

Chapter 1: Introduction

Paul Makdissi

Department of Economics, University of Ottawa

Fall 2012

Understanding public policies

- The government usually aims at some social objectives when implementing public policies.
 - These social objectives are linked to notions of social justice
 - Political philosophy
- Individuals choose their behavior taking into account the institutional framework,
 - These choices are analyzed by social sciences (economics, sociology, social psychology, etc)
 - The policy maker should use these forecasts on the individual's behavior to determine if their policy will aim well at the social objective.

Understanding public policies

- Two dimensions:
 - Definitions of the appropriate social objective
 - Models of social behavior
- What would be an appropriate social objective?
- What is the appropriate model of economic behavior?

Context

- “The subject of every state ought to contribute toward the support of government as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.” (Adam Smith (1776), *Wealth of Nations*)
- Does distributive justice has a moral foundation?
- Remember that Marx’s objective was to develop a scientific theory and not a moral theory. For him, the answer to this question is NO.
- “What is a *fair* distribution? Isn’t it the case that the *bourgeois* says that the actual distribution is fair? Isn’t it the only *fair* distribution based on the actual production system?” (Marx, *Werke, Vol. XIX*, translated by the author)
- Note that although he was reticent to ethical judgments, Marx made implicit moral judgments in his analysis of *exploitation* and *domination*.

Basic principles

- Nozick, R. (1974), *Anarchy, State and Utopia*
- 3 principles:
 - Self ownership
 - Fair transfers
 - Fairness in original appropriation

Fairness in original appropriation

- Finder-keeper approach.
 - Kirzner, I. (1979), *Perception, Opportunity, and Profit. Studies in the Theory of Entrepreneurship*
 - Kirzner argues that those who discover the existence of a resource, or discover an unknown valuable use for a known resource, are really creators of an economic resource.
- Lockean Proviso.
 - Locke requires that, when appropriating an unowned resource, “enough and as good” be left for others.
 - Nozick reinterprets the Lockean proviso by requiring that no one be left worse off by the appropriation than he would be if the thing remained in common use.

Fairness in original appropriation

- Equal sharing of the rent associated to natural resources
 - This idea was introduced by Paine, T. (1796), *Agrarian Justice*
 - Left libertarians reinterpret Paine's idea by requiring that the person who appropriates the resource pay a tax equal to the market value of this resource. The proceeds of this tax are then shared equally among all.
 - Steiner, H. (1994), *An Essay on Right*
 - Valentyne, P. (1998), Le libéralisme de gauche et la justice, *Revue économique*, 50, 859-878.

Implications

- A social organization is just
 - If the original appropriation is fair.
 - Transfers between individuals are free.
 - There is compensation for past injustice
- Nozick argues that an economic allocation is just if the procedure that generates this allocation is just. He considers that the distribution of income or other economic advantages (consequence) is not relevant for the analysis of social justice.
 - Wilt Chamberlain example

Critics

- Wilt Chamberlain's parable is a particular example in which everyone has the same autonomy in accepting or refusing the contract.
- The island parable (Van Parijs and Arnsperger, 2003).
- Should we consider that Bill Gates' son and the kid born in a poor rural area of Burkina Faso have the same autonomy when taking their free decision in life. Do they have the same resources to support their liberty?
 - Some may argue that if the difference in autonomy is due to bequest, then we may prohibit bequest.
 - If we let individuals free to pay the price they want for basketball tickets, what is the argument to prohibit them of accumulating savings for their children.

Critics

- Nozick's philosophy is essentially based on history.
- History was not a sequence of free transfers between individuals. Just think of Attila, Caesar, Napoleon, the European colonization, ... In this context, only the compensation for past injustice in transfers would be a very redistributive political program!!!

Unanimity and Paretian improvements

- **Utility:** Level of satisfaction of an individual consuming a basket of goods.
- **Pareto Optimum:** A feasible allocation is Pareto optimal if there is no other feasible allocation such that the utility of one individual increases without decreasing the utility of anyone.
- **Pareto improvement:** A modification to a given economic allocation for which no one has a decreased utility.

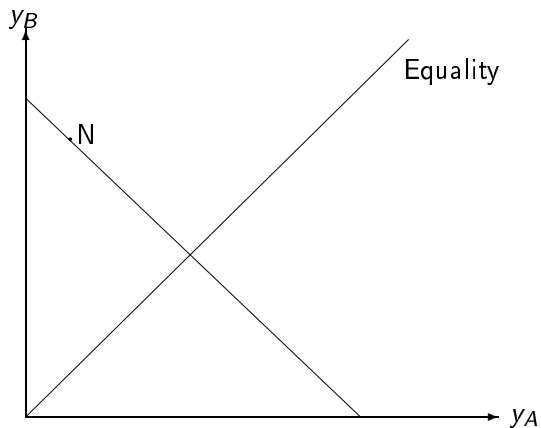
First welfare theorem

- Competitive economy:
 - Consumers maximize their satisfaction regardless of any social norm
 - Each firm maximizes its profit
 - No one has any control on the level of prices.
 - There is no public good.
 - There is no externality.
 - All the agents share exactly the same information.
- **Theorem:** *A competitive equilibrium is a Pareto optimum*

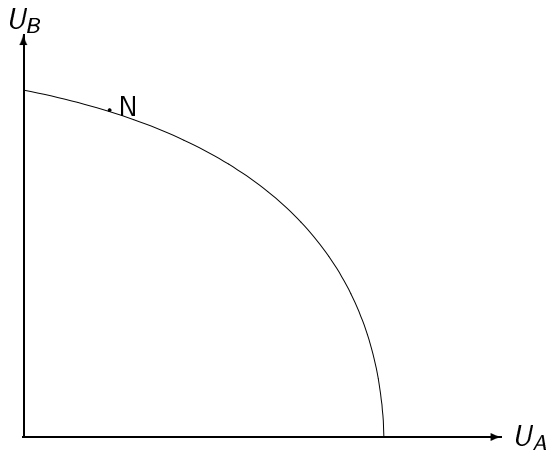
First welfare theorem

- A Walrasian equilibrium is deemed good by a Paretian analyst.
- It is also deemed good by a libertarian analyst but not for the same reasons.
- The logic of the Paretian argument is:
 - There is an initial situation.
 - There is a free transfer process between individuals.
 - The result of the free transfers process is a Pareto optimum.
- The libertarian analyst considers that the Walrasian equilibrium is “good” because of the free transfer process (procedural justice) while the Paretian analyst considers that it is “good” because the consequence of this process is Pareto optimal (consequential justice).

Paretian approach and welfare economics



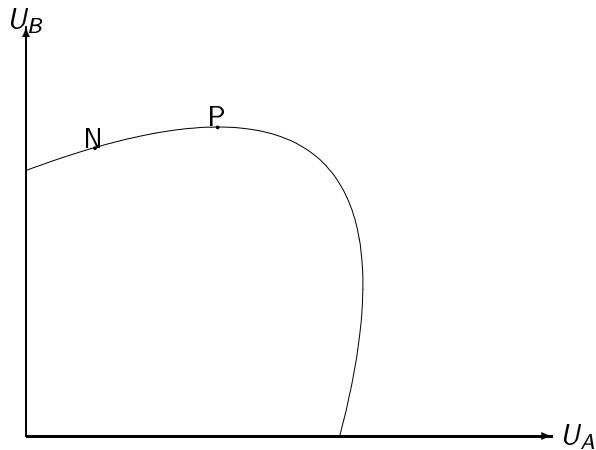
Paretian approach and welfare economics



Paretian approach and welfare economics

- **Question:** Should there be something else other than the person's own income y as an argument of the utility function $U(\cdot)$?
- There is a possibility that utility is a function of both income and income distribution. (Hochman et Rogers, *American Economic Review* 1969)

Paretian approach and welfare economics



Paretian approach and welfare economics

- If the mechanism of free exchange in the market is accompanied by the possibility of private voluntary transfers, then will this not be sufficient to achieve the welfare improvement from N to P ?
- If there is more than one rich, charity towards the poor has the characteristics of a public good and decentralized charity is inefficient.
- We have a first argument for government intervention.

Utilitarianism

- Mozi (470-390 BC).
- Actions must be evaluated in the way that they lead to the biggest benefit for the biggest number of persons.
- Bentham (1781) → Utilitarianism.
- Mill (1863), *Utilitarianism*.

Utilitarianism

- Bentham $\rightarrow SWF_B = \sum_{i=1}^I u_i(x_i)$
- Mill $\rightarrow SWF_M = \frac{1}{N} \sum_{i=1}^I u_i(x_i)$
- Berstrom-Samuelson $\rightarrow SWF_{BS} = W(u_1(x_1), u_2(x_2), \dots, u_I(x_I))$.
- All those approaches are consequential. Social evaluation is made on individual utilities associated with the final allocation.

Rawls

- Rawls, J. (1971), *Theory of Justice*
- Contractualist approach: Rawls try to find the principles of justice on which the delegates of various comprehensive doctrines would agree on if they were negotiating behind the veil of ignorance.
- Rawls argues that social judgment must be made on the distribution of primary goods and not on the distribution of utilities.

Primary goods

- **Natural primary goods:** Health, talent, etc...
- **Social primary goods:**
 - **Fundamental liberties:** Political liberty (i.e., to vote and run for office), freedom of speech and assembly, liberty of conscience, freedom of property, freedom from arbitrary arrest.
 - **Access to all social position.**
 - **Socioeconomic advantages:** Income and wealth, power, social basis of self respect, leisure (added in Rawls (1993), *Political Liberalism*)

Principle of justice

- The principle of justice is based on primary goods.
- **Principle of justice:** In a lexical order:
 - **Basic liberties:** “Each person is to have an equal right to the most extensive scheme of equal basic liberties compatible with a similar scheme of liberties for others.”
 - **Fair equality of opportunity:** Offices and positions must be open to everyone.
 - **Difference principle:** Social and economic inequalities are to be arranged so that they are to be of the greatest benefit to the least-advantaged members of society.

Sen

- Sen (1980), *Equality of What?*
- In each theory of justice, equality is sought in some space.
- Space in which equality is required → equalisandum.
- Sen agrees with Rawls that we should not take into account differences between individuals in their ability to be satisfied. However, he thinks that Rawls went to far in the elimination of the differences between individuals.
- Goods and services → functionings → utility.
- Sen argues that social choice must be made in the space of capabilities which are defined as the sets of functionings available to an individual.

Others

- Dworkin (1981) → Equality of resources. He is the first to formalize the principle of individual responsibility inherent in Rawls and Sen.
- Van Parijs (1995) → Real liberties.
- Arneson (1989) → Opportunities of welfare. He criticizes Dworkin on the link made between resources and preferences and argues that individual responsibility must be on the link between opportunities and results.
- Cohen (1989) Opportunities in access to social advantages.
- Roemer (1993) formalizes the theories of equality of opportunities.

Models of economic behavior

- The standard neoclassical microeconomic model assumes that each consumer makes his choice in order to maximize his own satisfaction (utility) regardless of the social environment and of any social interactions.
- Sen, A. (1977), Rational fools: A Critique of the Behavioral Foundations of Economic Theory, *Philosophy and Public Affairs*, Vol. 6, 317-344. **1998 Nobel Price Winner**

Models of economic behavior

- In his **2001 Nobel Price** lecture, Georges Akerlof explained that his research program has been focussing on building the behavioral foundations of Keynesian economics. His work focusses on concepts such as social norms, cognitive dissonance, identity.
- **2002 Nobel Price Winners:**
 - **Daniel Kahneman:** *“for having integrated insights from psychological research into economic science, especially concerning human judgment and decision-making under uncertainty.”*
 - **Vernon L. Smith:** *“for having established laboratory experiments as a tool in empirical economic analysis, especially in the study of alternative market mechanisms.”*

Reference

- Fortin, B. and M. Yazbeck (2011), Peer Effects, Fast Food Consumption and Adolescent Weight Gain, CIRANO Scientific Series, 2011s-20.

Cost of obesity

- It is associated with serious health problems:
 - Type 2 diabetes
 - Heart disease
 - Certain cancers
- Economic cost of obesity: The Centers for Disease Control and Prevention (CDC) estimate the obesity health care costs to 147 billion US dollars a year.

Fortin and Yazbeck's paper

- They try to give one explanation for the dramatic increase in obesity in the US in the last 20 years.
- They argue that genetic factors alone cannot explain this drastic increase in the incidence of obesity.
- The literature has pointed out to the presence of a peer effect in obesity. If someone's friends are obese, this increases the probability of this person being obese.
- The issue that is addressed in their paper is whether the peer effects in obesity flows through the eating behavior channel (fast food consumption).
- They try to identify a variable that can be altered by policy makers through taxation (unlike BMI).

Fortin and Yazbeck's paper

- They use the AddHealth Survey. It is a nationally representative sample of American adolescents in grades 7 to 12.
- They use the “saturated” subsample which has 3000 observations.
 - It includes the information on nominated friends. This allow them to build the real social network of friends in school.
 - It includes information on the frequency of fast food consumption.
 - In includes information about the height and weight of the adolescents as well as information on their parents weight.
 - It includes socio-economic information on the family.

Fortin and Yazbeck's paper

- They find significant peer effects in fast food consumption at the global level.
- When stratifying by gender, they find evidence these results are stronger for girls.
- Results from their obesity “production function” reveal a positive significant effect of fast food consumption on the BMI.
- These econometric results indicates that those economic agents are subject to peer pressure and social norms.