionary struggle for survival and that, contrary to the arguments of the neoclassical and Marxist schools, there is no resolution that can be found within the economic system itself. The resolution of economic conflicts necessarily implies also the integrative system and/or the power system – and always involves the institutional arrangement.

Whenever economic conflict resolution does not involve the integrative system, the solution is very suboptimal and creates a savage capitalism that easily degenerates into confrontations in the power system (such as military or criminal struggles). Economic conflict resolution can only have a reasonable solution if it involves a proper institutional arrangement.

This manuscript is divided in two sections. In the first section, we review the theories of economic conflict resolution. In the second section, we discuss economic conflict in real life. We briefly present three critical cases: 1) Class conflict and income distribution; 2) misguided economic growth programs; and 3) globalization's conflicts.

## THEORIES OF ECONOMIC CONFLICT RESOLUTION

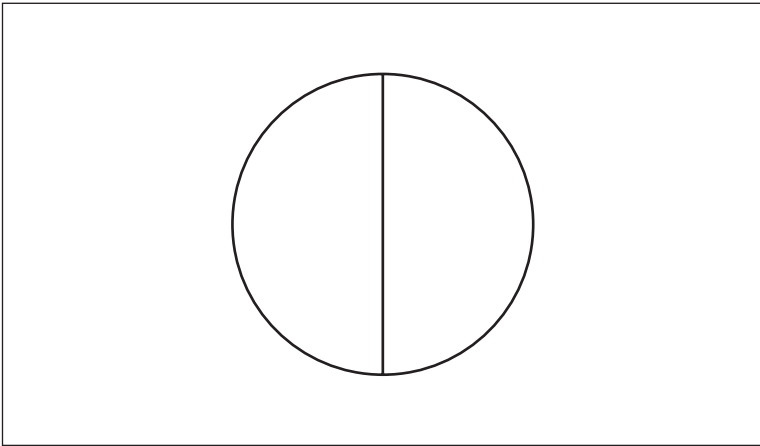
In this section we discuss the theoretical scientific reasons why the neoclassical resolution of economic conflict is incorrect; and we do the same for the Marxist one. Finally, we defend on theoretical grounds an evolutionary institutional view of economic conflict resolution.

### *The Neoclassical Resolution to Economic Conflict*

In order to express the contributions of traditional economics to the understanding of conflict resolution, the simplest approach is to understand conflict as the competition for scarce resources. Figure 1.1 shows a circle divided by half; if we assume that the circle represents the scarce resources under dispute, and that two economic agents are identical as to their competitive capacities (including personal abilities, financial means, information, strategical set, and all other resources) and as to their pref-

ferences, and that their preferences are independent, the division by half would likely be the solution<sup>1</sup>. It should be pointed out that the circle may mean a territory (which would make economic theory somewhat useful for war analysis), or a psychological or ideological field; thus there is some level of generality in the following analysis. Which however is insufficient to fully describe the nature of human conflicts.

FIGURE 1.1 CIRCLE DIVIDED BY HALF



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The first thing to notice is that differences in initial endowments (income or wealth) may result in an division alternative to the solution in half; the wealthiest individual will clearly be able to occupy more of the area in the circle. Thus, the distribution of initial endowments clearly affects the solution.

The second thing to realize is that, even if we assume that the initial endowments and any other competitive capacities are the same, but we allow for the two individuals' preferences upon distinct areas of the circle to be different, the solution by half does not work any longer either. If, for example, we assume that the agent A prefers the north part of the circle, while the agent B is indifferent to any location within the circle; it can be shown that the solution would imply for agent B to

<sup>1</sup> Destructive strategies are excluded.

obtain more than half of the total area in the circle, as long as it allows agent A to have more than half of the north region in the circle. In fact, what the agent A loses of the total area of the circle versus what he gains in the north area defines the economic price at which the two areas are exchanged.

The dependence of conflict resolution upon the initial endowments and the preferences of the economic agents was soon realized in economics.

The easy way to represent an economic conflict is the contract curve in an Edgeworth box, which Boulding called the conflict curve. The preferences of one individual over two goods are drafted against the ones of another. See figure 1.2. The tangential points between the curves show the contract curve—the Pareto points, defined as those in which any movement to improve one agent will mean for the other agent to be worse off. The conflict curve is a static game between two economic agents with given distinct preferences over two goods. It can of course be generalized to  $n$  agents. In a general equilibrium setting with  $n$  agents; given the endowments of any agent, the state of technology, and distinct individuals' preferences, and under a set of restrictive conditions, a unique optimal Pareto equilibrium can be found.

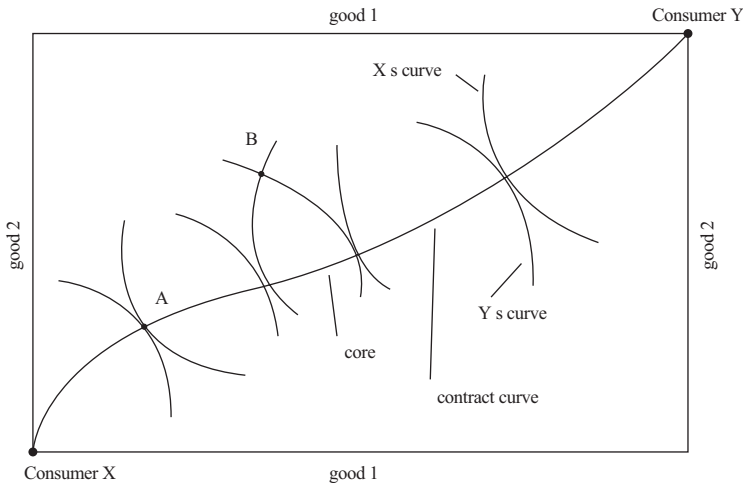
The conditions to establish one unique optimal equilibrium are however too restrictive to correspond to the real world. Information theory and game theory have shown the presence of multi-equilibriums; many of which are not even Pareto optimal. From the point of view of the theory of conflict this means that the resolution depends upon: a) the information set that the agents have; b) the settings of the game (in the real world, the institutional setting); and c) the strategies adopted by each agent. In terms of figure 1.1 what all this means is that the size of the circle is not given, and both the size of the circle and its distribution depend on the information set, the institutional arrangement, and the strategies adopted by the agents.

These results are fundamental to the understanding of the theory of conflict. The initial efforts of welfare economics and general equilibrium theory were channeled to show that economic conflict could be resolved by the market alone; the recent discoveries of information theory and game theory have shown that this is not the case. However, as we will discuss, that does not mean that institutions can replace the markets. Markets do play a crucial role in the solution of economic conflicts.

## Conflict Theory and Behavioral Economics

In traditional neoclassical economics, there is an implicit conflict between the economic agents, exemplified in a simple case by the contract curve in the Edgeworth box in figure 1.2. Such a vision assumes that economic agents are selfish, rational calculators defending their respective interests. But what happens if this assumption is not adequate? How does economic conflict look like then? In fact, there may be no conflict, and a cooperative solution may be found. Behavioral economics has shown empirically that, in the “dictator game” in which the player A is a dictator that can give whatever he pleases and keep the rest, surprisingly enough 74% divide the money equally and in the punishment stage 81% choose to share \$10 with a fair allocator instead of \$12 with an unfair one. How do you explain altruistic and cooperative behavior?

FIGURE 1.2 THE CONTRACT CURVE



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Behavioral economics was conceived mainly as a critique of the rational economic man of contemporary neoclassical economics, particularly in its free markets version<sup>2</sup>. The humans of behavioral economics

<sup>2</sup> There are five Nobel Prize winners that can be associated with behavioral economics: Simon (1978), Akerlof (2001), Kahneman (2002), Shiller (2013) and Thaler (2017).

are defined as non-rational, altruistic and social, cooperative individuals. Behavioral economics integrates psychology and economics and argues that we are “humans” and not “econs”<sup>3</sup>. “Humans” are not rational, they are emotional beings who under some circumstances may take the wrong choices and therefore need help from the government. Behavioral economists argue that there are powerful socio-economic and psychological incentives. People obtain wellbeing from compensations other than money, whether intellectual gratification, respecting others, social conventions, and social status. That explains why: paying students to study reduces the quality of their intellectual effort; charging parents for picking up late their children from a nursery had the effect that more parents did it, because they felt free to do it, once they paid for the service; payments for blood donation reduce donations; and higher wages encourage more work only if they are related to be treated well by the employer.

Economic decisions, behavioral economists argue, are not only related to prices but to human relationships and social interactions. Behavioral economics has been very useful to understand certain economic decisions<sup>4</sup>, and has been crucial in the implementation of innovative poli-

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<sup>3</sup> Good reviews of behavioral economics, ordered from simple to complex are: Baddeley, 2017; Tomer, 2017; Cartwright, 2018; and Dhami, 2016. Baddeley, M. (2017). Behavioral economics. A Very Short Introduction. Oxford University press.UK. Tomer, J.F. (2017). Advanced Introduction to Behavioral Economics. Edward Elgar, Northampton, Massachusetts. Cartwright, E. (2018). Behavioral economics. Routledge, New York. Dhami, S. (2016). The Foundations of Behavioral Economics. Oxford University Press. Oxford, UK.

<sup>4</sup> Behavioral economics' methodology to criticize traditional economics works as follows: 1) It shows that humans fail in their process of decision making, due mainly to the psychological characteristics of system 1 – as defined by Kahneman; 2) Intervention is required – in this case nudges are recommended. But, as we will show, the link between 1) and 2) is not necessarily well established. The following list of failures due to system 1 is not exhaustive, but good enough for our purposes. Decision failures due to psychological factors are: 1) Anchoring, 2) availability heuristic, 3) representativeness, 4) priming, 5) optimism and overconfidence, 6) status quo bias, 7) loss aversion, 8) psychologically overweighting rare events, 9) probabilities miscalculation, 10) reversals, 11) safety considerations, 12) endowment effect, 13) framing, 14) psychological memory, 15) time and adaptation as psychological dimensions, 16) regret, 17) mental accounting, 18) sunk costs, 19) inconsistent customer behavior in bargains, 20) the house effect, 21) the break even effect, 22) time inconsistent preferences i.e. hyperbolic discounting of the future, 23) altruistic behavior, 24) cooperative behavior, 25) punishing non cooperative behavior, 26) psychological fairness, 27) reciprocity, 28) conditional behavior, 29) lack of self control, 30) influences of advertising or other information, 31) conformity - peer pressure. Decision failures are also due to other three factors, mentioned by Thaler (2015): 1) economic transactions that do not allow for learning, 2) experts with conflict of interest, 3) lack of salience.

cies in these cases<sup>5</sup>. Behavioral economics has brought value added to the understanding of a relevant subset of economic problems like organ donation, individual saving decisions, and others<sup>6</sup>.

The empirical discoveries of behavioral economics necessarily open the question about the occasions on which economic agents behave selfishly, and on which other ones they behave in a cooperative and altruistic manner. The answer to this question becomes of critical importance for conflict theory.

On the one side, behavioral economics has shown that an important subset of economic problems cannot be explained with the assumption of the rational selfish calculator. But, on the other side, the notion of “humans”, as defined by behavioral economics, cannot explain either several empirical economic realities such as: 1) Why individuals do behave selfishly in large markets, even though they display altruistic and cooperative behavior in laboratory settings or in small groups - even in monetary transactions. 2) Why individuals can display altruistic and cooperative social behavior in some cases, like the dictator’s game in laboratory setting, or the high social expenditures in developed economies; and not do so in other cases, like the extremely low international aid (which is nothing else than a global dictator’s game in real life). 3) Why in some cases individuals can display very aggressive behavior, particularly to other “out-group” individuals not belonging to the in-group to which the individual belongs. 4) Why the companies with more global success are the ones which introduce new options to the customer and new ways to process information in a more rational way. 5) Why despite the presumed individual non-rationality, markets work so well both to allocate resources and to promote economic growth.

Therefore, in order to explain both the empirical realities mentioned in the above paragraph, and the empirical findings of behav-

<sup>5</sup> A list of principal behavioral economics interventions: 1) Save More Tomorrow; 2) A diversified portfolio: which automatically rebalances through time; 3) RECAP in mortgages; 4) RECAP in student loans; 5) RECAP in credit cards; 6) Nudges for the financial mistakes made in the 2008 crisis; 7) Prescription Drugs Plan for Seniors; 7) Presumed Consent for organ donation; 8) Disclosure of the main emitters of pollution; 9) Choosing a school; 10) freedom to buy or not the right to sue the doctor for negligence; 11) Replace official marriages for civil unions; 12) Give More Tomorrow; 13) The Charity Debit Card and Tax Deductions; 14) Stickk.Com - to help people remind their commitments; 15) Quit Smoking Without a Patch; 16) Motorcycle Helmets; and 17) Gambling Self-Bans.

<sup>6</sup> See Obregón, C. 2019, Beyond Behavioral Economics: Who is the Economic Man. Amazon.com, also available at Research gate.com



ioral economics, we need to go beyond the discussion of whether economic agents are “econs” (as defined by neoclassical economics) or “humans” (as described by behavioral economics). We need to go beyond the discussion of whether individuals are selfish or not, or rational or not. We need to get into a careful description of the social group, the institutions and the historical values of the culture of reference. Focusing only on the individual to explain social dynamics and economic relations is the wrong methodological approach. Social dynamics, as we will see, goes well beyond the individuals.

A landmark study in the psychology of social groups is the “robbers cave” experiment<sup>7</sup>, which showed how students became influenced by the in-group to which they belonged in the experiment, to the point of becoming extremely aggressive towards other students, considered the out-group. The aggression was due to a competition between the two groups for resources in a camping area. The experiment had to be stopped before the planned date for its conclusion, because of the high and unmanageable level of aggression that arose between the participants. This study leaves no question: we are social beings. We are influenced by others. The results of this study cannot be explained neither with behavioral economics nor with neoclassical economics. Individuals were socially cooperative, but only within the in-group, and they behaved selfishly and aggressive towards the individuals belonging to the out-group. Thus, individuals are neither always altruistic and cooperative, or selfish and aggressive – they behave differently in distinct situations. What this study basically showed, is that there are no permanent individual preferences; that they can be changed with the influence of the group - actually in a record time of less than a week.

To understand why the group is so decisive in defining the individual's behavior, and to explain with the same theory both: 1) the five empirical realities mentioned earlier; and 2) the empirical findings of behavioral economics; we have to go beyond both behavioral economics and neoclassical economics. We need to review the findings of economic theory as to the relevance of information and institutions in the solution of economic conflicts; this we will do later on, when discussing the institutional resolution to economic conflicts.

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<sup>7</sup> Sheriff M. and OJ Harvey (1961), *Intergroup Conflict and Cooperation: The Robbers Cave Experiment*, Norma OK, University of Oklahoma, Institute of Intergroup Relations.

*The Marxist Resolution to Economic Conflict*

To understand the theoretical flaws of Marxism, one must start by appreciating the limitations and misconceptions of classical economic theory. Classical economists explained capitalism based on two premises: 1) That economic progress was the consequence of the accumulation of capital; and 2) that this accumulation was the result of free trade and the capitalists' hunger for profits. Marx believed that an economy may accumulate capital without having capitalists, thus he refused the second premise; but he accepted the first one.

For Marx, as for the classical economists, capitalism through capital accumulation has solved the problem of economic progress. Therefore, the only thing a communist society has to do in order to have progress is to accumulate capital. This is what the USSR did; however, it did not work. What we have learnt is that capital accumulation does not necessarily generate progress; because investment is not always truly productive. Whether it is or not, depends upon the characteristics of the model of economic growth adopted.

By assuming that economic growth was solved through the accumulation of capital, Marx believed that capitalism signaled the end of the human prehistory and the beginning of a human history. With progress resolved by capitalism, the question that remained was how to distribute the abundance, and this was the question that Marxism was solving. Marx's answer was that capitalism was unjust, and that it would destroy itself to give rise to a new economic system – communism.

What must be realized is that the problem of economic progress, that still was central in Smith, was assumed as already solved by capitalism by later economists. And in fact the world economy was growing as fast as never before. Therefore, Ricardo, Marx and the neoclassical economists focused their efforts on the distribution problem. Ricardo and Marx solved this problem through the labor value theory. Later on, the failure of this theory, for reasons explained below, implied the need for a new answer – that the neoclassical school found in the price theory in free markets. Which as we commented before also failed, because there are multi-equilibriums and therefore neither the level of employment nor the economic growth of an economy can be defined by the price system alone.

What Marxism and the neoclassical school have in common is the belief that economic growth is a natural byproduct of capitalism. The ques-

tion about economic growth remained absent for many years of economic thought, and was not reopened until the publication of Nobel economist Robert Solow's famous 1956 seminal paper on economic growth, which actually formalized the fact that economic growth required the accumulation of capital (through savings). Solow's model leaves technology as an exogenous variable, and soon neoclassical economists explored the endogenous determinants of economic growth. They found four endogenous causes: 1) The quality of labor (talented individuals, education and so forth) – Baumol, Lucas and others; 2) learning by doing – Arrow and others; 3) Science – Phelps, Nordhaus and others; and 4) Research and Development – Romer, Aghion and Howitt and others<sup>8</sup>. Solow's model of economic growth inspired the communist growth model and the import substitution growth models, both based upon increasing savings. And both models failed, which showed that capital accumulation is not enough to obtain economic growth. Moreover, the communist model besides high savings incorporated: a very large market, high education, learning by doing, science, and research and development, and nevertheless it failed. Which showed that there are clearly institutional features that define economic growth, which were present in the only two successful models of economic growth that we have had so far: the Occidental model of economic growth and the Asian model of economic growth.

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<sup>8</sup> Science: Phelps 1966, Nordhaus 1967, Shell 1966 and 1967. Talented individuals: Baumol 1990 and Murphy, Shleifer, and Vishny 1991. Learning by doing: Arrow 1962. Research and development: P. M. Romer 1990, Grossman and Helpman 1991, Aghion and Hewitt 1992, D. Romer 2001. Phelps, E.S. (1966): "Models of Technical Progress and the Golden Rule of Research", *Review of Economic Studies* 33, pp. 133-146. Nordhaus, W.D. (1967): "The Optimal Rate and Direction of Technical Change", in Shell, K. (ed.): *Essays on the Theory of Optimal Economic Growth*, MIT Press, Cambridge, pp.53-66. Shell, K. (1966): "Toward a Theory of Inventive Activity and Capital Accumulation", *American Economic Review* 56, pp. 62-68. Shell, K. (1967): "A Model of Inventive Activity and Capital Accumulation", in Shell, K. (ed.): *Essays on the Theory of Optimal Economic Growth*, MIT Press, Cambridge, pp. 67-85. Baumol, W, 1990. "Entrepreneurship: Productive, Unproductive and Destructive". *Journal of Political Economy*, 98 (5 part I) 893-921. DOI: 10.1086/261712. Murphy, K.M., Shleifer, A., and Vishny, R.W. "The Allocation of Talent: Implications for Growth" *Quarterly Journal of Economics*, 106 (2) , 203-530. DOI: 10.2307/2937945. 1991 Arrow, K.J. (1962): "The Economic Implications of Learning by Doing", *Review of Economic Studies* 29-3, pp. 115-173. Romer, P.M. (1990). "Endogenous Technological Change", *Journal of Political Economy* 98, pp. S71-S102. Grossman, G.M., y Helpman, E. (1991): *Innovation and Growth in the Global Economy*. MIT Press, Cambridge. Aghion, P., Howitt, P. (1992). "A Model of Growth Through Creative Destruction", *Econometrica* 60, pp. 323-351. Romer, D. (2001). *Advanced Macroeconomics*, 2a ed., McGraw Hill, New York.

## The Failure of Labor Value Theory

The main problem of labor value theory from an economic point of view is that it is a tautological proposition. It asserts that value comes from labor – but only from socially necessary labor, that is, labor that has been revalidated by the market. But then, it is a tautology, because to measure labor we need market prices first. And this tautology, by the way, as Marx already understood, is the only way out, because clearly value does not relate to labor hours not revalidated by the market<sup>9</sup>. Marx's announcement of the necessary historical decay of capitalism was rooted in his labor value theory – which indicated a necessary fall in the rate of profits. The logic is as follows: as capital grows in relation to labor, and value is given only by labor – value/capital falls; this explains the falling rate of profit. The prediction has turned out to be false in the real world. The reason why is very simple, the tautology implied in the labor value theory is incorrect – value is not uniquely defined by labor; it is also created by capital and by technology. Ex-post one can define a tautological relationship between labor and value, but ex-ante it does not hold. As capital increases with labor given – value in fact grows. And as technology expands with both capital and labor given – value grows. Therefore, the same amount of labor in two economies with distinct amounts of capital and diverse technologies would relate to different values. What happened in the real world is that, as capital grew in relation to labor, value increased because of the additional capital and even further because of a very fast technological expansion. Thus, value/capital did not decrease – the rate of profits did not fall; and capitalism in the advanced economies never collapsed, as Marxism had forecasted.

### *The Institutional Resolution to Economic Conflict*

Institutions matter, neither full employment nor economic growth are uniquely defined within the economic system. Economic relations are embedded in the whole set of social institutions that define the conditions under which such relations happen.

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<sup>9</sup> Remember Marx's critique of Proudhon's labor value theory.

### *Conflict Theory and Information Economics*

Information economics focuses on the causes of coordination failures due to which the neoclassical equilibrium is not obtained<sup>10</sup>. Which means that the solution of the economic conflict cannot be obtained through the neoclassical price system, but also depends upon the information set that the economic agents have.

This literature shows the possibilities of multiple equilibriums, of which one or several can be sub-optimal; and, nevertheless, the markets, and even the existing institutions, may be insufficient to move the economy away from the sub-optimal equilibrium to an optimal, neoclassical equilibrium. In addition, the sub-optimal equilibrium can create path dependence<sup>11</sup>. And temporary shocks can have long-term consequences, there is hysteresis<sup>12</sup>.

The models used in the study of the information economy are dynamic, either with continuous or discrete decision variables. In some cases, the economic actors are identical; in others, they differ in their benefit functions (payoff); and in others, they differ in their strategy sets. The inefficiencies of information give rise to a large set of economic externalities, that can not be resolved through private arrangements, such as: 1) information; 2) group reputation effects; 3) effects of agglomeration; 4) spillovers of knowledge, and 5) pecuniary. The sequence is that there are multiple Pareto equilibriums that can be ranked according to their degree of efficiency; one of these equilibriums is superior to all the others in the sense that it is better for all, but the other inferior equilibriums exist, with their corresponding vector of prices, that do not move the system out of the inferior equilibrium. Information economics

<sup>10</sup> Information economics has produced five Nobel laureates: Mirrless and Vickrey, 1996; and Akerlof, Spence and Stiglitz, 2001.

<sup>11</sup> Engerman and Sokoloff, 1997, Hoff, 1994, Mookherjee and Debraj, 1999. Engerman, S.L., y Sokoloff, K.L. (1997): "Factor Endowments, Institutions, and Differential Paths of Growth Among New World Economies: A View from Economic Historians of the United States", in Haber, S. (ed.): *How Latin America Fell Behind: Essays on the Economic Histories of Brazil and México, 1800-1914*, Stanford University Press, Stanford, pp. 260-304. Hoff, K. (1994): "The Second Theorem of the Second Best", *Journal of Public Economics* 54, pp. 223-242. Mookherjee, D., Debraj, R. (1999): *Contractual Structure and Wealth Accumulation*, Boston University, inedited manuscript.

<sup>12</sup> 21 Tirole, J. (1996). "A Theory of Collective Reputations (with Applications to the Persistence of Corruption and to Firm Quality)", *Review of Economic Studies* 63-1, pp. 1-22.

has been applied to diverse economic problems, among them, financial crisis<sup>13</sup> and underdevelopment<sup>14</sup>.

There is a very close relationship between an insufficient information set, the inadequate institutional arrangement, and the uncertainty regarding the future. Knight and Keynes explored the consequences of uncertainty for obtaining economic equilibrium and for the determination of employment levels, but none of these authors managed to formalize their thinking<sup>15</sup> properly. Theorists of underdevelopment have argued for a long time that it was due to development traps such as low industrialization, low research, and inappropriate institutions; but they did not formalize their thinking either. The great contribution of information economy is that it formalizes: 1) that the economic equilibrium depends on the institutional arrangement; and 2) that the growth path of a given economy also depends on the institutional arrangement. A critical message is that today's market prices and institutions may not deliver neither the desired economic equilibrium, nor the required long term growth path.

Information economics argues that whatever institutional interventions have to be done, must be analyzed in a dynamic path. Information economics proved that even with strong rationality assumptions, markets do not necessarily produce either full employment or the desired growth path.

The main lessons learnt with information economics is that conflict resolution is highly dependent upon the information sets that the agents have, and that resolutions have to be analyzed in a dynamic path. In terms of the circle mentioned at the beginning of this manuscript, both the size of the area within the circle and its distribution are dependent upon the information set that the agents have.

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<sup>13</sup> Greenwald, B., Stiglitz, J.E., (2003): *Towards a New Paradigm in Monetary Economics*. Cambridge University Press. Cambridge.

<sup>14</sup> 23 Hoff, 2000; Hoff and Stiglitz, 2002. Hoff, K. (2000): "Beyond Rosenstein-Rodan: The Modern Theory of Coordination Problems in Development", in Pleskovic, B. (ed.): *Proceedings of the XII Annual World Bank Conference on Development Economics*, World Bank, Washington. Hoff, K., Stiglitz, J.E. (2002): "Modern Economic Theory and Development", en Meier, G.M., y Stiglitz, J.E. (eds.): *Frontiers of Development Economics. The Future in Perspective*, 3a ed., World Bank/Oxford University Press, Washington, pp. 389-485.

<sup>15</sup> See Obregón, C., 2021. *Keynes Today*. Amazon.com. Also available at Research gate.com

### *Conflict and Game Theory*

Game theory has shown that there are not only multi-equilibriums, but that many of them are not Pareto optimal – they are Nash equilibriums<sup>16</sup>. The main message is that once the game is set, it defines the conditions under which economic agents operate – basically none of them knowing what the other economic agents will do. And since there are no coordinating agencies, many of the economic decisions are not globally optimal – because they are optimized conditioned upon what economic agent A thinks the other economic agents will do. Therefore, such decisions in fact may produce many diverse suboptimal equilibriums. Notice that, even informing the participants that it is possible to achieve a Pareto optimal solution will not help; because the fact of the matter is that they cannot communicate with the other participant, or participants, to be able to establish a pact of no aggression and/of cooperation to the common goal of reaching the Pareto optimal equilibrium. And even if they can communicate, they need to be able to trust what the other participant, or participants, said he/they will do; in many cases, knowing that not complying with the committed behavior will bring extra benefits - that can be substantial- to the non-compliant agent.

Given the game, agent A does not know what agent B (or other agents) will do; and a movement of A towards the Pareto equilibrium may put him/her in a worse position than the one in which he/she started, if B decides not to cooperate – this can easily be shown in the “prisoner’s dilemma”<sup>17</sup> game.

There is a close relationship, as we mentioned, between the game, the institutional arrangement, the set of information, and the uncertainty as to the future. Both the wrong game, and the incorrect set of information, can be seen as the equivalent of having the inadequate institutional arrangement. And the uncertainty as to the future may also be seen as the lack of confidence in the institutional arrangement to manage properly future events.

Tirole has given a good example to explain what occurs in the real world: he shows that both a corrupt economy and a non-corrupt economy

<sup>16</sup> Nine Nobel prize winners have had very relevant contributions in game theory: Harsanyi, Nash and Selten (1994), Aumann and Schelling (2005), Hurwicz, Maskin and Myerson (2007) and Tirole (2014).

<sup>17</sup> The prisoner’s dilemma is a standard example of a game analyzed in game theory that shows why two completely rational individuals might not cooperate, even if it appears that it is in their best interests to do so.

have stable equilibriums<sup>18</sup>. In a non-corrupt economy, the optimal individual strategy is to be non-corrupt; but in a corrupt economy it is to be corrupt. That is why both equilibriums are stable. Notice that the equilibrium has little to do with the individuals' preferences. Even if we assume that all the individuals in the corrupt economy would rather live in a non-corrupt economy, the corrupt economy will persist, as long as there are no institutional features (including market prices – because markets are in itself an institution-) that allow the individuals to act in a non-corrupt manner. This example can be extrapolated to full employment or to the right development path; almost all, if not all, of the individuals rather have full employment and proper economic development, yet their individual optimal behavior may not take them there. Institutional interventions are required.

Game theory, like neo-institutionalism, and information economics, focuses on the settings that define the game; and not on the individual characteristics of the economic agents (as neoclassical economics and behavioral economics do). Even strong rational agents, in the wrong game, will produce suboptimal equilibriums<sup>19</sup>.

Again, in terms of the initial circle, both the area of the circle and its distribution partially depend upon the settings of the game, which in the real world can be understood as the institutional setting. Economic conflicts cannot be resolved exclusively by the neoclassical price system based upon selfish individual calculators, nor are they always easily solved by the cooperative behavior of altruistic individuals. There are many possible solutions for an economic conflict that are related to the distinct game settings – which in the real world correspond to diverse institutional arrangements.

### *Conflict and Institutional Economics*

Both neo-institutionalism<sup>20</sup> and behavioral economics argue that the contemporary neoclassical vision of how the economy works is wrong, and both agree that institutions are needed. However, their vision of the economic dynamics of the social system is diametrically opposed. Neo-institu-

<sup>18</sup> Tirole 1996, op.cit.

<sup>19</sup> Some of which are named Nash equilibriums in honor to its discovery by this Nobel prize economist.

<sup>20</sup> Several neo-institutional economists have received the Nobel prize: Coase (1991), Fogel and North (1993) and Olstrom and Williamson (2009).



tionalism focuses its analysis on the institutions, while behavioral economics focuses it on the limitations of the individual. For neo-institutionalism the analysis of social dynamics and economic equilibrium starts with the institutional arrangement, the individual economic agent is always a given datum. The individual is always creative, and he is the source of economic progress; but whether there is progress or not depends upon the proper institutional arrangement. A proper institutional arrangement is one that allows for individual creativity to be expressed. For the behavioral economists, on the other hand, the individual economic agent cannot always identify what his/her best interest is and needs the help of institutions. For neo-institutionalism proper institutions are required; but not to guide the individual, just to let him express his/her creativity. For behavioral economics the individual has to be guided, and institutions are responsible of this guidance. For neo-institutionalism the individual is a fixed datum and there is nothing wrong with him/her, economic problems such as underdevelopment arise due to improper institutions. For behavioral economics individuals have to be guided and institutions must decide what is best for him/her – because even though the individual is given a choice, it is predictable which choice he/she will make depending upon how the institution frames the question or the circumstance.

Neo-institutionalism has been influential to such a degree that nowadays the thesis that the market is delimited by an institutional arrangement is generally accepted. Despite this, it is still not clear what exactly is meant by institutional arrangement and there is discussion about this<sup>21</sup>. In general, neo-institutionalism has been predominantly influenced by the analysis and study of the institutions of Western economies. The vision of institutions is derived from the microeconomic analysis of transaction costs, the analysis of property rights, and the development of contract theory. Coase's proposal<sup>22</sup> that neoclassical economics without friction does not correspond to the real economy -which is characterized by transaction costs (costs of searching and obtaining information, costs of negotiating and deciding, and costs of monitoring and make contracts effective) - led to important changes in the study of the industrial organization in the contributions of Alchian, Williamson and others. In this friction economy, the system of property rights defines the incentives

<sup>21</sup> Obregón, C; 2008. *Institucionalismo y desarrollo*. Pensamiento Universitario Iberoamericano (PU), México. Available in Amazon.com and in Research Gate.com

<sup>22</sup> Coase, R.H. (1937). "The Nature of the Firm", *Economica* 4, pp. 386-405. In Stigler, G.J., y Boulding, K.E. (eds.): *Readings in Price Theory*, Richard D. Irwin, Homewood, 1952.

of economic agents. North, for example, makes a historical analysis of the consequences of different systems of property rights. In this type of institutional economy, asymmetric information problems as well as incentives are central, and contract theory becomes basic for the analysis. The agent's theory<sup>23</sup> studies the information problems between the contractors, while the relational and incomplete contracts theory<sup>24</sup> studies the information problems between the contractors and an interested third party, a judge for example.

The historical roots of the ideas of neo-institutionalism reside in the North American institutional thought of Commons. This author defined the institution as the collective action in control of individual action<sup>25</sup>. Commons placed a special emphasis on the study of the transaction as a transfer of ownership. It is notable that there is no influence of Veblen's thinking on neo-institutionalism, and this is particularly due to the vision of this new school, which considers history and institutions only from the point of view of the institutional arrangement that characterizes the West; so that a broader and more general historical point of view, like Veblen's, was left aside. More on this point, below.

In fact, the idea that markets work under uncertainty and lack of information and that, therefore, economic decisions depend upon an institutional arrangement, has a long tradition in economic thought. Even though this idea never managed to dominate the mainstream of economic thought, it was always defended by various economists throughout the history of economic thought<sup>26</sup>.

Neo-institutionalism is a great contribution to economic thinking, uncertainty and lack of information make institutions essential. Neo-institutionalism has allowed a new vision of the harmony of Adam Smith. Coase, Alchian, Williamson, North and others have had a great influence on contemporary economists. The most recent growth models explain the non-neoclassical convergence based on institutions. Information economy finds in the institutions the explanation of the possibilities of multi-equilibriums. Sen's moral economy sees in the establishment of institutions -for example,

<sup>23</sup> Fama, Alchian, Demsetz, Stiglitz and Holmstrom.

<sup>24</sup> Macaulay, McNeil, Williamson and Alchian.

<sup>25</sup> Commons, 1934, p.69. *Institutional Economics: Its Place in Political Economy*, University of Wisconsin Press, Madison/MacMillan, New York.

<sup>26</sup> In this tradition one can point out, among other authors, Smith, Malthus, Marshall, Keynes, Knight, Marx, Schumpeter, Veblen and Boulding. See Obregón, C.; 1984. *De La Filosofía a la Economía*, op.cit.

democracy or individual freedom- the path of economic progress. But, despite its great success, neo-institutionalism is far from being an integrated discipline with a precise, unique vision. There are important contradictions, for example, Williamson versus North. At one extreme, neo-institutionalism has adherents who consider it an extension of the neoclassical model<sup>27</sup>, which should be expanded and include more restrictions. At the other extreme, some other exponents of neo-institutionalism consider the new paradigm as antithetical to the neoclassical model and incompatible with it<sup>28</sup>. There is not a well-integrated view, of general acceptance, that we could call the neo-institutionalist model of the economy, which could constitute a true alternative to the well-developed neoclassical model. However, neo-institutionalism clearly delimits the neoclassical perspective, even giving rise sometimes to opposite conclusions<sup>29</sup>.

Neo-institutionalism shares with most of the other new schools the concept that underdevelopment is the result of the absence of the institutions that the West has. For this school, the Western individuals creativity is the motor that generates historical change; and progress is generated by establishing institutions that adequately motivate respect for private property, democracy, and for law and order in general. The problem with this vision is that it prevents the study and understanding of the historical evolution of other societies, which do not consider the individual as a central figure in their social dynamics<sup>30</sup>.

From the point of view of economic policy, neo-institutionalism allows to understand problems such as the firm, oligopolies and others, for which it has been very useful. However, as regards to the international policy of patent protection, the case of its importance for global development has been exaggerated by some exponents of this school. Rodrik has pointed out that such a protection is not always justified from the point of view of the interests of the underdeveloped countries<sup>31</sup>. North's contribution on the resilience of informal institutions allows to explain why

<sup>27</sup> Dahlman, C.J. 1979. "The Problem of Externality", *Journal of Law and Economics* 22, p. 141-162.

<sup>28</sup> Furubotn, E.G., y Richter, R. (2003). *Institutions and Economic Theory. The Contribution of the New Institutional Economics*, University of Michigan Press, Ann Arbor.

<sup>29</sup> As for example in anti-oligopoly regulation and the auction of public monopolies.

<sup>30</sup> This topic is developed with breadth in Obregón, C; 2008 *Globalización y subdesarrollo*. PUI, México. Available in Amazon.com and in Research Gate.

<sup>31</sup> Rodrik, D; 1999, p.148. *The New Global Economy and Developing Countries: Making Openness Work*, John Hopkins University Press, Baltimore.

in certain cases the export of Western institutions to underdeveloped countries does not work properly (this is the historical example of India or Mexico); and this was a great contribution. But what North does not explain are the strengths of these informal traditional institutions that, mixed with heterodox new formal institutions, have produced economic success stories in countries like China and other Asian countries, that never fully adopted the Western institutions<sup>32</sup>.

Neo-institutionalism showed that economic development is a function of the institutional arrangement; but it failed to prove that Western institutions are indispensable for such development, nor that the establishment of Western institutions in underdeveloped countries promotes economic development.

Neo-institutionalism, alike the neoclassical school, sees development as a natural process. Development occurs naturally once the appropriate institutions are implemented. Seeing development as a natural process, however, has diverted the attention of economists from the study of two central problems, that have not been sufficiently studied: 1) the analysis of how development could be generated from the current conditions of the underdeveloped countries, and from their own, specific historical institutions; and 2) the possibilities and development consequences of reordering the international institutional arrangement that exists between developed and underdeveloped countries. The framework of neo-institutionalism, even though it constitutes a great advance, continues to be influenced by the predominating epistemology of economic thought, that of the economy of reproduction. This epistemology conceives economic development as a natural consequence of individual economic freedom – which is supposed to produce progress and accumulation of capital. Therefore, neo-institutionalism has restricted the analysis of underdevel-

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<sup>32</sup> Rodrik represents an advance on North as he recognizes the importance of the strength of domestic institutions to stimulate development, but there is still in Rodrik the insistence on seeing the institutions of other countries as a transition to the optimal institutions, which are the Western ones; and to explain the success stories based on these institutions, i.e., respect for private property and democracy. Rodrik's proposals are presented more extensively in Obregón, 2008 *Teorías Del Desarrollo*, Amazon.com. Also available at Research Gate. The reality is that Asia developed mostly without democracy and that in China respect for individual rights is very limited, and of course there is no democracy. These societies are competitors of the West, not their followers; they have adopted from the West the minimum necessary to integrate globally and compete, but basically they continue to be societies with values and institutions that are very different from the West. Openly analyzing these differences is relevant, and changes our focus on the problem of underdevelopment; see also Obregón, C; *Institucionalismo y Desarrollo* 2008, and *Globalización y Subdesarrollo*, 2008 which are widely dedicated to this analysis (both available in Amazon.com and in Research Gate.com).

opment to the absent Western institutions in the underdeveloped countries that impede individual economic freedom. This epistemological position has precluded the analysis of other routes to development, like the one followed by China and other Asian countries.

It is convenient to establish the main difference between neo-institutionalism and traditional institutionalism, particularly in the works of Veblen and Boulding. In Veblen, as in the neo-institutionalism of North, an institution includes both the conceptual system of values and the actual institutions that implement the conceptual system. But there are two key differences, one that in our opinion favors North and another one that favors Veblen. What favors North is that in Veblen, like previously in Marx, social change happens only as a consequence of technological change; North introduces the social change that results of intentional social design, a key feature of contemporary societies. But what favors Veblen is that, while the individual is a given datum in North, in Veblen it changes historically. Thus, in Veblen we can understand the historical genesis of the free economic man. It becomes very clear thanks to Veblen, that the free expression of the individual's selfishness in large markets is a particular institutional characteristic of contemporary Western societies. Historically, the individual is not always the agent of change in Veblen, while he is clearly so in North.

Boulding, on the other hand, pointed out that the economic relation through the market is just but one of the three key relations of the individual with the society; beyond the economic system there is an integrative system and a power system. This contribution of Boulding is central, because it points out that man's behavior changes according to the system in which he interacts with society. He may behave selfishly in large economic markets, and yet be altruistic and cooperative within the integrative system. Moreover, if we put together Veblen's and Boulding's contributions, we can see that there is a historical dynamic of the three social systems. And therefore, the interaction of the individual with the society in each one of the three systems is distinct in diverse societies and in different points in time in the same society. All this means that there is not a unique human nature. There are basic evolutionary traits of humans, but how they are expressed depends upon the specific historical institutional arrangement. Our nature as humans cannot just be defined on the basis of empirical laboratory findings in a particular society and at a given point in time (as behavioral economics does) – mainly because these findings already imply a given institutional arrangement. Human behavior cannot

be disentangled from the institutions that are influencing it. An individual economic agent just does not exist by himself. The laboratory findings are very useful, but they have to be related to what we know from other social disciplines, in an evolutionary and historical institutional perspective.

Take for example the finding of behavioral economics that, in the dictator game, people display altruistic behavior. As we said, voluntarily 74% of participant dictators divide money equally with the other participant; behavioral economics argues that this result demonstrates empirically that humans are not rational selfish calculators maximizing their personal wellbeing. But what it really shows is that in developed countries there is a strong integrative system. And we must recall that both the integrative system and the power system are reflected in monetary and economic transactions. Therefore, it is not surprising to find that the integrative system plays a role even in monetary transactions in the laboratory in the dictator game and others.

In order to appreciate to which extent the integrative system and the power system are part of the economy, consider that at the beginning of the 20th century, governments accounted on average only for about 10% of GDP in developed economies, today they represent around 40%; of which the power system represents around 4%, social expenditures around 25% and other integrative functions 11%. Thus, the integrative system represents around 36% of the economy, the power system 4% and the economic and exchange system 60%<sup>33</sup>. Individuals living in developed economies experience a world in which social cooperation is a reality, that is why they display cooperative and altruistic behavior within their countries. That however does not mean that they will behave altruistically in a large competitive market, in these markets in fact it has been shown empirically that they behave selfishly. Moreover, internationally there is a very weak integrative system, therefore it should be expected that humans will not behave altruistically, and this is the case. While the integrative system represents around 36% of GDP in a developed economy, the international aid from developed economies to emerging economies is only around 0.2% of the world's GDP.

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<sup>33</sup> These calculations are not precise because available data do not allow to do it. But they are good enough proxies. For calculations on government size and social expenditures see Obregón, C; 2018 Globalization: Misguided Views. MPRA\_paper\_85813.pdf which uses OECD data. Military expenditures can be found in CIA world factbook – [www.indexmundi.com](http://www.indexmundi.com), which are updated up to January 1, 2018. Military expenditures are around 2.5% of GDP. The power system includes military expenditures plus other enforcing agencies of which no hard data can be found, but we estimate that they do not add more than 1.5% of GDP.

Institutional economics shows clearly that the solution to an economic conflict may have very different solutions, depending upon the distinct institutional arrangements that characterize the economic situation. Therefore, it highlights that the area of the circle introduced at the beginning (and its rate of growth) is not given – it changes with the institutional arrangement. Economic conflicts are not zero sum games. Moreover, the division of the area, whatever it is, is not defined only by exchanges through the price system, it is also influenced by the institutional arrangement. Which, however, as the examples studied below will clearly show, does not mean that institutions can substitute the markets in the solution of the economic conflicts. Both efficient markets and a proper institutional arrangement are required for an adequate solution to an economic conflict.

We have finished with the theoretical review of economic conflict, and in the next section we will present three real cases of alternative solutions for economic conflicts; as we will show, the critical issue is to understand economic conflicts in a dynamic way – understanding that whatever is going to be distributed changes along with the involved negotiations.

## ECONOMIC CONFLICT IN REAL LIFE

The erroneous conception of economic conflict as a zero-sum game (in which the size of the circle and its rate of growth are given and remain fixed for the rest of the game) dominated most of the thinking in neoclassical and classical economics, which mistaken policy recommendations still are followed in many countries. In this section we will apply the economic theory of conflict to three real cases: class conflict and income distribution; misguided economic growth programs, and conflicts derived from globalization.

### *Class Conflict and Income Distribution*

As we explained earlier, for Marx, economic value came from labor, therefore whatever was not paid to labor was exploitation. To unravel history, it was needed for the proletariat to own the means of production

so that it receives the value it produces. And once this happens, a communist society will evolve by itself into a humane society, concerned with the true needs of individuals as a “species being”. The main assumption in Marx’s economics, which he shares with the rest of the classical school, is that capitalism has solved the problem of economic growth (which is also an assumption in the neoclassical school). In terms of the circle introduced earlier, this means that the size of the circle and the growth of its area are given by the forces of accumulation of capitalism: therefore, the only problem that remained was one of distribution. In real life, this has induced the adoption of income distribution policies that were unrelated to economic growth programs – which in practice, have not helped the lower income groups they intended to benefit, as they should have done. In real life, the circle and its growth is not given; and capitalist accumulation does not always mean proper economic growth. Therefore, an income distribution policy only works well if it is associated with a proper economic growth program.

On the other hand, as we have also pointed out, for the neoclassical school economic conflict can always be resolved through the price system. Therefore, economic growth should be a natural consequence of free markets. And economic growth should by itself take care of the income distribution problem. In the real world, economic growth did not happen in the developing economies which followed the neoclassical recommendations, but rather in those which followed the Asian growth model – which adopted a specific institutional arrangement to promote economic growth.

Economic growth is not a natural consequence neither of capital accumulation nor of free markets. Distribution policies without a proper model of economic growth do not work well, and neoclassical openness does not generate neither economic growth nor a more egalitarian income distribution.

Several studies have shown that aggressive income distribution policies do not really work to improve the living conditions of the most needed, mainly because they are usually associated with low economic growth, compared to other economies that adopted more focused economic growth programs. Creating an open class conflict, through aggressive income distribution policies not associated with a proper economic growth program, reduces the potential size of the economic income to be distributed, and everybody ends up worse off. In terms of the initial circle, its area is drastically reduced.



Researchers have compared how much changes in inequality matter for poverty reduction relative to economic growth. In 2002, Dollar and Kraay found that the income of the poor on average rises proportionately with average income; and therefore, growth on average does benefit the poor as much as anyone else in society<sup>34</sup>. The authors alert us that their findings do not imply that growth is all that is needed to improve the lives of the poor; but certainly they show that economic growth is the most powerful determinant of the prevailing levels of poverty. In 2014, the same authors (joined by Kleineberg), in a panel study of 117 countries covering the time frame from 1970 to 2012, took into account not only poverty, but also the change in the standard of living of individuals above the poverty line. They conclude that: “Most of the cross-country and over-time variation in changes in social welfare is attributable to growth in average incomes. In contrast, the contribution of changes in relative incomes to social welfare growth is on average much smaller than growth in average incomes, and moreover is on average uncorrelated with average income growth. These findings suggest that the welfare impacts of changes in inequality observed over the past four decades are small when compared with the welfare impacts of growth in average incomes”<sup>35</sup>.

Obregón 2020<sup>36</sup> has empirically shown that income distribution policies that are not associated with a proper economic growth program do not achieve the desired results. To provide an example, 1990 to 2018 Russia followed an aggressive communist income distribution policy which meant that q1 (the lowest income quintile) income share increased from 4.39% to 6.91%. In the same period q1 income share in China decreased from 8.97% to 6.80%. That means that the inequality ratios clearly favor Russia. The inequality ratio China/Russia = .48  $((6.80/8.97)/(6.91/4.39))$ . Which means that the Chinese’s improvement versus their own nationals was less than half the one of the Russians’. However, because the average income in China during the period grew at an annual average of

<sup>34</sup> Dollar, David, and Aart Kraay. (2002). “Growth is Good for the Poor,” *Journal of Economic Growth*, 7, 195-225.

<sup>35</sup> Dollar, David, Aart Kraay, and Kleineberg Tajana (2014). *Growth, Inequality, and Social Welfare Cross-Country Evidence*. <http://documents1.worldbank.org/curated/en/651701468182332804/pdf/WPS6842.pdf>

<sup>36</sup> Obregón, C. 2020. *Three Lesson from Economists That Policy Makers Should Never Forget*. Amazon.Com. Research Gate.

8.81 %, versus only 0.83% in Russia; the q1 Chinese income grew at annual rate of 7.74% versus only 2.48% for the q1 Russians. Therefore, the income ratios favor the Chinese. The income ratio China/ Russia = 4.06 (the income ratio China/Russia is obtained by dividing the total growth in income during the given period in China by the one in Russia). Which means that despite q1 Chinese losing income share against the rest of their nationals, and the Russians gaining it, the income of the q1 Chinese grew 406% more than the one of the Russians. Therefore, relative to their starting income the q1 Chinese in 2018 were 406% better off than the Russians. Obregón 2020 also compares Malaysia and Russia, for the same period; the q1 inequality ratio Malaysia/Russia is 0.79, and the income ratio is 2.15. Again, despite Russia's aggressive income distribution policy versus Malaysia's, the q1 Malaysians ended up more than twice times better off than the q1 Russians, in relative income terms.

Obregón 2020 analyzes similar results in a sample of 23 countries and finds that the high growth countries always have an adequate q1 income ratio versus the average; and that the high distribution countries with low growth do not have adequate q1 income ratios versus the average, except for a few exceptions and at the expense of very inadequate income ratios for the rest of the population. Therefore, the only income distribution policies that achieve adequate q1 income ratios are the ones of high economic growth, and neutral growth and high distribution. Obregón 2020 also shows that given a high growth economic policy the income distribution policies do make a difference, and therefore they are welcome. The lesson is that income distribution policies are beneficial, but that they should never be adopted at the expense of economic growth.

For the interested reader we describe the results in more detail in the following paragraphs. Obregón 2020 analyzes the lowest quintile (q1) income growth, in order to answer the question of whether it is influenced by the average economic growth, by the q1 social redistribution policy, or by both, and to which extent. Countries are denominated high economic growth countries (HG) if the income ratio is higher than 1.1<sup>37</sup>; neutral (NG) if it is between 0.90 and 1.1; and low economic growth countries (LG), if it is less than 0.90.

<sup>37</sup> The income ratio is obtained dividing each country's income growth by the average income growth of the twenty-three countries.

Countries are denominated high q1 distribution countries (HD), if its q1 inequality ratio<sup>38</sup> is greater than 1.1; neutral (ND), if it is between 0.90 and 1.1; and low q1 distribution countries (LD), if it is less than 0.90. He finds that that the HG countries explain better a higher than one q1 income ratio than the HD countries, 1.74 versus 1.21. The same happens with the neutral countries, NG=1.12 versus ND=0.87. The LG explains better a low q1 income ratio than the LD, 0.71 versus 0.92. All HG countries have q1 income ratios significantly greater than one, independently of how high or low the q1 distribution is. Conversely, HD countries also have a q1 income ratio greater than one, except Russia. But there is a huge difference as to the wellbeing of the rest of the population. In all the HG countries the (q2- q5) -d10<sup>39</sup> income ratio is greater than one, even if they have low q1 distribution; while in the HD countries with low growth it is significantly less than one. The HD countries (except Russia) do achieve a q1 income ratio greater than one; but the ones with low economic growth obtain this result at the cost of (q2 - q5) - d10 income ratios significantly less than one. And, in most cases, the tradeoff is too expensive. In Nicaragua, the q1 income ratio is 1.17 but (q2 - q5) - d10 income ratio is 0.71, that is 70% of the population is 29% worse off for 20% being 17% better off; that is a preference ratio of 5.97 ((70\*29)/(20\*17)) favoring q1 over the rest of the population. In El Salvador, 20% is 29% better off and 70% of the population is 26% worse off, a preference ratio of 3.14 favoring q1. In Guatemala, 20% is 5% better off versus 70% of the population being 34% worse off, an unbelievable high preference ratio of 23.80 favoring q1. Thus, it is clear that a policy of low economic growth in most cases does not achieve a social distribution goal; in the sense that despite local redistribution, the income of q1 is not acceptable (i.e., it is not an income ratio greater than one) due to the low economic growth; this happens in 11 out of 14 countries (79%). And in the three countries that did achieve an acceptable q1 income ratio, it was too expensive for the rest of the population, and it would be very improbable that any democracy would consciously approve such expensive preference ratios favoring q1. The average LG+ ND and LG+LD cases all have income ratios less than one. LG+HD has

<sup>38</sup> The inequality ratio is obtained dividing each country's q1 share change by the average share change of the twenty-three countries.

<sup>39</sup> q2 = second lower income quintile. q5 = highest income quintile. d10 = highest income decile.

a q1 income ratio greater than one but at the expense of (q2-q5) – d10 income ratio significantly less than one (the cases analyzed in the previous paragraph for Nicaragua, Guatemala, and El Salvador). Thus, with low growth it is impossible to have a successful income distribution policy, or it becomes too expensive for the rest of the population. In the HG countries all the income ratios are significantly higher than one, independently of whether they have a high, neutral or low distribution. It is interesting to note that for the HG countries d10 income ratio is greater than one, the high growth benefits everybody. Thus, high growth guarantees a satisfactory level of q1 income even with low distribution. With neutral growth only high distribution obtains both higher than one q1 and (q2-q5) – d10 income ratios, at the expense of d10 being less than one. q1 income then is acceptable with high growth or with neutral growth and high redistribution. Thus, it is clear that the growth policy dominates the results. But it should also be emphasized that the distribution policy has the desired consequences. HG+LD has a higher q1 income ratio than HG+ND and HG+HD; because in HG+LD we find China and India, and their high growth dominates any distribution efforts made by other countries. But despite the fact that growth dominates in general, we can observe the positive results of the distribution efforts: q1 HG+HD > q1 HG+ND; q1 NG+HD > q1 NG+LD; q1 LG+HD > q1 LG+ ND.

In summary: without proper economic growth, aggressive income redistribution policies cannot really be successful – they do not actually help the most needed, they do not resolve the class economic conflict. But given adequate economic growth, income redistribution policies do make a positive difference and should be used.

### *Misguided Economic Growth Programs*

There have been three unsuccessful economic growth programs: the neo-classical, the communist, and the import substitution model. What they have in common is the erroneous belief that capital accumulation by itself generates economic progress. What we have learnt is that while capital accumulation is required, it is not enough; a proper institutional arrangement is required.

## The Failure of the Neoclassical Model

The neoclassical model assumes that capital accumulation is a natural feature of capitalism and therefore it guarantees progress. The problem of underdevelopment, it argues, is that capital does not flow properly to the developing economies. But given the adequate distribution through free markets, capital will move into the low wage countries; global growth will be optimized, and in the medium term the problems of poverty and underdevelopment will be solved – there will be no class conflict any longer<sup>40</sup>. This was the basis of the Washington Consensus' recommendations for developing countries. The model did not work because of two reasons: 1) enter barriers to capital such as an underdeveloped legal system, inadequate infrastructure, political instability and so forth; and even more decisive, 2) the ICT (Information; Communications; Technology) revolution which allowed the central management of a company to remain in a developed country, while fragmenting the actual physical production within several developing countries. The ICT revolution meant that the risk taken in a specific developing country was greatly diminished; therefore, the multinationals were more interested in the particular benefits that a specific developing country offered for the production of a given element, than in the overall “neoclassical qualities” of the country, which would only be relevant if the whole process of production were to be exported to the developing country.

For a good discussion of the failure of the neoclassical model the interested reader is referred to Obregón 2020<sup>41</sup>. The comparison between Mexico's economic growth 1988 -2018, which followed closely the neoclassical model, and South Korea's, which followed the Asian development model, illustrates the neoclassical failure. Mexico's annual growth rate was 2%, while South Korea's was 3.9%. Which means that in this period of thirty years South Korea grew its economy 3.2 times, while Mexico only did so 1.8 times<sup>42</sup>.

To a large extent the failure of the neoclassical model was to assume that economic growth was given by the accumulation of capital and the

<sup>40</sup> See Lucas, R.E., Jr. (2002): *Lectures on Economic Growth*, Harvard University Press, Cambridge/London.

<sup>41</sup> Obregón, C. 2020., *New Economics*. Amazon.com. Also available at Research gate.com

<sup>42</sup> For a description of the import substitution model see Obregón, C., 2020 op.cit. Data in 2011 comparable constant international dollars from Maddison data base 2020., <https://www.rug.nl/ggdc/historicaldevelopment/maddison/releases/maddison-project-database-2020>

endogenous changes in technology; and that all that was needed was to free the markets to benefit from the high potential economic growth of capitalism. The solution for economic growth has proven significantly more complex – it requires proper institutions.

### The Failure of the Communist Model

During 1950-2000, the USSR grew in per capita terms at an annual rate of 1.2% while the US grew at 2.2%; which means that the USSR grew its economy 1.8 times in these fifty years, while the US grew it 3.0 times.<sup>43</sup> The failure of the communist model in the USSR, in Eastern Europe, in Cuba and in China (until it adopted the Asian growth model) clearly showed that capital accumulation is not enough to generate economic growth. The case of the USSR is particularly relevant because it had very high savings (therefore rapid capital accumulation), science and technology, research and development, learning by doing and a very large market. Almost all the elements that, according to the neoclassical models, explain economic growth, were present in the USSR. It is true that it did not have free markets, but as we have seen Mexico's growth program did include free markets, and it also failed. To understand what went wrong in the communist model is critical; because it allows us to realize which is the key element that distinguished the Occidental model from the communist one. What went wrong in the communist model is that it produced with obsolete technology, because the frontier technology was developed in the West in a larger market guided by the dynamic changing preferences of a very extended middle class. Therefore, when the USSR finally opened up to the West it was highly uncompetitive, and it had the huge economic crisis of the 1990s.

### The Failure of the Import Substitution Model

The import substitution model was centered on high savings to accumulate capital for the creation of national industries aimed at substituting imports<sup>44</sup>. Its main problem was like the USSR's, the production with obsolete technology which meant low international competitiveness. Latin

<sup>43</sup> Ibid, for a discussion of the communist model. Data same source than footnote 41.

<sup>44</sup> For a description of the import substitution model see Obregón, C., 2020 op. cit.

America & Caribbean grew 1960-2018 at an annual rate of 1.9%, while East Asia grew at an annual rate of 3.9%; which means that, while the first region grew its economy only 3.0 times in these 58 years, the second one grew it 9.4 times<sup>45</sup>.

### What Distinguishes the Successful Economic Growth Programs?

As we mentioned, there have been two successful economic growth programs: the Occidental and the Asian. What distinguishes them is that they have a proper institutional arrangement that is suited for their specific local and international historical time. In the case of the Occidental model, the institution of democracy was critical to the expansion of the middle class which enlarged the market and whose changing preferences guided the technological development<sup>46</sup>. In the case of the Asian model, specific institutions were designed to export to the Western middle class, and therefore producing with frontier technology was key<sup>47</sup>. The Occidental model included free markets that were critical to transmit the rapidly changing preferences of the middle class. Markets are essential to transmit this information and cannot be substituted by institutions. The Asian model included only partially free markets, but it depended for technological guidance on the free middle-class markets of the Western world.

### *Globalization's Conflicts*

In terms of income distribution, the world at large looks very much like an underdeveloped economy<sup>48</sup>. And while it is true that economic progress has characterized the world economy, it is also true that it is well behind its potential. While GDP per capita 1820- 2018 grew 16.5 times - or at annual rate of 1.42% - in the Western World (this includes Western

<sup>45</sup> Data same source that footnote 41.

<sup>46</sup> Again, for a description of these two models see Obregón, C., 2020 op. cit.

<sup>47</sup> For the Asian growth model see Obregón, C., 2020 op. cit.

<sup>48</sup> For data on the income distribution of the world see Obregón, Carlos. 2018 *Globalization Misguided Views*. Amazon.com. Also available at Research gate.com

Europe, Eastern Europe and Western Offshoots as defined by Maddison 2020); it grew in East Asia 15 times - at an annual rate of 1.37%; and in the rest of the world only 12.4 times, at an annual rate of 1.28%. Therefore, the per capita income difference of the Western countries versus East Asia and particularly versus the rest of the world has widened in the last 198 years of capitalism. In 2018 the per capita income in the Western World was \$38,262 (2011 international constant dollar), versus \$16,237 in East Asia and only \$11,349 in the rest of the world. Thus in 2018, the Western countries had a GDP per capita 2.34 times the one of East Asia and 3.37 times the one of the rest of the world. Any institutional policies directed to close that gap would have a significant positive impact on the economic growth of the world at large, and on the wellbeing of the inhabitants of the planet – including the ones living in the Western countries. It would mean having a larger global middle class which would widen the global markets and accelerate technological development<sup>49</sup>.

Even the economic growth of the Western world itself has been below its potential due to military confrontations. The Western annual rate of economic growth in the second half of the twentieth century was almost twice as fast as the growth in the first half, in which the world suffered the Great Depression and the two World Wars. 1900 to 1950 the Western countries grew at an annual rate of 1.01% or 1.66 times in fifty years; while during 1950- 2000 these countries grew at an annual rate of 1.95%, or 3.23 times in fifty years.

By avoiding huge military confrontations and having a stronger international integrative system during the second half of the twentieth century, the world not only grew much faster, but also became a fairer place to live – and this happened while the standard of living in the Western countries increased even more. Economic conflicts are not zero sum games. The size of the circle, and the growth of its area, depend upon the institutional arrangement. The world has much to gain by understanding this concept and applying it to the real world. Unfortunately, this will not be easy. The historical development of the world has been characterized by the coexistence of distinct nations with diverse interests, which produced the lack of a proper international arrangement; this complicates to a large extent the potential outcomes of the economic games between the participant nations and creates the possibility of very suboptimal results. As I write this book, the war of Russia with Ukraine has become a reality – which will produce very suboptimal outcomes for the world economy.

<sup>49</sup> For a further elaboration of this point see Obregón, C., 2018 *Globalization Misguided Views*. Op.cit.



However, at least having the right conceptual framework helps: economic conflicts that are not solved with the aid of a strong institutional arrangement (with a powerful integrative system), will not be solved within the economic system itself, and will create suboptimal solutions – many of which will end up in power confrontations.

Not only is the world economy clearly growing behind its potential, but the world has many other global problems such as: recurrent financial crises, extreme poverty, inadequate income distribution, international crime, lack of respect for human rights, underdeveloped countries, environmental crises, global health crises, lack of control of financial flows, the existence of fiscal paradises, recurrent wars, and so on. In other works, I have documented that the resolution of many of these global economic problems requires a stronger international institutional arrangement<sup>50</sup>. These global economic conflicts cannot be solved by the economic system itself. Savage capitalism produces very suboptimal global solutions, an appropriate international institutional arrangement providing a strong integrative system is required.

## CONCLUSION

There is a natural human tendency to evaluate things in a static manner. Economic conflict resolution historically has been seen, by the main schools of economic thought, as the distribution of given, scarce resources. It has been understood as if the area in the circle presented at the beginning of this manuscript was given, and its growth was naturally produced by capital accumulation. The neoclassical school argued that the distribution was efficiently solved by the price system, and the Marxist school argued that a revolution to distribute wealth and income in favor of the less privileged was required. Both have been wrong. As modern economic theory in information economics, game theory and institutional economics has shown, the solution to any economic conflict has to be evaluated in a dynamic setting.

While it is true that the price system is very efficient, and it is required for an appropriate conflict resolution, and it is also true that adequate income distribution policies are required – what is most important is to

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<sup>50</sup> See Obregón, Carlos. 2020. *A New Global Order.*, Amazon.com. Also available at Researchgate.com

have a proper economic growth program. What is most relevant is that any distribution policy has to be embedded in an adequate economic growth program. Markets only work well if the institutional arrangement is favorable. Which does not mean that conflict resolution can be achieved without efficient markets, institutions cannot substitute or replace markets – but markets without proper institutions do not provide a solution either.

Class conflict produces suboptimal results when compared to the ones obtained through class cooperation. Income distribution policies work well when they are designed within a strong integrative system with a proper economic growth program – thus whatever is distributed is socially agreed, and economic growth leaves everybody better off. Income distribution policies which are not socially agreed give rise to social confrontations that undermine the potential economic growth of the whole economy and leave everybody worse off.

The lesson that game theory provides for conflict theory is critical and must be emphasized: even if the conflict is analyzed in dynamic terms, the result may still be suboptimal. The key of why this can happen is that one economic agent does not know what the others will do. But even if we hypothetically assume: a) that all economic agents are informed of what the potential optimum solution is; and b) communication between them to announce their future actions is allowed – it may still be the case that the optimum solution will not occur, because in addition to be informed of the other economic agents' future actions, the economic agents have to trust that they are saying the truth – knowing that they may benefit from lying.

But trust is not a feature neither of the economic system, nor of the power system, it is a feature of the integrative system. The main lesson learnt in this manuscript from the analysis of economic conflict is that it does not have a solution within the economic system itself, the solution requires an institutional arrangement of trust that necessarily involves the integrative system.

The institutional arrangement required for economic progress, full employment and adequate income distribution goes well beyond the economic system. Economic conflict resolution does not occur only within the economic system, the power system is involved because peace is required, and the integrative system is involved because trust is needed.

In fact, when the integrative system is not involved in the resolution of economic conflicts, savage capitalism produces very suboptimal solutions that can easily end up in forceful confrontations in the power system (in

some cases, military). The lack of a proper international institutional arrangement is the cause of many of the unresolved international conflicts. The economic system will remain unable to solve such conflicts. Unless a stronger integrative international system is forged, we will continue seeing very suboptimal global solutions and continuous military and other power confrontations, like international crime.

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