Why We Need Economic Insights to Know What's Good For Us

Both at the level of individual choice behavior and at the aggregate societal level, there are economic insights crucial for understanding what is going on and for identifying the consumer interest. We provide examples of useful insights at both the individual and societal level in order to focus on what matters and to provide a test of policy proposals as to whether they are both in the consumer interest and in the public interest.

James N. Morgan, University of Michigan[1]

Consumer Interest and Public Policies

It is useful to start with what I shall not cover, namely insights from the other social sciences. Political Scientists understand the need for several powerful groups in favor and no more than one against, to get policies enacted. They know the importance of controlling the agenda. They also know how a sequence of binary choices can produce inconsistent results. Social Psychologists and Sociologists know about forming groups, developing consensus, separating loyalties from shibboleths, and expecting perceptual biases and distortions. And demographers understand the differences between a person's age, his/her generation (cohort) and the current year, which have indistinguishable effects. In Miami, people are born Spanish and die Jewish. Old people are much better off than they were ten years ago, but almost everyone becomes worse off, the older they get. Today's old are different people.

I want to concentrate on economic insights, without which we are almost sure to do good badly, get deceived, and advocate policies or individual actions which are not optimal. Many choices involve principles of interest, annuities, and insurance, and apply both to individual decision making and to defining the consumer interest in public policy.The insights necessary for individual choices that won't be regretted, or wouldn't be if one knew more, have been spelled out in an earlier article of mine. (Morgan, 1995) To introduce another awful acronym, they are DREADful, meaning that each alternative is to be assessed by its Discounted, Real, Expected, After tax, Dollar net benefit, that is, discounting the future for foregone interest, adjusting for inflation, multiplying by the probability, converting to after tax costs or benefits, and converting non-money costs or benefits into dollars using imputations or opportunity cost. Since the focus is entirely on the future, the overall implication is that the past is irrelevant except where it helps us predict the future. All decisions are ultimately based on predictions about the future. But let focus first on the insights essential to discussing the consumer interest in public policy.

At the Societal level, we need a structure and a set of principles to guide us. What economists generally agree on is that competition and free markets work well most of the time, driving prices and profits down, wages and employment up, and spurring increases in efficiency. Competition provides a threat of loss and private property allows a promise of profits for doing things optimally. So a first consumer interest is in preserving and promoting competition and free markets. All the concerns that involve the consumer interest, can be categorized as to where they keep the system from working the way economic theory says it should. The best analysis was published many years ago in a book by Abba Lerner. (Lerner, 1944). An optimal economic system expands the production of each good or service until the added social cost of one more gets larger than the added social benefit. Where does the equality break down?

MARGINAL SOCIAL COSTS=PRICE OF INPUTS
PRICE OF INPUTS=MARG PRIVATE COSTS
MARGINAL PRIV COSTS=MARG PRIV REV
MARG PRIV REVENUE=PRICE OF PRODUCT
PRICE OF PRODUCT=MARG SOCIAL BENEFIT

We discuss these equations in order:

1. Prices of inputs do not represent social costs where there are costs not payable by private enterprise, the so-called externalities like pollution. The external costs can be internalized by pollution

charges, or taxes on fossil fuels, etc. In 1904 George Bernard Shaw pointed out that Britain was subsidizing its shippers by allowing stevedores' wages to be so low that they ended up at the age of 30 as drunken derelicts. (Shaw, 1904) The price of inputs only reflects social costs if all these equations hold for all other production as well.

2. The second equation implies that any lack of competition in the markets for labor, land, or materials will spoil the equality of input prices and private costs. Again, remember that the principle here is not opposition to profits but opposition to distortions of the vaunted efficiency of the whole system. To be fair, we should point out that really tough unions like some of the old craft unions and some of the professional associations today, violate this equality. We come back to the issue of competition later in equation four, since many inputs of goods or services are also someone else's output.

3. Making sure marginal costs equal marginal revenues is the formula for maximum profits (or minimum losses), so for equation three we only need to assume that most businessmen are reasonably smart, or that the others soon fail and dissapear.

4. Monopoly in markets for goods and services will spoil the fourth equality, whether a natural monopoly like the distribution of water, gas, or electricity, or disposal of sewage and garbage, or a government created monopoly from acreage restrictions, leasing of government lands, licensing, tariffs, subsidized water, etc. A natural monopoly must either be regulated, (at the cost of two sets of accountants and lawyers, and a difficult course between too tight that discourages enterprise and too loose that encourages excess profits and prices), or run as a government enterprise, (at the cost of possible indolence). Recent talk of privatization often fails to distinguish between competitive areas where the government should probably not be in business (housing?), and natural monopolies like electric lines, water pipelines, sewage lines, railroad lines, and roads, where privatization before regulation is in place can lead to excessive profits. "Privatization", often means selling off government assets and creating not private property but new private monopolies. Whatever price is paid can then be used to justify raising the rates to produce a "fair return on investment". England has had a series of scandals from selling off city water supplies, trying to "privatize" pensions, and selling electricity suppliers. The electric producers immediately tried to buy the distribution system, the part that is a natural monopoly, and almost got away with it. (See various issues of The Economist.) In this country we have recently seen an emasculation of anti-trust laws which were weak and slow even before that. Unfair restraints of trade to keep out competition can theoretically lead to damage suits, but they take so long that the damage is usually not remediable, and they are hard to finance in a contingent-fee system. There seem to be few restrictions on mergers and buy-outs, however unreasonable. For example, three major pharmaceutical manufacturers each bought up a company that was negotiating better prices for hospitals and other large users, for a total of more than 12 billion dollars, with immediate market responses driving up the values of their stocks as an indication of the monpoly value of such vertical integration.

Governments help create many of the restrictions on competition, often in the guise of consumer protection or market stability. Once a privileged position is so established, its monopoly value can be capitalized and sold, making it difficult (and unfair) to remove it. Examples are taxi and liquor licenses, rights to grow tobacco and other crops, federal leases for grazing, mining, timber, or oil, and even protective tariffs and licensing of artisans. Scarce rights need to be auctioned off, not transferrable, and renewable at a changing price set by the auction price of any new ones that come on the market. And a blind sequential auction like the recent one of rights to broadcasting bands avoids collusion while allowing increased bids.

5. The fifth equality is the most difficult and complex assumption of all. It assumes three other things: (a) attention to external benefits not included in the price, (b) wise and informed consumers and no frauds, and (c) a fair enough distribution of purchasing power so that prices paid can reflect social benefits, We take them up in order:

5a. The first assumption reminds us that there are "external benefits", where individual decisions or societal actions produce benefits which cannot be made exclusive and sold. Where individual actions benefit society at least in part, as with education, encouragement and even subsidy may be in order. Wherever public provision is efficient, but it is difficult to fund by user charges, as with lighthouses, weather warnings, police and roads, such "social goods" call for public funding. Information is a public good because one can give it away and still have it.

5b. The second condition, wise consumers and no frauds, may be fulfilled by a mixture of laws and consumer information agencies and organizations. The choice between consumer education and consumer protection seems to be shifting, properly, toward education. Information requires education as to its meaning, and selection to leave out irrelevancies. In a complex world where attention is a scarce resource, information may be detrimental, diverting our attention from what is important to what is unimportant. Laws and regulations cannot keep up with the complexity of the choices consumers face. Disclosure requirements may help. In 1994 the California Department of Insurance issued a requirement that insurance companies reveal the effective interest rate on the savings part of life insurance policies, allowing consumers to compare them with alternative (tax exempt) investments. In 1996 the California State Legislature in an almost unnoticed piece of anti-competitive legislation, abrogated that regulation and substituted one mandating a lot of fairly useless information.

It is doubtful that ordinary citizens could evaluate the quality of their chldren's education, or of their own medical care, or of their retirement programs, even if there were competing suppliers. And it has been so evident that most are unwilling and/or unable voluntarily to save for their own retirement and some other major risks, that Social Security systems force them to do so in every major country. A privatized Social Security would need compulsion and regulation, as recent scandals and bankruptcies in England and Chile prove. (The Economist or Kritzer, 1996). There are also areas where many are not responsible so that it is a legitimate government function to make them so. Child support payments need some compulsion. Elsewhere we have proposed a surtax on each parent for each child produced, to fund health care and support payments for children, the tax to continue twice as long as the support, catching some parents after they start earning. (Hill and Morgan, 1991)

Whenever a drug hurts people other than the user (amphetamines), there is justification for suppressing it. Where it hurts only the user, there is a choice between trying to outlaw it, often making it expensive, subversive of the police, and profitable to criminals, or taxing it and using the funds for helping the victims and trying to educate the transgressors. A mixture may be good, but a movement toward using market prices to induce better decisions seems in order.

5c. But it should now be obvious that these market solutions to breakdowns of free-market capitalism fail if the distribution of purchasing power is too unfair. Do we really believe that the amount of productive resources devoted to Mercedes cars and cosmetic surgery relative to the amount devoted to child health and nutrition reflects proper social priorities? Even the Economist, that bastion of belief in markets and privatisation, now says the vastly increased inequality of income and wealth in much of the developed world is unacceptable, without going so far as to suggest that this might require restoring some progressivity to the tax system in addition to improving the job market. Economists pointed out early that one could not separate the issues of efficiency from those of equity, the very definition of efficiency breaking down if there was inadequate equity. That lesson seems to be forgotten by those who want to cut the capital gains tax (benefiting the rich for dubious gains in efficiency) or to substitute a value-added tax for the income tax, making the tax structure still more regressive, since a value added tax is a sales tax that cannot even be made less regressive as many sales taxes are by exempting food and medicine. Economic incentives, or even the ingenious proposals to use voluntary negotiated contracts as compensation mechanisms for externalities must depend on equality of bargaining power which ultimately depends on the distribution of purchasing power among consumers. (See Hal Varian, 1994)

Many changes sold as improvements in incentives turn out to benefit the lucky who can take advantage and to punish the unlucky who cannot. We changed Social Security to reward those who kept working till they were 65, thereby punishing the large number whose health or job gave out so that they could not keep working. Where all are not free to choose, one person's incentive may be another's punishment.

The much-maligned income tax is unique in its ability to make the distribution of purchasing power less unequal while maintaining incentives (if you earn more you always keep some of it) and causing minimal distortion of choices. If you spend your income, any taxes on spending reduce incentives to work as much as an income tax, (actually, with any tax you might work harder in order to maintain living standards), and there are less inequitable ways of encouraging saving than exempting it from income taxes.

Perhaps the most important implication of all this is that a reasonable distribution of purchasing power is doubly crucial for an open market economy, first to assure that the basic optimization equations are realized, and second to allow market remedies when other problems occur. Hence it is frightening that 72% of Americans think income inequality is not too large, far more than people in Japan or any European country except East Germany. (Basanez, Inglehart, and Moreno, 1997) In fact, our inequality is substantial and growing. Americans are also far more likely to think equality of opportunity exists.

Many public policies involve issues of insurance or annuities, including pensions and Social Security, where the ordinary citizen is usually baffled. Insurance eliminates risk by pooling, provided there is no adverse selection (only those likely to collect join, or company only insures those not likely to collect). Individuals eliminate their risk by purchasing insurance, and the insurance company eliminates its risk by pooling (diversification of a sort).

A life insurance policy which combines insurance with a saving program, developing a cash surrender value, can only be assessed and compared with other insurance policies and with other ways of saving money, by knowing the rate of interest on the saving part of the policy. This can only be estimated by an iterative calculation because the higher the interest rate, the more the cash value builds up and the less real insurance you have whose cost is to be deducted. The amount of real life insurance one needs is what would be needed on top of savings and Social Security survivors' benefits, to take care of one's dependents. That amount hits its peak when the last child is conceived, and drops rapidly, reaching zero long before retirement age because retirement savings accumulate. Hence, anyone with life insurance after age 55 is probably worth more dead than alive. Social Security survivor benefits are in the sensible form of an annuity on each survivor until he/she matures, or in the case of the spouse, dies. And in the aggregate, they are worth more than all the private life insurance in force.

Any insurance is a good buy if you have something to lose, someone who cares, and the premium reflects all the possible losses times the probability of each. The last is not likely to be true if those likely to cash in are more likely to buy the insurance. The ideal insurance covers everyone, so if it is not to be a single payer system, all the competing insurers must be compelled to take all comers. The trend is the reverse, with companies "cherry picking" the good risks, and that trend would be exacerbated if one tried to "privatize" medicare or Social Security.

Interest is important over long periods. If your accumulation earns interest at 3% until you actually get it back in a pension, then with 45 years of accumulation and 20 years of collecting, you get back nearly three times what you put in. So some of the claims that Social Security pays too much are clearly wrong, particularly if you allow for inflation and apply higher interest rates. In practice, whenever interest rates are higher than 3%, there is inflation wiping out future values, so that one should always use 3% in calculations, and insist on earning 3% plus inflation on savings. At 5% you get back six times what you put in, though it's worth less than that.

Saving reduces one's current level of consumption, hence reduces the standard one might need to maintain in retirement, so saving helps doubly. Permanent income increases can be spread over a remaining lifetime, consuming a regular amount which is a smaller fraction of the increase, the more retirement years there are relative to the years of higher earnings. Windfalls can be spread over a remaining life as though one bought a lifetime annuity earning 3%.(Morgan, 1995)

A lifetime annuity is the mirror image of life insurance, eliminating the risk of living too long by pooling. In order to live well if you should live a long time, you must bve willing to give up most of your contribution to others if you die early. Fudging this by insisting on getting something back if you die early, violates the principle and reduces the amount of annuity you get.

Social Security retirement is a system that forces us to save for our old age and use up the savings as a lifetime annuity. Social Security also involves a life insurance (survivors benefits), disability insurance, and after retirement, some medical insurance. They are important, but the main element is the retirement program, accounting for about two thirds of the contributions (withheld, paid by employer, or implicitly accrued as interest).

We have all been bamboozled and kept from a sensible assessment of Social Security retirement by a rationalization for covering people during the depression of the thirties before they had contributed much. The pay-as-you go excuse said each generation paid in on the promise that later generations would pay for their retirement. And an unfunded system with no real reserve fund and earning no interest could have a schedule of contributions and benefits that mimicked an annuity that paid interest, that implied rate of interest being the rate of growth of the total wage bill (working population times real wage rate). But if population and/or real wages do not grow steadily, that doesn't work.

The issue, then, is not one generation versus another, but the obligation of a country that borrowed the reserve funds of the system to make up any deficits out of general taxes on all of us, including the aged. The system as presently constituted, is paying about 4% on the contributions of those currently retiring, and that rate will drop to 1.7% by the middle of the next century. (Leimer, 1995). Hence, if we reduce the benefits further, or raise the payroll tax, or raise the retirement age which is the equivalent, we face some future generation with the prospect of not even "getting its money back". We would be converting a sensible system into an explosive Ponzi scheme. Some changes to account for increasing life expectancies may be in order. However, the argument that the cost of living adjustment exaggerates the real increase in the cost of living ignores the fact that a major component of the increase is medical care, and the fraction of income spend on medical care, in spite of Medicare, is more than 12%+ for those 65 and older compared with less than 4% for the young. (USBLS,1997) Recent arguments that medical costs haven't really risen because quality is better are unconvincing to those with no real choice whether to get treatment.

Hence, any future "deficits" if they really do appear, and that depends on how the population and productivity grow and how much inflation we have, are a genuine obligation of the whole society, some of the implied interest on what we all borrowed from the system in the thirties, and should be covered by taxes on all of us, including the aged, not by changing the Social Security tax, benefits, or retirement age. Some very old people are getting benefits beyond what they earned, but they are the poorest and are on their way out. So long as the implied interest earned by each generation as a whole is reasonably small, there is really no more intergenerational transfer involved, and no reason stir up unnecessary intergenerational hostility. The predicted "deficit" if it occurrs will be only the tip of an iceberg. The surge of added workers from the baby boom, immigration and women working more, will retire and start spending their accumulated Social Security and pension rights and assets, leading to massive inflation unless the Federal government raises taxes to run a budget surplus. No one seems to be dealing with this real problem, being diverted by the senseless fight over Social Security. (Note that 85% of the Social Security benefits are now counted as income for Federal income tax purposes, properly so because there have been no prior taxes paid on the employer contributions or on the implied interest.)

All this is confused by largely erroneous arguments about redistributions within each generation. In fact women benefit because they live longer, blacks die earlier but benefit from the benefit minima, and the major redistribution is insurance-annuity redistribution from the healthy and those who die early to the disabled and sick and those who live a long time. The number of years of covered earnings that must be included (including zeroes) in calculating benefits is now 35, so there are no real free riders. Misleading critics focus on the payroll tax as "regressive", ignoring the fact that when the benefits are considered the system is mildly progressive.

Medicare is a different issue, insoluble unless we do something about the whole medical care picture. But I would predict that most old people, given a choice between reducing benefits and an increase in premiums, would choose the latter. Enforcing the copayments now almost universally evaded, would help a lot. Medicare is often confused with Medicaid, a means tested, non-contributory transfer, much of which pays for nursing home care for Alzheimers victims, after they have exhausted their assets (or divested themselves of them). The two are combined with Social Security under a demeaning title of "entitlements", confusing contributory programs with means tested welfare programs.

Policy Issues Force Us Back to Thinking About Individual Choices

Many policies are proposed to improve people's incentives assuming that they are freely choosing whether to work, support their families, retire, save, etc. But for individuals unable to respond to these incentives, what seems a reward to others is a punishment to them. Hence, it is clear we need better research on whether and how individuals really make choices. Various disciplines have theories about choices: Economics is about how people should make choices, while Sociology is all about why they don't have any choices to make. A major research task is finding out what choices people have, and what choices they think they have, and how they choose.

I would urge broadening the area of economic insights tested in both experiments and surveys beyond risk and game strategy to include discounting the future, applying probabilities to estimate expected values, adding in imputed (non-money) costs and benefits, ignoring past (sunk) costs and benefits, taking account of taxes, seeking more information, and waiting for better opportunities. (Morgan, 1995) The policy implications of better understanding of choice behavior are enormous, since crucial policies are currently made based on untested assumptions about whether people have choices, and whether they understand the implications of those choices, and even what matters to them. Recent welfare reforms are a good example.

The implications for behavioral research are equally great. Estimating the level and significance of "rational" responses to changes in prices or wages or incomes while ignoring what choices were available and what other forces affected decisions is typical. Economists have always assumed that their theories only worked, and only needed to work, "at the margin". So one might think of selecting those who, on the basis of environmental and personal factors, have a probability of doing something of .2 to .8, then seeing whether the economic incentives to be tested affect them. But it would be better to develop a rich understanding of everyone's choices.

One can, however, study effects of differential income changes on panel families' consumption of food and housing, and compare them with cross-section estimates to uncover lag effects. (Morgan, 1985). We suggest starting with retrospective accounts in spite of the problems of memory loss and distortion, hoping to fine tune our models before investing in expensive longitudinal studies.

The benefit-cost theory implies a lot of calculation which seems so formidable and unrealistic that we have proponents of "bounded rationality", rules of thumb which prevent serious mistakes even while not optimizing. Installment credit involves paying a high interest rate while earning a low one on one's savings, but it might force one to save in the form of debt repayment as the car depreciates. Finally, people hopefully learn from experience, or from the experiences of others, and many decisions are made more than once in a lifetime.

Summary

It should be clear by now that the consumer interest in public policy can only be made clear by the application of some rather sophisticated economic analysis, and some further research on consumer behavior. Policies that assume well-informed consumers with many free choices to make can be badly misguided and unfair. Finally, it often takes sophisticated economic analysis to uncover the consumer interest or the public interest in proposed policies.

References

Basanez, Migual; Ronald Inglehart and Alejandro Moreno,(1997) Human Values and Beliefs: A Cross Cultural Source Book, Ann Arbor, Mi.; University of Michigan Press

Hill, Martha S, and James N. Morgan,(1991) "Enhancing Choices for Human Capital Expenditures: A Proposal to Enhance the Financial Security of Children." in Robert Mayer, ed. Enhancing Consumer Choice, Columbia, Mo.: ACCI.

Kritzer, Barbara E.,(1996) "Privatizing Social Security: The Chilean Experience," Social Security Bulletin 59:45-55

Leimer, Dean R. (1995) "A Guide to Social Security Money's Worth Issues,Social Security Bulletin,Summer.

Lerner, Abba,(1944) The Economics of Control, New York:Macmillan.

Morgan, James N. (1995) "Justifying the Use of Economic Insights in Ordinary Decisions", Financial Counseling and Planning 6:45-52,

Morgan, James N. (1985) "Comparing Static and Dynamic Estimates of Behavioral Responses to Changes in Family Composition or Income." Journal of Consumer Research,121:83-89

Shaw, George Bernard (1904) The Common Sense of Municipal Trading, Westminster: Constable and Co.

U. S. Bureau of Labor Statistics, Consumer Expenditure Survey: Quarterly Data from the Interview Survey, Report 910, 1997.

Varian, Hal (1994) "A Solution to the Problem of Externalities When Agents are Well Informed." American Economic Review 84:1278-93

Endnotes

1. Emeritus Research Scientist, Institute for Social Research, and Emeritus Professor of Economics, The University of Michigan.