ON THE ECONOMICS OF BENEFITS IN KIND

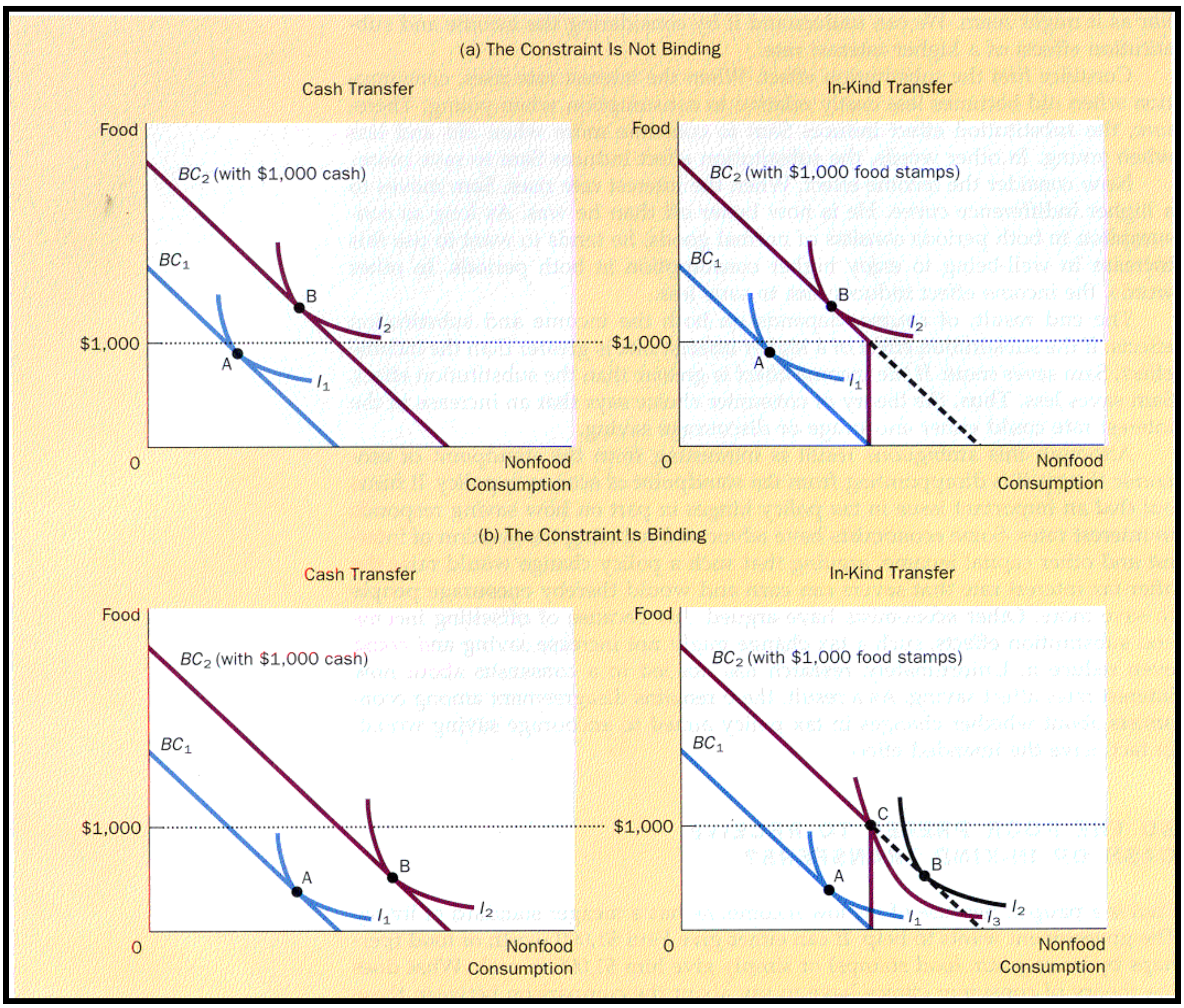
or

Why Economists are Lousy (but Efficient) Lovers

or

Why Big U.S. Business Loves Government Spending

One of the more triumphant moments in the lives of economics professors occurs when they demonstrate to students, with the formidable analytic apparatus reproduced below, that if government offered poor persons the choice between, say, (A) $2,000 worth of food or (B) $2,000 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. This particular artwork is taken directly from an earlier edition of Harvard economics professor N. Gregory Mankiw's celebrated introductory textbook of microeconomics.



Much to my consternation, even without this formidable analytic apparatus virtually 100% of the students of prior classes in this course always have routinely arrived at the same conclusion during the first 10 minutes of the first lecture. The mystery to me, a properly trained economist, is how you students can do this, when a Ph. D. in economics needs all these multi-colored graphs to arrive at the same conclusion?

My tentative answer is that you guys cheat. You do it by secretly relying on common sense, which often we set aside in economics for some higher analytic goal.

Your common sense, and our profession's formidable analytic rendition of it, raises several fundamental questions:

> *Why do so many politicians all over the world typically prefer to grant poor people option A (benefits in kind) rather than Option B (the cash equivalent)?*
>
> *Could it be that millions of politicians and the people they represent are stupid, and only economists are smart?*
>
> *Or, heaven forfend, might it possibly be the other way around?*

Let us think a bit more about these questions.

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

One plausible answer is that, here as elsewhere, economists all too often construct in their own and their students' minds a deeply flawed model of how the real world works. It is known to have happened before.

Deep in their hearts, economists always dream of being benevolent dictators overruling the myopic and sometimes venal preferences of the plebs. Thus, in the case of benefits in kind, 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 should seek to maximize the <u>happiness of the poor per dollar of tax money spent by citizens who pay taxes</u>. Do you agree with that proposition?

Given their seemingly sweet ethical premise, economists then reason that on the approach they recommend, the poor would be happier with cash, because with it they could either buy the benefit-in-kind or spend it in ways that please them even more. At the same time, taxpayers would pay the same amount for the program, one way or the other. Therefore, argue economists, taxpayers should be indifferent to the choice of cash vs. benefit-in-kind and the poor happier.[1]

Thus, in connection with government programs that buy 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*

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[1] Actually, it gets a bit more complicated with health insurance benefits, because they afford the poor not only health care when needed or wanted, but also the piece of mind that comes with health insurance, as it reduces uncertainty over the household budget. One could imagine that some lower-household incomes with chronically sick members might value health insurance at more than it costs taxpayers to provide it to the poor.

income and allow the poor to decide which additional goods and services they wish to buy.[2]

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.[3]

Do you buy into these *dicta*? On their face, they surely are persuasive.

B. ARE NON-ECONOMISTS WRONG?

As noted earlier, on the basis of graphs such as the 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.

Why, then, do governments the *real* world over quite typically prefer benefit-in-kind programs to cash-distribution programs? Victor Fuchs hints at the answer:

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.[4]

And why might this be more "practical"? One can think of two distinct explanations:

1. *Politicians tend to find it politically more attractive to provide benefits in kind to poor citizens than to provide these citizens with cash because powerful, moneyed special interests can profit from the strategy. Standard ornithology, to be enlisted below, can provide useful insights here.*[5]

2. *Even if the first factor played no role, the median, taxpaying voter may prefer to give the poor benefits in kind rather than cash.*

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

[3] 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.

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

[5] See Hsiao Lien Reinhardt, Hsiao Nio Reinhardt and Uwe E. Reinhardt, "Lessons for Hospital Payment from Ornithology," _Journal of Policy Analysis and Management_, Vol. 6, No. 3 (Spring, 1987), pp. 449-450

Let us examine these alternative explanations, in turn.

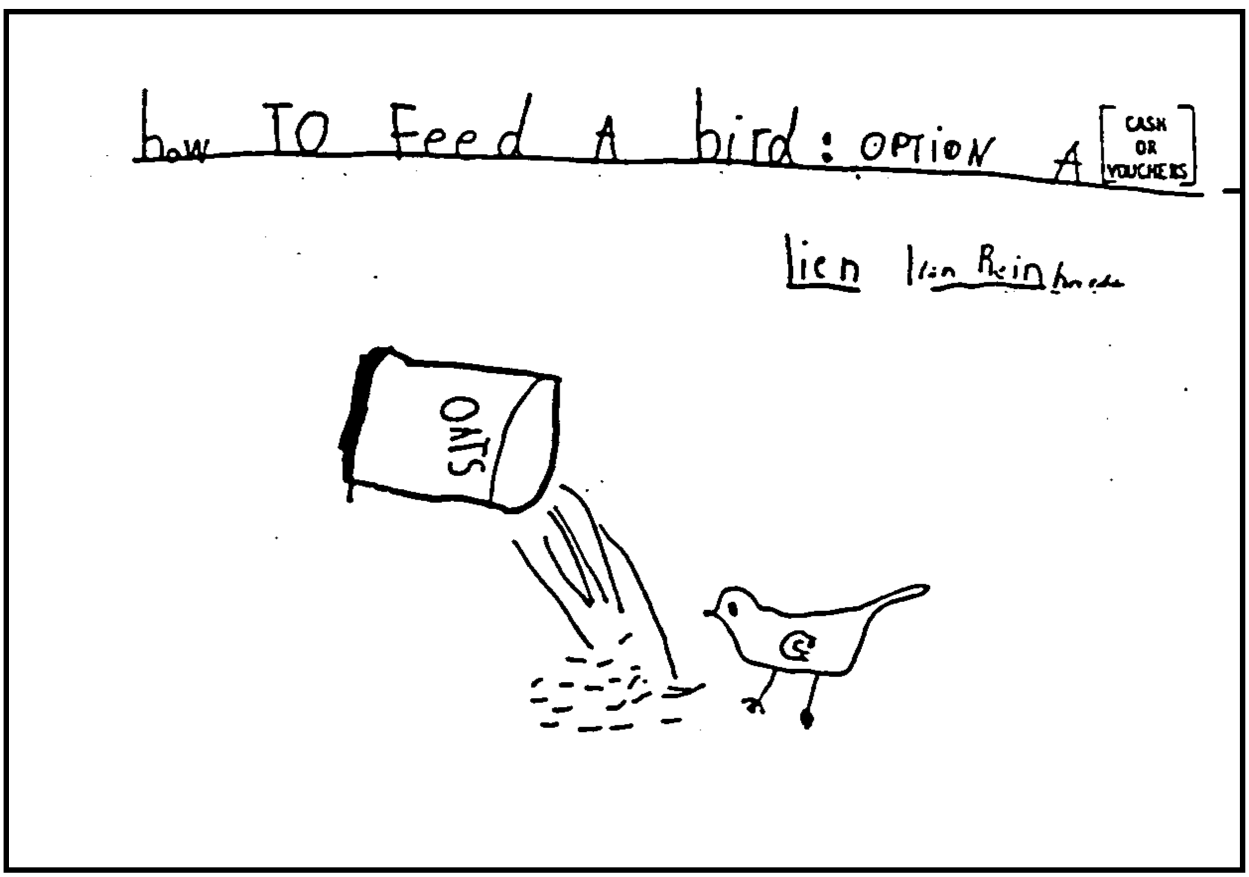
1. Lessons from Ornithology: Feeding Horses to feed the Birds

When a government distributes benefits in kind –e.g., food or health care or education—it effectively purchases these benefits from producers who profit from providing them (e.g., doctors, hospitals, teachers, farmers). Often these producers are what is known as “big business,” with legions of lobbyists on K Street in Washington, D.C.. We have seen how both large and small business firms have profited from the mellow concept of “nation building” in Iraq and Afghanistan.

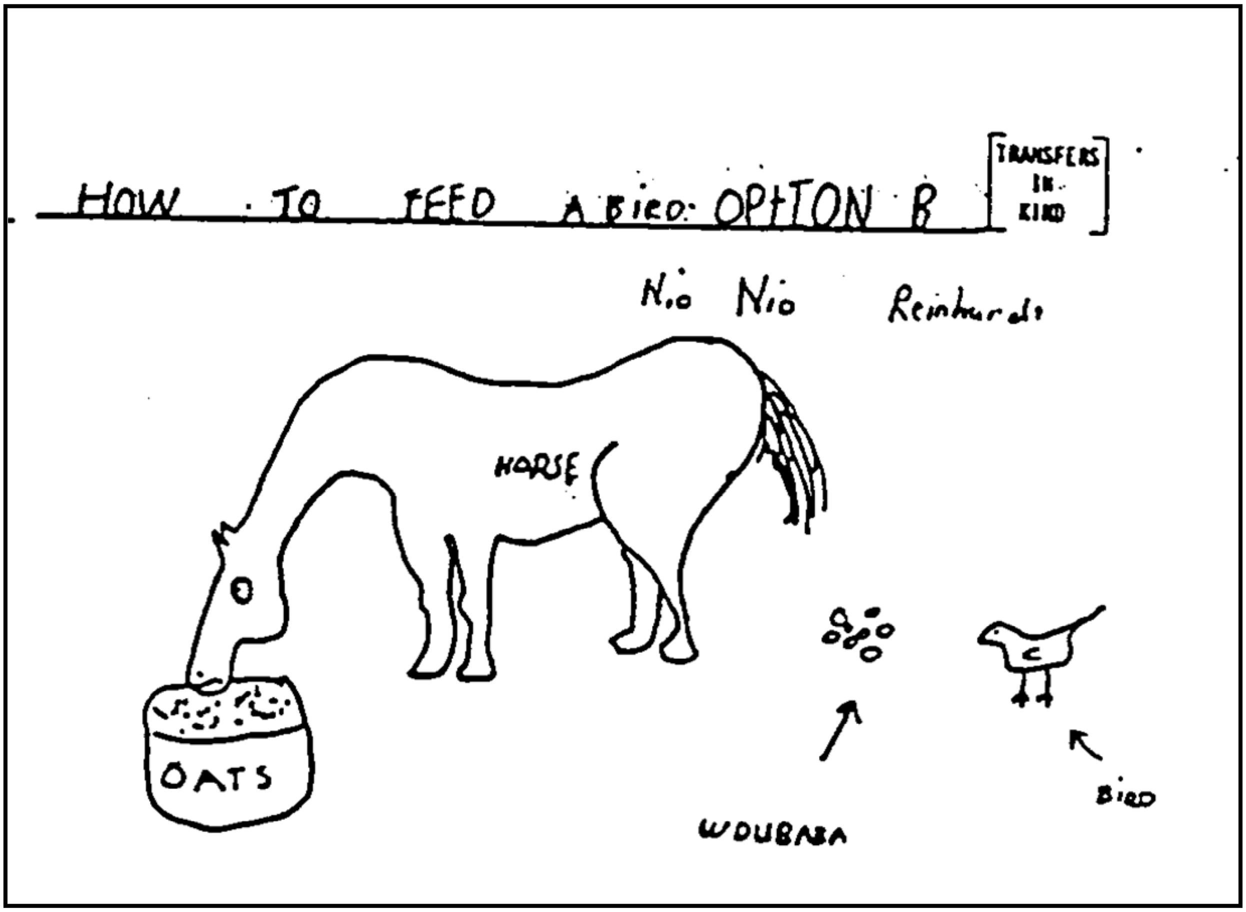
Although primarily driven by pure self economic interest, these producers then become the political champions of the beneficiaries of the benefit-in-kind programs and lobby on behalf of the poor with touching concern, always pretending, of course, that personal profit is furthest from their minds. The American Medical Association and the American Hospital Association are experts at this game, as are defense contractors worrying about equipping our soldiers in the field, big agri-business championing food stamps or business firms making money off saving the environment.

It is all part of the ritual. In the vernacular, this ritual is often described as “feeding the horses to feed the birds.” Using a unique graphical display, our children Hsiao Lien (Little Lotus—then about 6 years old and Hsiao Nio (Little Bull—then about 8 years old) once produced for their dad the following renderings of this phenomenon as it applies to feeding birds.

This is Hsiao Lien’s rendering. Her strategy would be to feed the birds directly by pouring oats – the analogue of cash – out on the ground in front of them.



Hsiao Lien's older brother Hsiao Nio, at age 8 much wiser to the world, scoffed at his little sister's model and proposed instead the benefit-in-kind model sketched out below.



The idea here is to use taxpayers' money first of all to feed some hungry horses (who gain the affection of legislators by doing them favors, such as campaign financing or free corporate jet service). Once fed, the horses would then let benefits in kind trickle down on the birds in the form of what is called in Chinese "woubaba". It is a substance that can make plants grow.

Huge segments of American business rely on Hsiao Nio's model for their wealth – defense contractors large and small, health-care providers, education, and in many other sectors of the economy.

Think about it! Every time we shoot a smart missile at someone or something, someone working for the producer of the missile at home has his or her paycheck fed by it, some executive of that company sees his performance rating and year-end bonus go up and some shareholders of that company is likely to get a small boost to the market value of the company's stock.

Washington is a wealthy city mainly because of the thousands of highly paid lobbyists who live there, have their offices there and ostensibly plead the cause of birds, but really are paid to plead the cause of hungry horses. It is all part of the splendid democracy our Founding Fathers bestowed on us and of which we are so proud that we seek to export the model to all four corners of the world. I promise you that it will never change, regardless of who runs our country.

You might as well get used to this arrangement and not get too despondent about it. Indeed, my hunch is that many of you will profit from it.

So the hungry-horse theory is one explanation for why governments all over the world may prefer to distribute benefits in kind to distributing cash to the poor.

But, hungry-horse theory aside, there is yet another reason why politicians find it easier to distribute benefits-in-kind rather than cash is that the median voter, widely thought as a good representative of the voting public, may prefer it, even if they do not profit from producing the benefits and even after studying the economist's elegant analysis on the issue.

2. The Utility Function of Taxpayers

The economist's normative dictum is driven by the naive assumption that taxpayers maximize their own utility when the recipients of tax-financed transfers, e.g., the poor, are allowed to maximize any which way they choose 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.

A more realistic assumption might be that taxpaying voters typically exhibit a more parental form of altruism towards their poorer fellow citizens. 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.

If that hypothesis were valid, if taxpayers want the poor to consume at least minimum adequate quantities of a select few commodities, then it would seem hopeless that we would ever find a single, politically acceptable distribution of generalized purchasing power (cash) that would distribute through the free market all commodities among members of society in a fashion that the general public will accept as just.

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 6-disc CD changer. [You may wonder how a presumably underpaid, poor professor could possibly know that.] Taxpayers routinely do buy such 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 but practically dead wrong. Professor Mankiw's elegant graph would then be a waste of paper and printer's ink.

It all reminds me of the following story, which could plausibly have happened:

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. "Hello, Sir!" shout the balloonists. "Can you please tell us where we are?" 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 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. Princeton women are said to behave this way; but I would not vouch for Yalies, not even to speak of Harvard women.

As New York Times columnist Maureen Dowd reports in her "*The Manolo Moochers*[6]," (*The New York Times*, August 29, 2001), going "Dutch" was customary among professional women in the United States in the late 1960s and 1970s. Alas, Ms. Dowd goes on,

> G*oing 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.

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 the 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 *Pancake House* -- replete with a sufficiently aged Burgundy and a fine dessert wine afterwards, can easily run to $250 to $300, not including the huge tips for the table captain and the waiters that must be tendered to impress the lady. 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 *Manolo Blahnik* sling-backs – perhaps even *Christian Louboutins* -- with change to spare. Might she not prefer the *Manolos* or *Louboutins* to the dinner, which probably had too many carbs in it anyways?

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

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 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 can more *efficient* than mere transfers of cash.

Professor Mankiw probably would recommend, for example, that men should wherever possible have her (or “their”, in case of multiple recipients) initials engraved on gifts, always making sure, of course, that initials always match the intended recipient’s name, and not someone else’s, lest the gift trigger a deadweight loss.

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.

As noted above, in their normative mode all economists dream of being little benevolent dictators who can redistribute economic privilege – and happiness – among the plebs so as to maximize something they call “social welfare.” As they practice it, it is a bastardized version of Benthamite utilitarianism, resting on a peculiar distributive ethic that no rabbi or priest would be likely to embrace. (We shall cover this topic later in some depth.)

As I have sought to illustrate with this exploration of benefits in kind vs. cash payments, however, economists can be awfully naïve or sloppy when they stand on their public soap boxes, proclaiming their **normative** *dicta*. Listening to them could cost you an election in the political arena or, worse still, ruin what might otherwise have been a perfectly “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 clients may judge the economist “politically naive,” not to use the word “stupid.”