

Rational Choice

(Abridged from Wikipedia)

When are choices “rational”?

The "rationality" described by rational choice theory is different from the colloquial and most philosophical use of the word. Typically, "rationality" means "sane" or "in a thoughtful clear-headed manner." Rational choice theory uses a specific and narrower definition of "rationality" simply to mean that an individual acts *as if* balancing costs against benefits to arrive at action that maximizes personal advantage. In rational choice theory, all decisions, crazy or sane, are postulated as mimicking such a "rational" process. Thus rationality is seen as a property of patterns of choices, rather than of individual choices: there is nothing irrational in preferring fish to meat the first time, but there is something irrational in preferring fish to meat *and* preferring meat to fish, regularly.

Although models used in rational choice theory are diverse, all assume individuals choose the best action according to unchanging and stable preference functions and constraints facing them. Most models have additional assumptions. Those proponents of rational choice models associated with the Chicago School do not claim that a model's assumptions are a full description of reality, only that good models can aid reasoning and provide help in formulating falsifiable hypothesis, whether intuitive or not. In this view, the only way to judge the success of hypothesis is empirical tests.

However, it may not be possible to empirically test or falsify the rationality assumption, so that the theory leans heavily toward being a tautology (true by definition) since there is no effort to explain individual goals. In recent years the theoretical vision of rational choice theory has been subject to more and more doubt by the experimental results of behavioral economics. More economists these days are learning from other fields, such as psychology, in order to get a more accurate view of human decision-making than offered by rational choice theory.

Assumptions of Rational Choice in Bargaining

When applied to contracting, rational choice theory makes five assumptions about the bargainers' preferences for action:

- **Perfect Information** -- An individual has full information about exactly what will occur due to any choice made.
- **Free Choices** – An individual's choices are not forced upon him.
- **More is better.** Individuals are never satiated.
- **Completeness**– all actions can be ranked in an order of preference.
- **No Externalities** – All individuals affected by a contract are parties to it.
- **Rationality**, which in turn means:
 - Transitivity -- if action a_1 is preferred to a_2 , and action a_2 is preferred to a_3 , then a_1 is preferred to a_3 .
 - Independence of Irrelevant Alternatives -- If A is preferred to B out of the choice set $\{A,B\}$, then introducing a third alternative X, thus expanding the choice set to $\{A,B,X\}$, must not make B preferable to A.