

MICROECONOMICS AND POLICY ANALYSIS - U8213

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Class Notes - Spring 2001

Economic Reasoning

Monday, April 16th

Reading: Schelling

There is tension between multiple objectives when making policy choices.

For example: in developing countries that are scarce in resources, how do you choose between schools versus healthcare? In some contexts you can afford to expand everything (budget surpluses), but not usually.

The Ethics of Policy (p3)

However, when making policy choices, those choices will affect people other than yourself. Public, elected officials usually have their own interest. Many politicians are keenly aware of how it will affect their re-election possibilities. But what perspective should we adopt?

“Ethics of policy” is “what we try to bring to bear on which we don’t have a personal stake”.
(p.3) The policy should be formulated from the point of view of who the policy will affect rather than the effects on you.

The Ethics of Pricing

Schelling uses the example of an energy shortage, where the price of gasoline goes up and leads to gasoline rationing.

If the market is left to regulate itself what would happen. When the price goes up, the poor can’t afford gasoline. Then energy coupons would allow everyone to buy a little gasoline.

In the example of gasoline rationing, is there way to reformulate the policy to see if you can make a pareto improvement. Yes, in energy rationing you can. An energy coupon has a monetary value. Once it is assigned a monetary value it can be traded. It would not be as flexible as cash or a cash coupon. You could use it to buy something else. So, the best thing for the individual would be cash.

Dehejia used the example of buying a gift certificate for ice cream cones (his recommendation for ice cream is a place called Cones on Bleeker Street). Would people be better off with a \$5 gift certificate or \$5 in cash. Do we trust people if we give them cash? This issue is important in cases where there may be a diversion of interests for example in the case of giving money to adults and we want it spent on children.

Schelling's initial argument is that economics need not be involved in ethical debates about what is good and what is right. The first step is to delink the ethical discussion from the economic discussion.

The Clash Between Equity and Incentives

Schelling discusses the issue of moral hazard in policy making. The inescapable element of moral hazard is that we want to help people in need of help. This creates a situation where people may not have the motivation to change their situation.

He states that "an unsympathetic way to restate this is that a preponderance of government policies have the purpose of rewarding people who get into difficulty" (p.7). He goes on to say that "almost any compensatory program directed toward a condition over which people have no kind of control, even remote and probabilistic control, reduces the incentive to stay out of that condition and detracts from the urgency of getting out of it" (p.7).

He is essentially saying that there really is not question of ethics. It is simply a fact that if compensated, people will not avoid the condition that created their need or remove themselves from it. Policy making becomes important in identifying that the principals that conflict – creating policy that equitable and the issues of moral hazard.

Valuing the Priceless

How do assign value to things that are priceless such as the cost of a human life? Safety? False verdicts?

Schelling suggests that people should price their own life. "Instead of asking what society's obligation to *them* is, we should ask how *they* would want *us* to spend their money". If one person is poor and you are rich, Schelling argues that you don't necessarily need to feel guilty that the poor person would rather spend their money on something else other than safety.

Using his reasoning two things become evident:

- 1) the issue of poverty is somewhat erroneously tied into a large number of policy debates
- 2) the policy issue of installing lights cannot be divorced from the question...what else could this money be spent on?

Schelling's method for policy making is to compare alternatives and evaluate the policies based on the weighting system of those the policy affects.

Escaping the Dilemma of Equity and Efficiency and the Market Ethic

- 1) have the view that people are capable about making decisions about themselves on their own behalf – "people are better at spending their own money than somebody spending it for them" (p. 25)
- 2) should be clear about how many issues and keep them separate

For any intervention you should be clear about

- 1) justifying the intervention
- 2) what types of intervention you need

