

Democracy, the Market, and Human Behaviour

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AGF-Lecture 2012

British Academy

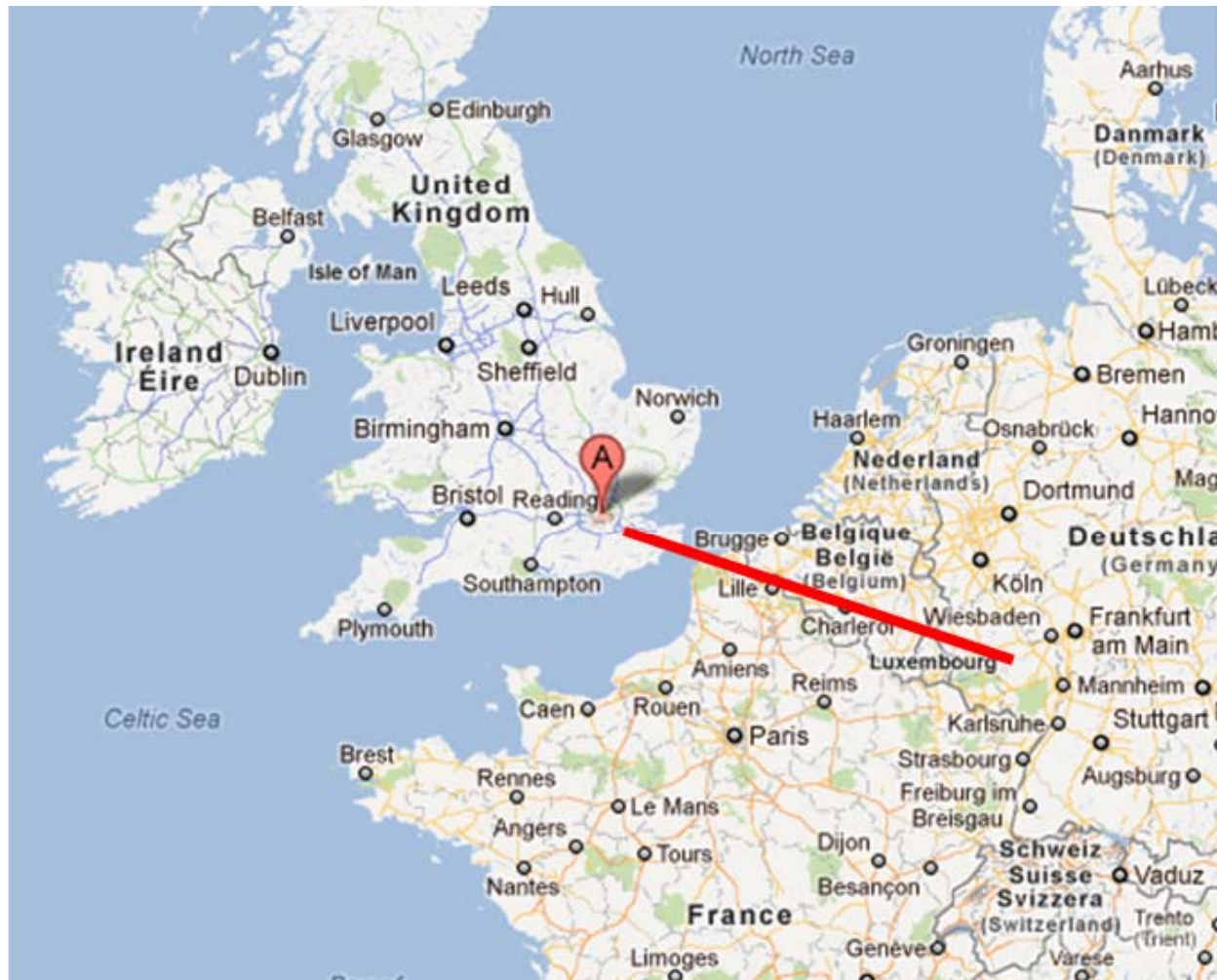
London 31 January 2012

I Britain and Germany: Ideas for a Good Economic System

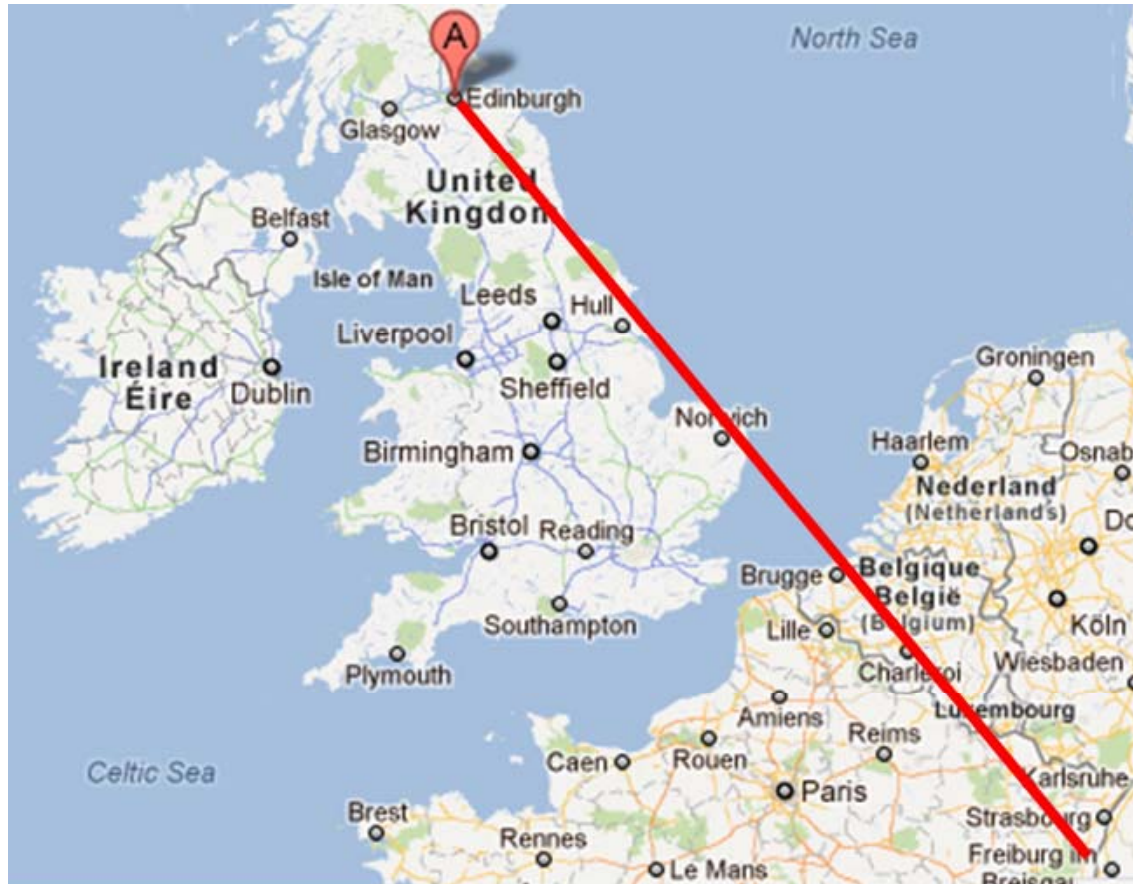


Germany: The Economic Laboratory after 1945

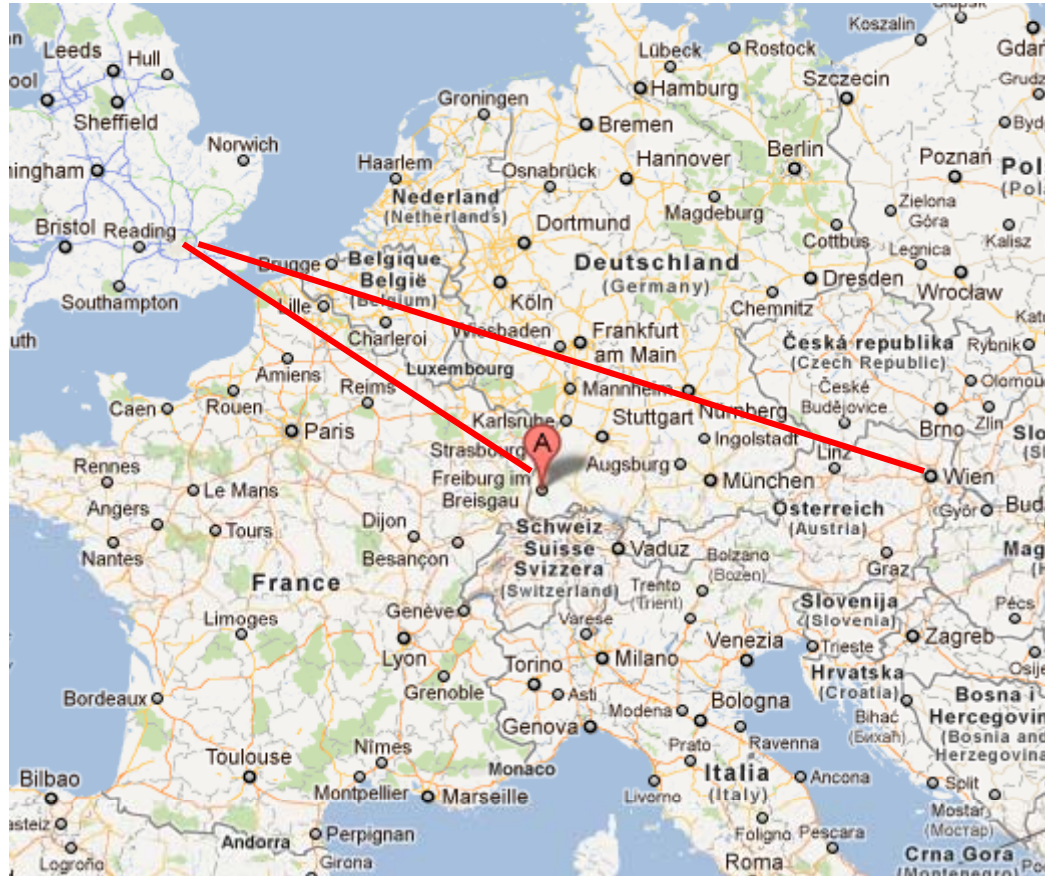
“The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler a few years back. “ J.M. Keynes (1936)



Marx: From Trier to London



Adam Smith to Eucken (Freiburg School)



Hayek: from Vienna to London to Freiburg

The Social Market Economy:

1. An Economic Order of Competitive Markets
2. A System of Social Security

On the second point see:

Sir Tony Atkinson

Britain, Germany and Social Europe 1973-2020

First Anglo-German Foundation Lecture

25 January 2011

My lecture is on the first point

II Normative individualism: how
to put "freedom" into economic
models?

Why homo oeconomicus has survived for so long

- “Normative individualism” -> welfare economics
- Individual preferences are the measuring rod of performance of economic institutions
- Assumption of homo oeconomicus implies the assumption of fixed externally given preferences
- Does this programme break down when preferences are endogenous?

Normative individualism – welfare economics – is about the question: how does a society of **free citizens** work?

III Adaptive preferences: the fundamental theorem

The Endowment Effect

The coffee mug experiment

50 students:
willingness to sell



50 students: willingness
to buy



500 € selling price



Anti-endowment effect =>
Circular improvement
sequences

700 € buying price



Adaptive preferences (AP)

A generalisation of the endowment effect. Here I define AP with respect to influences of the person's past on present choices.

But the theory also applies to interpersonal influences on tastes.

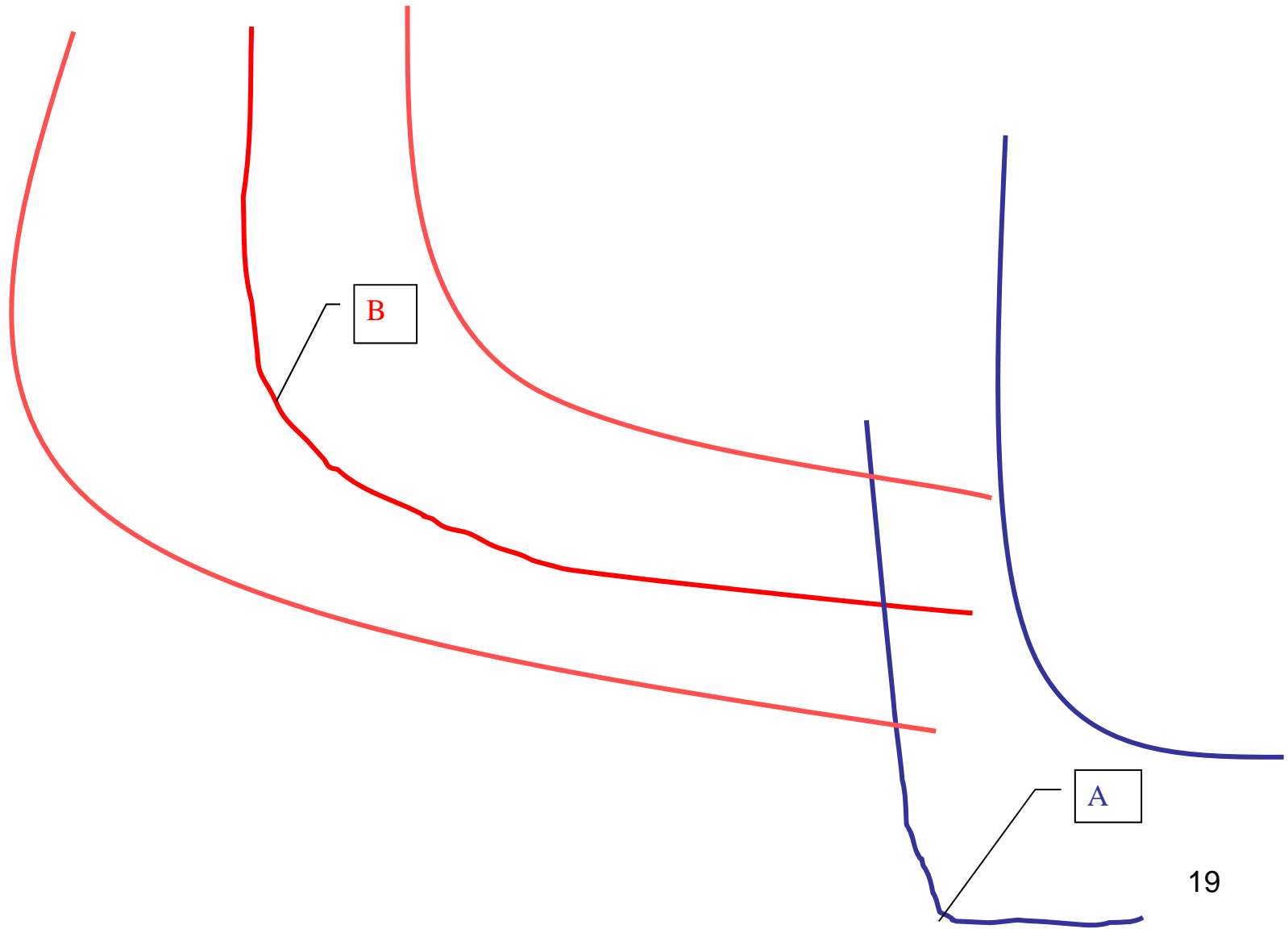
Behavioural economics supports the hypothesis of adaptive preferences

- Sunstein and Thaler: Nudge
- Endowment effect
- The Default Option: The Oblomovian trait in us
- Framing: Kahneman and Tversky
- Preferences dependent on reference point
- Loss aversion
- Satisficing: Herbert Simon, Reinhard Selten („Anspruchsanpassungstheorie“)
- Follow the crowd: imitation

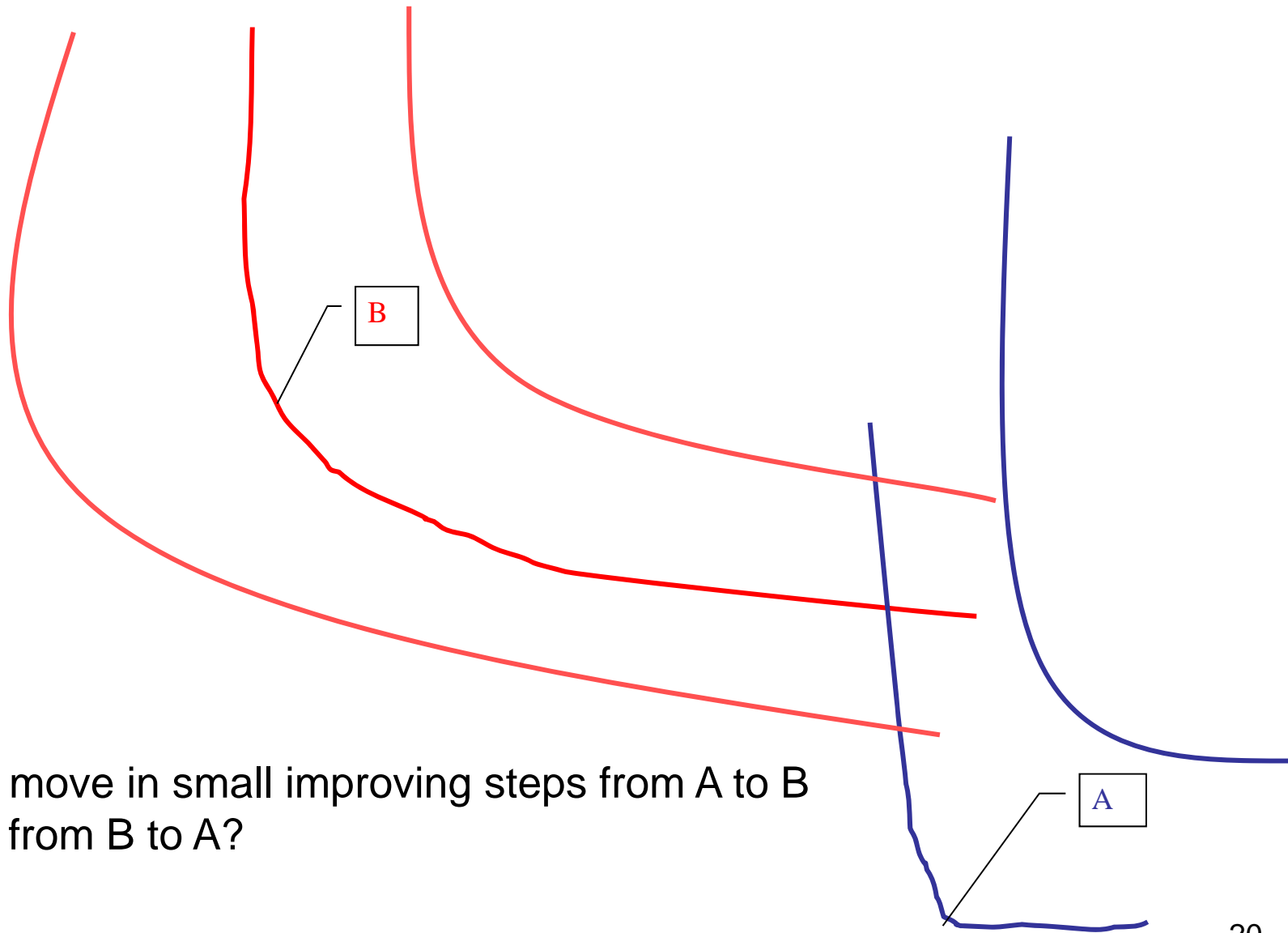
Adaptive preferences, continued

It means: **preference conservatism**

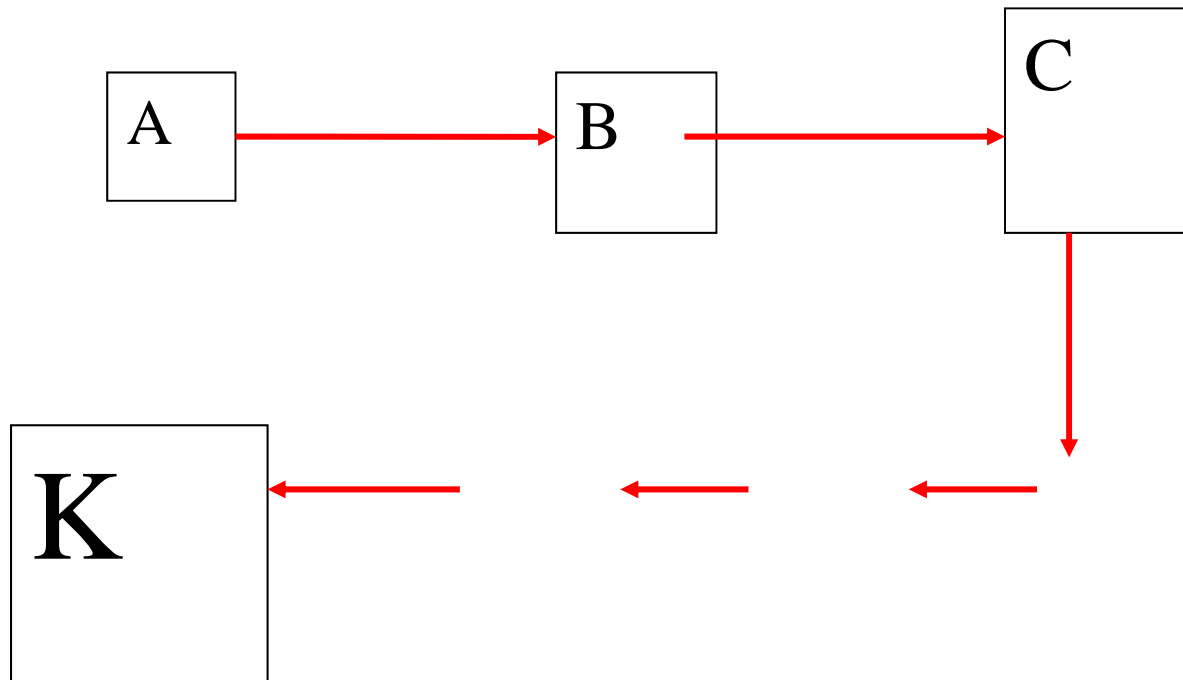
The comparability problem



The comparability problem



Could we move in small improving steps from A to B
– but not from B to A?



An improvement path = a non-circular improvement sequence

Equivalence theorem:

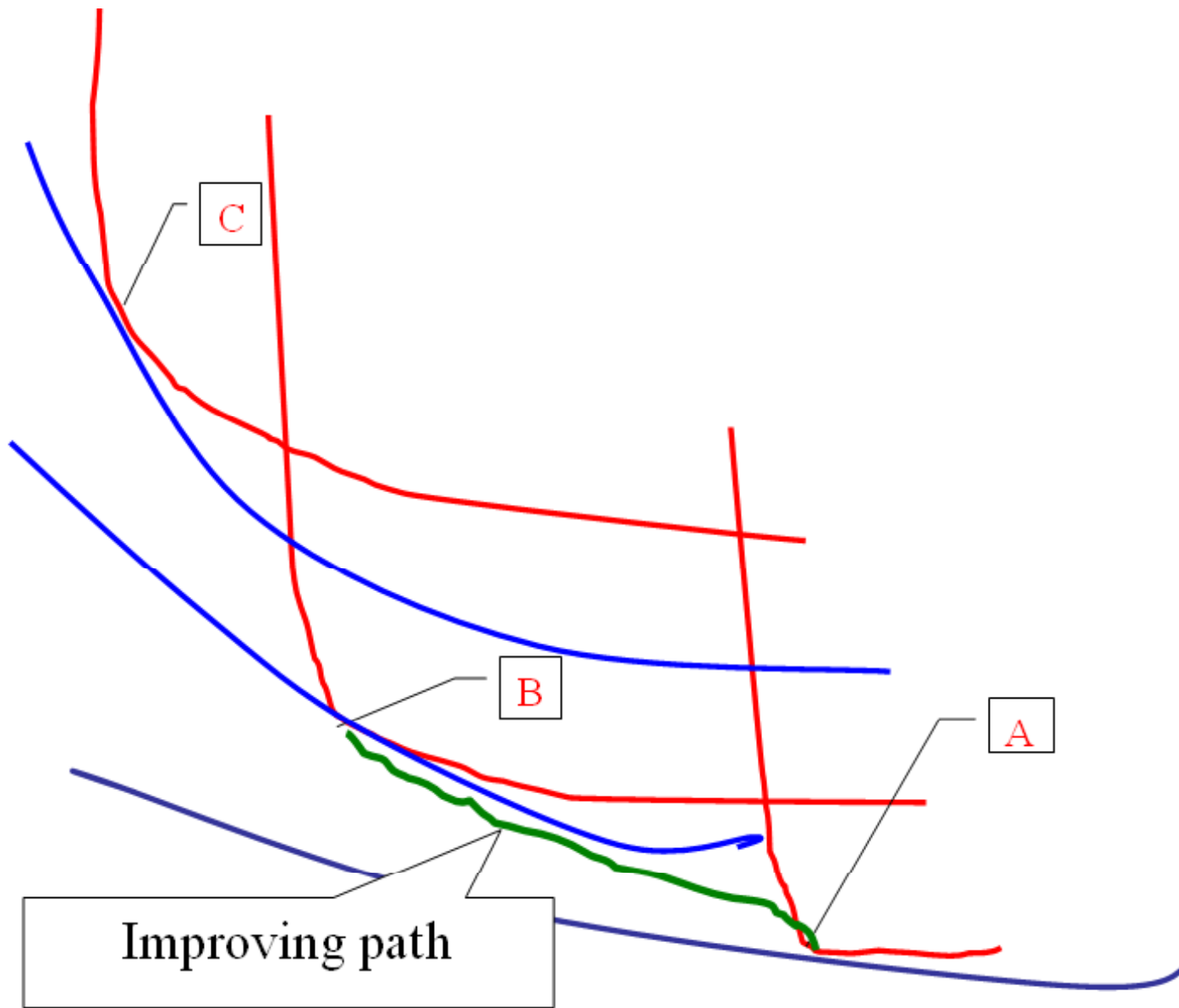
1. If every improvement sequence is an improvement path then preferences are adaptive
2. If preferences are adaptive then every improvement sequence is an improvement path

IV Characteristics of the "long run demand function" under adaptive preferences

short run demand function: $x = f(p; q)$

long run demand function: it satisfies the strong axiom of revealed preference

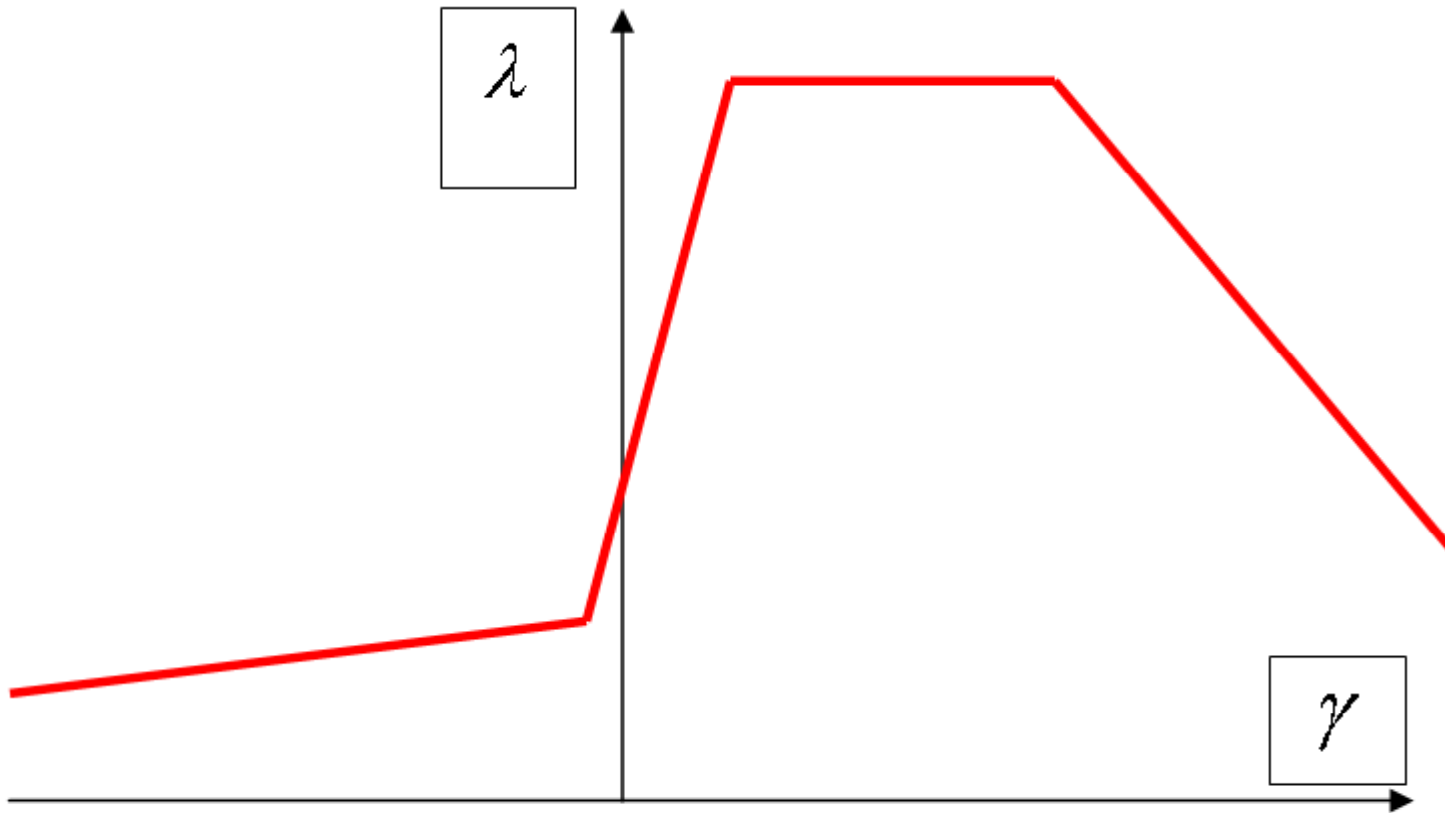

$$x = F(p)$$



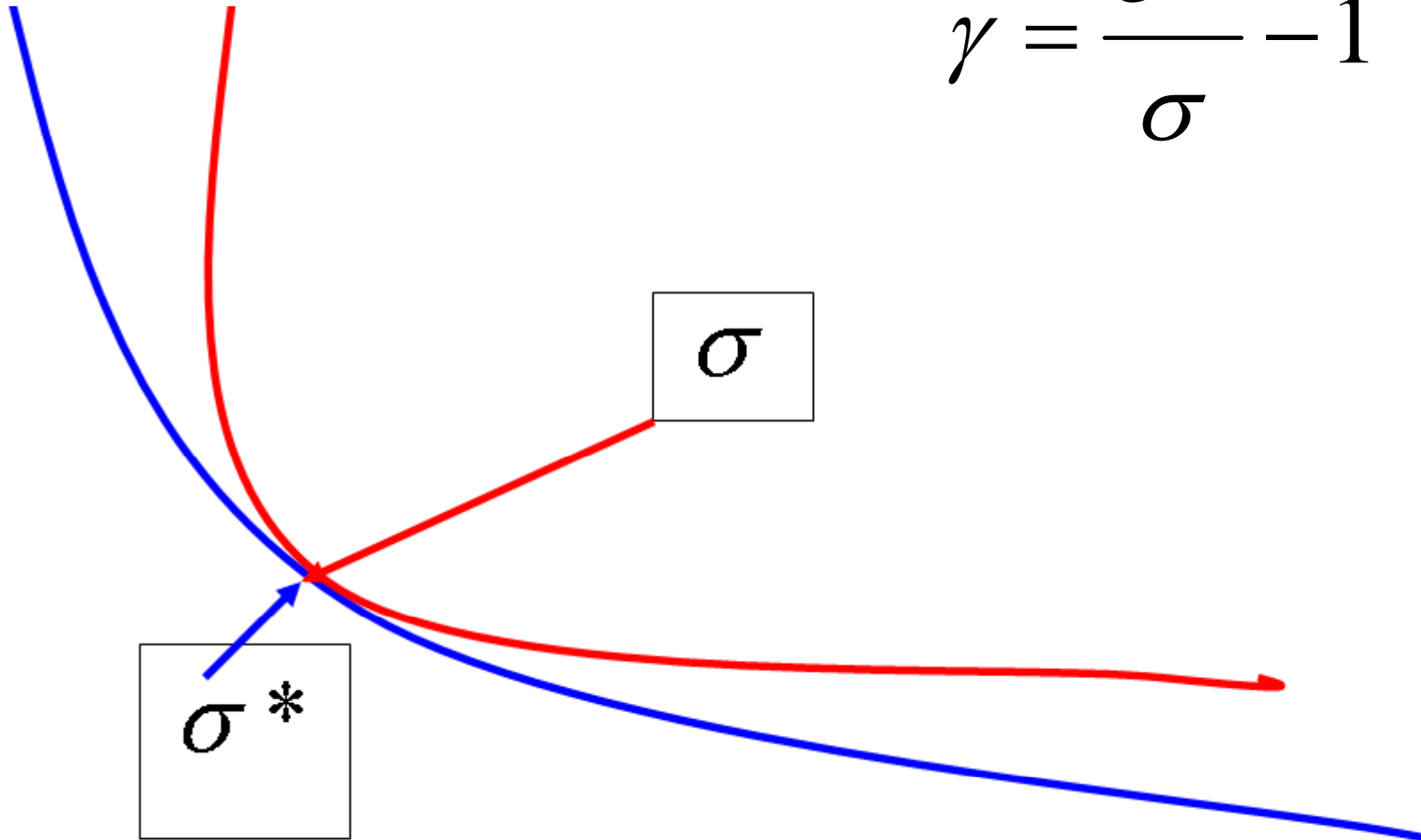
V Rethinking rationality

- Even if we are “irrational” we want to be rational: nobody wants to be seen as a fool
- Even if we lack willpower we want to have willpower
- Improvement path: Learning rationality
- Rationality as a process rather than a state we are in or are not in. “Unfolding” of rationality
- A degree of rationality as a prerequisite of democracy
- Quasi rationality of adaptive preferences (survival value of adaptive preferences)

$\lambda(\gamma)$ survival value of the “degree of adaptiveness” γ



$$\gamma = \frac{\sigma^*}{\sigma} - 1$$



VI The chores of education

- Adaptive preferences include the habit of imitation
- A large part of the child's education is imitation
- Habit formation: if you want your child to like reading books when grown up you induce him/her to read books when young
- Education would fail if preferences were anti-adaptive

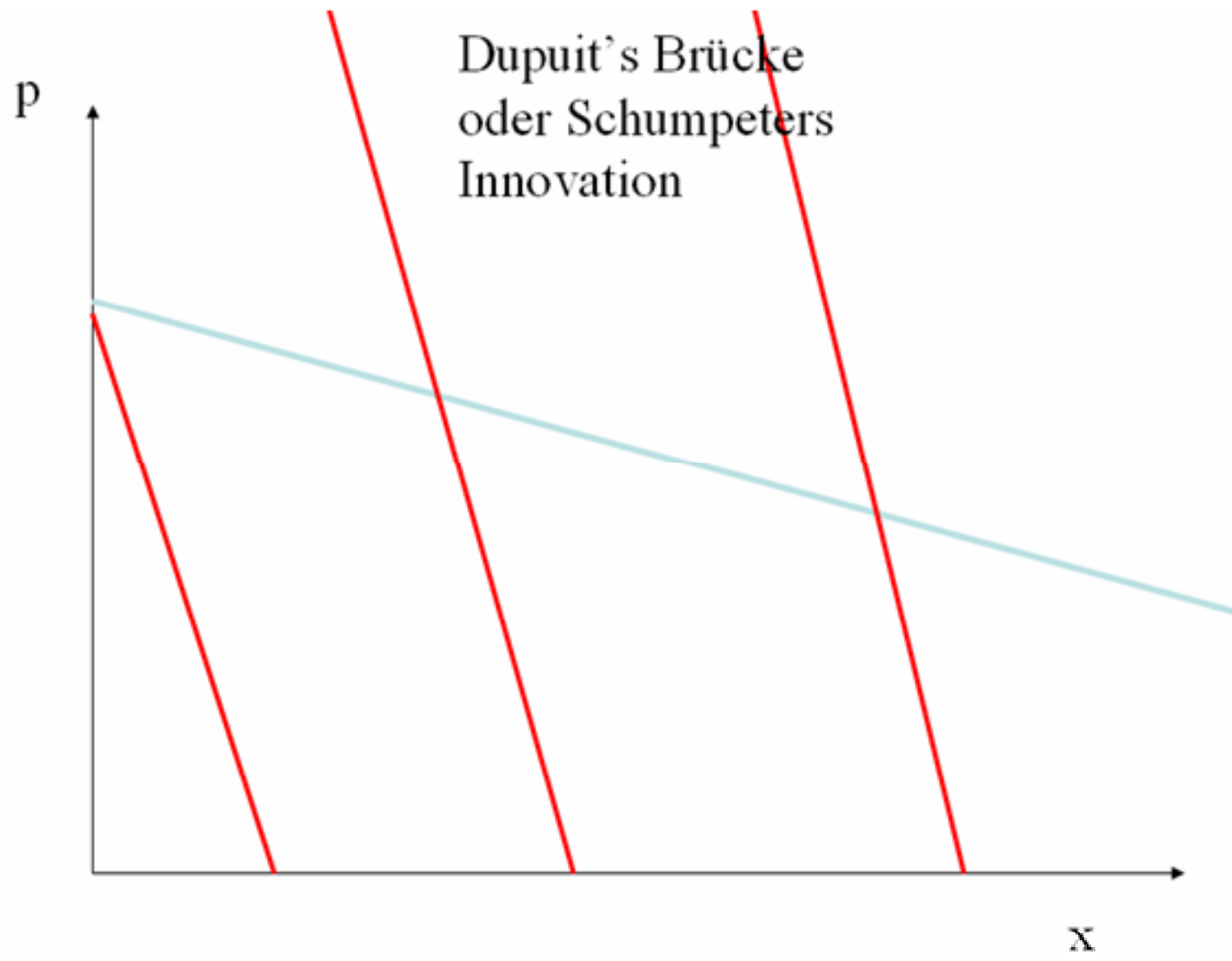
VII Decentralised Decision Making

- Partial Equilibrium Analysis
- "incremental efficiency" – or Kaldor- Hicks- Scitovsky efficiency
- Universal use by government and by private firms as well as by individuals
- The "rest of the world" generally is represented by the money involved in the particular decision
- "money form" of the representation of everything with everything. Is it appropriate?
- If yes, this is a vast simplification which is the prerequisite for a dynamic economic system
- Otherwise the economy would stagnate, because the default option to change nothing would be overwhelming

Decentralised Decision Making contd.

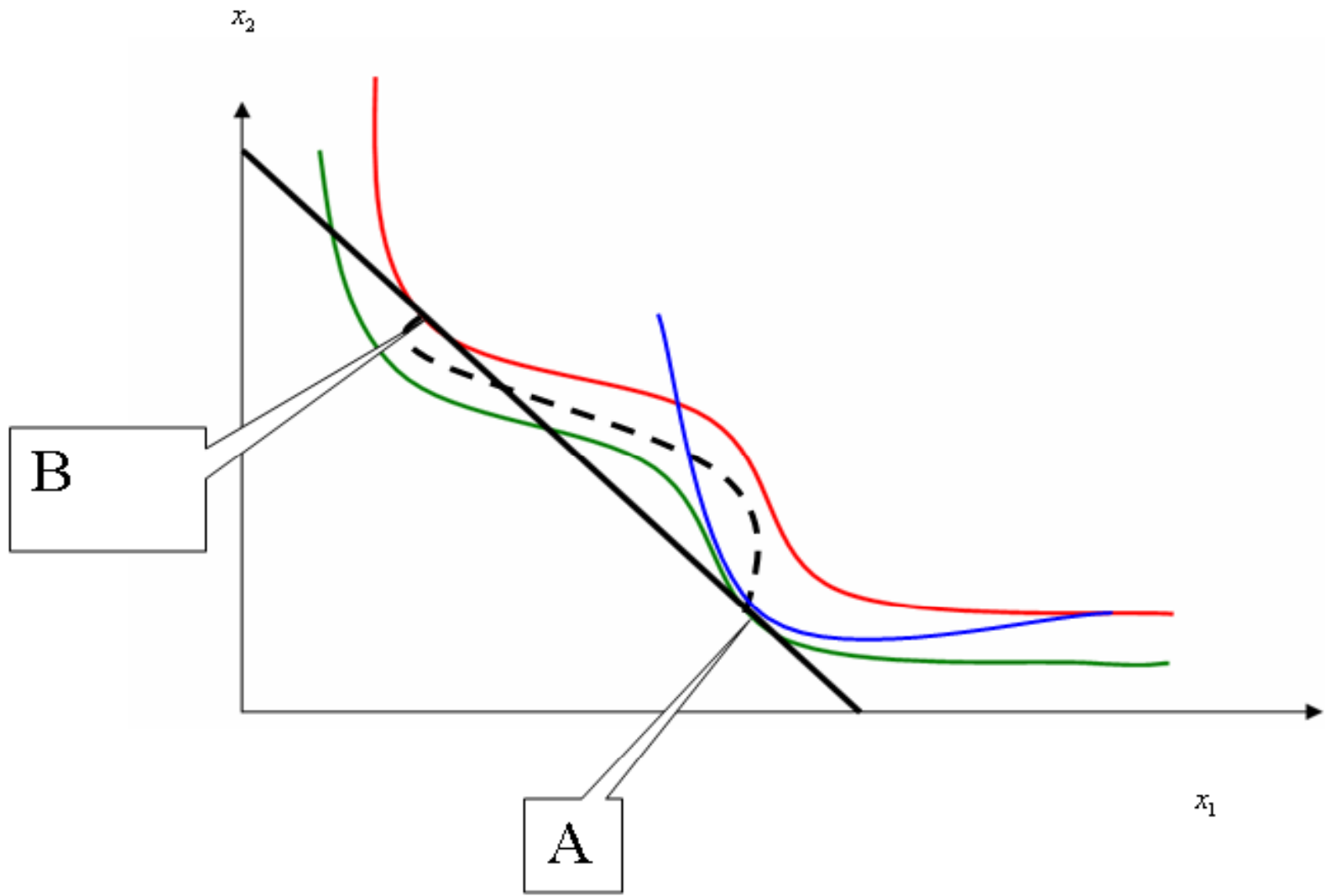
When is partial equilibrium cost benefit analysis appropriate?

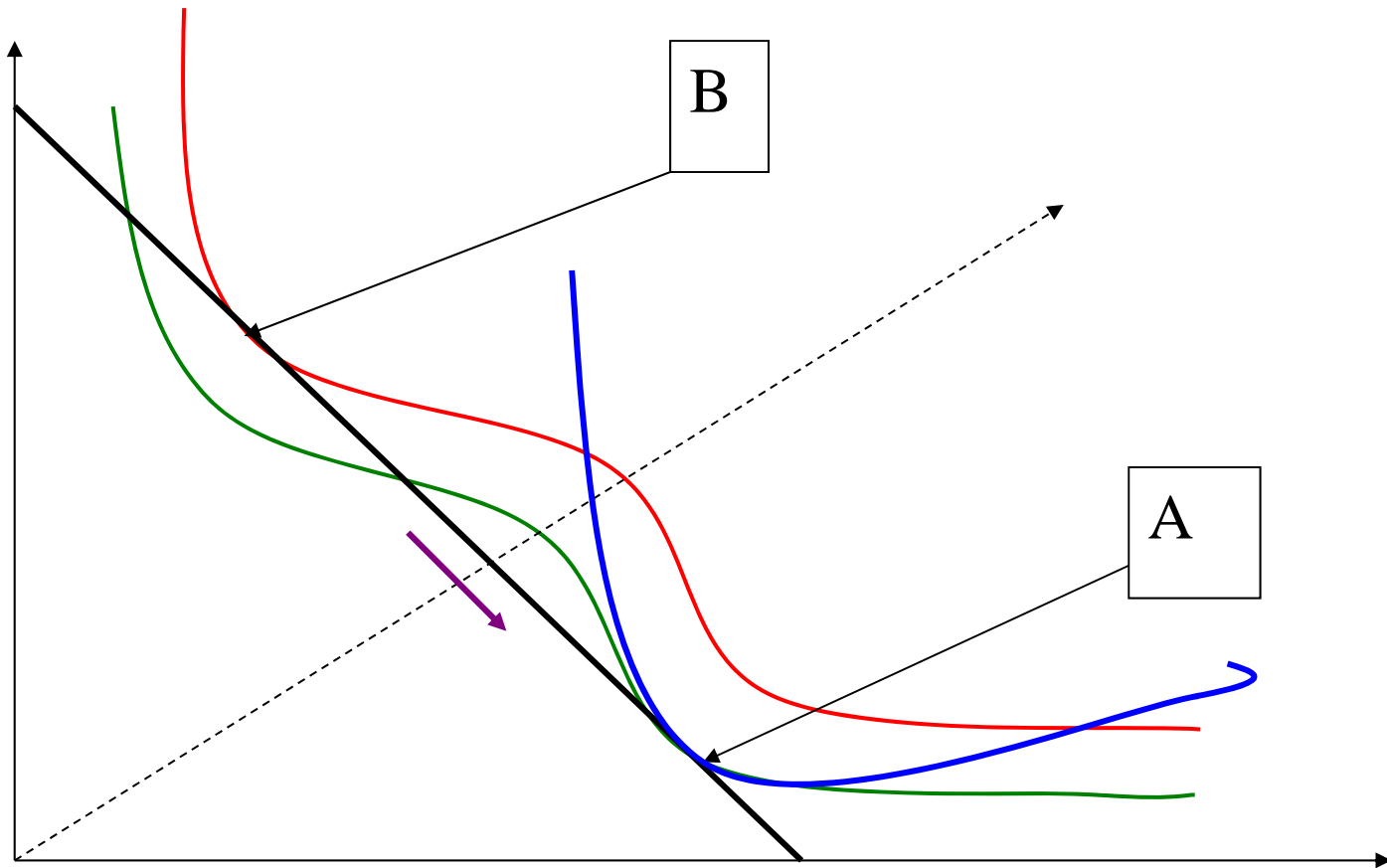
- Under which conditions is it appropriate with adaptive preferences?
- Test: if a project is accepted with ex-ante preferences will it also be accepted with ex-post preferences?
- There is a large class of “projects” that pass this test
- There is a conservative bias: the reverse “test” will frequently fail: if a “project” would pass under ex-post preferences it may frequently fail under ex-ante preferences and thus may not be implemented



VIII

Psychic provincialism: The impossibility of global optimisation





IX Collective conservatism

- Health care financing: United Kingdom, Germany, Switzerland
- Nobody is satisfied with the domestic system
- But in all three countries people want to stick to **their** system
- => adaptive preferences
- If there are many equilibria do there exist improvement paths between them?
- But the politics of health care systems makes it impossible to overcome the observed preference conservatism

Collective conservatism in general

- Provided an institution has reached a local equilibrium it will be very difficult to obtain fundamental change by majority vote.
- The importance of the default option: the law remains what it is.
- Language preferences. Language diversity
- Stability of religions, once established in a region
- Stability of cultural diversity

X The politics of adaptive preferences

- **The problem of the best economic order**
- if everything were decided by majority vote society would stagnate and stay in the local equilibrium into which it had moved a long time ago
- Schumpeterian entrepreneurs are likely to anticipate preference changes, if they bring new products to the market.
- And they don't need a majority vote
- **People say "no" to change; but if this change is progress and if it is implemented anyway then they say "yes" ex-post, where ex-ante they had said "no".**

The “Quintessence”

- Normative individualism remains possible with endogenously changing preferences, as long as preferences are **adaptive**
- Adaptive preferences correspond to observed human behaviour and have high survival value
- Adaptive preferences imply **preference conservatism**
- This implies collective conservatism
- The market economy and Schumpeterian entrepreneurship provide change and progress overcoming collective conservatism, **due to adaptive preferences**

Economists!

**I recommend that you to join me
in this exciting
research programme!**

Non-Economists!

**It's never too late to become an
economist!**