

RESEARCH ARTICLE

# Logic is a harsh mistress: welfare economics for economists

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## Abstract

Every economic explanation assumes maximization. How strange, then, that few economists accept one of maximization's most straightforward implications: *every observed institution is efficient*. My aim is to persuade economists of this fact and thus to dissuade them from making illogical claims about social welfare. To frame my argument, I consider the “property rights approach” to institutions developed by Yoram Barzel. I speculate that economists resist what maximization implies about institutional efficiency because they think that efficiency-always precludes them from improving the world, and hope of improving the world is what attracted them to economics in the first place. But, besides being inconsistent, resistance is unnecessary: efficiency-always does not preclude economists, or anyone else, from improving the world.

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The existence of waste ... is inconsistent with maximizing behavior. (Barzel, 2002: 129)

The main task of economics has always been to explain. (Stigler, 1982: 5)

What they said. (Me)

## 1. Introduction

The economic approach to human behavior is grounded in a simple assumption: individuals maximize. Every economic explanation – from Gary Becker and Richard Posner's (2004) explanation of suicide to Richard Thaler's (1980) explanation of the “endowment effect” – assumes maximization. How strange, then, that few economists accept one of maximization's most straightforward implications: *every observed institution is efficient*.

My aim is to persuade economists of this fact and thus to dissuade them from making illogical claims about social welfare.<sup>1</sup> To frame my argument, I consider the “property rights approach” to institutions developed by Yoram Barzel (1997, 2002, 2015). Barzel's approach is ideally suited to this task, since it's also the economic one: it applies maximization to the analysis of institutions consistently and persistently.

I speculate that economists resist what maximization implies about institutional efficiency because they think that efficiency-always precludes them from improving the world, and hope of improving the world is what attracted them to economics in the first place. But, besides being inconsistent, resistance is unnecessary: efficiency-always does not preclude economists, or anyone else, from improving the world.

<sup>1</sup>I'm not the first to try this. See Statan and Umbeck (1989) and Cheung (1998). See also, Alchian *et al.* (1996), Demsetz (1969), and Cheung (1969). I apply the logic developed by these authors to institutions in particular.

## 2. Barzel's property rights approach to institutions

Barzel's property rights approach distinguishes "legal" and "economic" property rights.<sup>2</sup> The former are what government recognizes as belonging to you. The latter are what you can actually do with properties, whether they belong to you legally or not. For example, the state may recognize your ownership of a home, but if a squatter seizes it, many economic rights to the home are his. Legal rights may enhance or undermine economic rights; the state may help or hinder property protection/recovery. But what ultimately matters to you is economic rights, since they determine what you can actually consume.

Defining, protecting, and exchanging property rights uses resources, which are called "transaction costs" (Allen, 1991).<sup>3</sup> For example, it required resources to measure your home's boundaries, to secure its door, and to evaluate its qualities so that rights to it could be exchanged. Property rights security and exchange are therefore objects of choice.

Choosers, in Barzel's approach, are maximizers. Maximizers choose to secure properties until the expected cost of defining/protecting additional rights to them equals the expected benefit of additional security. Thus, positive transaction costs imply that some rights are left in the public domain, subject to capture. Likewise, maximizers choose to exchange property rights until the expected cost of effecting exchange (e.g. identifying potential exchange partners, describing the good, and setting the terms of exchange) equals the expected benefit of additional trade. Thus, positive transaction costs also imply that some exchanges that would be realized if transaction costs were zero are not.

The collections of property rights that result from these choices are called "institutions," and they organize life socially, politically, and economically. Institutions vary across people because people's property rights choices vary, and those vary for the same reason do people's other choices: because of differences in people's constraints. Just as different labor costs lead maximizers in Bangladesh and Switzerland to make different production decisions, different transaction costs lead them to make different property rights decisions, resulting in different institutions. And just as the variety of observed production modes are each optimal given the respective constraints, so are the variety of observed institutions.

## 3. Greetings from Dr. Pangloss

In Barzel's property rights approach, the only bills left on the institutional sidewalk aren't worth picking up. If a rights rearrangement were profitable, it would be the rights arrangement we observe. That we don't means, *ipso facto*, it's not. Thus, all observed institutions are efficient.

"But what about agricultural subsidies in the United States?" They're efficient. "Autocracy in Turkmenistan?" Ditto. "Communism in North Korea?" The logic doesn't change just because the example becomes more extreme. And somewhere around here is where most economists who might have been on board jump off.

Maximization implies efficiency, *always and everywhere*, because maximizers maximize, *always and everywhere*. I realize that's stating the obvious. But denial of the obvious is why most still won't accept that witch trials in Ghana are perfectly efficient.

Yet if you accept maximization, you must. For then all institutions in Ghana, in the United States, and in North Korea – indeed, every institution observed anywhere – reflects the best that people can do given their constraints. *Per* Dr. Pangloss, we're living in the best of all possible worlds. Not the best of all imaginable worlds, mind you; just imagine one that's less severely constrained. But the best world currently *possible* is that which maximizes net benefits given current constraints.

<sup>2</sup>For a critique of this approach, see Hodgson (2015). For rejoinders, see Allen (2015) and Barzel (2015). For a recent complementary overview of Barzel's approach, see Piano and Rouanet (2018).

<sup>3</sup>More generally, for Barzel, any difference between net benefits when defining, protecting and/or exchange property rights consumes resources and when it does not constitutes "transaction costs."

You wouldn't aver that railroad-track production is "inefficient" because, if platinum were less costly, railroad tracks would be made from platinum instead of steel.<sup>4</sup> So why aver that autocracy in Turkmenistan is "inefficient" because, if defining, protecting and/or exchanging property rights were less costly, Turkmenistan would instead be democratic? The fallacy is the same. "Inefficiency," "failure," or "waste" by any other name is phantom, conjured only by judging what's achieved under *actual* constraints against what's achievable under *fictitious* constraints that are less severe. And that violates our starting assumption: maximizers do the best they can, not the best they can't.

I can already hear the riposte: "That analogy is atrocious! The world's endowment of platinum is given by nature, but transaction costs depend on choice." That they do, but so does the quantity of platinum available to produce railroad tracks. We could mine more platinum, its cost would fall, and if we mined enough, its cost would fall enough to make it profitable to construct railroad tracks from platinum. The reason we don't is that making it profitable to construct railroad tracks from platinum would not *itself* be profitable.

And so it is with institutions in Turkmenistan – or anywhere else. Different institutions, once in place, may reduce transaction costs. But the transaction costs of changing institutions must exceed the savings; otherwise, institutions would be different.

Careful: I did not say that institutions don't change. They do. When constraints change, maximization ensures that institutions change – and that the new institutions are efficient. Our *method* of analyzing institutional change is static: comparative statics. But that's an altogether different matter, and it applies to any economic analysis, which is never truly dynamic because economics has no laws of motion. Even if it did, that would not "undo" efficiency-always, since maximization implies that motion so described would also be efficient.

"But what about mistakes? Maximization means people never err!" No, maximization means people always maximize. Unlike gods, people have limited cognitive abilities, limited abilities to execute their intentions, limited information. *Ex post*, many choices that maximizers make turn out to be "wrong." But the institutional results are no more "inefficient" than a marksman's wide shots. Pursuing a goal as best you can is no guarantee you'll achieve it.

Ironically, in this, George Stigler, who is most (in)famously associated with efficiency-always, did not go far enough. Stigler (1992: 459) astutely noted that "every durable social institution or practice is efficient, or it would not persist over time." He also correctly observed that "New and experimental institutions or practices will rise to challenge the existing systems"; efficiency does not preclude change. Then he spoiled it by adding, "Often the new challenges will prove to be inefficient." With this caveat, Stigler sought to account for the fact that people make "mistakes." But this fact requires no accounting, for mistakes are not at odds with maximization. In a world of costly information, maximization *requires* "mistakes."

Still, it would be helpful if you avoided this one: supposing that equally maximizing net benefits implies netting equal benefits. It does not. Identical twins were separated at birth: one had a tragic childhood accident that left him nearly paralyzed; he became a panhandler. His brother became a world-class sprinter and now enjoys fortune and fame. Both men's occupational choices are constrained bests, but the second one's constraints are less severe, so his best is better.

The same is true of institutional choices. Turkmenistan's institutions produce (far) smaller net benefits than South Korea's, and South Korea's institutions produce (somewhat) smaller net benefits than those in the United States. Each population's institutions maximize net benefits, but the maximums differ because of differences in the severity of their constraints.<sup>5</sup> Is there a social welfare claim to found here? Well, there's this: it's better to be less severely constrained than to be more so.

"Better," given individuals' subjective valuations. Economics doesn't say that maximizing net benefits is righteous, only that maximizing net benefits is what individuals do. It doesn't say that an

<sup>4</sup>Platinum is harder, smoother, and more durable than steel and thus the technologically superior track material.

<sup>5</sup>For more, see Leeson (2014a, 2017).

increase in net benefits is an improvement from the perspective of Arete, only that it's an improvement from the perspective of the individuals in question.

About here, despair sets in. You *disapprove* of autocracy in Turkmenistan, and you want economics to ratify your disapproval. Unable to wring from it a declaration of moral failure, you beg it to declare an institutional one: "autocracy in Turkmenistan is inefficient." Cruelly, economics declares the opposite. Alas, logic is a harsh mistress.

But she's also incredibly productive, which is the reason we keep her around. *Why* is Turkmenistan autocratic? *Why* did English spouses sell their better halves at public auctions?<sup>6</sup> *How* could immolating children have maximized net benefits in Orissa?<sup>7</sup> Because the world is efficient, such institutions require explanation. And because maximization guarantees efficiency, it's possible to explain them.

Since observed institutions reflect the choices of maximizers given their constraints, and since maximizers' choices vary predictably with their constraints: (1) we know where to look for answers to institutional questions – at people's constraints – and (2) we can check our answers by comparing the institutional differences we observe to those predicted by maximization under different constraints. What efficiency-always takes from our power to judge the world, it gives our power to illuminate it.

#### 4. Have your cake, sort of

And therein lies the rub. I suspect that many got into this work not just to understand the world but to *improve* it. By banishing institutional "failures," the inexorable logic of maximization seems to dash that hope, which is the reason most economists resist it. But resistance is unnecessary, for efficiency-always doesn't preclude improving the world – and it's possible to do so by explaining it.

Go ahead, let me have it: "Talk about inconsistency! If the world can be improved, then institutions weren't efficient to start with. Who's being illogical now?"

You are. Here's a refresher: (1) Maximization implies that when constraints change, institutions change so as to maximize net benefits under the new constraints. (2) Maximization implies that institutions adopted under less severe constraints yield larger net benefits than those adopted under more severe constraints: it's better to be less severely constrained than to be more so.

It follows that if you reduce the severity of the constraints that maximizers face, they'll adopt new institutions that yield larger net benefits; you'll have improved their welfare. Check both sleeves; I insist. You'll find that maximizers are still maximizing and that whatever is, is still efficient.

Consider a country where property rights could be profitably rearranged *but for* the fact that it would cost citizens too much to rearrange them: learning that the rearrangement would yield net benefits is too expensive. The country's institutional status quo persists, and that's efficient. Now suppose you publish a book that explains the country's institutional status quo – that demonstrates that the rearrangement would be profitable but for citizens' cost of learning this fact. Citizens read your book, learn the fact, and as a result find it profitable to rearrange property rights. The country's institutions change, and that too is efficient. Net benefits realized under the new institutions are larger: citizens' welfare is improved. The reason is that their constraints are less severe, made so by your research.<sup>8</sup>

A remote possibility, I'll admit. But I never said that improving the world as an economist was easy. I said that it wasn't logically precluded by efficiency-always, and as you can see, it's not. Still, it would be rude of me to buoy your hope with a logical possibility that has never been realized in practice. And I'm a gentleman.

So let me introduce you to this one: economist Steven Cheung. According to Cheung (2005) – an efficiency-always purist if there ever was – institutional change in contemporary China, from

<sup>6</sup>See Leeson *et al.* (2014).

<sup>7</sup>See Leeson (2014b).

<sup>8</sup>Careful! It makes no sense to say that before you published your book, institutions were "inefficient." That would be like saying that before Louis Pasteur published his research, public health policy was "inefficient." If you're tempted to invoke "inefficiency" in either situation, go back and reread Section 3.

communism to greater reliance on private property rights, increased net benefits and was contributed to by the activities of economists. Here's a sketch of his account.

Between 1946 and 1948, China was ruled by the Kuomintang, ostensibly under a policy of "capitalism." Those years were a disaster, "a period of disruption, of wars followed by anarchy, of official corruption beyond belief, and of the panic flight of capital from China. Thus, when [in 1949] communism won over China, it could not fail to improve upon what it inherited" (Cheung, 2005: 628). And for a while, it did. Consequently, "the Chinese people equate[d] capitalism with the Kuomintang *débâcle* and communism with the 'good years' of 1949–1957" (Cheung, 2005: 627). What happened next is bloody history: the Great Leap Forward, begun in 1958, proved to be exactly the opposite, its deadly results compounded by the Cultural Revolution of 1966–1976.

Greater reliance on private property rights, Cheung explains, stood to increase net benefits in China *but for* the fact that rearranging institutions was then too costly: "communism, a system of exceptionally high transaction costs in its operation ... survived because of the cost of changing institutions" (Cheung, 2005: 650). Particularly problematic were "The costs of discovery (information)," which are "exceedingly important for institutional change because a solid nucleus of people must be well informed and confident about the facts, if not the theory, of alternative institutional arrangements before change can be seriously considered" (Cheung, 2005: 645).

You see, "the Chinese people ha[d] for decades been indoctrinated with ambiguous ideas. Moreover, only knowledge c[ould] dispel the '1957 illusion' of the unqualified success of communism in China. The cost of obtaining this knowledge [wa]s compounded by the naïveté of a people deprived for a full generation of any extensive education and long intimidated into silence and confusion" (Cheung, 2005: 646).

Yet *circa* 1979, institutions in China began to change, exhibiting greater reliance on private property rights, and with impressive results. According to Cheung, an important contributor to this change was the activities of Western economists. "Milton Friedman was ... welcomed on a lecture tour" in China, and "works by economists who favour the capitalist system have been translated and are available in book shops" (Cheung, 2005: 650–651). Economists' activities helped erode old ideas about communism and introduced new ideas about capitalism.

"Ideas," Richard Weaver (1948) famously declared, can "have consequences." One of them, Cheung illustrates, is relaxing constraints in the way of institutional rearrangements that, but for the cost of rearrangement, increase net benefits.<sup>9</sup> In fact, this is how Cheung sees his research that explains institutional change in China: "Academic economists can do no more than expound. Within that narrow scope, I hope that this paper will contribute to a better understanding among the Chinese of how an economic system operates – for lack of knowledge about institutions can severely obstruct economic growth" (Cheung, 2005: 664).

So go forth and "expound." Call it your contribution to improving the world if you like. Just don't call observed institutions "inefficient."

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<sup>9</sup>And "consequences" can also give rise to "ideas," which do not escape the explanatory framework of economics. See, for instance, Leeson (2013).

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