From economic imperialism to social science inspiration

BRUNO S. FREY*
Institute for Empirical Economic Research, University of Zurich, Blümlisalpstr. 10, CH-8006 Zurich

1. Public choice as economic imperialism

It has become generally accepted within the economics profession to apply economic reasoning beyond the area of the economy. In particular, the invasion of rational choice into politics has proved to be a major success, and this approach is also likely to have a major impact on sociology (see, e.g., Opp, 1985; Lindenberg, 1985; Coleman, 1990). However, there are signs that the easy gains in insights achieved when a paradigm is applied to a new area (see Becker, 1976; or Kirchgässner, 1991) are diminishing (see Hirshleifer, 1985). Public choice is no longer as exciting as it used to be; for better or for worse, normality has taken over. Progress on the whole is marginal, the subject becomes more and more standardized (i.e., orthodox). Many contributions are rather mechanistic, while originality and innovation tend to disappear. Today, people fancy other areas such as evolutionary or chaos theory, but it is of course an open question whether these new currents will ever reach a degree of popularity comparable to public choice.

This rather sober evaluation of the present state of public choice does not imply that there are no fascinating areas and topics in the field. Over the last few years, relevant new insights have been gained even in traditional subjects. It suffices to mention two:

(i) The literature on political business cycles has considerably advanced by a systematical consideration of the aspects of reputation and time consistency (see, in particular, Alesina, 1987; Alesina and Tabellini, 1990). It is, however, interesting to note that this work has not been undertaken in the framework of established public choice institutions (the respective Societies and Journal), although it draws, of course, on earlier public choice work.1

(ii) The problem of political organization in the presence of free riding incen-

tives has been extended (mainly by Ostrom, 1990) far beyond Olson’s (1965) pathbreaking contribution. Based on theoretical and empirical research, we now know many of the conditions under which a prisoner’s dilemma can be overcome not only by government intervention, but also by voluntary self-organization.

Several new areas also provide interesting challenges. Up to now, a large part of political economy has been concerned with democratic politics (this is clearly seen in Mueller’s 1989 survey). Non-democratic governments, by far the largest share of all nations, have rarely been studied. As so often in the past, Tullock (1987) has taken the lead, and without doubt, the present work (e.g., Wintrobe, 1990; Palda, 1992) will be followed by further noteworthy inquiries.

While the success of public choice within positive economics and political science is beyond doubt, its impact on normative economics and on actual policy making leaves much to be desired. When it comes to making recommendations, the standard approach in economics still follows the traditional welfare view: A social welfare function is maximized subject to the appropriate resource constraints. In public economics, for instance, this is the procedure followed by the Theory of Optimal Taxation and Optimal Public Pricing (see, e.g., Diamond and Mirrlees, 1971; or Stern, 1987). On a macroeconomic level, the same approach is used for instance to argue for the “harmonizing”, i.e., equalizing of taxes in the European Community (e.g., Musgrave and Musgrave, 1989; Sinn, 1990). It seems that the fundamental message of Constitutional Economics applied to policy-making (Brennan and Buchanan, 1985; Frey, 1983) has been totally neglected in many quarters of economics. A survey of professional economists undertaken some years ago revealed a surprisingly large share who agreed with the proposition that “… politicians endeavour to pursue an economic policy maximizing social welfare”. In the Federal Republic of Germany, 52% of the respondents “generally agreed” or “agreed with provisions” to this statement (Schneider, Pommerehne and Frey, 1983), in Austria it was 50% (Pommerehne, Schneider and Frey, 1984), and in Switzerland 49% agreed (Frey, Pommerehne, Schneider and Weck, 1982).

Little is known about the impact of public choice on practical (everyday) politics. The scarce evidence that exists seems to suggest that it is small. An analysis (McLean, 1992) of the practical application of social choice had just two cases to boast, namely that the then acting president of the public choice Society, John Ferejohn, was an advisor to the legislature of Mongolia, and that Rein Taagepera (a name not even mentioned in Mueller’s second edition of Public Choice) was elected into the constitutional committee of Estonia. While these activities should not be derided, being a member of a committee does of course not mean that any public choice idea has been applied in reality. One would certainly wish that there were many more, and more important, cases of practical applications of public choice.

2. The future: Social science inspirations

The diminishing marginal returns of the “imperialist programmes” of economics applied to politics (and other areas) as well as the limited impact on policy-making suggests that the time has come for a change in direction: In the future, the main emphasis should not lie on exporting economics but rather on importing aspects and insights from other broadly conceived social sciences. Inspirations from other social (and literary) sciences are very well compatible with the basis of modern economics, which has proved to be so useful. Indeed, the economic model of human behaviour properly understood perfectly lends itself to the integration of so far neglected aspects of people’s actions. What is needed, however, is an effort to overcome the model of “homunculus economicus” who is at all times in full control of his or her emotions, who does not know any cognitive limitations, who is not embedded in a personal network, who is but extrinsically motivated and whose preferences are not influenced by processes of discussion. Due to loose discipline of political markets and low cost of individual decisions, such extensions can well be introduced into public choice.

There is already a considerable body of literature pointing the way in which this future development may go, and there are a great number of ideas from various social sciences which have been fruitfully introduced into economics (see the discussion in Frey, 1992a). In order to illustrate how economics in general, and public choice in particular, can profit from such “social sciences inspirations”, I shall discuss two areas in which experimental cognitive social psychology has proved to enlighten economics: the areas of behavioural anomalies, and of human motivation. A third area borrows from sociology and philosophy, emphasizing the role of verbal discourse and personal connections for human interaction.

2.1. Behavioural anomalies

Experiments by psychologists (see Kahneman, Slovic and Tversky, 1982; Arkes and Hammond, 1986; Dawes, 1988) as well as by economists (see Schoemaker, 1982; Hogarth and Reder, 1987; Thaler, 1992) have by now revealed overwhelming evidence that humans, as well as animals, see McDonald, Battalio and Kagel (1991), do not act rationally in the sense of following the von-Neumann/Morgenstern axioms. They systematically deviate from expected utility maximization. Related anomalies of individual behaviour have been identified in “real life”, and even in a market which almost completely corresponds to perfect competition, i.e., the stock exchange (see Thaler, 1992: Ch. 11-13). The reaction of economists to these empirical findings has over-
whelmingly been to expand the classical subjective expected utility model or to formulate a more general non-expected utility model of preferences (see, e.g., Machina, 1987). Maximizing these utility functions yields behavioural aspects which are consistent with the empirical observations; the former “anomalies” therefore become integrated into formal theory.2

The efforts to reestablish logical consistency have only been partly successful. While many of the behavioural anomalies such as certainty effect, preference reversals or probability biases can be integrated into a more generalized utility theory, there are other anomalies, in particular framing effects, which have proved evasive.

It may, nevertheless, be argued that economists’ efforts to integrate behavioural anomalies into the existing narrow notion of individual rationality is ill conceived. Individuals are in fact more rational than orthodox theory thinks them to be, and this in two respects:

(a) Due to their cognitive limitations, individuals are not able to act consistently all the time and under all circumstances. But it is one of the defining characteristics of human beings (see Frankfurt, 1971) that they are able to recognize their weaknesses and to overcome them (at least partly). A much-discussed way to circumvent anomalies, or to reduce the cost incurred when falling prey to them, is to establish rules of self-commitment. Probably more importantly, individuals resort to social institutions in order to get help when struggling with their weaknesses (Frey and Eichenberger, 1989). For example, individuals who know that they are unable to resist the temptation to consume more and faster than they wish3 have an incentive to support political actions forcing them to care more for the future, e.g., by introducing an obligatory old age pension scheme run by the state.

(b) Under some circumstances, individuals do not desire to act rationally in a narrow sense. Among close friends, but especially within the family, humans deviate from axioms of logical consistency on purpose in order to acknowledge a particular relationship. A large share of the fine arts (literature and drama) deals with this kind of behaviour, the most prominent case being “l’amour fou” or infatuation, where a lover rationally choses to act irrationally, in order to express his or her emotions and feelings. The reverse emotion of intense hatred irrespective of the cost has also been the subject of many novels and plays, a famous example being Heinrich von Kleist's “Michael Kohlhaas”. Maybe economists are not exactly the kind of people who experience this sort of sensation, but they should at least be prepared to acknowledge that it exists (for a similar argument, see Frank, 1988).

As in the case of cognitive limits to consistent behaviour, this does not mean that the rational choice approach has to be relinquished. Rather we should look at rationality with a broader mind. Individuals are superrational in the sense that in general they are able to guard themselves against self-destructive infatuation and hatred by resorting to appropriate rules and institutions. Thus, for example, in most countries of the world, political action has led to laws forcing individuals to let a certain time pass before getting married.

Analyzing behavioural anomalies by accepting that human beings are either not able or not willing to act consistently — rationally in the orthodox sense — differs fundamentally from accounting for the same empirical observations by generalizing individuals’ utility functions. The latter “integrating” approach models human behaviour by adjusting individual utility functions; the former “institutional” approach looks at the institutions arising as a reaction. The difference becomes particularly clear in an extreme case. If no behavioural anomalies are observed empirically, the individual’s utility functions are, according to the “integrating” approach, unchanged, but, according to the “institutional” approach, there may well be individual rules and social institutions owing their existence to the anomalies; i.e., if the institutions were removed, these anomalies would reappear. For political economy, this procedure seems to be more relevant because it helps to explain the emergence of political actions and institutions.

2.2. Human motivation

Economic analysis is based on the idea that individuals respond systematically to changes in relative prices. The incentives set from outside motivate people to act in a predictable way. This (generalized) law of demand has proved to be extremely successful for explaining voters’, politicians’ and bureaucrats’ behaviour. However, perceptive public choice economists are well aware that there must be other motivating forces. In particular, the standard rational choice calculus is not able to explain the level of vote participation (but it serves quite well to account for the variations).

There are a great many other cases relevant for political economy where individuals free ride far less than predicted by economists.4 For instance, the expected punishment for tax evasion is so small that even risk-averse citizens should cheat much more than they actually do.5 The reason for the surprisingly high tax contributions has widely been attributed to tax morale (e.g., Witte and Woodbury, 1985; Graetz and Wilde, 1985). Tax morale indeed provides a good explanation for the difference in tax compliance in the case of Switzerland, where this factor can (indirectly) be identified (Pommerehne and Frey, 1992).

Psychologists and sociologists more generally distinguish two kinds of moti-
vation: *Extrinsic* motivation induced by manipulations of rewards or sanctions from the outside (the economist's relative prices), and *intrinsic* motivation, where people perform an activity for its own sake because of reasons lying within their own person (DeCharms, 1968; Deci, 1971). Anybody looking at people's behaviour must be aware that a phenomenon such as intrinsic motivation does exist. Economists might nevertheless argue that they are only interested in changes of behaviour (i.e., higher or lower vote participation or tax evasion), but not in the level of those changes (see, e.g., Kirchgassner, 1980). As a consequence, important aspects of the political and social life are left unexplained by rational choice analysis. This position becomes fully untenable when intrinsic motivation is not an (unexplained) constant, but is influenced by social factors. Experimental research in psychology has shown that under identifiable conditions external interventions affect people's sense of self-determination, of self-perception and of their feeling of justice, which in turn influences intrinsic motivation (e.g., Deci and Ryan, 1985; Pittman and Heller, 1987). Among psychologists, much attention has been paid to the "hidden costs of reward" (see Lepper and Greene, 1978), stating that introducing a reward into a situation where people already have a high interest in an activity results in a decrease in their intrinsic motivation. The damaging influence on intrinsic motivation by changing external instruments helps to explain why pricing (monetary rewards) and regulating (the use of punishment) under identifiable conditions prove to have little or sometimes counterproductive effects. Thus both, the use of regulations and of effluent charges may undermine environmental ethics because individuals perceive that the locus of control has shifted from internal to external forces and that their own mental involvement is depreciated. Similar effects can be identified for crime deterrence by punishment, in social and in manpower policy (Frey, 1992b).

The detrimental effect of external controls on intrinsic motivation is also directly relevant for constitutional economics. Following David Hume6 and James Stuart Mill, Brennan and Buchanan (1983) argue that a constitution should be designed so that it is able to check the behaviour of the men of worst intentions trying to free ride and to exploit the system. "Average" behaviour is deemed to be of no concern, because the costs imposed on society by the most immoral men dominate. This argument overlooks that people's intrinsic motivation to act as good and responsible citizens is undermined when the constitutional provisions suggest that everyone acts as a knave anyway. It may well be that a constitution should give its citizens the feeling that they are trusted and that they will not in general act as free riders. Such an approach bolsters citizens' self-determination and self-perception, and meets their sense of fairness. Such a constitutional policy is consistent with the empirical evidence collected on free riding behaviour and tax evasion.

2.3. *Speechless economics and human discourse*

In economics, language and verbal exchange are attributed a minor role. Economists are particularly fond of models with no communication between the actors. Thus, the classical prisoner's dilemma game, which has shaped our thinking on free riding, artificially constructs a situation in which the prisoners are not able to speak to each other. Clearly, communication as such does not guarantee that no free riding occurs, but it definitely helps to form enforceable contracts to prevent it. While there may be some implicit agreements, the vast majority of contracts designed against free riding are in verbal and often written form.

A related aspect disregarded by economists are *personal relationships* which again serve efficiently to prevent free riding. Economists tend to overlook that a large part of all activities within firms of all sizes and between firms is based on personal connections (Osterloh, 1992). The same holds for other institutions, in particular for interest groups, public bureaucracies, parties and government. Indeed, in small countries—such as Switzerland—virtually all the politicians know each other, and the situation is not much different in larger countries. The interaction has the character of a repeated game, or, in sociological terms, "embeddedness" (Granovetter, 1985) matters, leading to quite different outcomes than if the personal relationship did not exist.

These considerations are relevant for political decision-making, but they have been largely neglected so far. In public choice, direct democracy is exclusively looked at as a particular form of taking a social decision between known alternatives (see Mueller, 1989: Part II). The discourse among the citizens, which puts the issues on the individuals' agenda, raises their perception and exchanges the arguments in the media and among individual persons, is of crucial importance and should therefore be studied. The choice between known alternatives is only one aspect of direct democracy; perhaps even more important is the process of verbal exchange which takes place before casting the vote in a referendum or initiative, i.e., before an issue is well defined and put on the ballot. According to the philosophical and sociological theories of Habermas (1983) and Apel (1990), such discourse not only improves citizens' perception and information, but may also shape the normative evaluation of the problem at stake (though the *basic* preferences may well stay constant; see Stigler and Becker, 1977).

3. Concluding remarks

Public choice, and economic imperialism more generally, has been a great success within the social sciences. While progress can certainly be made by further applying the economic approach to politics (and other areas), diminishing
returns have set in. Public choice has joined the ranks of normal science, originality and innovation play an increasingly smaller role.

It is time now to embark on a new course and to switch from an exporter to an importer of ideas. The social and literary sciences contain many ideas which can enrich future public choice without giving up its sound foundations. The areas of behavioural anomalies and human motivation are two fields where political economy can benefit from insights from psychology; and discourse and personal embeddedness are aspects which public choice can learn from philosophy and sociology. Many other concepts and ideas can fruitfully be borrowed from other social sciences. If political economists are ready to take this challenge, public choice will prosper in the coming 25 years.

Notes

1. To a surprisingly large extent, current work proceeds in isolated parts, so that disconnected "islands of knowledge" appear. For instance, among the American contributors to present day politico-economic modelling, the "Harvard group" (e.g., the book by Alesina and Carliner, 1991) does not make any reference to the "Carnegie group" (e.g., Melzer, Cukierman and Richards, 1991), and vice versa, although they deal with the same issue. The major European contributions (e.g., Paldam, 1981; van Winden, 1983) are almost completely disregarded by Americans, while the European economists dutifully quote the Americans.

2. It is worth noting that the same procedure has been followed in the case of another inconsistency within established theory: Economists have reacted to the "impossibility theorem" (Arrow, 1951) by searching how individual preferences must be changed for the paradox of preference aggregation not to occur, e.g., in the case of uni-dimensional issues single-peakedness of individual preferences (Black, 1958).

3. For empirical evidence see Loewenstein and Thaler (1989).


5. For the United States, as well as for other countries, calculations based on empirical magnitudes show that taxpayers would have to exhibit risk aversion far in excess of anything ever observed for compliance predicted by expected utility theory to approximate actual compliance" (Ahn, McKee and Beck, 1990).

6. "In constructing any system of government, and fixing the several checks and controls of the constitutions, every man ought to be supposed a knave, and to have no other end, in all his actions, than private interest" (David Hume, "Of the independence of parliament". Essays – Moral, Political and Literary, pp. 117–118).

7. Johann Wolfgang von Goethe may be a little too optimistic, but basically right when he argues that "if you treat an individual as he is, he will stay as he is, but if you treat him as he ought to be and could be, he will become as he ought to be and could be" (quotation from Anderson, 1980: 121).

8. In reality, there is a network of information exchange in all prisons, and even prisoners held in isolation are able to communicate with others.

9. Evidence suggests that in Switzerland, where referenda and initiatives play by far the most important role the world over (Rannez, 1981), the outcome is strongly influenced by the discussion process taking place before the actual vote.

References


