GUIDING THE INVISIBLE HAND

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Mark Twain has reported in his letters from the Earth of Adam's first great contribution to science, the discovery of the Principle of Fluidic Precipitation or put simply, the law that water flows downhill, not up; and how the law later got into dispute and the credit was given to a more recent person. *The Principle of Governmental Responsibility* which Keynes taught us in macro-economics and even laissez-faire economists such as Henry Simons accepted in micro-economics seems to be about as firmly accepted as Adam's Law. Thus, it seems it will have to be rediscovered all over once again and again (2).

The view that keeps trying to emerge is what might be called unadulterated laissez-faire, which sees all types of regulation as an unfortunate meddling with the market mechanism. While the view of regulation as meddling is sometimes warranted, it is not an especially helpful view, nor is it correct. The correct view is that regulation is fundamental to the workings of the market mechanism and the relevant policy issue is not: whether or not to regulate; the issue is what form of regulation

(1) Professor Gianrocco Tucci asked Abba Lerner to prepare this paper in early 1981 in honor of this journal's tenth anniversary. Abba's health precluded his writing the paper alone and since we were working together on other papers, Abba suggested we write a joint paper. We discussed the idea for the paper which was an elaboration of an argument Abba had made in a comment on Frederick Hayek's work which was receiving considerable attention after Hayek won a Nobel Prize. Unfortunately Abba died in October, 1982 before we had actually written the paper. To complete the paper, I took my notes from our discussions together with arguments Abba made in earlier articles and wrote this paper consistent with Abba's views. Throughout the paper I footnote other articles where Abba has made the arguments and I try to stay close to Abba's original work. The general arguments are thus Abba's but the specifics and interpretations are mine.

(2) This story was told in A. Lerner " Keynesianism: Alive, if not so well at forty ", in J. Buchanan and R. Wagner (eds.) *Fiscal Responsibility and Constitutional Democracy*, M. Nijhoff, Boston, 1978.

is called for. The confusion stems from the unfortunate practice many economists have of thinking of the market as natural, and anything else, as unnatural. It follows from this practice that meddling with the market is bad while leaving the market alone is good. Hayek, for example, lumps all kinds of meddling with the market mechanism together as the fruits of "Constructivism" — of treating the economy as a "mechanism" which can be improved on (as well as messed up) instead of reecognizing it as an "organism" which can only be injured by any attempt to improve its workings. One almost wonders whether he has ever considered how the operation of human organisms has been improved by such "constructivist" meddlings as eyeglasses, wheelchairs, appendectomies, vaccinations, insulin or organ transplants (3).

Our point is a simple one. Even economic organisms can stand a helping hand now and then. Just as technological progress in either organisms or mechanisms requires entrepreneurial activity, so too does technological progress in social organization. It is only natural to work toward creating a better and more healthy society; to avoid doing so is unnatural. In fact, markets themselves should be viewed as precisely such a technological advance. Markets and the concept of private property upon which they are based have been created by man to fill a need. Markets developed when some entrepreneur recognized the gains to be made by coordinating society's actions within the framework of markets. It follows that just as we need business entrepreneurs to give the private economy its dynamic thrust, so too do we need *institutional entrepreneurs* who study markets, determine when they are working and when they are not, and decide when we can advantageously make adjustments in markets. It is precisely this role of institutional entrepreneur that economists should be, but often are not, fulfilling.

Regulation enters the argument because it is one of the forms of adjustments that can be made to markets. Like other adjustments, it should be seen as an option with costs and benefits. In considering any new regulation we should examine it as carefully as we can in the light of what we know about how it would work. To reject it purely on the basis of a general sociological principle that any extension of government responsibility starts us on the slippery path to totalitarianism is no wiser than to embrace any and every extension of governmental action, without

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(3) This statement of Hayek's views comes from A. Lerner, "A Keynesian on Hayek", *Challenge*, Sept-Oct. 1980.

amining its particular merits, as a step out of chaos toward a consciously anned rational society (4).

The danger of the "regulation as meddling" view is that it takes onomists out of the more fundamental decision of what type of medling there is to be. Even economists who believe that all regulation is ad surely do not believe that all regulation is equally bad. It is a fact f life in a democratic society that when a problem with the market evelops, government will intervene. If economists attack equally all orms of regulation they cannot be instrumental in guiding that regulaon so that it is as compatible as possible with the market process, which, pon reflection, is recognizable as merely a built in form of regulation.

IOW TO MEDDLE CONSTRUCTIVELY: NSTITUTIONAL ENTREPRENEURSHIP IN ECONOMICS

Because economists have not specifically recognized their role as intitutional entrepreneurs, they have been remiss in developing new intitutional forms which can meet society's evolving needs. In macroeconomics, we have tried to remedy that situation by developing MAP, the market anti-inflation plan (5). This plan is a form of regulation that restricts individuals' rights to raise and lower their prices. Because it is a form of regulation, it has come under severe attack as merely another form of price controls. This is untrue. The difference between MAP and its administrative counterparts is that MAP, rather than obstructing the market, actually improves its efficiency in a way which is fully compatible with the market system. In fact, it creates a new property right — the right to raise and lower prices — and allows trading of this right in the market. Rather than being an extension of regulation, it is an extension of the market.

Introducing a new property right is nothing new. As the economy has evolved, the range of activities which could ideally be regulated has changed. For example, before land was scarce, there was no price on land. If you wanted some land, you just burned down some trees and used the ashes for fertilizer. Then, in a few years, when the land was worn out, you cut down some more trees. Eventually it became apparent

(4) This general argument was made by Abba Lerner, "Planning and Freedom", *International Post-War Problems,* New York, July 1945.

(5) We present a statement of *MAP* in A. Lerner and D. Colander, *MAP: A Market Anti-inflation Plan,* Harcourt Brace Jovanovich, New York, 1980.

to most that the invisible hand was not guiding our decisions properly. The previously abundant resource, land, was becoming scarce. In response, some wild-eyed institutional entrepreneurs established regulations stating that you have to buy the right to cut down trees.

To add flexibility to the regulation, land was made a marketable good. Doing so created enormous bureaucratic problems: title searches, transfer difficulties, and selling costs, but these costs were undertaken by society because the benefits exceeded the costs and, eventually, we came to regard property rights in land as natural (6).

Although fully justifying our position is beyond the scope of this paper, we believe that the time has come to extend the market to cover the right to raise and lower prices. In the absence of this market, or some other form of regulation, too many individuals want to raise their wages and prices. Something must stop them and, given our present set of institutions, that something is unemployment and weak markets which create hunger which in turn creates an incentive to lower prices (7).

Sufficient unemployment or "excess supply" maintained for a sufficiently long time, (perhaps indefinitely) rations the right to raise price to those who least fear hunger and thereby holds the wage and price level down. This unemployment is a "natural" or "equilibrium" level of unemployment that is necessary to prevent the inflation from accelerating. By creating a market in the scarce commodity, price rises, the price of raising price will ration the right to raise price. In doing so it will directly limit inflation so that unemployment and weak markets need not.

INSTITUTIONAL ENTREPRENEURSHIP AND DEREGULATION

Anti-inflation policy is only one area in which most economists have been remiss in their role as institutional entrepreneurs. There are others, some of which involve regulation and some of which involve designing new institutional forms within which the existing markets can operate more effectively. For example in the United States, the transportation industry has been undergoing a rapid deregulation in the last few years. Most economists agree that this deregulation has been beneficial as the existing regulations no longer reflected the needs of society. (Whether

(6) This argument is made in A. Lerner, *op. cit.*, 1980.

(7) For a further development of this idea see A. Lerner and D. Colander, "Anti-inflation Incentives", *Kyklos*, 1982.

ıey ever did is debatable). However, in this deregulation process econ-nists lost a novel opportunity to introduce a variety of institutional in-ɔvations which could have played an important role in instituting eco-ɔmic reforms which would be supported by a majority of both liberal ıd conservative economists.

For example, in air transportation, on theoretical grounds economists ave long advocated a movement to marginal cost pricing which requires ariable pricing and non-refundable ticket sales, where ticket prices re-ect the dynamic inventory costs of maintaining an empty seat. With new dvances in computer technology, such a pricing system has become not nly feasible; it has become highly cost effective. We suspect some en-epreneur has envisioned entire airport waiting lounges with computer reens where the latest bid and ask prices for tickets are posted and a ating area where one can buy a ticket with the push of a button. In-ituting such a system could have increased load factors in internal United tates routes to a level at which airlines were profitable at the new ɔmpetitive rate structure. Yet, despite economists' role in the deregula-on process in the airline industry, the movement toward such pricing ystems was not fostered and is now only slowly being introduced by rms, not because economists led the way, but because of financial ne-essity. Another aspect of air transportation that could use some econom- entrepreneurship concerns landing rights and use of airport facilities. Iere, again, there is a scarce commodity that could be effectively al-ocated by the market, replacing administrative regulation with market egulation.

In other areas of transportation, a variety of new technical develop-ıents have occurred which make new pricing systems feasible. For xample, in road transportation, where previously, it was impossible to llocate road space temporally and spatially, with modern technology it technically possible. The technology now exists so that automobiles an be fitted with small sensors. Additional sensors would then be ıstalled on major arteries and as a person drives on these roads, charges vill be automatically assessed to his account.

If our argument that the above changes are essentially Pareto optimal hanges is true, the question automatically arises as to why they have ıot been already adopted. Our answer is that economists have failed in heir role of institutional entrepreneurs. There are a variety of reasons vhy they have failed. Some have failed because they have focused on nathematical models to such a degree that what should be "mathematical conomics", a branch of economics that uses economics as a tool, has become ecomathematics — a branch of pure mathematics that finds its axioms in some propositions in economics (8). For many of these ecomathematitions the concept "price" is meaningless, other than as a representation of a Lagrange Multiplier. The problem of such overmathemization of economics is that there is a tremendous gap between the general precept: price at marginal cost and the institution of a responsive pricing system that reflects dynamic inventory costs. The first requires a thorough understanding of calculus and optimal control theory; the second requires a general understanding of mathematics and a thorough understanding of how institutions and the pricing system work in practice. Somehow the insights of economists need to be translated into the rules and regulations guiding "general accounting practices". To advocate marginal cost pricing is insufficient; economists must identify what the relevant marginal costs are and design regulations so that they guide businessmen into charging that marginal cost.

A second reason such Pareto optimal changes have not been introduced was discussed above; some economists have so strongly argued that all regulation is bad that they have lost their role in shaping new regulations so they are as compatible as possible with new pricing technologies. Only by taking an active role in the development and modification of regulation can economists hope to institute such efficiency improving changes.

The view of economists as institutional entrepreneurs goes directly against the grain of Hayek and others who argue that the sole role for economists should be to prevent the state from interferring with the market. In some formulations of this view a few economists even seem to be arguing that that which is—is optimal. Their argument goes as follows: since free individuals will exploit any profit opportunity, there can never be any unexploited gains from trade, given transactional, informational, and other frictional costs. This argument can be seen in some formulations of the Coase theorem, and in some of the rational expectations formulations of macroeconomics.

The flaw in this argument is that the logic behind it is too neat; it allows no room for individual or governmental action. Disequilibrium must exist to lead individuals singlely, and collectively—through government, to correct that disequilibrium. Good institutions benefit society in general, not any specific group or individual. For this reason,

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(8) This argument is made in A. Lerner, "Environment-Externalizing the Internalities?", *American Economic Review*, March 1977.

stitutional entrepreneurship has public good aspects and society must
ıd a way to encourage it. Otherwise, institutional evolution will
flect solely the interests of private groups.

The correct statement of the argument is as follows: society optimally signs economists to the task of devising new institutional forms and an onomist offering a new policy proposal is as much a part of the equiliating process as is a private entrepreneur offering a new project. The ›ase theorem, by endogenizing economists, makes any policy proposal ey suggest part of the process and no a-priori statement can be made as whether the effects of that policy will be positive or negative. Each oposal must be judged on its own merits.

HE LIMITS OF ACTIVISM

The above arguments are, or at least should be, well known, but dging from the professional journals, they need to be repeated rather ten. However, it is also possible to push the activism argument too r. It does not necessarily follow that merely because a regulation or odification of the market mechanism will theoretically improve the onomy's performance that it should be implemented.

The simplest reason why is that implementation of any regulation ill invariably be subject to political pressure and the actual regulation ill be quite different from the hypothesized regulation. It is as inapropriate to think that government will undertake actions because they are eneficial to society, as it is to believe that no actions government unertakes could possibly be in society's best interests. Conservatives have ecognized this fact and have led the way in modelling the economy ith more institutional richness than the perfectly competitive model with xogenous government. They have recognized the simple fact that ıdividuals in the political sphere act in much the same way as they do ı the economic sphere. Individuals and groups lobby government to chieve their desired ends. Simultaneously, bureaucracies develop and ight to preserve their interests. It follows that the institutions that must nplement economists' policy recommendations often will have goals of heir own. Thus, given a political process, government reactions to events re partially endogenous and outside the control of both economists and olicy makers.

Because the government's reaction to events is partially endogenous, n making policy suggestions economists cannot merely state what is a good policy. They must use backward induction to determine the likely end result of the policy proposal after it filters through the political process. The optimal policy proposal can only be judged in reference to the expected outcome of that proposal.

This argument in no way suggests that economists should only propose "practical policies". Oftentimes, totally impractical proposals can force people to think and thereby indirectly affect the political process and the set of feasible policies more than would any practical proposal. Without the vision of wild-eyed academic dreamers, the practicality of today would still be dreams.

The expansion of the economic model to include political economy is an advance; the conclusion that is often drawn from it, that government involvement and regulation reflect only political interest groups pressure, is not. The reality is somewhere between the two extremes. Endogenizing the political process leaves economists with a problem; it places the analysis of regulation outside the narrow confines of competitive markets, leaving no reference point by which to judge actions. Once the competitive market institutional structure is no longer assumed, one must have an analysis of what institutional structure will develop and how that institutional structure will evolve, given the political structure of the country. The new "rent seeking" and "endogenous institutions" literature in regulation captures some of these insights, providing insight about how regulations and other institutions develop (9).

If economists hope to influence policy they must provide the ideas of new institutional structures which the political process can institute. Rather than being merely engineers or technicians who keep the present economic system operating, economists should see themselves as society's investment in research and development; they should be ten to twenty years ahead in thinking through the effects of new economic institutional structures. Our failure to do so and our focus on the present institutional structure will not lead to less regulation; it will merely lead to foolish regulation or what Carl Landauer called "planless planning" (10).

The above arguments in no way support the view that economists are omniscient or will be correct in the policies they advocate. It is only to suggest that they are more likely to suggest a positive institutional reform than is the political process without any input from economists.

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(9) This literature includes work in public choice and lobbying. For a recent survey, see R. Tollison, "Rent Seeking: A Survey", *Kyklos*, 1982.

(10) This argument was made in A. Lerner, *op. cit.*, 1945.

Semi-endogenous political institutions are not the only reason to activist policy proposals. A second reason is a bit more subtle. osed economic policy actions, of which regulation is one type, are echnological developments that follow from economists' research. For ty, these policies are the outcome of the investment it made in omists. Just as a firm ranks its investment projects, so too must a ty rank its investment in economic institutions by their expected inal efficiency of investment. Where political entrepreneurship is ed, so that it has a high shadow price, and the price of using the ical process decreases with intensity of effort, it is often optimal to : in only one or two areas, leaving a variety of beneficial projects including their cost in political entrepreneurship) on hold. In our nt economic situation, the macroeconomic problems of inflation and ıployment are so pressing that macroeconomic institutional reforms ide many microeconomic reforms.

A final limit to activism is the subtlest. The market is a set of rules in which people operate. For those rules to be useful, they cannot ontinually changing. Since new regulations are a type of change, an nent can be made for keeping the existing rules, even when changes ıem can improve the short run situation. Over time, however, so- s evolve and as they evolve the rules and regulations which may been appropriate are no longer so and eventually they will not be minimally acceptable. Thus, rules must change (11).

Optimal change, however, is not likely to be continual change, as inual change will destroy the value of the rules. Instead the optimal y is likely one in which the existing set of rules and markets will fixed for a time, with laissez faire the appropriate policy. Then, at : point, sudden significant changes in the rules will be required. In een rule changes, even if the existing rules and institutions could be inally improved upon by a policy change, it does not follow that a change is warranted. Rules and institutions have value unto them- s and a conservatism toward existing institutions merely because they : is warranted. For this reason, long run equilibrium of an economy robably not, and should not be seen as a steady state or even a mic steady state with a constant rate of change. Long run equili- m in economics should be seen as a *punctuated equilibrium* with

(11) If one could specify a full set of contingent rules which specified what should one in every eventuality, no changes would be needed. But any realistic rule of d contingency will almost inevitably need modification.