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Robust Political Economy

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If you look at some of the economic arguments advanced in favor of markets, economists have come up with good defenses against various market-failure theories. If you look at political theorists, they have come up with good responses to the kind of anti-market arguments made by egalitarians and by communitarians. What has been lacking is a unified theoretical framework that can bring together all these criticisms and the classical liberal responses. We don't have a unified framework that can respond not only to the economic objections that have been raised against classical liberalism, but to the political and ethical challenges that have been raised against the tradition as well.



*Mark Pennington is professor of politics at the University of London. He spoke about his new book, *Robust Political Economy: Classical Liberalism and the Future of Public Policy*, at the Cato Institute in March.*

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There are three challenges that I think classical liberalism needs to respond to: the challenges from “market-failure economics,” the challenge of communitarianism, and, finally, the challenge of egalitarianism. We can respond simultaneously to all of these challenges with the framework of robust political economy.

What is “robust political economy?” Something is “robust” if it’s able to withstand various stresses and strains. In the context of political and economic institutions, we can define something as being robust if it’s able to withstand the stresses and strains wrought by human imperfections. There are two human imperfections that I want to focus on.

The first is the idea of “limited human rationality.” Human beings

kind of institutions minimize the consequences of what will be inevitable human mistakes or human errors?

The second human imperfection that we have to take account of is the problem of “limited benevolence.” People may, under certain circumstances, act out of self-interested motivations. They may be opportunistic in certain circumstances. We need to evaluate institutions in terms of the incentives they provide to channel potentially opportunistic actors to behave in a way that increases the overall level of well-being in society.

So those are the two human imperfections that robust institutions have to deal with. In the first part of the book, I claim that challenges to classical liberalism fail to meet the criteria of robustness. Their particu-

lar alternatives to the classical liberal ideal of a minimal state and open markets do not address how their own favorite institutions will deal with the problems of limited rationality and limited benevolence. The classical liberal case for a minimal state framework with an open-market economy based on the dispersed ownership of property is based on the

claim that these institutions are more robust in the face of limited rationality and limited benevolence. A competitive context is the best context to deal with the fact that people are imperfectly informed.

When we have lots of different decisionmakers making different sorts of decisions, we can facilitate a process of trial-and-error learning

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are not fully rational agents; they are not omniscient beings. Whenever they make decisions, they do so in a context of considerable uncertainty and there is always imperfect information when they’re making decisions. If decisionmaking takes place in a context of imperfect information, what kind of institutions facilitate learning over time, and what

that minimizes the consequence of any particular error. If you centralize decisionmaking and people make mistakes, then the consequences are much more far reaching than if the decision-making power is more dispersed. Likewise, a classical liberal framework that provides for exit enables people to escape from the depredations of potentially predatory actors. If people are acting opportunistically, the capacity to exit from relationships with these actors provides a disciplinary check on potentially self-interested behavior.

Market-failure economics, or “mainstream neoclassical economics,” evaluates market institutions against the benchmark of full-information equilibrium. Any departures from this full-information equilibrium are described as “market failures,” which are considered a right for some kind of corrective government action. If we take the perspective of robust political economy, and focus first on the idea of limited rationality, then this notion of perfection, or full information, simply isn’t a valid standard against which to evaluate either market institutions—or any other institutions for that matter. The case for markets isn’t that they are “perfect” institutions; the case for markets is based on the view that they are best placed to cope with the inevitability of imperfect information and limited rationality. Take the notion that neoclassical economists focus on—imperfect competition—which is often consid-

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ered to be ripe for corrective government action. If we’re in a world of limited rationality, of imperfect knowledge, then knowledge of what should be produced and how it should be produced isn’t going to be evenly distributed. Some firms are going to judge the market better than others. Some firms are going to make more profits than others. Other firms are going to make losses. It is precisely through these imperfections, or inequalities, that a learning process is set in motion, so that people can learn over time to copy the more successful firms and to avoid the business models that are adopted by the less successful firms. Any market that is based on imperfect information and unevenly distributed knowledge is going to look imperfect when judged against a standard of perfection. The question is, what is the alternative to this imperfection? Is it a world where regulators somehow magically know what the ideal market structure is? If we’re in a world of limited rationality, there’s no reason to suppose that government regulators know what the ideal market structure is.

You may say that this kind of analysis is somewhat old hat, that there are new market failure theo-

rists, such as Nobel laureate Joseph Stiglitz, who are well aware that government is likely to fail in the way that markets fail. When push comes to shove, however, they always hold markets to a different standard than public policy interventions or government regulators. Stiglitz is fond of saying that the price system, because of its various imperfections, is too coarse a decisionmaking instrument to enable people to make effective decisions. What he lacks is an account of why government regulators should be assumed to be in a position to correct for these market imperfections. We're supposed to trust that government regulators are going to be improving on the market outcome. Stiglitz doesn't give any justification for this assumption whatsoever. He fails, in my view, to meet the standards of a robust political economy.

Let's now turn to communitarianism. There are many different claims that communitarians make, but there is only one that I want to focus on for the purpose of this brief talk. Communitarians challenge classical liberalism on the grounds that we shouldn't evaluate institutions on their capacity to respond to, or to satisfy, given individual preferences. In the communitarian view, we should evaluate institutions on

whether they have the capacity to challenge the preferences of individuals. What they're getting at is the notion that liberalism lacks any account of how we can elevate people's preferences, how we can encourage people or educate them to have a more informed or enlightened set of preferences. In a communitarian view, democracy



is better placed than the market to challenge irrational or prejudiced preferences that people may have, precisely because it's based on majority rule. In a communitarian view, people's preferences should have to be justified to the majority before they can be put into practice, and this majoritarian check will provide the context within which

bad preferences can be weeded out, creating an overall elevation in the quality of the preferences.

This kind of view, if we think about it in terms of robust political economy, is based on a hopelessly romanticized view of how any democratic or majoritarian process can actually operate. It's based on a complete failure to understand how most people learn in most situations in life. The most important form of learning in society—especially if you take Hayek's ideas seriously—isn't the kind that takes place when we argue with one an-

other in a public forum and come to a majority decision about which particular view is best. The most important form of learning takes place from seeing what other people do in their lives, and learning from their experiences. In order for that sort of learning to take place, it's absolutely imperative that the widest possible number of experiences—or experiments in living, if you like—actually occur. Majoritarianism, by its very nature, squelches the process of experimentation. The way we get value change in most fields of life is by entrepreneurs, whether in the economic domain or in the moral domain, breaking from the majority position and doing something different. Then, gradually, through an incremental process, the majority view changes.

Hayek puts this very well when he states, "It is always from a minority acting in ways different from what the majority would prescribe that the majority in the end learns to do better." A system of private-property rights that allows people to carry out experiments in living is much more likely to challenge existing prejudices and preferences than is any socialist or collectivist alternative.

Now it's not only in terms of this knowledge problem or the problem of limited rationality that the communitarian view fails. It also fails to adequately take into account notions of incentives. I draw in the book on Bryan Caplan's work.

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Caplan makes the point very persuasively, following people like Geoffrey Brennan and Loren Lomasky in the past, that the institutions of democracy do not actually provide people adequate incentives to challenge their own preferences. Why? Because if you try to revise your preference in a majoritarian context, it actually makes no difference to the final outcome that you personally will experience. That is going to be determined by whether everybody else challenges their preferences. In a market context, you can profit personally by challenging the prejudices you may have. If you're an employer who has racist or sexist prejudices, you can profit by breaking from those prejudices, thus expanding your market. But nobody in a democratic arena can actually profit personally from challenging their own views when they can't change the outcome until they've persuaded everybody else to expect some kind of a change in the law. So again the communitarian view fails to meet the requirements of a robust political economy. ■



Cato Scholar Profile: **ILYA SHAPIRO**

ILYA SHAPIRO is a senior fellow in constitutional studies at the Cato Institute and editor-in-chief of the *Cato Supreme Court Review*. He has contributed to a variety of academic, popular, and professional publications and regularly provides commentary on a host of legal and political issues for various TV and radio outlets. Shapiro lectures regularly on behalf of the Federalist Society. He holds an AB from Princeton University, an MSc from the London School of Economics, a JD from the University of Chicago Law School, and is a member of the bars of New York, the District of Columbia, and the U.S. Supreme Court.

You've spent much of the last year touring the country, debating the constitutionality of the Patient Protection and Affordable Care Act. What's your impression of how students assess that issue?

It's been gratifying to see a real thirst for knowledge about the constitutional issues being raised, among all audiences, not just law students. As on many other issues, the American people are not just engaging in a policy debate—does a particular proposal make economic sense?—but are questioning the source of the power the government asserts. That's a healthy discussion to be having. In the health care context, we've come a long way since Nancy Pelosi reacted to this type of question by implying that the Constitution was the last refuge of the scoundrel who lacked “serious” (policy) arguments.

Are there other constitutionally troubling portions of the Act besides the individual mandate?

The individual mandate is crucial: if you knock it out, the whole Rube Goldberg machine—setting aside tangential provisions like those relating to Indian reservations and indoor tanning services—simply ceases to function. But there are plenty of other problems, some of which make for viable claims under existing doctrine and others that would require a constitutional revolution of sorts to remedy.

For example, the Act's transformation of Medicaid impermissibly coerces states by forcing them to accept a greatly expanded program. States face a Hobson's Choice: accept the new regime and suffer devastating consequences to strained budgets, or forgo billions of dollars

collected from all taxpayers but returned only to Medicaid states.

Another issue is that the state-specific carve-outs—the Louisiana Purchase, Cornhusker Kickback, Gator-aid, etc.—violate the principle that all federal legislation needs to be for the general welfare. This is different than earmarks because here New York, say, isn't eligible for a similar benefit to what Florida gets.

What's your prediction of the outcome of the eventual Supreme Court decision?

Upholding the legislation would allow the federal government to mandate that Americans engage in assorted activities, turning citizens into subjects. Without exaggeration, nobody would be able to claim that the Constitution limits federal power.

But will the Court go there? On the one hand, it refrained from striking down such facially unconstitutional pieces of fundamental legislation as Social Security. On the other, that legislation was popular and came during a time of great social upheaval. If, as the old saw goes, “the Court follows the election returns,” the rise of the Tea Parties and the “shellacking” the Democrats received in 2010 may have steeled judicial spines.

It will, unsurprisingly, come down to Justice Anthony Kennedy. We advocates need to convince him that this is about basic liberty—he is fairly libertarian in cases thus framed—rather than “mere” governmental structures. But if Kennedy rules against the individual mandate, it will likely be Chief Justice John Roberts who dictates how much of the remaining legislation, if any, survives. ■

The Estate Tax... Congress Kicks the Can Down the Road



In December 2010, Congress slapped an 11th hour band-aid on the estate-tax mess. Essentially this quick fix pumps up the exemption level (the amount of assets exempted from estate tax) and lowers the tax rate for a couple of years. It does not tackle the larger questions of whether estates should be taxed at all and, if so, at what level.

Indeed, Cato's scholars have long argued for a complete repeal of the estate tax, commonly called the "death tax." They point out that the tax is typically imposed on the accumulated earnings and savings from a lifetime and, therefore, tends to tax—for a second time—assets that were already subjected to income and/or capital gains taxes during a person's life. Beyond the inherent unfairness of this double taxation, Cato's scholars maintain that the estate tax is hugely inefficient—it is difficult to enforce and administer and it is the progenitor of a wasteful cottage industry devoted to estate-tax avoidance. It is also worth noting that several industrial nations have no estate tax.

If you are wondering why we reached a crisis point at the end of 2010, the answer is that the Bush administration could not garner enough votes for the full repeal of the estate tax. As an alternative, it opted for an awkward legislative compromise: a series of increases in the amount of assets exempted from the tax and a one-year repeal in 2010, followed by a reinstatement of the tax in 2011. That 2011 reinstatement was scheduled to come with a

kicker. Tax rates and exemptions levels were to be reinstated at punitive 2001 levels—that is, rates as high as 55 percent and a mere \$1 million exemption.

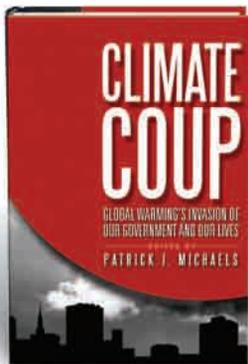
Given the widespread recognition of the innate unfairness of the estate tax, Congress and the president knew that something had to be done before the reinstatement witching hour. Hence, a last-minute compromise, signed into law on December 17, 2010, reinstated the estate tax but provided for an increased exemption amount of \$5 million per person and a decreased maximum rate of 35 percent.

The catch is that the increased exemption and decreased rate are available for 2011 and 2012 only. Unless Congress intervenes again, these relief provisions sunset on December 31, 2012, and the law reverts back to a \$1 million exemption and a 55 percent top rate.

So, once again, Congress has kicked the can down the road and taxpayers are left with some temporary relief but lack the long-term stability necessary for generational planning. Hopefully, when the debate heats up sometime in 2012, Congress will get it right and will finally repeal the estate/death tax. Perhaps the only certainty in this sorry mess is that Cato's scholars will continue to argue that the estate tax is both unfair and unworkable.

If you would like to discuss estate planning or gifting ideas, please feel free to contact **Gayllis Ward**, our director of planned giving, at gward@cato.org or at (202) 218-4631. ■

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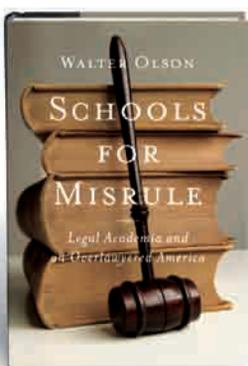


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