

# **ECONOMIC DECISIONS OF LATVIAN RURAL ENTREPRENEURS: INTERPRETATION OF MODERN SOCIO-ECONOMIC DISCOURSES**

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## **Abstract**

The basic assumption of European social science tradition is a conclusion that every decision made by an individual or an organization is well-founded and rational. The uppermost thesis of classical economics is a desire of every economic entity to attain maximum income by applying minimum possible resources. Hereto, income is usually defined by fiscal indices. Modern economics theories confirm that economic decision making processes can be explained more precisely with concepts of behavioural economics. Agents who make economic decisions are “rationally bounded” and elements of social positioning possibly exceed values expressed in categories of economic utility. The objective of this article is to prove that economic decisions made by Latvian rural entrepreneurs can be explained with the help of modern theories of social science that complement classical thought with an interdisciplinary view on socio-economical processes.

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**Keywords:** Behavioural economics, bounded rationality, economic decisions, social hierarchy

## **Introduction:**

The basis of the scientific tradition established globally is a conclusion that classical economics theory treats rationality mostly as a desire of each economic entity to attain maximum benefit with minimum possible resources. Hereto, income is usually defined in the terms of fiscal indices i.e., money. Nevertheless, daily empirical view of processes and phenomena certifies the fact that economic decisions are not entirely based on exact economic calculations. There is a substantial number of other factors impacting decision making processes of both individuals and organizations and they are socially, psychologically and culturally determined. Therefore, classical economics models act as a common doctrine in explaining economic processes but lack adequacy when analysing concrete and real economic decisions. Without understanding significant social and other factors, a classical economics discourse substantiating decisions made by individuals and economic organizations will not be adequate and correspond to real life processes. The task of the research is to explain processes happening in the society in a truthful way. Hence, if decisions made by economic entities are determined by a complex value system that exceeds and deviates from paradigms of classical economics theories, the task of the research is to study all possible factors that impact a decision making process. Consequently, the research process acquires an interdisciplinary view or, in other words, the classical research set of instruments has to be enriched with new concepts and cognitions.

When analysing economic decision making process impacted by interests of an individual or a group we can state that empirical observations and cognitions expressed by economic agents do not confirm with the rationality principle of positive economics. In the attempt to explain the contradiction between the classical rationality dogma of economic decision making and empirical reality, behavioural economics, a new sub-division of socio-economic theory, was formed. Its task is not to contradict but to enrich the thought system of classical economics theories with cognitions of other social sciences in order to explain economic activities of economic agents in a more truthful way. Behavioural economics changes the notion of rationality from abstract construction to a model explaining daily decisions. As a result, one can explain economic actions of economic subjects by applying behavioural economics apprehension discourse.

Economics is a science where performance of laboratory experiments in order to validate hypothesis of the study, is almost impossible. As a result, its set of research instruments differs from the one applied in natural sciences. The research process, especially on a microeconomics level, has to be carried out in the environment where economic activity subjects both act and make decisions. In-depth interviews, subjective reflections of respondents and their theoretical conceptualization become a set of scientific research instruments.

This aspect makes the study of rural manufacturers especially interesting. Agriculture has got a number of peculiarities making it different from other industries of national economy. Rural entrepreneurs are attached to a specific territory, they usually live in a relatively closed social environment, and they possess manufacturing means that are limited in absolute terms (such as the land) or are relatively expensive (such as agricultural machinery). Rural entrepreneurs in the EU countries operate within restricted competitive conditions and gain substantial subsidies from transnational regulatory bodies. Agricultural entrepreneurship encompasses both gains from economic activities that can be classically interpreted and immaterial income such as rural lifestyle.

In view of aforementioned managerial peculiarities of rural entrepreneurs, well-founded explanations of economic decisions made by rural entrepreneurs and consecutive scientific interpretations serve as a successful example for further and more generalised substantiation of comprehension concepts involving socio-economic processes.

### **Theoretical Assumptions:**

Behavioural economics as a scientific sub-division has got a relatively long history. Already centuries ago, philosophers understood the complexity of the decision making process that was not subjected to rationality. When making decisions including economic ones, people follow not only the desire to gain maximum benefit by applying minimum resources but also a number of other social, political, psychological and emotional factors.

### **Bounded rationality concept**

One of the most quoted management science authors is the 1978 Nobel Memorial Award winner Herbert A. Simon whose contribution is legitimization of the bounded rationality concept. He believed that limitation on human rationality and calculation existed “by the disparity between the complexity of the world and the fitness of human computational capabilities” (Simon, 1997, p.319).

Simon regarded the decision making process as a complex set of activities not falling within interpretations of a single scientific discipline. The neo-classical economic rationality within daily practices can contradict the person’s social objectives, limited available information or the total educational level. Simon shifted the decision making process from a one-dimensional rational viewpoint to a complex systems approach. The Simon’s

interpretation of the decision making process as an element of “social architecture” is of special importance since it highlights the complex nature of economic decisions.

According to Simon, the bounded rationality theory “does not come from the assumption of rationality but rather from the assumption that rationality is, at least in some important respects, bounded” (Simon, 1997, p.332). Also, Simon advanced a thesis that was later incorporated in the theory of behavioural economics: in the decision making process, actors are simultaneously led both by short term immediate challenges and long term comprehensive thinking (Simon, 1983, p.12). Simon especially stressed the knowledge and level of perception that the decision maker was endowed with. The decision maker can operate solely within the boundaries of a familiar social field and on the basis of the volume of available information; thus, constructing an individual rational assumption instead of an absolute one.

Those judgements, despite being in conflict with the comprehensive rational behaviour concept of neoclassical economics theory, have formed nowadays a basis of a separate subdivision of economic thought and gained a status of economic school by being able to explain empirical data supported through household practices with the help of behavioural economics concept developed by Simon.

### **Conspicuous consumption**

The consumption process can be referred to both common products necessary for the provision of human existence and manufacturing means and long term commodities. The objective of the consumption can be equally to meet immediate needs and, on a more complex level, to present a social status, as an example.

The scientific study of consumption process has got a relatively long history. Back in 1899, Thorstein Veblen revealed the complex nature of conspicuous consumption in his book “*The Theory of the Leisure Class: An Economic Study in the Evolution of Institutions*” (1899). T. Veblen wrote that by acquiring goods unnecessary for daily survival, the social agent demonstrated his economic power and belonging to a certain higher social class (Veblen, 1899). The acquired goods thereby possess functions of both economic utility and social representation. The products representing prosperity can be obtained by financially secured market players. Moreover, those products carry a certain status of luxury goods. Whereas founders of the conspicuous consumption theory T. Veblen (1899) and P. Nystrom (1928) regarded luxury goods of mass consumption as status goods, with the development of national economy and improvement of the quality of life, manufacturing means also became representative products to demonstrate a higher social status (Trigg, 2001, pp. 99-115).

### **Positional goods**

Continuing the discourse on the social nature of consumption, Fred Hirsch (1976) defined characteristics of positional goods: they could be both products and services, the consumption of which relate to the user’s place within the social hierarchy. With the improvement of the entire well-being, products and services increasingly fulfil a representation function of the social hierarchy instead of a sustainable survival function of an individual or an organization. On the one hand, it promotes an ongoing development of the national economy to meet the needs of continuously increasing consumption; on the other hand, an unlimited consumption of positional goods threatens the depletion of natural resources and the raise of social inequality.

In the context of modern economics theory, the discussion on the attribution of real estate, including the land, to the status of positional goods is of special importance. The products of limited availability should be certainly attributed to positional goods. With regards to real estate, its territorial placement allows it to be included among such products. In its turn, the discussion on the land employed in agriculture, is a more complex one. On the

one hand, the land resources are limited within a territorial and, consequently, a social field and, hence, the owner of those resources is both economically and socially privileged. On the other hand, the property of positional goods is mainly characterised by a high social status and economic prosperity. Rural entrepreneurs have often acquired the land historically and they treat it not only as manufacturing means but also a lifestyle instrument. Nevertheless, the modern development of the industry increasingly positions the land resources as insufficient to ensure sustainable development of a rural farm; hence, shifting the land to the comprehension of positional goods and presenting the owner of agricultural land as somebody who occupies a high social status, at least in the hierarchy of its social field.

### **Prospect theory in economics**

Nowadays Daniel Kahneman can be regarded as the most splendid representative of behavioural economics. He enriched the belief system of behavioural economics with a number of cognitions, of which Prospect theory was presented with the Nobel Memorial Award in 2002. Kahneman continued to develop the theory of cognitive diversity of decision making rationality. The theory developed in partnership with Amos Tversky ( Kahneman, Tversky, 1979, pp. 263-327 ) confirmed the following: in making economic decisions, agents did not apply equal importance to probabilities of opportunities and losses. The decision making mostly takes place on impulse and on the basis of the historic experience that does not always reflect the existing reality. The possibility to avoid losses is regarded as proportionately more significant than the possibility to gain additional income under equal, unknown probabilities.

### **Research Methodology:**

A valid methodological approach is a part of scientific study. Socio-economic studies cannot be carried out in laboratories and confirmed through the method of experiment. Nevertheless, a set of instruments has been developed in modern times, allowing to prove conceptual constructions with empirical data.

Vernon L. Smith (1982) developed the theory of experimental economics that enriched theoretical assumptions with analysis of empirical results. The agents of socio-economic processes act in real economics and the decisions made by them cannot be replicated in laboratories. The parameters modelled in the study process do not always correspond to real economic practices. Hence, empirical data such as statistics on a macro level and polls and participatory observations on a micro level can be regarded as methodologically acceptable analytical tools.

With the objective to find out the rationality of economic decisions made by Latvian rural farms in the context of neoclassical economics theory, 44 rural farms were surveyed between September 2011 and June 2013. The subject of the study were large-scale farms which manage minimum 300 hectares of farm land and regard themselves as participants of the food commodities' market, and which have been granted subsidies by the institutions of the European Union for both rural management and the purchase of agricultural machinery.

Responses to questions of an unstructured interview and self-reflections of respondents form the set of the studied data. The study demonstrated that it was not only the formal owner of the farm but also the spouse and other employees of the farm playing a significant role in the decision making process, which is comprehensible in the context of rural manufacturing.

It should be specially noted that the manufacturers of Latvian large-scale farms were the study subject, a priori occupying the highest hierarchical position of the respective social field.

**Findings:**

Thirty four farm representatives or 77% of the targeted farms realize and during the interviews acknowledge the fact that the purchase of agricultural equipment, subsidized by institutions of the European Union, is not subjected to such factors as the lowest possible price or a potentially higher productivity output being the most essential reasons for choosing particular entities. The decision to purchase particular means of production is equally impacted by such equipollent social argument as a status assigned to the equipment by neighbours. The desire to occupy a social status above one's neighbours is the key factor in choosing the particular model of agricultural equipment. The labour productivity characteristics of the equipment play a secondary role. The treatment of the above written in terms of economics theory is an outcome that managers of Latvian rural large-scale farms utilize support programmes of the European Union in the purchase of positional goods. If the purchase of status goods is described as irrational in terms of national economy, then it is logical to ask why the support programmes of the European Union have to finance, at least partially, the acquisition of such products. Surely, a theoretical mechanism has been developed to prevent an acquisition of positional and status goods in the form of a tender where the equipment with the lowest price is deemed to be the winner. However, according to 39 ( 89 % ) of the respondents, such tender has got a formal status.

The statement made by interviewers during informal interviews of such choice being irrational did not convince respondents for their response arguments mainly confirmed the conceptual thesis of “bounded rationality”: rationality comprehension was ambiguous and could not be measured in terms of economic parameters.

It is noteworthy to share the following conclusion of the study: at the moment of purchasing the equipment as part of rural support programmes of the European Union, only 6 of the 44 interviewed managers of Latvian rural large-scale farms or 14% considered such economic categories as the equipment's value at the end of its depreciation period and the possibility to resell it for an appropriate price. Thus, it serves as an illustrative cognition of the prospect theory that short-term priorities of decision makers prevail over long-term utility aspect.

**Conclusion:**

Throughout the course of the study, there was a strong presence of the contradiction between the desire to support the development of rural farms with the objective to ensure long-term development of rural enterprises as expressed by institutions regulating agricultural policy of Latvia as the European Union country and the comprehension and real economic decisions of farmers that could be only explained with concepts of behavioural economics and that were more socially than economically orientated.

Consequently, the problem of agricultural support methods and forms funded by tax payments of member states remains unsolved and requires further study.

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