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Oren Cass: When Market Economists Fail

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Essay by Oren Cass

When Market Economists Fail

Saying goodbye to self-defeating libertarianism.

"The Schoolmaster," woodcut by Albrecht Dürer, 1510

The professor paces with purpose before his pupils. "Ask yourself," he intones, "who should decide things: Private investors who can go bankrupt and are responsible for the risks they take, or the State?" A student offers, perhaps tentatively, perhaps with confidence, "Well, the State, because it wants what is good for us in the long run. The market is just about selfishness." The professor's steel trap of logic slams shut. "Where is this state you speak of?" he retorts. When they say, "The state should have the power to direct resources, and the market should be suppressed," they should remember to take out "The state" and replace it with "People chosen by parties and elected by voting dominated by large corporate interests."

"In fact," he continues:

> you should replace "The state" with "Donald Trump." Say it with me: "I think that corporate CEOs and professional investors should have all their funds taken away at gunpoint, and then all investment decisions, for the whole U.S. population, should be made by Donald Trump. He wants what is best for all of us, and he has a longer-term perspective."

This tale is neither satire, nor a liberal fever-dream, nor a surreptitiously recorded exchange. It is the proudly self-reported pedagogy of Michael Munger, professor of economics and political science at Duke University, former president of the Public Choice Society, and a former editor of the journal *Public Choice*. His binary choice between "private investment" and "the whims of Donald Trump" to "decide things" is a perversion of so-called "public choice theory"—one all too familiar to anyone who engages in policy debates with market fundamentalists.

The basic insight of public choice theory, first developed in the mid-20th century, is a valuable one: government is not an abstract and beneficent "it," but is composed of individuals pursuing their own interests and it is they who wield the instruments of public power. Thus, while the natural tendency may be to identify some market failure or other social problem and then conclude that "government should solve it," in fact one has to go further and contemplate what the actors within government, given their own incentives, are likely to do. What failures will they have, and is the eventual outcome likely to improve the situation? George Mason economics professor Donald Boudreaux put the point well in a 2016 conversation sponsored by the Mercatus Center's F.A. Hayek Program: "When we want to understand the proper respective roles of the state versus the market, we have to compare the two in a way that uses the same

assumptions about human motivations in one as…in another."

The excesses and abuses of public choice theory stem from abandoning this useful apples-to-apples framing for a dangerously skewed apples-to-oranges analysis of its own. Yes, matters may become messy with government action, but a failure to act can leave quite a mess as well. Public choice devolves into self-parody when it replaces the "apple" of actions taken by self-interested individuals in the face of government *inaction* with the "orange" of a self-regulating market overseen by incorruptible libertarians. The problem is threefold: First, public choice enthusiasts steadfastly refuse to apply the same scrutiny to the private sector that they eagerly heap upon government. Second, they forget that the existing system is subject to all the same drawbacks that they detect in any proposed reform. Third, they exempt themselves from their claim that public actors are merely economic agents.

The result is an approach that presumptively vetoes almost any proposal for government action, precludes the development of useful policy agendas, and leaves conservatives scared and ill-equipped to exercise public power. President Ronald Reagan famously captured the sentiment with his wry remark that "I've always felt the nine most terrifying words in the English language are: I'm from the government, and I'm here to help." Few of the pundits who gleefully recycle the comment seem aware that it was delivered as preamble to announcing a "decision on grain exports" and "record amounts of assistance" for the agriculture sector. The Right needs to appreciate public policy's limitations while still recognizing the many cases in which it is necessary and productive.

Compared to What?

Public choice enthusiasts describing the theory in the abstract will generally be careful to acknowledge that markets, too, are "imperfect." But when actual policy proposals reach the table, that caution vanishes.

A good example comes from Professor Boudreaux, who argues against the regulation of financial markets on the ground that they give rise to *no* negative "externalities" or unforeseen side effects; any such suspicion, he says, is "psychosomatic." On his blog, Café Hayek, he continues:

> Investors who buy other firms spend their own money and money entrusted to them voluntarily. When their merged firms succeed, these investors profit; when these firms fail, they lose. Likewise, owners who sell their assets gain when their decisions are wise and lose when they aren't. This prospect of gain and threat of loss "internalizes" on those who make financial-market decisions the benefits and costs of these decisions.

Policymakers shouldn't regulate the financial sector, he believes, because in fact it is taxes and regulations that create whatever externalities we might observe. "It certainly makes no sense to ask the very people who impose these harmful interventions—politicians—to address the problem with *additional* interventions rather than simply to remove the offending ones."

No part of this argument is correct. Financial markets are, quite obviously, subject to a variety of market failures. Investors can make a great deal of money even when firms they have acquired go bankrupt. And who—to use the framework of public choice—are these "investors"? A private-equity fund, for instance, consists of individuals, all pursuing their own self-interest, which may not align with maximizing either the fund's profit or the acquired firm's profit. Nor would maximizing the firm's profit—say, by offshoring production and throwing workers onto the unemployment rolls and government benefit programs—necessarily be of net value to society. The resources invested, meanwhile, often come from pension funds owed to millions of American workers and endowments that back large non-profit institutions, controlled by investment managers (often public or non-profit employees) with the assistance of high-priced consultants, all of whom have incentives of *their* own. Over the past decade, the entire private-equity industry has collected roughly $230 billion in fees while delivering returns no better than a passive market-index fund—a "wealth transfer from several hundred million pension scheme members to a few thousand people working in private equity," Oxford finance professor Ludovic Phalippou told the *Financial Times* in June, that "might be one of the largest in the history of modern finance."

> The starting point for any policy debate is not the blank slate of a libertarian paradise.

Here is another example: in the Liberty Fund's *Concise Encyclopedia of Economics* (2007), the entry on "public choice" by William Shughart, editor-in-chief of *Public Choice*, uses a "prospective home buyer" to illustrate how incentives and constraints in private markets "channel the pursuit of self-interest." The buyer "chooses among the available alternatives in light of his personal circumstances and fully captures the benefits and bears the costs of his own choice." Just another day in the smooth, well-functioning, externality-free housing market. Nothing to see here—neither infrastructure nor public schools nor mortgage market affects his choice; nor in turn will his family's presence affect the neighbors, the schools, or the tax base. The public choice enthusiast, in his zeal to identify every possible way in which state action may not yield the desired result, rarely leaves time for considering how the private sector actually works.

The enthusiast will also tend to err in overstating his case against the public sector by disregarding the nation's political structures. Professor Munger's self-inflicted *reductio ad absurdum* of "all investment decisions, for the whole U.S. population, should be made by Donald Trump" is particularly pronounced. More generally, the leap from the assertion that public servants pursue their own interests to one that they will *not* act in the public interest forgets that a central premise of democracy is to ensure at least some alignment of these interests, and that the U.S. Constitution, in particular, was designed precisely to channel when possible the individual interest toward the common good. "*The Federalist Papers*," Judge Frank Easterbrook once noted in the *Harvard Law Review*, "can be thought of as the first chapter in the modern theory of public choice."

In fact, both the democratic process and the scrutiny of an independent media are powerful forces that push public actors to do well by doing good, and that establish a correlation between the actor's effectiveness and his attainment of status and power. The internal motivation that led many to public service in the first place is at work, too. As Adam Smith observed in *The Theory of Moral Sentiments*, man "desires, not only praise, but praiseworthiness; or to be that thing which, though it should be praised by nobody, is, however, the natural and proper object of praise."

These forces are imperfect, and countervailing ones push in other directions, but the question must again be: *compared to what*. Profit only partially guides private actors and, even to the extent they do lead their organizations toward profit maximization, the problem remains that this pursuit may not advance the public interest. The electorate only partially guides public actors and, even to the extent they do curry its favor, the problem remains that what is popular may not be in the public interest. Most challenges and goals will thus call for some combination of public and private action, neither of which will accomplish everything we might wish, but the combination of which can accomplish more than either on its own.

Empirically, this has proven true. Many public programs, though imperfect, are substantial improvements over not having adopted them in the first place. From public safety and public schools, to infrastructure and research, to Social Security and Medicare, to even the rat's nests of regulatory complexity and inefficiency in areas like employment and environmental law, self-interested public actors have repeatedly advanced the common good. Each of these fields is rife with flaws and failures, and yet no meaningful constituency takes the view that America would be better had policymakers taken public choice theorists' warning to steer clear entirely. The public choice enthusiasts are themselves remarkably quiet on which of government's tentacles they would lop off. Shall we "Defund the Police"? Public choice is always a reason to reject the new, but rarely is it wielded against the old.

Globalization and the Common Good

The strange respect accorded to status-quo policy is the second of public choice's apples-to-oranges mistakes. The starting point for any policy debate is not the blank slate of a libertarian paradise, but rather the accumulation of actions—and decisions not to act—taken over decades by politicians subject to all the same incentives that public choice worries about in any new proposal. The concern that some proposal will *introduce* "government failures" into a field is invariably misplaced—they are already there.

Debates over globalization and the free flow of goods, people, and capital across borders provides an especially pronounced example of this phenomenon. Globalization has been a *process* undertaken from a starting point of high tariffs, immigration restrictions, and capital controls. The new global order had never before existed and would not arise on its own; policymakers built it. Yet to the public choice analyst, it represents an ideal from which any departure is presumptively destructive.

Writing recently in *National Review*, Ramesh Ponnuru and Michael Strain, both at the American Enterprise Institute, acknowledge that "[s]pecific proposals to limit imports or promote domestic production have to be considered on their own merits. Their usefulness and cost-effectiveness cannot be ruled out in principle." Nevertheless, they maintain, "we have ample reason to be skeptical of such proposals, and to think that a political system that reduces its skepticism will be opening the door to many more destructive than constructive policies." As an example, they offer a textbook public choice critique of steel and aluminum tariffs that "dovetailed with a powerful lobby's desires."

On the one hand, Ponnuru and Strain are correct that proposals to limit imports or promote domestic production should raise public choice concerns, and also that many of the Trump Administration's actions have been inept. On the other hand, it doesn't follow that greater openness to such proposals would be on balance negative. The playing field on which imports face few restrictions and domestic producers receive little support is not one that predates government action, but rather is a direct result of decades of intensive lobbying, negotiation, and compromise by the very same kind of interests that Ponnuru and Strain distrust. Why should policymaking deserve greater skepticism when pursuing one trade strategy than another? They never say. Tellingly, they do say they would prefer to see policymakers proceed along the lines of the

Trans-Pacific Partnership, a trade agreement that grew to more than 5,000 pages through 19 rounds of negotiations and lobbying from 200 companies and associations. With respect to the quality of *that* document, the incentives of negotiators and the role of lobbyists go unraised. This seems like public choice for thee, but not for me.

One might make the case that trade barriers inherently raise greater public choice concerns than the trade agreements that have benefited large multinational corporations at the expense of less-skilled American workers; or that straightforward immigration quotas are more worrisome than programs like the H-1B visa (of which the primary users are large Indian outsourcing firms). But this is hardly obvious.

The more plausible view, as Samuel Hammond wrote recently for an American Compass symposium on supply-chain reshoring, is that phenomena like "industry capture" are inevitable—indeed, that useful analysis of political economy should begin from an acceptance that categories like "politics" and "economics" cannot be neatly separated and policymaking should accept and leverage their inevitable interaction. "[I]n a second-best world," Hammond continues:

> our choice may not be between *whether* our government is captured but *by whom*. Indeed, today's America has a robust industrial policy for Wall Street, soybean farmers, Hollywood, drug companies, and trial lawyers. Is it any coincidence that the systems governing these sectors are also some of the most captured?
>
> Reorienting American industrial policy toward productivity growth, upward mobility, and breakthrough innovation will require strengthening our coordinating institutions to resist certain forms of capture. But in many cases, it will also require identifying *superior captors*, for whom the "special interest" and "general interest" roughly align.

James Pethokoukis, an AEI colleague of Ponnuru and Strain's, inadvertently underscores this framing on Twitter when he asks, "Whatever 'industrial policy' is in the abstract, the real-word American version would seem likely to look like cronyism + political payoff with some good stuff mixed in. A net gain?" The question implies that the "real-world American version" of some alternative economic policy does not suffer from "cronyism + political payoff." That's not right, as Pethokoukis himself would attest. Shortly before President Trump's election, when most expected eight years of President Obama to lead into a Clinton Administration, he published a blog post entitled, "How much of US corporate profits comes from cronyism? Maybe a lot and growing."

Whatever *any* policy is in the abstract, the real-world American version would seem likely to feature cronyism and political payoff. This applies to the policies we already have, and to any proposed. That is, of course, the central insight of public choice! The interesting question for policymakers seeking "net gains," as Pethokoukis's formula highlights, will usually be how much "good stuff" is mixed in. And then in determining *how* to pursue a particular strategy, insights from public choice can point helpfully toward better designs.

The Limits of Libertarianism

The cynic may conclude that public choice enthusiasts deploy their concerns selectively against any policy whose substance they dislike. But a more generous, and likely, explanation is also available: they exempt themselves from their framework. They tend to be libertarian; the same distaste for coordinated public action that draws them to a minimal-government ideology also attracts them to an analytical frame that casts government's processes and participants in the worst possible light. And they retain a conviction that if *they* had the opportunity to implement *their* agenda, acting as they could with a sophisticated grasp of public choice's constraints, they might achieve *their* worthy objectives.

"Advocates of the free market know that it will take a long time to get to our Promised Land," writes Robert Tracinski, a columnist for the webzine the *Bulwark* and author of a reader's guide to *Atlas Shrugged*, "and we've given up expecting the laissez-faire utopia in our lifetimes." Clearly, though, they have not given up altogether.

Consider the seemingly inexhaustible supply of energy expended on tax reform. A formal public choice analysis would surely identify tax policy as among the most fraught areas in which government might act. Concentrated special interests have enormous financial stakes in every complex, arcane clause. Opportunities abound for manipulation, mistakes, and unintended consequences. And yet the same public choice enthusiasts who see in any other vote the prospect of mischief and a likelihood of only making matters worse, see endless opportunity in tax reform. When tax cutters advance a bill, some reason exists to believe it will in fact be a constructive one. More broadly, when comparing policy visions, the libertarian option is granted a presumption of clean hands and wise implementation, while public choice's unflattering lens focuses squarely on the alternative.

A corollary of this phenomenon manifests itself in consistent befuddlement on the part of libertarians at the idea that their market fundamentalism has dominated establishment conservatism in recent decades. How could this be the case, if government continued to grow throughout the period regardless of who held power? Had politicians of such noble bearing led the way, surely we would by now have reached the Promised Land! They have forgotten public choice, or at least forgotten its application to their own ideological brethren.

What a Republican Party in thrall to market fundamentalism delivered is precisely what public choice theory would predict, suggested by President Reagan's joking that government help is to be feared while at the same time announcing massive new farm programs—cronyism, political payoffs, and some good stuff. Except, under market fundamentalism, the "good stuff" meant cutting taxes, releasing capital from constraint, and otherwise doing nothing, which has proved not so good.

This last of public choice's foibles is particularly regrettable because correcting it so thoroughly undermines the entire enterprise. Taken seriously, the claim that "we should regard actors in the public sphere as always rationally self-interested" ought to apply to public choice scholars themselves, who after all are public actors. If they develop and advance their insights simply in order to maximize their own advantage, we cannot credit them with actually believing what they say. Nor, for that matter, does it much matter what they say, for they cannot disinterestedly persuade anyone of anything, seeing as we will all pursue *our* self-interest regardless.

Of course, that is nonsense. Ideas do matter, precisely because public actors may, and often do, have a substantial interest in advancing the common good—alongside, no doubt, a desire to be successful themselves. We should not want our public choice friends to vanish in a puff of illogical smoke. Their *legitimate* insights counsel humility, check grandiose ambitions, and offer guidance for effective policy design. But their days at the table's head, striking items from the agenda and overruling conservatives who would exercise public power, must come to an end.

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