Econ 1101
Spring 2013

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4/10/2013

Announcements

- Go to recitation this week to get assigned to a group for your second platform debate!
- Also, you will do a monopoly worksheet this week that will be very helpful

Agenda

- Broader applications of consumer theory in social sciences.
  - Rational Choice Theory and Crime
- Application of consumer theory to food stamps

Rational Choice Theory and Crime

- This course satisfies liberal education requirements for social science. As such, it is useful to discuss the place of economics more generally in social science.

- The approach of economics, modeling decision makers as rational agents who solve a maximization problem, subject to constraints (like maximizing utility subject to a budget constraint), has had wide application in social science.

- In sociology, it is applied to analyze criminal behavior. This branch of sociology (or criminology) is called rational choice theory.

Moreover…

- It is also applied to analyze family decisions (whether or not to get married, have a kid,….)

- In political science it is applied to analyze whether or not an individual votes. And if the individual votes, it is applied to study how the individual votes.

- Let's work through a simple example of rational choice theory applied to the analysis of the incentive to commit a crime. In addition to illustrating the point, the example provides a nice review of income and substitution effects.

Setup:

- Freddie has 10 hours a day to work.
- Can earn $1 an hour through honest means
- Initially can earn $2 an hour through dishonest work (e.g. selling drugs)
- The graph shows Freddie's indifference curves between honest money and dishonest money.
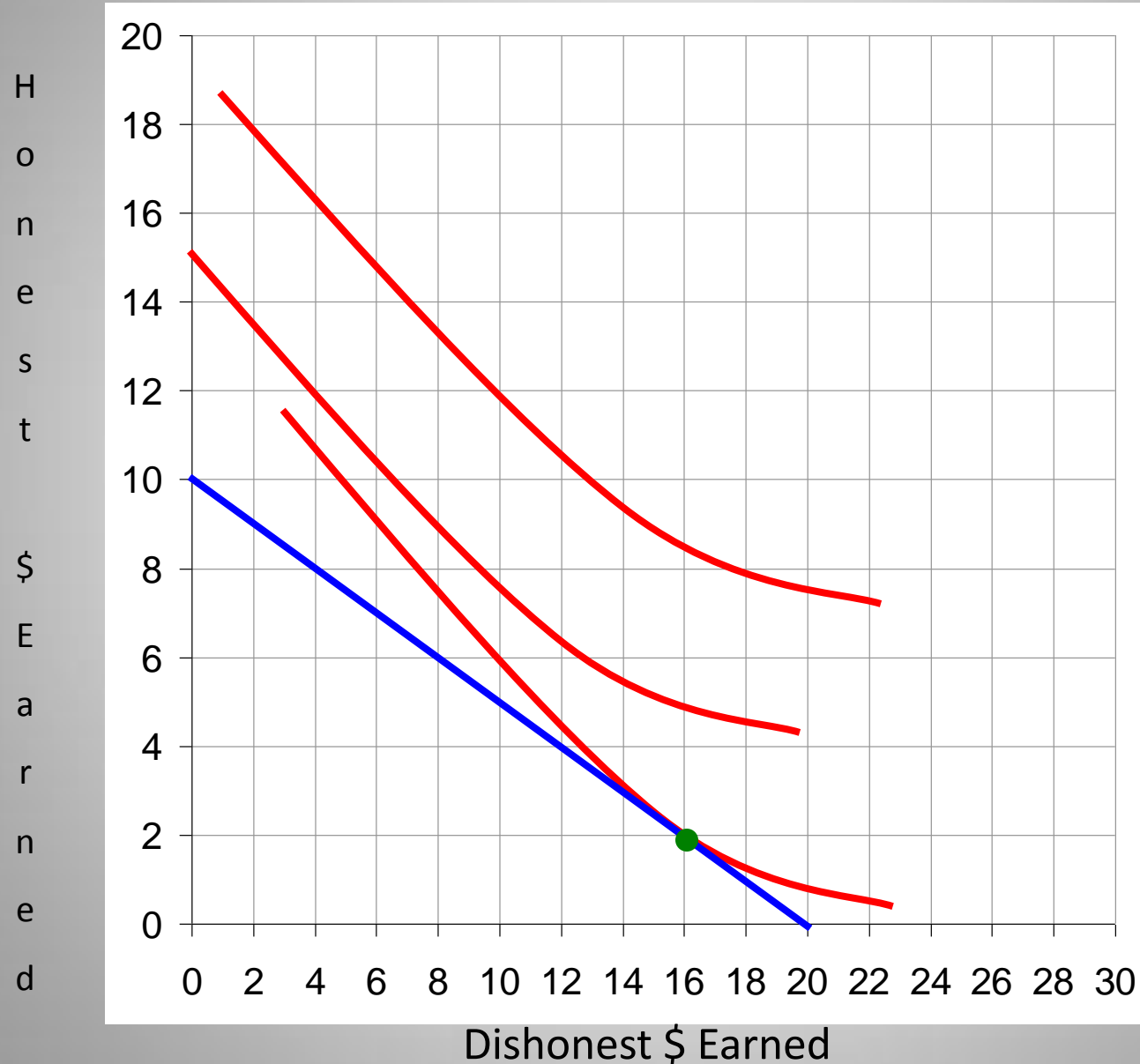
Plot Freddie's budget constraint.

- Optimal choice of dishonest $ earned is
  ___16___ and honest $ earned ___2___
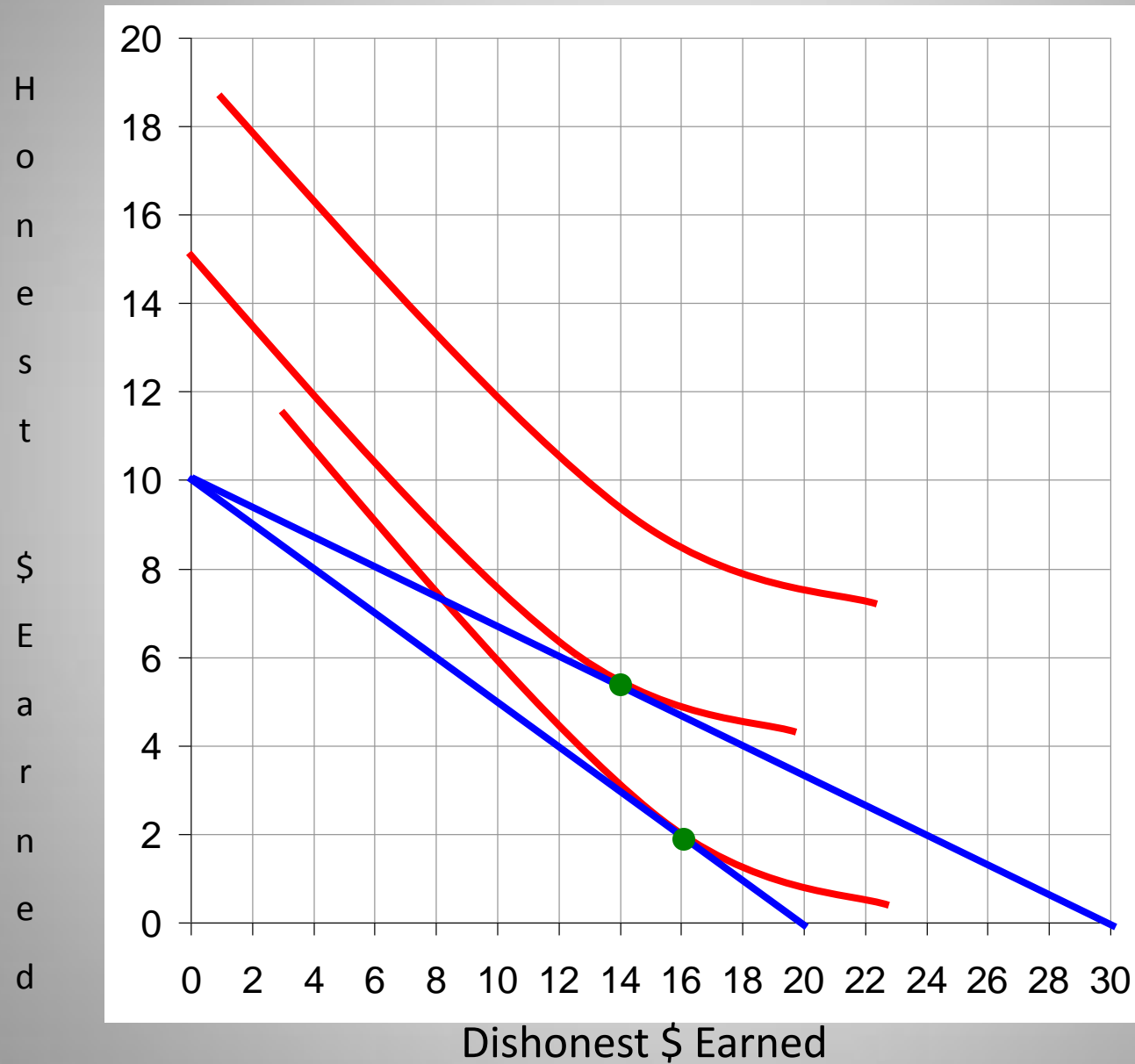
Now suppose can earn $3 an hour through dishonest work?

Freddie has 10 hours a day to work.
Can earn $1 an hour through honest means
Initially can earn $2 an hour through dishonest work (e.g. selling drugs)

Honest $ Earned (y-axis)

Dishonest $ Earned (x-axis)

Now earns $3 for dishonest work instead of $2

Honest $ Earned

Dishonest $ Earned

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- The return to dishonest work goes up, but Freddie chooses to commit less crime and spends more time on honest work!

- Think about this in terms of an income and substitution effect.

- Dishonest income is an <u>inferior</u> good.
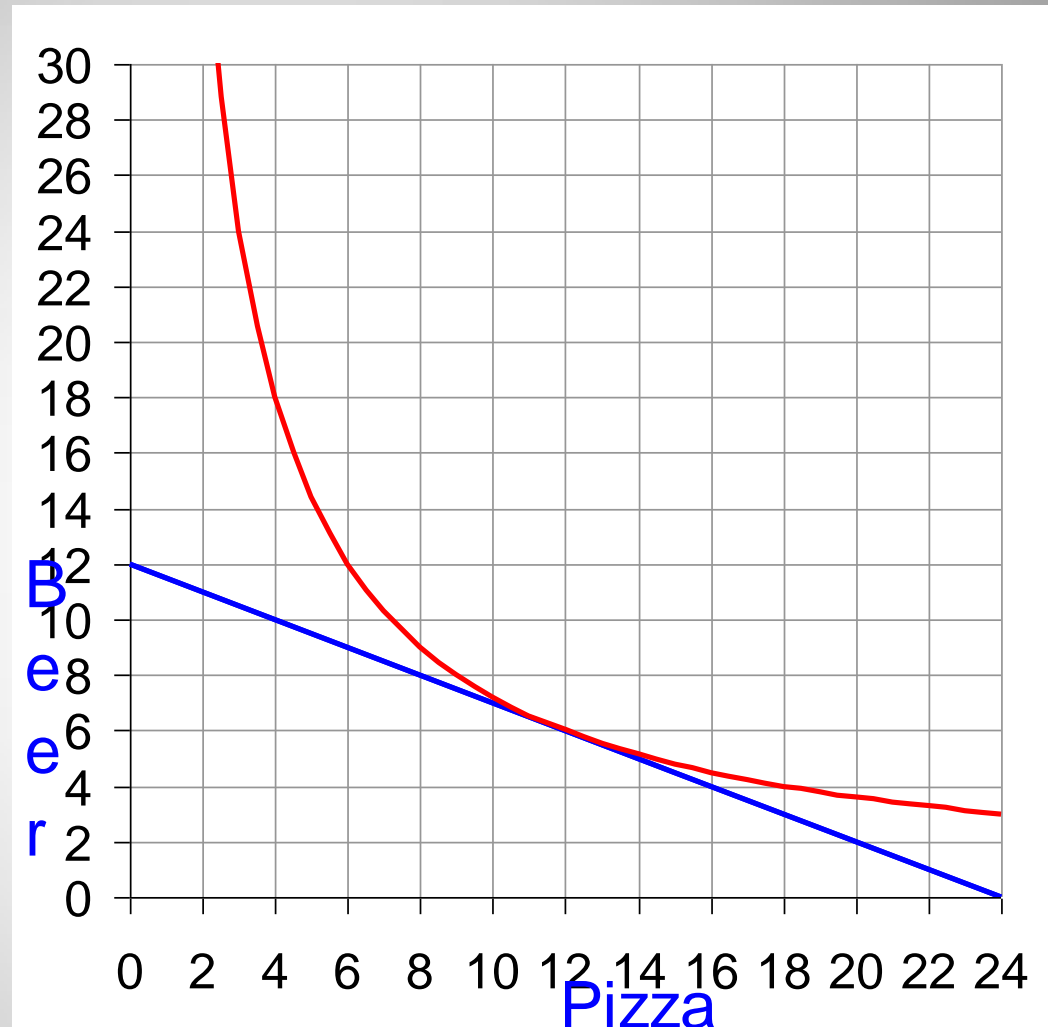
Give cash instead of food stamps?

Go back to our earlier case where Louie has an income of $24 and faces prices:

- P_{pizza} = $4, P_{beer} = $2

- Suppose Scrooge McDuck (the government) offers Louie pizza stamps worth $3 per pizza (subsidy, like food stamps)

- So effective price faced by Louie is P_{pizza} = $1.
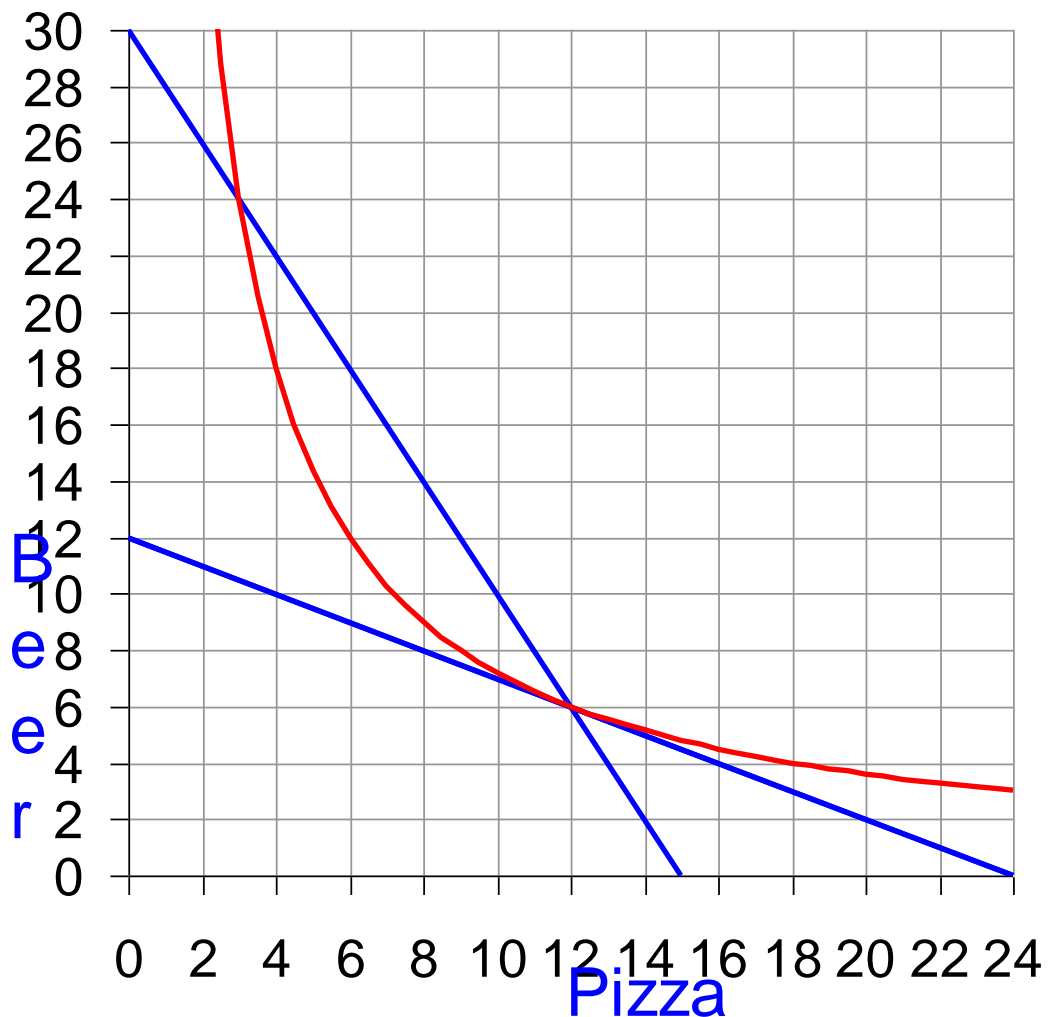
Choice with pizza stamps (subsidy)

- 12 pizza, 6 beer

This costs government $3×12 = $36

Suppose the government gives $36 in cash:
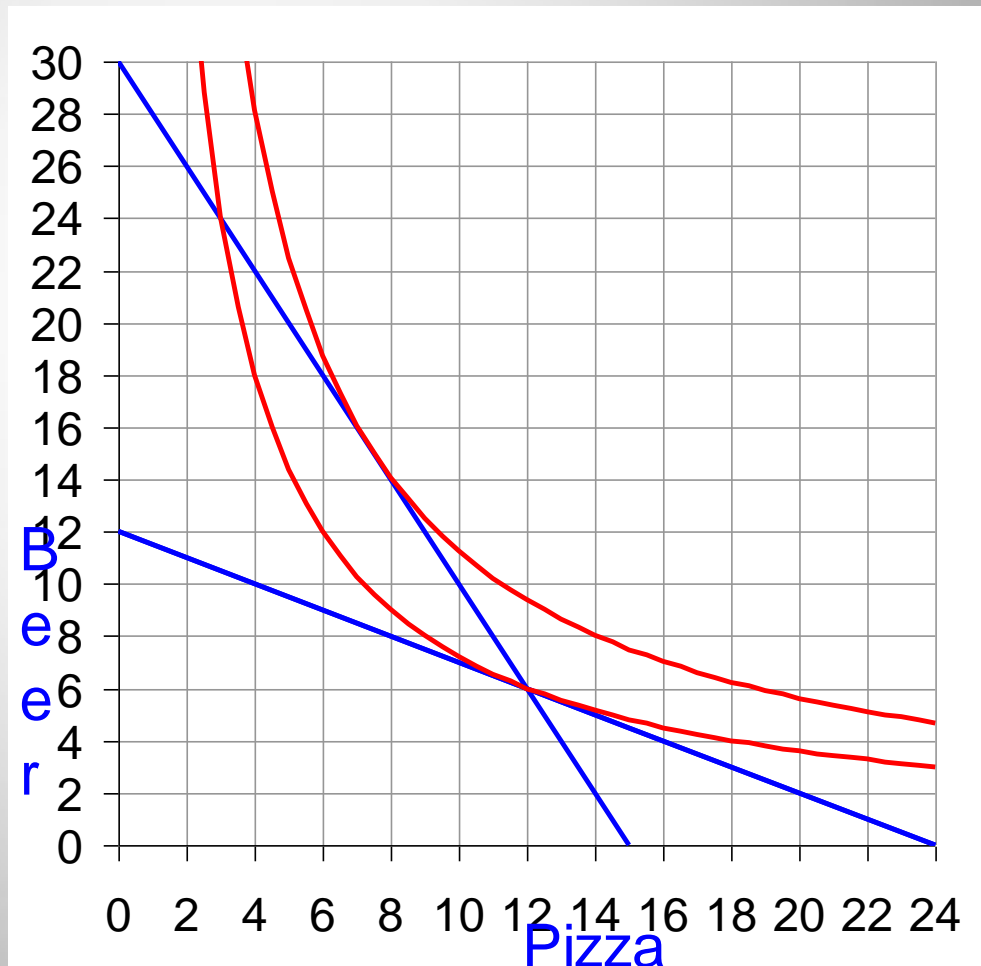
(so Louie has $24+$36 = $60)

Budget constraint goes through original choice but with new slope.

Get to new higher level of utility!

Consume:

- 7.5 pizza, 15 beer

Louie better off with cash.

- The Government (McDuck) spends $36 either way

- Give cash, get Pareto improvement!

- Same point from before that subsidies lead to deadweight loss. But fancier pictures!

So can we say based on this diagram that food stamps are a really bad idea?

What is this analysis missing?

(i) Externalities?

Suppose Louie has kids. We want him feeding them pizza, not beer!

- Pizza stamps (food stamps) not so bad.

(ii) Can be difficult to tell who needs help. So providing a homeless shelter (rather than giving cash) sorts out people who need it.