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The Political Limits of Economics

"War is too serious a matter to entrust to military men."
Georges Clemenceau, French Prime Minister during WWI

When a Jehovah's Witness needs a blood transfusion, the doctor limits herself to explaining the risk involved in refusing a transfusion. If the patient is conscious and refuses the transfusion, the doctor follows his wishes, no matter the consequences, including worse performance measures for her hospital (Chand et al., 2014).

In principle, the role of economists should be no different. Neoclassical economics is based on the assumption that consumers are capable of making the best decisions for themselves. Yet, when it comes to economic policy, we economists seem to behave very differently from doctors. Rather than trying to follow or infer people's will, we try to substitute it with "sound economic thinking." This substitution is intellectually justified by some (not always well-specified) political failure. In this article, I will review what these justifications are and to what extent they are logically inconsistent with the very model most economists use. I will discuss two inefficiencies produced by this substitution: distortion in preferences, as economists have values and beliefs different from the majority; and experts' failure, i.e., when delegating to experts produces worse outcomes. Finally, I will propose some changes the economic discipline can make to mitigate these distortions.

1. Political Failures

In spite of Arrow's (1951) impossibility theorem, most economists accept – at least in theory -- the idea that social preferences should be determined through a democratic process and that the role of an economist is simply to maximize the social welfare function derived from these preferences. In practice many economists, both in their theoretical work and in their advising practices, seem to break this separation and take a more patronizing attitude, where they claim (explicitly or not) that they know what it is good for society more than its elected representatives. Thus, they use their tools and expertise to impose their view, rather than playing a mere advisory role. When they do so, however, they generally do not question the democratic principles, but they identify a reason why the political system fails to represent the true will of the people (which here I simply identify with the will of the majority). Therefore, they claim their actions are not only legitimate, but also necessary to fix a political failure.

1.1 Voters Alleged Stupidity

The crudest form of political failure is the one assumed by Jonathan Gruber, President Obama's advisor on the health care reform. In a panel discussion at the University of Pennsylvania, he said the Affordable Care Act was deliberately written "in a tortured way" to disguise the fact that it creates a system by which "healthy people pay in and sick people get money." The obfuscation was necessary due to "the stupidity of the American voter."[1] Thus, the presumption is that a majority of American voters do not want a healthcare system that pools risk because they are ignorant or stupid and thus the role of the advisor is to implement this system anyway—if necessary obfuscating the effects from voters, so they cannot possibly undo it.

This attitude is not unique to Gruber nor to the Democrats. Philip Swagel, a senior official in the Bush administration, wrote that "that under pricing insurance coverage is economically similar to overpaying for assets—but it turns out to be far less transparent" (Swagel, 2009). He laments that the Bush administration did not exploit this insight as much as the Obama administration. Again, the idea is that voters are stupid and prevent economists from doing the right thing (in this case overpaying for toxic mortgages to relieve the banking sector). In both cases, economic advisors see their role as disguising from voters what they are doing in order to perform what they think is the right course of action.

1.2 Voters Are Myopic

An only slightly more sophisticated version of the above argument is the one advanced by Blinder (1997). "Myopia is a serious practical problem for democratic governments" – he writes – "because politics tends to produce short time horizons -- often extending only until the next election, if not just the next public opinion poll. Politicians asked to weigh short-run costs against long-run benefits may systematically shortchange the future." The implicit assumption here is that economic experts do not suffer of this myopia. It is not clear whether it is because of different incentives (which can be changed) or because of some intellectual superiority of the category.

Given these assumptions, Blinder concludes that Americans "have drawn the line in the wrong place, leaving too many policy decisions in the realm of politics and too few in the realm of technocracy." Hence, he advocates the creation of more independent agencies like the Fed in the areas of taxation, trade, the military, etc., since "the argument for the Fed's independence applies just as forcefully to many other areas of government policy."

1.3 Time Inconsistency

[1] https://www.youtube.com/watch?v=G790p0LcgbI

A more refined version of the previous attitudes stems from the time inconsistency literature (Kydland and Prescott (1977)). This version does not question people's ability to vote according to their own preferences, but it questions voters' ability to vote strategically, taking into consideration the long-term consequences of their decisions. Take for instance the example of capital taxation. Lower capital taxation leads to higher savings, but once the capital generated by these higher savings is in place, the Government will be tempted to tax the sunk capital. In the model, even the most benevolent government cannot resist this temptation, because ex post taxing sunk capital is the least costly way to raise revenues.

The assumption underlying this model is that voters do not understand or internalize the consequences of the Government deviating from the optimal long-term policy and they do not punish their elected representatives for this. When George H. W. Bush deviated from his pledge--"Read my lips, no new taxes" -- he failed to be re-elected. German voters would certainly punish a government who violated a pledge to maintain low inflation, even if this violation had produced a temporary rise in employment. In sum, the idea is that unlike voters, economists understand the value of commitment. Thus, they need to build this commitment through the creation of some institutions, like an independent central bank run by economists.

It might seem unfair comparing Gruber's stupidity model with Kydland and Prescott's time inconsistency one. Yet, both models rely on some cognitive limitations suffered by voters, limitations not suffered by economists or investors. Both models also deliver as optimal strategy some non-transparent actions undertaken by economists or other administrative personnel and justified by the desire to maximize the very welfare of recalcitrant voters.

To appreciate why these commitment institutions are non-transparent, consider the fact that, given the irreversibility of some of these choices, they should be approved with the procedures reserved for constitutional rules. In joining of a commitment mechanism like the euro, however, many countries did not follow a constitutional process. In addition, all too often when these commitment mechanisms are adopted, some of their long-term costs are purposefully hidden from the political debate. For example, only after he brought Italy into the euro Romano Prodi admitted, "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But some day there will be a crisis and new instruments will be created."[2] So Prodi, an economist by training, saw the euro as a commitment strategy to reach a goal (European political union) that voters did not want, but he thought was good for them to achieve.

1.4 Economic Inconsistency

[2] Lionel Barber, Peter Norman, Prodi pledges to relaunch career, «Financial Times», December 5th, 2001.

The most explicit form of substitution is when economists de facto abrogate an existing law because they deem it inconsistent with economic thinking. This is the case with the Robinson-Patman Act. Approved in 1936, the Act amended section 2 of the Clayton Act providing that

"[i]t shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers of commodities of like grade and quality (15 U.S.C. sec. 13a).

The Act aimed to "protecting small business firms from competitive displacement by mass distributors at a time of general economic distress" (Rowe, 1980). In spite of the several attempts to repeal it, the Robinson-Patman Act is still on the book.

In a parliamentary democracy, Congress conveys the will of the people. Thus, the failure to repeal an Act indicates a desire to keep pursuing the goals embedded in that Act. Yet, the Act is not enforced, because economists, who found it "inconsistent with the antitrust goal of promoting competition" (Blair and DePasquale, 2014), have de facto abolished it. In the Act's first two decades of life, the Federal Trade Commission brought 429 Robinson-Patman cases and issued 311 cease-and-desist orders. In the last two decades, it filed only one such case (Blair and DePasquale, 2014).

Interestingly, promoting competition was not the stated goal of the Act nor necessarily the legislators' (only) goal in passing most U.S. antitrust law. As Pitofsky (1979) convincingly argues, Congress "exhibited a clear concern that an economic order dominated by a few corporate giants could, during a time of domestic stress or disorder, facilitate the overthrow of democratic institutions and the installation of a totalitarian regime." The Robinson-Patman Act is consistent with this goal. Why, then, is it not applied?

In the 1970s the introduction of economic analysis to antitrust law, pioneered by the so-called Chicago School, led to the consideration of the maximization of consumer welfare as the only goal of antitrust (Bork, 1978). Once this idea became mainstream, laws like Robinson-Patman could be "repealed" for manifest inconsistency with this overarching goal (as chosen by economists).

1.5 Nirvana Fallacy

I do not ignore the fact that some (if not all) the political failures described above can be real. Nevertheless, I fear we economists fall into a version of what Harold Demsetz (1969) called "nirvana fallacy." Demsetz lamented that imperfect markets were compared with an idealized form of government intervention. As a result, the mere proof of existence of a market failure was sufficient to justify a government intervention.

Most economists fall into a similar trap when they encounter a political failure. The failure of the political process is compared with an idealized version of philosopher king-like experts. As a result, the

mere existence of a political failure is sufficient to justify substituting democratic processes with economic experts' decision-making. Unfortunately, this substitution ignores both the potential biases we economists might have and the potential inefficiencies in our decision-making process.

In the next section I will discuss extensively both these points. Before doing so, however, I want to raise another problem: the sample selection in the choice of political failures on which to focus. I am not aware of any attempt to rank political failures, based on empirical relevance. For example, Gilens and Page (2014) show that U.S. government policy seems to be driven more by the interests of economic elites and organized business than by the preferences of the majority. This seems to be a first-order distortion of the political process. Yet, I am not aware of any economic model designed to address this distortion.

2. *Economists' Preferences*

Doctors follow their patients' wishes. When these wishes are not clear, they resort to the moral guide provided by the Hippocratic Oath. What do we economists do when we are, legitimately or illegitimately, without a democratic guide? We do not have anything like the Hippocratic Oath. In the absence of any professional guidance, we are likely to apply our own preferences and beliefs. This would not be a problem if we economists were a representative sample of the population and if our training would not distort values and beliefs. Unfortunately, both these assumptions appear to be false.

2.1 Are Economists Different?

There is evidence (Frey and Meier, 2003) that economics students are more selfish than the average student is and that higher level of selfishness is due to self-selection, not indoctrination.
Yet, education seems to be playing a role too. Wang et al. (2011) show in an experiment that the teaching of economics makes students more selfish and less concerned about the common good.

Sapienza and Zingales (2013) compare the responses to the same set of questions given by a representative sample of Americans and by the Chicago Booth- IGM panel of economic experts. Economists tend to trust both the government and the market much more than average Americans. When it comes to issues of government intervention and redistribution, however, economists respond like (Bill) Clinton Democrats: more in favor of redistribution than the average American, but trusting markets much more than even the average Republican.

2.2 Economic Credo

While selection might play a role, education certainly plays a big one. Not only does our discipline instill a great trust in markets, it also makes us focus on efficiency issues rather than distributional ones.

In the early treatises, our discipline was called political economy.[3] Only after Alfred Marshall was the political term dropped and it became simply known as "economics." This is not a coincidence: with the introduction of calculus, the Marginalist Revolution brought a clear separation between production efficiency and distribution. The role of economists is to maximize the production efficiency, given a technology. This maximization generates an economy's production possibility frontier. The social optimum is just the tangency point of that frontier with exogenously given social preferences, assumed to be the result of some political process outside the economic realm, in the same way in which the existing technology is assumed to be the result of some technological process, outside the economic realm.

At a first approximation, distributional issues are absent. First, in perfect competition any factor receives the value of its marginal contribution to the final outcome. Thus, distribution is driven by external impartial forces, which might have their own moral legitimacy. Second – and most importantly – any distribution can be achieved through a system of taxes and transfers without altering the efficiency of the production process. Thus, the economic problem (allocation of resources) can be separated from the political problem (the distribution of those resources).

Neoclassical economics, however, went even further. According to the Kaldor–Hicks criterion, a reallocation of resources is an improvement if those that are made better off could hypothetically compensate those that are made worse off and lead to a Pareto-improving outcome. It is not necessary that a redistribution take place to determine that an allocation is more efficient. The Kaldor–Hicks criterion justifies economists' focus on the total size of the economic pie and our ignoring distributional issues. If the economic pie is maximized, the economists' job is done. The remaining political problem is somebody else's job.

2.3 Economic Experts vs. Average Americans

The impact of economics education in creating a divergence between economists' perspective and that of average Americans can be seen in economists' responses to the Chicago-Booth IGM survey. Economists agree among themselves most in the topics most covered in the economic literature. Yet, these are the topics on which their opinions differ most from those of average Americans. This divergence is even more pronounced on distributional questions. For example, 95% of economists believe that "on average, citizens of the U.S. have been better off with the North American Free Trade Agreement" vs. only 46% of Americans. Similarly, only 12% of economists think that "Buy American" may have a positive impact on manufacturing employment vs 76% of average Americans (Sapienza and Zingales (2013)).

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[3] See for example David Ricardo, "On the Principles of Political Economy and Taxation," (1817), Jean-Baptiste Say, "Traite' d'Economie Politique," (1841), and John Stuart Mill, "Principles of Political Economy" (1848).

One might think that these differences in opinion might be due to the superior knowledge possessed by economists. Yet, for the example of the carbon tax Sapienza and Zingales (2013) show that this divergence is not due to lack of understating of the problem, but simply to the average American's lack of trust that the government will rebate the proceeds of the tax.

3. Economic Experts' Failures

Thus far, I have only considered the problem of divergence of interests. Yet, there are expert-specific failures as well. From eugenics to the Bay of Pigs, from Chernobyl to economic development policy, history is littered with disastrous failures produced by the most famous experts (Koppl, 2018). The main reasons behind these major failures are twofold: i) the capture of experts by their employers (like the World Bank experts described by Easterly (2014)); and ii) groupthink (Janis, 1972), i.e., a psychological phenomenon that occurs within a group where the desire for conformity results in a dysfunctional decision-making outcome.

3.1 Economists' Capture

Economic experts might end up making the wrong decision because their opinion reflects their interest (or the interest of those who pay them) more than the interest of the people whom they represent (Koppl, 2018). As I explain in Zingales (2014), this capture can be conscious, as occurs when regulators tilt their decisions to favor their future employers, or subconscious, when only economists holding certain beliefs are chosen for certain jobs. Maximizing total output regardless of distributional concerns, for instance, might seem an impartial approach until one considers how it combines with the political process. If the political process favors the rich and powerful, then value-enhancing proposals that favor the bottom of the distribution are not even discussed. The only proposals that are discussed are those that tend to concentrate the benefit at the top. Thus, by ignoring distributional issues economists tend to become (involuntary) instruments of the rich and powerful.

3.2 Economists' Groupthink

The generalized adoption of mathematical tools not only favored the separation between economics and politics, but also greatly contributed to the power and prestige of the economic profession. Most importantly, it created a barrier to entry that separates economists and non-economists, infusing in the former a sense of superiority vis-à-vis other social scientists (Fourcade et al., 2015).

Unfortunately, this sense of superiority fosters groupthink, especially when a group feels threatened from the outside. Entertaining a critical hypothesis is seen as betrayal of the group and punished with

ostracism. John F. Kennedy's adviser Arthur Schlesinger recalls remaining silent during the cabinet's discussion of the Bay of Pigs invasion for fear of being cut out of the inner circle (Janis, 1972). The result is excessive conformism, especially on those ideas that are very far away from those of the rest of the population. This pattern is consistent with what Sapienza and Zingales (2013) observe with survey data.

4. Potential Remedies

In spite of my criticisms, I do believe that economic expertise is useful. The problem is how to use it in a way that is both effective and democratic (i.e., respectful of the will of the majority). This problem can be addressed from two perspectives: from the institutional perspective (how to delegate power to economic experts to minimize the above problems) and from a disciplinary perspective (how to change the economic discipline to minimize the above problems).

Tucker (2018) tackles the first problem in the context of independent government agencies, with the goal of ensuring the democratic legitimacy of these agencies at all times. While his goal is not to minimize preference distortions and inefficient decision-making, it is pretty highly correlated. With this goal in mind he elaborates five delegation principles for expert agencies: i) a clear purpose; ii) clear procedures; iii) clear operating principles; iv) sufficient transparency/accountability; and v) a clear mechanism to limit experts' power in emergency situations. In the rest of this article, I will focus on the second problem: what we economists can do, inside our profession, to reduce the risk of preference distortions and groupthink.

4.1 Economic Relativism

The solution is not for economics to abandon the mathematical rigor, but to re-connect itself with the other social sciences. Philosophy purports to be about the search for absolute truth. However, once we realize that not only the search process, but also the very notion of absolute truth differs from period to period, the "truth" loses its absolute nature. Italian philosopher Benedetto Croce calls this process historicizing philosophy. Economics not only needs to be historicized, but also sociologized and even politicized, in the higher sense of embedding it in political science, not of making it an instrument of partisan politics.

An example of the necessity of historicizing economics comes from antitrust. In 1966, the US Supreme Court blocked a merger between two grocery stores because the combined market share would have reached 8.9%. At the same time, the market capitalization of the largest company in America (IBM) was less than 4% of GDP and the largest five banks controlled less than 9% of deposits. Fifty years later,

Amazon alone controls 50% of on-line sales. There are four companies with a market capitalization larger than 4% of GDP and the largest five banks control more than 45% of deposits. Should the attitude towards antitrust enforcement be the same as 50 years ago? Obviously not. There are no absolute dogmas; economic prescriptions should change with the historical context.

An example of sociologizing economics comes from the support for the euro. In Europe, all mainstream economists support the idea of a common European currency, whereas in the United States many prominent economists from Milton Friedman and Martin Feldstein to Paul Krugman do not. Is economic science different in Europe? Or are political considerations distorting economists' beliefs on one side of the Atlantic or the other (or both)? By not studying sociology, economists end up being unconscious victims of sociological pressures to conform.

While in neoclassical economics efficiency and distribution are separable, in reality they are not, and economists' push for efficiency is not neutral from a distributional perspective. Economists cannot ignore the role that their research and ideas play in the lobbying effort. For example, Hubert (2019) describes the role economic research played in promoting the regulatory success of Uber. By claiming the technical and narrow scope of our papers, we cannot pretend to ignore the bigger picture these papers are playing any more than physicists at Los Alamos could claim to be mere scientists. Are we comfortable with this? Many people (myself included) think that the Manhattan Project was well justified, but nobody can claim it was just technical and not political.

The benefit of re-embedding economics into social sciences is threefold. First, it will ensure that economists' prescriptions are less at odds with the desires of the rest of society. Second, by diminishing economists' sense of superiority, it will reduce the risk of groupthink. Finally, it might attract a broader and more representative set of people in the economic profession.

4.2 Political Economy Welfare Analysis

In the last 50 years, we have seen an explosion of work in Public Choice and Political Economy. The success of these innovations consists in having imported economic mechanisms into political decision-making: political actors are not utopian figures, but common human beings, who maximize their own utility.

Interestingly, this effort has mainly focused on positive, not normative, analysis. A similar effort should be made to incorporate political science into our economic welfare analysis. Rather than using political failures to justify arbitrary economic interventions (as described in Section 1), we should incorporate the very frictions present in the political process to conduct a feasible welfare analysis. The idea can be best illustrated with an example.

Assume for instance that each person has a marginal utility that is very high up to a minimum income level and then constant. Assume that the social welfare function assigns equal weight to all individuals. Absent any friction in the political process, this welfare function would induce policy makers to maximize output, reallocating income in favor of those who earn below the minimum income level.

Let us now introduce a realistic friction in the redistribution process. If there are a few billionaires and a large mass of unemployed people, the cost of redistribution would be very concentrated, while the benefit diffuse (Olson, 1965), making the redistribution more difficult (let us say for simplicity, impossible). Then, the separation between production efficiency and distribution falls apart; so will many of the standard economic predictions. For example, is it optimal to let Walmart first and Amazon later eat up all the mom-and-pop retail stores? In the traditional framework, the answer was straightforward. To the extent that Walmart and Amazon are more logistically efficient, it is optimal to let them prevail and – if necessary – redistribute some of the income.

If the formation of large concentrations of wealth, however, prevents redistribution and the elimination of many mom-and-pop stores leaves many individuals without the means to earn the minimum income, then letting Walmart and Amazon eat all the local distributors may not be optimal. In this context, a law like the Robinson-Patman Act can be an effective way to ensure a minimum income, without needing a massive fiscal redistribution. It can be doubly effective if this Act also prevents the formation of large concentrations of wealth because, if necessary, it facilitates fiscal redistribution. Note that introduction of a minimum wage cannot ensure the same result. If the mom-and-pop owners and employees do not have skills employable in other sectors, in the presence of a minimum wage, they will remain unemployed and necessitate a transfer.

This is just an example. The social welfare function is not necessarily realistic and the political failure too stark. Nevertheless, it highlights how the incorporation of the political frictions in our welfare analysis could lead us to rationalize even those conclusions most despised by economists.

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