Ethics and Policy Decisions
An Economic Perspective

Tom McGuckin
Professor of Economics
New Mexico State University

Terms of Use: The author created this material for classroom use in conjunction with NMSU’s Daniels Fund Ethics Initiative. No permission or compensation is needed for classroom use as long as it is acknowledged to be the creative work of the author and NMSU’s Daniels Fund Ethics Initiative. For publication or electronic posting, please contact NMSU’s Daniels Fund Ethics Initiative 1-575-646-4083.

Copyright 2012 - NMSU College of Business.

© 2012 NMSU College of Business Daniels Fund Ethics Initiative
Decisions

• Economics breaks down decision making into four general categories
  – Individual choice
  – Exchange and contract
  – Public policy decisions
  – Conflicts
Individual Choice

• Rational and self motivated individuals maximize their individual utility or preference ordering but are constrained by their budget
  – You buy a pizza because it is what you want and you have $20 in your wallet. Economists feel everyone is best off making their own decisions
    • Consumption decisions
    • Work decisions
    • Exchange decisions

• Both Donald Trump and Mother Teresa can be viewed as maximizing their utility
  – The theory doesn’t require you buy material things or value just your self – giving fits well into the theory
Exchange

- Buyers and sellers
  - Supply and demand
- Negotiate through a market
  - Not necessary, there is plenty of individual exchanges
- The market achieves an equilibrium
  - There is a price
- Economist feel that well functioning markets best enhance peoples capability to choose what they want

© 2012 NMSU College of Business Daniels Fund Ethics Initiative
Public Policy

• Public policy exists when markets do not provide for certain things.
  – Defense (though there are private armies) most people feel this is best provided by the government
  – Schools
    • Could be private for rich but the public policy is provide everyone with the opportunity for an education.
  – Minimum living standards
    • Social security for older people
    • Welfare for poor people
    • Medicare and Medicaid for people who cannot afford health care

• Since policy occurs outside the market, there has to be a criteria for deciding what is a good policy
• Politician have a sort of exchange (vote for me and I will get a new military base in my district)
• But there has to be a filter – what is good and ethical public policy
Conflict

• Conflict occurs when normal exchange breaks down
  – Two parties want mutually exclusive outcomes but cannot work out an exchange

• Usually decided in court of law (except through violence)
  – Dispute over contract interpretation or performance
  – What is the Precedence in the case
  – Do the parties have standing?
  – Are there third parties involved?

• Most of the time outcome of a conflict is decided by judge, jury or an arbitrator
  – Usually decision is made based on law and precedence
  – Some cases don’t have clear jurisdiction or precedence
    • What is an ethical decision – what is right
Positive versus Normative Economics

• Positive Economics: predicts how people behave in an economic world – individual choices on consumption and work and how they exchange what they got for what they want
  – Scientific based
  – Prediction
  – Empirically verifiable
  – Not value based

• Positive Economics is not that useful in the policy arena. Economists have developed a normative methodology
  – Normative economics asks a question is this policy good from an economic point of view
  – Normative economic is a subjective opinion about a particular course of action
Pareto Improvement

• The cornerstone of normative economics (often called welfare economics – not the same as people on welfare) is the seemingly obvious statement: If a policy can make one person better off without making anyone worse off, then the policy is a pareto improvement – a good thing.

• It is very difficult to actually find policies that do this – so economists have come up with a modified pareto improvement:
  – If the person better off compensates the worse off person from the policy and the net is positive the policy is good.

• If one thinks about it this is the basis of a contract. Two parties negotiate a deal one getting something one giving something up, but the getting party compensates the giving party. The contract is consummated because the net is positive – both parties either gain or at least stay even:
  • Economists assume the transaction is voluntary on both and
  • that parties are informed and negotiate rationally that is they both expect a positive gain in the deal.
Benefit Costs Analysis

• Compensation is difficult so Economists have come up with a 2\textsuperscript{nd} best analysis for policy
  – A policy is good if:
    • Present value: Benefits > Costs
    • Benefits and costs are discounted over time to present value
      – A dollar in the future is not worth as much as dollar today
What is the ethical dimension?

- A man might rationally choose to embezzle his employer
  - Economics could analyze such criminal behavior as the individual weighing the probability of gain against the probability of being caught and make a conclusions as follows
    - More lax accounting measures and non-existent audits lead to more unaccounted losses by the firm
  - Is this ethical?
    - Ethics is non considered. “Positive” economics is only trying to predict human behavior not make a moral or ethical statement about it
    - But economics can get into ethical decisions too

Ethics and Public Policy Economics Distribution effects

- Benefit cost analysis does not consider distribution effects
  - All the benefits could go to one rich person, call costs could be laid on poor people
  - Economists think a secondary criteria should be a redistribution effect rich: -> poor

Minimize third party or external effects

Environmental effects

- A good policy might be bad for the environment but difficult to measure in benefit/cost analysis
Arbitration

• Courts are there to optimize social policy or redistribute wealth
  – Based on law
    • Precedence
    • Jurisdiction
• Arbitration can consider economics but usually does not – doesn’t have the resources
  – Benefits > costs
• Arbitration can be based on the ethical consideration of the arbitrator
  – What are the distribution effects
  – What are the third party externalities
  – Can not step beyond the law

© 2012 NMSU College of Business Daniels Fund Ethics Initiative