



Cash on the table: Why traditional theories of market failure fail



Robert H. Frank*

Johnson Graduate School of Management, 327 Sage Hall, Cornell University, Ithaca, NY 14850, USA

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ABSTRACT

Many modern progressives attribute the market's failings to conspiracies by powerful corporate actors to exploit workers and consumers. In this paper I defend the claim that many of the same failures are instead often rooted in competition among individuals for relative advantage. In the familiar stadium metaphor, all stand to get a better view, only to discover that no one sees any better than if all had remained comfortably seated. Analogous discrepancies between individual and collective incentives help explain the presence of overtime laws, workplace safety regulations, and many other institutional features of the modern welfare state. These features would be useful even if all consumers were perfectly informed and rational and markets took the perfectly competitive ideal form described in textbooks.

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Our current private spending patterns entail waste on a grand scale. The precise magnitude of this waste is difficult to estimate, but it is likely in excess of several trillion dollars a year in the aggregate. This waste occurs not because we spend carelessly, but rather because our individual spending incentives are often squarely at odds with our collective incentives. As in the familiar stadium metaphor, all stand to get a better view, only to discover that no one sees any better than if all had remained comfortably seated. As individuals, similar incentive gaps lead us to spend in ways that are mutually offsetting, and hence largely wasteful.

How much, for example, do parents feel they need to spend on their daughter's wedding? They want guests to remember it as a special occasion, but "special" is an inherently relative concept. Fast food hamburgers for the reception dinner would of course be ill-advised in most cases. But how much should they spend on catering and floral arrangements?

* Correspondence to: Robert H. Frank, H. J. Louis Professor of Management and Professor of Economics, Johnson Graduate School of Management, Cornell University, Ithaca, NY 14853, USA.

E-mail address: rhf3@cornell.edu

Standards differ from place to place and from era to era. In 1980, the average American wedding cost \$11,000, a princely sum in most parts of the world even today. But by 2014, that figure had escalated to \$30,000, and in Manhattan the average wedding now costs more than \$76,000 (Market Watch, 2015).

Why are people are spending so much more? The short answer is that the standards that define special have escalated sharply. I will say more about why that has happened, but for now note that no one even pretends that today's more expensive weddings have made marrying couples any happier. On the contrary, it appears that increased expenditures on weddings may actually make them more likely to divorce (Francis and Mialon, 2014). But even setting that possibility aside, if you share my belief that an across-the-board rollback in wedding expenditures would leave wedding celebrants no less happy than before, then this particular escalation in expenditures qualifies as pure waste.

What is more, there are simple, unintrusive policy measures that could free up a large share of the resources currently being wasted in similar ways—more than enough to solve even our most difficult environmental and economic problems. We could tackle our infrastructure maintenance backlog, expand health care coverage, ameliorate climate change, and do much to reduce poverty, all without requiring painful sacrifices from anyone.

This ought to strike you as a ridiculous claim. But as I will try to explain, it follows from simple logic and empirical evidence that most of you already accept. My argument has few moving parts, none of which should strike you as controversial.

Adam Smith's invisible hand—the idea that self-serving actions in the marketplace would lead to the greatest good for all—was a revolutionary breakthrough. It succinctly explains the historically unprecedented explosion of economic growth that has lifted billions of people from poverty during the past three centuries. But Smith was not nearly as enthusiastic about unfettered self-interest as many of his modern disciples. He thought it remarkable that self-interested actions *often* produce good results for society. But for reasons that he was not in a position to appreciate fully, market allocations are often profoundly wasteful, and much of this waste would be relatively easy to eliminate.

Charles Darwin saw the big picture more clearly, and my explanation of wasteful spending patterns rests heavily on his theory of evolution by natural selection. (I develop this argument in detail in Frank, 2011.) In time, I believe that most of us will come to view Darwin as having offered a far more compelling account than Smith's of the relationship between individual and collective interest. Darwin was of course heavily influenced by Smith, Ricardo, Malthus, and other economists. Yet he saw clearly that competition in nature often did not always lead to the greatest good for all.

Often it does, of course. A mutation that codes for keener eyesight in hawks, for example, helps individual hawks and also helps hawks as a species. But many other traits that help individuals entail negative consequences for larger groups.

Consider the antlers of bull elk, which often span four feet and can weigh up to 40 pounds. Elk are a polygynous species, meaning that males take more than one mate if they can. But if some succeed, others are left with no mates at all, which is of course the worst possible outcome in Darwinian terms. Natural selection favored bigger racks of antlers because bulls that had them were more likely to win their fights with other bulls for access to females. But big antlers are a serious handicap for bulls as a group, limiting their mobility in densely wooded areas and making them more vulnerable to predators.

If bulls could enact a binding regulation requiring all antler racks to be reduced by half, they would have compelling reasons to do so. Since it is relative antler size that matters, all fights would have the same outcome as before, and each bull would be less likely to experience the agony of being surrounded and killed by wolves. But bulls have neither the cognitive capacity to recognize the source of their difficulty, nor the power to enact regulations of any sort.

Darwin's framework differs from Smith's primarily in emphasizing that important aspects of life are graded on the curve. When relative performance matters, humans—like other animals—become embroiled in arms races analogous to those that spawned massive antlers in elk. Many of our current spending patterns are mutually offsetting and hence profoundly wasteful. But unlike elk, we have both the cognitive and communication abilities required to solve such collective-action problems.

Popular accounts of waste in the economy focus overwhelmingly on wasteful government spending, of which there are of course many compelling examples. Yet most of the waste spawned by the arms races I will describe occurs in the private sector. As we will see, this is good news, because private waste is much easier to curtail than public waste.

The waste I have in mind occurs in large part because every human evaluation is heavily dependent on context. Which of the two horizontal lines in the figure below is longer? Suspecting a trick, many are quick to respond that their lengths are the same, which in fact they are. But do you think they *look* the same? If so, you should consider scheduling a neurological checkup. Because of the different contexts in which the horizontal lines sit, normal human brains perceive the one on the top as longer.

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