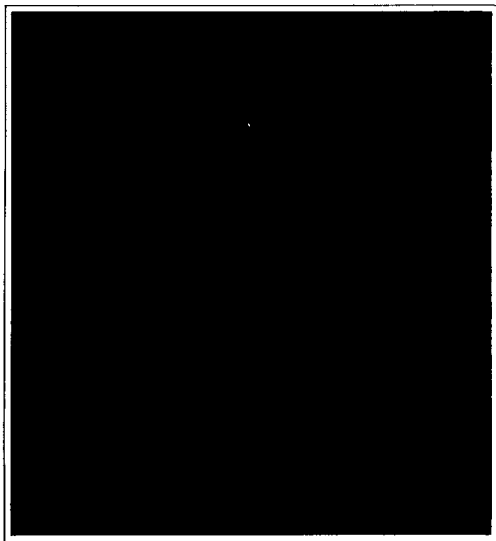


# THE ECONOMIST'S VIEW OF THE WORLD

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PUBLIC POLICY

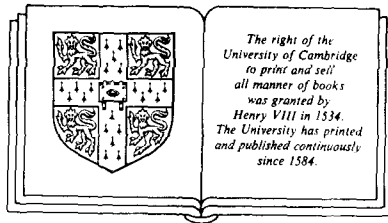


**Steven E. Rhoads**

# THE ECONOMIST'S VIEW OF THE WORLD

GOVERNMENT, MARKETS, AND PUBLIC POLICY

STEVEN E. RHOADS



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## THE ECONOMIST'S VIEW OF THE WORLD

To the Queen of the Forest  
and our brood:

**Bananaman, Poo-man-chu, and the Birdman**

## PREFACE

This book is written, first and foremost, for intelligent, educated readers who are interested in domestic public policy and who know little or nothing about economics. Some of these readers will be found in public-policy courses taught outside economics departments. Some will be professors interested in learning more about an influential sister discipline. But many will have long since left the groves of academe. All these potential readers may associate economics with some best-selling ideological tract or with long afternoons spent in Economics 101 peering at supply and demand curves on dusty blackboards. I ask such readers to give economics another chance. The ideological tract may not have been written by an economist; even if it was, it almost certainly did not represent most economists' opinions. And there are no graphs in this book.

I hope that my book will show that economics is more substantial than the best-selling ideological tracts indicate and more interesting than most economists' explications suggest. I am a political scientist who believes that some knowledge of contemporary microeconomics is a prerequisite for intelligent citizenship. Succeeding chapters show that a large number of congressmen, consumer advocates, and business and union representatives give no evidence of having met the prerequisite. They show also that our public policy is the worse for that failure. Laurence Silberman, undersecretary of labor at the time the Occupational Safety and Health Act was passed, has said that he would have pushed hard for an alternative approach if he had had his present understanding of economics.<sup>1</sup> I know a number of other advanced students of public affairs who, after being reintroduced to economics, have expressed amazement that they could have so long ignored a subject so central to their concerns. Many have said that they will never again read a newspaper in quite the same way. Noneconomist readers should expect to be surprised at how often what is controversial politically is not controversial among most economists, and vice versa. I in turn will be surprised if such readers

are not led to rethink a number of their current opinions on public-policy issues.

Though I am glad to have spent the last decade immersed in economics, I am also glad that, as a political scientist, I will not have to spend the next decade so thoroughly immersed. The last part of the book explains why. This is not the place to indicate the nature of my critique of economics, but the potential reader should be made aware here that the book's early praise of the discipline is followed by quite spirited criticism. I think this unusual mix of strong praise and sharp criticism is necessary to do justice to a discipline that is full of both marvelous insights and troubling blindness.

Though my principal audience is a "nonexpert" one, I hope that my attempt to assess the strengths and weaknesses of their discipline will also be of interest to economists and their students and to others in the policy-analysis community. This "expert" audience has a right to expect extensive documentation when a noneconomist attempts a comprehensive and frequently provocative assessment. The resulting notes have been placed at the end of the book so as to be as undistracting as possible to my principal audience.

STEVEN E. RHOADS  
*Charlottesville, Virginia*  
*April 1984*

## ACKNOWLEDGMENTS

If this book has any virtues, their genesis was at the Cornell University of the 1960s. As a master's candidate in public administration, I was drawn to Cornell's economics department. There, from Alfred Kahn and Robert Kilpatrick, I learned that the fields of regulatory economics and public finance addressed issues of policy substance in a disciplined and illuminating way.

Many years later, at a chance meeting, Kahn foolishly agreed to look at a manuscript I was working on. When I later deposited 550 pages on his doorstep, he kept any groans inaudible, and, in the midst of a schedule busier than any I will ever know, he produced twenty-two single-spaced pages of detailed, exceedingly helpful comments. Those who followed Fred Kahn's career in President Carter's administration will not be surprised to learn that at Cornell he was famous for his buoyant energy, wit, and intelligence. They may know less than I do of his astonishingly generous nature.

Toward the end of my study of economics at Cornell, I had the good fortune to encounter another legendary campus figure, Allan Bloom. It was later my privilege to study with this peerless teacher when he was finishing his work on Plato's *Republic* and beginning his study of Rousseau's *Emile*. Like most other graduates of what today pass for good liberal arts colleges, I had never read these, or indeed, almost any other truly important book. From Bloom I learned of views of the world richer than those of economists. My book would be a far better one if I knew even a few of the great books of political philosophy half as well as he.

After receiving my master's degree, I worked under Charles Schultze at the U.S. Bureau of the Budget. There I was able to see the economist's view of the world as it first began to gain a real foothold in government through the studies that grew out of the old Planning, Programming, and Budgeting System.

When I returned to Cornell to obtain my Ph.D in government, I was fortunate to be able to work with Richard Fenno, Allan Sindler, and Walter



Berns. My efforts here to let economists speak in their own words whenever possible are a tribute to Fenno's more skillful use of this method to bring alive the life of the Congress. In their very different ways Sindler and Berns provided me with important models of how one can find in political science a source for thoughtful analysis of the issues of American politics. Sindler chaired my dissertation committee and has helped in many ways in succeeding years.

A manuscript that attempts to cover as much as this one does would be riddled with errors were it not for the kindness of readers more expert than I about various parts of it. The entire first draft of the manuscript, or substantial portions thereof, was read by Edward Banfield, Lawrence Brown, Donna Hawthorne Carfagno, James Ceaser, Ward Elliott, Joseph Goldberg, William Johnson, Alfred Kahn, Carnes Lord, Harvey Mansfield, Jr., Edgar Olsen, James Pontuso, Abram Shulsky, Allan Sindler, Aaron Wildavsky, Leland Yeager, and several anonymous readers. Though I think my readers' comments have made this version much improved, they are of course blameless if I have made things worse instead.

The graduate students in the public administration classes of 1983 and 1984 were involuntary, but extraordinarily helpful, readers. I extend thanks to them and to my wife, Diana, the only person who has had to read every page of every draft. She is a superb editor, but that is the least of her virtues.

Cathy Dooley, Jim Crane, and Roxanne White were the last of a long line of research assistants who performed important but unglamorous work with skill and good cheer. Barbara McCauley did her usual superb typing job. The Institute for Educational Affairs, the Earhart Foundation, and the Center for Advanced Studies at the University of Virginia provided generous fellowship support that made possible a full year for writing. The university's small grants committee and the Department of Government and Foreign Affairs provided funds to type and reproduce the manuscript. And finally, Colin Day has been a gifted and helpful editor from the very first. It has been a pleasure to work with him, my excellent copyeditor. Mary Byers, and the rest of the staff at Cambridge University Press.

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# 1

## INTRODUCTION

When the educated layman looks at the economy, he sees unemployment, inflation, and low growth. When he looks at the economics profession, he sees chaos. The cartoonist Mal captures the public perception perfectly. In one picture he depicts a frightened stranger entering a doorway labeled "Department of Economics" beside which is a sign saying "Abandon All Hope Ye Who Enter Here." In another he has his bewildered moderator standing at the podium of an economic forum say, "We will now hear from another eminent economist who will refute everything the previous eminent economist has had to say." Little has changed since the days when a wag commented, "If parliament were to ask six economists for an opinion, seven answers would come back – two, no doubt, from the volatile Mr. Keynes." One might, of course, seek to resolve this problem of conflicting advice by taking counsel from economists who consider the point of view of all schools of thought. But then the frustration felt by Harry Truman is sure to return. After an afternoon of hearing "on the one hand...on the other hand," Truman declared that he was going to get himself a "one-handed economist."

Economists feel misunderstood. People notice only their showy, disheveled, and presumptuous half, macroeconomics, while their solid, elegant, better half, microeconomics, remains unseen. Thus one can find prominent economists calling microeconomics "the Cinderella side of the discipline" or complaining that "macro gives micro a bad name."<sup>1</sup>

The economists have a point. The discipline as a whole is not in shambles, far from it. In academia there are more micro- than macroeconomists, and in government there are far more. Microeconomists and those associated with fields that have spun off from microeconomics, such as welfare and benefit-cost economics, public finance, and public choice, have never been more influential. In the universities economic concepts and models appear often in the work of psychologists and sociologists.<sup>2</sup> Economists have been so influential in political science that one of their number, Gordon Tullock, was

ected to the governing council of the American Political Science Association.<sup>3</sup> Even contemporary philosophy has been heavily influenced by the study of economics.<sup>4</sup>

The pervasiveness of economic thinking in the professional schools is even more striking. Both in this country and abroad it is increasingly important to the study of public administration.<sup>5</sup> In the interdisciplinary public-policy programs that have grown enormously at our best universities, microeconomics is acknowledged to be the most influential specialty.<sup>6</sup> Almost all the best law schools now have at least one economist on their faculties, and economic principles significantly affect teaching and scholarship in traditional fields such as torts, contracts, property, antitrust, and administrative law. Economics has even reached the medical schools. A path-breaking book, *Costs, Risks and Benefits of Surgery*, edited by two doctors and a statistician, draws heavily on economic theory and cost-benefit analysis.<sup>7</sup>

As might be expected, this economic imperialism has met opposition wherever it travels. But even the critics of economics grant its influence, sometimes explicitly,<sup>8</sup> and sometimes by the very vigor and frequency of their protests. The disciplines that make up the humanities and social sciences study human beings from a wide variety of perspectives. If an award were to be given to the discipline that has had the most influence on other disciplines over the last two decades, the Cinderella side of economics would make economics an all but certain winner.

The public perception of economics as a discipline riven by schisms is largely true of macroeconomists, but that perception is wildly wide of the mark for microeconomists. Indeed, one source of microeconomists' great influence is the consensus they have reached on important questions of fact and theory. This consensus extends even to evaluative questions. Economists tend to use the same normative framework and evaluative criteria when examining domestic programs, whatever the functional area. More remarkable still, on a host of controversial policy questions, economists, whether liberal or conservative, Democratic or Republican, come to the same general conclusions. They make the same criticisms of existing government policies, and they make similar suggestions about desirable alternatives. The late Arthur Okun put it this way:

Economists of contrasting political views agree among themselves on many issues. In particular, on a number of issues, a bipartisan majority of the profession would unite on the opposite side from a bipartisan majority of the Congress.<sup>9</sup>

Opinions like those of Okun have been voiced by a number of other prominent economists, and the existence of the consensus he describes has been confirmed by a recent poll of the profession as well.<sup>10</sup>

Macroeconomics focuses on broad economic aggregates such as total output, total employment, the price level, and the rate of economic growth. Macroeconomic policy seeks to keep inflation and unemployment low and

economic growth high. Microeconomics focuses not on broad aggregates, but on particular sectors of the economy and the relations among the sectors. Microeconomics seeks to determine how scarce resources are allocated among competing sectors and among competing societal ends and who gets the goods and services provided. Policy-oriented microeconomists usually want to change the mix of goods and services produced by the economy so as to more efficiently satisfy consumers' preferences. Typical policy concerns of microeconomists are government's inefficient regulation of transportation and communications, inefficient controls over rent and energy prices and over minimum wages, and the inefficient design of environmental and occupational safety policies.

Growth, unemployment, and inflation sound more important, and in the final analysis they probably are. But microeconomics is concerned with more than technical, uninteresting details. For one thing, micropolicies affect macroproblems. As discussed in Chapter 6, micropolicies that discourage savings and investment hurt economic growth, and laws requiring minimum wages increase unemployment rates among poorly educated, inexperienced workers. And though the design of environmental policies sounds pretty dry, the stakes are not small. As will be discussed in Chapter 4, economic studies show that better designs could save tens of billions of dollars at no cost to the environment. Thus, good solutions to macroquestions must take account of micro-particulars. There would be no cause for congratulations if all our workers were fully employed producing low-priority goods in a wasteful manner.

This book explains and assesses the way that most micro, welfare, and benefit-cost economists look at the world of public policy. It evaluates the views of mainstream economists, those whose outlook has been shaped by the principles discussed in standard microeconomic or public finance texts. As I use the term, "mainstream economist" encompasses a clear majority of economists – liberal and conservative, Democratic and Republican. Though Chapter 9 contains a brief discussion of John Kenneth Galbraith, I make no attempt to consider systematically the spectrum of opinion among radical, socialist, or Marxist economists.<sup>11</sup>

Academic economists working in government are often appalled by the ignorance of economics that they encounter.<sup>12</sup> Yet they readily acknowledge that what they add to the policy process is primarily "a basic orientation and general framework" or "the simplest, most elementary concepts of economic theory."<sup>13</sup> This book explores that basic orientation, those elementary concepts, and the policy conclusions they point to.

Parts I and II consider the two types of policy guidance provided by the micro, or resource allocation, side of economics. Part I discusses opportunity cost, marginalism, and economic incentives, three illuminating concepts central to the world view of almost all economists. Opportunity cost reminds us that since resources are scarce and ends multiple, to worry about costs is to

care about benefits, benefits forgone in other sectors. This seeming truism has not in fact been fully understood by a number of intelligent politicians and public administrators. Marginalism shows why neither the intrinsic importance of a public function nor a ranking of problems facing a community provides much guidance for public-expenditure choices. Marginalism suggests looking at the details – understanding that most budgeting decisions concern spending a little more or a little less, not whether we should address a problem at all. After looking at the details we may find that added expenditures will have little effect on the relatively intractable “most important” problem while they could dramatically alleviate the third most important. Finally, the *economic-incentive insight* allows us to see how we can achieve a number of our public goals more cheaply and successfully if we pay more attention to private self-interest when designing our government programs. Many of our new regulatory programs, such as those for environmental protection and worker safety, try to change the behavior of millions of individuals and business firms by way of detailed laws and regulations. Economists have convincingly shown that changing material incentives so as to make private interests more congruent with public goals is, in many cases, a dramatically superior approach.

The concepts of opportunity cost, marginalism, and economic incentives are less ambitious than the economics discussed in Part II. They do not seek to provide comprehensive frameworks or conclusive answers. They are instead ideas to be kept in mind – factors to be weighed against other relevant factors when thinking through a problem or policy. Though these concepts are less ambitious, they are not necessarily less useful. One can reject the evaluative principles behind the economics discussed in Part II and still learn from Part I’s concepts.

Chapter 5, the first in Part II, explains why most economists, liberal and conservative, have great respect for market systems and great skepticism about the efficiency of governments. Markets do, however, fail in some situations, and these are outlined and explored in the fields of public finance and welfare economics. Economists working in these fields believe that reflection on market failures, particularly on the type of failure called an externality (an effect on a third party that is not transmitted through the price system), can lead to conclusions about the desirable scope of government. When externalities can justify government programs, economists then look at the geographical scope of the externalities to help decide whether federal, state, or local governments should take the lead in addressing the problems at hand. Chapter 7 outlines and explores the policy relevance of these teachings. For example, it shows how the externality concept can be used to criticize some political arguments concerning the desirability of voluntarism in environmental enforcement and of subsidies for rail transportation.

The principles of welfare economics provide guidance about the appropriate



agenda for government. Benefit-cost economics, the applied branch of welfare economics and the subject of Chapter 8, goes even further and gives advice about how much money should be spent on justifiable objectives and functions. For economists the benefits of a government program are entirely dependent on the preferences of consumers, that is, on their willingness to pay for the program. Chapter 8 contains a nontechnical explanation of the way economists estimate consumers' willingness to pay for several domestic programs. It also assesses the political and intellectual controversy concerning the legitimacy of benefit-cost analysis.

Welfare and benefit-cost economics tell economists that societal welfare is maximized if individuals' preferences determine the use of scarce resources, but they say nothing about whose preferences should count the most. The standard economic framework, however, does acknowledge that achieving whatever society considers a fair distribution of income is a legitimate purpose of government. Chapter 6 explores the controversy among economists about the equity or fairness issue. It shows that there are large differences in the profession over evidence and appropriate societal values. Still, even on this controversial equity question economic analysis is more than an amalgam of conflicting ideologies. Economists have reached a remarkable consensus about the best way to achieve an equity objective, and they agree that there is a tension between the goals of economic efficiency and growth on the one hand and a more equal distribution of income on the other. The substance of the consensus on these issues will seem provocative to most noneconomists. Noneconomists may also be surprised to learn that liberal Democratic economists join conservative Republican economists in advocating a tax on unemployment insurance benefits and an end to the tax on corporate income. And that most economists, Republican as well as Democratic, believe that welfare and Medicaid should be primarily federal, not state and local, responsibilities.

Parts I and II of the book emphasize the ways that economics can improve public policy. Part III focuses on weaknesses in the public-policy perspective of most economists. Economists hope to avoid controversy by simply taking preferences as they find them. Chapter 9 shows that this procedure does not avoid controversy, however, since it can sometimes make policy choices turn on the gains to the criminal from crime or the costs to the malevolent from saving lives. Moreover, in practice economists are often not neutral about preferences. Despite the formal openness of welfare economics, in their policy work many economists overemphasize the importance of money as a human motive and source of happiness.

Welfare-economic principles do not allow one to distinguish between high and low or moral and immoral pleasures. The externality concept does, however, allow for government encouragement of activities that bring third parties pleasure and government discouragement of activities that bring third parties