Book Review

Getting Economics Back in the Game

Jean Tirole

Economics for the Common Good

Princeton University Press 2017

Reviewed by Gregory K. Leonard

Jean Tirole, chairman of the Toulouse School of Economics and winner of the 2014 Nobel Prize, is one of the world's foremost economists. In an age when most economists specialize narrowly, Tirole has, over the course of his career, made significant contributions to an impressively broad number of areas within economics.[1] Now, in a new book entitled *Economics for the Common Good*, Tirole has taken on a formidable task: convincing non-economists that economics can—and should—play an important role in developing policies and institutions that further the "common good." Antitrust practitioners familiar with Tirole's work in industrial organization will not be surprised to find that competition policy and related subjects such as innovation and regulation are central to Tirole's vision and are given extensive treatment in the book.

Tirole is troubled by widespread rejection of economic thinking, particularly among members of the populist movements that have arisen around the globe: "Nowadays, people with expert knowledge are often dismissed. Populist politicians and media in particular show complete contempt for elementary economic mechanisms."[2] He recognizes that economists are partly to blame for this unhappy state of affairs. Some economists sequester themselves in their ivory towers, refusing to participate in policy debates where their input could be valuable; other economists are all too willing to provide superficial soundbites to the media that are counterproductive in their simplicity and sometimes not even within their area of economic expertise.

Tirole fears that, unchecked, the move away from economic thinking will result in policies that are disastrous for the common good. Too often, discussion of a policy is based on superficialities rather than a complete assessment of the policy's actual benefits and costs, including a comparison to potential alternative policies. He points out that indignation often enters into policy discussions, but is a poor guide: ignoring that there are tradeoffs because making such tradeoffs seems "immoral" (e.g., consider a potential market for organ donation) is just sticking one's head in the sand.

So, how can economics contribute to sound policy-making? Tirole identifies a number of ways. Economists are good at identifying adverse unintended consequences that a well-intended policy may have. He gives an example of how the French government prohibited the opening of large

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[1] *See, e.g.*, Scientific Background on the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2014, Jean Tirole: Market Power and Regulation, Compiled by the Economic Sciences Prize Committee of the Royal Swedish Academy of Sciences (Oct. 13, 2014), https://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/2014/advanced-economicsciences2014.pdf.

[2] JEAN TIROLE, ECONOMICS FOR THE COMMON GOOD 481 (2017).

supermarkets, a policy intended to restrain the market power of supermarket chains. But the unintended consequence was that it restrained competition by preventing entry (both store expansion by existing chains and new chains), which in turn resulted in higher prices for consumers—the exact opposite of what was intended. Economists are trained to consider all of the effects of a policy, including effects that are small for each individual in a given group but significant in the aggregate. The voice of such groups is often lost in the political process in comparison to what may be a small number of individuals for whom the effects are large. Economists "insist[] on reality rather than fairytale," which counters wishful thinking and other cognitive biases that would otherwise favor poor economic policies.[3] Finally, economists do not let emotion get in the way of reasoned thinking about tradeoffs. Tirole asks, "Isn't it absurd to spend a large sum on saving one life when, for the same amount of money, dozens of others could be saved? Yet, the financial nature and apparent cynicism of such considerations shock people, who refuse to engage with them."[4]

[A]n economist worth listening to is one who has expertise in the area under discussion, makes economic judgments, not political pronouncements, and exhibits humility in acknowledging limitations on the state of economic knowledge and uncertainties in the analysis.

Tirole's proposed approach for regaining the public's respect for the profession is for economists to strive to "mak[e] economic ideas comprehensible to a general audience," thereby providing the public with a basis to understand which policies would serve the common good.[5] This will make it harder for the false promises of economically unsound policies to gain political support and also make it easier for governments to implement sound policies, the benefits of which are hard for the economically naïve to perceive. This book is a useful step in that direction.

An early section of *Economics for the Common Good* is devoted to gently convincing readers that much of what they think they know about economics is wrong. Uniquely for a general interest book on economics, it tries to build a connection with the reader by explaining in detail the process by which economic research is conducted, from theoretical model-building to empirical testing to peer review. To dispel the caricature of economics as a static field clinging to abstract mathematical models detached from reality, Tirole explains how economics has, in fact, substantially expanded the range of human preferences and motivations that it encompasses. For example, moving beyond the basic assumption of the individual as homo economicus, economists have studied how preferences for things like altruism can be incorporated into economic models, which in turn provides a deeper understanding of many real-world phenomena. For example, paying a fee to blood donors could decrease, rather than increase, donations. Why? Because when donors are paid, donation loses its value as a signal of virtue. Given that many people have preferences for appearing virtuous to others (or themselves), they could be less inclined to donate blood after its virtue-signaling value has been diminished by the introduction of payments for donations.[6]

Having established that economics has something useful to contribute, Tirole sets forth a set of principles that should guide economists' participation in public policy debates. While this section may seem to be aimed at his fellow economists, it also helps the general public evaluate which economists they should trust: an economist worth listening to is one who has expertise in the area under discussion, makes economic judgments, not political pronouncements, and

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3 *Id.* at 19.

4 *Id.* at 40 (footnote omitted). Economists generally are in favor of understanding the tradeoffs involved when making a decision. Which route is chosen ultimately may be a political decision that incorporates factors such as notions of morality, but this decision will be better informed if the tradeoffs are known.

5 *Id.* at 481.

6 Roland Benabou & Jean Tirole, *Incentives and Prosocial Behavior*, 96 AM. ECON. REV. 1652 (2006).

exhibits humility in acknowledging limitations on the state of economic knowledge and uncertainties in the analysis. Some of these principles are also applicable to economists who serve as expert witnesses in antitrust proceedings. For example, Tirole suggests that economists should never make a statement in a public policy setting that they would not also make in a seminar in front of other economists. This echoes the Supreme Court's statement in *Kumho Tire* that an expert should "employ[] in the courtroom the same level of intellectual rigor that characterizes the practice of an expert in the relevant field."[7]

Tirole views the current institutions for policy-making in Europe and the United States as problematic, with politicians driven to avoid grappling with hard solutions by their incentives to be reelected. Instead, they adopt feel-good, but ineffective (and sometimes even counterproductive) policies. He favors making elected officials responsible only for setting high-level principles, with relatively independent administrative agencies being responsible for implementing detailed policies in line with those high-level principles.[8] Such agencies can be staffed with experts capable of performing the serious analysis and thinking that is necessary to produce sound policy. Being independent, they would not be subject to the same political pressures as elected officials. Tirole points to competition authorities as exemplars of the independent expert agency. However, it is unlikely this approach would win over the populists whom Tirole wishes to persuade, given their suspicions concerning "experts" and fears that independent agencies take on a life of their own (e.g., "the deep state").

In trying to further the common good, should we count on the market or the state? Tirole answers forcefully that both are necessary and that indeed, they are complementary in the sense that each serves as a remedy for the other's limitations. With their decentralized nature, markets excel at producing outcomes that reflect the information held by market participants. States that have attempted to take over decision-making for firms or industries generally have failed spectacularly—the former Soviet Union, China under Mao, Cuba, and, most recently, Venezuela are powerful examples. On the other hand, markets are subject to certain failures, such as externalities (e.g., pollution) and internalities (e.g., cognitive biases of consumers). Tirole argues that it is the role of the state to correct such failures, for example, by using tradeable emissions permits in the case of pollution externalities. He emphasizes that state interventions in the market should recognize the state's informational limitations as compared to market participants. Thus, tradeable emissions permits are preferred to state-imposed industry-by-industry caps on emissions because, with the former, the market sorts out which firms have the highest marginal value of being able to pollute, something the government would be unlikely to do well given its limited information. Tirole notes that studies have shown that the performance of industry-by-industry emissions caps has been vastly inferior to that of tradeable permits on a cost per unit of emission reduction basis.

A difficult question is defining what we mean by the "common good." Tirole notes that it is ultimately a value judgment, rather than one based on economics, and a judgment on which people may differ. He suggests that reaching agreement on a definition may be easier if our contemplation takes place behind a Rawlsian "veil of ignorance," i.e., in a hypothetical state that exists

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7 Kumho Tire Co. v. Carmichael, 119 S. Ct. 1167 1176 (1999).

8 James Madison's argument for a republican form of government, rather than direct democracy, runs along similar lines. THE FEDERALIST No. 10 (Madison).

before we know how abilities, endowments, etc. will be allocated across people.[9] For example, behind the veil, prior to knowing either how much pollution we each will create or how much we each will suffer at the expense of others' pollution, it may be easier to agree on the idea that the common good should require a polluter to pay for the externality it creates. Similarly, the concept of social insurance may be easier to agree to behind the veil, when each person may yet be the recipient of bad luck (e.g., poor health), than ex post when allocations are known. Where economists come in, Tirole notes, is helping to understand what is economically feasible, given people's incentives, preferences, and the information available to them and to the state, and how to develop policies that will further the common good, once defined.

In the second half of the book, Tirole turns to important policy issues of the day. He does not always offer concrete answers, but explains how economics can help us to understand the problems better and begin thinking about solutions that will actually be effective. He starts with chapters on the "macroeconomic challenges" presented by, respectively, climate change, the labor market, the state of the European Union, and the financial crisis of 2008. He then turns to the "industrial challenge," where he addresses competition policy and industrial policy. Speaking to the populists, Tirole notes that fostering competition is important, not only for prices, efficiency, and innovation, but also to avoid corruption and "crony capitalism."

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Tirole devotes two chapters to the digital economy. He offers an excellent explanation of how digitization has been revolutionary, in particular by creating an environment that has supported development of two-sided platforms. Platforms are distinguished from traditional firms by their matching of individual buyers and sellers. On the one hand, the information available through digitization makes such matching possible; on the other hand, the vast amounts of information about potential matches would overwhelm platform users without the platform's assistance in finding a good match. A nugget the book provides that may be surprising to many non-economists is that digitization and platforms actually can lead to higher prices for some products. An example is used books. Prior to the existence of platforms to identify matches, sellers were unlikely to encounter buyers with large valuations, leading them to sell at low prices to the low valuation buyers they encountered. The platform puts them in touch with buyers who have high valuations. Of course, prior to the platforms, high valuation buyers also had trouble finding sellers with the books they wanted. So, having the platform is better not only for sellers, but also for buyers—despite the higher prices.

Tirole explains why competition policy for platforms can be tricky—for example, low prices on one side of the market may be a poor indicator of predatory pricing by the platform because the low prices may be designed to build users on one side of the market, which will ultimately result in more users on the other side of the market and therefore the ability to charge high prices on the other side. He also notes competition issues that arise in the platform context, such as an incumbent platform tying a complementary product to the platform to deter entry of a supplier that might start with the complementary product that interacts with the incumbent's platform and later use this product as a springboard to introduce a competing platform.

Tirole also offers chapters on intellectual property, explaining, among other things, how to design patent pools to solve the royalty stacking problem while avoiding anticompetitive coordinated interaction, and regulation. Changes in the way natural monopolies are regulated around the world has been a significant success story for economics, and one in which Tirole was cen-

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[9] John Rawls, A Theory of Justice (1971).

trally involved.[10] For example, Tirole (with frequent collaborator Jean-Jacques Laffont) showed that an effective way to regulate a firm with multiple products is to impose a cap on the average price of the firm's products, but then let the firm, which has better information than the regulator, choose a structure of prices subject to the cap.[11] The firm will have the incentive to choose prices for the products that satisfy Ramsey pricing, i.e., the price of each product will be proportional to the inverse of its demand elasticity, which is efficient. Price caps in general also provide strong incentives for the firm to reduce its costs.

Economics for the Common Good achieves Tirole's goals of showing non-economists what economics can do and pointing ways forward on the serious policy dilemmas facing the world. Perhaps equally important is that a certain decency and sincerity pervade the book. One is left with the thought that if policies were designed and implemented by an army of Tiroles, we would see dramatic improvements in economic outcomes and the common good. Unfortunately, it seems that decency and sincerity are on the wane. Will *Economics for the Common Good* fall on deaf ears? Or will we see a movement back towards decency: keeping an open mind, assuming others have honorable intentions until proven otherwise, and engaging in honest debate? If the latter, *Economics for the Common Good* provides a roadmap for how, together, we can move the world to a better place for people of all political stripes. ●

[10] *See, e.g.*, JEAN-JACQUES LAFFONT & JEAN TIROLE, COMPETITION IN TELECOMMUNICATIONS (2000); JEAN-JACQUES LAFFONT & JEAN TIROLE, A THEORY OF INCENTIVES IN REGULATION AND PROCUREMENT (1993).

[11] LAFFONT & TIROLE, COMPETITION IN TELECOMMUNICATIONS, *supra* note 10, at 66–73.