

Main Tutorial WS 2015/2016

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Public Choice in Theory and Practice

Lecture 1: Course Information

Introduction to Key Concepts

This Lecture

- Purposes:
 - 1) To investigate key ideas on background knowledge that is not covered in the lecture.

Course Information 1

- Readings for the Lectures will be linked in ILIAS. ilias.uni-freiburg.de
 - Password Ilias: Mueller16
- Lecture Slides will be posted our website
 - Password Slides: Mueller

Presentations

- Every individual will work in groups and give a presentation to the class.
- Please see course outline for presentation topics.
- All students must submit their top three topic preferences for assignment before our second lecture Tuesday 13.12.2016 by email
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Lecture 1 Concepts

- Introduction to the Basic Analytical Tools:
 - Public Choice vs Welfare Economics
 - Positive Vs Normative Analysis
 - Methodological and Normative Individualism
 - Homo Oeconomicus

Public Choice

- “**Public Choice**” is the branch of economic analysis that applies the behavioral model of Homo Oeconomicus model to the political analysis.
- (i.e why bureaucrats spent as much as they do? What are the relationships between elections and spending?)

It has different focus than economics!

Where Can We Apply Public Choice Theory

- **“Economic Policy”**:
- Investigates the public/collective activity, with Economy the main objective and the State as main player in economic policy making.
- (setting rules which restrict individual behavior in the economic system).

- **“Political Economics”**:
- The scientific analysis of the systematic study of economics, politics and their interplay using economic analysis tools.

Question for the Class

- What do you know about welfare economics and its application to economic policy formation?
Focus on the basic behavioral assumptions.
 - Take 3 minutes to talk with other member of the class
- Why would the basic assumptions within welfare economics change the implications from and predictions about players within politics?
 - Take 3 minutes to talk with other members of the class

Public Choice vs Welfare Economics

- **Welfare economics:** benevolent dictator is the addressee of efficiency maximizing policies, which will be implemented by the omniscient government.
- (Violates methodological and normative individualism)
- **Public choice:** Investigates the collective (political) decisions and actions of the individual in a society, where the individuals are the carriers of sovereign power who are rational and self interested.

Question for the Class

- Why would the basic behavioral assumptions within welfare economics effect the implications from and predictions about players within politics?
 - Take 3 minutes to talk with other members of the class
- How would the application of Public Choice behavioral assumptions change the analysis of political actors?
 - Take 3 minutes to talk with other members of the class

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 are low”
“The prices are high”

Normative Economics

“Scientific analysis of how the world should to be”

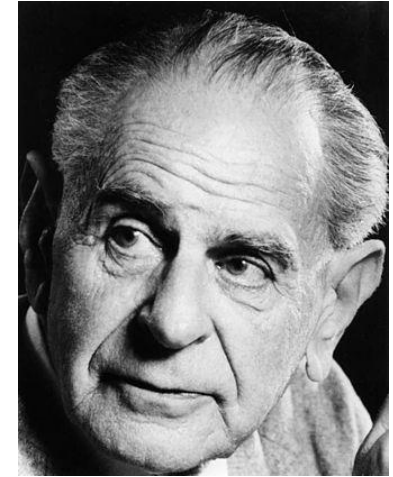
In Normative Economics studies economic propositions (theoretical scenarios) of how things should be.

Specifically : Policy Recommendations

“Interest rates should be higher”
“The prices should be lower”

Methodological and Normative Individualism

What is Methodological Individualism
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.
- → There is **NO** “collective action”.
- Social entities like government, corporations, unions etc. do not act as “collectives”.

- **Individuals** = actors of the society.
- **Social or collective level phenomenon** = individual actions of the actors.

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

Methodological and Normative Individualism

Normative Individualism by Vanberg:



“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 individual who live under (or are affected by) the arrangements”

Normative Individualism by Buchanan:

“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.

Homo Oeconomicus

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

Background assumptions of Homo oeconomicus:

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

Homo Oeconomicus 1

1.Fixed Preferences:

- Criterion to evaluate alternative situations or opportunities .
- Allows an ordinal ranking.
- Differ among different individuals (different subjective valuations for the same goods).
- “driver” of market exchange.

Example: A preference of apples over oranges.



Homo Oeconomicus 2

2. Variable Restrictions/ Constraints:

- Anything that limits the individuals alternatives to act and influence 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

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”

Homo Oeconomicus 3

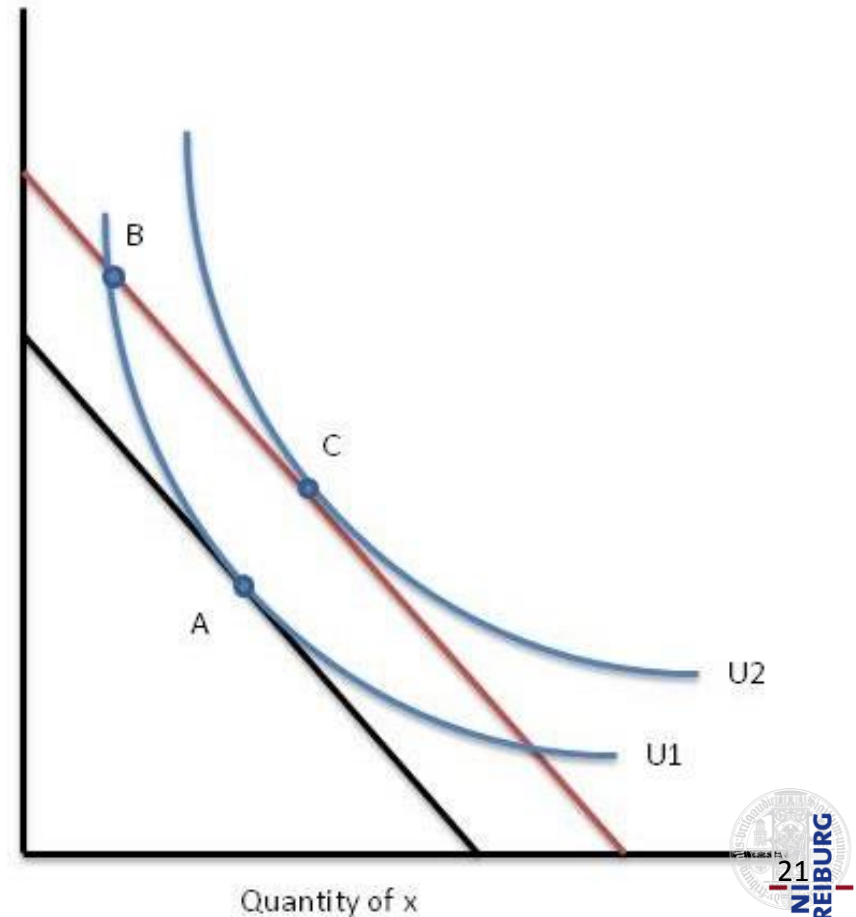
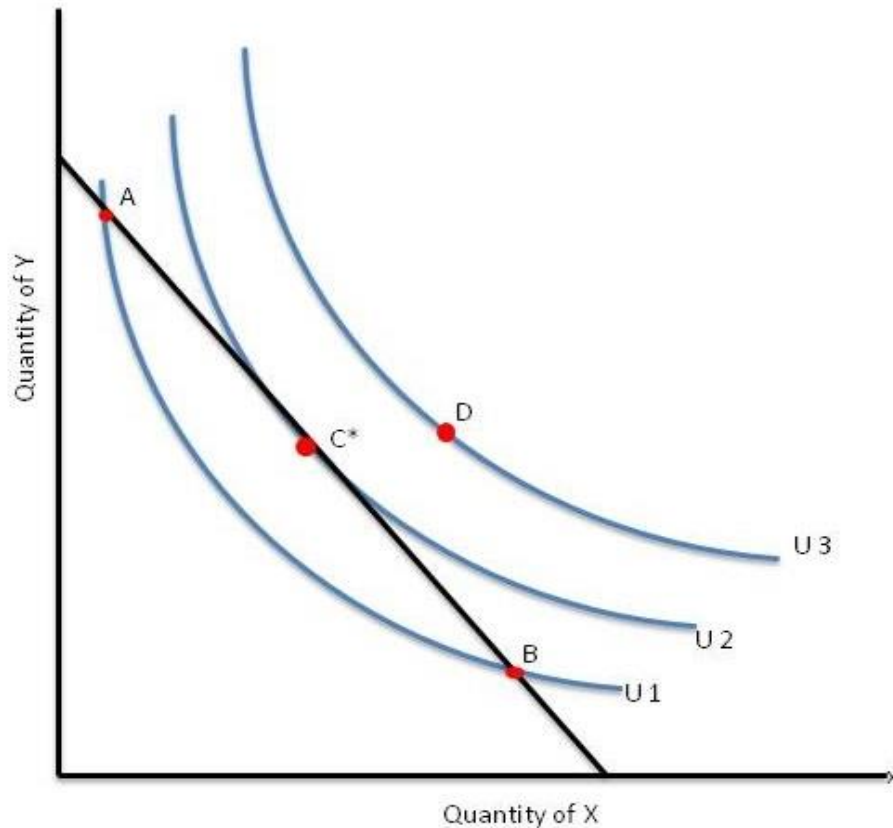
- **Utility maximizing point** (on the graphs) is found on the tangency between utility curve and budget constraint.
Tangency conditions: the *slope* of the budget constraint and the indifference curve is the same.

$$\mathbf{MRS} = \frac{\partial u(x_1, x_2) / \partial x_1}{\partial u(x_1, x_2) / \partial x_2}$$

→ the rate by which we have to substitute one good for another to keep the individual consumer indifferent

Homo Oeconomicus 3

- What is the point of utility maximization in graph one?
- What does the line shift in graph two to represent? The shift is from the black line to the red line or a rightward shift. Is this person better off and why?



Homo Oeconomicus 4

4. Complete Rationality:

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

- posses 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

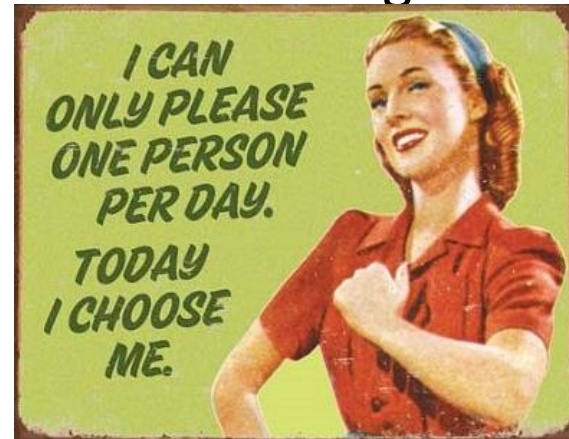
→ Rationality is the LINK between restrictions and preferences.



Homo Oeconomicus 5

5. Self Interest:

- Individuals are:
 - selfish (complete egoists) utility maximizers (concerned with their own benefit).
 - Neither “nice” or “mean” (only care about themselves, their own well-being).
- Altruistic or vicious behavior results from arguments in the individual’s utility function.



Recap

- The topics discussed today:
 - ✓ Public Choice vs Welfare Economics
 - ✓ Positive Vs Normative Analysis
 - ✓ Methodological and Normative Individualism
 - ✓ Homo Oeconomicus

