

Political Economics

Lec.3

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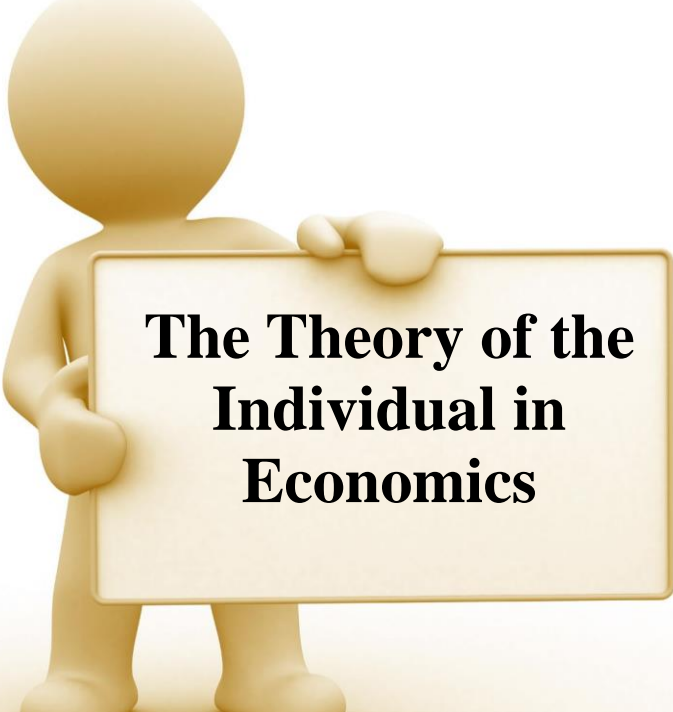
The Theory of the Individual in Economics

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The Theory of the Individual in Economics

Introduction:

- Economics is a social science:

➔ ■ it is about **people** and about how we organize ourselves to meet our needs and enhance our **well-being**.

Ultimately, all economic behavior is human behavior.

- if you look closely at any **economic outcomes**, you will find that they are ultimately determined by **human decisions** or **behavior**

- The concept of the individual is one of the most **fundamental** in contemporary society.


- Democracy,
- Freedom,
- Human rights,
- The development of knowledge and science,
- The quality and meaning of life

Individuality

- We cannot understand the historical evolution of political systems without recognizing the centrality of the individual to our thinking.

■ Individual is central to the understanding of **Political System**

■ Individual is central to the understanding of **Behavior** in Economics



**Classical, Neoclassical,
Recent Theories of
Individual**

A) Classical Economic Views of Individuals

Adam Smith (1759 & 1776)

An Inquiry into the Nature and Causes of the Wealth of Nations

The Theory of Moral Sentiments

- According to the concept of the **invisible hand**, people acting in their own **self-interest**

➤ This would, through markets, promote the **general welfare**.

- This is a basic goal of **government**

Does invisible hand mean selfishness?

The desire of people to have **self-respect** and the **respect of others**

This depends on people acting **honorably, justly**, and with **concern and empathy** for others in their community.

- Selfish acts can “**promote the public interest.**

individual self-interest was mixed with more **social motives.**

We can conclude that:
The behavior of any person always had to be understood
within that person’s social context.

Followers: David Ricardo; John Stuart Mill; Alfred Marshall

Marshall



Optimistic about the motives of human actors

Human actors were motivated by a desire to improve the
human condition. (e.g., the reduction of poverty)

B) The Neoclassical Model

The **neoclassical approach** dominated economic thoughts during the twentieth century

A **narrower view** of human motivations

Two main types of economic actors
Firms (profits) and households (utility)

Simplifying assumptions about how these two types of actors behave and interact

The two kinds of agents are assumed to interact in perfectly competitive markets.

Economic behavior can be expressed in **figures, equations, and graphs.**

Analyzing the determination of **prices**, the volume of **trade**, and **efficiency**

Paul Samuelson (the second half of the twentieth century)

promoted the idea of economics as a “**value free**” science

NO reference to any
human goals or values

It should derive **conclusions** from simple **assumptions**,
about the **motivations** of **market actors**.



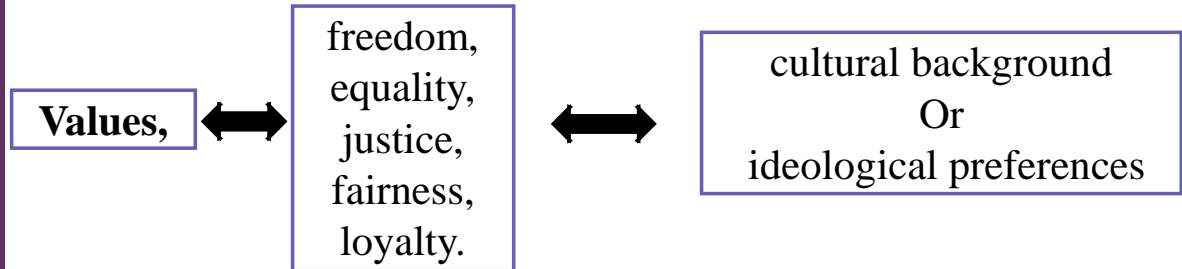
Conclusion can be deduced
from one essential axiom

Discipline was more **scientific** than other social sciences

Its public image is that: an analytically rigorous scientific discipline seeking to attain **objective truth** about certain phenomena, **independent of opinion.**

A key aspect of this development within economics has been to implement a sharp distinction between facts on the one hand, and values on the other.

If you want to be **scientific** and **attain objective truth**,
 → you must deal only with **empirically testable facts**.



With values, there is no **obvious measure** of who is **right** or **wrong**.

C) Recent Economic Theories

- **Recent economic theory** examined economic behavior that consider people's (1) choice of goals, (2) the actions they take to achieve these goals, and (3) the limitations and influences that affect their choices and actions.

Behavioral Economics

A subfield of microeconomics that studies how individuals and organizations make economic decisions.



Explain behaviors such as:

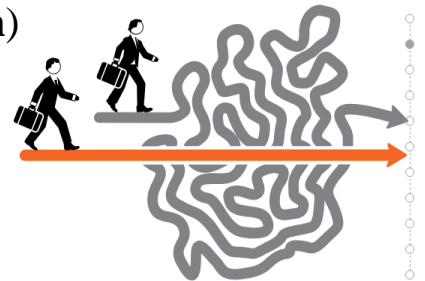
- those that lead to **stock market swings**,
- the ways that people react to **good and bad fortune**,
- and why people often seem to act **against** their own **self-interest**.

- Rather than **making assumptions** about human behavior,
 - behavioral economics relies heavily on **scientific experiments** to determine how people behave in different situations.

- Availability **Heuristic/Bias** (**Kahneman**)

a method for solving problems

Importance of **information** that is easily **available** or **vivid**



The **availability Heuristic (Bias)** happens we people often judge the likelihood of an **event**, or frequency of its occurrence by the ease with which **examples** and **instances** come easily to mind.

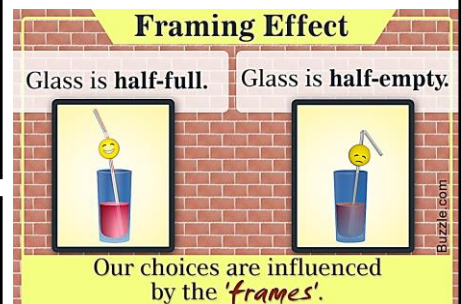
An Example

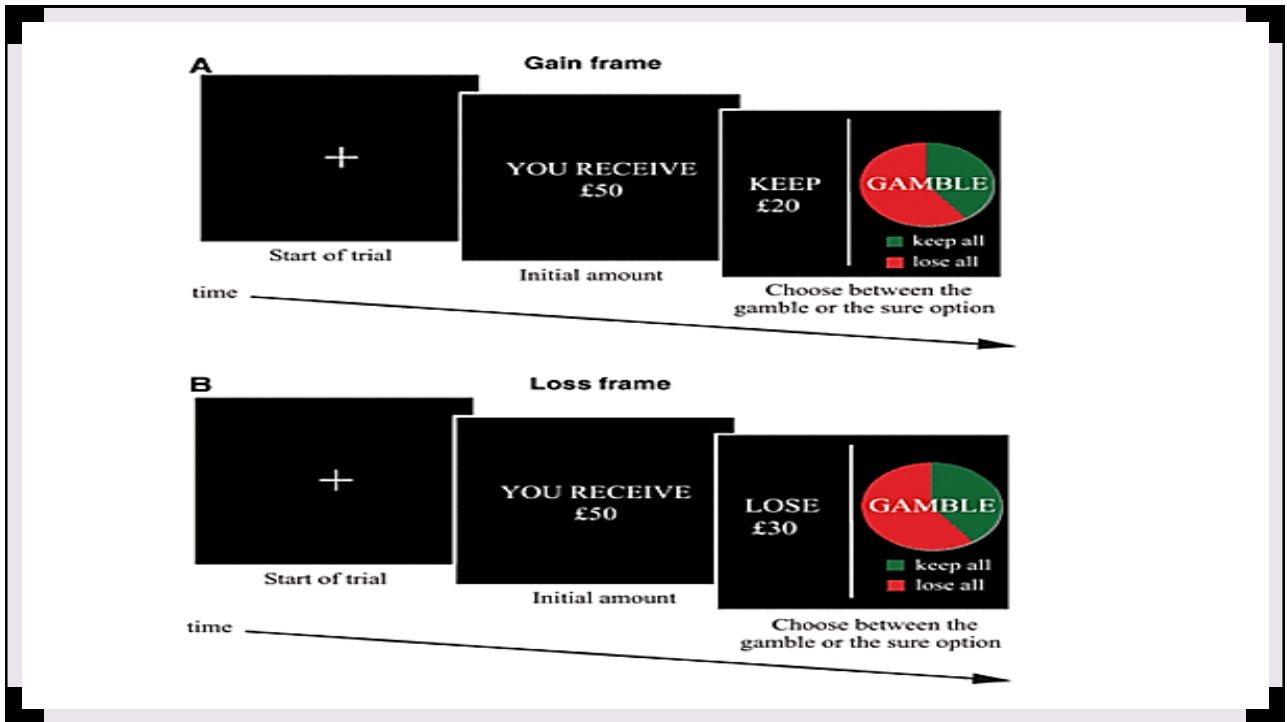
- Suppose that college students are deciding which **courses** to take next semester, and they see **a summary of evaluations** from hundreds of other students indicating that a certain course is very **good**.
- Then suppose that they **watch a video interview** of just one student, who gives a **negative review** of the course.
- Even when students were told in advance that such a **negative review** was **atypical**, they tended to be more influenced by the **vivid negative review** than the summary of hundreds of evaluations, even though such behavior seems **irrational**.

- Furthermore, the way a decision is **presented** to people can **significantly influence** their **choices**, an effect he referred to as **framing**.

Framing (cognitive bias): changing in the way a particular decision is presented to people in order to **influence** their **behavior**.

Choices can be presented in a way that **highlights** the **positive** or **negative** aspects of the same **decision**, leading to changes in their **relative attractiveness**.





Prospect theory (The financial decision-making task/Gambling)

- | | |
|---|---|
| <p>■ A gamble option: was represented as a pie chart depicting the probability of winning (green) or losing (red) all of the starting money.</p> <p><u>all-or-nothing gamble</u></p> | <p>■ A sure option: was presented in the Gain frame trials (A) as an amount of money retained from the starting amount (e.g., keep £20 of the £50) and in the Loss frame trials (B) as an amount of money lost from the starting amount (e.g., lose £30 of the £50).</p> <p><u>"Keep £20" or "Lose £30."</u></p> |
|---|---|

Results

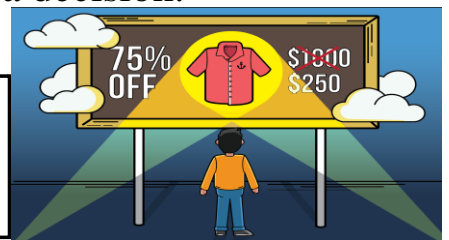
- ✓ **62** percent of participants chose to gamble with the money **if the other option was to lose \$30**,
- ✓ But only **43** percent of people chose to gamble **if the other option was to keep \$20**.

- (That is, of course, despite the fact that the second option in both scenarios leaves the participant with \$20.)
- This shows the power of **the framing effect**: setting up a question in a way that makes someone think about **losing something** will make them come to a **different decision** than if the question made them think about keeping something.

- An effect similar to framing is known as **anchoring**, in which people rely on a **piece of information** that is **not necessarily relevant** as a reference point in making a decision.

- **Anchoring Effect:**

overreliance on a **piece of information** that may or may not be **relevant** as a **reference point** when making a decision



An anchor is any **aspect** of the **environment** that has **no direct relevance** to a decision but that nonetheless **affects** people's judgments.

Once an idea or a value is **firmly anchored** in someone's mind it can lead to automatic decisions and **behaviours**. For example, “Big Price Drop” campaigns by supermarkets



The Role of Time in Economic Decisions

In making decisions about retirement program, people might not appropriately weigh the future.

- people seem to place undue emphasis on gains or benefits received today **without considering** the implications of their decisions for the future.

Example

- people who have acquired significant high-interest credit card debt.
- compulsive shoppers in USA who seek instant gratification with little concern of debt.

- **Person** who **does not** pay much attention to **the future consequences** of his or her actions.

This person has a very **high time discount rate**

- While a **person who** pays much attention to **the future consequences** of his or her actions.

This person has a **low time discount rate**

Time Discount Rate: an economic concept describing the **relative weighting** of **present benefits** compared to **future benefits**.



Economic Rationality

A **rational** behavior decision-making process is based on making choices that result in the most optimal level of benefit or utility for the individual.

Choosing Goals and Trying to Achieve Them

Economists generally proceed from a **belief** that **people** should be **free** to **choose** their own **goals**, even if their **chosen goals** differ from those of most others.

However, Some goals that people pursue may be **unachievable**.

People may also **choose reasonable goals**, but engage in **irrational behavior** that leads them away from their **achievement** rather than toward it.

The Role of Constraints and Information

■ economic decisions are always made subject to constraints

including limits on:

- income and other resources
- and on physical or intellectual capacities.

In assessing their options, **economic actors** make use of their **existing knowledge** but often need to collect **additional information**.

The neoclassical approach

assume that rational behavior is optimizing behavior, based on the further assumption that rational economic actors have “perfect information.

Herbert Simon: one first needs to have **complete knowledge** of all choices in order to identify that **optimal point!**

people rarely optimize. Instead they do what he called satisficing; they choose an outcome that would be satisfactory and then seek an option that at least reaches that standard.

additional information might be very costly in time, effort, and money. and difficult to obtain

Satisfice: to choose an outcome that would be satisfactory and then seek an option that at least reaches that standard

Given **constraints** of **time** and so forth, **satisficing** seems to be a reasonable behavior.

another deviation from rational behavior as traditionally defined has been called ameliorating

Ameliorating: starting from the **present level of well-being** and continuously attempting to do better

One result of using amelioration as the real-world substitute for theoretical optimization is its implication that **history matters. (i.e. Path Dependence)**

Path Dependence: situations in which what is possible, or what is chosen, in the present depends on what has happened in the **past.**

Satisficing and **ameliorating** may both be included under the term **bounded rationality**.

Bounded Rationality: the hypothesis that people make **choices** among a somewhat **arbitrary subset** of all **possible options** due to limits on:

- **Information,**
- **Time, or**
- **Cognitive abilities.**

Thank you