

universität freiburg

Economic Policy and Public Choice

Main Tutorial WS 2022/2023

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Tutorial 1: Course Information Introduction to Key Concepts



Course Information 1

- Literature/Readings for both Lecture and Tutorial are uploaded in ILIAS: <https://ilias.uni-freiburg.de/>
- Slides are available only on the chairs' website: <https://gwp.uni-freiburg.de/wintersemester-2023-2024/economic-policy-and-public-choice/>
- Password ILIAS: **Mueller23**
- Password Slides Main-Tutorial: **Mueller**

Tutorial Goals

- 1) Deepening the understanding of the issues discussed in the main lecture.
- 2) Investigating key ideas on background knowledge that is not covered in the lecture.
- 3) Showing different concepts that are not discussed in the lecture.
- 4) Answering your questions.

Tutorial 1 Literature

- Brennan, Geoffrey, and Buchanan James M. "The reason of rules: Constitutional political economy" (1985).
- Buchanan, James M. "The Collected Works of James M. Buchanan – Volume 17 – Moral Science and Moral Order" (2001).
- Gaus, Gerald. "It can't be rational choice all the way down: comprehensive Hobbesianism and the origins of the moral order." In: *Tensions in the Political Economy Project of James M. Buchanan* (2018): 117-145.
- Rodrik, Dani. "Economics rules: The rights and wrongs of the dismal science" (2015).
- Weldes, Jutta. "Marxism and methodological individualism." *Theory and Society* 18.3 (1989): 353-386.

Tutorial 1 Key Concepts

- Introduction to the Course
- Introduction to the Basic Analytical Tools:
 1. Economic Policy and Public Choice
 2. Positive Vs Normative Analysis
 3. Methodological and Normative Individualism
 4. Homo Oeconomicus
 5. Issues with Homo Oeconomicus in Public Choice

Introduction to the Course

- What is this course about?
 - What is economics really about?
 - “Economics Rules: The rights and wrongs of the dismal science” (Rodrik, 2015)
- How does this course differ from other courses you have done in your studies?
- Why is this course so interesting / different?

Economic Policy and Public Choice

- **“Economic Policy”:**

Investigates the public/collective activity, with Economy as the main objective and the State as the main player in economic policy making.

(setting rules which restrict individual behavior in the economic system).

- **“Political Economics”:**

The scientific analysis of economics, politics and their interplay using economic analysis tools.

Economic Policy and Public Choice

- **“Public Choice”**

“Is the branch of economic analysis that applies the behavioral model of Homo Oeconomicus to the political analysis.”

- (i.e. why bureaucrats spent as much as they do? What are the relationships between elections and spending?)
- Public Choice has a different focus than economics, i.e. rules for the political sphere instead of the economic sphere.

Economic Policy and Public Choice

- **Public choice:**

“Investigates the collective (political) decisions and actions of the individual in a society, where the individuals are the carriers of sovereign power.”

- **Welfare economics:**

“Benevolent dictator is the addressee of efficiency maximizing policies, which will be implemented by the all knowing government.”

(Violates methodological and normative individualism)

Positive Vs Normative Analysis

Positive Economics

“ Scientific analysis of how the world is”

Positive Economics study economic propositions that can be verified by observation of events or states of the real world.

“The interest rates in 2023 are lower than in 2022”

“The prices in 2023 are higher than in 2022”

Normative Economics

“Scientific analysis of how the world should be”

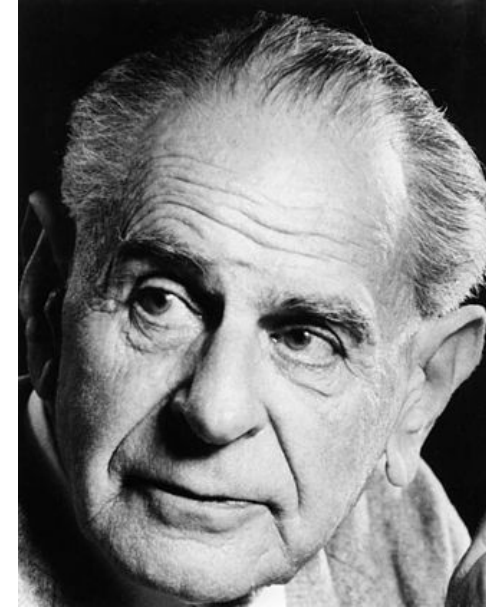
Normative Economics studies economic propositions (theoretical scenarios) of how things should be. Specifically: Policy Recommendations

“Interest rates should be higher”

“The prices should be lower”

Methodological and Normative Individualism

What *Methodological Individualism* is by Karl Popper:



“The important **doctrine that *all social phenomena***, and especially the functioning of all social institutions, *should always be understood as resulting from the **decisions, actions, attitudes, etc.**, of *human individuals* and that we should **never be satisfied** by an **explanation in terms of so-called “collectives”** (governments, states, nations, races, etc.)*

Methodological and Normative Individualism

Methodological Individualism explains the social phenomena by aggregating the individual behavior.

- Acting at the **micro level** (individuals) **defines** action at the **macro level** (society).
- Individual actions, individual decisions & interactions between individuals are the basis for "collective action".
- An analytical aggregate such as "the state", "society" or "social group" **does not exist** in methodological individualism. There is **NO** "collective action".
- The **analytical unit** is always **the individual and his/her actions**, which influence social phenomena (formation of laws, cultural traditions, social norms, ...).

For example : A government action is explained by individual choices of members of that government.

Methodological and Normative Individualism

Normative Individualism by Vanberg: **Normative Individualism by Buchanan:**



“The assumption that the desirability and legitimacy of constitutional arrangements is to be judged in terms of the preferences of, and the voluntary agreement among, the individuals who live under (or are affected by) the arrangements”



“No ‘social’ values exist apart from individual values”

Methodological and Normative Individualism

Normative Individualism

→ use of individual preferences to provide the measuring rod to formulate normative statements on

1. Economic states
2. Processes in general
3. Policy measures in particular

These preferences are not to be evaluated from some “external” perspective, i.e. in a paternalistic way.

Methodological and Normative Individualism

Critique of Methodological Individualism:

- sharp distinction between “observable” and “unobservable” language
- holistic or social terms are exclusively theoretical, only individual (observation) terms give meaning
- but: all terms are theoretically defined (see the works of Feyerabend)
- empirically, social phenomena can be observed!
- If we look at game theory: Intentions, preferences and utility is also unobservable but give “meaning” in terms of findings

See: Weldes, Jutta. "Marxism and methodological individualism." *Theory and Society* 18.3 (1989): 353-386.

Methodological and Normative Individualism

Critique of Methodological Individualism:

- individual and social predicates are not so easily separated
- individual-level predicates are based on the salient features the individualist has formed from the relevant social context.

Example: withdrawal of money from a bank

- requires not only empirical generalizations describing the behavior of customers and bank employees
- but also a theoretical understanding of the banking system in which the behavior occurs
- which in turn requires reference to other organizational features of society, such as its legal and monetary systems.

Homo Oeconomicus

Homo Oeconomicus or the “economic man” is a behavioral assumption made to characterize decision-making in a world of scarcity.

Generally: Assumption of finite & scarce resources in market decisions. But also social decisions, e.g. how to schedule one's time is what households do with scarce resources (time).

Background assumptions of Homo oeconomicus:

- Fixed Preferences
- Variable Constraints / Restrictions
- Information and Complete Rationality
- Existence of Relevant Alternatives
- Self-Interest

Homo Oeconomicus

1. Fixed Preferences:

- Criterion to evaluate alternative good, situations or opportunities.
- Allows an ordinal ranking (A is preferred to B).
- Preferences are individually different (different subjective valuations for the same good) and are seen as driving for market exchange.
- Preferences arise over time and do not change spontaneously.*

Example: A preference of apples over oranges.

* Important: We define the assumptions we use for human behavior on average to explain human behavior. How realistically these assumptions are evaluated here is not the subject of discussion.

Homo Oeconomicus

2. Variable Restrictions/ Constraints:

- Anything that limits the individuals alternatives to act and influences its utility maximization actions.
- Changes in behavior are attributed to changed restrictions (and not to change preferences).

- Some typical neoclassical restrictions are:
 - household income.
 - production technology.
 - production capacities.
 - budget constraint.

Homo Oeconomicus

3. Existence of Relevant Alternatives:

Preferences and Utility Function:

- **Utility functions:** the mathematically convenient way of handling preferences. When individuals maximize utility they aim to maximize their utility within the given budget.
- **Budget Constraint:** shows the total expenditure of an individual under its **constraints** = sum of single expenditures over all goods $1, \dots, n$.
- Limits to consumption options exist and the individuals need to find out how to optimally allocate one's resources given such consumption constraints.

“more is better but at diminishing rates”

→ A certain commodity bundle can be seen as a relevant alternative when it brings the same utility to the individual.

Homo Oeconomicus

4. Complete Rationality:

In order to be able to make the most rational choice individuals:

- possess complete information about the present and future,
- are attributed with unlimited data processing ability,
- are able to adjust instantly to a changed decision environment,
- translate preferences into behavior always calculating the optimal strategy.

Rationality is the LINK between restrictions (2.) and preferences (1.).

Homo Oeconomicus

5. Self Interest:

- Selfish means that the elements in the utility function to be maximized affect only the benefit of the individual, not the utility of other individuals.
- The Homo Oeconomicus is by assumption not an altruist (prosocial/nice) and also not a malicious individual (asocial/mean).
- However, observations of altruistic or malicious behavior are possible:
 - If altruistic behavior exists as an element of one's utility function.
 - Impact of one's actions on others without involving them in the decision-making process is called externalities.
 - Cooperative behavior in an environment of repeated, social interactions may well be in the interest of the individual and does not constitute a violation of self-interest

Homo Oeconomicus

Alternatives to Homo Oeconomicus

Approach	Conception of man	Rationality concept
Neoclassical	Homo oeconomicus	Cost-Benefit-Rationality, Utility maximization, Efficiency
Game Theory	Homo oeconomicus neumannensis	Cost-Benefit-Rationality, Payout maximization, Optimal strategy
New institutional economics	Homo oeconomicus institutionalis	Cost-Benefit-Rationality, Efficiency of rules, Institutions
Humanistic economics	Dual self	Reasonability
Socioeconomics	I & We	Sub-Rationality
Critical institutionalism	Homo culturalis	Procedural rationality (practical reasonableness)
Ecological economics	Homo oecologicus	Sustainability as an open-ended process, Co-evolution
Precautionary economics	Precautious self within context	Practical, communicative, emotional reasonableness

} math & formulas

Issues with Homo Oeconomicus in Public Choice

- Gaus, Gerald. "It can't be rational choice all the way down: comprehensive Hobbesianism and the origins of the moral order." In: *Tensions in the Political Economy Project of James M. Buchanan* (2018): 117-145.

Issues with Homo Oeconomicus in Public Choice

- Public Choice: the branch of economic analysis that applies the behavioral model of Homo Oeconomicus to the political analysis.
- Hobbesian model of individuals:
 - Self-interested individuals
 - Strategic manipulators
 - Maximizing utility

Issues with Homo Oeconomicus in Public Choice

- Public Choice question: How do certain legal and political orders arise out of the interaction of self-interested individuals?
- Solution: Mixed-motive games
 - Prisoner's Dilemma
 - Stag Hunt/Assurance Games
- Accepting a regime of rights benefits each agent → „Paretian frontier“

Issues with Homo Oeconomicus in Public Choice

- Hobbesian contractarianism:

How do contracts and constitutions evolve at all?

- a) Either: Individuals act in an „unruly“ condition (war of all against all)
- b) Or: In a rule-based political order

→ where a) helps us to see why we end up in a particular type of b)

- However: Is there no „ruly“ social and moral order before the state?

→ Montesquieu (1748): „the effectiveness of any constitution depends on the habits, manners and morals of the population“

Issues with Homo Oeconomicus in Public Choice

What happens if we analyze current institutions with Homo Oeconomicus logic?

- No problem if we have a „normless environment“
- But what if we already have an informal moral order?
 - a) Problems are not the same for „norm-followers“ and „egoists“
 - b) Solutions for individuals are different
 - c) Evaluations will be different (solutions must correspond to their already-endorsed moral norms)

Issues with Homo Oeconomicus in Public Choice

- For Buchanan, „each person treats other persons exclusively as a means to further his own ends and advantage“ (Buchanan 2001, p. 190)
 - ➔ Homo Oeconomicus model as strategical players
- Suppose a player, Alf, has a choice between two rules of behavior and that a rule „commits“ to certain actions:
 - a) N: Moral norm that secures the benefits of cooperation and social order
 - b) R: Personal maxime of behavior that allows him to secure what he sees as the best results in an unconstrained way

Issues with Homo Oeconomicus in Public Choice

- Kantian-inclined agent chooses N (regardless of the behavior of others)
- Hobbesian agents chooses R
- Let $m_a(N_x)$ be the utility Alf receives if x numbers of others act on the cooperative norm N
- Let $m_a(R_x)$ be the utility if Alf acts on R
- Hobbesian agent: Alf should choose N if $m_a(N_x) > m_a(R_x)$ (→ if x is high), but that is unlikely that many of the x choose N as well
 - Alf should act on his own personal rule (choose R)

Issues with Homo Oeconomicus in Public Choice

- Suppose we have a wide range of value on the benefits of social cooperation
 - ➔ Even for low values of x , it will hold that $m_a(N_x) > m_a(R_x)$
- Let there be a group b who was skeptical of the benefits of cooperation. If they see that group a has adopted N , they might as well say $m_b(N_x) > m_b(R_x)$
- ... And so on, for all groups!

Issues with Homo Oeconomicus in Public Choice

- Unstated Assumption: Alf can secure the cooperative benefits of the norm only if he acts on N himself
- But: What if Alf receives $m_a(N_x)$ without acting on N himself?
- Utility:
 - Acting on N: $m_a(N_x) - m_a(R_x)$
 - Acting on R: $m_a(R_x) + m_a(N_x)$
- Regardless of x , Acting on R is strictly dominating Acting on N

Issues with Homo Oeconomicus in Public Choice

- But: What if others make their acting on N toward A conditional upon his acting on it?

→ **Folk Theorem:** If one can deny the benefits of cooperation to defectors, a stable cooperative equilibrium can be achieved

- Open question:
 - How can punishment (denying the benefits of cooperation to defectors) be plausibly modeled into large population of Hobbesian/ rational agents?
 - Individuals might have incentives to invest into conflict (later in the Lecture/Tutorial)

Issues with Homo Oeconomicus in Public Choice

- „it is illegitimate to restrict Homo Oeconomicus to the domain of market behavior while employing widely different models of behavior in non-market settings, without any coherent explanation of how such a behavioral shift comes about“ (Brennan and Buchanan, 1985, p. 50)
- If Homo Oeconomicus is inherently domain-specific, we should start with these questions:
 - When do people maximize by playing subgame perfect equilibria and when do they trust others even when doing so fails to make the best (i.e. equilibrium) response?
 - When do they bargain about interests, and when will they sacrifice interests for ideologies?
 - When will they act selfishly and when do they fairly contribute to public goods?

Recap

- The topics discussed today:
 - ✓ Economic Policy and Public Choice
 - ✓ Positive vs. Normative Analysis
 - ✓ Methodological and Normative Individualism
 - ✓ Homo Oeconomicus
 - ✓ Alternatives to Homo Oeconomicus
 - ✓ Issues with Homo Oeconomicus in Public Choice

Next session:

- Edgeworth Box
- Shibata Box