Future challenges in economics – The evolution of identity economics

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ABSTRACT

As societies and economies evolve, a need for the development of economic theory also arises. In recent decades, among other subfields, behavioral economics has developed in order to provide a more realistic account of economic decision making than the explanations offered by mainstream economic theories. This new approach put emphasis on human psychology from an individualistic perspective by incorporating the findings of cognitive psychology into economics. However, behavioral economists have still omitted the observation that economic decisions are embedded into the social environment. Due to the seminal work of Akerlof and Kranton (2000) on identity economics, a new window of opportunity has arisen to fill this gap. In our paper, we aim to describe the emerging field of identity economics and outline the current and future challenges it faces before it can exert significant influence on the development of economic theory. We review economics studies that attempt to incorporate findings from the field of psychology, which provide the basis of behavioral economics. Our review finds that from the current strains of study, identity economics will have an important role in the future of economics research.

Keywords: identity economics, social identity theory, social environment, behavioral economics

Introduction

Mainstream economics, as characterized by its use of rationality to describe individuals, is increasingly challenged by other economic subfields that aim to provide explanations for observed irrational behavior. The long-running expected utility theory (Bernoulli, 1738/1954; Von Neumann & Morgenstern, 1944), and its variation, the subjective expected utility theory (Savage, 1954) assume that individuals make rational decisions to maximize utility. The rational choice theory (Smith, 1776) likewise asserts that individuals use rational calculations to make rational decisions to achieve results aligned with their self-interests. Furthermore, the homo economicus model (Mill, 1836/1874) portrays individuals as consistently rational, self-interested beings, who optimally pursue their goals.

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These concepts, however, are not seen as realistic and do not provide an accurate description of how individuals act in reality, as argued by Simon (1955) when describing his groundbreaking bounded rationality theory. The analogy of bounded rationality's pair of scissors (Simon, 1990), where its blades represent the internal cognition and external environment, provides the basis for the current analysis of the economics subfields of behavioral economics, new institutional economics, and identity economics in search of a possible future development path for economics that moves on from the atomistic understanding of individuals to a view that embeds the individuals in the society.

Bounded Rationality

In order to put the presented future development trajectory of economics in context, it is important to first discuss the theory of bounded rationality (Simon, 1955). Opposing the previously dominant views of optimizing, rational decision-making behavior, Simon (1955) argues for a view of individuals where they strive for satisfying outcomes instead of optimized outcomes. This act is called satisficing, an amalgamation of the words 'satisfy' and 'suffice'. This behavior exists because individuals lack the cognitive capacity to process all the available information and are incapable of calculating the optimal decision for each instance of choice present. Additionally, individuals also take into account the external environment and institutional setting for decision-making purposes, which contribute to the decisions' not resulting in personal utility maximization.

The two parts of the theory, cognitive limits and environmental constraints describe the concept of bounded rationality. Simon (1990) describes these two components using the apt analogy of a pair of scissors, which has two blades that are required for it to be functional. These blades are the cognitive limitations and structures of the environments, internal and external components, respectively. They show the partial rationality and irrationality of individuals, and provide an illustration about how despite the limitations, the mind is capable of using the environmental structures to provide adequate or satisficing answers to decision-making dilemmas.

Cognitive limitations

Behavioral economics has developed largely based on the bounded rationality theory (Simon, 1955), of which the line of research being discussed in the current paper are regarding heuristics (Tversky & Kahneman, 1974). However, the behavioral economics subfield only takes into consideration one blade of the metaphorical pair of scissors, the cognitive limitations, when presenting non-rational decision-making behavior. Tversky & Kahneman (1974), as psychologists argue that individuals use heuristics, or, in other words, rules of thumb to reduce the complexity of probability calculations in face of limited information processing ability. Although, it is noted that heuristics while being economical at providing acceptable results, cause systemic errors that can be predicted.

There are a significant number of heuristics available for use by an individual, who chooses the one that achieves the goal of simplifying a probability calculation for a certain situation.

For example, the representativeness heuristic can be used to point out the most likely occupation of an individual from a list. In this case the individual is assessed based on how stereotypical they are for a certain occupation on the list. If the assessed individual likes reading books, then the probability of them being a librarian is high according to the heuristic in use. This conclusion can, however, be false, as the probability calculation is done with limited information and the processing of said information is not done with painstaking rigor (Tversky & Kahneman, 1974).

On the other hand, Gigerenzer (1991) who is also a psychologist criticizes the view of Tversky & Kahneman (1974) that heuristics are to be treated as negative phenomena leading to systemic errors. He argues that while decisions made via heuristics violate the principles of the rational choice theory (Smith, 1776) in the fixed rules context, they are shown empirically to be rational in certain environments. Thus, when the structure of a boundedly rational decision matches the structure of information in the environment, ecological rationality appears (Gigerenzer, 1991). This ecological rationality unites the simultaneous analysis of the internal cognitive processes with the regularities of the external environment. In this sense what appears as the rational choice might be not ecologically rational as the individual's goals are not based on achieving the rationally most optimal outcome, but of an outcome that matches their criteria that is based on external factors that were not accounted for in the rational view.

Structures of the Environment

The other blade of Simon's (1990) theoretical pair of scissors of bounded rationality, the structures of the environment are represented in the field of economics by new institutional economics. In this subfield the institutions are defined as the "rules of the game" (North, 1990), encompassing both formal and informal rules of the social environment. The formal rules are humanly devised constraints that include the legal rules and laws that dictate how individuals can act in certain situations and describe formal punishments for breaking them in order to discourage unpredictable behavior. On the other hand, informal rules are the social norms, habits, traditions and customs that are not formalized constraints, but still present in unwritten forms that individuals are expected to adhere to. Punishments for informal rule breaking is found in the external, social environment, where other social groups might exclude the rulebreaker from future social interactions and economic transactions because of the unpredictability and increased costs it would imply.

The formal and informal constraints are integral to the development of economic transactions in a society (North, 1991). In a small village, individuals know each other, transaction costs are low, and informal rules are enough to regulate trade, although with low potential of specialization. As the size of the trading network increases, the need for more formal rules of transaction rise. The formal rules also require more resources allocated to enforce the law; however, religious precepts also allow regulation as long as they are regarded as binding by the society. In a large network of long-distance trade, specialization becomes more important as economies of scale characterize the economic environment. However, long-distance trade introduces increased transaction costs due to agency problems, where a caravan needs to be ensured to act on behalf of the owners. Additionally, the rules of the game might be different in another part of the world in which the caravan attempts to conduct business, creating uncertainty about trade negotiations and piracy (North, 1991).

Assembling the Pair of Scissors

The emerging field of identity economics spearheaded by Akerlof & Kranton (2000) uses both the cognitive limitations and the structures of the environment to construct an extended utility function that includes the social identity as a factor. This framework follows in principle the social identity approach (Tajfel & Turner, 1979; 1986), which is a social psychologist approach explaining social group memberships, and how they influence salient identities (Davis, 2007). The social identity theory predicts how individuals react based on social group memberships, as an individual would have a positive disposition to ingroup members, contrasted by a more negative attitude towards outgroup members (Tajfel &Turner, 1979). The theory is extended by the self-categorization theory, which describes how individuals categorize themselves into social groups, which influence how they see themselves, changing their motivations and goals to align with their social group memberships (Turner, 1985; Tajfel & Turner, 1986).

Identity economics by using the identities in the utility function is able to show how individuals act non-rationally as their goals are aligned to the salient identity of the context. Thus, goods that are related to the salient identity provide positive utility, while goods not associated with the identity or that are opposed provide negative utility (Akerlof & Kranton, 2000). These utility providing goods might not align with what a rational analysis might point to in isolation, but for the individual in the particular social context make logical sense. The identity economics framework is applicable to the job market and organizations, explaining gender segregation and optimal remuneration, and education, where motivations for studying are influenced by identity and the utility generated factoring in the institutions (Akerlof & Kranton, 2000).

However, the identity economics literature has other approaches aside from Akerlof & Kranton's (2000) use of the utility function from mainstream economics. Davis (2007) criticizes the identity economics framework as being atomistic in its portrayal of individuals' social identities, which fails to explain how multiple social identities and social group memberships interact with each other or ignores how multiple salient social identities can possibly exist simultaneously. In his reinterpretation, Davis (2007) introduces a sociological view of identities, where the personal and social identities are treated separately, which allows for the self and the society to influence each other in an interactive reciprocal relation. In this view individuals cannot be explained by their social group memberships alone, but are shaped by them, shifting the viewpoint from an atomistic view to a socially embedded view.

The socially embedded view of economics is discussed by Sen (1977), whose work has had a direct influence on the line of thinking of Davis (2007) regarding the socially embedded view of identity economics (Bağçe & Yilmaz, 2020). Sen (1977) introduces the concepts of sympathy and commitment. In his view, sympathy is the concern for others that has a direct effect on an individual's welfare, such as being appalled by knowledge of a certain action like torture of others. Whereas commitment is distinguished from sympathy as a concept that does not explicitly make the individual worse off, but despite that, the individual is ready to act out of conviction for the cause. Acting out of commitment can result in utility gained that is less than the optimizing decision would provide. In this line of thinking the welfare of an individual is only incidentally related to the choice made by the individual, instead of being the sole driver of it (Sen, 1977). These concepts are a departure from the atomistic understanding of economic agents to a socially embedded view, where the external social environment influences the individuals' decision-making resulting in non-optimizing, but logical behavior from the individuals' point of view.

Another distinct approach is from the motivated belief and reasoning literature by Bénabou and Tirole (2016). The authors' framework incorporates affective beliefs, which help an individual make themselves or their future look better, and functional beliefs, which assist in attaining a certain internal or external goal. It is noted that religion, a prominent belief system, incorporates both types of beliefs. These beliefs cause individuals to manipulate their information processing in a way that might not be rational. This selection of information usage is done to assist in preserving or shaping one's valued beliefs by self-deception and dissonance-reduction.

Personal and social identities are also connected to the motivated belief-based approach, as identity is argued to be a set of beliefs regarding who they are and which social groups they belong to (Bénabou & Tirole, 2016). Individuals are invested in maintaining an image of honest and prosocial look in the personal identity space and strive to belong to groups that are compatible with and attractive to their beliefs. The theory of motivated cognition therefore also shifts to a socially embedded view of economics, as it is argued that not only cognitive limitations cause irrational behavior, as described in behavioral economics by biases and heuristics (Tversky & Kahneman, 1974), but instead by a broadened concept that is integrated into the environment (Bénabou & Tirole, 2016). The socially embedded view of identity economics is also seen in the work of Garai (2017), in which he argues for viewing individuals not from an atomistic, isolated perspective, but in context of social relationships. This model describes individuals' transactions as being made through the social environment, where the transacting partners' relations to each other influence the transaction costs, or whether the transaction occurs in the first place. For illustrating this point, he has an example from a setting of Germany in the 1930s, in which there are three German individuals, a bourgeois, and two proletarians, one of which is a Jew. To understand the cost of transaction among these individuals, the external environment has a key role as the then-prevalent political hostility would dramatically influence whether the Jew individual would be transacted with due to institutional risks (Garai, 2017).

These relationships are products of the specific circumstances, as in a different time period the social groups would shift, creating different transaction costs for different parties. Such an approach would allow for analyzing economic transactions in a more complex manner, considering socially embedded actors and transactions. This view would allow us to simultaneously analyze individual cognitive processes and the patterns found in the external environment by shifting the focus from the individual actors to the relationships of the transacting parties. Economic analysis could explain a wider set of economic decisions, many of which were deemed irrational and fell out of the analytical focus of mainstream economics.

Conclusions

The current essay set out to outline a possible future development path of economics as a guideline for future studies. We reviewed the subfields of behavioral economics, new institutional economics, and identity economics in the context of the mainstream economics' stance on the rationality of individuals and the alternate theories of the subfields. The main theme of the paper revolves around the theory of bounded rationality (Simon, 1955), and how it describes two pillars of the individual's rationality and irrationality; the internal cognitive limitations that contextualize irrational response, and the external structures of the environment that make decisions rational from the perspective of specific situations. The future path outlined is one where the atomistic model of individuals is replaced by a socially embedded view, where individuals are defined in terms of social group memberships and relationships that change depending on the situation, salient identities and the institutions of the environment**.**

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