Economic Policy & Public Choice

Part III: The public choice of economic policy

1 Rational and behavioral public choice

Reference for Chapter 1:

Cullis, J.; Jones, P.: Public Finance and Public Choice, 3rd Ed., Oxford et al. 2009, 486-513.

- Individual failure and psychological and neurological behavior

→ psychology (and sociology as well as "neuro-logy") of behavior

⇒ 'broad' view on economic man (integrating psychological and neurological aspects of behavior in the model of economic man)

⇔ logic of *individual* failure
(↔ market failure, collective failure, government failure)
⇒ individual failure in market exchange,
individual failure in collective decision-making,
individual failure in governmental action

- Support of economics by other sciences

  → ethics / moral behavior
  (Adam Smith, Harsanyi, Buchanan, …)

  → mathematical logic
  (Edgeworth, Marshall, Arrow, …)

  → psychology
  (Akerlof, Tversky/Kahnemann, Frey, Fehr, …)

  → neurobiology
  (Glimcher, Lowenstein, Zak, Fehr, …)

- Rational behavior:

  - consistency
  - economics: given preferences, changes in constraints
  - rationality under pure self-interest or social preferences, benevolence or malevolence
  - optimizing / maximizing behavior

- Self-interest:

  - egoistic individuals;
  - self-interest in terms of utility, income, wealth
  - individual is concerned only with his own utility (no utility interdependence, no benevolence, no malevolence)

- Behavioral “anomalies” (seemingly irrational behavior):

  → based on experiments and psychology

  - bounded rationality (individual failure)

  [- interdependent preferences (social preferences)]

  [- affected preferences (endogenous preferences)]

- Aspects of anomalies / bounded rationality (constrained capabilities)

(1) History matters

→ sunk cost effect
(past costs influence decisions)

→ endowment effect / entitlement effect
(goods in your endowment have a higher value than those not held)

⇒ willingness to pay < willingness to be compensated

(2) Contexts and environments matters

→ framing effect
(‘presentation’ of information: as good news or bad news, by complex explanation or transparent explication, …)

→ reference point effect
(not only utility level, income, wealth base the decision but also a reference point (e.g., status quo); framing moves the point ⇒ changing decisions even if utility or monetary payoffs do not change)

→ overconfidence effect
(one beliefs too much in his knowledge)

→ preference reversal effect
(you would like to pay more for that what you do not prefer
⇒ willingness to pay does not *reveal preferences*!)

→ opportunity cost effect
(monetary costs give more ‘disutility’ or ‘loss’ than opportunity costs of the same size)

(3) Beliefs about probability matters

→ certainty effect

→ small probability effect
(choosers overestimate the very low probability of winning)

→ availability bias
(experienced events are overweighted)

- Endowment effects in economic policy problems

→ loss aversion in market exchange
(Kahnemann/Tversky 1979)

⇒ relevant market equilibrium!?!

→ realization of economic policies

criterion:
economic policy leads to (potential) Pareto optimality/improvements

⇒ relevant costs and benefits of policy projects

⇒ relevant willingness to pay [WTP]
(if good is not in the endowment)

⇒ relevant willingness to accept to forgo [WTA]
(if good is in the endowment)

→ no endowment effect:
WTP = WTA

→ endowment effect exists:
WTP < WTA resp. WTP << WTA

→ empirical data support endowment effect

$\Rightarrow$ consequences for economic policy design (*policy implications*)

$\rightarrow$ underestimation of losses measured by willingness to pay

$\Rightarrow$ too much economic policy

$\rightarrow$ WTP < WTA implies smaller gains from exchange/trade in the Edgeworth Box

$\Rightarrow$ Policy implications based on the logic of Edgeworth Box analysis may be overvalued

$\rightarrow$ WTP < WTA implies that final allocation is not independent of initial allocation
(different gains from different initial allocations in the Edgeworth Box)

$\rightarrow$ Paternalistic government

- vulnerability of citizens ("enemy within") is based on their irrationality / bounded rationality (irrationality $\Leftarrow$ endowment effect)

$\Rightarrow$ self-protection via public institutions

$\Rightarrow$ government tasks:

- protecting citizens from themselves
  (~ hard paternalism)

- support the implementation of individual rationality
  (~ soft paternalism)

$\rightarrow$ preventing anomalies

- behavioral traps

  $\rightarrow$ setting and spiking commercial traps by sellers
  to exploit the endowment effect of consumers

  $\Rightarrow$ *Policy implications*

- legislation as a safeguard

  $\rightarrow$ the economic policy of regulation of economic actions may be justified by endowment effects

  $\rightarrow$ e.g., rent regulation with incumbent tenants (I) and challenging tenants (C)

  $WTP^C < WTP^I$, but

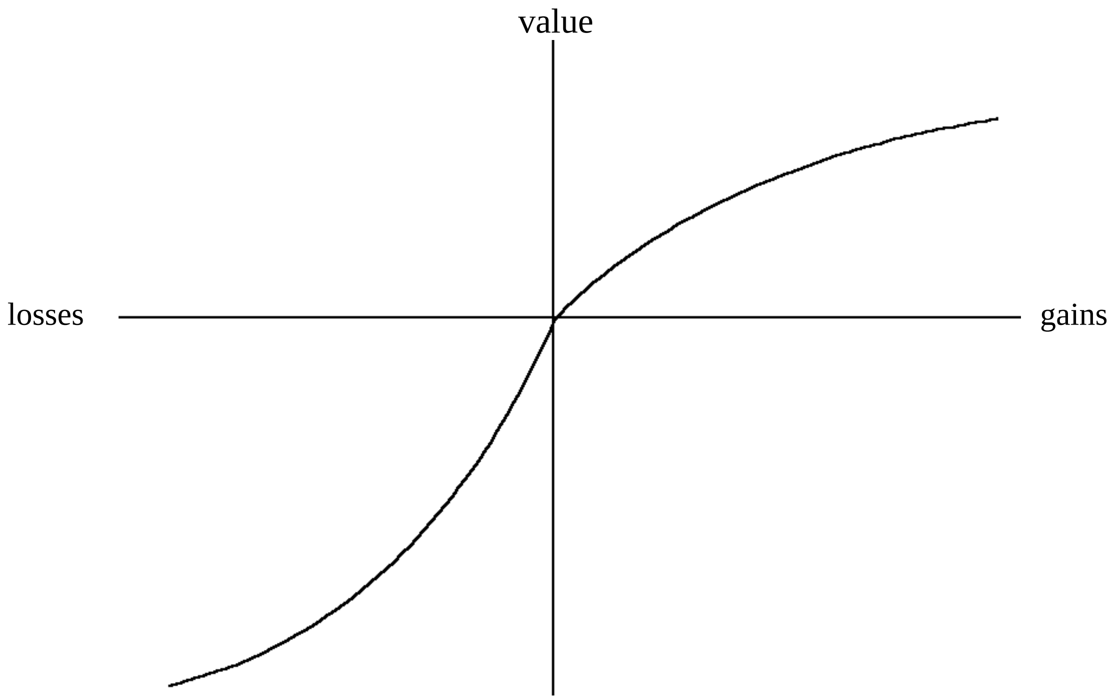
  $WTA^C > WTP^I$

- Framing in economic policy

→ prospect theory

- a certain value function instead of utility functions
- decision weights instead of probabilities

→ characteristics of the value function



- S-shaped function
- steeper in the loss region (in comparing equal absolute terms of losses & gains)

⇒ no consistent choices in terms of expected utility (risk-seeker, risk-avoider)

⇒ identical prospects are treated differently (decision weights instead of probabilities)

⇒ risk-aversion for gains,
risk-loving / risk-seeking for losses

→ framing

⇒ decision problem is recognized/presented as a

- loss problem (frame 1)
- gain problem (frame 2)

⇒ individuals are responsive to frames and (institutional) environments of the choice

⇒ *choices* are endogenous to different
- environments,
- frames (reference positions),
- modes and strategies of information transmission

(e.g., choosing option A or B)

⇒ *preferences* may be endogenous to different reference positions and environments
(e.g., preference structure of risk seeking or risk aversion)

⇒ *policy implication*:
optimal strategies for a framing of economic policy to change behavioral response
(optimal political framing)

⇒ *policy implication* (public choice):
prevent framing policy which influences public decisions against the interest of the citizens
(limit the abuse of political framing)

→ Framing preferences for public policy

- perception of a certain economic policy as a loss or as a gain

  → exploitation of different attitudes to fairness

    ⇒ different fairness preferences/positions under a “policy story of losers” than under a “policy story of winners” (Schelling 1981)

  → exploitation of different attitudes to risk

    ⇒ control incentives for tax evasion / tax compliance

    - perception of tax compliance as a loss or as a gain

      ⇒ risk seeking under (unexpected) tax payments at the end of the year (loss from gross income)

        ⇒ loving the risk of tax evasion

      ⇒ risk aversion under (unexpected) refunds of tax payments in a withholding system (gains in net income)

        ⇒ avoiding the risk of tax evasion (high tax compliance)