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Daniel L. McFadden [Ideological Profiles of the Economics Laureates]

Daniel B. Klein, Ryan Daza, and Hannah Mead

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Abstract

Daniel L. McFadden is among the 71 individuals who were awarded the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel between 1969 and 2012. This ideological profile is part of the project called "The Ideological Migration of the Economics Laureates," which fills the September 2013 issue of *Econ Journal Watch*.

Keywords

Classical liberalism, economists, Nobel Prize in economics, ideology, ideological migration, intellectual biography.

JEL classification

A11, A13, B2, B3

Link to this document

http://econjwatch.org/file_download/745/McFaddenIPEL.pdf

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Daniel L. McFadden

by Daniel B. Klein, Ryan Daza, and Hannah Mead

Raised on a farm in North Carolina, Daniel McFadden (1937–) says he was taught as a youth to "be modest, take my satisfaction from work done well, and avoid being drawn into competition for status or rewards" (McFadden 2001). As a junior in high school, McFadden was suspended for starting a petition against a school policy. He went to work on his uncle's farm in Minnesota, and at age 16 was admitted to the University of Minnesota (ibid.). He earned his bachelor's degree in physics and also became interested in mathematical modeling of economic choices. In an 2000 interview, McFadden discussed how he came to study economics:

> Well, I came from the natural sciences, from physics. I was a graduate student in physics and found psychology very interesting, and the psychology of behavior. I had an opportunity to enter this disciplinary program in the behavioral sciences. And I pursued that for my Ph.D. and got into economics pretty much by accident, because the formal modeling, the axiomatic work that I was interested in was being done primarily by two economists, John Chipman and Leo Hurwicz. So I made economics my specialty in order to work with them. (in Heckman and McFadden 2000)

At Minnesota, he worked with Hurwicz and Chipman, and he visited Stanford to work with Kenneth Arrow. After earning his Ph.D., he did post-doctoral work at the University of Pittsburgh, and then was on the faculty of the University of California at Berkeley. After spending over a decade at Berkeley, McFadden went to MIT, where he enjoyed the intellectual climate fostered by Paul Samuelson, Robert Solow, and Franco Modigliani. In 1991, he returned to Berkeley, where he started the Econometrics Laboratory (McFadden 2001). He earned the 2000 Nobel Prize "for his development of theory and methods for analyzing discrete choice," sharing the prize with James Heckman.

A major contribution came about when a graduate student sought his help modeling freeway design choices, which led him to build "an econometric model based on an axiomatic theory of choice behavior" (McFadden 2001). The applicability of his ideas is broad:

> These developments, now called the multinomial logit model and the random utility model for choice behavior, have turned out to be widely useful in economics and other social sciences. They are used, for example, to study travel modes, choice of occupation, brand of automobile purchase, and decisions on marriage and number of children. (McFadden 2001)

David Henderson describes the importance of McFadden's innovation:

> Before McFadden's work, empirical economists who studied various issues tended to assume that the variables they were studying were continuous. This works well when one studies, say, the demand for sugar, because people buy various amounts of sugar along a continuum. But what if one is studying the demand for refrigerators? Because most people have only one refrigerator, the choice of a refrigerator is a discrete choice. (Henderson 2008)

John Rust (2008) notes that "McFadden developed the econometric methodology for estimating the utility functions underlying probabilistic choice theory."

McFadden rarely criticizes government intervention and sometimes advocates it. He does not appear to have changed his views over his lifetime. McFadden has signed petitions opposing the George W. Bush tax cuts, in favor of government-oriented healthcare reform, in favor of a financial transaction tax, in favor of liberalizing immigration, in support of John Kerry for president in 2004, and in favor of Federal Reserve independence (Hedengren et al. 2010).

In a 2006 article, McFadden made the following remarks:

> Consumers who know their own tastes, and are relentlessly self-interested and self-reliant, relish choice, and welcome market opportunities that expand their options. Most economists accept this concept of the consumer, and the attendant economic theory that

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> demonstrates the efficiency and Pareto optimality of decentralized, competitive markets. Over the past 30 years in the United States and elsewhere, these market-oriented views have driven economic policy, leading to deregulation of air and truck transportation, telecommunications, and energy markets; establishment of property rights and markets to manage environmental externalities; and globalization of international markets for goods, capital, and services. Notable successes were the deregulation of truck and air transportation, and of telecommunications, where dysfunctional regulation worked at cross-purposes to competition. Another success was making air pollution a property right, allowing Coasian markets to internalize environmental externalities. There have also been striking failures, such as the breakdown of the incompletely deregulated energy market in California a few years ago, the rail transport deregulation in Great Britain which got wrong the incentives for track maintenance, and the British system of private retirement accounts which allowed excessive fees and overselling. However, the sweep of decentralization and privatization is, I believe, widely viewed by economists as an almost universal success, with the failures due to correctable flaws in market design. Romantics of the economic right would carry the concept of self-interested consumers and free markets even further, embracing a withering of authority and a nirvana of Hayekian self-reliance. …
>
> My concern in this paper is that it is not enough to find ways to handle information and technology issues in privatization if consumers are not up to the task of functioning satisfactorily in such markets. The argument is not that consumers should be coddled; they may need to see the stick to get the incentives for self-reliance right. However, the efficiency and stability of an economy requires that all consumers be part of the franchise, in reality and in perception, so that good economic policies, including privatization and free markets when they make sense, receive broad support. (McFadden 2006, 5-6)

Regarding the 2008 bailouts, McFadden was quoted as saying: "I don't think it is a great package. … It is more important that something be done than what is in the package. … I don't know about one approach versus the other, but psychologically it is important that something be done" (quoted in Lott 2008).

In 2006, McFadden expressed cautious optimism for Medicare Part D, under which the government subsidizes prescriptions but allows individuals to choose where to purchase their medication, in his presidential address to the American Economic Association:

> The new Medicare Part D prescription drug insurance market illustrates that leaving a large block of uninformed consumers to "sink or swim," and relying on their self-interest to achieve satisfactory outcomes, can be unrealistic. To make the Part D market work, in the sense that it provides choices that consumers want, and achieves the efficiencies it seeks, CMS [the Center for Medicare and Medicaid Services] will have to make a diligent effort to manage the market, and to reach all consumers and provide them with information and assistance in making wise choices. What the Part D market, and other market privatization initiatives, need is a component of Thaler and Sunstein's (2003) *libertarian paternalism*, in which understanding consumers' limitations, helping consumers to help themselves, and convincing them that the market will serve their interests are intrinsic parts of mechanism design. (McFadden 2006, 23, emphasis in original)

By 2007, McFadden considered Part D to have been largely beneficial. He wrote in the *Wall Street Journal* that the program had "succeeded in getting affordable prescription drugs to the senior population," and that "[i]ts privatized structure has not been a significant impediment to delivery of these services." But McFadden advised caution in applying privatization elsewhere in health care, stating "the success of Part D depends substantially on thoughtful and muscular management of the market." Instead, McFadden made three recommendations for health care reform: Reducing inefficiencies of administrative overhead and medical malpractice costs; enacting universal health insurance coverage, particularly focusing on preventative medicine; and matching costs with benefits by placing "treatment choices and financial responsibility on the individual" (McFadden 2007).

Regarding Social Security, McFadden wrote in 2005 that the "system is not in immediate crisis, but it does need adjustments to guarantee its future solvency" (McFadden 2005, 1). He went on to say that the current system can be maintained with simple adjustments to taxes and benefits, or it can be redesigned to "offer a degree of individual choice, encourage savings, and reduce political and demographic risks to the system without destroying its important 'social safety net' features of insurance and redistribution that protect the most unfortunate among us" (ibid.). On this latter route, however, he warned against destroying the system: "It will be truly unfortunate if the penchant for aggressive marketing and zeal for

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market solutions in the Bush administration result in what one might dub 'the Fox News plan to guard the Social Security chickens'" (ibid.).

McFadden says that he is increasingly focused on behavioral anomalies.

> In recent years, my research has concentrated on the deviations from the economic theory of choice, found particularly in the experiments in cognitive psychology conducted by Danny Kahneman and Amos Tversky, and their implications for economic analysis and the interpretation of economic data. (McFadden 2001)

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