Liberalism, Rationality, Self Interest, and the role of the state in political economy

Rational Choice Theory

Review: Liberal Theory of Resource Allocation

Assumptions Individuals desire freedom above everything Economic actors are rational Free, rational actors naturally create markets The model The market Non-coerced Exchange Private Property Markets clear through supply, demand, and price

Three important concepts

- Voluntary exchange is consensual and free
- **Consensual exchange is efficient** (no transaction costs because the exchange is mutually beneficial)
- **Property rights** are necessary (so everyone has something to exchange

How do Liberals feel about the role of the State?

•Does this mean they want weak states because the market allocates resources efficiently?

In fact, Liberals want state power to do a lot of things.
All liberals agree that the state should protect the competitive market, protect property rights, protect the right to be free

•Liberals aren't opposed to authority, only to certain kinds of authority

But should governments also....

- Take positive action?
 - Intervene in markets when they fail?
 - Regulate in order to minimize externalities?
 - Provide public goods?
 - Provide social safety nets for those who cannot participate in market allocation?
- Liberals are split between those who want the government to protect the market and those who want it to take positive action

The split comes down to preferences for more freedom and efficiency (produces the ultimate social good) vs. more protection of equality and community (individual freedom can produce social "bads")





Today's Menu: The case for freedom and efficiency

- The rationality assumption
- Self-interest
- constraints
- competition
- When is there a need for cooperation?
- How do you get cooperation?
- and the role of the state in political economy:

Classical liberal assumption: Individuals are self interested

- Individuals are at the center of all social activity
- self-interest is not the same as "selfishness"
- self-interest is premised on the idea that all
- individuals have specific ("reasonable") goals and that they behave in
- way that best enables them to achieve those goals

Assumption : Individuals are Rational

- Individuals are rational
- They are motivated by goals that express their preferences
- But you can't always have what you want!
- Goals are shaped by constraints and incentives like
 - Other competitors in the market
 - Information (which is always imperfect)
 - State policy (which sometimes tries to constrain the individual for the good of society as a whole

Goals

- Can you achieve your goals more rationally by cooperating with others or by striking out on your own?
- We make these calculations all the time.....
- Often whether we cooperate or compete depends on the size of the group we are participating in

How rationality is different depending on the size of the group LARGE GROUPS SMALL GROUPS

- the typical participant won't cooperate that much—it's not rational
- If cooperation is tried, there will be lots of free riders
- No social costs for narrow selfinterested behavior
- Large groups trying to cooperate can't act efficiently
- Selfless behavior is not even praiseworthy.

- More social incentives
- Selfless behavior is rational
- Transparency
- Reputation
- Social pressure
- Interaction
- Trust
- consensus

Markets allocate resources in large, impersonal groups that don't require coordination

- Rationality is different in large groups than in small groups
- Large groups encourage self interest
- They discourage cooperation
- They encourage competition
- Markets depend on self-interest and competition to provide the efficiency that produces wealth

One group of liberals believe that "large group" rationality is endemic to human nature

- Most incentives encourage narrow, selfinterested rationality
- Our very nature discourages cooperation

Game Theory: Life is just a Game!



Game of Achieving what you want : The Stag Hunt---



Cooperation is always optimal but rarely achieved: Here is what the calculations look like:



Our calculations about whether to go off on our own or cooperate are dependent on what others do



That's a second game: Strategic interaction and the prisoners dilemma



The problem is imperfect information

THE PRISONER'S DILEMMA

Column Player

		Cooperate	Defect
Row player	Cooperate	R=3, R=3 Reward for mutual cooperation	S=0, T=5 Sucker's payoff and temptation to defect
	Defect	T=5, S=0 Temptation to defect and sucker's payoff	P=1, P=1 Punishment for mutual defection

And imperfect information leads to behavior that causes social costs



Why so much doping?

THE PRISONER'S DILEMMA

Column Player

		Cooperate	Defect	
Row player	Cooperate	R=3, R=3 Reward for mutual cooperation NO DOPING Low Payoff	S=0, T=5 Sucker's payoff and temptation to defect	Column gets High payoff because Row is a sucker and gets nothing dope because we get something
	Defect Ro pa	T=5, S=0 Temptation to defect and sucker's payoff w gets High yoff because	P=1, P=1 Punishment for mutual defection We botl At least	
	Co	lumn is a sucker		

Each of us, acting rationally, contributes to climate change



Cooperation is optimal

- You get more meat by all chasing the stag together
- You can mitigate climate change if everyone cooperates to do so
- You won't ruin sports if everyone cooperates to reject doping
- But if you are rational, what are your incentives to cooperate and reduce your own freedom?

So if cooperation is optimal, how do you get it?



You gotta have trust

- it is very hard to move from the low-trust situation, in which both prisoners confess, each hunter chases his own rabbits, --or everyone drives their car as much as they want---to the more trusting situation, in which both team up to get a light sentence, to bring down the stag—or everyone together stops climate change.
- You try to achieve what you want on your own because the risk that others will defect from cooperation is too high
- If you have trust, you recalculate your risk of cooperating---trust lowers your perception of risk

How do you get trust?

 Any move to the high-trust environment is going to require its own, possibly costly, attempt at coordination. Can only higher authorities coordinate, change risk, reward calculations and create trust in large groups?

- Trust reduces our "transaction costs" in groups
- That's why we have institutions to help create cooperation
- institutions formalize trust and thus dramatically expand our ability to interact with those beyond our immediate neighbors.
- That's why we have laws and law enforcement

Governments coordinate economic activity when uncoordinated markets "fail"



But are governments really the best solution to cooperation in large groups? Some liberals say No: Governments don't have good information and they make big mistakes Take this example



Some liberals say NO: Governments don't have good information and they make mistakes



Herb Farm that wants organic certification



Coase Theorem



Important role of Information

Action ↑ ↑ Desires←Beliefs ↓ ↓ Information

Let's look again at the problem of illegal drugs and try to bring all these things together



Supply is abundant.....



Production costs are low.....



Processing is easy and cheap....



Demand is High and steady despite illegality (repressed supply)



Market is large



Price should be low because production is cheap and demand high

 Assumption: price is determined by the quantity supplied and the quantity demanded





If supply and demand both become illegal....demand and supply are repressed, raising the price





Risk of arrest, jail, destruction of supply

Illegality creates rational incentives to produce cocoa.....

Corn: \$150 per acre Livestock: few \$ per acre Cocoa: \$5-10,000 per acre



What crop would a rational farmer grow?

And it's rational to sell it.....







So...applied to the drug trade: Illegality and high prices create drug lords with market monopoly. Monopoly creates.....

Obscene profits for drug lords

\$1,390,965.00 U.S. Currency

Pomona, CA 1/18/2006

At the very least, the state should legalize the drug trade because illegality leads to monopolies and Monopolies oppose freedom



- Because they limit alternatives for consumers
- Because they block competitors from entering a market
- And therefore block freedom of exchange

And it gets worse: Govt. efforts to make the market illegal means using the military to try to get rid of the market



And imposing Harsh Penalties for participating in the market



And fostering corruption of law enforcement.....



And creating a nightmare of jails filled with casual drug users.....



All adding up toGovernment Repression of Freedom



So some Economic Liberals believe: The War on Drugs suppresses Freedom...



What would the Coase theorem say?

