

Phil. 4800

Notes #22: Behavioral Foundations of Economics

I. Traditional assumption: Egoism

- People are rational egoists.
 - Problem: This seems not to be true.
 - But it is approximately true in certain areas. War, contracts.
- A way to make it definitionally true:
 - “Interests” = utility = preference-satisfaction.
 - Preference = “revealed preference”, which is revealed by actual choices.
 - The only way to falsify the theory is for people to be inconsistent.
 - *Objections:*
 1. There are non-choice sources of information on preferences.
 2. Not all preferences are selfish. This definition of “selfishness” is an evasion.
 3. The theory is close to being empty & unfalsifiable. It only rules out inconsistency. But, it is difficult to distinguish inconsistency from changing preferences.
- Three possibilities:
 - Egoism
 - Utilitarianism
 - Other. People may have commitments to specific people/groups, such as family, friends, nation, etc. People may also have various non-utilitarian ethical values (freedom, justice, equality, etc.).

II. Commitment vs. Sympathy

- A distinction between 2 kinds of motivation:
 - *Sympathy:* This is where your welfare is tied to (awareness of) others’ welfare. Learning of others’ happiness makes you happy (or unhappy [“antipathy”]).
 - *Commitment:* This is where you have beliefs about what is good/right, separate from your own welfare.
- The 2-apples story
 - A offers B the choice between the 2 apples. B chooses the larger. A is upset because he thinks B should have chosen the smaller. A would have chosen the smaller.
 - A would have chosen the smaller apple. Why? *Sympathy:* Then he should be happy.
 - *Commitment:* explains why he is angry.
- Sympathy might be consistent with egoism. Commitment is not.
- The railway story.

Someone asks you, “Which way is the railway station?” “Over there,” you say, pointing to the post office. “And while you’re there, could you post this letter for me?” The other person says “Yes,” and takes your letter, determined to open it and see if it contains anything valuable. This is what rational egoists would do.

III. How does commitment affect economics?

- Consumer choices: boycotting of South African avocados. Rare cases.
- Provision of public goods. [It is unclear what his point is about this.]
- Voting behavior:
 - Utility maximizers should not vote. Your vote makes no difference.
 - People are motivated by “a desire to record one’s true preference”.
 - Related: The expressive theory of voting. People vote to express their feelings.

- This can lead to altruistic decision-making.

IV. Work motivation

- Ways of motivating people to work:
 - Constant supervision w/ rewards & punishment. Impractical.
 - Rewards for production.
 - General social norms. Work ethic, etc. This plays an important role.

V. Metarankings

- Rankings of alternatives: Specify which actions are better than (or preferred to) which.
- Meta-rankings: Specify which rankings are more moral (or otherwise better) than which. Closely related to second-order preferences.
- Can be used for:
 - Explaining *akrasia*
 - Explaining behavior in Prisoner's Dilemma. People often fail to do the "rational" thing in PD's.
 - * Maybe they are thinking in quasi-Kantian terms: what preferences would they like everyone to have?

VI. Rationality & Egoism

- The egoistic model of rationality:
 - Consequentialist: only consequences matter
 - Act- rather than rule-consequentialist.
 - Only effects on self-interest matter.
- Challenges:
 - We might have non-consequentialist obligations.
 - We might focus on rules rather than acts.
 - We might care about something other than our own well-being.
- Sidgwick's challenge:
 - "Why care about others' interests?" Is this question like, "Why care about interests at a later time?" Compare:
 - * Interests at present time vs. interests of other times (other time-slices of oneself?)
 - * Agent's own interests vs. other agents' interests.

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Notes #23: Economic Methodology

I. Positive & Normative Economics

- Positive Economics is independent of any value judgments.
- Most economic policy debates depend on positive questions, not value questions.
 - Example: Minimum wage laws.

II. About scientific theories

- They have 2 components:
 - A “language”, a kind of conceptual filing system.
Should be judged by clarity, usefulness, etc.
 - A body of substantive hypotheses.
Should be judged by predictive accuracy.
- Evaluating substantive hypotheses
 - “Predictions” must be of phenomena previously unknown to the predictor.
 - * Need not be of future events.
 - * [Think about: Why does he say this? Is this right?]
 - Problem: There are always infinitely many hypotheses consistent w/ data.
Solution: non-empirical criteria:
 - * Simplicity
 - * Fruitfulness
 - Problem: lack of controlled experiments
 - * Some physical sciences lack controlled experiments: astronomy.
 - * Ability to control is a matter of degree.
 - * But economic data is much harder to interpret. Unsuccessful hypotheses are always cropping up again.

III. About Realistic Assumptions

- A commonly held view: Two ways to test an economic theory:
 - By testing its implications
 - By testing the realism of its assumptions
- But this is wrong. The most “important” hypotheses have “wildly inaccurate”, “descriptively false” assumptions. (14)
- Accuracy of assumptions can only be evaluated by accuracy of implications. Example:
 - For falling bodies, $s = \frac{1}{2} gt^2$.
 - This formula “assumes” no air resistance. Is this “assumption” accurate enough?
 - How to test this: by testing the implications.
 - There is no other standard of “close enough” to a vacuum.
- “Assumptions” may be wildly inaccurate: Example:
 - The leaves of a tree behave as if they were seeking to maximize the sunlight they capture.
 - But leaves do not have beliefs and desires, etc.
 - There is another, evolutionary explanation of this phenomenon. This theory is better, not because it has more realistic assumptions, but because it is more fruitful, connected to other knowledge.
- Example: Predicting the shots of an expert billiard player.
 - They behave as if they had detailed knowledge of physics & do calculations before each shot.

- This doesn't mean they actually have this knowledge.
- The theory is plausible because, unless players behaved this way, they would not be *expert* players.
- Economic example:
 - Businesses maximize their profits.
 - They may not actually perform complex calculations to do this.
 - But unless they behaved in this way, they would not be in business for long. (Or their businesses would not grow.)
 - There is a lot of evidence for this. But it is difficult to document.

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Notes #24: Interpersonal Utility Comparisons

I. Hausman's Article

Hausman's Thesis

- A theory of welfare: S's level of wellbeing = the degree to which S's preferences are satisfied.
 - Note: Preference-satisfaction not = feelings of satisfaction.
 - Hausman thinks this theory is wrong.
- Can we say that one person's utility is higher than another's?
 - This is important for ethics.
 - Some say no, perhaps because interpersonal utility comparisons (IPU's) cannot be tested.
- Hausman argues: //we take the preference theory of welfare, then we cannot compare welfare levels.
 - Therefore, we should reject the Preference Theory.

1. Ordinal Utility & Interpersonal Comparisons

- Suppose we have only an ordinal ranking of preferences. This means that we can order events as our 1st preference, 2nd preference, etc.
- Robbins says: IPU's are untestable.
- Actually, they would be meaningless. In an ordinal ranking, there is no *quantity* of utility.
- *Counter-proposal*: Measure by how far up your preference ranking you are.
 - Count # of alternatives in one's pref ranking above and below one's current state?
 - Problem: How to individuate alternatives.
 - Problem: There might be infinitely many alternatives.[Comment: # of preferred/dispreferred alternatives also seems morally irrelevant.]

2. Extended Sympathy

- Maybe we can use an "extended sympathy" function, which gives a preference ranking among person-state pairs, e.g., _____ prefers Ira-with-x over Jill-with-y.
- What goes in the blank?
[Some weird discussion that doesn't make much sense in this section.]

3. Maybe we can make IPU's in special cases:

- When someone is at the top/bottom of their preference ranking.
- But this isn't very useful.

4. Cardinal Utilities

- To make IPU's, we need a maximum & a minimum utility. Degree of pref satisfaction =

$$\frac{\text{Actual U} - \text{minU}}{\text{maxU} - \text{minU}}$$

- This uses the "zero-one rule": Your maximum utility = 1. Your minimum utility = 0.
 - Note: Any affine transformation of this utility measure is equally good. *Affine transformation* the result of multiplying everything by a constant & adding a constant.
- This must be correct because

- If two people both have their minimum utilities, then their preferences are not at all satisfied.
- If Ira and Jill's preferences are both "not at all satisfied", then neither's preferences are any more satisfied than the other. So they have the same utility.
- Similarly, if Ira and Jill both have their top preference, then their pref's are equally satisfied, so they have = utility.
- [Note: Basically ignores any other possible way of measuring "degree of preference satisfaction". E.g., ignores the possibility that degree of preference satisfaction depends on strength of desires.]
- Objection: Then a person's imaginativeness affects their well-being. People who have imagined wonderful possibilities are thereby worse off.
 - Reply: This is just a further objection to the pref-satisfaction theory of welfare.
 - Or, maybe we should use hypothetical, fully-informed preferences.

5. Other people's criticisms of the zero-one rule

- Hammond: We'd have to give more to greedy people than to people with modest desires. This is unfair.
 - o Reply: This is just an objection to the pref-satisfaction theory of welfare. [Really?]
- Sen:
 1. Suggests that we could, e.g., assign 1 to the *sum* of all possible utilities.
 - o But this would obviously not measure degree of preference satisfaction. (Repeat argument from section 4.)
 2. Suggests that handicapped people might have uniformly lower utilities.
 - o [Sen seems to be counting only utility functions over *feasible* alternatives, not all imagined or imaginable alternatives.]
- Rawls:
 1. The rule assumes that everyone has similar capacity for satisfaction.
 - o This seems to conflate preference-satisfaction w/ feelings of satisfaction.
 2. It also implies that great social utility would result from educating people to have simple desires.
 - o (Repeat argument of section 4.)
 - o [What's the objection here? Isn't this implication *true*?]
- Griffin: it assumes that we "reach the same peaks and valleys".
 - o Rep. section 4. All these people are refusing to take the pref-satisfaction theory seriously, because obviously, once you accept it, you have to accept the zero-one rule.

6. Implications

- We should reject the preference theory of welfare.
 - Actual preferences probably can't be represented by a cardinal function. [Why not?]
 - See the criticisms from section 5. [I think he has in mind:
 - o Greedy people shouldn't get more \$. (Hammond)
 - o We can't improve the world by teaching people to have simpler desires. (Rawls)
 - o Some people might have uniformly lower welfare levels, like the disabled. (Sen)
- Objection: We only use pref-satisfaction as a *proxy* for welfare.
 - Reply: It is too hard to measure to make a good proxy.

[Skip sections 7-8.]

II. Weintraub's reply

A. Hausman's first argument for the zero-one rule

- He says "to question whether Jill's bottom might be lower than Ira's is implicitly to reject the notion of utility as merely representing how well preferences are satisfied."
- Objection: You wouldn't say this about pain.
- Possible reply: But pain is an intrinsic state.
 - This doesn't matter. Compare a person's "P-height", the sum of their parents' heights. It is not intrinsic, but it is measurable on an absolute scale.

B. Must interpersonal welfare comparisons be possible?

- Hausman says a theory of welfare should allow IPU's; otherwise, it should be rejected.
- But many plausible accounts of well-being do not allow interpersonal comparisons.
 - E.g., levels of enjoyment, friendship, authenticity, accomplishment, etc., are all part of well-being.
 - Those things are hard (impossible?) to quantify.
 - So we couldn't make IPU's.

III. Hausman's Reply

A.

- Analogy: Compare two quantities:
 - X: How much water you have in your cup.
 - Y: How full your cup is.
- The zero-one rule is appropriate for measuring Y, but not X.
- "How well satisfied your preferences are" is like Y.
- [Why couldn't it be construed like X?]

B.

- Not all theories require precise interpersonal comparisons.
- [What is his point? Is it that we must have *some* interpersonal comparisons, but they need not be *precise*? And the preference-satisfaction theory does not enable even imprecise comparisons?]

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Notes #25: Corporate Social Responsibility

Q: Do corporations have a “social responsibility”?

For example, should they reduce pollution, below what is required by law?

Should they hire employees who *need* jobs the most?

Should they keep their prices down to resist inflation?

I. Milton Friedman

- *Biographical note:* Famous, Nobel-prize-winning economist. Prominent defender of free market capitalism, + monetarist macroeconomic theory. Author of *Free to Choose* and *A Monetary History of the United States*. Argued that the Great Depression was caused by monetary mismanagement by the Federal Reserve.
- Primary responsibility of corporate executives is to maximize profits.
 - Corporate resources are owned by shareholders.
 - Executives are *agents* of shareholders.
 - Shareholders want profit.
 - o Stated purpose of (most) businesses.
 - o Purpose of investing.
- Constraints on pursuit of profit: Friedman says each of these at different points:
 - Must obey the socially accepted rules.
 - Must obey laws.
 - Must obey accepted ethical limitations.
 - Must have “open and free competition without deception or fraud”.

[Questions about Friedman’s constraints:

Could the socially accepted ethical rules include notions of “social responsibility”? If no, why not? What is open & free competition? Does it preclude monopoly? Does it preclude Microsoft-like tactics?

What if some shareholders want the corporation to exhibit “social responsibility”?]

- Failure to maximize profits is wrong.
 - It is like “taxing” shareholders, customers, or employees. [He should have said it is like stealing from shareholders, or misusing funds.]
 - Executives don’t have the right to tax.
 - Social ends should be chosen by the democratic political process.
- Social responsibility initiatives won’t work.
 - Executives don’t know how to benefit society. That is the job of the political system.
 - Shareholders will fire them.
- Social responsibility philosophy will destroy society.
 - It supports the idea that profit-making is bad.
 - This will lead to socialism.
- But, it is permissible to start “social responsibility” initiatives as a cynical publicity ploy.

II. John Mackey

- *Biographical note:* Co-founder and CEO of Whole Foods Market. Supporter of free market economics, vegetarianism, & organic foods movement. Donates to animal welfare groups.
- The stakeholder philosophy: The business serves the interests of all its stakeholders:
 - Investors

- Customers
- Employees
- The community
- Entrepreneurs
- Why do this?
 - Because we care.
 - It improves the “brand” of capitalism.
 - It’s also good business.
- Response to Friedman:
 - The Whole Foods philosophy was in place long before our IPO. It was publicly announced.
 - Anyone who didn’t like it didn’t have to buy in.
 - Shareholders have the right to introduce resolutions to change the philosophy. No one has done so.
 - Therefore, management is not stealing from shareholders, etc.

III. Friedman’s Response

- As long as the corporate philanthropy is good business, there’s nothing wrong with it.
 - It must be good business; otherwise, Whole Foods would be out of business.
 - [Seems to ignore Mackey’s distinction about the *purpose* of corporate philanthropy, etc.]
- Giving to charity through a corporation makes sense only because of the tax laws (deductibility of corporate charity).
 - This means we should change the tax laws.
- Whole Foods Market has no special competence in distributing charity.
 - So their money would do more good if used to expand the business, or distributed as dividends.
 - [Not clear why Friedman thinks this. Is he confusing financial value with moral value?]

IV. T.J. Rodgers

- Mostly irrelevant attacks on Mackey:
 - Mackey didn’t hire his investors, because he can’t fire them; they can fire him. Mackey “spouts nonsense”.
 - Mackey is no libertarian. He’s closer to a Marxist.
- Maximizing profits is great.
 - Giving to charities is not better than maximizing profits (and thus giving to investors).
 - Businesses contribute to society by seeking profits. They lower costs for everybody. Ex: the semiconductor industry has lowered costs of transistors from \$3 to \$0.000003.
- Capitalism’s brand is fine.
 - Only 0.1% of public companies are guilty of serious wrongdoing.
 - Politicians and journalists have much worse records.
 - The public knows this. Businessmen are more respected than politicians or journalists. [No source cited.]

V. Mackey Responds

- To Friedman: No, we’re not in agreement:
 - Friedman says: Philanthropy is the means to maximizing profit. Profit is the end.
 - Mackey: Profit is the means of pursuing Whole Foods’ mission of improving health and well-being for everyone.
 - Friedman didn’t respond to this: The entrepreneurs define the purpose of the enterprise.

- o You can start an enterprise devoted only to profit.
- o But you don't have to do that.
- Again, my (Mackey's) message is better marketing for capitalism.
- To Rodgers:
 - Rodgers is indulging in personal attacks. I'm not a Marxist, etc.
 - I am not giving all stakeholders a property right in Whole Foods. Analogy: doctors have a responsibility to their patients. This doesn't mean the patients own the practice.
 - My business model is better than Rodgers'. Whole Foods Market is doing much better than Cypress Semiconductor.

Comparing Whole Foods Market (WFMI) and Cypress Semiconductor (CY):

- Stock price:



- Net income, 12 months ending 9/2009:
 WFMI: **\$111 million**
 CY: **-\$567 million**

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Notes #26: Public Choice Theory

I. About public choice in general

- Economics analyzes people's behavior using the assumption of *instrumental rationality*.
- Traditional economics:
 - Focuses on market participants.
 - Sometimes uncovers *market failures*: cases in which the free market outcome deviates from the socially optimal (utilitarian) outcome.
 - These are often used as grounds for state intervention.
- Public choice theory:
 - Applies the same principles to analyze *political choices*, incl.:
 - Voters
 - Politicians
 - Bureaucrats
 - Lobbyists
 - Etc.

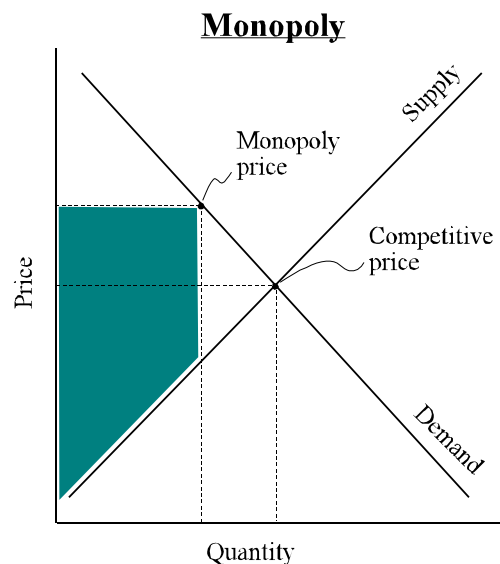
How do these people make their decisions? What are the social consequences?

II. The problem of monopolies & cartels

- What they do:
 - Restrict output, raise prices.
 - Results in lower total utility, esp. for consumers.
- A similar phenomenon: Cartels. Multiple businesses join together and make an agreement to raise prices & restrict output.
- This is often cited as a reason why we need government.

III. Why it is hard to establish cartels

- Cartel tries to raise price & limit production.
 - Parties outside the cartel produce more at the higher price, taking advantage of the cartel.
 - Cartel members have an incentive to "defect" against their fellow members.



IV. Government to the rescue (of the industry)

- Solution: Get government to enforce a cartel.
 - This is a typical solution to a "public goods" problem.
 - Gov't sets prices, to maximize industry profits. They say they are controlling the industry for public benefit.
- Why can they do this?
 - Regulatory agencies staffed by former and future industry leaders.
 - Industry insiders have more knowledge of the industry, its regulations, and their effects.
 - Industry insiders care more about the regulations than anyone else.
- What's the problem?
 - Harms the rest of society.

- Benefit to the industry is minimal
 - o They expend money on lobbying.
 - o They expend money on trying to steal customers with non-price competition. Increased quality, etc.
- Ex: The Civil Aeronautics Board fixed plane fares (until deregulation).
 - PSA's fares were about ½ of interstate airline fares.
 - Airlines ran planes half empty.
- Similar logic applies to craft unions: Plumbers, electricians, doctors.
 - Impose licensing requirements.
 - Alleged purpose: to ensure quality for consumers.
 - Actual function: To limit supply and drive up prices.
- Example: The AMA
 - AMA controls state licensing boards.
 - They claim to be ensuring quality. But limiting # of physicians means fewer people get medical care, or everyone gets less medical care.
 - Licensing restricts supply & drives up prices.
Ex.: Applicants must be U.S. citizens; tests must be taken in English.
 - The AMA controls which medical schools are approved. They make medical schools restrict entry.
- Analysis of the incentives
 - Industry insiders: restrict supply, raise prices. Concentrated, well-organized interest group.
 - Voters: Face a public goods problem. Diffuse, unorganized. No individual has interest in doing anything.
 - Politicians: Help industry, not consumers.

V. The problem with democracy in general

- Good laws are a public good.
 - Costs of producing them: Time, energy. Borne by the individual.
 - Benefits go to society as a whole.
- Public goods are underproduced.
- That is why good laws are underproduced.

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Notes #27: Economists versus the Public

I. The public has 4 main biases

- Anti-foreign bias. They see interactions with foreigners as a threat.
 - Outsourcing
 - Trade & protectionism
 - Immigration
 - Foreign aid
- Make-work bias. “Jobs” are an end in themselves. Labor-saving is bad.
 - Downsizing
 - Technological progress
 - Trade & outsourcing again
 - Gov’t policies that cost labor. Being costly in labor is good, because it “creates jobs”.
- Anti-market bias. The market is bad.
 - Prices result from conspiracies, rather than supply & demand.
 - Executive pay needs to be controlled.
- Pessimistic bias. Things are constantly getting worse.
 - Living standards over the past 20 years.
 - Will the next generation live better than this one?
 - Deficits, welfare dependency, high taxes are disasters waiting to happen.

II. Are the economists biased?

- Because of their high incomes?
No. High-income non-economists think like the rest of the public, not like economists.
- Because of their conservative ideology?
No. Most economists are Democrats.
- The simplest explanation for the disagreement is that the experts have knowledge, and the lay public do not.

III. Implications

- Explains why public policy is often bad. Voters are confused. They vote for policy-makers who share their confusions.

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Notes #28: Rational Ignorance & Irrationality

I. Rational Ignorance

- Theory
 - Benefits of information: Better decisions.
 - Costs of information: Time & effort.
 - Collect information when the expected benefit exceeds the expected costs.
 - Political information is a public good: Benefits go to society, costs go to individual.
 - o Prediction: Little political information will be purchased.
- Evidence
 - Most voters do not know length of House terms & cannot name their representatives & senators.

During the 1992 presidential campaign 89 percent of the public knew that Vice President Quayle was feuding with the television character Murphy Brown, but only 19 percent could characterize Bill Clinton's record on the environment... 86 percent of the public knew that the Bushes' dog was named Millie, yet only 15 percent knew that both presidential candidates supported the death penalty. Judge Wapner (host of the television series "People's Court") was identified by more people than were Chief Justices Burger or Rehnquist.¹
- Solutions
 1. The Miracle of Aggregation: Assume ignorant voters vote randomly. Informed voters vote for the best candidate. ◦ Best candidate will win.
 2. Voters could punish wayward politicians very severely.
 3. Special interest laws: Someone could introduce an omnibus anti-special-interest-law bill repealing all of them.
 4. Voters aware of their own ignorance could adopt the rule, "When in doubt, say no." Similar to buyers who are ignorant of the quality of a used car.
- Q: Why don't these things happen?

II. Rational Irrationality

- Premises
 - Voters have non-epistemic belief preferences: They want to believe things for reasons other than truth, evidence, etc.
 - Voters can exercise some control over their beliefs.
 - Correct political beliefs are a public good. And voters know this.
- Prediction: Rationality will be underproduced.
- Evidence explained by the theory
 - Individuals are emotionally committed to their political beliefs & resist new information, even if it's free.
 - Ignorance commonly conjoined with high degree of subjective certainty.
 - Systematic biases in voter preferences. E.g., protectionism, general anti-foreigner attitudes.
- Against the standard theory of special interest influence: Inefficient policies are *popular*.

¹ Delli Carpini & Keeter, *What Americans Know about Politics and Why It Matters*, 101.

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Review of Unit 4

Things you're supposed to know:

These people & their views:

Amartya Sen
Milton Friedman
Daniel Hausman
Ruth Weintraub
John Mackey
T.J. Rodgers
David Friedman
Bryan Caplan

These concepts/distinctions:

(Psychological) egoism
Sympathy / Commitment
Act- vs. rule-consequentialism
Positive (vs. normative) economics
Preference satisfaction (Hausman)
& the theory of welfare based on it
Interpersonal utility comparison
Ordinal vs. cardinal utility
The zero-one rule
Corporate social responsibility
Public choice theory
Monopolies & cartels
Rational ignorance
Rational irrationality
& costs/benefits of rationality
These biases:
anti-foreign
make-work
anti-market
pessimistic

These examples & what they show:

Falling bodies & wind resistance (M. Friedman)
Degrees of pain (Weintraub)
Cups of water (Hausman)
The AMA (D. Friedman)
The CAB (D. Friedman)

These views/arguments:

Comparison between self-vs.-others and present vs. future-self (Sen)
Friedman on justification for economic theories & realisticness of assumptions
Hausman on how to measure degree of preference satisfaction
- if you have ordinal utilities
- if you have cardinal utilities
Friedman on responsibility of business executives
& how "social responsibility" initiatives are like taxes (or theft)
& the competence of executives.
Mackey's "stakeholder" philosophy
& response to Friedman on taxes/theft
& how purpose of corporation is defined
How good laws are a public good
Why regulations serve concentrated, organized interests & industry insiders
Monopolies & cartels: what they do
The problem with maintaining cartels
The miracle of aggregation
& why Caplan thinks it fails
How rational irrationality explains more than ignorance (Caplan)

