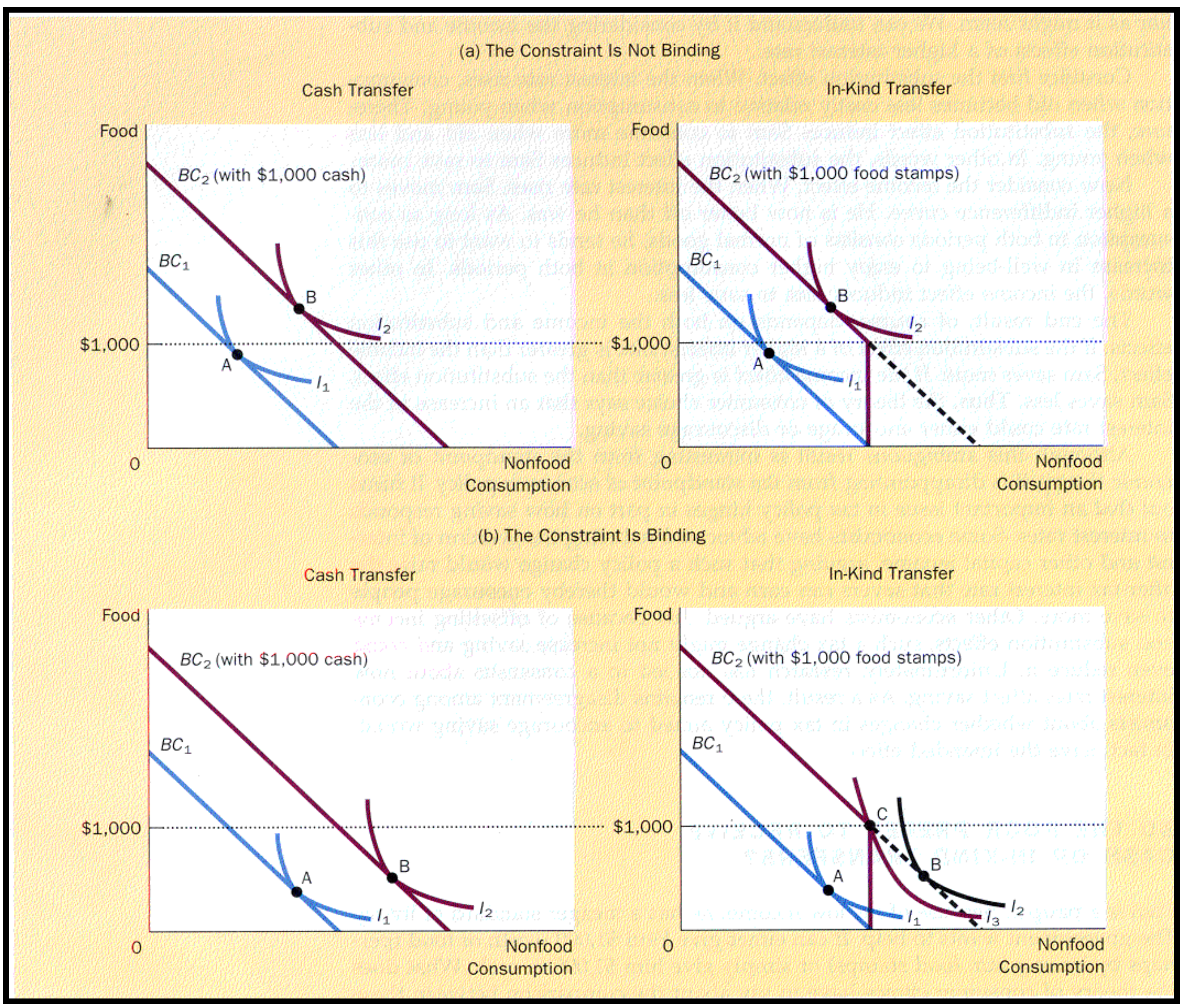
WHY ECONOMISTS ARE LOUSY LOVERS:

On the Political Economy of benefits in Kind

One of the more triumphant moments in the lives of economics professors – certainly in my life -- occurs when we demonstrate to students, with the elegant analytic apparatus reproduced below, that if government offered poor persons the choice between, say, (A) $1,000 worth of food products or (B) $1,000 in cash that can be spent any way the poor person chooses, the poor typically would prefer option B – the cash.

Here's the analytic rendering economists use to arrive at this powerful insight, taken from a popular textbook in microeconomics. Many other texts have similar graphs. They would occur to any economist.



To my great puzzlement and dismay, virtually 100% of the students in my freshman economics classes at Princeton have routinely arrived at the same conclusion during the first 10 minutes of the first lecture, before ever having seen this formidable analytic apparatus.

To a properly trained economist the mystery is how first-year students can do this, when a Ph. D. in economics needs all these multi-colored graphs to arrive at the same point? Does the brain of a Ph.D. operate differently from those of normal human beings, after years of graduate study?

The students' response, and the economist's formidable modeling thereof, also raises the question why so many politicians in rest of the world typically prefer to grant poor people only option A (benefits in kind) rather than Option B (the cash equivalent).

How can so many politicians be so dumb, you may ask, when so many of them once sat in a freshman economics class absorbing their economics professor's wise and truly clever analysis of this issue? Some students may even have wondered whether economists are the only brilliant people on earth and the rest of humanity is stupid, because surely it could not be the other way around.

A. THE ECONOMIST'S <u>NORMATIVE</u> PREMISE

A plausible answer is that, here as elsewhere, economists construct in their own and their own and their students' minds a deeply flawed model of an imaginary world quite apart from the one in which we live. In fact, economists describe the latter, often with some derision, as "the real world."

Economists base what may seem like a purely scientific analysis on a purely non-scientific, highly subjective <u>normative</u> premise, namely, that public policy <u>should</u> seek to maximize the <u>happiness of the poor</u> per dollar of tax money spent by citizens who pay taxes. It is a noble criterion. Deep in their hearts, economists always dream of being benevolent dictators overruling the myopic and sometimes venal preferences of the plebs, in the pursuit of the nirvana envisaged by Benthamite utilitarianism.

Given their ethical premise, economists reason that, on the approach they recommend, the poor would be happier with cash, because with it they could either buy the promised benefit-in-kind or spend the cash in ways that please them even happier.

You may argue that is true only if the recipients can purchase the benefits-in-kind in question on the same terms and at the same prices as government can -–– for example, that as individuals, cash in hand, they could buy health care at the same prices from pharmacists, doctors and hospitals at which Medicaid and Medicare can procure these items care for them.

This is often not the case in what economists call "the real world"– most certainly not in health care – but making this assumption vastly simplifies the analysis and also makes it more persuasive, and so we assume it.

Taxpayers would pay the same amount for the program, of course, one way or the other. Therefore, argue economists, taxpayers should be completely indifferent to the choice of cash vs.

benefits-in-kind, although, in the economist's mind, taxpayers, too, ought to see the poor made as happy as can be for the sacrifices taxpayers bring.

In connection with the public Medicaid program that buys health care for low-income families, for example, the well-known health-economist Victor Fuchs has remarked:

> *While elementary justice seems to require greater equality in the distribution of medical care, the question is complicated by the fact that the poor suffer deprivation in many directions. Economic theory suggests it might be better to redistribute income and allow the poor to decide which additional goods and services they wish to buy.*[1]

Similarly, in his exploration of the willingness-to-pay approach for tax-financed benefits-in-kind programs, health- economist Mark Pauly observes:

> *If we want to provide benefit to low-income people, a more efficient approach would be to use the money that would have been spent on the [benefit-in-kind] program to make a direct money transfer to them, since the money will benefit low-income people more than the [benefit-in-kind] program would. If the community decides not to make the money income transfer, it must not have attached high value either to low-income persons' health or to their overall welfare.*[2]

B. ARE NON-ECONOMISTS WRONG?

As noted earlier, on the basis of graphs, such as the elegant rendering presented on page 1, thousands of economics professors across the globe persuade millions of undergraduates around the globe that granting the poor distribution of benefits-in-kind is less "efficient" than simply transferring to them cash in an amount equal to the cost of the benefits-in-kind, and millions of undergraduates eagerly eat it up to regurgitate this wisdom on final exams. Students seem to find it utterly persuasive, judging by their answers on final examinations when this issue crops up.

But why, then, do governments the *real* world over quite typically prefer benefit-in-kind programs to cash-distribution programs?

Victor Fuchs answers this way:

> *As a practical matter, however, it may be easier to achieve greater equality through a redistribution of services (such as medical care) than through a redistribution of money income.*[3]

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[1] Fuchs, V.R. 1983. Who Shall Live? *Health, Economics and Social Choice*. New York, NY: Basic Books; pp. 148-9.

[2] Pauly, M.V. 1995. "Valuing Health Care in Money Terms." In Sloan, F.A. ed*., Valuing Health Care*. Cambridge, England: Cambridge University Press; p. 117.

[3] Victor Fuchs, *op. cit*.; p. 149.

And why might it be easier?

The economist’s normative dictum is driven by the assumption that taxpayers maximize their own utility when the recipients of tax-financed transfers, e.g., the poor, are allowed to maximize in any which way their own happiness per dollar of taxes borne by the taxpayers.

It would mean that, if the recipients of public transfers are happier spending their transfers on, say, movies or alcohol or visits to Disneyland than on, say, health care for their children or housing then, say economists, so be it, as long as the utility of the poor is maximized per dollar of taxpayers’ money.

Is there persuasive *empirical* evidence that the typical taxpayer's utility function actually does conform to the economist's imagination in this regard? I think not. President Reagan, for example, frequently appealed on the campaign trail to the legendary welfare queen who took her tax-financed welfare payments to buy frivolities.

A more realistic assumption might be that taxpaying voters typically exhibit a more <u>parental</u> form of altruism towards their poorer fellow citizens. In plain English, they do not trust the poor and do not believe that the poor would managed the cash they would be given wisely, as the taxpayers would want them to spend it.

On that view of the world, taxpayers would like poor families to use a select few basic commodities (for example, health care and education and housing) in adequate amounts, but specifically would not favor letting the poor use tax-financed subsidies to purchase whatever goods and services the poor might fancy.

The preference among voters for bestowing on the poor benefits-in-kind rather than cash transfers -- apparently so puzzling to economists who write textbooks and give advice to governments -- may well rest in good part on that characteristic of the typical tax payer’s utility function.

A coronary artery bypass graft (CABG), for example, can easily cost the equivalent of a fully loaded Mercedes Benz E-350 with GPS and a six-deck CD player. Taxpayers do buy such medical procedures for fellow Americans with few questions asked. Can we imagine taxpayers voting for handing out the equivalent amount in cash to the stricken poor?

If that hypothesis about the taxpayers’ utility function is valid, if they actually wish to be parentally altruistic, then the economist’s traditional, normative dictum on benefits-in-kind may be analytically elegant – and eminently suitable for a final examination in an economics course-- but practically dead wrong.

So, no, non-economists probably are not wrong on the issue of benefits in kind and economists may be wrong. It reminds me of the following story:

> *Two people in a hot air balloon are hopelessly lost. They descend until they hover over a gentleman in tweed jacket with elbow patches, pensively pacing up and down in his backyard while puffing a pipe. “Hello, Sir! Can you please tell us where we are?” shout the balloonists. Pensively scratching his chin, the gentleman thinks for a bit and then, with angelic clarity, he shouts up: “You are in a balloon.” Frustrated, the balloonists pull up the balloon. “That damned economist!” mutters the first balloonist angrily. “How did you know he’s an economist?” queries the second. “You can tell by his reply. It was precisely correct, but completely irrelevant.”*

C. THE ECONOMICS OF DATING AND GIFT GIVING

Having invested this much effort in seeking to understand the economics of benefits-in-kind, we might as well shine our analytic spotlight on two other related human activities: dating, and gift giving in general.

Proud, modern, independent women with a high degree of self confidence tend to go "Dutch" on dates with men. Under that approach, the man and the woman jointly decide what to do on the date and what all to consume, and they then to split the bill somehow, if not on every date, then at least over time across several dates, by alternating who pays.

Manolo Moochers

As New York Times columnist Maureen Dowd reports in her "*The Manolo Moochers*[4]," (*The New York Times*, August 29, 2001), going "Dutch" was customary among most professional women in the United States in the late 1960s and 1970s.

Naturally, I assume that it remains customary to this day among proud and self-confident Princeton women (although I would not vouch for women at Harvard and Yale).

Alas, Ms. Dowd goes on, "*going Dutch now is an archaic feminist relic among new generations of spiffed up young women who would not dream of picking up a check and who expect to be fully subsidized on romantic jaunts*."

Nowadays, Ms. Dowd reports, a man dating a woman in effect is expected by her to purchase the pleasure, real or imagined, of her company through the transfer of benefits-in-kind to her, at dinner and elsewhere during the date. Ms. Dowd suggests that women in such post-feminist arrangements tend to measure their self-worth – as did women in the Victorian age-- by the nature (and estimated cost) of the in-kind benefits that the man bestows on her.

Economists to the Rescue

Purebred economists naturally wonder whether, even in cases in which women measure their worth by the cost of the gifts men bestow on them, it might not be more efficient if the man simply wired the lady in question cash in the amount that he would have spent on a proposed date -- or gift – urging the lady to maximize her own happiness with that cash as she sees fit, and later meet him in a public park, where hanging out is free.

Think about it! A dinner for two in an upscale restaurant – say, New York's *Lutèce* or Princeton's finest, our *Pancake House* -- replete with a sufficiently aged Burgundy and a fine dessert wine afterwards, can easily run to $250 to $300, not even to speak of impressive tips for the table captain, the sommelier and the waiters that must be tendered to impress the lady of your prowess.

Add to it taxis or, more appropriately, limo service and possibly a night cap at a swanky bar on the way home, and you are talking about real money – surely enough to cover a pair of top-of-the-line

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[4] Presumably named after the famous *Manolo Blahnik* footwear fancied these days by upscale women.

Manolo Blahnik or *Christian Louboutin* sling-backs, with change to spare. Might she not prefer the, like, *Manolos* or *Louboutins* to the dinner, which probably would have had too many carbs in it anyways?

It is thoughts like this that can explain why, among romantic and sentimental humanists -- and even engineers! -- economists are known as lousy lovers. That label does not trouble economists at all, of course, as long as no one calls them “inefficient.” To be called “inefficient” would be the ultimate insult.

But, as even the author of your text (N. Gregory Mankiw, *Principles of Microeconomics*, 4th ed. (2007): p. 488-9) points out (read the caption under the picture), economists may have it wrong here, too.

In many instances the recipient of a gift might be offended where he or she to be given cash rather than a benefit-in-kind, because not only the cash spent on a gift, but also the time and thought going into its selection enters the recipient’s utility function.

In such cases, if the aim is to please the recipient, benefits-in-kind are more *efficient* than mere transfers of cash. In the case of courtship, for example, men should wherever possible have her initials engraved on gifts, trying to make sure, of course, that these initials match the intended recipient’s name, and not someone else’s (as happened to our head TA this year).

D. TAKE-AWAY MESSAGE

The central message of this little lecture is that in thinking about *efficiency* in economics, it is important to know the **goal** that is to be achieved. To move efficiently to a goal you do not want to reach may be efficient and make economists happy. But is it smart?

As I have sought to illustrate with my exploration of benefits in kind vs. cash payments – and in other areas of this course as well -- economists can be awfully naïve or sloppy when they stand on their soap box, proclaiming their **normative** dicta, or even seeking to describe how the world works. Listening to them could cost you an election in the political arena or a meaningful relationship in the sphere of dating.

Specifically, the goals that economists tacitly or explicitly posit in developing their normative prescriptions may not be at all the goals that the relevant decision makers have in mind. If so, the economist’s prescription may miss the mark entirely, and the economist’s client may judge the economist inept, and rightly so.