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Countering the Power of Vested Interests: Advancing Rationality in Public Decision-Making

Joseph E. Stiglitz

Abstract: Seemingly Pareto-improving reforms face more opposition than they should. In earlier work, I presented an explanation: voters correctly saw reforms as part of a long-term dynamic game, and they correctly saw how the reform affected outcomes (e.g., by affecting beliefs or coalition formation). Recent advances in behavioral economics derived from insights from sociology emphasize preference endogeneity, noting that beliefs are affected by those of others with whom one identifies and need not be consistent with rationality, as conventionally defined. Thus, individuals may have beliefs about the economic system that differ from those of economists. People may support policies which economists' analyses suggest are contrary to their interests because they believe these policies advance their interests. Based on previous analyses of the causes of these seeming perversities, I show how economists can modify policy proposals in ways that enhance likelihood of support, e.g., with contingent provisions which are operative in the states of the world that economists know (believe) are unlikely to occur, but which enhance the wellbeing of individuals with such beliefs in those states. Those selling products that are adverse to one's health have learned how to persuade customers to buy them. Likewise, politicians who are selling policies that are adverse to society's wellbeing have learned how to market their ideas. Economists will similarly have to learn how to persuade citizens of the desirability of the evidence- and theory-based policies that they advocate.

Keywords: evolutionary economics, public decision-making, vested interests

JEL Classification Codes: B15, D7, D8

The Puzzle

After serving as chairman of the Council of Economic Advisers, I wrote an article describing my puzzlement at the inability to push through reforms that we believed

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were Pareto improvements — or near enough to being Pareto improvements — which in a democracy should have received overwhelming support.[1] At the Council, we had struggled to devise such Pareto or near-Pareto improvements, only to be disappointed by the outcomes of the political process.

I speculated that this turn of events was related to the fact that participants in the political process saw it as a long-term, dynamic game, and any changes today had to be seen in terms of their impact on how that game played out. Thus, even if a reform seemed to make everyone better off *today* (without *direct* adverse long-run effects — in many cases, the long-run effects were even more positive), it might have adverse effects on certain interests in the longer run, particularly because of the way the political game would play out. It might, for instance, change the information available to different participants, and that in turn could have large effects. For example, the fact that hydroelectric power is sold to those in the state of Washington at very low prices is known and understood to be a hidden subsidy. But if unused hydroelectric potential were privatized and the electricity thereby generated sold at a market price to those elsewhere — benefitting the Treasury, reducing carbon emissions, and potentially lowering prices relative to what some of those without access to cheap hydroelectric power have to pay — it would make more transparent the magnitude of the hidden subsidy. Anyone receiving the subsidy might worry that this seemingly Pareto improvement would lead these subsidies to be eliminated in the long run, at which point the reform would be far from a Pareto improvement.

Moreover, the political process surrounding the passage and/or implementation of reform legislation might lead to the formation of new coalitions.[2] Coalition formation is often difficult, with high fixed costs, as history has shown. And history matters. The consequence of these new coalitions is hard to predict, but clearly the net effect on some groups could be adverse.

Since my time on the Council, I have come to think that there is another and perhaps more important set of reasons: in some sense, also related to hard-to-foresee dynamics, but this time related more deeply to the functioning of the economy and society itself rather than to the political process. In spite of the advance of economic science, there are marked differences in beliefs about how the economy functions and, even more fundamentally, about the nature of man. Economics begins with a widely accepted set of premises within the profession: individuals have a fixed set of preferences, unalterable and, therefore, unaltered by policy (and, more generally, by experience). Thus, there is no worry that policies could have an impact on individuals or the nature of society. There is only a worry about incentives: namely, that too high a tax rate might reduce incentives for working, not that a policy might make individuals lazy or dependent. So, too, individuals are individualistic, thinking only about their own wellbeing. There is no concern about how policies might affect individuals' sense of community, and words like "solidarity" and "community" play no role.

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[1] See Joseph E. Stiglitz (1998).

[2] Of course, if the reforms were perceived as Pareto-improving, there would be no need for coalitions. But if some groups believe that, because of the long-run dynamics just described, these reforms would lead them to be worse off, those who gained would need to join together to get the reform enacted.

Yet, many voters have quite different views — views that are more consonant with recent advances in economics, attempting to incorporate insights from other social sciences than with traditional economics, but which undermine traditional welfare analyses, and necessitate asking deeper questions about what one means by a good society and the effect of alternative policies in achieving that.[3] Economists, steeped in social-choice theories, similarly think of the political rules of the game that determine the outcome of the political process. By contrast, there is a proclivity to anthropomorphize the political system among the broader citizenry. Governments are lazy, or shirkers, or irresponsible. Like a stern parent, one has to teach governments to behave well by disciplining them when they are bad.

Making matters worse is that economists themselves disagree about so much, thus making it easier for others to take the view that everything is a matter of opinion. With everything being a matter of personal opinion, what might seem to me (and to most economists that I respect) as almost surely a Pareto improvement, might be quite a different thing for others. This is even more so for changes that are "near-Pareto improvements," for the few losers have every incentive to try to persuade citizens that others — including the majority — would also be among the losers. Thus, for example, a tax on land speculation would not lead to a decrease in the supply of land, and it might cause more investment in productive assets and human capital to be allocated to more productive uses. But land speculators have an incentive to conflate such a tax with a tax on entrepreneurship, and to suggest that such a tax would be "unfair" to the speculators and counterproductive to the economy.

The question is: Why do economists see the world through such different lenses? There has been considerable evidence that economists suffer from confirmatory bias no less than ordinary mortals do. They are more likely to find (or at least publish) results that are consistent with their priors.[4] Ascertaining causality is always difficult. In some cases, economists' research findings may have affected their political beliefs, but in others, the causality runs the other way.

Theorems are just that — theorems. But the question is: What is to be made of the theorems? How much attention do we pay to the caveats, the limitations of the assumptions? When Bruce Greenwald and I showed that whenever information is asymmetric or insurance markets are not complete, competitive markets are not constrained Pareto-efficient[5] — that is, there always existed some government intervention(s) which could make everyone better off — I was amused at the flurry of work by conservative economists who attempted to show that our analysis was wrong or that the results were not robust. Almost four decades later, the results appear to be very robust, and have been established in a variety of contexts with a number of alternative proofs.[6] Conservatives then respond by suggesting that the departures from efficiency are small — without presenting proof, or even some methodology through

[3] For a review, incorporating particularly notions of endogenous preferences, see Karla Hoff and Joseph E. Stiglitz (2016).

[4] See, for example, Zubin Jelveh, Bruce Kogut, and Suresh Naidu (2014).

[5] Bruce Greenwald and Joseph E. Stiglitz (1986).

[6] See, for example, Richard Arnott, Bruce Greenwald, and Joseph E. Stiglitz (1994).

which one could ascertain that. Indeed, one of the other important results in information economics is that even small amounts of information imperfections and asymmetries can have tremendous effects.[7]

These differences in views about the functioning of the economy, human nature, and polities play out in many of the most important policy discussions, and help account for the persistence of ideas and policies that are so clearly counterproductive. They even help *partially* account for another, related puzzle: Why do *individuals* in their political lives so often support policies that seem counter to their interests? They typically believe that these policies are consonant with their interests. In democratic societies, vested interests often win through persuasion of the electorate. In some instances, ordinary individuals have been persuaded to identify with the rich. For example, citizens may oppose the estate tax because they believe that they are likely to strike it rich (far more likely than any statistics would suggest), and they then empathize with their (potential) new rich selves in desiring not to pay the estate tax. But, more often, they believe that these policies would be good for them *as they are.* Many have come to believe in trickle-down economics in all of its variants, such as, for example, that taxing the rich — seen as the job creators — would result in fewer jobs being created, thus lowering wages and employment.

We should hardly be surprised, as modern corporations have learned how to sell dangerous products — including products that kill (like cigarettes). They have similarly learned how to shape opinions about tobacco and climate change. If one can sell dangerous products and cast aspersions on ideas that have overwhelming scientific support, clearly, one can sell ideas like trickle-down and supply-side economics. One can persuade individuals that what is not in their interests is, and vice versa.[8]

At times, evolutionary economists might take comfort in the notion that, in the long run, things will work out for the best. The actions that are most conducive to a well-functioning society will eventually win out through a process of natural selection. But even if the process worked in the long run, the costs to those living in the interim may be high. Evolutionary processes are imperfect, at best, as we saw in the run-up to the Great Recession: those firms and managers that wanted to take more prudent actions did not survive the recession.[9, 10]

The Response

It is important to understand the reasons for the failure to advance policies that are in the general interest and to know how to respond. Consider, for instance, the first set of reasons for the failure of seemingly Pareto improvements to be adopted: that the political dynamics are such that what might appear to be a Pareto improvement in fact

[7] See, for example, Peter A. Diamond (1971) and Michael Rothschild and Joseph E. Stiglitz (1976).

[8] See Joseph E. Stiglitz (2012, chs. 5 and 6).

[9] See Joseph E. Stiglitz (2010).

[10] More generally, evolutionary processes do not necessarily take adequate account of the value of adaptability. Imperfections of capital markets mean that strategies which might have a long-run value do not necessarily survive (see, for example, Stiglitz 1974, 1994).

is not when considered from a long-term perspective. One way to respond — but not without its costs — is by devising better commitment mechanisms. While, in democratic societies, one government cannot fully commit later governments, there are ways to increase the costs of potential reversals. The cost is that these policies may make it more difficult to undo the damage from "bad" policies.[11]

If the reason is that there are differences in views about the world, sometimes the clever design of policy can provide an ex ante expected utility gain for both. Consider, for instance, the debate about using cap-and-trade to limit carbon emissions as a way of addressing climate change. Some in the private sector worry that the price of carbon would rise excessively. Environmentalists dismiss the concern as alarmist. A simple modification to the standard proposal may allay both concerns: a safety valve that allows for the issuance of more permits should the price exceed a certain level. Environmentalists, who really believe that the price would never get that high, should be willing to agree that there is a near-zero probability (in their minds) of such a contingency and the private sector would then know for sure that the price cannot exceed a certain threshold.[12]

Sometimes, advocates of change should take advantage of the heavy discounting of the future, and of differences in discount rates. For those who are confident that particular reforms would lead to — say — a better, more efficient and more equalitarian society, a delay of ten years in implementation would have little impact on the present discounted value of benefits. (There is no reason to discount the benefits that will accrue at a high rate, for example, because of risk.[13]) On the other hand, critics of the reform may have a much higher discount rate, and ascribe little cost (in terms of present discounted values) to something that would not be implemented for a decade.

The deepest problems, however, are posed by differences in values and perceptions of the world (including perceptions about how the economy functions). Those who adhere to enlightenment beliefs would hope that reasoned discussion — combined with scientific research — would help to narrow the magnitude of the differences in beliefs.

Advances in behavioral economics and the research mentioned earlier have undermined confidence in this process. Those who wanted to believe that austerity works, and that excessive debts had adverse effects on growth, published papers showing that this was the case.[14] They even wrote about "expansionary contractions."[15] These arguments were taken up and used by politicians who were

[11] Some of these ideas are further explored by Anton Korinek and Joseph E. Stiglitz (2008).

[12] This is an application of a general principle. When there are differences in (probabilistic) judgments, there are always "deals" (bets) than can make both parties better off, giving rise to what I call "pseudo-wealth" (see Guzman and Stiglitz 2016).

[13] In any case, it is generally wrong to deal with problems of risk by changing intertemporal valuations.

[14] See Carmen M. Reinhart and Kenneth S. Rogoff (2010).

[15] See Alberto Alesina and Roberto Perotti (1995), as well as Alberto Alesina and Silvia Ardagna (2010).

looking for evidence to support their positions. As a result, normal standards of proof and argumentation were suspended.[16]

Even more disturbing is that large segments of the population in the US today have questioned the Enlightenment and the scientific process, at least when it proves convenient (e.g., in challenging climate change). Still, I remain confident that, in the long run, the Enlightenment values and the scientific process will win. Research, tainted as it may be by priors, will help us understand the relative merits of alternative policies. It has now become clear that trickle-down and supply-side economics do not work, although it has taken far longer to realize that than it should have. And even after it has become clear that these ideas are not working, there remains a debate about what features of the policies associated with them were responsible for failures and what the appropriate alternative policies are.

Neither markets nor the democratic process exhibit the kind of rationality that some economists have traditionally hypothesized. Accordingly, we cannot and should not expect them to respond perfectly rationally to theory and evidence, for example, about which policies might be good for the typical citizen. This fact simply increases the burden on those who believe in theory-and-evidence-based policies: namely, to engage in serious research; to attempt to explain the results and the underlying ideas in ways that can be understood by and motivate others; and not to leave the political process even more open to manipulation and control by vested interests.

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[16] By now, there have been a large number of critiques of both arguments (on the adverse effects of debt on growth, see Herndon, Ash and Pollin 2014; Panizza and Presbitero 2014; and Pescatori, Sandri and Simon 2014; on expansionary contractions, see Baker 2010, Jayadev and Konczal 2010; and IMF 2010).

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