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Differences of Opinion Among Economists About Government and Market Efficacy

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LINK TO ABSTRACT

Economists view activist government policy and social insurance as potentially protecting individuals from risks and from market failure. Perhaps differences among economists in support for activist government policy in social insurance and regulation reflect differences in beliefs about the relative efficacy of government and markets. Economists for whom market failure is relatively more salient and government failure is relatively less salient will tend to favor government activism, and conversely.

Start with four propositions, two of which concern values and two of which reflect one's assessment of alternative social mechanisms.

1. Consumer satisfaction: A good society is one in which individuals are able to make choices as consumers that serve their long-term interests.
2. Risk protection: A good society is one in which individuals are able to obtain insurance against major risks to economic well-being, including expensive health conditions, uncertain longevity, unemployment, and being born into adverse circumstances.
3. Market failure: Decentralized decisionmaking and market processes can sometimes leave consumers unable to make decisions that serve their long-term interests and unable to obtain insurance against major risks to economic well-being.

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4. Government failure: Centralized decisionmaking and political processes can easily fail to achieve desired goals and leave consumers worse off.

In theory, economists could differ in their support for government activism on the basis of differences in values. For example, an economist who does not value consumer satisfaction or risk protection very highly might have little motivation to support government policies intended to further those objectives.

In practice, however, I believe that economists' views on government activism are not explained by differences in values. I suspect that nearly all economists value consumer satisfaction and risk protection highly, and that differences about how those desirables might be traded off with other social goals are relatively unimportant.

If it were the case that differences in values were a dominant factor, then it is unclear how one would explain the fact that support for activist regulation and high levels of social insurance are correlated. Why should placing a high value on consumer satisfaction and placing a high value on risk protection be correlated?

I find it much more plausible to believe that economists differ in their support for government activism because as an analytical matter some economists assign great significance to market failure relative to government failure, while other economists tend toward the reverse. If this view is correct, then the correlation of views is easily understood. An economist with relatively high trust in markets and relatively low trust in government is going to be inclined against government activism in both regulation and social insurance, and conversely.

To explore further this source of divergence, let me next propose a list of what most economists would agree are sources of market failure and government failure.

Sources of market failure

- Time-inconsistent preferences (consumers choosing today what they will regret tomorrow)
- Miscalculation (particularly in decisions about risk, e.g., a failure to properly apply the laws of probability)
- Inadequate information (choices based on misleading or inaccurate information or that go against expert advice)
- Market power (firms able to exploit dominant positions)
- Externalities (high cost of addressing these through multi-party bargaining or other decentralized mechanisms)

- Uninsurable risks (for example, the risk of being born into adverse circumstances; also, for someone already diagnosed with an illness, health risk may not be insurable)

Sources of government failure

- Preference aggregation (problems with expressing consumer/voter preferences: for example, an individual vote may not matter; also, voters choose from among candidates representing large bundles, not narrow specific policies)
- Principal-agent problems (the mechanisms for aligning the interests of government agents with those of the consumer/voter principals are weak)
- Rent-seeking (manipulation of government for private ends)
- Government monopoly (the absence of competitive pressure to innovate, discard ineffective programs, and evolve toward excellence)
- Socialist calculation (overriding or doing without information provided by the price system)

Why economists disagree with one another

Suppose that one could construct a survey that elicits from economists their beliefs about the relative significance of each of these sources of failure. For example, one could present an economist with the eleven sources of failure listed above. Next, ask the economist, "In teaching students about how to think about economic issues, which of these is the most important? Take 99 points and allocate them among the 11 sources of failure. If they are equally important, give 9 points to each. If one is much more important than the others, you may give it all 99 points."

My conjecture is that (a) some economists would give noticeably more points to the government failure sources than would other economists and that (b) the economists giving relatively high points to government failure sources would also be less supportive of activist government policy.

If my conjecture is correct, then there is a great deal of logical consistency in the views held by economists. If my conjecture were not correct, then I would be inclined to turn away from rational explanations for economists' beliefs and instead be open to suggestions from social psychologists.

Assuming that my conjecture is correct, there still may be room for social psychology to explain why some economists see government failure as salient while others see market failure as salient. Indeed, one cannot rule out the possibility that economists start with views on the role of government and then work backward to their views on the relative salience of market failure and government failure. However, I think that in principle we ought to be able to conduct rational discussions in which economists with differing points of view are able to justify their positions to one another, and even to set up thought experiments which might lead someone to change his or her mind.[2]

Explaining hypothetical survey responses

How would you have answered the survey question that I posed? For what it is worth, I would have assigned 70 points to government failure (30 for government monopoly, 20 for preference aggregation, 10 for rent-seeking and 5 each for principal-agent problems and socialist calculation) and 29 points to market failure (8 points for externalities, 7 points for uninsurable risks, 6 points for miscalculation, 5 points for inadequate information, 2 points for market power, and 1 point for time-inconsistent preferences). I tend to be skeptical toward the current level of government activism in both regulation and social insurance in the United States, but I am supportive of some government activism in each.

I think that most neoclassical economists would provide different weights. They would give little weight to government monopoly and more weight to other factors. That is because neoclassical economics treats the economy as a mechanism for production and allocation using existing resources and knowledge. My own orientation stresses the importance of learning through experimentation, evaluation and evolution.[3]

In the past, I have offered this glib characterization of economists' differences:

> Chicago economists say, "Markets work. Use markets."
> MIT economists say, "Markets fail. Use government."
> I and others like me say, "Markets fail. Use markets."

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2. Note that there is a case to be made that all disagreements must be unreasonable to some degree (Cowen and Hanson 2004).

3. Another way to put this is that neoclassical economics focuses on static efficiency, meaning optimal allocation of resources taking technology as given. The alternative is to emphasize dynamic efficiency, meaning the ability of the economy to generate and incorporate new methods of production. Nick Schulz and I have elaborated on this distinction (Kling and Schulz 2009).

What I term a Chicago economist believes that markets generally work well and that government tends to move the economy toward outcomes that are inefficient. What I term an MIT economist thinks that markets often fail and that government can frequently improve on market outcomes. My own position emphasizes that inefficiencies in current arrangements are better corrected through the market's experimentation/evaluation/evolution mechanism than through government mechanisms.

In terms of the survey above, I would expect market-oriented neoclassical economists (Chicago) to place low importance on the factors that adversely affect the ability of consumers to make decisions in their long-term interests. For example, they might view as suspect findings in behavioral economics that consumers tend toward miscalculation. The Chicago economist might argue that such findings are obtained under artificial experimental conditions, rather than in real-life situations in which consumers soon learn how to avoid mistakes. At the same time, I would expect Chicago economists to place a great deal of emphasis on preference aggregation and principal-agent problems. That is, they believe that the choices that we make as individuals for ourselves, spending our own money, are very likely to prove better than choices made for us by government agents who are spending other people's money. I would cite the late Milton Friedman as an exemplar of that point of view.

Conversely, I would expect neoclassical economists who favor government activism to assign high importance to each of the sources of market failure. They would have more confidence in the ability of technocrats to design mechanisms to improve consumer choice and less concern about preference aggregation or principal-agent problems. For example, MIT's Jonathan Gruber was an architect of both the Massachusetts health care reform passed under Governor Mitt Romney and the Affordable Care Act passed under President Obama. Gruber would argue that government-enforced insurance mandates and limitations on choice are necessary in order to guide consumers to make decisions that are in their long-term best interest.

What leads different economists to have these different points of emphasis? My guess is that we are affected by undergraduate courses, graduate courses, and general life experience. Someone whose formative coursework is with Chicago economists is more likely to end up sharing their viewpoint. Someone whose formative coursework is with MIT economists is more likely to end up sharing their viewpoint.

My own formative coursework was as an undergraduate at Swarthmore College, under professor Bernard Saffran. Saffran was an eclectic economist, equally comfortable suggesting that we read "What Do Bosses Do?" (Marglin 1974) and "The Uneasy Case for Progressive Taxation" (Blum and Kalven 1952). I recall

Saffran describing the Chicago-MIT divide by saying, "Friedman and Samuelson each teach the same elementary price theory, but Friedman applies it to policy."

In contrast, my graduate education at MIT, where I earned my Ph.D., was disappointing. I regarded the courses as exercises in mathematical hazing that I had to get through in order to stay with the program. Subsequently, I became disillusioned with my main field of macroeconomics.[4]

I also spent much of my career in business, where I found that the production-and-allocation story fails to capture what people in business think about and focus upon. The main efforts in real-world business seem to go into trying to figure out better ways of operating and then persuading people inside and outside the firm to adopt new methods.

Getting off the academic track also allowed me to be influenced by a wider set of authors. Reading George Gilder's *Microcosm* (1989) helped me appreciate the role of human ingenuity in wealth creation. Reading Douglass North's *Structure and Change in Economic History* (1981) helped me to see the importance of institutions. There are other avenues to these insights. However, the typical graduate school curriculum, at least as I encountered it, is more narrowly focused on teaching mathematical techniques.

In short, my hypothesis is this: If your formative experiences were undergraduate or graduate courses with Chicago economists, then you are somewhat more likely to share their views. If your formative experiences were undergraduate or graduate courses with MIT economists, then you are somewhat more likely to share their views. Or if your formative experiences led you to appreciate the role of human learning, ingenuity, and institutions, then perhaps you ended up more like me.

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4. See my book *Memoirs of a Would-be Macroeconomist* (**link**).

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