Should Congress Listen to Economists?

Peter VanDoren

The Journal of Politics, Vol. 51, No. 2 (May, 1989), 319-336.

Stable URL:
http://links.jstor.org/sici?sici=0022-3816%28198905%2951%3A2%3C319%3ASCLTE%3E2.0.CO%3B2-A

The Journal of Politics is currently published by Southern Political Science Association.

Should Congress Listen to Economists?

Peter VanDoren
Princeton University

Economists prescribe well-known remedies for those situations where private behavior does not maximize allocational efficiency. Legislatures, however, rarely enact microeconomic policies without substantially altering economists' solutions.

Those who defend elected officials' alterations offer three categories of justification—windfall losses of income negate efficiency improvements; indirect redistribution, though inefficient, serves progressive goals without generally repudiating market incomes; command-and-control regulation produces valuable symbolic outputs. Only the first line of argument has merit. Policy prescriptions often are insensitive to the wealth losses they create and can be improved through congressional attention to distributional issues. For the most part, however, no normative goal is well served when Congress ignores economic efficiency in the design of policies.

INTRODUCTION

The division of labor between political scientists and economists in the field of public policy analysis is a source of continuing intellectual friction, particularly in policy schools where they jointly teach. Economists prescribe well-known remedies for those situations where private-market behavior does not maximize allocational efficiency. Political scientists describe how "real" legislatures work (they generally don't listen to economists), develop positive theories to explain why the Congress does not enact microeconomists' policy proposals (Fiorina, 1977; Shepsle, Weingast, and Johnsen, 1981; Shepsle and Weingast, 1984; Niou and Ordeshook, 1985), and analyze large distributive questions (Rawls, 1971; Nozick, 1974; Hochschild, 1981). The question I consider in this paper is whether political scientists have a normative role not only at the Rawlsian level but also at the level of garden-variety market interventions (energy, housing, transportation, and telecommunications) where applied microeconomics is so prescriptively dominant.

I first characterize the main features of domestic microeconomic policy recommendations and then examine three potential political rationales for modifying economists' recommendations, paying particular attention to Steven

An earlier version of this paper was presented at the annual meeting of the Midwest Political Science Association, April 9–11, 1987. I would like to thank Douglas Arnold, Rebecca Blank, Jason Cheever, Amy Gutman, James Hines, Mark Hughes, and the anonymous referees for the *Journal of Politics* for their helpful comments.

JOURNAL OF POLITICS, Vol. 51, No. 2, May 1989

Kelman's critique of economic incentives.[1] I conclude that legislators should directly tax and transfer income to adjust the distributional consequences of microeconomic policies but otherwise should optimally correct market failures as economists suggest.

Economists' Policy Prescriptions

Economists who evaluate domestic public policies invariably conclude that problems exist because:

1. prices do not equal true marginal social costs;
2. certain markets are nonexistent or underdeveloped; or
3. negative distributional aspects of market economies such as disinvestment, income fluctuation, and short-term rents are altered with sector-specific microeconomic policies instead of general tax-and-transfer methods.

When prices do not equal true marginal costs, economists propose that the legislature enact taxes if prices are too low and encourage firm entry if prices are too high. For example, in a recent article on interstate highways, Kenneth Small and Clifford Winston (1986) conclude that trucks do not pay road user fees that cover the marginal damage they inflict on highways. Small and Winston recommend that truck fees be raised drastically now to pay for better-built roads and then lowered once a more damage-resistant road system is in place.

When markets do not exist for various commodities, economists recommend that the government create new property rights. For example, numerous authors have argued that environmental problems are caused mainly by the lack of tradeable property rights in air and water (Kneese and Schultze, 1975; Friedlaender, 1978; Crandall, 1983). To be sure, the Congress would make initial collective choices regarding the acceptable ambient air- and water-quality levels, but once those choices were made, a free market actually would allocate pollution discharges across firms.

When distributional problems (including disinvestment, income variation, and excess profits) arise, economists recommend general tax-and-transfer remedies rather than specific market interventions. Let me offer one example. Robert Crandall (1981) argues that falling world iron-ore prices and innovations in ocean shipping during the 1960–1970 period removed constraints that previously had given U.S. steel mills, located near iron-ore deposits, a cost advantage. The U.S. steel industry did not respond to these

[1] I do not discuss the appropriateness of market allocation for the military draft or other tragic choices such as kidney and heart transplants (Calabresi and Bobbitt, 1978). Nor do I discuss the utility of economics as a general positive theory of behavior (Rhoads, 1985). And I do not attempt to explain Congress's behavior except to observe that those citizens who are well-served by Congress's current decisions obviously have more effect on legislators' behavior than the rest of us who do not benefit.

changes and instead continued to use high-cost iron and labor inputs. As a consequence, the return on steel investment in the United States, as estimated by Crandall, is negative and disinvestment has been widespread since the late 1970s, creating real distributional problems for steel workers. Policies that promote markets for high-cost domestic steel, however, support steel-worker incomes at a very high real cost to the economy and also encourage consumers to substitute away from steel products, thus exacerbating the pressure on steel-worker incomes. Everyone would be better off if steel-worker incomes were supported directly through transfers rather than indirectly through steel-market adjustments.

Economists, then, have standard recommendations when they give policy guidance. Should the legislature modify these policy prescriptions? Three subsidiary questions must be answered in order to ascertain whether political institutions ought to alter these microeconomic policy recommendations.

1. What is the normative status of the one-time losses of income and wealth that result when any sector's prices are raised or lowered to remedy market failures?
2. Is the use of price and/or quantity techniques as an indirect method of ameliorating income inequality ever justified?
3. Is the creation of markets to prevent the overuse or underuse of commodities morally inferior to other policy solutions?

Transition Losses of Income and Wealth

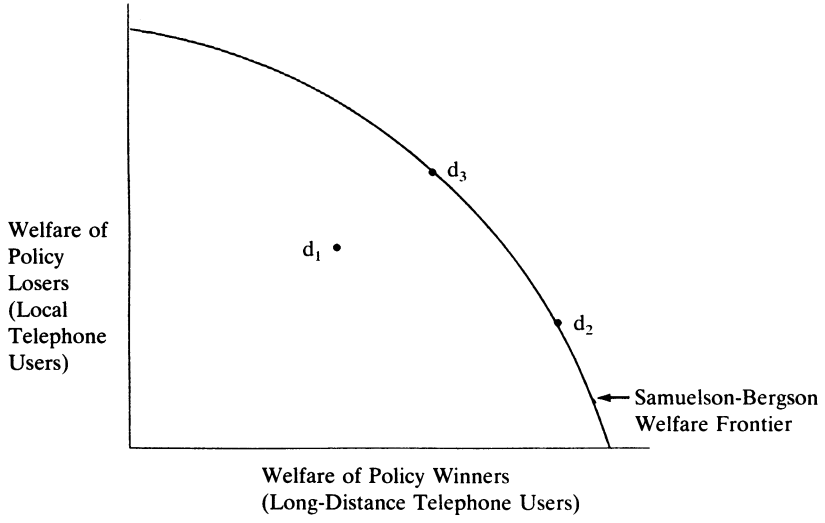
One potential reason to alter economists' policy proposals is the subtle but important distinction between potential and actual Pareto improvements. All policy proposals that alter prices or create markets to improve allocational efficiency create one-time wealth gains and losses. Should those who lose wealth and income because of such policies be protected by political institutions and what form should that protection take? Should gainers be taxed?

Potential Versus Actual Pareto Improvements

Figure 1 graphically displays the wealth difficulties created by most microeconomic policy proposals. The axes represent utility for two groups in society affected by an efficiency-enhancing policy such as the pricing of both local and long-distance telephone service at marginal cost. Social welfare for telephone users before the 1980s is represented by distributions d_1. Total social welfare is less than it could be in this initial state (within the welfare frontier) because long-distance prices are above incremental costs and numerous long-distance calls whose utility would exceed their costs are not made. Social welfare after long-distance prices were lowered is represented by distribution d_2. Those who make long-distance calls are better off. Those who make no long-distance

FIGURE 1

ACTUAL VERSUS POTENTIAL PARETO IMPROVEMENTS



calls are worse off because local service is no longer cross-subsidized. And total welfare is much larger than the initial state.

Economists initially argued that any policy, such as telephone repricing, that moved the economy from d_1 to d_2 was a Pareto improvement because the resulting distribution always could be rearranged to make everyone better off (distribution d_3) (Kaldor, 1939, 1940; Hicks, 1939, 1941). Scitovsky (1941), however, demonstrated that if the distribution d_2 that resulted from the implementation of an economic policy actually had more goods for some parties and fewer for others, then a move back to the status quo (d_1) also would be an improvement by the same criteria that approved the move to d_2, if the change in distribution also changed equilibrium prices. The logical contradiction noted by Scitovsky can be solved if actual compensation is required and the people who would lose from the policy change, such as the users of local service, would be incapable of bribing those in favor of it, large users of long distance, for less money than they would require in compensation to approve the change.[2]

Political scientists argue that the problems of mixed gains and losses found in potential Pareto improvements should be managed through majority rule instead of compensation (Rae, 1969; Taylor, 1969). The use of majority rule

[2] The Scitovsky criterion insures that the better distribution could not be brought about through simple redistribution instead of microeconomic changes plus compensation (Little, 1957, p. 100).

maximizes a citizen's benefits from social decisions, given uncertainty about his position and the position of his descendants in the distribution of decisions involving gains and losses. Majority rule lowers the likelihood that individuals become pivotal and thus able to extract large sums for their consent to transactions that inflict losses. The losers, however, are forced to accept social decisions without compensation. The fairness of majority rule depends on whether the members of winning coalitions vary across decisions. If those who lose under majority rule lose repeatedly, then gains and losses do not balance across time and lack of compensation becomes a severe problem.

The issues involved in compensation versus majority rule relate directly to current dilemmas in the microeconomic management of airlines, telephones, banks, trucks, and the environment. In each of these areas, policies have been enacted or proposed that either lower prices through the elimination of entry restrictions (airlines, telephones, banks, and trucks) or raise them through the replacement of allocation by regulation with allocation by price (environment). In the former, employees lose income and owners lose wealth as the loss of entry barriers lowers the value of their assets. In the latter, holders of wilderness rights and discharge permits lose income, while owners of land, the taxpayers at large, and those who seek to utilize the environment (but cannot because of entry regulations) gain income. These policies, then, are potential Pareto improvements of the character d_1 to d_2 in figure 1 and not actual Pareto improvements because compensation for the regulatory changes does not occur.

Can Losers Be Categorized?

Should the losers in these cases have political standing and, if so, what should political institutions do for them? The choice between majority rule and the new welfare economics is whether changes in status-quo property rights are purchased or simply enacted by majority rule. One possible solution would categorize changes in property rights as compensable or noncompensable and allow majority rule redistribution of rights only in those situations defined as noncompensable. In compensable situations, losers would have to give their consent freely to changes, presumably in return for compensation.

Compensable policy changes might include genuine shifts in priorities or responses to exogenous events where citizens could not have foreseen the need for modifications in the rules of the game. For example, the siting of roads, prisons, and mental health facilities often creates negative externalities for surrounding residents who purchased a certain collective ambiance along with their homes. Compensation could accompany the construction of such facilities. Noncompensable changes could include those windfall losses created by the proper collective treatment of public goods and market failures where citizens could foresee the need for reform. For example, if the legislature enacted policies only where market failures existed, then citizens never

would have had the privileges created by milk-marketing restrictions, taxi medallions, and airline and trucking regulation. The removal, therefore, of the privileges created by policy errors would not be compensable.

In practice, the distinction breaks down between losses created by the eradication of privilege (noncompensable) and those created by normal alteration of the rules of the game (compensable). Public policies that create privilege (augment the income of a particular sector) increase the value of existing assets, but as entry occurs into the sector, the asset values return to their pre-privilege levels. Even if entry does not dissipate the rents entirely, only those entrepreneurs who own assets prior to the policy change would receive windfall wealth gains. Those who buy assets after the policy change would pay for the increased income and would not receive excess profits.

The reverse occurs when a policy change removes or alters a policy privilege. Returns are lowered to below normal levels initially, but disinvestment and unemployment occur to restore the equilibrium. If the industry is competitive, then only those who go bankrupt lose wealth. If the industry is not competitive (difficult entry and exit) two results occur. Those firms that remain in business and were in business prior to the enactment of the privilege simply lose the windfall gains they received. Firms that enter the industry after the enactment of the policy privilege and remain in business after its removal lose real wealth because they never received windfalls when they entered the industry (Tullock, 1980; Dorfman, 1981).

The enactment of policy privileges creates wealth windfalls only when entry is restricted and only for existing owners. The repeal of policy privileges creates compensable losses in only two situations: when entry (and exit) are easy and some owners become bankrupt (and some employees lose their jobs) and when entry is restricted and newcomers who paid for the policy privileges suffer real wealth losses. Thus, a classification scheme that sorts economic transactions involving gains and losses into compensable and noncompensable categories based on the origins of those benefits that were lost would require an extensive accounting system to monitor the timing and price of asset sales.

Compensation Useful Even If Imperfect

Even if such an accounting system could not be developed, some compensation, even if haphazardly distributed, probably would be better than none at all for two reasons. First, regimes that frequently rearrange the rules of the policy game without compensation risk undermining the stability of property rights and lowering total investment because of wealth-loss uncertainty. Second, the provision of compensation improves the likelihood of enacting legislation that promotes allocational efficiency that otherwise would be blocked through political action.

Recent changes in the income-tax law illustrate both propositions. Tax changes have occurred so frequently in the last ten years (1978, 1981, 1982,

1984, and 1986), each time creating windfall income and wealth changes, that many political actors support a tax-changes moratorium to create stability in the rules of the game (Shanahan, 1986). The 1986 reform also contained 686 transition rules that protected many citizens and firms from one-time losses of income and wealth. These rules were decried by the press and some members of Congress as favors for the "fat cats," but, in fact, many of the transition rules did ameliorate legitimate wealth-loss concerns and thus facilitated the passage of reform. To be sure, the transition rules did not provide full or equitable compensation because the privileges were not given to all firms and most rules merely delayed the timing of the wealth loss, but the tax-reform experience illustrates that explicit attention to transitional wealth losses can facilitate the passage of reforms that enhance allocational efficiency.

Compensation and Moral Hazard. Some economists believe that actual compensation would not enhance efficiency even if accounting systems were developed to monitor asset ownership and determine how asset values were affected by policy decisions (Baumol, 1986, chap. 5). In particular, Baumol believes that compensation both discourages externality victims from protecting themselves and encourages people to become victims. For example, Baumol believes that once citizens suspect a policy change will happen, they would buy the relevant assets or seek employment in the affected industries in order to receive compensation when the wealth loss occurred. I believe that moral hazard of this sort could be minimized through the enactment of retroactive legislation. Congress already manages wealth games by enacting grandfathering provisions. For example, to avoid a last minute equipment-buying spree, the repeal of the investment tax credit in the Tax Reform Act of 1986 was effective January 1, 1986, even though the Act was enacted in August.

If the meaning of compensation is expanded to include schemes that legislatively create a limited but non-zero amount of property rights for "harms," allocate them equally across individuals, and require those who commit harms to buy the rights to do so (compensation), then Baumol's position is even less tenable for two reasons. First, victims' consent surely ought to be an input into the production process. At competitive equilibrium, the price of consent (compensation) would equal the cost of the least expensive preventative measures that victims could practice to keep their welfare constant. If they choose to accept compensation but not take preventative measures, allocational efficiency would not be reduced because their preferences were served better by money than by prevention. Second, Baumol also assumes the victims' behavioral choices include only prevention and inaction. The absence of compensation, however, induces citizens to use political activity to prevent policy changes that cause wealth losses. Political activity, of course, consumes resources and must be considered in any claims about optimality.

Compensation and Windfall Gains. An additional obstacle to compensation is the need for symmetry in the treatment of windfall gains and losses created by policy activity. If compensation is provided to those who lose from economic transactions, then they need not expend resources on political activity designed to prevent losses imposed by the political system. The gains from reduced political activity will not be realized, however, if the windfall gains that result from political action also are not taxed because interest groups will seek to gain through the taxation of the general public knowing that if they succeed, their gains cannot be taken without compensation. In order to enhance allocational efficiency and distributional equity, the same accounting devices used to determine compensation also must be used to extract taxes from those who benefit from public action.

The Congress, then, either can provide compensation to those who lose and tax those who gain wealth and income because of changes in microeconomic public policies, or they can enact such changes through majority rule without compensation. At equilibrium both policies would have the same distributional effects because if no compensation ever were offered, all asset prices would be lower, reflecting the uncertainty that majority-rule political activity would create losses (Posner, 1980). The expected value of profits would be identical under both regimes.

Allocational efficiency, however, probably would differ under the two schemes. Total investment and income would be higher if owners knew that wealth losses created by policy changes would be compensated assuming the actual transaction costs involved in determining the scope and level of compensation were not prohibitive, the compensation schemes did not create moral hazard as discussed by Baumol, and windfall gains also were taxed. If compensation were not provided, total investment probably would be lower and numerous resources would be devoted to blocking legislative decisions that promote efficiency but create wealth losses. On balance then, compensation is the desirable option if the costs of implementation do not exceed the other benefits.

Indirect Versus Direct Redistribution

In practice, the main discrepancies between actual policy decisions and economists' proposals occur because elected officials alter microeconomic relationships within a sector of the economy to augment the incomes of particular citizens or firms. Agricultural price supports, steel- and auto-import quotas, telephone cross-subsidies, tax privileges, rent controls, occupational licenses, and numerous other policies attempt to alter the market distribution of income in favor of groups that legislatures deem deserving.

Economists believe such indirect redistributive policies are counterproductive for a number of reasons. First, deadweight loss, a measure of sales that do not take place because of distorted prices, is created by all indirect

measures and severely limits the actual amount that is redistributed. David Bradford (1986, p. 207), for example, reports that efficiency losses created by tax privileges equal one-quarter to one-third of the current federal tax revenue. The recent voluntary auto-import quotas protected auto employment at an estimated cost of $160,000 per job (Lawrence and Litan, 1985). Auto workers earn much less, of course; the differences are deadweight loss, which simply disappears from the economy, and rents to other countries, such as Japan.

Second, the intended redistribution does not occur at all if policies do not restrict firm and labor entry into the sector receiving the subsidies. The tax provisions affecting oil companies provide an illustration. Since the 1930s, liberals have railed against the depletion allowance and the intangible drilling-cost allowance—two features of the corporate income tax that allegedly create excess profits for oil-well owners. After these tax provisions became law, the rate of return on petroleum wells indeed did rise above the market rate of return. Those excess profits, however, spurred entry into the petroleum business to lower the rate of return. To the extent the rate of return did not fall to the market level, because of various entry barriers, the higher than normal cash flow created by the tax provisions was capitalized into the price of petroleum assets. Existing owners and their employees received windfall gains, but all subsequent owners paid a higher price for the assets, reducing their rate of return to the market level. Thus, contrary to conventional accounts of struggles over the retention or repeal of policy privileges, many recipients of these privileges really do not receive windfall gains in income or wealth.

The third problem with indirect price-and-quantity regulatory attempts to augment incomes (when they actually do redistribute) is their pronounced tendency to aid precisely those individuals who don't require help. When prices for energy, apartments, and phones are kept below market levels, the bulk of the benefits flow to upper-income people if the commodity use is income elastic, as it often is. When prices for steel, autos, and other commodities are held above market levels, high-wage workers and the owners of assets are beneficiaries. Rarely are indirect strategies utilized to raise the incomes of K-Mart employees or secretaries.

Finally, redistribution by indirect means creates allocational distortions that alter consumer and firm behavior to the point where new policy problems are created and governmental intervention in the economy is discredited. Petroleum policies illustrate this pattern.

Since the 1930s, attempts to augment the incomes of petroleum producers through tax privileges and price stabilization measures generally have induced more investment, more petroleum production, and further downward pressure on incomes. By 1966, wells in Texas were producing only at 34% of capacity in order to preserve prices at what were thought to be acceptable levels (McDonald, 1971, p. 189). Efforts to protect consumer incomes also have

induced counterproductive behavior. Domestic petroleum price controls, used during the 1973–1979 period to protect consumer incomes, created unequal profits for refiners. To equalize the profits of refiners that had differential access to price-controlled oil, the Department of Energy developed an oil-entitlement program that gave money to those refiners that imported more than average amounts of crude oil. Refiners responded, of course, by importing oil and placing pressure on the world market exactly at the time when our stated policy was energy independence (Kalt, 1981).

Elected officials use sector-specific microeconomic policies to redistribute income because most Americans give special moral status to incomes earned through labor market activity (Hochschild, 1981). Legislators do not get elected on the basis of campaign slogans that state we could reduce federal spending greatly if only we paid people to live in rural states instead of calling them farmers and paying them to grow commodities for which there is no demand. Politicians do get elected by promising to save farmers, save industries, and save communities. Economic analysts cannot state that such slogans are wrong. They only can state that we pay an extremely high price to shroud our redistributive efforts with political symbols. If the public were fully informed of the arguments against microeconomic redistributive efforts, perhaps citizens would favor more direct redistribution and oppose such steep costs for symbols.[3]

Creation of Markets

A final dispute between economists and Congress involves the resolution of market failures, that is those situations where market institutions do not implement the Pareto rule successfully. Transactions that make some citizens better off and none worse off, that do not take place in private markets are called positive market failures (externalities) while those that make some citizens worse off but still occur are called negative market failures.

Positive externalities often are referred to as public goods. Private uncoordinated behavior will supply these goods in less than optimal amounts because consumption cannot be restricted easily to those who pay and because one person's consumption does not detract from another's consumption. Knowledge, defense, and local streets, just to name a few commodities, have such characteristics, and all are provided suboptimally by private markets.

Negative externalities exist when markets for harms do not exist or are underdeveloped. Bad outcomes are oversupplied in these situations because the commodity in question does not have to be purchased. Pollution, congestion, and land-use conflicts are examples of negative externalities that exist because

[3] If citizens continued to favor the use of microeconomic policies to redistribute income even after they were fully informed of the consequences, then economists could only note the price paid for such tastes.

property rights do not adequately protect third parties from losses in welfare.[4] What institutions can remedy the failure of markets to implement the Pareto rule in these situations? In this final section, I characterize economists' solutions to market-failure problems and compare their recommendations with those of a prominent political scientist (Kelman, 1981).

Economists and Market Failures

Economists have demonstrated that optimal provision of public goods requires the state to utilize blind bidding to ascertain the demand for these goods, provide an amount equal to the sum, and charge citizens according to their individual bids (pure price discrimination) (Lindahl, 1919). The supply of public goods and the allocation of charges that result from Lindahl's scheme have been shown by Samuelson (1954) to be Pareto optimal.[5] In practice, of course, Congress uses majority rule to make separate expenditure and revenue decisions, but if the legislature used a more Samuelson-like procedure, many of our current fiscal problems would disappear.[6]

Coase (1960) has shown that the resolution of negative externality problems need not involve any public action. In the absence of transaction costs, private behavior will "correct" negative externalities. The distribution of income and the equilibrium amount of nastiness, however, may differ depending on the assignment of status-quo property rights. For example, if firms must bribe residents before producing pollutants, ambient air quality probably will be better and the income transfer higher than if citizens must bribe firms to reduce negative environmental effects.

In addition to these initial wealth effects, most real-world externalities involve gains and losses for groups of people and not individuals, such as the farmer and rancher used in Coase's analysis. In group situations, externalities will not be resolved optimally because the benefits of the bargain cannot be restricted to those who contribute to the negotiations and subsequent income transfer. Externality negotiations are a public good from the perspective of individual members of the group. In these situations, collective action by government can improve citizens' welfare. For example, the legislature could provide bargaining, negotiation, and preference-revelation services to diffuse consumers to facilitate their bargaining ability in those situations where they bargained with a firm, airport, or any other organized entity.

[4] See Kneese and Schultze (1975) or Schultze (1977) for the standard argument.

[5] Economists have designed various bidding procedures that promote accurate preference revelation and are Pareto optimal. See Clarke (1971); Groves and Loeb (1975); and Tideman and Tullock (1976). Most economists treat these preference-revelation mechanisms as theoretical curiosities rather than practical plans. An exception is Kunreuther, et al. (1987).

[6] Analysts largely have concluded that the differences between reality and a public-goods auction result in overexpenditure on essentially private goods that interest groups secure from Congress and underexpenditure on genuine public goods (Mueller, 1979, chap. 8).

When property rights are created for behavior that has negative side-effects such as SO_2 emissions, airport noise, the location of poor people, or imported oil use, their distribution is a pure political problem. As long as the rights are dispersed sufficiently to allow a robust competitive market to develop, economic efficiency is not better served by one distribution or another. I personally favor an equal distribution, but other distributions are defensible.

Political Scientists and Market Failures

Market-failure solutions proposed by political scientists (regulatory approaches) differ from economists' prescriptions in several important ways.[7] First, the regulatory approach has no particular procedures for establishing the amount of public good to be provided, such as the level of ambient air quality in the case of air pollution. Environmentalists, strong advocates of the use of bureaucratic standards to create a clean environment, often believe that ambient air quality should equal the preferences of those individuals who favor the cleanest air. Other environmentalists simply calculate the appropriate amount of clean air indirectly by summing the maximum technologically feasible individual pollution-reduction efforts. Numerous environmental laws, for example, require firms to install equipment that reduces emissions as much as is technically feasible (Ackerman and Hassler, 1981). Whatever ambient air quality results from this reduction effort is the collective choice. I find nothing, however, in Kelman's (1981) defense of existing regulatory procedures that necessitates or even discusses these or any other procedures to determine the amount of clean air to be supplied.

The second difference between the economic and regulatory approaches is the latter's insistence that firms expend resources to reduce equally their pollution discharges, regardless of the relative costs of doing so across firms. From Kelman's perspective, contributions to the environment are analogous to contributions to national military service. Just as no one should be able to evade his draft responsibilities in exchange for money, no one should contribute unequally to the nation's environmental quality.

Third, under the command-and-control approach, firms do not pay for emissions whose levels are below the standard, whereas under the economists' scheme, all emissions are paid for.[8]

Finally, proponents of the regulatory approach believe that economic methods cannot supply certain symbols that are essential components of a

[7] I use the terms legal/bureaucratic, regulatory, standards and fines, and command and control interchangeably throughout the remainder of the paper to refer to policies that directly specify compliance behavior.

[8] Technically, of course, the state can allocate initial emission rights at no cost and then allow trading to occur.

good society. Kelman argues that the application of economics to the supply of clean air and other market failures:

1. does not stigmatize those who violate the rules of the public-good provision scheme;
2. prevents society from examining the motives of those who don't comply with the rules of the public-good provision scheme; and
3. reduces the value of the public good compared to provision motivated by shared belief in the commons.

Table 1 lists the main characteristics of the regulatory and economic approaches applied to the air pollution case. The economic scenario supplies one output—clean air—and supplies it at levels that people want at minimum cost. The regulatory approach supplies several outputs—clean air, implementation discretion, all the symbols that legal proceedings can provide, and the good feelings that arise when goods are equally distributed and trading is not allowed. Does the command-and-control approach supply these extra outputs as Kelman asserts? Is the economic approach incapable of supplying them? If the command-and-control approach actually supplies these extra outputs, are they worth the costs?

The Outputs of Regulatory Solutions to Market Failures

Kelman correctly asserts that an ideal regulatory system does castigate and stigmatize those who violate social rules and sends signals to the rest of us to internalize norms and abide by the law because we should, not because our interests are served. In practice, however, the regulation of behavior through legal procedures deviates from the ideal and, as a result, the symbols that Kelman values are not produced frequently. Legal procedures are extremely expensive and collectively we seem unwilling to expend the resources necessary to operate an effective legal system. The actual behavior of many court systems approaches the market that supporters of the legal approach so deplore. Those who transgress the rules of the game and get caught often plea bargain and pay a charge for their bad behavior.

The production of stigma by regulatory procedures is probably less related to the use of judicial procedures per se than to the fraction of the population that engages in the behavior, the severity of punishment, and the degree of public exposure. Automobile moving violations probably endanger more lives, and deserve more stigma, than heroin operations run by the Mafia, but legal procedures do not stigmatize those who commit the former because too many people commit moving violations and the punishment is not severe. Legal procedures create stigma if and only if other social norms degrade and limit the incidence of the behavior.

The second virtue of traditional legal-regulatory approaches in Kelman's view is their ability to take account of motives. Not all people who shoot others

TABLE 1

CHARACTERISTICS OF REGULATORY AND ECONOMIC SCHEMES OF POLLUTION ABATEMENT

Characteristic	Regulatory Approach	Economic Approach
Method for determining amount of clean air provided	Maximum feasible emission reduction creates aggregate result	Standard public goods aggregation procedure
Distribution of property rights	Citizens own air and firms pay	Separate collective decision
Payment for infra-marginal units of pollution	No	Yes
Level of discharge reduction by individual firms	Equal subject to discretion of judicial system	Whatever levels maximize gains at a given cost level
Is stigma placed on those who discharge at unacceptable levels?	Yes	No

are convicted of murder because the law cares deeply about why people kill others and not simply about the fact that someone has killed another person. Kelman correctly asserts that the economic approach to pollution abatement is concerned with results—ambient air quality—and their costs and not with the reasons firms pollute, but in my view the command-and-control approach is not concerned with motives either. Motives play a role in the adjudication of policy violations regardless of whether regulatory or economic methods are used. Command-and-control techniques directly prescribe behavior while economic techniques prescribe property rights and prices, but motives play no role in either system until someone violates the rules. Then, and only then, do motives play a role and, as I explain in the next section, motives can play a role in the adjudication of violations under either system.

The final and most difficult claim to assess is whether the standards-and-fines approach, through its emphasis on equal contribution to a public good (or prevention of a public bad), effectively promotes norms that discourage free-rider behavior. The ideal driving Kelman's argument is the response to a small-town barn fire, flood, or similar collective problem. Citizens simply pitch in and get the job done. Kelman is absolutely correct when he argues that markets work and property rights receive respect, in large part, because we internalize the rules and not because we calculate the marginal benefit of compliance. But how much should the small-town analogy govern national public-goods policies?

Because small towns are small by definition and often homogenous through self-selection and exclusion, equal contribution to public goods occurs volun-

tarily and with few costs. As the population grows and diverges in beliefs and circumstances, however, identical behavior creates costs for those individuals who disagree. As groups grow in size and become more heterogeneous, should people be allowed to trade what were previously equal public-goods obligations? If they are allowed to do so, will they retain enough shared norms to maintain a civil society?

Kelman answers both questions negatively. I share Kelman's concerns but believe that national public goods realistically cannot be provided in the same manner as small towns rebuild barns. Second, and more importantly, the regulatory system does not create the emotional bonds and internalized norms that Kelman so values. In fact, many argue that the extensive use of legal methods to resolve disputes in the United States has eliminated the role of trust in professional and managerial relationships (Vogel, 1983).

The Outputs of Market Solutions to Market Failures

Regardless of whether regulatory solutions to market failures produce valued symbolic outputs, if the solutions favored by economists also can provide stigma, motive examination, and emotional bonds, then the difficult trade-offs between the two approaches disappear. Both proponents and opponents of economic solutions to policy problems often forget that market systems require enforcement and hence require the legal methods favored by Kelman just as much as a command-and-control regulatory system. Firms that discharge pollutants in excess of the air rights they have purchased are similar in all respects to firms that violate standards under a regulatory approach. In both cases, violations must be detected and legal methods used to determine guilt and punishment. If stigma and motive examination are produced by legal methods, they easily can be part of the economic approach.

The one attribute of a legal-regulatory approach that cannot be created by market solutions is the equality of contributions to a collective good. Since the structural heart of the market approach is the ability to trade (and therefore to allow contributions of actors to vary), whatever outputs are created by equal contributions cannot be supplied by market methods. As I argued in the previous section, however, I do not believe that nonmarket regulatory methods actually produce the shared norms and community that proponents believe and hence the apparent loss is not a real one.

Are Symbols Worth the Cost?

Assume for a moment that Kelman's arguments concerning the important benefits that flow from nonmarket regulatory methods are correct. The implementation of these methods still might not be a sound social policy because they impose costs. The first is the deadweight loss that arises because firms cannot contribute differentially to collective goods. Under existing policy,

costs and benefits are not equated across pollutants or across different point sources for the same pollutant. While precise estimates of the welfare loss are unknown, Crandall (1983, p. 64) has demonstrated that pollution fees that are set too low or too high (marginal costs lower or higher than marginal benefits) create smaller efficiency losses than pollution standards that are set too low or too high as long as threshold health effects of the pollutant are minimal (marginal benefit curve is relatively flat).

Standards are optimal only for those pollutants where errors in the amount of discharge would create enormous costs. If the tax on nerve gas, for example, were incorrectly set and a bit too much were released, the nearby population would die, creating a large welfare loss. The industrial pollution debate, however, is about particulants, hydrocarbons, sulfates, and nitrogen oxides that do not have pronounced threshold effects, and not about nerve gases.

A final cost of standards is the tendency for Congress and the bureaucracy to design and implement standards that create additional wealth windfalls for existing firms beyond those created by the lack of payments for discharges that are less than the standards set by Congress and the EPA. Jackson and Leone (1981) argue, for example, that implementation of water-pollution regulation in the paper industry created quasi-rents for existing firms and delayed entry of new firms. Pashigian (1984) concludes that environmental laws have sharply reduced the growth of small firms and increased the size of the optimal plant. Crandall (1983, chap. 7) argues that the New Source Performance Standards are an attempt by northern congressmen to slow the growth of new industry in the South and West. The redistribution of wealth from taxpayers to firms created in the existing system by the lack of payment for discharges less than the standard and the use of differential standards for existing firms does not seem defensible on distributional grounds. Certainly most environmentalists would be appalled when informed that the policies they support give wealth to the "bad guys."

Conclusion

More often than not, Congress does not implement the policy prescriptions of microeconomists. Political scientists have extensively and successfully documented why members find it electorally useful to ignore efficiency advice. In addition, however, political scientists often have supplied distributional or philosophical rationales for Congress's behavior. In this paper, I have examined these arguments and the relevant economics in order to ascertain whether some obvious defensible normative goal is served when Congress ignores economists' policy recommendations.

I conclude that economic policy prescriptions often are insensitive to the transitional wealth losses that occur when market failures are corrected through policy. Congress clearly has a role to play in designing compensation

schemes to alter the distributional consequences of policies that promote efficiency, but it has rarely done so. Congress has played a more active role in the traditional distributional concerns of politics, but its persistent use of indirect, sector-specific, and regulatory methods to serve equity and moral concerns actually results in extensive privileges for the already fortunate.

Congressional deviations from economists' recommendations, often thought by political scientists as necessary to serve distributional goals, only rarely aid the poor. If Congress really wishes to aid those citizens that currently benefit from indirect, sectoral, price-and-entry policies, it could do so more cheaply if it followed economists' advice.

In conclusion, I find no defensible normative goal that is well served when Congress ignores economic efficiency in the design of policies.

Manuscript submitted 25 April 1988
Final manuscript received 21 October 1988

References

Ackerman, Bruce, and William T. Hassler. 1981. *Clean Coal/Dirty Air*. New Haven: Yale University Press.

Baumol, William. 1986. *Superfairness: Applications and Theory*. Cambridge: MIT Press.

Bradford, David. 1986. *Untangling the Income Tax*. Cambridge: Harvard University Press.

Calabresi, Guido, and Philip Bobbitt. 1978. *Tragic Choices*. New York: Norton.

Clarke, Edward H. 1971. Multi-part Pricing of Public Goods. *Public Choice*, 11:17–33.

Coase, Ronald H. 1960. The Problem of Social Cost. *The Journal of Law and Economics*, 3:1–44.

Crandall, Robert W. 1981. *The U.S. Steel Industry in Recurrent Crisis*. Washington: Brookings Institution.

———. 1983. *Controlling Industrial Pollution*. Washington: Brookings Institution.

Dorfman, Robert. 1981. Transition Costs of Changing Regulations. In Allen R. Ferguson, ed., *Attacking Regulatory Problems*. Cambridge: Ballinger.

Fiorina, Morris. 1977. *Congress: The Keystone of the Washington Establishment*. New Haven: Yale University Press.

Friedlaender, Ann F., ed., 1978. *Approaches to Controlling Air Pollution*. Cambridge: MIT Press.

Groves, Theodore, and Martin Loeb. 1975. Incentives and Public Inputs. *Journal of Public Economics*, 4:211–26.

Hicks, John. 1939. The Foundations of Welfare Economics. *The Economic Journal*, 49:696–712.

———. 1941. The Rehabilitation of Consumers' Surplus. *Review of Economic Studies*, 8:108–16.

Hochschild, Jennifer. 1981. *What's Fair?* Cambridge: Harvard University Press.

Jackson, John, and Robert Leone. 1981. The Political Economy of Federal Regulatory Controls. In Gary Fromm, ed., *Studies in Public Regulation*. Cambridge: MIT Press.

Kaldor, Nicholas. 1939. Welfare Propositions of Economics and Interpersonal Comparisons of Utility. *The Economic Journal*, 49:549–52.

———. 1940. A Note on Tariffs and the Terms of Trade. *Economica*, 7:377–80.

Kalt, Joseph P. 1981. *The Economics and Politics of Oil Price Regulation*. Cambridge: MIT Press.

Kelman, Steven. 1981. *What Price Incentives?* Boston: Auburn House.

Kneese, Allen, and Charles Schultze. 1975. *Pollution, Prices, and Public Policy*. Washington: Brookings Institution.

Kunreuther, Howard, Paul Kleindorfer, Peter Knez, and Rudy Yaksick. 1987. A Compensation Mechanism for Siting Noxious Facilities: Theory and Experimental Design. *Journal of Environmental Economics and Management*, 14:371–83.

Lawrence, Robert Z., and Robert E. Litan. 1985. Living with the Trade Deficit: Adjustment Strategies to Preserve Free Trade. *The Brookings Review*, 4:3–13.

Lindahl, Eric. [1919]1958. Reprint. Just Taxation—A Positive Solution. In R. A. Musgrave and A. T. Peacock, eds., *Classics in the Theory of Public Finance*. London: Macmillan.

Little, I. M. D. 1957. *A Critique of Welfare Economics*. New York: Oxford University Press.

McDonald, Stephen. 1971. *Petroleum Conservation in the United States*. Baltimore: Johns Hopkins University Press.

Mueller, Dennis C. 1979. *Public Choice*. New York: Cambridge University Press.

Niou, Emerson, and Peter Ordeshook. 1985. Universalism in Congress. *American Journal of Political Science*, 29:246–58.

Nozick, Robert. 1974. *Anarchy, State, and Utopia*. New York: Basic Books.

Pashigian, B. Peter. 1984. Effect of Environmental Regulation on Optimal Plant Size and Factor Shares. *Journal of Law and Economics*, 27:1–28.

Posner, Richard. 1980. The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication. *Hofstra Law Review*, 8:487–507.

Rae, Douglas W. 1969. Decision Rules and Individual Values in Social Choice. *American Political Science Review*, 63:40–56.

Rawls, John. 1971. *A Theory of Justice*. Cambridge: Harvard University Press.

Rhoads, Steven E. 1985. *The Economist's View of the World*. New York: Cambridge University Press.

Samuelson, Paul A. 1954. The Pure Theory of Public Expenditure. *Review of Economics and Statistics*, 36:386–89.

Schultze, Charles 1977. *The Public Use of Private Interest*. Washington: Brookings Institution.

Scitovsky, Tibor. 1941. A Note on Welfare Propositions in Economics. *Review of Economic Studies*, 9:77–88.

Shanahan, Eileen. 1986. Deficit May Give Tax Lobbyists a Chance to Press Their Cases. *Congressional Quarterly Weekly Report*, 44:2345.

Shepsle, Kenneth, and Barry Weingast. 1984. Political Solutions to Market Problems. *American Political Science Review*, 78:417–34.

Shepsle, Kenneth, Barry Weingast, and Christopher Johnsen. 1981. The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics. *Journal of Political Economy*, 89:642–64.

Small, Kenneth, and Clifford Winston. 1986. Welfare Effects of Marginal-Cost Taxation of Motor Freight Transportation: A Study of Infrastructure Pricing. In Harvey Rosen, ed., *Studies in State and Local Public Finance*. Chicago: University of Chicago Press.

Taylor, Michael J. 1969. Proof of a Theorem on Majority Rule. *Behavioral Scientist*, 14:1145–82.

Tideman, T. Nicolaus, and Gordon Tullock. 1976. A New and Superior Process for Making Social Choices. *Journal of Political Economy*, 84:1145–59.

Tullock, Gordon. 1980. The Transitional Gains Trap. In James Buchanan, Robert Tollison, and Gordon Tullock, eds., *Toward a Theory of the Rent-Seeking Society*. College Station: Texas A&M Press.

Vogel, David. 1983. Cooperative Regulation: Environmental Protection in Great Britian. *The Public Interest*, 72:88–106.

Peter VanDoren is assistant professor of politics and public affairs, Woodrow Wilson School of Public and International Affairs, Princeton University, Princeton, NJ 08544.