

Economic Regulation and Social Regulation, 1. INTRO

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Abstract

“Health, safety, morals, and the general welfare” are the traditional subjects of the police power of the state. When we think of government regulation we usually think of economic regulation, which is generally efficient only for a narrow range of activities and is subject to abuse by private parties who can profit from it. Laissez faire is the economist’s default rule, subject to important exceptions. Social regulation is another area of government regulation, and one where the presumptive efficiency of laissez faire disappears, because market imperfections are more common and capture by special interests less profitable. That the government should engage in social engineering does not follow immediately, because our current knowledge of social processes is primitive. Libertarianism, however, is less likely to lead to social efficiency, leaving a place for tradition and for careful design of regulation.

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1. Introduction

“What you say is very fine indeed, Cephalus,” I said. “But as to this very thing, justice, shall we so simply assert that it is the truth and giving back what a man has taken from another, or is to do these very things sometimes just and sometimes unjust? Take this case as an example of what I mean: everyone would surely say that if a man takes weapons from a friend when the latter is of sound mind, and the friend demands them back when he is mad, one shouldn’t give back such things, and the man who gave them back would not be just, and moreover, one should not be willing to tell someone in this state the whole truth.”

“What you say is right,” he said.

“Then this isn’t the definition of justice, speaking the truth and giving back what one takes.”¹

Maintaining contracts and property rights— “speaking the truth and giving back what one takes”— are important functions of government. It is as appealing to modern Americans as to ancient Greeks that people should be free to do what they want with their property, so long as they respect other people’s property rights. There exists, at the same time, a strong feeling that the economy would work better if the government intervened in it to control the prices people charged when selling their property or the kinds of property they are allowed to sell, but this feeling diminished sharply from the 1930’s to the 1990’s. After experiencing deregulation of industries such as air travel, trucking, and telephone sales, both the educated and the uneducated public seem to be less interested in government regulation of prices. The virtues of *laissez faire* have come to be part of the conventional wisdom.

Not all life is monetized, even in America. Political issues are conventionally divided into the Economic, the Social, and Foreign Affairs. Of Foreign Affairs we will say nothing, but in the Social as in the Economic spheres, there is intense controversy over not only what the government should make people do, but whether it should intervene at all. Table 1 lists a number of issues in each sphere that have been controversial in America in the past decade, whether in political campaigns or in the courts.

¹ Plato, *The Republic*, translated by Allan Bloom, Basic Books, (1968) at 331c.

Table 1: SOCIAL ISSUES AND ECONOMIC ISSUES

Social Issues	Economic Issues
Abortion Legalizing marijuana Homosexuality Gun control Pornography Gambling	The minimum wage Outsourcing National health insurance Social Security privatization Medicare drug benefits for the elderly Living wage ordinances

Most of the issues here are not what is conventionally called regulation, but they all involve using the power of the State to restrict people’s behavior, rather than simply to raise money for public goods.

The idea of social insurance— whether it be national health insurance, Social Security, or Medicare— is to require people to buy insurance, and whether they are required to buy it from the government or from private companies is secondary.

It is not entirely clear how these are divided into the social and the economic, of course. Marijuana sales are market transactions, so why not call the ban on marijuana economic regulation? The reason, I think, is that although the market for marijuana is monetized, the aim of the regulation is not to improve the workings of the market, but to eliminate marijuana, to remove it from the economy rather than to enhance its role. Whether the marijuana passes through the market or whether someone grows it in his own hydroponic tank, the case for regulation is equally strong.

In America there is a curious difference between liberals and conservatives in their positions on the role of government. On social issues, conservatives tend to support heavier government regulation. This is only a tendency, of course— it is liberals who want stricter regulation of guns, for example— but it is a tendency nonetheless. On economic issues, liberals tend to support heavier government regulation. Libertarians, who would like to restrict government impositions on freedom in both the economic and social spheres, enjoy criticizing liberals and conservatives alike for inconsistency.

Table 2 lays out these tendencies in a two-by-two grid.² There are four possible combinations of attitudes towards regulation. I have mentioned those occupied by conservatives,

² “Neoconservatives” are perhaps defined by their foreign policy attitudes than anything else, but they have been an important libertarian strand in American thought. Classic liberals might belong either with American conservatives or libertarians, since most Victorians (e.g., Macaulay, Gladstone, Disraeli) favored free trade but not free love, but John Stuart Mill is an important exception, who led the way for modern liberalism— he opposed

liberals, and libertarians already; what remains is the attitude that the government ought to regulate both social and economic behavior. This is less prominent in America, but is common in the rest of the world on both left and right. I have put “European conservatives” and “Marxists” in that box, two groups that are hostile to each other as to particular regulations but which agree that people behavior ought to be restricted. In Anglo-American thought, this attitude might be labelled “Tory”, with the idea that the slowing of change in all spheres of life is an important function of government.

Table 2: POLITICAL ATTITUDES

		Social Regulation	
		FOR	AGAINST
Economic Regulation	FOR	European conservatives (“Tories”) Marxists	American liberals
	AGAINST	American conservatives Classic liberals (“Whigs”)	Libertarians Neoconservatives

Libertarians can claim human freedom as their highest good. Liberals put emphasis on a variety of rights to decide behavior for oneself, most of which fall in the social sphere rather than the economic. The European conservatives, Tories, and Marxists who support government intervention broadly each have their own visions of the nations they are trying to construct. But what of the Whigs? Is there a way to make their position consistent? We shall return to that question later.

In both the economic and social spheres, deregulation has existed simultaneously with new regulation. The general picture is one of increased tolerance, with libertarianism on the rise in both the economic and social spheres among intellectuals, but with growing acceptance, also, of government environmental, safety, and quality regulations. The success of the has been paralleled by the success of the law-and-economics movement, many of whose adherents have a strong tendency towards libertarianism. The economic approach to law has been applied in great detail to economic regulation and deregulation, to the point where knowing some economics is indispensable for anyone trying to do serious policy research in the area. It has been much less applied to social regulation, although by 1992 it seems clear that in comparison with other

Sabbatarian legislation and prohibition of strong drink, bigamy, and opium; John Stuart Mill, *On Liberty*, 194, 196, 198, 203 (1859), in *Utilitarianism, Liberty, and Representative Government*, E.P. Dutton and Co., Inc., 1951.

developed countries, the social problems of the United States are much more severe than the economic problems.

Is this simply because economics has nothing to say about nonmonetary problems? No. The two driving ideas of economics are that of the rational maximizing individual, who chooses actions depending on costs and benefits; and that of the competitive marketplace, which generates predictable collective consequences from the independent actions of many individuals. These ideas have been applied to many topics traditionally allocated to other disciplines such as political science, law, sociology, and biology.³ The economic approach seems to explain behavior in a variety of cultural and historical settings, and even the behavior of animals in laboratory experiments.⁴ Social interactions call for somewhat different tools of analysis than economic interactions, even starting from the base of maximization and markets, but the rise of game theory and information economics in the 1980's has vastly expanded the number of tools at our disposal, and we can expect continued progress.

In the traditional interactions studied by economics, individually rational behavior tends towards collectively optimal consequences. Smith's famed Invisible Hand guides property to be traded until no one can benefit from future voluntary trades. At that point, almost by definition, no intervention can make any one person better off without making someone else worse off. Economists therefore favor the libertarian view that government regulation is unnecessary and pernicious if society is to reach results that are optimal given the constraints of resources and biology. People are often surprised by economists' policy conclusions, because economists they thought were liberal turn out to oppose the minimum wage and rent control, and economists they thought were conservative turn out to favor legalization of marijuana and homosexuality. The explanation is that in each case, the economist supports legalization of voluntary interactions between consenting adults, which makes both parties to the transaction better off.

Government plays a role in recognizing and protecting property rights, but it decentralizes authority by allocating those property rights to individuals. A property right is effectively the right to take some action. If the horse, Dobbins, is allocated to *A*, *A* is allowed to take a number of actions with respect to Dobbins— to ride him, drown him, eat him, or sell him— but *B* cannot do any of those things without *A*'s permission. In the economic world of perfect competition, every action is under the control of someone; there are no actions which a person cannot undertake if he is willing to pay someone else enough to do so. In addition, the action is an

³ Gary Becker is the best known imperialist, e.g., Gary Becker(1974), "A Theory of Social Interactions," *Journal of Political Economy*, 82: 1063-1093 (November/December 1974); Gary Becker(1981), *A Treatise on the Family*, Harvard University Press, 1981. He has been joined by many other scholars using "rational choice" analysis in: law, Richard Posner(1998) *Economic Analysis of Law*, 802 pp., 5th edition (1st edition, 1972), Aspen Law and Business, 1998; sociology, James Coleman, *Foundations of Social Theory* (1990); political science, Peter Ordeshook, *Game Theory and Political Theory: An Introduction* (1986); biology, John Maynard-Smith(1982) *Evolution and the Theory of Games*, 224 pp., Cambridge University Press, 1982.

⁴Raymond Battalio, John Kagel, Howard Rachlin & Leonard Green (1981) "Commodity-Choice Behavior with Pigeons as Subjects," *The Journal of Political Economy*, 89:67-91 (February 1981).

alienable property right; *A* can either ride Dobbins himself or sell that right to *B*. A government regulation or a social custom that forbade the riding of Dobbins by anyone, or made the right inalienable by allowing only *A* to ride him would reduce welfare, because nobody would get the benefit of the ride, or the benefit would go to *A* rather than to someone else that valued it more.

Economists are like Cephalus in *The Republic*: they view the role of government as to define and protect property rights and to make people keep their promises. But Socrates dismisses Cephalus and the economist's definition of justice, only seven pages into the three hundred and three pages of *The Republic*. He does not scoff; this is the first definition of justice, and Cephalus is the paradigmatic solid citizen, the pillar of society. Yet something is missing. This article will try to determine whether given the assumptions of the economic approach the government does serve any purpose other than to set property rights and settle contract disputes.

To these two functions, economists, and, I expect, Cephalus, would add the provision of public goods such as national defense. Since the provision of public goods is independent of regulation, in the sense that it imposes no constraints on individual behavior beyond requiring that someone pay taxes, I will not discuss it further, except to briefly distinguish taxation from regulation. Taxation is the use of government force to acquire funds with which to buy things. Regulation is the use of government force to change people's behavior. In both cases, government force is used, but the purposes differ. A pollution "tax" is really regulation, since its primary purpose is to change behavior and only incidentally does it raise revenue. A requirement that private employers provide health insurance is a tax since the end there is to buy things for people that the government could pay for itself. This distinction has even been recognized in law, as the celebrated Nollan case illustrates (*Nollan v. California Coastal Com.*, 483 U.S. 825 (1987)). The State of California would not let Mr. Nollan build a house unless he built a public path. The U.S. Supreme Court ruled that this was not regulation, since the path did not solve any problem created by building the house, but simply a tax, and a tax specific to the individual. This made California's requirement a taking without compensation. Since such takings are forbidden in the U.S. Constitution, California was required to allow Nollan to build or else compensate him for not building. In this paper, we will be concerned with regulation, not taxation.

There is a fine shading from human interactions we call economic in our speech to those we call social. At the one end is the highly competitive market in which a standardized good is bought and sold for private uses of no concern to anyone but the user. At the other end is the relationship between husband and wife, two people who exchange favors but who care deeply about each other and whose actions affect their children as well as themselves. The two extremes shade into each other gradually. The essence of what we call economic is not dollar prices; barter is just as economic. It is not the competition of large numbers of people for something; sporting events and courtship are that. Rather, in subject matter what is economics and what is sociology is demarked by clusters of characteristics. The economic is monetized, competitive, selfish, and self-centered. The social leaves prices unstated, is full of special bilateral relationships, and is full

of concern for other people's welfare and for what they think and do. "A definition may be very exact, and yet go but a very little way towards informing us of the nature of the thing defined; but let the virtue of a definition be what it will, in the order of things, it seems rather to follow than to precede our inquiry, of which it ought to be considered as the result." (Edmund Burke, *On the Sublime and the Beautiful*, p. 13). So we shall see here.

I will argue that while the method of economics is useful for analyzing human interactions beyond the traditional economic markets, the default policy recommendation of laissez faire becomes dubious if one goes too far afield. The old recommendation does not match local circumstances in the newer provinces of economics' empire. The analyst can still usefully assume that the individual acts rationally, but he cannot deduce that this leads to efficiency in the absence of government regulation and social custom. The positive predictions of economics will still be valid, but not the usual normative conclusions. A presumption of the optimality of laissez faire is not a bad thing for economic regulation, but for social regulation a better presumption is that the status quo should be left untouched.

This conclusion is important for law because it implies that judges should not invalidate statutes merely because they do not make sense on purely economic grounds. Judges who pronounce on the "reasonableness" or "rational basis" of statutes and private covenants are too self-confident, and they should be more deferential to the status quo of customary law and practice. The burden should be on those opposing the rules to show that they have a bad purpose, not on those who support them to show that they have a good purpose. The argument will not be based on making tradeoffs between standard economic goals and other values, as in discussions that trade off efficiency and equality. Here, efficiency— in the economist's sense— will be the only goal, so the conclusions will be based on the utilitarian premises standard in economics, not on religious or liberal premises. This requires some preliminary discussion to clarify society's objectives. The objective, surplus maximization, will be to maximize utility by making the appropriate tradeoffs. This is different from trying to reconcile absolute rules that conflict with each other or from trying to discover the will of God. My hope is that by starting from the generally accepted premise that it is better to make people happier, the analyst can come to useful conclusions about how the government should restrict behavior. If it turns out that the resulting government regulation offends an ethical or religious principle of the analyst, the analysis is nonetheless useful, in showing that the principle cannot be imposed without reducing human happiness.

Even in a utilitarian framework, the individuals under analysis may have religious and ideological beliefs, and these will affect policy under surplus maximization. If some people believe that God forbids people to work on Sunday or others believe that Kant forbids people to ban pornography, the feelings of those people must be taken into account. The analysis will neither ignore such beliefs nor take them as final: rather, they are data on utility to be fed into the utilitarian calculus. If enough people are enough upset by Sunday work or pornography bans,

those things will be restricted.⁵ In evaluating both economic and social regulation, the objective will be to examine taboos as means to increasing human happiness rather than as ends in themselves; the Sabbath will be for man, not man for the Sabbath.⁶

The thrust of this book will be that laissez faire is the presumptive best policy in the economic sphere, with, of course, many exceptions and special cases, but tradition is the presumptive best policy in the social sphere. This is a modernized version of the argument of the English jurist James Fitzjames Stephen.⁷ In *Liberty, Equality, Fraternity*, Stephen admires John Stuart Mill's *Principles of Political Economy*, with its careful explanations of the workings of the Invisible Hand in economic markets, but he attacks Mill's *On Liberty* as a confused muddling of

utilitarian principles. Mill, Stephen says, is willing to create human unhappiness merely for the sake of abstract ideals (liberty, equality, and fraternity) that benefit no one and lack a rational basis.⁸ That was a dispute between two Liberals, each claiming to start from the same premises of maximization of human happiness as the goal of society. I will start from the same premises, with the difference that I will update the discussion using twentieth century economic theory.

We thus will end up providing a justification for the attitude of the Whigs in Table 2, who tend to favor social regulation and oppose economic regulation. The justification will be a utilitarian one: that these tendencies will, if properly used, result in the greatest amount of human happiness.

I will start out, in Chapter 2, with a lengthy discussion of value maximization, also called "efficiency" or "wealth maximization," which is the economist's criterion for goodness. In the context of perfect competition, laissez faire maximizes value, but as Chapter 3 shows, market failures of various standard types make government regulation useful. Regulation brings up the possibility of government failure even worse than market failure, however which is the topic of

⁵ In law and economics, this approach is best known from the work of Richard Posner. See Michael McConnell & Richard Posner (1989) "An Economic Approach to the Issues of Religious Freedom," *University of Chicago Law Review*, 56: 1, Posner, Richard (1992) *Sex and Reason*, 458 pp., Harvard University Press, 1992. I will not be addressing the concerns of those who object to "universal commodification" of relationships or "incommensurability" of values. See Joseph Cropsey (1955) "What is Welfare Economics," *Ethics*, 65: 116-125 (1955). Reprinted in *Political Philosophy and the Issues of Politics*, University of Chicago Press, 1977; or, for an overview, Matthew Adler, "Law and Incommensurability: Introduction," *University of Pennsylvania Law Review*, 146: 1169 (1998). The utilitarian framework leaves considerable room for analysis and is less liable to the criticism of assuming its conclusions than many other approaches, as is evidenced by the differences between Posner's conclusions and my own.

⁶The intellectual ancestor of this approach is David Hume: "But there is this material difference between *superstition* and *justice*, that the former is frivolous, useless, and burdensome; the latter is absolutely requisite to the well-being of mankind and existence of society.... Were the interests of society nowise concerned, it is as unintelligible why another's articulating certain sounds, implying consent, should change the nature of my actions with respect to a particular object, as why the reciting of a liturgy by a priest, in a certain habit and posture, should dedicate a heap of brick and timber and render it thenceforth and forever sacred." David Hume (1751) *An Inquiry Concerning the Principles of Morals*, p. 29, Bobbs- Merrill Co. Inc. 1957.

⁷ James Stephen, *A History of the Criminal Law of England* (1883)

⁸ James Stephen, *Liberty, Equality, Fraternity*, 2nd edition (1874), page numbers from Chicago University Press edition, Richard Posner, ed.(1992).

Chapter 4. Chapter 5 will apply these ideas to various government policies: pollution regulation, mandatory recycling, bicycle helmet laws, labor union laws, and so forth. This first part of the book is a reprise of standard economic theory, the necessary grounding for looking at social regulation.

I will then proceed to the heart of the book: the application of value maximization to social interactions not traditionally considered economic. Chapter 6 will elaborate on the concept of externalities, with emphasis on mental externalities— what happens when Smith’s conduct displeases Jones even without any physical interaction or effect on Jones’s material wealth. Chapter 7 elaborates on failure of decisionmaking, whether due to poor information, poor information processing, or disregard for the future.

The analysis of social regulation will bring up several topics which will benefit from their own chapters. Chapter 8 will contrast value maximization with other justifications for regulation based on religion, fairness, or self-centeredness. Chapter 9 will address the issue of whether government failure is as big a problem for social regulation as for economic, and will look at how social regulation actually comes about. Chapter 10 will relate the book’s pro-regulation conclusions to libertarianism and will discuss issues of federalism and pluralism.

The book’s argument, put simply, is this. (i) Laissez faire works well in economic interactions, with certain exceptions, and regulation is apt to be misused by the government (ii) In social interactions, where the exceptions dominate, the case for laissez faire is much less compelling. (iii) Government officials face less temptation to use social regulation contrary to the public good, but since it is difficult to predict the effects of social innovation, the best strategy is to vary the status quo only slowly cautiously.