

They can afford full-time lobbying staffs at state capitols and in Washington, and their largesse during elections assures them that their lobbyists will be welcomed by public officials. No matter that everyone's vote counted equally in the polling stations—one person, one ballot, one vote. In the legislative assemblies and regulatory agencies where policies are made, some people's votes count far more than others'.<sup>29</sup>

Ultimately, equality of voice is the most important equality issue of all. To the (very large) extent that government policies determine the distribution of resources, privileges, and welfare, the distribution of political power shapes all other distributions.

<sup>29</sup>For sobering descriptions of the political dominance of economic elites, see Robert Kuttner, *The Squandering of America* (New York: Random House, 2007); Robert Reich, *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life* (New York: Knopf, 2007), chap. 4; and Sheldon S. Wolin, *Democracy Incorporated: Managed Democracy and the Specter of Inverted Capitalism* (Princeton: Princeton University Press, 2008).

### 3

## Efficiency

Efficiency is a fancy name for a simple idea: getting the most for the least, or achieving an objective for the lowest cost. But, as the political scientist Aaron Wildavsky observed, efficiency doesn't tell you *where* to go, only that you should arrive there with the least possible effort.<sup>1</sup> It is a way of judging the merits of different ways of doing things. Thus, efficiency isn't a goal in itself. It isn't something we want for its own sake but rather because it helps us attain more of the things we value. Still, I include it in the section on goals because it has become such a prominent way of discussing and evaluating public policy.

Efficiency is a comparative notion. It has come to mean the ratio between input and output, effort and results, expenditure and income, or cost and benefit.<sup>2</sup> As a criterion for judging goodness, it has been applied to all manner of things. Efficient organizations are ones that get things done with a minimum of waste, duplication, and use of resources. Efficient people are ones who get a lot done in a little time. Efficient programs are ones that result in the largest benefit for a given cost. Efficient distributions, say, of farm land or oil drilling rights, are ones that yield the most value for society from existing resources.

All these definitions are variations on the theme of getting the most out of something. Like the "equal slices" solution to the problem of dividing resources, getting the most out of something is an intuitively appealing solution to the problem of how to choose between policy alternatives.

<sup>1</sup>Aaron Wildavsky, *Speaking Truth to Power: The Art and Craft of Policy Analysis* (Boston: Little, Brown, 1979), p. 131.

<sup>2</sup>Sumner H. Slichter, "Efficiency," in *Encyclopedia of Social Sciences*, Edwin R. A. Seligman, ed. (New York: Macmillan, 1947), vol. 5, pp. 437–39.

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No one is opposed to efficiency any more than people are against equity. Everyone would like to attain things they value in the least costly way. That is why politicians routinely promise to deliver the same or better results for less money. The conflicts arise over three questions: Who gets the benefits and bears the burdens of a policy? How should we measure the benefits and costs of a policy? And what mode of organizing human activity is likely to yield the most efficient results?

### WHAT IS EFFICIENCY?

In one of the classic essays on efficiency, Herbert Simon speculated on how to apply the efficiency criterion to running a public library. A "good" public library, he concluded, is not one that owns all the books that have ever been published, but one that has used its limited funds to build up as good a collection as possible under the circumstances.<sup>3</sup> Building on Simon's work thirty years later, Aaron Wildavsky and colleagues used the same approach to evaluate the efficiency of a real library system in Oakland, California. They began with the idea that "an agency is inefficient if it can (but does not) produce more outputs for its budget."<sup>4</sup> Here is a summary of their analysis:

One output of a library system is circulation. A key to circulation is a lively, up-to-date stock of books. New books cost money, which could be found by reallocating funds in the budget. Our analysis of library staffing showed significant over-qualification among the personnel. Many branch libraries had a staff of two or more professionals where one professional with a paraprofessional could have handled the work. High-salaried professionals often did clerical tasks. If staffing policies were adjusted to the actual work load, the savings in salary could be put toward new books.<sup>5</sup>

In short, an efficient library is one that builds up a good collection of books, and Oakland's library would be more efficient if it replaced some professionals with paraprofessionals and spent the savings on books.

We can imagine several plausible challenges to this solution.

1. Some citizens might ask whether the book collection is really what matters about a library. Maybe instead, a library system should provide computers and Internet access, public lectures, discussion groups, storytelling, reference services, archives of community oral history, or summer and after-school jobs for local teenagers. Who set "building a book collection" as the main objective and how should all the different functions of a library be prioritized? In short, how do we know which objectives to use to judge the costs of attaining them?
2. Book lovers in the community might debate what kind of book collection would be "as good as possible." Should it emphasize books for kids or adults? Sci-fi, history, or romance? Entertainment or reference? Each type of book would benefit a different group of library users. What about loaning digital readers and MP3 players, and stocking audio books, DVDs, and podcasts? Such a collection would create a new set of library users. These are all questions of constituency: whom does the library serve?
3. The librarians who would be sacked by the professors' prescription would be quick to point out that public libraries provide valuable employment for the community and avenues of upward mobility, especially for women. They would look at staffing as an output of libraries, not just an input. Staff salaries should count as expenditures on one side of the ledger but also as income to community members on the other side. Because, as is so often true in the polis, inputs are simultaneously outputs, calculating efficiency makes for some confused arithmetic.
4. The librarians might go on to list other community benefits from their services. They help unemployed people fill out job applications and use the Internet to search for work. They read to kids in story hours, and effectively provide after-school care, giving parents free time to do other productive things. Maybe, the librarians might concede, these functions don't require professionally trained librarians, but wouldn't Oakland get more output for its expenditures if it took money from the book budget and put it into salaries for more paraprofessionals? There is no limit to the types of benefits one can imagine for any input. How do we know where to stop counting positive ripple effects and how to put values on the ones we do count?
5. The costs of any activity, economists tell us, include not only the actual money outlays for it but also the forgone opportunities that could have been accomplished with the same expenditure. Perhaps

<sup>3</sup>Herbert Simon, *Administrative Behavior* (New York: Macmillan, 2nd ed. 1947), pp. 186-87.

<sup>4</sup>Wildavsky, *Speaking Truth to Power*, op. cit., note 1, p. 365.

<sup>5</sup>Wildavsky, *ibid.* Wildavsky and his colleagues would be quite sensitive to the kinds of challenges I am about to raise. I use this example not to criticize them but to show that apparently clear-cut definitions and criteria become much more complex when we think politically.

instead of buying books, the money could build a new space for reading groups, classes, and performers. There are lots of other things the library administrator could have done with the budget besides either buying books or paying salaries. Which of all the possible forgone opportunities should count as "opportunity costs" in the efficiency calculation?

6. Some people think of an efficient library as one that would waste the least amount of time. Users would waste less time looking for books if there were always a large staff on duty able to help them, but that would mean lots of idle librarians. Librarians would waste the least time if they were always busy helping patrons, but that would mean making the users wait in lines. One person's efficiency is another person's waste.
7. Some people think of an efficient library as one that is easy to use. Oakland residents might find their library system easier to use if it had many small branches within walking distance of every neighborhood. Sure, people could borrow from interlibrary loan, but without a local branch it's harder to browse books to inform their choices and they would have to wait longer to get their desired book. Town budget officials, though, see branches as unnecessary duplication of collections, so they close branches in the name of efficiency. Thus, the duplication in a multibranch system can be seen either as helping citizens get the most out of their library or as wasteful spending.

Measuring efficiency is like trying to pull yourself out of quicksand without a rope. There is no firm ground. Policy objectives constantly change, because they are forged in political conflict, not handed down on a stone tablet. Even a very narrow objective such as a good book collection is subject to competing interpretations. What kind of book collection? And good for whom? And even if we settle these questions, how do we measure the costs and benefits of any library policy, given that costs are simultaneously benefits to someone else, that benefits extend in an infinite chain, and that costs conceived as forgone opportunities are limited only by our imagination?

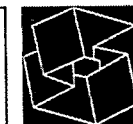
As the library example illustrates, there are many possible paths to the goal of "most value for the money." Each path favors different interests. These paths can't be scored on any fixed metric of efficiency. Everyone supports the general idea of getting the most out of something, but to go beyond the vague slogans and apply the concept to a concrete policy choice requires making assumptions about who and what counts as

### CONCEPTS OF EFFICIENCY

*Simple Definition* Getting the most output for a given input

*Complications in the Polis*

1. Who determines a program's main objective or goal, and how should we weigh the importance of multiple objectives?
2. How do different outputs benefit different groups?
3. How should we count inputs (such as labor costs) that are simultaneously outputs to somebody else (such as jobs and income)?
4. How should we decide which secondary and tertiary outputs to count in the efficiency equation?
5. How should we count the virtually unlimited opportunity costs of resources used as inputs?
6. One person's efficient use of time could be another's waiting time or downtime.
7. Apparently wasteful duplication and redundancy might increase the value of a program or resource.



important. There are no correct answers to these questions to be found outside the political process. The answers built into supposedly technical analyses of efficiency are based in large part on political claims. By offering different assumptions, sides in a conflict can portray their preferred outcomes as being most efficient.

### MARKETS AND EFFICIENCY

Markets are networks of exchanges where people come together to swap goods or trade goods for money. These exchanges have two important characteristics that serve as defining assumptions of the market model and allow its adherents to claim that markets are the most efficient mode of social organization. First, the exchanges are voluntary. People engage in trades only if they want to, and they want to trade only when they believe a trade will make them better off. Second, people make their voluntary exchanges on the basis of two kinds of information—objective information about the price and quality of all alternatives available for

trade, and subjective information about their own needs, desires, and abilities (or "preferences" in the language of economics).

In the theory of markets, assuming that exchanges meet certain conditions, they always lead to efficiency. Resources always move in a direction that make people better off, because exchanges are personal choices. Individuals survey the exchanges available to them, compare available alternatives with their personal preferences, and select the exchange that yields the "best results." Since no one would voluntarily do a trade that made him worse off, and people would engage in trades only when at least one side was made better off, all voluntary exchanges must lead to situations where at least one person is better off and no one is worse off.

In the theory of markets, voluntary exchanges transform resources into something more valuable. One kind of transformation is straightforward—the conversion of raw materials into finished goods. But there is another more mystical sort of transformation in market theory, and that is the exchange itself. In markets, all items have two values: their market price, or what we might call universal value, and their value to a person or a firm, or what we might call subjective value. My loaf of bread and your two dollars are equivalent in the first sense, but we engage in a trade only because they are unequal in the second sense. Your need for food makes bread more valuable to you, and my ability to convert flour into bread makes the cash more valuable to me. We are both made better off by the exchange, even though our little economic system contains the same two dollars and loaf of bread before and after the exchange.

Voluntary exchanges are supposed to ensure "getting the most for the least," because they leave decisions in the hands of the people who have the best information about subjective values—individuals themselves. And—now comes a big "if"—if all the exchanges in a system are efficient, then the result will be maximum *social welfare*. Why? Because in the market model, social welfare is *defined* as the grand total of all individuals' well-being added together.

The logic works for producers as well as buyers and sellers. Manufacturers, farmers, bankers, hospitals, and schools know best how to design, make, and market whatever they produce. Given freedom to innovate and do things as they see fit, they will optimize their productivity, quality, and profitability. Competition disciplines producers to fight for customers by being as efficient as possible, or, in today's marketing lingo, by giving customers the most value for money. Producers who aren't efficient will lose to the competition and go out of business. Because competition weeds out

weaker and less efficient firms, markets are naturally self-correcting and self-regulating.

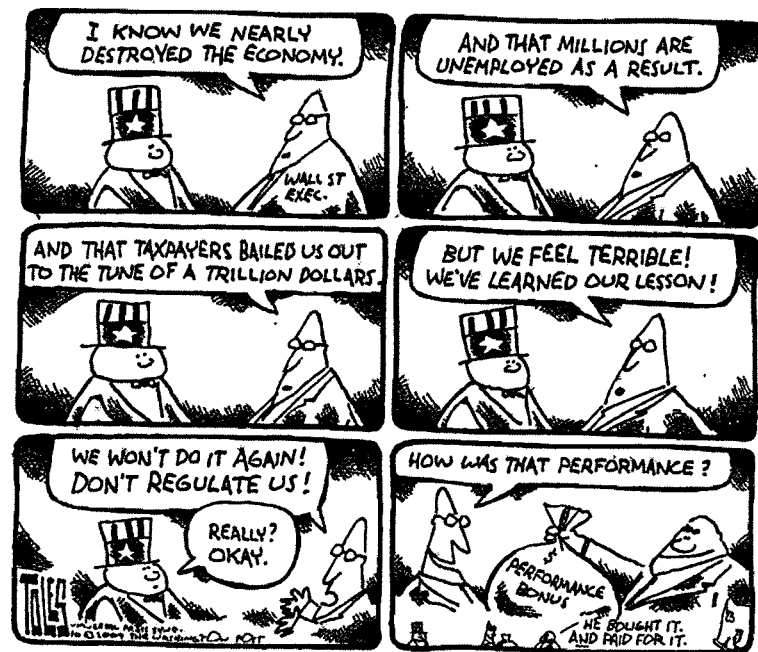
Even though the free-market logic rests on models of simple buyer-seller exchanges, many proponents leap from these market microcosms to national political economies to claim that free markets can produce social welfare more effectively than governments. Therefore, the broader theory holds, political leaders should minimize government regulation, keep taxes low, cut government spending and services, and allow private businesses to operate as freely as possible.

Behind the theory of markets and efficiency, then, there is an ideological debate about whether government should try to manage competitive capitalism or let free markets drive the economy. Free-market theory undergirds a political worldview that goes by many names: classical liberalism, conservatism, free trade, laissez-faire, globalization, the Washington Consensus, or neoliberalism—the name I'll use. On the other side of the ideological debate, in a worldview variously called liberalism or progressivism in the U.S., social democracy or social markets in Europe, and socialism in many other places, proponents believe that unrestrained markets lead to dangerous concentrations of power and wealth, and that democratic governments must manage market capitalism for social progress and prosperity.<sup>6</sup>

Through the twentieth century, the pendulum swung back and forth between these two ideas about how best to organize a national economy. The Russian Revolution in 1917 triggered a strong reaction in the West against government planning and in favor of maximum freedom for business. Then, following the Great Depression and the worldwide economic collapse of the 1930s, policy makers lost faith in the capacity of competitive markets to regulate themselves. John Maynard Keynes, a British economist and strong believer in the virtues of markets, put forth a theory of why markets can sometimes go awry and fail to right themselves before they cause huge damage. Government, he thought, should anticipate these failures and establish corrective mechanisms. Keynes's theory became the basis of policy in Europe and North America through the early 1970s.<sup>7</sup> Meanwhile, neoliberal free-market advocates and many corporate leaders pushed back against government regulation of the

<sup>6</sup>For an excellent critical review of the debate between markets and government in American politics, see Lawrence D. Brown and Lawrence R. Jacobs, *The Private Abuse of the Public Interest: Market Myths and Policy Models* (Chicago: University of Chicago Press, 2008).

<sup>7</sup>Peter Hall, *The Political Power of Economic Ideas: Keynesianism Across Nations* (Princeton: Princeton University Press, 1996).



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economy. Starting in the mid-1970s in the U.S. and soon after in Europe, policy swung back in the direction of deregulation and free markets, until the financial crash of 2008, which led to another cycle of skepticism about self-correcting markets and another round of regulation.<sup>8</sup>

### MAKING MARKETS IN THE POLIS

Neoliberalism is so important in contemporary policy discussions that it deserves some careful analysis: Like all the theories, the theory that markets yield efficient outcomes and maximize social welfare depends on some key assumptions. We'll start by laying out these assumptions, then examine how markets work as social mechanisms and whether the assumptions are realistic.

<sup>8</sup>An excellent review of this policy history in the U.S. is Robert Kuttner, *The Squandering of America: How the Failure of Our Politics Undermines Our Prosperity* (New York: Knopf, 2007). For an exploration of the intellectual debates, see Mark Blyth, *Great Transformations: Economic Ideas and Institutional Change in the Twentieth Century* (New York: Cambridge University Press, 2002).

### Rationality

Market theory assumes that people are rational and self-interested. They have goals, gather information about how best to reach their goals, and make decisions based on their assessment of which choices will maximize their self-interest. In the polis, people rarely form their goals independently. Peer pressure, families, historical tradition, trends of the times, public opinion, and political alliances all influence individual desires and goals, and thus diminish the independence and voluntariness of any individual choice. When sellers use marketing and advertising to persuade people to buy their products, they deliberately manipulate consumer preferences. Professionals such as doctors, lawyers, engineers, and consultants sell not only their services but also advice about which services clients need. In modern service-dominated economies, then, consumers are much more dependent on sellers than market theory acknowledges. And if consumers' preferences are often subtly shaped by others, especially by sellers, we can no longer assume that each transaction maximizes the welfare of both parties.

In the new field of behavioral economics, researchers examine discrepancies between economic theory and how people actually process information and make decisions. "If you look at economics textbooks, you will learn that homo economicus can think like Albert Einstein, store as much memory as IBM's Big Blue, and exercise the willpower of Mahatma Gandhi," write two of these critics.<sup>9</sup> Real people, the ones policy makers must plan for, can be confused, ignorant, forgetful, forgiving, spontaneous, silly, passionate, obsessive, obstinate, and overly optimistic, among our other endearing human traits.

But beyond quirkiness, people sometimes make decisions that aren't in their best interests as they themselves define them. They smoke, although they want to be healthy. They text while driving, although they don't want to die or kill somebody. They vote for candidates who promise economic policies that will hurt them, or don't even bother to inform themselves before casting their vote.<sup>10</sup> They cruise along on inertia, rather than taking the trouble to gather new information. In thinking about their personal security, they overestimate dangers that appeared on last night's news—such as contaminated lettuce—and go to great lengths to

<sup>9</sup>Richard H. Thaler and Cass R. Sunstein, *Nudge: Improving Decisions About Health, Wealth, and Happiness* (New York: Penguin, rev. ed. 2009), p. 8.

<sup>10</sup>Larry M. Bartels, "Homer Gets a Tax Cut: Inequality and Public Policy in the American Mind," *Perspectives on Politics* vol. 3, no. 1 (Mar. 2005), pp. 15–31.

avoid them. Meanwhile, they underestimate dangers such as junk food that are old news and part of their comfortable mental furniture.<sup>11</sup>

Sometimes people can't know which alternative will maximize their welfare; for example, a dangerous job with high pay and health insurance, or a safer job with low pay and no health insurance. Sometimes people give more weight to other people's interests than their own, as parents routinely do. Sometimes people must choose between advancing their own welfare and helping others, as humanitarian aid workers do when they serve in dangerous places. If people often don't know what will maximize their welfare, or don't make choices that will yield the best outcomes for them, or they can't maximize one aspect of their self-interest without jeopardizing another, the chief mechanism by which free markets produce efficiency falters.

### *Full Information*

In order for exchanges to yield the best situation for everyone, buyers and sellers must have complete and accurate information about the available alternatives. Full information, though, is an ideal that is rarely met. Buyers often lack the background to understand technical information or even to ask the right questions. These problems can be addressed with professional quality ratings, such as doctor licensing or consumer product testing. In the polis, though, there's a far bigger obstacle to full information. People wield information strategically and use secrecy as part of their competitive strategy. Manufacturers hype their products with exaggerated claims. Pharmaceutical companies have been known to withhold studies showing that a new drug is ineffective. Insurance, credit card, and mortgage companies typically conceal negative features of their contracts in fine print and impenetrable jargon. Buyers conceal information as well. Job seekers and would-be borrowers don't readily disclose their negative histories.

Some market advocates think that the problems of deliberate concealment are solvable through regulating information; for instance, requiring price disclosure, food content labeling, and hazard warnings. In the polis, though, concealing and shading are so essential to business strategy that regulation can't eliminate them. After research showed that low-nicotine cigarettes are just as dangerous as full-strength ones, regulators prohibited tobacco companies from calling cigarettes "light" or "mild," so as not

to mislead consumers. But tobacco companies immediately figured out how to convey the misleading idea to smokers: use light colors as names ("gold," "silver"), package the low-nicotine cigarettes in light colors, and continue using the same package designs that smokers already recognized as "light."<sup>12</sup>

### *Voluntarism*

Market theory assumes that people engage in trade voluntarily, but in the polis the line between voluntarism and coercion is fuzzy. In theory, workers sell their labor to employers at prices they agree upon; in practice, most people must work for a livelihood, so there's a coercive element to employment relationships. Poverty and inequality undermine voluntarism in market exchanges. Very poor people live under constant threat of starvation or homelessness and don't experience most of their purchases as choices but rather as dire necessity. For employees of some third-world factories, for women and girls in brothels built on sex trafficking, and for undocumented immigrants in some U.S. workplaces, working conditions are so oppressive and coercive that they approximate slavery. Even aboveground market relationships in mainstream institutions can be coercive. Long-term relationships between landlords and tenants, insurance companies and policyholders, banks and borrowers, and employers and employees are essential to well-being, but in every case, unequal power of the two sides compromises voluntarism. The stronger side sets the terms, leaving the weaker side little or no choice but to accede if they want to continue the relationship.

The theory of markets requires that people *enter* into trades voluntarily, but it says nothing about *terminating* them. In long-term relationships, if the stronger side suddenly terminates the relationship, the weaker side can feel coerced. Think of company layoffs. And laid-off workers can feel doubly coerced when they accept a new job offer with lower pay and benefits. Although no one holds a gun to their heads when they sign the new contract, "voluntary" probably wouldn't be the first word on their lips.

Thus, when we look at how markets actually work, many lack the voluntarism necessary to produce social welfare according to free-market theory. When we look internationally at how free-market economies often come into being, the lack of voluntarism is even more apparent. In many

<sup>11</sup>Thaler and Sunstein provide a fun, readable overview of behavioral economics in *Nudge* (op. cit., note 9).

<sup>12</sup>Duff Wilson, "Color Coding: No More 'Light' Cigarettes, but Big Tobacco Is Betting Smokers Will Recognize the Gold Box," *New York Times*, Feb. 19, 2010.

countries of Latin America, Asia, and the former Soviet Bloc, free markets were established by force—by dictators, armies, and oligarchs who sold off publicly owned resources to private investors, ended subsidies and tariffs that protected local business, disbanded unions, reduced wages, and cut social welfare payments that cushioned citizens against market instability. Some of these free-market transformations were achieved by forcefully suppressing popular protest, sometimes with massive killing, jailing, and torture. In developing countries, whose economies and citizens are already in dire straits, international lenders and donors sometimes require recipient governments to privatize publicly owned companies and natural resources, cut social spending, and open their fragile domestic production to foreign competition. In these market economies born of coercion and violence, it's doubtful whether subsequent exchanges can fairly be called voluntary.<sup>19</sup>

### *Externalities*

During the mid-twentieth century, when free-market advocates were trying to restore faith in markets as a positive social force, the field of “welfare economics” emerged. Welfare economists began by acknowledging that markets sometimes fail to maximize social welfare, and went on to explore circumstances that might lead to this failure. Markets could be made to work well, welfare economists argued, if government corrected the specific defects that cause some markets to deviate from the assumptions of ideal or perfect markets. Two defects became extremely important in policy thinking: *externalities* and *public goods*.

In order for markets to yield maximum social welfare, the exchanges between buyers and sellers must not affect the welfare of people who aren't part of an exchange and don't have any say in it. Without this condition, even if the buyers and sellers are fully informed and act voluntarily, we can't be sure that exchanges make everyone better off. For example, when chemical plants and their customers negotiate contracts, they don't have to take into account the impact of their pollution on everyone else. Effects on people outside an exchange are called externalities. In the theory of markets, externalities can be corrected by forcing people to consider social costs and harmful effects on others when they engage in any exchange. This is the rationale for pollution taxes or for raising taxes on cigarettes to pay for public health measures.

<sup>19</sup>Naomi Klein documents these processes with meticulous detail in *The Shock Doctrine: The Rise of Disaster Capitalism* (New York: Picador/Henry Holt, 2007).

In the 1970s, when awareness of pollution and environmental damage was relatively new, the idea of externalities seemed an important but limited exception to the principle that free markets work to society's advantage. Yet in the polis, market externalities are the norm, not the rare exception. We know now that *all* production and consumption has environmental impacts; that's the message of the “carbon footprint” metaphor. Apart from environmental impacts, virtually every market transaction affects people who aren't party to it. When an American firm relocates its production abroad, the harms ripple beyond its own employees to employees of firms in its supply chain, to all of their family members, to retailers in surrounding areas who lose business, to local governments that lose tax revenue, and to communities that lose their ability to fund health care, education, culture, and recreation. The benefits of relocation go to new employees and their families in the form of jobs and wages, to American consumers in the form of lower prices on the goods, and to investors in the form of higher profits. Outsourcing is a dramatic example, but with a little imagination, you can trace the ripple effects of any economic transaction.

### *Public Goods*

According to welfare economics, free markets work well for goods and services that are consumed individually—things like food and clothes. But some things that communities value are “public” or “collective goods,” meaning that they can serve many people at the same time. One person's use doesn't diminish the supply for everyone else. Lighthouses and national defense are the ubiquitous textbook examples, but schools, hospitals, and national parks are good examples, too, as are a community's social safety nets, its system of justice, or its government.

It's hard if not impossible to charge people individually for these collective goods. But why would anyone voluntarily contribute to national defense, or having a hospital nearby, or any other public good? If the system gets built, everyone will benefit from it regardless of whether they helped to pay for it. For an individual, the rational, most efficient course of action would be to “get the most for the least,” that is, to free-ride on other people's contributions. Thus, voluntary exchanges alone will fail to generate enough public goods because individuals won't voluntarily pay for them.

Until fairly recently, welfare economists acknowledged that free markets would undersupply public goods, and for these situations they advocated collective action through government. However, the purist free-market thinking of the past two decades, sometimes called market

fundamentalism or market utopianism, holds that competitive free markets can accomplish almost every social function more efficiently than government. Influenced by this thinking, state and federal governments have contracted with for-profit firms to provide significant portions of military defense, intelligence, prison management, welfare administration, public education, and disaster services—and free-market advocates press to privatize even more government programs, such as Social Security pensions and public transit.

In the polis, community is the paramount public good. Markets can't produce community (whatever kind of social glue that is), because markets are inherently competitive and divisive. They stimulate individuals and firms to look out for Number One and they punish those who don't. They promise huge rewards to companies that can patent and hoard new knowledge, or even the basic scientific resources for new knowledge such as cell lines. As a result, markets discourage and even hinder collaboration for the common good.<sup>14</sup>

Markets can divide communities by reinforcing and perpetuating discrimination. Markets allow people to express and satisfy their preferences—that is exactly how markets enhance people's welfare. But the market isn't a teacher, a preacher, or a judge. It doesn't care *why* people think what they think and do what they do. If they act on the basis of prejudice or stereotypes, so be it, because they know best how to maximize their welfare. If a white employer thinks blacks aren't as competent as whites, or that they're lazy and aggressive, he won't hire any—not unless laws and regulations prohibit him from racial discrimination. But then it's no longer a free market—it's an employment market constrained by government regulation. Even if employers aren't prejudiced themselves, they have to worry about satisfying their customers. If, for example, the head of a construction management company knows that his customers don't trust women as engineers, electricians, and builders, he will fear losing business if he hires women. Market forces pressure people to satisfy popular tastes. They can create discriminatory behavior, even when employers don't harbor any prejudice themselves.<sup>15</sup>

Paradoxically, markets are themselves public goods, because they couldn't function without all the collective effort that goes into governance.

<sup>14</sup>Michal Heller, *The Gridlock Economy: How Too Much Ownership Wrecks Markets, Stops Innovation, and Costs Lives* (New York: Basic Books, 2008); and Kuttner, *Squandering of America* (op. cit., note 8), pp. 186–94.

<sup>15</sup>Cass R. Sunstein, *Free Markets and Social Justice* (New York: Oxford University Press, 1997), chap. 6, "Why Markets Don't Stop Discrimination," pp. 161–66.

## CHALLENGES TO THE THEORY OF FREE MARKET

### EFFICIENCY

#### Market Theory

1. Buyers and sellers make rational decisions.
2. Buyers and sellers have full information about decisions they are contemplating.
3. Buyers and sellers enter into exchanges voluntarily.
4. Exchanges between buyers and sellers must not harm people who are not party to them.
5. Welfare Economics: Free markets under-provide public goods because it is hard to charge people for them individually.
6. Neoliberalism: Markets can provide everything more efficiently than government, including public goods such as military defense.

#### Polis Realities

Human decision making doesn't correspond to the rationality model; it includes emotional, moral, and social considerations.

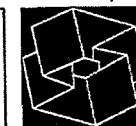
People use information strategically, by sharing it and withholding it.

Buyers and sellers in some relationships have vastly unequal power. The weaker side may experience the exchange as coercive.

Almost all exchanges can have harmful effects on people who are not party to them.

Government must provide public goods by using its authority to require citizens to pay for them.

Markets cannot produce some public goods, especially community and the trust necessary for markets to function.



Without government to enforce contracts, people would be loath to trade with strangers or to make exchanges that couldn't be completed on the spot. They wouldn't buy anything much more complicated than a banana, whose quality and durability they can judge for themselves. Markets can't work without trust. Trust, in turn, depends on people's confidence that others will obey rules and honor their commitments, and that a strong authority will enforce rules and contracts.

Peter Barnes, who launched a successful mutual fund called Working Assets, wondered why so many people trusted him and his colleagues to

invest their money when the fund was brand-new and its managers were unknown. "The answer, of course, is that they didn't trust *us*, they trusted *the system* in which we operated." They sent their money to strangers because they trusted the American financial system, the Securities and Exchange Commission, the courts, and the fundamental honesty of corporations (this was before 2008). "That trust, and the larger system it was based on, was built over generations, and we had nothing to do with it," Barnes says. The financial crisis of 2008 underscores the point. Markets need government to keep them trustworthy and healthy.<sup>16</sup>

### Competition

Market theory assumes producers and sellers will compete in ways that improve efficiency and make everybody better off. But there are lots of ways to compete, and some are better for communities than others. A manufacturer or retailer can drive down its prices to be more competitive by finding cheaper raw materials, streamlining operations, innovating to increase worker productivity, improving management—or by cutting wages and benefits for its employees. Health insurers can compete by offering benefits that people value, providing excellent customer service, designing effective prevention programs—or by insuring only very healthy people and denying claims of policyholders who need expensive treatment. (This is exactly the competitive strategy that Obama's health reform tries to restrain.) Companies can compete for investors by coming up with a compelling idea, by demonstrating actual and potential growth—or by using accounting gimmicks to hide liabilities and weaknesses. Different competitive strategies benefit some people and harm others. Competition by itself doesn't guarantee improvements for everyone.

### WHOSE EFFICIENCY?

In the library conundrum that opens this chapter, we saw that efficiency is a political claim, a way of portraying a situation that makes some people or things look more important than others. In the face of many different but equally plausible meanings of efficiency, we should doubt the very possi-

<sup>16</sup>Peter Barnes, *Capitalism 3.0: A Guide to Reclaiming the Commons* (San Francisco: Berrett-Koehler Publishers, 2006), p. 67. This point is also developed in Brown and Jacobs, *Private Abuse of Public Interest*, op. cit., note 6, and Kuttner, *Squandering of America*, op. cit., note 8.

bility of proving that one kind of social system leads to "the greatest good given our collective resources."

If efficiency is a malleable concept, "social welfare" is even more so.<sup>17</sup> Market theory equates societal welfare with the sum of everyone's individual welfare. This easy mental arithmetic breaks down when we try to put it into practice. It breaks down, first, because each of us has many roles that conflict with each other. As consumers, we benefit from low prices, yet a system that gives us rock-bottom prices harms us as workers and family members by giving us low wages, assigning grueling schedules, cutting health and pension plans, and stinting on quality and safety.<sup>18</sup>

The mental arithmetic of market theory fails, second, because many public policy goals can't be broken down into discrete situations of individuals. People are social creatures. We *care* about others and want others to care about us. We derive much of our happiness from our relationships with others. We take pleasure in others' well-being, and we usually feel some distress at others' misfortunes. We find rewards in relationships with places, such as parks and homes; with groups, such as clubs, teams, and choruses; and with religious, cultural, and regional traditions. It's a mistake to think that each person's welfare is independent of everyone else's, and that policy analysts can add up individual well-being to arrive at Total Social Welfare.

Third, free-market arithmetic breaks down because it ignores distribution. Two countries with the same total income and growth rates would be considered equally well-off, no matter that in one, all citizens enjoy a standard of living close to the average, while in the other, a small class enjoys unimaginable wealth while the rest live in squalor and misery. And as we saw in Chapter 2, inequality depresses individual and communal well-being.

Finally, free-market arithmetic breaks down because we have goals for our communities as well as goals for ourselves as individuals. Markets may be excellent at procuring the best deals for consumers and the highest profits for investors, but these are not the only or even most important kinds of well-being that ought to go into a calculus of total social welfare. As citizens, we hold civic values, too. We care about whether our public policies create equal opportunities for everyone to live a decent and satisfying life and to nurture their families; whether policies respect civil

<sup>17</sup>In Chapter 4, we'll examine concepts of welfare in more detail; here, we focus on the concept of social welfare in market theory.

<sup>18</sup>Robert Reich, *Supercapitalism: The Transformation of Business, Democracy, and Everyday Life* (New York: Knopf, 2007).

and human rights and foster tolerance and understanding; whether they protect the environment; and whether they empower us to participate in shaping our collective future.<sup>19</sup>

### THE EQUALITY-EFFICIENCY TRADE-OFF

In Chapter 2, we looked at many arguments for and against policies to reduce inequality. Now we come to the longest-running policy argument against redistribution: the idea that equality and efficiency are fundamentally incompatible goals. We can't have more of one without settling for less of the other. Redistributive policies such as income assistance, public health insurance, minimum wages, and progressive income taxes inevitably reduce efficiency (the neoliberal argument goes). That means lower productivity, lower employment, lower economic growth, and lower social welfare. A better way to help those at the bottom is to let the competitive free-market economy run at top efficiency, unfettered by government restrictions. With a larger, richer economy, everyone gains because there's more to go around.

Until the 1990s, the equality-efficiency trade-off theory seemed bolstered by the dismal performance of socialist economies. They were woefully inefficient and sluggish, hobbled by bloated bureaucracies. With the fall of the Berlin Wall in 1989 and further discrediting of planned economies, conservatives pushed even harder to unshackle markets from government regulation and redistributive policies. Then came the crash of 2008 and a sudden realization that unfettered markets and unrestrained pursuit of profit can destroy economies just as handily as iron-fisted planning. Efficiency gains can turn into losses overnight.

But even with a new consensus that market capitalism needs to be monitored and managed, the dominant economic paradigm still sees equality as a drag on economic prosperity. Thus, it's worth analyzing the logic of the trade-off view. Keep in mind that in this debate, "equality" is shorthand for "redistribution." No one in the political mainstream is talking about radical, Soviet-type redistribution to maintain absolutely equal incomes of the equal slices sort.

There are two main reasons efficiency and equality are thought to be in a trade-off. First, unequal rewards motivate people to be productive. Without the prospect of getting ahead of the pack, so to speak, people wouldn't

<sup>19</sup>These ideas are richly explored in Kuttner, *Squandering of America* (op. cit., note 8); Reich, *Supercapitalism* (ibid.); and Barnes, *Capitalism 3.0* (op. cit., note 16).

work as hard, take so many risks, or invest and innovate so much. Any step toward equalizing incomes through progressive taxation, income assistance, public pensions, health insurance, or wage increases will inevitably reduce individual effort, personal savings, investment, innovation, and, eventually, economic growth.

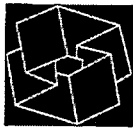
Second, redistribution wastes a lot of resources. To promote equality requires administrative machinery that uses up resources but doesn't produce anything valuable in itself. The administrative machinery of equality—tax bureaus, welfare agencies, labor departments, and courts—consumes valuable resources. The labor, buildings, computers, and energy they use could go to producing other things. The economist Arthur Okun dramatized this argument with a metaphor: redistribution is like carrying money from the rich to the poor in a leaky bucket.<sup>20</sup> The policy question, he said, is how much waste society should tolerate before deciding the gain in equality isn't worth the loss in resources. Of course, you now know that the answer depends on whom you ask. A poor person will give a different answer than a rich one. The fallacy is thinking that policy makers can ask "society," or that policy analysts can come up with a single best answer.

Before the fall of communism, much of this argument was ideological and theoretical. Then social scientists began putting it to empirical tests. Instead of speculating about the impact of redistributive policies, we can compare advanced industrial nations whose policies have produced more or less distributive equality and see how they do on economic performance. We can also compare the U.S. at different historical moments to see whether economic performance declines when taxes and redistribution are higher.

The equality-efficiency argument doesn't hold up against the evidence. Among the countries of the Organization for Economic Cooperation and Development, some have relatively strong welfare states and low inequality, while others have relatively strong free markets and high inequality. Contrary to the trade-off argument, nations that have more equal income distributions do as well as or better than more unequal nations on measures of economic prosperity, including employment, gross domestic product (how much output a country produces), and economic growth rates.<sup>21</sup> Between 1970 and 1990, France, Germany, Norway, Belgium, Italy,

<sup>20</sup>Arthur Okun, *Equality and Efficiency: The Big Tradeoff* (Washington, D.C.: Brookings Institution, 1975). This short book popularized the idea of an equality-efficiency trade-off.

<sup>21</sup>Jonas Pontusson, *Inequality and Prosperity: Social Europe vs. Liberal America* (Ithaca and London: Cornell University Press, 2005), chap. 1.



### IS THERE AN EQUALITY-EFFICIENCY TRADE-OFF?

Yes	No
1. Maintaining equality reduces or eliminates the motivation to work.	People are motivated to work by inherent satisfactions, self-esteem, need for belonging, and desire to contribute to the common good.
2. Maintaining equality requires bureaucracy, and bureaucracy equals waste.	Administration is a productive activity in itself.
3. Redistribution to maintain equality reduces economic growth.	Redistribution does not reduce economic growth; it stimulates work, innovation, and risk-taking by providing economic security.
4. A trade-off between equality and efficiency is inevitable.	Society can have both equality and economic growth; how to balance these goals is a political choice.

Ireland, and Finland all had higher taxes than the U.S., but all had higher productivity growth, too.<sup>22</sup> During the period of highest productivity growth in the U.S.—1951 to 1963, when productivity grew 3.1 percent per year—marginal tax rates on high earners were at their peak (91 percent on incomes of \$400,000 or more in 1957, for example).<sup>23</sup>

In developing countries, equality actually enhances economic growth, and extreme inequality retards it. Equality and efficiency go hand in hand. Extreme inequality limits the capacity of the very poor to contribute to growth. They can't get credit for supplies or equipment that would

<sup>22</sup>Bart van Ark, Mary O'Mahoney, and Marcel P. Timer, "The Productivity Gap between Europe and the United States: Trends and Causes," *Journal of Economic Perspectives* 22, no. 1 (Winter 2008), pp. 25–44.

<sup>23</sup>Joel Slemrod, ed., *Does Atlas Shrug: The Economic Consequences of Taxing the Rich* (Cambridge, Mass.: Harvard University Press, 2000), p. 3.

enable them to be more productive, nor can they invest in themselves or their children, because they don't have resources beyond what it takes to survive. By reducing poverty, therefore, public policy can improve poor people's productivity and increase economic growth. Economic growth means a bigger pie—and greater societal welfare.

Policies that increase equality also make economic growth a more efficient mechanism for reducing poverty. For example, in Kenya the poorest 20 percent of the population receives 6 percent of the income. With this distribution pattern and a 1 percent economic growth rate, it would take until 2030 for the poverty rate to be cut in half. But if the share of growth going to the lowest 20 percent were doubled (through greater taxes on the rich and more public benefits for the poor), the poverty rate would be halved by 2015, even at the same low 1 percent growth rate.<sup>24</sup>

Government policies, especially those concerning taxes, wages, and social benefits, determine how much different segments of the population will benefit from national income growth. Examining distributive patterns in the U.S. from 1948 to 2005, Larry Bartels found distinctly partisan patterns of income growth among poor, middle-class, and affluent families. In years when Republicans controlled the White House, affluent families consistently saw their incomes grow more rapidly than middle-class or poor families. Under Democratic administrations, the shares of income going to the rich, the middle class, and the poor were much more equal, with families in the bottom 20 percent often receiving the largest share. Inequality increased under Republican presidents and decreased under Democratic presidents. Meanwhile, unemployment was almost 30 percent higher under Republican presidents than Democratic ones, and growth of GNP was more than 40 percent *lower* under Republican presidents.<sup>25</sup>

The equality-efficiency trade-off is not an immutable natural law. Rather, political leaders choose to promote economic growth in different ways and to distribute the fruits of the economy in different ways, too. The distribution of national cake is a political choice.

Markets are a way of organizing social activity, just as other forms of governance are. They require a set of rules about who can sell, what can be sold, what constitutes a valid contract, and how contracts will be enforced. They also happen to be a mode of organizing social activity

<sup>24</sup>United Nations, Human Development Report 2005, *International Cooperation at a Crossroads: Aid, Trade and Security in an Unequal World*, chap. 2, available at [hdr.undp.org/en/reports/global/hdr2005](http://hdr.undp.org/en/reports/global/hdr2005).

<sup>25</sup>Larry M. Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age* (Princeton: Princeton University Press, 2008), chap. 2.

that gives more power to people who control money and property than to people who do not. If we start from the premise that efficiency itself is a contestable idea about what constitutes social welfare, then the best way to organize society to achieve efficiency is to provide a democratic governing structure that allows for these contests to be expressed and addressed in a fair way.

## 4

### Welfare

"Government is a contrivance of human wisdom to provide for human wants," wrote Edmund Burke in his *Reflections on the Revolution in France*.<sup>1</sup> By wants, Burke didn't mean desires and wishes; he meant the older sense of lacks or needs. ("For want of a nail, the kingdom was lost.") Both senses figure in political argument about what it means for government to promote human welfare. At the level of political rhetoric, governments promise to promote welfare in the more subjective sense—"life, liberty and the pursuit of *happiness*," as the Declaration of Independence put it. But when designing programs on the ground, policy makers typically seek objective standards of need to define the scope of public responsibility for social welfare.

Just as most people are all for equity and efficiency in the abstract, most people believe that society should help individuals and families when they are in dire need. But beneath this consensus swirls turbulent conflict over how to distinguish need from desire. The distinction matters in politics, because need is one of the strongest moral claims. Even toddlers know that if they want their parents to buy them ice cream, they stand a better chance with "I need it" than "I want it." Because need is such a strong moral claim, the question of what people need for their welfare strongly influences larger debates about what government should strive to provide for its citizens. Defining need for purposes of public programs becomes a political contest. Groups of citizens try to portray their desires as objective, essential, and impossible to reject. Policy makers seek to portray their program criteria as objective, so as to put the programs beyond political dispute.

The simplest, most common, and in some ways intuitively most appealing definition of need is what is necessary for sheer physical survival.

<sup>1</sup>Edmund Burke, *Reflections on the Revolution in France*, J. A. Pocock, ed. (Indianapolis: Hackett Publishing Co., 1987, orig. ed. 1790), pp. 52–53.