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Help Me Help Myself
The Economics of Private Charity and Redistribution

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Abstract

Government redistribution and other forms of social insurance have been justified on the grounds of market failure. The traditional argument is that charitable giving suffers from a free-rider problem and will thus be underprovided in a free market. More recently, behavioral economists have argued that individuals exhibit cognitive biases that require paternalistic intervention to improve their welfare. Using insights from public choice theory and behavioral economics, our paper confronts these arguments and finds them insufficient to justify government intervention. Private forms of charity and redistribution respect individual autonomy and are more robust than public charity and redistribution.

Keywords: behavioral economics, externality, free-rider problem, internality, self-control problems

Help Me Help Myself: The Economics of Private Charity and Redistribution

Human beings owe to each other help to distinguish the better from the worse, and encouragement to choose the former and avoid the latter. They should be forever stimulating each other to increased exercise of their higher faculties, and increased direction of their feelings and aims towards wise instead of foolish, elevating instead of degrading, objects and contemplations...with respect to his own feelings and circumstances, the most ordinary man or woman has means of knowledge immeasurably surpassing those that can be possessed by any one else. The interference of society to overrule his judgment and purposes in what only regards himself, must be grounded on general presumptions; which may be altogether wrong, and even if right, are as likely as not to be misapplied to individual cases, by persons no better acquainted with the circumstances of such cases than those are who look at them merely from without. In this department, therefore, of human affairs, Individuality has its proper field of action.

John Stuart Mill, *On Liberty*

1 – Introduction

In America today, classical liberals and conservatives are alarmed by the runaway level of government involvement in our lives. Interventions affect and complicate nearly every facet of our lives and impose tremendous explicit and implicit costs on individuals. The sheer number and complexity of the rules governing our behavior seems to be at an all-time high, and the rapid increase of government interventions in the everyday lives of individuals in order to ‘make them better off’ deserves explanation.

Alternative opinions about the overall scale and scope of government intervention depend, of course, on one’s more general theoretical understanding of the welfare state. Analysis of the current state of poverty alleviation programs in America cannot be separated from one’s general model of the welfare state and individuals. We take as our point of departure Thomas Sowell’s claim (2003, B7) that, “The welfare state is not really about the welfare of the masses. It is about the egos of the elites.” That is, we accept the classical liberal claims that government intervention hampers people’s lives and that increases in intervention beget more intervention. Our main purpose in this paper is to critically examine older arguments for government intervention into charity and retribution, as well as recent efforts to employ insights from behavioral economics to expand the welfare state.

Historically, the economic justification for government involvement in programs for the poor was based on public goods theory. Lee and McKenzie (1990) credit Friedman (1962) with first making this point in his classic *Capitalism and Freedom*. As Friedman (1962, 191) put the argument: “I am distressed by the sight of poverty; I am benefited by its alleviation; but I am benefited equally whether I or someone else pays for its exclusion.” Friedman’s claim that programs that helped the poor was picked up by others, such as Hochman and Rodgers (1969), who made the case for government redistribution on the grounds that private charity and transfers were underprovided in a free market because of individuals free-riding on the donations of others. At the core of their argument was the notion that individuals have interdependent utility functions, i.e., the utility of individual A is dependent in part on the utility of individuals B.

In this essay we rebut this argument in two ways. First, we show that it is not clear that individuals have interdependent utility functions. Most charitable giving seems to occur because of the direct benefits received by the donor. Private motivations for giving significantly reduce the argument for government intervention because private charity will reduce or eliminate the gap between the ‘market failure’ level of charity and redistribution and the socially optimal level of charity and redistribu-

tion. Second, we show that even if individuals have interdependent utility functions and free-riding occurs, the resulting outcome is not inefficient because no resources are misallocated. Interdependent utility functions generate pecuniary externalities, which do not misallocate resources. We argue that the ‘ideal’ situation where no free-riding occurs is analogous to a market situation with no competition. Just as an absence of competition would not be good for competitive markets, an absence of pecuniary externalities in charitable consumption would not be good because much of the innovation in charitable fund-raising flows from the pecuniary externality associated with charitable giving.

More recently, the emerging field of behavioral economics has brought forth new justifications for government intervention into private charity and transfers. Behavioral economics is a large and growing field that calls into question some of the most basic microeconomic principles. A prominent strain of behavioral economics maintains, for example, that people have self-control problems that prevent them from properly smoothing out investment and consumption decisions over their lifetime. As a result of these self-control problems, individuals do not save ‘enough’ for emergencies or old age. Behavioral economists point to a number of other behavioral anomalies that, when taken as a whole, challenge standard microeconomic theory.¹ Their attack comes from a deeper skepticism about basic economic assumptions, such as the claim that people are rational and that markets generally work well at allocating resources.

According to behavioral economists, the case for government is strongest in those areas where individuals deviate from the rational actor model the most. While critics have been quick to point out the similarities between older forms of paternalism and this new paternalism (Rizzo and Whitman 2007), behavioral economists insist that their argument is an argument for “libertarian paternalism” or “anti-anti-paternalism” (Thaler and Sunstein 2003; Sunstein 2000). Their new paternalism is said to be a kinder, gentler form of regulation that is meant to ‘nudge’ people towards desired outcomes rather than force them. For example, if people are failing to save enough for retirement, old paternalists might force them to save a particular fraction of their income. By contrast, the new paternalists say that individuals should be free to choose how much to save, but that government can encourage savings by simply making people opt out of savings as opposed to opting in (Benartzi and Thaler forthcoming). If policymakers are careful with the way they frame decisions, the ‘right’ outcome can be reached with little to no harm imposed on people.

While we think that the behavioral economists are making an important point in that individuals do deviate from the strict rational actor model, we maintain that in many walks of life these behavioral anomalies and imperfections can best be dealt with in the private market rather than through government intervention. Our argument here is an argument for humility. We are not making the strong claim that there is no role for government intervention when individuals depart from the rational actor model. There may, in fact, be cases where government intervention can improve on matters. However, we argue that the presumption should always be in favor of laissez-faire because of the robustness of the market process and the fragility of the political process. The issues raised by the behavioralists are real, but they do not negate the problems identified nearly fifty years ago by Buchanan and Tullock (1962).

An economic analysis of these arguments yields important insights into the proper role of government towards charity and redistribution. The desire to help the worst-off in society is strong, and that sentiment can engender considerable support for the welfare state in its various forms, from transfer programs to a paternalistic regulatory state. Our analysis shows that best approach to helping people help themselves is through a decentralized market process. The remainder of our paper proceeds as follows. Section 2 discusses market failure theory in the context of helping others in society. Section 3 critically examines the notion that charitable giving suffers from a market failure, while

1 Camerer, Loewenstein, and Rabin (2003) provide one of the best introductions to the field of behavioral economics.

Section 4 discusses that government intervention is necessary to help those with self-control problems, arguments primarily target at the poor. Section 5 concludes with some policy implications of our analysis and some insights from private charity and paternalism.

2 – Helping Others and Market Failure Theory

The paternalism of contemporary America comes from an obvious and pernicious source: politicians. Politicians—both liberal and conservative—have been promising voters a world of increased health, safety, and wealth. What voters have been slow to realize is that politicians can never succeed at fulfilling these promises. But, in their attempt to satisfy our every desire, politicians have made good on delivering one thing to voters: a massive increase in the scale and scope of government. In a fundamental sense, politicians are simply recognizing that Americans are afraid to be free, and they are delivering policies that exploit this fear.²

The free lunch promises made by paternalistic politicians has led to a large increase in government. In addition to growing in overall size, the government has become increasingly concentrated at the Federal level because more local sources of authority cannot make sense out of all of the contradictory regulations being created by politicians. For those trained in Austrian economics, this increased concentration of power comes as no surprise. As Mises (1983 [1944]), 3) put it when describing the bureaucrat,

He has arrogated a good deal of legislative power. Government commissions and bureaus issue decrees and regulations undertaking the management and direction of every aspect of the citizens' lives. Not only do they regulate matters which have hitherto been left to the discretion of the individual; they do not shrink from decreeing what is virtually a repeal of duly enacted laws...Every day the bureaucrat assumes more power...There cannot be any doubt that this bureaucratic system is essentially anti-liberal, undemocratic, and un-American...

What results, over time, are piecemeal interventions that beget more interventions, and the process does not end until we have arrived at a totalitarian state.

While man's desire for more regulation has played an important role in the rise of the regulatory state, the market failure literature in economics has also helped to justify and make popular many government proposals. The standard market failure argument maintains that since people do not care about the spillover benefits/costs of their behavior, government must enter markets with externalities to correct for these alleged failures. The remedies to market failure can take many specific forms, but the general rule is that some kind of disincentive is required to curb negative externalities and some kind of positive incentive is needed to encourage behaviors that have positive externalities.

Advocates of market failure theory believed that correcting for market failures was a rather straightforward task (Samuelson 1947; 1961). More sophisticated critics of this literature recognize the epistemological challenge involved in sorting out the markets that are failing, estimating the size of the failure, and prescribing corrective remedies (Wagner 1989). Public choice economists also criticized market failure theorists for their naiveté, claiming that, even if bureaucrats and politicians had the necessary information about external costs, they lack the proper incentives to be correcting for market failures (Shleifer and Vishny 1998).³

2 Buchanan (2005) argues that big government will remain an enduring problem because of man's yearning to escape, evade, and even deny the responsibilities that come with being free.

3 Levy (2002) and Boettke and Leeson (2004) argue for a "robust" approach to political economy that makes "worst case" assumptions where politicians and bureaucrats are said to be both non-benevolent and non-omniscient.

Over time, policymakers in Washington have ignored the criticisms of market failure theory and latched on to the academic writings of market failure theorists. This new literature helped politicians justify interventions, and it undoubtedly affected the general public's attitude towards government. As Lord Keynes (1936, 383) put it:

...the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist.

Hayek (1960 [1949], 371) concurred with Keynes on this point, arguing that "...[intellectuals] have probably never exercised so great an influence as they do today...by shaping public opinion."

For both Keynes and Hayek, the views of the intellectual come to shape the political landscape in an extremely watered down fashion. There is error in this process, and many of the ideas selected by policymakers are not necessarily the best ideas or the "right" ones, but, rather the ideas that a progressive intellectual stands behind. Market failure theory is one such idea. It is hard to imagine there ever being a time where a majority of economists supported widespread interventions to correct for market failure. Yet, market failure arguments gained traction because they provided intellectual support for a variety of government interventions.

The implicit assumption of the market failure literature is that with enough regulation, all problems can be solved. By constantly passing new laws and massaging our fear to be free, politicians supply the false sense that government is 'solving' market failures. Like Demsetz (1969), we argue that much of this literature suffers from the nirvana fallacy. In its simplest form, the nirvana fallacy is a comparison of real markets with perfect government. In terms of charity and redistribution, an argument that charity has public good characteristics and thus is prone to free-riding behavior is taken as sufficient proof of the need for government intervention.

This perspective ignores, however, that government interventions are determined by fallible men and women with their own biases and agendas. A proper stocktaking of the desirability of intervention would: (1) evaluate a market failure argument on its own terms (i.e., is it really a market in the sense of misallocating resources), and (2) compare the robustness of markets and government in addressing the failure in the short and long run. The latter point is important because government could be more efficient in mitigating the short-run effects of a market failure but crowd out the evolution of decentralized institutional mechanisms that would be superior in the long run. With an eye towards both market and government failure, in the remainder of this essay we critically evaluate two of the most prominent arguments for government involvement in charity and redistribution

3 – Old Arguments: Consumption Externalities and Pareto Optimal Redistribution

One of the primary economic arguments for the public provision of charity is that it the supply of charitable activities will be underprovided in a free market because charitable giving has the properties of a collective consumption good. Technically speaking, collective consumption goods are those for which a large number of individuals can simultaneously consume the good without reducing the amount available for consumption.⁴ National defense is the classical example of a collective consumption good. An increase in a country's population increases the number of individuals consuming national defense in a manner that does not reduce any other citizen's consumption. The problem

4 In his seminal paper that essentially created public goods theory, Samuelson (1954, 387) describes collective consumption goods as those "which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtractions from any other individual's consumption of that good...."

that can arise with collective consumption goods such as national defense is that individuals have an incentive to become free riders, since they could enjoy the benefits of national defense without contributing to it. Under certain scenarios, government intervention can improve upon the voluntary outcome by requiring all individuals to contribute through compulsory taxation.

Individuals donate time and money to charitable organizations for many reasons. Some donate for personal edification while others donate because they care about the increased utility of those helped through an organization's programs. Individuals whose utility depends on the utility of others are said to have *interdependent utility functions*. For individuals with interdependent utility functions, charitable donations increase their utility because of the knowledge that the recipients of charity are better off. To the extent that donors have interdependent utility functions, the argument goes, charitable giving is like a collective consumption good in that all potential donors benefit when someone gives to charity. If I am a potential donor whose utility depends on the utility of the African poor, my utility increases when I hear that the Bill and Melinda Gates Foundation has donated \$47 million to help treat tropical diseases plaguing Africa's poor (Dugger 2006).⁵

Just as in the case of national defense, individuals can receive the 'warm glow' that comes from knowing the poor are being made better off without having to contribute. Hochman and Rodgers (1969) argue that in this situation at least some individuals will free ride on the charitable donations of others and thus the supply of charitable giving in a free market will be underprovided. Maximizing utility, they argue, requires government intervention to ensure that the 'optimal' level of transfers is made to the poor (Holcombe and Sobel 2000). This argument has been used to in an attempt to provide economic justification for various programs designed to increase charitable giving such as the charitable deduction Hochman and Rodgers (1977).⁶

This line of argumentation is problematic for many reasons. At the most basic level, what if most individuals do not have interdependent utility functions? Or to put it another way, why don't all donors free ride? Arrow (1972) was among the first to point out that many people obtain personal pleasure in giving even though they cannot observe the effect of their actions on the welfare of the recipients. While Arrow's formulation of donor motivation is surely not true for all donors and thus some free-riding is inevitable (Rose-Ackerman 1982), a considerable amount of donor motivation for giving does not appear to be about the welfare of the recipient. Donors appear to care about the 'warm glow' associated with charitable giving as well as signaling that they are wealthy enough to give (Glazer and Konrad 1996).

An easy way to observe that donors are not altruistically motivated is to observe the behavior of charities when soliciting donations. Development officials do not rely primarily on stories regarding the charity's work to raise money. While the charitable works are always part of the marketing campaign, the actions of development officials point towards donors being motivated by the approbation flowing from giving or the signaling value of a donation. One manifestation of the signaling motivation is in 'naming rights,' where a new facility or program is named after a donor. Or charities provide different 'tiers' of giving, with the choicest of status gifts being given to the highest donors (e.g., 'gold circle members receive regular updates from the president *and* monthly donor receptions').

The 'warm glow' that comes from feeling good about giving to charity is also a powerful motivator. Donors not only want to see the poor better off, but they want to feel good about having been part of the effort. Andreoni (1990) quotes the Red Cross using the slogan "Feel good about yourself – Give blood!" Donors appear to be motivated by many reminders of their charitable deeds, either for internal reasons or because of external approbation of their efforts. The fact that individuals spread

5 Celia W. Dugger, "Gateses Give \$47 Million to Bolster Coordinated Assaults on Diseases," *NY Times*, 20 December 2006.

6 Gergen (1988) provides an excellent discussion of arguments for an against the charitable deduction, including that of Hochman and Rodgers (1977).

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their charitable giving around instead of focusing on the cause they feel does the ‘best’ is more evidence that people are not entirely altruistic about their charitable giving.⁷ In an interesting study of bequests to the poor using data from seventeenth-century English wills, McGranahan (2000) finds that individuals were more likely to leave bequests to the poor if they had more non-immediate family and friends. Even in death, individuals appeared to be more concerned with how they were perceived by others.

Note that we are not making a normative claim about people’s motivations for giving. Rather we are merely trying to rebut the claim that individuals are primarily motivated to give out of altruistic reasons. We do not believe that individuals who give out of purely altruistic reasons have any moral claims over those who give out of a desire to win others approval. We believe that Adam Smith (1759 [1790], section III.I.6) said it best in *The Theory of Moral Sentiments* when he states:

To be amiable and to be meritorious; that is, to deserve love and to deserve reward, are the great characters of virtue; and to be odious and punishable, of vice. But all these characters have an immediate reference to the sentiments of others. Virtue is not said to be amiable, or to be meritorious, because it is the object of its own love, or of its own gratitude; but because it excites those sentiments in other men.

Giving in order to be perceived in a favorable light by others is thus not lacking in virtue, and in fact is far more virtuous than any other alternative.

Compared to private charity and redistribution, transfers to the poor done through democratic means are almost certainly less virtuous. The replacing of voluntary transactions with a compulsive democratic process transforms helping the poor from a virtuous activity into an obligatory one. The self-reinforcing cycle that is individuals donating because they seek the approbation of their fellow citizens is instead replaced by representative democracy that often transfers resources to the middle class in the name of helping the poor. Our opinion is that while it might be nice to contemplate an idealized world where individuals give solely for altruistic reasons, we do not live in such a world and charities must appeal to individuals’ self-interest as well as altruism in order to get donations. If it were possible to compare the transfers to the poor under a completely private system of charity versus a more public system, we believe that a completely private would be superior because of closer link between donation and outcome. Even if many United Way fundraisers are organized by real estate agents and owners of car dealerships because it is good for business (Hartford 2006), that situation is superior to a world where individuals have no incentive to become involved in private charity at all.⁸

Even if people gave out of entirely altruistic reasons and had interdependent utility functions, however, government intervention is not warranted because there is no misallocation of resources.⁹ This is because the type of collective consumption externality pointed out by Hochman and Rodgers (1969) is a pecuniary externality, which do not lead to market failures (Holcombe and Sobel 2000). In fact, pecuniary externalities are necessary for competitive markets. To understand why pecuniary externalities do not lead to economic inefficiency, it is important to better understand the distinction

7 This argument is made by Landsburg (1997), who argues that if the motivations of individuals were purely altruistic, they would give all their charitable donations to the charity they think does the greatest good. Giving to ten different charities is evidence, Landsburg argues, that individuals care about their own sense of self-satisfaction.

8 Lee and McKenzie (1990) show that once private benefits from charitable giving are taken into account, the public good argument for redistribution is hard to justify.

9 Reece (1979) finds, using the Bureau of Labor Statistics Consumer Expenditure survey, that people *do not* have interdependent utility functions. His evidence is that there is no relationship between charitable giving and the consumption level of potential recipients of said charity.

between pecuniary and technological externalities.

Nearly every activity in markets generates effects on third parties. There are two types of these third-party effects (also called externalities), technological externalities and pecuniary externalities. Technological externalities are externalities that directly affect the production of the individual or firm. For example, let us assume that a factory moves next door to a dry cleaning establishment and begins emitting pollution that makes it impossible for the dry cleaner to launder clothing while the factory was operating. As a result of this externality, the profits of the dry cleaner owner fall.

Pecuniary externalities, on the other hand, are third-party effects transmitted through prices. Let us assume that instead of a factory moving next door to a town's only dry cleaner it was another dry cleaning establishment who quickly engaged the incumbent dry cleaner in a price war. As a result of this competition, the profits of the incumbent dry cleaner fall by the same amount as in the factory example. Clearly both pecuniary externalities and technological externalities lead to welfare losses for the dry cleaner.

In terms of public policy, however, the implications of each type of externality are quite different. The technological externality can lead to market failure because resources are misallocated. For example, the factory owner did not take the effect of her pollution on the output of the dry cleaner into account and thus there may have been too much pollution. In the pecuniary externality case where a new dry cleaner comes in next door, however, no resources were being misallocated and thus there was no inefficiency. In fact, the truth is exactly the opposite. Pecuniary externalities are necessary for the efficient operation of markets as they are the byproduct of the competitive process.

Holcombe and Sobel (2000) take the distinction between technological and pecuniary externalities from the production literature and extend it to the consumption literature. They show that consumption externalities, such as the case of interdependent utility functions identified by Hochman and Rodgers (1969), are pecuniary externalities in that they do not directly affect household production. Free-riding does not influence the amount of charitable giving that can households can produce given a fixed set of inputs. Instead, utility falls because of the actions of others lower the return associated with a particular set of inputs. Just as intervention is not required competition among dry cleaners reduces the profits associated with a set of inputs into their production process, neither is intervention required when the actions of others reduce the utility an individuals receives from a set of inputs into the charitable process. Thus, contrary to Hochman and Rodgers, Holcombe and Sobel (2000) conclude that the Pareto-optimal public policy is to have no government intervention.

In fact, we would argue that in terms of 'robustness' free markets appear to be superior because the entrepreneurial efforts of development officials have found ways to harness individual self-interest on behalf of the poor. Making high levels of donations status goods, for example, links donors' interests in being seen as someone who can afford to give a lot with the interests of the poor. The bundling of desired goods with donations, such as public recognition or exclusive access to social networks, is another such innovation. In finding new ways to align the self-interest of potential donors with the interests of the poor, entrepreneurial development officials help to expand the level of charitable giving in an economy in a manner that government intervention cannot. While government officials can raise taxes or reallocate funds to the poor, doing so does not create a 'culture of giving' that leads others to give out of a desire for approbation (and might, in fact, crowd out future giving).

4 – New Arguments: Self-Control and the Problem of Internalities

Citizens of the United States live with a significant amount of paternalism in their lives.

The government tells us, in painful detail, what we can and cannot do. Most of the time, these regulations aim to protect one party in an exchange. For example, the Food and Drug Administration's

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strict guidelines on dairy production aim to protect milk consumers from bad milk. Building codes ostensibly aim to protect homeowners from harms that could arise from sloppy construction. Most of the regulations that affect our lives can be broadly considered as correctives to externalities. People are familiar with this type of regulation because it has been around for a long time and it is so widespread.

In the past, justifications given to involve government in the affairs of the poor were based on market failure arguments. But, as we mentioned earlier, a new justification for helping the poor is based on the idea that the poor incur “internalities” (Whitman 2006) on themselves. Like market failure theory, this literature sees a positive role for government in correcting for market imperfections. Unlike market failure theory, however, the correctives are not aiming at protecting one party from another, but, rather, aim to protect people from themselves.

The common theme running through most of the work in behavioral economics is that, for a variety of reasons, human beings are imperfect. We make mistakes and regret many of our choices. Many of us have an irrational fear of flying. Others cling to stereotypes regardless of evidence to the contrary. And, most of us would prefer to put off doing things that really should be taken care of today. Quite often, our basic set of psychological tools leaves us ill-equipped to do the “right” or “rational” thing, and we often end up failing to advance our own best interest. To the extent that some outside observer—whether it be an expert, family member or government—can tell that people are making mistakes, it is possible that our deviant behaviors can be corrected for.

Behavioral economists maintain that our cognitive limitations lead us to make predictable mistakes when we are faced with difficult decisions. The literature pointing out behavioral anomalies is vast and growing. We do not intend to provide a comprehensive survey of the literature. However, it is worthwhile to point readers to a few of the more important papers that deal with self-control problems. Warner and Pleeter (2001) looked at benefit packages offered by the U.S. military to encourage separation. The package could be taken as an annuity or a lump-sum payment. Consistent with many other findings in behavioral economics, they found that actors use discount rates far in excess of the market interest rate. O’Donoghue and Rabin (2003) provide evidence supporting the idea that overeating is an externality that can be corrected through taxation on junk foods. And, in one of the more seminal works in behavioral economics, Thaler and Shefrin (1981) provides a more general theory of self-control that models people deviating from rationality in many walks of life.

According to behavioral economists, biases, cognitive limitations, and problems of self-control are rampant and these biases do not cancel each other out when we are dealing with large numbers of people. In fact, under the right circumstances, our worst fears and biases might even cascade out of control in large group settings (Kuran and Sunstein 2000 [1999]). Nor do people learn quickly from their past mistakes. Time and again, we will fail to take account for the true costs and benefits of our decisions. Unless we adopt some kind of self-enforcing rule that ties our own hands or get the government to regulate and restrict us from engaging in the deviant behavior, our foolish decisions ultimately result in addiction, obesity, poverty, and tremendous ex post regret. Given the fact that people will sometimes come up short of the rational actor model, government can, in theory, improve upon the outcomes that emerge from individuals deciding for themselves.

Unlike the old paternalism, however, new paternalism is said to take people’s ends as given. That is, new paternalism accepts the premise that individuals know what is best for them at some kind of meta-level. At the meta-level, people do not want to be obese; they know they should quit smoking; and they know that procrastinating today is going to make life harder tomorrow. Given the fact that there is widespread agreement about what is best for people at the meta-level, the policymaker must simply find ways to help people attain their meta-goals. If our meta-goals were to change so that our true self wanted to be fat, poor, and addicted to cigarettes, new paternalists would have to come up with policies that actually discourage self-control! It is the fact that people have notional demands to control themselves that justifies interventions to curb our behaviors. The task for the

new paternalist, then, is to design policies that might create some short-term harm to individuals, but will ultimately produce a life more worth living in the long run.

Moreover, some of us suffer from more severe biases and have greater difficulty debiasing than others. The poor and low-educated seem particularly susceptible to self-control problems (Beaulier and Caplan 2006). Crime is just one of the social pathologies that seem to be over-represented among the poor. Even though there is little money in assault, drug possession, drunk driving, and rape, the poor commit these crimes at much higher rates (Harlow 1998). Crime is not a good escape route from poverty, but the poor cling to these counterproductive and damaging routes because they suffer from especially severe biases and self-control problems. If there were ever a case for a good dose of paternalism, it seems especially strong when dealing with individuals at the bottom of the income distribution.

The devil is in the details, however, when it comes to moving from paternalism in theory to paternalism in practice. Far too often, regulation of externalities in practice has meant the use of blunt regulatory instruments that overshoot in correcting for undesirable behavior. EPA regulations, for example, have been notoriously costly on factories that are already emitting low levels of a particular pollutant. Cable television regulations that ban swearing and nudity stifle creativity and water down programs. Government remedies to market failures often lack the specificity needed to truly take care of the problem. In many cases, the best regulatory efforts are counterproductive. More troubling than the fact that most regulations simply do not improve economic outcomes, though, is the implicit epistemological conceit of bureaucrats who feel confident that they know best. Both the old paternalists and new paternalists share this arrogance.

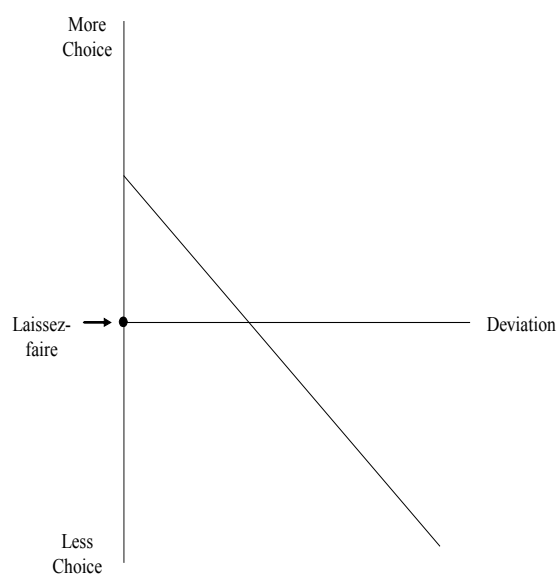
Paternalists are correct that, in theory, a social planner could come onto the scene and carefully restructure the economic order so that fewer deviations occur. But, the information costs of separating deviant actors from rational actors are so high that policy, at best, can be applied in broad strokes (Glaeser 2006). Ideal social policy—from a behavioral perspective—requires greater analytical sensitivity than this. Rather than attempt social reform with a broad brush, new paternalism should be applied in a case by case manner:

those who are not deviating from the rational actor model should be given more freedom, while the deviants should have their behaviors curbed through taxes and regulation. Figure 1 illustrates this point.¹⁰

As Figure 1 indicates, the behavioralist perspective calls for more government in some areas and less government in other areas. When individuals are behaving according to the rational actor model, they should be given even more choice than laissez faire allows. By contrast, when people are significantly deviating from rationality, their freedom of choice needs to be severely constrained. As Beaulier and Caplan (forthcoming, 19) explain, “...the behavioralist perspective argues for different

FIGURE 1

Deviations from Neoclassical Assumptions and Optimal Policy



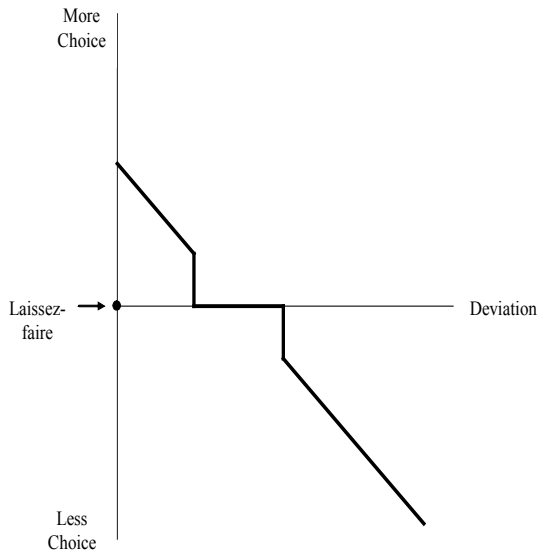
¹⁰ The graph comes from Beaulier and Caplan (Forthcoming, 30).

government policies, but not necessarily for less government.”

The case for new paternalism weakens once a good dose of public choice economics is introduced to the story. While in theory, optimal policy is attainable, once fixed costs of policy are taken into account, there are a whole range of policies over which the best remedy is laissez faire (Figure 2).¹¹

FIGURE 2

Deviations from Neoclassical Assumptions and Optimal Policy with Fixed Costs



As the graph suggests, the behavioralist perspective, coupled with public choice insights, can actually push us towards classical liberal policy implications (which we explore in the next section of the paper). But, we must be careful not to make too much of the behavioralist perspective: there are many policies where laissez faire is inferior to some government action.

Consider recent restrictions on “trans fat.” Standard microeconomics tells us that consumption of these fats, which are found in french fries, doughnuts, and many other unhealthy foods, must be desirable otherwise people would not bother taking them in. The case for restricting “trans fat” must rest on externalities. One possible externality is that

when people become obese, taxpayers pay for some of their medical bills. Therefore “trans fat” regulations are protecting taxpayers from the overeaters.

Behavioral economics introduces a new justification to “trans fat” regulation: eating “trans fats” imposes costs on ourselves. Our lack of self-control and inner battle with our meta-selves leads us to consume foods that, in the long run are bad for us. Banning “trans fats” or imposing “optimal” taxes to raise the price of these foods can actually help obese people (O’Donoghue and Rabin 2003). Moreover, since obese people might already have a greater urge to consume foods that are bad for them, the fact that these policies are particularly harmful towards them is actually a good thing. “Fat taxes,” then, can be viewed as a potential improvement over laissez faire.

Behavioral economics forces us to look more carefully at regulations and taxation. When we look through a behavioral lens, there appear to be more benefits from some paternalist policies than originally meet the eye. In particular, many of the policies actually reduce deviant behavior among those particularly prone to deviate. The fact that these people are made better off in the long run must be accounted for when engaging in cost-benefit analysis of regulation.

The lesson to be taken from this literature is not that all behaviors should be regulated, but, rather, that greater analytical sensitivity is necessary before one makes the case for widespread regulation or unlimited laissez faire. At one extreme, the new paternalism takes us down the same road as old paternalism: one size fits all policy that is aimed at a particular group, but ends up imposing costs on everyone. At the other extreme, we have case by case policy where our level of taxation and regulation is based on how far each and every individual departs from rationality. This, too, seems implausible when information costs and fixed costs of government are taken into account. At best, behavioral insights encourage us to “do no harm” when recommending policies and to consider reducing

¹¹ Figure 2 comes from Beaulier and Caplan (Forthcoming, 31).

choice for some government programs. If, instead, behavioral insights are used to reform every deviant behavior, the costs of so much tinkering in one's life are certain to be far in excess of the costs that come from minor departures from rationality.

As far as we can tell, behavioral economists do not want to apply their policy solutions with a broad brush. Doing so would be too costly for members who are not deviating from the rational actor model. Instead, they want a certain group of people who deviate from the rational actor model the most—namely, the poor and less educated—to have their freedom of choice constrained. Their argument is ultimately an elitist argument that maintains that economic experts can do a better job of telling people how to live than people, left to their own devices, can do on their own.

5 – Conclusion

This paper has examined justifications—both past and present—for government involvement in helping the poor. On the supply side, we have argued that the lack of charitable giving may not be a market failure at all, and that it is unclear that interdependent utility functions are as rampant as some theorists suggest. Moreover, even if the collective consumption characteristics of charity lead to a reduction in charitable giving, this undersupply is not economically inefficient in the sense of misallocating resources. More importantly, private charity and redistribution are more 'robust' in the sense of finding ways to align the incentives of potential donors and the poor. In doing so, free markets help to foster sympathy for the less well-off and a culture of approbation for those who help them. Government intervention, on the other hand, transforms a private, voluntary transaction into a public obligation. This places a strong presumption in favor of *laissez-faire*.

There are also problems when we turn to demand-side justifications based on the idea that the poor must be protected from themselves. While behavioral economics can be used to justify welfare, public choice insights weaken the case for intervention. Many government programs that were created with the intent of improving the welfare of the poor do not. Some programs, such as Medicaid in the United States, have been expanded to the point where they help supplement the retirement of the middle class instead of providing for the old age of the poor. Other anti-poverty programs appear to make the poor worse off.

For example, behavioral economics forces us to reconsider the distinction between the "deserving" and "undeserving" poor (Himmelfarb 1991). The "deserving" poor are not necessarily those who are in the worst economic shape, but, rather, those who are more closely following the rational actor model, but nonetheless suffering from bad luck. The "undeserving" poor are those who, despite our best efforts to educate them, are nowhere near the rational actor model. Their economic starting point could be better or worse than the "deserving" poor. In other words, in light of behavioral insights, it is not the level of income that should matter when allocating scarce resources towards poverty alleviation, but, rather one's overall state of mind. Of course, allocating charity in this way is far messier than a simple and mechanical approach based on income.

Ultimately, the difference between those who want government involved in charity and redistribution and those opposed comes down to a belief in the individual's ability to help himself and his fellow man. The fact that some people are different than others is not, *ipso facto*, an argument for paternalism, but, rather, an argument for leaving people alone. Efforts to deliberately control or "nudge" people (or force them to contribute to anti-poverty programs), take away from the richness and general culture of society and inhibit the learning that is a byproduct of the market process.

Those in favor of government involvement in poverty alleviation are guilty of making the perfect the enemy of the good. This attitude regards almost all government intervention as desirable and sees many areas where more government involvement could improve market outcomes. But, it suffers from the same problem that all arguments for big government encounter: it assumes that other people—the experts—are outside and above the economic order and that these people are ca-

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pable of deciding for everyone what's best. By trying to make their values (or, to be more precise, the values of the "rational actor") the values that everyone should have, they fail to notice the collective wisdom that comes from millions of people pursuing their own interests according to their own values.

The problems addressed in this paper are problems that have been dealt with extensively in economics and political philosophy. Unfortunately, the solutions being offered by many contemporary economists are an effort to put new wine into old bottles. Government as a corrective to market failures and paternalism, whether it be new or old, are inferior solutions to poverty problems when compared to the private sector. One of the greatest, and largely unaddressed, costs of big government is that it has crowded out a whole range of private charitable organizations that were quite effective at dealing with "free riders" and deviant behavior. In the absence of government, we do not and cannot know what specific mechanisms might arise to deal with the "free rider" and self-control problems discussed in this paper, but we do have some historical experiences where mutual aid arrangements worked quite well (Beito 2000; Friedman 1962, 190-91).

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