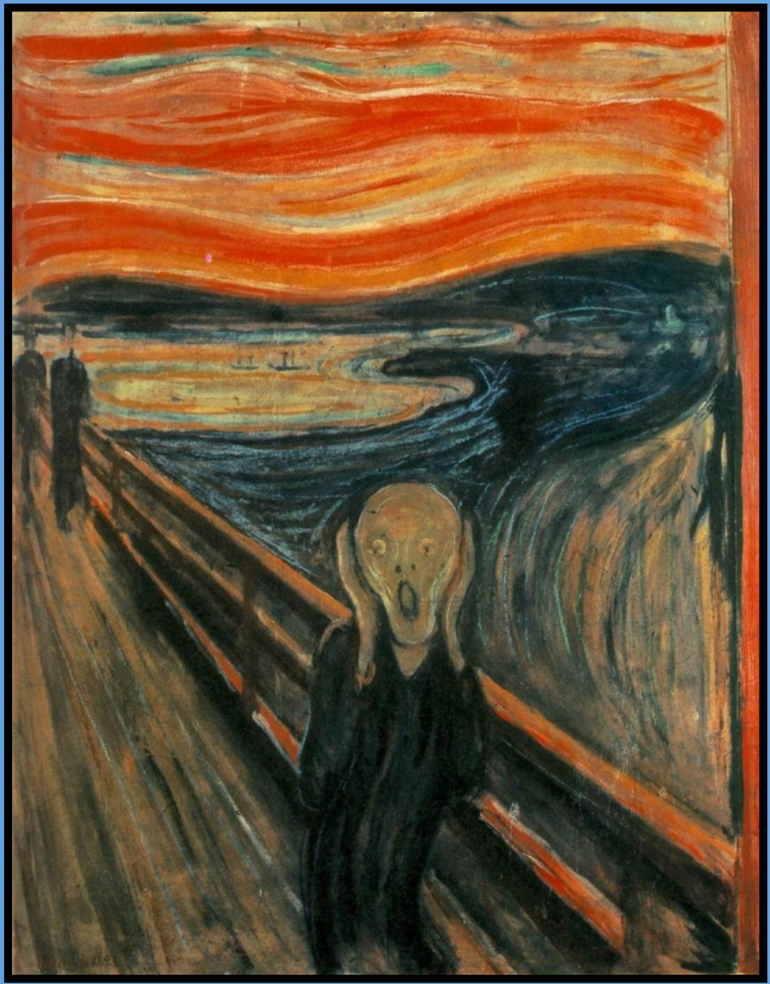
Standard Models in Economic Analysis and Political Science



Standard Assumptions in Economics

1. Individuals are rational decision-makers
2. Decisions are based on available information
3. Individuals make decisions based on self-interest
4. Self interest includes actions that benefit others
5. Markets bring together differing interests to achieve an equilibrium
6. Market equilibrium conditions can achieve economic efficiency in many cases
7. When markets fail, government intervention through taxes and spending may bring an economy closer to economic efficiency
8. Market institutions work to some degree to achieve distributive justice, which with the principle of economic efficiency constitutes a measure of total social welfare that is the object of actions by states and markets

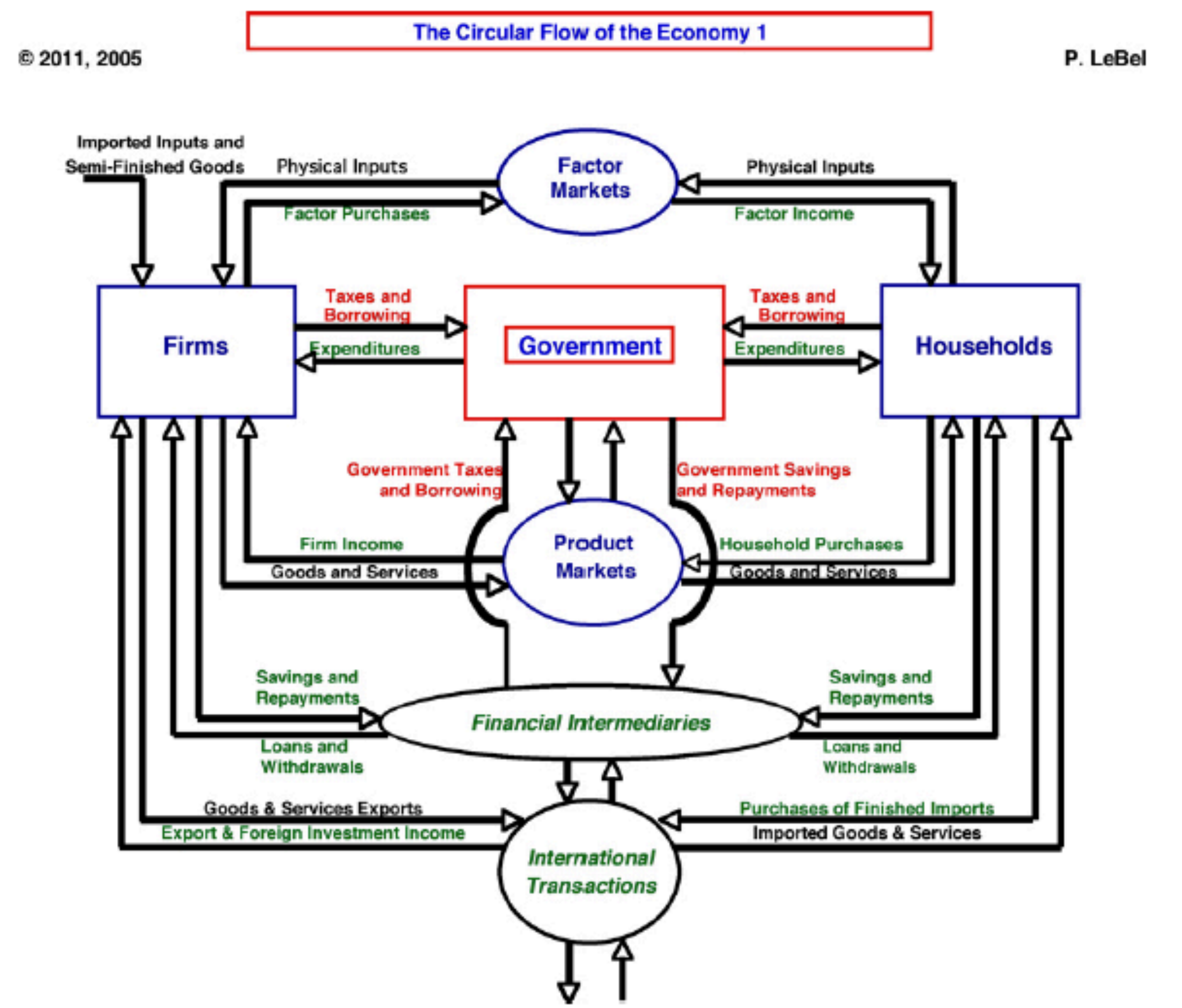
Standard Models in Political Science

1. Rulers and institutions of political regimes seek legitimacy through elections, through coercion, or force.
2. Claims of political legitimacy may derive from historical, cultural, and religious traditions.
3. Some regimes base claims to political legitimacy on divine rights in the sovereign, the population, or as informed and diffused to the population through natural law.
4. In an evolutionary scheme, regimes may pass from autocracy, monarchy, oligarchy, and democracy. The historical evolution of regimes may not lead automatically to democracy, the institution by which most Western countries have established their governing institutions, but which many countries find alien to their local traditions.
5. In democratic regimes, elections that are inclusive and transparent are considered a key standard for achieving governing mandates, and thus political legitimacy.
6. Democratic regimes acknowledge that those who govern may act out of self-interest but in a competitive electoral environment, voting and legislative decisions work to the greater benefit of society as a whole.
7. Rules of elections are complex and can lead to distorted electoral and legislative voting outcomes. In comparison to alternative modes of governance, it is better to have a flawed democratic set of institutions than any of the alternatives.
8. Democratic elections are seen as opportunities to re-visit economic and social priorities as new information becomes available.
9. Constitutions both written an unwritten seek to articulate standards of governance that together constitute the basis of political legitimacy of a regime.

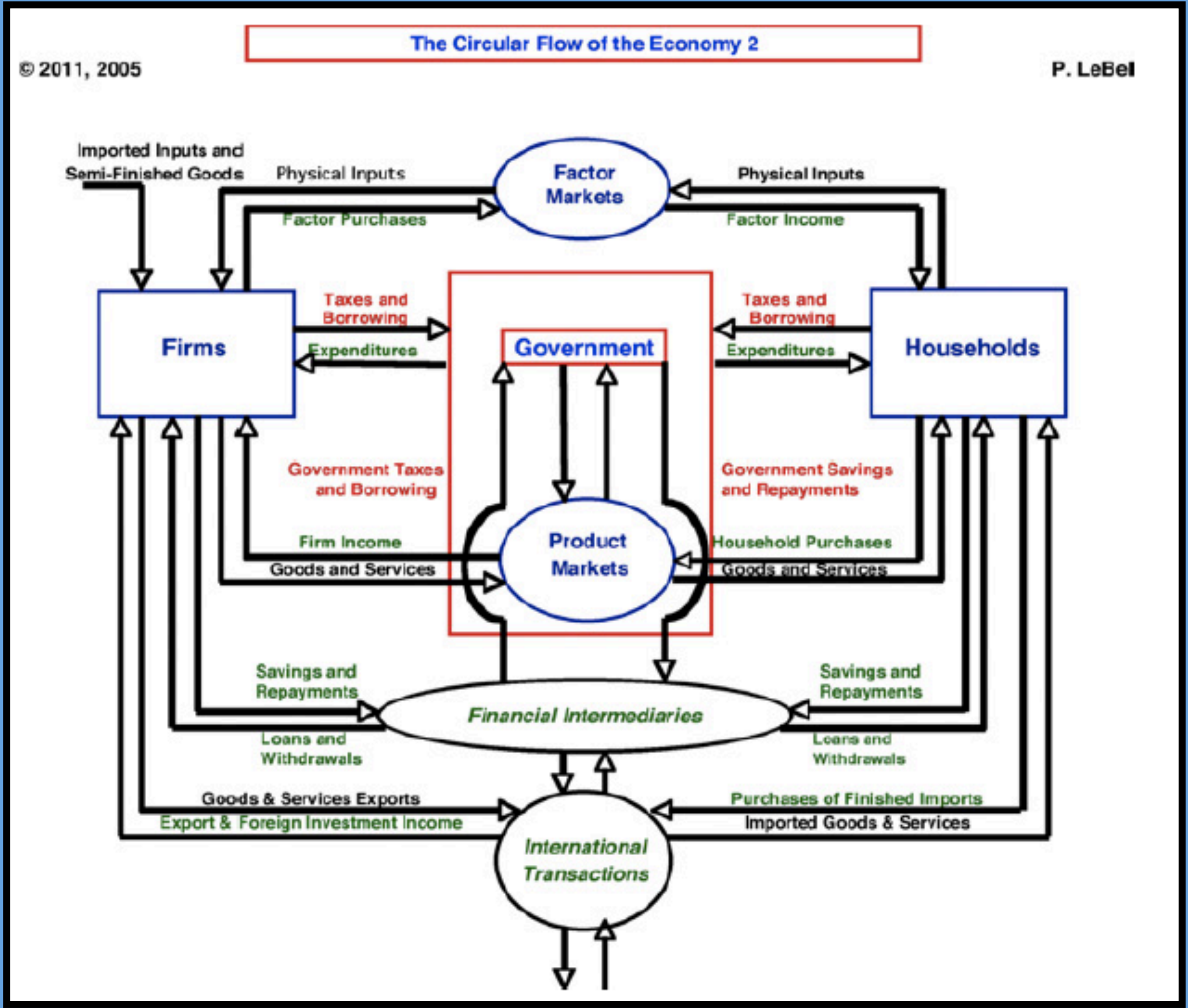
Risk in States and Markets

1. Economic theory and models have incorporated risk into decision-making, namely, through the emergence of game theory. Instead of utility or profit maximization in decision-making, it is expected utility and expected profit maximization that govern transactional relationships.
2. Incorporating risk into economic models has been pursued with the underlying theory that rational decision-making is the norm.
3. Risk-based decision-making still can lead to market equilibrium solutions, and where market failure conditions arise, suitable forms of government spending and taxation can be used to make rational corrections.
4. The incorporation of risk in political science involves a larger drawing of insights from psychology, in which manipulation can displace the rational reasoning used in economic models. Fear and hope displace the standard calculus of governing models and these can cause disequilibria in governance to arise. Greater disequilibria in governance undermines political legitimacy but measures can be adopted to reduce the underlying volatility in which sentiment displaces the rationality calculus of reasoning in economic and traditional political models.
5. Given the divergence of economics and political science under conditions of risk, the question that remains is how can society make rational decisions involving taxation and government spending. Ultimately, this question links risk to addressing the optimal size of government in the presence of economic institutions.
6. To the extent that democracy is the basis of political legitimacy, can one resolve the question of the optimal size of government in the presence of risk? This requires new insights that draw from research in psychology to get at the determinants of risk and risk perceptions.

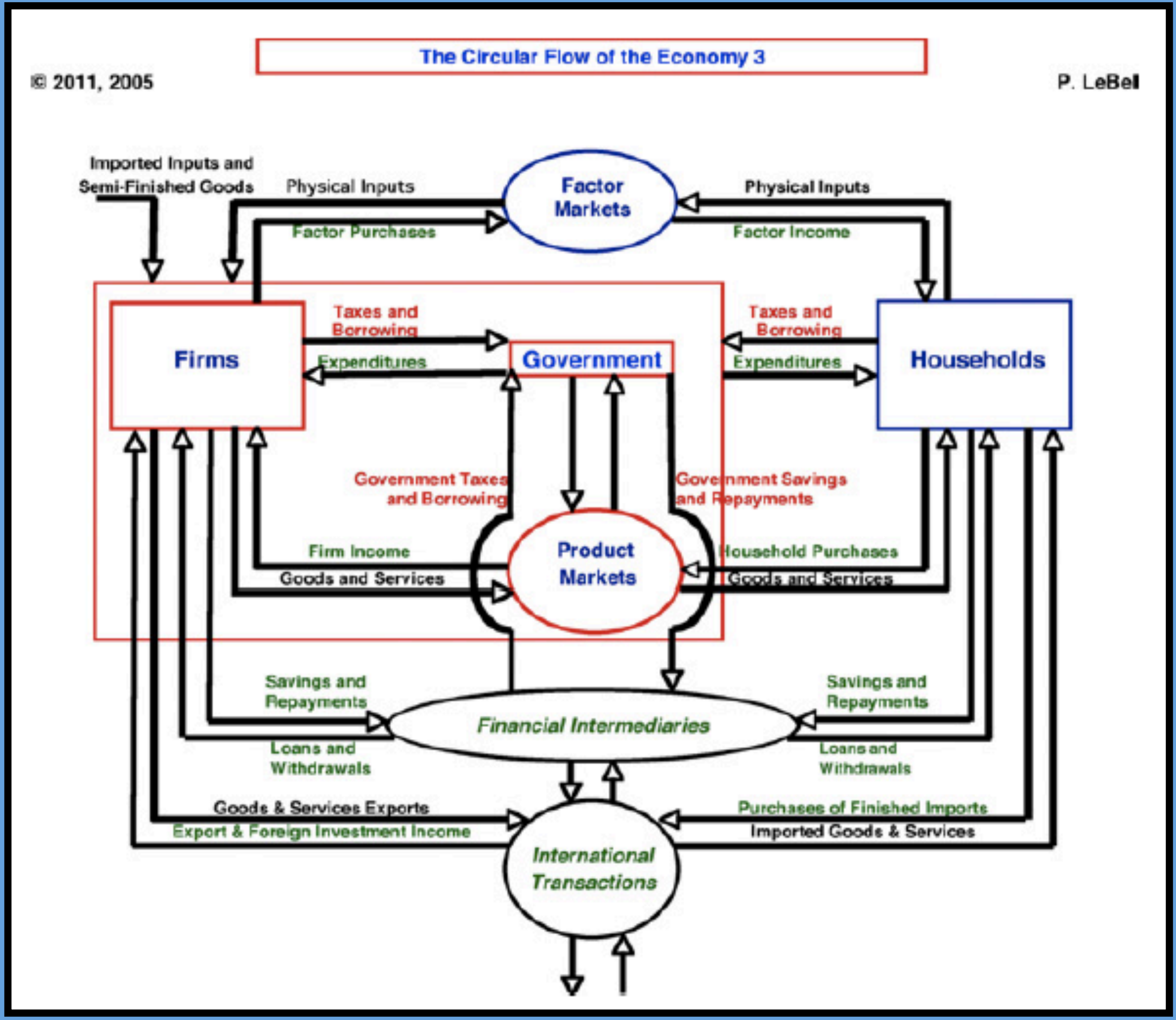
The Circular Flow of Goods and Services 1



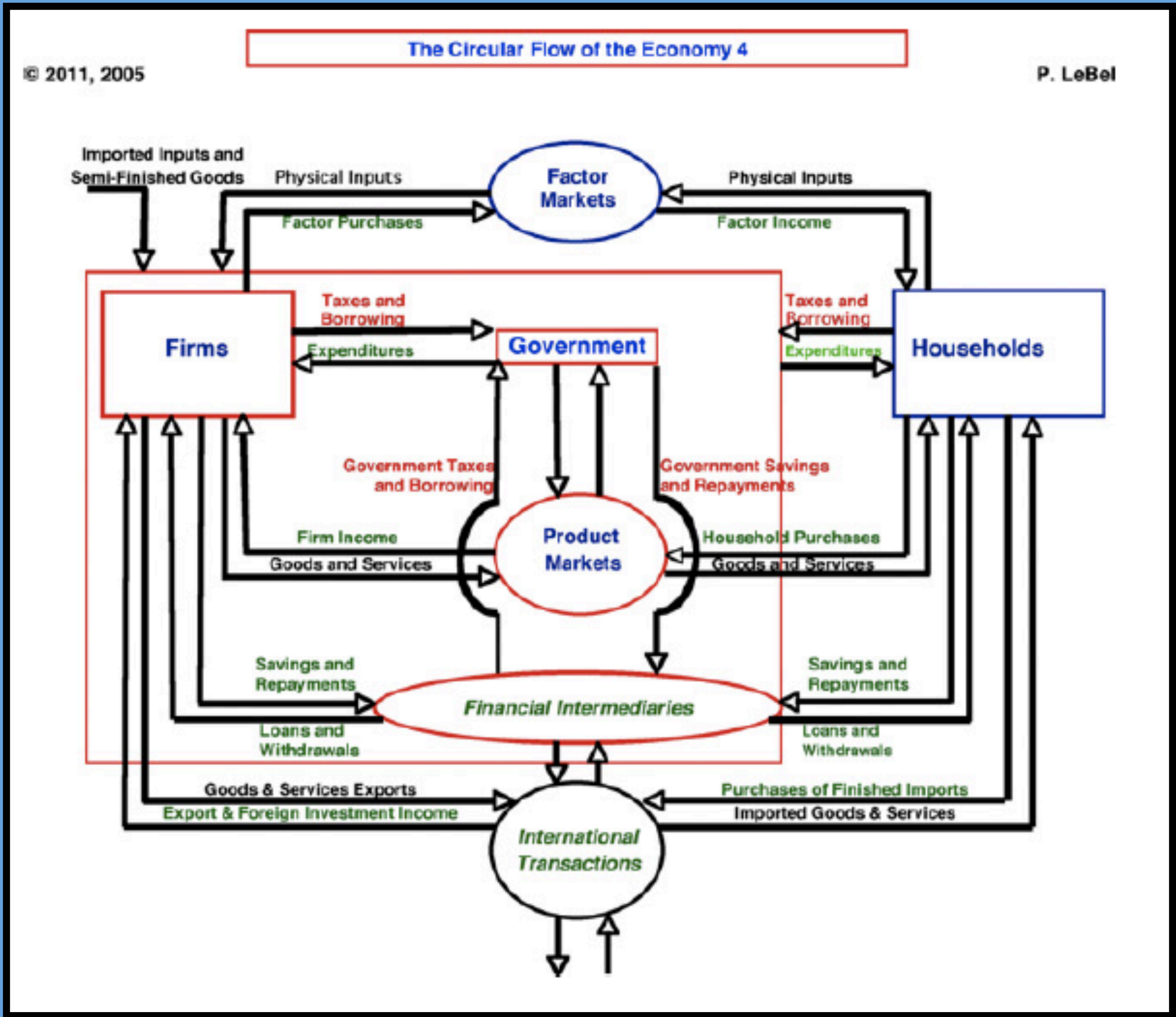
The Circular Flow of Goods and Services 2



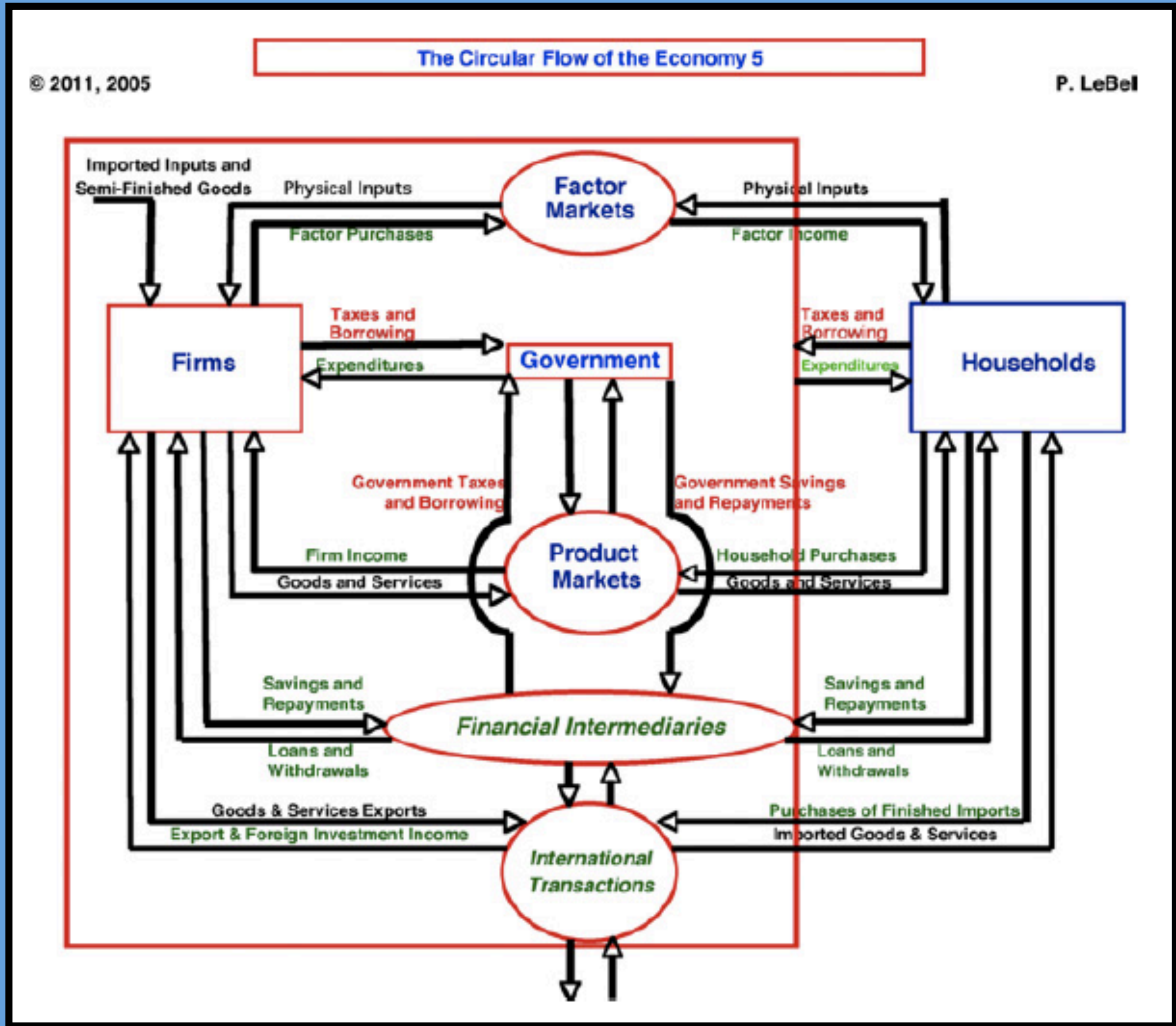
The Circular Flow of Goods and Services 3



The Circular Flow of Goods and Services 4



The Circular Flow of Goods and Services 5



Economic Functions of the Public Sector

On the Economic Functions of the Public Sector

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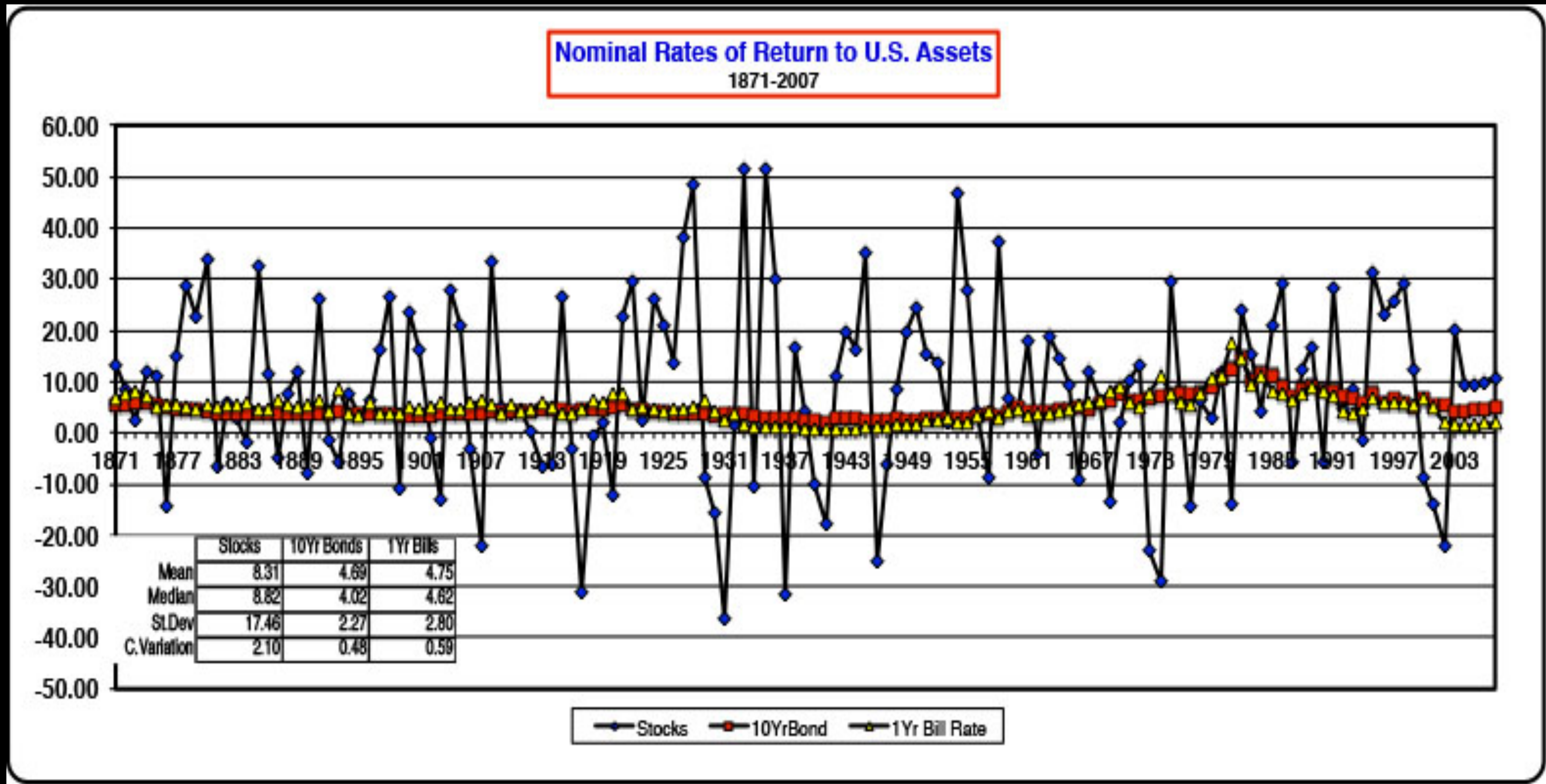
Regardless of the socio-political system, the economic functions of the public sector depend in varying degrees on individual and social perceptions toward risk. The greater the degree of individual and social risk aversion, the higher will be the probability that the public sector will be called on to perform a series of economic functions. We list below five of these functions in the context not just of individual and social perceptions but also whether society fosters the development of institutions that can efficiently price risk in the context of market economic systems. To the extent that prices can incorporate all relevant dimensions of risk within and across time, the less will be the need for the public sector to perform any combination of these economic functions. Since the future can never be predicted with absolute certainty, real world policy thus turns on the extent to which risk can be incorporated into market pricing systems.

1. **Provide a legal and institutional framework for the efficient allocation of resources**
2. **Promote competition in support of economic efficiency**
3. **Foster economic stabilization and economic growth**
4. **Promote distributive economic justice**
5. **Reallocate resources to promote the efficient composition of production**

Risk in Economic Decisions



	Stocks	10Yr Bonds	1Yr Bills
Mean	8.31	4.69	4.75
Median	8.82	4.02	4.62
St.Dev	17.46	2.27	2.80
C.Variation	2.10	0.48	0.59