

Chapter 6

The Nirvana Approach

The view that now pervades much public policy economics implicitly presents the relevant choice as between an ideal norm and an existing “imperfect” institutional arrangement. This *nirvana* approach differs considerably from a *comparative institution* approach in which the relevant choice is between alternative real institutional arrangements.

The nirvana approach is much more susceptible than is the comparative institution approach to three logical fallacies—*the grass is always greener fallacy*, *the fallacy of the free lunch*, and *the people could be different fallacy*.

— Harold Demsetz (1969), “Information and Efficiency: Another Viewpoint.”

In the now-famous article quoted above, Harold Demsetz, then back at the University of Chicago after his earlier time at UCLA, presented the “nirvana approach” and contrasted it with the “comparative institution” approach. His term “the nirvana approach” has become famous and most economists who discuss it currently refer to it as the “nirvana fallacy.” The latter term has become so well known that it has earned its own entry in Wikipedia. (Wikipedia even got it right.)

In his 1969 article laying out the problem with the nirvana approach, Demsetz criticized at length a 1962 publication by Kenneth Arrow, who later won the Nobel Prize in economics. Arrow had argued that a free-enterprise economy would underinvest in invention. Arrow then stated the conclusion that he thought followed:

The previous discussion leads to the conclusion that for optimal allocation to invention it would be necessary for the government

or some other agency not governed by profit-and-loss criteria to finance research and invention. (Demsetz, 1969).

After quoting that statement, Demsetz pointed out the key problem: Arrow didn't carefully examine how "the government or some other agency" would solve the problem. He just *assumed* that it would.

Here's how Demsetz put it:

Whether the free enterprise solution can be improved upon by the substitution of the government or other nonprofit institutions in the financing of research cannot be ascertained solely by examining the free enterprise solution. (1969: 2).

That is like a judge in a figure skating contest between two contestants seeing the first contestant's performance and then, on that basis alone, awarding the prize to the (unseen) second contestant.

This, Demsetz noted, is "the grass is always greener" fallacy. We can't know whether the grass on the other side of the fence is greener without examining it. Demsetz did acknowledge that in the last few paragraphs of his paper, Arrow "does discuss some problems in substituting the government for the market." But, Demsetz noted, this does not lead Arrow "to reconsider his allegation of inefficiency in the market."

The free lunch fallacy

That takes us to Demsetz's major point: We can't say that a situation is inefficient if the other likely alternatives to it are not more efficient and could be less efficient. It's a matter for comparison: thus, his term for his preferred approach is "comparative institutions." The question Demsetz always asks is: What institutions get us closest to the desirable outcome?

Demsetz dug further into the Arrow paper, probably, we suspect, because Arrow was already a giant in the field of economics, but mainly, we also suspect, because Arrow was such a clear writer who, in one paper, displayed all the elements of the nirvana approach.

Arrow argued that for private enterprise to yield optimal invention, there must be "commodity-options" so that inventors can redirect risk to other

people who are willing to bear it.¹³ Arrow wrote that a commodity-option is a contract “in which buyers pay an agreed sum and sellers agree to deliver prescribed quantities of a given commodity *if* a certain state of nature prevails and nothing if that state of nature does not occur” (italics in original). Arrow argued that “the real economic system does not possess markets for commodity-options” (1962: 610-611). Demsetz took issue, noting that commodity-options did exist. Imagine how much stronger Demsetz’s empirical case would have been if he had written it in 1974, just after the Chicago Board Options Exchange had come into existence in 1973: commodity options are traded on that exchange. But Demsetz noted an important reason that they didn’t exist as fully as Arrow would have liked: the cost of creating them. Demsetz wrote:

Arrow here has slipped into the fallacy of the free lunch. The word “non-optimal” is misleading and ambiguous. Does it mean that free enterprise can be improved upon? Let me suppose that the cost of marketing commodity options exceeds the gain from adjustment to risk. This would account for their presumed absence. Can it be said that free enterprise results in a nonoptimal adjustment to risk? To make this assertion is to deny that scarcity is relevant to optimality, a strange position for an economist. In suggesting that free enterprise generates incomplete adjustments to risk, the nirvana approach, by comparing these adjustments with the ideal, is led further to equate incomplete to nonoptimal. This would be correct only if commodity-options or other ways of adjusting to risk are free. In this way, the nirvana approach relies on an implicit assumption of nonscarcity, but since risk shifting or risk reduction cannot generally be accomplished freely the demonstration of nonoptimality is false. (1969: 3-4)

In short, the fact that many commodity-options do not exist is, far from being a market failure, a market success. Markets weed out goods and services whose costs exceed their value.

¹³ The idea here is that because not all people have the same attitude to risk, it makes sense for those who are more risk averse to pay less risk averse people for bearing risk. Commodity-options achieve that transfer of risk.

Even if there were commodity-options, argued Arrow, the free market would still underinvest in information. Arrow gave two reasons: risk aversion and moral hazard.

The “people could be different” fallacy

Demsetz pointed out the “people could be different” fallacy in each. If people are risk averse, noted Demsetz, then “the taste for risk reduction must be incorporated into the concept of efficiency.” Risk is something that people, all else equal, would like to avoid.

Moral hazard, a term from insurance, refers to the fact that when people are insured against a bad outcome, they make less effort than otherwise to avoid that bad outcome. When moral hazard arises in insurance markets, argued Arrow, insurance is “incomplete.” Certain things are left uninsured.

Demsetz didn’t challenge the fact of moral hazard—it is a well-known problem. What he pointed out, though, is that moral hazard is a cost of providing insurance and therefore should be treated like any other cost. Moral hazard, he wrote, “is not different from the cost that arises from the tendency of men to shirk when their employer is not watching them” (1969: 7). He also compared the moral hazard problem to the problem posed by the cost of mining iron ore:

Some iron ore is left unearthed because it is too costly to bring to the surface. But we do not claim ore mining is inefficient merely because mining is not “complete.” Some risks are left uninsured because the cost of moral hazard is too great and this may mean that self-insurance is economic.

Arrow has fallen prey once again to the “free lunch fallacy.”

Of course, Arrow could point correctly to the fact that if insurance did not tempt people to underinvest in care, there would not be a problem. But then, noted Demsetz, Arrow’s reasoning would be committing the “people could be different fallacy.”

Demsetz did not dogmatically argue that free markets are necessarily preferable to some degree of government intervention. What he did do, though, was practice what he preached. Because Demsetz advocated a “comparative institutions” approach, he proceeded to compare institutions.

Consider, for example, attitudes to risk. Demsetz wrote:

The psychological propensity to be risk averse, if it is present, is found in employees of government as well as in employees of private enterprise, and a government probably is averse to political risks. (1969: 9)

Moreover, Demsetz noted, government officials are often much *more* risk-averse than are businesses in the private sector. He pointed out that creating a better postal service “seems to be technologically possible and economically promising.” But because politicians are “very averse to the risk of being voted out of office” they hold back on improvements that might lead to layoffs of postal employees.

The nirvana approach in real life

Demsetz’s work probably shifted the economics profession somewhat in the direction of humility when it came to advocating government policy. Consider, for example, Joseph Stiglitz, who was co-winner of the Nobel Prize in economics in 2001. Stiglitz is far from a member of the UCLA School. Stiglitz often advocates government intervention to “solve” market failures. But a careful reading of his 1988 textbook *Economics of the Public Sector* shows that even he at least grappled with the problem of inducing government institutions to carry out efficient policies rather than politically popular policies or policies driven by interest groups. For example, after noting that most of the benefits of federal rice subsidies go to rich rice farmers, he pointed out that a more efficient policy to help rice farmers would be simply to give each rice farmer a fixed sum that does not depend on the amount of rice the farmer grows. Although Stiglitz did not elaborate on why this would be a more efficient policy, economists know the argument well. Such a policy would end the artificial incentive to grow more rice. The problem with a straightforward subsidy, noted Stiglitz, is a political problem: such grants “would expose the true distributive implications of the program, that is, that most of the benefits accrue not to the poor rice farmers, but to the rich” (Stiglitz, 1988: 167). In other words, the political system purposely hides the facts about who benefits. It should be noted, though, that even though a fixed sum payment to each rice farmer is more efficient than the system that Stiglitz criticized, it is

less efficient than the policy of not subsidizing rice farmers at all. The fixed payment would require taxes and all taxes that are used in the United States today distort people's consumption and or production decisions and, thus, create an inefficiency that economists call deadweight loss. Moreover, Stiglitz did not address why the subsidies exist in the first place. The fact that they exist or, at least, did exist when he wrote, is itself evidence of the inefficiency of the government sector.

In another section of his book, Stiglitz also showed evidence that he understood the problem with the nirvana approach. In discussing natural monopoly, he noted a policy that economists have advocated for about a century: have the government “provide a subsidy and insist that the firm charge a price equal to marginal cost.” He continued:

Such a policy is sometimes referred to as “first-best.” It ignores, however, the question of how the revenues required to pay the subsidy are to be raised; it assumes, in particular, that there are no distortions associated with raising this revenue. Moreover, it assumes that the government knows the magnitude of the subsidy that will enable the firm to be viable (Stiglitz, 1988: 185)

Later Stiglitz stated:

[T]he political mechanism is a far from perfect means for allocating resources, since it is subject to manipulation by special-interest groups. Further, any regulations and rules devised in the public sector have to be enforced by a bureaucracy with all of the limitations noted earlier. (Stiglitz, 1988: 220)

Unfortunately, economists today still engage in the nirvana approach. Consider an example of market failure in one of the popular textbooks in public finance, the 9th edition of Harvey S. Rosen and Ted Gayer's *Public Finance*. Rosen and Gayer write:

In reality, markets for certain commodities may fail to emerge. Consider, for instance, insurance, a very important commodity in a world of uncertainty. Despite the existence of firms such as

Aetna and Allstate, there are certain events for which insurance simply cannot be purchased on the private market. For example, suppose you want to purchase insurance against the possibility of becoming poor. Would a firm in a competitive market ever find it profitable to supply “poverty insurance”? The answer is no, because if you purchased such insurance, you might decide not to work very hard. To discourage such behavior, the insurance firm would have to monitor your behavior to determine whether your low income was due to bad luck or goofing off. However, to perform such monitoring would be very difficult or impossible. Hence, there is no market for poverty insurance—it simply cannot be purchased. (Rosen and Gayer, 2010)

Notice the similarity between their argument and the one Arrow made almost half a century earlier. Rosen and Gayer, like many economists, have failed to check their nirvana approach.

More recently, economist Mark Thoma used the nirvana approach when he wrote:

All participants must also have perfect information about the market. If the buyer does not know the exact quality of art, wine, or health care services, if a home-buyer is unaware of a big problem with a house, if a seller misrepresents the quality of a good (a fake watch instead of a real one, or a tipped scale), if a service provider does not have the credentials that are claimed, and so on, then the market will be distorted – people will pay more than they would have if they had been informed.

Despite free market rhetoric, we want government to intervene to ensure that weights and measures are accurate, there is no fraud, people are truthful about their credentials, and known defects in a product are disclosed to buyers. In some cases, as with wine or art quality, there is little government can do beyond ensuring that that the type of grape or the artist is accurately represented,

etc., but when government can intervene and prevent information problems, it improves market outcomes. (2015, June 30)¹⁴

Thoma's writing above is one of the purest recent examples of the nirvana approach. Notice his extreme assumption in the first paragraph: all market participants must have *perfect* information. Notice also that in his solution, Thoma doesn't say *how* the government will effectively prevent information problems. Government is just *assumed* to work well. Thoma even asserts that we want the government to ensure that there is *no* fraud. That wish is extremely unrealistic.

Private enterprise and conditions of imperfect information

While Demsetz used knowledge creation to illustrate his argument, the more general point is that criticizing private enterprise because it functions under conditions of imperfect information and resulting transaction costs is nothing more than wishing away facts of life. Alchian (1969) developed this point further in a discussion of unemployment. The existence of unemployed labour, he argued, is not necessarily a failure of private enterprise. Alchian highlighted the relevance of the costs of gathering and disseminating information. In the case of labour markets, it is costly for jobseekers to obtain information about their best opportunities. Timely information about pay, working conditions, and the durations of available jobs, noted Alchian, does not come cheap. It requires searching, and searching takes time and effort. A worker often faces a choice between staying employed full time while searching for a job in his spare time and quitting the job to search full time. In many cases, trying to gather job market information can be more drawn out if one stays employed full-time. This is particularly so if one's wages are reduced because, say, his or her employer is having economic problems. A lower wage means the opportunity cost of engaging in a full-time job search is reduced.

More generally, Alchian argued that seemingly unemployed assets such as vacant apartments or unsold cars sitting on used car lots do not indicate malfunctioning markets. Unemployed assets can be part of a seller's inventory which, in turn, reduces the costs of information to potential buyers. An alternative to holding inventory is to change prices on a minute-by-minute

¹⁴ The authors thank Matt Gilliland for this example.

basis to ensure that, say, landlords never have any apartments at any time that do not have tenants. Would this make prospective renters better off? Not necessarily. In addition to having to search for information about the availability of rental apartments, prospective renters would have to continuously inform themselves about changes in supply and demand conditions in the rental housing markets in which they are interested in order to try to forecast rental prices. Most prospective renters would find the costs of becoming a fully informed real estate specialist prohibitive and, as a result, landlords would find themselves with fewer prospective renters. Holding inventories that generate no direct income is a cost to sellers that ultimately will be shared with those who rent or buy the items in inventory. However, customers might well prefer paying a higher rental or purchase price in order to invest less in needed information and expertise about market conditions. If so, then unemployed assets may well indicate market success rather than market failure.

It is worth summarizing the main points of this chapter. The UCLA School does not argue that private markets are perfectly efficient. Rather, it argues that it is inappropriate to measure the performance of private markets against some unattainable standard of perfection. Public policy should be guided by realistic alternatives.