Advocacy and Neo Classical Economics

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To assume all the knowledge to be given to a single mind in the manner in which we assume it to be given to us, as the explaining economists is to assume the problem away and to disregard everything that is important and significant in the real world. (Hayek, 1945, p. 91)

Introduction

The neo-classical economist faces a serious dilemma when he criticizes government economic policies such as tariffs and farm price supports. His economics tells him such policies reduce welfare; at the same time, neoclassical economics is based on the assumption that people are rational utility maximizers. If they are also rational maximizers in the political market place, then policies consistently beneficial to the majority who elect the government. The economist can react to his finding in three contradictory ways: (1) he can advocate changing the policy, (2) he can assume he doesn't fully understand the situation and the policy is in some way beneficial to the majority acting in its own self-interest. Nowhere does this contradiction seem sharper than in the conflicting views of the University of Chicago Nobel Prize winners Milton Friedman and George Stigler (Beder, 1982). This paper examines the advocacy dilemma as it is expressed in the writings of Stigler and Friedman and attempts to resolve the contradiction in a fashion consistent with Chicago neo-classical economics.

II. Stigler's View

Stigler believes that most lasting government policies are in the self-interest of the majority of voters. He reasons simply that the neo-classical rational consumer and producer will also be a rational voter. Therefore, under a system of democratic majority rule, the policies followed will: (1) be favored by the majority; (2) be beneficial to that majority.

Why should businessmen—and consumers and lenders and other economic agents—know and foster their own interests, but voters and political coalitions be so much in need of his and our lucid and enlightend instruction? Do people in political life not know their own interests, or do they not seek to further them? (Stigler, in Beder, 1976, p. 312)

From Stigler's perspective it makes no sense to criticize persistent government policies as mistakes. Rational voters observing the results of government policies do not repeat mistakes for decades, e.g. the minimum wage laws, or centuries, e.g. restrictions on free trade. More important, calling policies mistakes is merely giving a name to our ignorance as to why they were adopted. Without a theory of why "mistakes" are made, calling a policy a mistake precludes analysis. It is to engage in what Stigler called "error theory".

"My complaint against that is, unless I manage to explain when errors are made and why and what kind, I have stopped all explanation; since one of the greatest things about errors is that they can come from anywhere and go in any direction. Of course I can say that the middle classes in particular were mistaken as to both the democratic nature of socialism and its human nature, and so to its economic efficiency. And that explains that event. And then if socialism goes into decline, I can say that they saw through the error. And if it doesn't go into decline, the error persisted." (Stigler, 1984, p. 48)

If Stigler is right that voters know their self-interest, there will be few mistakes to correct. Consequently the role for the intellectual, in general, and the economist, in particular, in policy making is quite limited. The most economists can do is to formulate the details of policies that voters and their elected representatives have already decided upon.

To Stigler economists and other intellectuals are similar to business firms: they will only be patronized if their product is in demand. Only the intellectuals who says what people already want to hear will find an audience.

"That intellectuals purvey ideas congenial to their society, however, is due much more to demand than to supply factors. I am prepared to assume that individuals always know their true self-interest given sufficient time to learn the effects of alternative policies. Each sector of the public will therefore demand services from intellectuals favorable to the interests of that sector. Those whose skill and viewpoint are congenial to the interests of large groups will prosper and become leaders of opinion and those lacking either skill or acceptable viewpoint will write letters to provincial newspapers." (Stigler, 1982, p. 60)

Stigler points out that the funds allocated to economic research are quite limited. He believes this is strong evidence that the public sees economists as unimportant.

must concede that if economists are being used efficiently, their impact on policy will be small. Remember my estimate that our research bill in economics is perhaps one-quarter of a billion dollars, and considerable parts of this are spent in support of economists with conflicting views. Those who believe that economists are more important than this meager standard by an order of magnitude, must believe that society is seriously underinvesting in economics." (Stigler, 1982, p. 66)

Economists, according to Stigler, do have an impact via pure research to discover economic realities. A society of rational men will heed reality whatever their interests and preferences.
"The first and the purest demand of society is for scientific knowledge: knowledge of how the economic system works. Knowledge of the consequences of economic actions. One can be a more efficient protectionist or a more efficient free trader if one knows the effects of tariffs on factor prices, on the sizes of various industries, on national income." ([Stigler, 1952, p. 81])

Friedman's View

Friedman's starting point is a distinction between ultimate ends and the concrete policies used to achieve these ends. He believes economists and the majority of (disinterested) voters agree on ultimate goals, but not necessarily which policies will achieve them. Friedman believes that the progress of positive economics will give the economist (as an advocate) convincing arguments for the policies he favors.

"I venture the judgement, however, that currently in the Western world, and especially in the US, differences about economic policy among disinterested citizens are predominately from different predictions about the economic consequences of taking action - differences that in principle can be eliminated by the progress of positive economics - rather than from fundamental differences in basic values..." (Friedman, 1955, p. 51)

"The current prestige and acceptance of the views of physical scientists in their fields of specialization - and, all too often, in other fields as well - derives, not from faith alone, but from the evidence of their work, the success of their predictions, and the dramatic achievements from applying their results. When economics seemed to provide such evidence of its worth, in Great Britain in the first half of the nineteenth century, the prestige and acceptance of 'scientific economics' rivalled the current prestige of the physical sciences." (Friedman, 1952, p. 4)

Friedman is, of course, a very active advocate of smaller and more limited government. Friedman views his advocacy in the context of very long swings in the public's perception of the proper role of government in the economy.

"Public opinion moves in one direction for long periods, but all the time there are countercurrents. It is only when these counter currents are at a maximum that one should expect a major change in public opinion and in politics..." (Friedman, in Isolden 1975, p. 80)

"That tide of opinion toward economic freedom and limited government that Adam Smith and Thomas Jefferson did so much to promote flowed strongly until late in the nineteenth century. Then the tide of opinion turned - in part because the very successes of economic freedom and limited government in producing economic growth and improving the well-being of the bulk of the population rendered the evils that remained (and of course there were many) all the more prominent and evoked a widespread desire to do something about them. The tide toward Fabian socialism and New Deal liberalism in turn flowed strongly, fostering a change in the direction of British policy early in the twentieth century, and in U.S. policy after the Great Depression.

That trend has now lasted three-quarters of a century in Britain, half a century in the United States. It, too, is cresting. Its intellectual basis has been eroded as experience has repeatedly contradicted expectations. It supporters are on the defensive." (M. Friedman and R. Friedman, 1979, p. 286)

We can infer from Friedman's writings that he believes these factors are now causing a trend away from big government: (1) experience that government intervention in the economy has frequently not had the desired results, (2) the progress of positive economics which can now elucidate more clearly the harmful effects of many government policies, (3) advocacy by economists and others which brings (1) and (2) to the attention of voters.

The Friedman's most recent book is entitled 'The Tyranny of the Status Quo. The title expresses their perception that in the U.S. and some other countries also, the battle to convince the majority that government should have a more limited role is largely won. The problem is now more how to translate the change in sentiment into changes in policies. They believe that progress under the Reagan Administration has been slow because the 'iron triangle' of bureaucrats, politicians, and bureaucrats is difficult to defeat.

"The United States has made some progress since the election of Ronald Reagan in 1980 in satisfying the desires of the majority of the citizenry for a smaller and less intrusive government. Progress has often seemed slow.

1. The strongest political influence on a legislative body is exercised by special-interest groups of citizens who favor a government program that confers substantial benefits on them, while imposing small costs on a large number of their fellow citizens. Each such group is a corner of an iron triangle of beneficiaries, politicians, and bureaucrats.

2. A corollary is that we cannot correct this situation by electing the "right" people to Congress. Once elected, the "right" people will do the wrong things. And they will be pressured to do so by us, in our capacity as members of special-interest groups." (M. Friedman and R. Friedman, 1984, p. 165)

The source of the problem, according to the Friedmans, is transaction costs which arise out of the legislative procedure of voting on one program at a time. The majority is really a collection of minorities each benefiting from some programs but losing from the total of all programs. In general, the majority know that a cut in all government programs and taxation would help them; however, when each program comes up for a vote the beneficiaries have no way of tying a cut in the program which helps them to cuts in the others which hurt them. Thus under their many minority holds the majority of voters go on pressuring the Congress for special interest legislation.
"As we have seen, our elected representatives in Congress have been voting larger expenditures year after year—larger not only in dollars but as a fraction of the national income. Every survey of public opinion shows that a large majority believes that government is spending too much money... How is it that a government of the majority produces results that the majority opposes?

The paradox arises because there is no effective bottom line for government. We are ruled by a majority, but it is a majority composed of a coalition of minorities representing special interests—2 percent in favor of a particular governmental measure will vote for a representative on the basis of how he votes on that measure regardless of how he votes on any others, 3 percent in favor of another specific measure, and so on down the line... Each minority may well lose more from measures benefiting other minorities than it gains from measures benefiting itself... Even if it were willing to give up its own special measures as part of a package deal eliminating all such measures, there is no way currently it can express that preference." (M. Friedman and R. Friedman, 1964, p. 52)

The Friedmans believe the transactions costs can be reduced to manageable levels by constitutional amendments to limit the powers of government to tax, spend, etc. The essence of a constitution (and its amendments) is laying down general rules which control whole classes of legislation. Thus constitutional rules solve the problem of tying together various current and potential government programs. Friedman emphasizes that the constitution and amendments are package deals providing net benefits to a broad majority of the electorate. A constitutional amendment tying the growth of government spending to the growth of national income (as Friedman advocates) would limit the possible increases in expenditures benefitting a single voter to those that would have the prospect of greater benefits from the limitations on expenditures (and taxes) benefitting voters M, Y, and Z but hurting him.

"The Constitution of the United States was conceived precisely as a way of making a package deal of the kind that is currently needed. There is hardly a provision in the original Constitution that would have been accepted separately by the requisite number of original States required to make it effective... the framers of the Constitution produced a package deal that all of the original Thirteen States ultimately adopted." (Friedman, 1964, p. 54)

To summarize, Friedman and Stigler hold very different views about the behavior of democratic political markets even though their views on economic markets are virtually identical. Stigler sees the outcomes in democratic political markets as usually serving the self-interest of the majority which elects the government. For him the majority knows both its goals and which policies will achieve these goals. Friedman believes voters often do not know which policies will achieve their ultimate goals; therefore, the electorate can support policies for long periods which are not in their self-interest. He further contends that ordinary legislative processes may not always serve the majority will; sometimes this can only be served by constitution making and amending. For Stigler advocacy can have no impact, the voters will only listen if they are already convinced. Friedman believes the voters need help to understand which policies will further their ultimate ends; the economist can have a significant impact advocating the policies he knows are superior.

Resolution

While the conflict between the approaches of Friedman and Stigler appears quite fundamental, a resolution would seem to lie in Stigler's economics of information. Though all are rational, neither the producer, the consumer nor the voter can have intimate good information about the appropriate production methods, products, or government policies to achieve their various ends. All must purchase such information, and they purchase it to the extent that the expected benefit exceeds the expected cost. The producer, will frequently be able to hire specialists to discover for him the profit maximizing products and production methods. The consumer can, if he wants to, purchase goods purchased in the market, obtain adequate—though not perfect—information through search, the opinions of experts and experience with goods repeatedly purchased. The voter has largely been lacking in means to purchase adequate information about government policies at a cost which does not exceed the expected benefits.

The expected benefits to a typical voter from knowing what government policies to favor are quite limited for several reasons. First, he must choose between candidates not between actual policies. The various candidates will usually support some of the policies the voter believes correct along with some policies he does not like. Furthermore, there is considerable uncertainty whether the elected candidate will, in fact, work for the policies recommended in his platform. Second, the chances that any one voter will influence the election (or non-election) of a candidate are very small in major elections. Third, the benefits to the individual voter from any single correct government policy are often quite small even though the benefit to all 200,000,000 Americans is in the billions of dollars. Thus, the expected benefit from knowing what policy is likely to be beneficial to the majority is limited while the cost to non-economists of knowing which government economic policies are in the fact beneficial is considerable. Since the benefit-cost ratio of knowing correct government economic policy is quite low, it is not surprising that the majority of all interested voters have not invested enough time to understand the complexities.

The unfavorable benefit-cost ratio explains the lack of well informed voters but not their support of big government welfare state policies. Stigler demands that any analysis be able to explain: (1) the support for limited government until this century, (2) the support for big government during much of the 20th century, (3) the recent switch back to small government (if one believes it is really taking place) (Stigler, 1984, p. 47).

Stigler himself explained the first period of support for limited government quite well. He maintained that the poor, who were the majority, have more to gain from free markets and they know it (Stigler, 1982, p. 30).
Explaining the swing to supporting big government is more difficult. A full explanation is not possible, but Stigler and Friedman go part of the way. They both point out that the rise of the welfare state is, in part, a consequence of the success of free market capitalism. Friedman emphasized that this success highlighted unsolved problems (quote, p. 5). Stigler emphasized that the middle income groups (who became the majority) received considerable redistributive benefits from government capitalism. Friedman provided considerable direct and indirect demand for the services of intellectuals, accordingly, they are among the middle income groups supporting big government. However, Stigler does not see their support as a major cause of big government.

The recent turn towards support for smaller government (if it has taken place) can be explained in terms of the factors discussed earlier: experience with big government's failures, the progress of political economy (including the decline of Keynesian macro-economics), and advocacy.

The role of advocacy derives from high information costs (relative to benefits) in political markets. Political markets, accordingly, clearly slowly and advocacy can accelerate the process.

Beyond advocating individual government policies, Friedman and others advocate an 'economic bill of rights', a set of constitutional amendments limiting government. In their most recent book the Friedmans emphasize the importance of enacting a constitutional amendment as a means of reducing transaction costs, however, constitutional rules can also be viewed as information economist institutions. The rule is decided upon and then we need not consider in detail proposed policies which violate it. In Free to Choose, the Friedmans pointed out that the enactment of constitutional amendments creates additional voter information. Given the long-run and far-reaching effects of such amendments, there would be an incentive for larger groups of voters to become informed about the issues.

"In order for a written - or for that matter, unwritten constitution to be effective it must be supported by the general climate of opinion, among both the public at large and its leaders... Nonetheless, we believe that the formulation and adoption of an economic Bill of Rights would be the most effective step that could be taken to reverse that trend toward ever bigger government. First: because the process of formulating the amendments would have great value in shaping the climate of opinion; second, because the enactment of amendments adds a direct and effective way of converting that climate of opinion into actual policy than our present legislative process.

Given that the tide of opinion in favor of New Deal liberalism has crested, the national debate that would be generated in formulating such a Bill of Rights would allow us to assure that opinion turned definitely toward freedom rather than toward totalitarianism. It would disseminate a better understanding of the problem of big government and of possible cures. (Friedman, 1979, p. 300)

The differences between Stigler and Friedman's approaches to advocacy can be summed up by the familiar long-run short-run distinction. Stigler believes democratic political markets are usually in what we can call long-run equilibrium: the majority of the electorate gets the government policies it wants and which serve its self-interest. Friedman believes political markets are for longer periods in a sort of short-run equilibrium where voters get the policies they want, but these policies do not in fact achieve the voters' goals. The 'short-run equilibria' are produced by the (changeable) constraints of information and transactions costs. For Stigler advocacy has no significant role since voters already know what policies serve their interests. From Friedman's perspective advocacy is potentially important. The economist has a comparative advantage in understanding the impact of government policies, by advocacy he uses this advantage to reduce the information constraints on voters. Advocacy has the potential for accelerating the movement from short-run to long-run political equilibria in which voters get the policies which serve their goals. The economics of information changes the conflict between the Stigler and Friedman points of view from a logical contradiction into a question. Specifically, how important are information constraints on voters? The answer is a matter to be settled by empirical research.

Footnotes

1 There is a large literature on the 'paradox of voting' as it is referred to. A few examples are Downs 1957, Riker and Ordeshook 1968, Stigler 1972, and Owen and Grofman 1984.

2 There are additional connections between the success of free market capitalism and the rise of the welfare state. The majority of the labor force has gone from being independently employed to become employees, often of large corporations. The independent businessman does not need economists to tell him the harmful effects of government regulation; he sees this in his daily activities. This change has not been lost on government agencies. Another result of the success of free market capitalism is the tremendous record of economic growth (and probably an even greater potential) relative to earlier eras (Kuznets, 1966). This powerful engine of growth allows standards of living to go up in spite of the negative impacts of the expansion of government on economic growth (Landau, 1965).

References


1. Introduction

It was the opinion of the late Congressman Wright Patman that it is senseless "to fight inflation by raising interest rates. Throwing gasoline on a fire to put out the flames would be just logical."\(^1\) Marco models of the 1950's or 1960's were unable to evaluate this populist view, since they detailed only the aggregate demand side of the model. More recently, since the OPEC oil price shocks, aggregate supply has come into sharper focus, revealing many ways in which high interest rates may have adverse effects on aggregate supply.\(^2\)

That these supply side effects have repercussions for the theoretical properties of otherwise conventionally specified macro models is increasingly being realized. It is now known, for example, that they may make stability less likely (see Mitchell (1984)), that they may adversely shift the trade-off between output and price stability (see Driskill and Sheffrin (1985)), and that they may cause fiscal policy to have perverse effects on the output gap during a monetary disinflation process (see Myatt and Scarth (1986)).

In the light of these developments it is conceivable that high interest rates may have inflationary impacts which persist through time. If aggregate supply reductions exceed the aggregate demand reductions consequent upon interest rate increases, the price level could be bid up, creating inflationary pressure and a transition to a higher price level. What is not clear however, since it depends on the model and its stability condition, is whether this could generate further rounds of inflation unless and/or until the government took offsetting measures. The possibility of instabil-

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\(^1\)Cited by Driskill and Sheffrin (1985).

\(^2\)If working capital advances are required (as in Taylor (1981)) or if real balances enter the production function (as in Levhari and Patinkin (1963)), these adverse effects are associated with a rise in nominal interest rates. On the other hand, if goods are held as inventories (see Myatt (1985)) or if adjustment costs are labour using (see Scarth (1984)) these adverse effects are associated with a rise in real interest rates. The only possible benign effect of high real interest rates comes from intertemporal substitution on the part of labour suppliers (see Lucas and Rapping (1970)).