Integrating Sex and Drugs into the Principles Course: Market-Failures Versus Failures-of-Market Outcomes

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Abstract: The author's central argument in this article is that the current micro principles course is structured around an approach to policy that avoids many of the controversial but central issues of policy. These include (1) the interplay of moral issues and efficiency, (2) questions of consumer sovereignty, and (3) questions of the interrelation between measures of efficiency and income distribution. The current market-failure organizing framework of microeconomics principles textbooks excludes discussion of a broader set of failures of market outcomes: situations in which the market is doing everything it is supposed to be doing, but society is still unhappy with the result. The author suggests a dual market-failure and failure-of-market-outcome policy framework that encourages discussion of these broader issues.

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The introductory economics course has become an institution, propagated by a set of textbooks that determine the course structure. These textbooks reflect the desires of reviewers who must teach the course, and these desires generally reflect the structure of existing textbooks. This situation makes any change in the textbooks gradual and generally leaves the basic structure almost unchangeable. The overall structure has developed for a variety of reasons: pedagogical simplicity, need to fit in current issues, and a consensus of what elements of economics are best taught to principles students. Changes in theoretical viewpoints that show up in graduate schools enter into the principles course only with a long time lag.

My central argument in this article is that the current micro principles course is structured around an approach to policy that avoids many of the controversial but central issues of policy. These include (1) the interplay of moral issues and efficiency—that is where sex comes in, (2) questions of consumer sovereignty—that is where drugs come in, and (3) questions of the interrelation between measures of efficiency and income distribution—that is where technical issues are raised about drawing policy implications from our standard allo-

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cation theory. I argue that all three of these issues should have greater prominence in the standard micro principles course than they currently do. The reason is twofold: (1) discussing them makes the course more interesting to students and (2) discussing them is necessary to relate economic thinking to real-world policy debates.

More generally, my argument is that the current policy-organizing framework of principles of microeconomics textbooks—what I call the market-failure framework—excludes discussion of a broader set of failures-of-market outcomes: failures in which the market is doing everything it is supposed to be doing, but society is still unhappy with the result. By not addressing these issues, we open ourselves up to the complaint that we are unfairly advocating market solutions by not addressing issues where markets do not solve society's problems in a way that is acceptable to most people. In this article, I suggest a dual market-failure and failure-of-market-outcome policy framework. I argue that this dual framework provides students with a more useful policy framework than does the market-failure framework alone.[1]

I begin with a story included in my principles textbook (Colander 2001a) that raises a failure-of-market-outcome issue. It is a story about Lady Astor and Winston Churchill.[2] Churchill asks Lady Astor if she would sleep with him for one million dollars. They know each other quite well, and she contemplates the offer as part of a broader intellectual game they played. After some thought, she responds, "Yes, if the payment could be guaranteed." To which he replies, "Would you sleep with me for $1?" To which she replies, "Of course not, what do you think I am, a whore?" He responds triumphantly, "We've already established that; now we're simply negotiating about price."

Even though reviewers generally liked this story, my publishers were concerned about including it in my principles book because they felt it might hurt sales with religious schools and with feminists. They strongly urged me to remove it. In this case, I resisted, and it was included, but in the majority of cases, the publishers win out, and textbooks avoid offending anyone.

I clearly have no desire to reduce sales or to alienate the religious right or feminists. I wanted to include this story because I believed it raised important questions about applying economic reasoning to policy issues that are usually avoided in economic textbooks. Specifically, I wanted to raise such questions as the following: How should policy makers deal with the tradeoff between moral issues and efficiency? Is that tradeoff lexicographic or so incomparable that the tradeoffs are considered only outside the range of feasible prices? These are messy questions, but they are questions that should be raised in a policy-oriented principles course that deals meaningfully with actual policy issues.

If we do not deal with such issues, we fail two different types of students. We lose the interest of the thoughtful students who recognize these issues and want some guidance in how they can be integrated into their policy thinking; these thoughtful students drop out of economics and go into ecology, philosophy, or sociology. We make our less thoughtful students think that policy is easier than it is. They come out of the course thinking that policy is an easy task if only people listened to economists and understood economic theory.

Let me be clear about what I am proposing. In my role as a teacher, I do not know, and do not care, what positions my students take on such moral questions. But I do want students to think seriously about such issues and to understand that policy issues must be decided within a broader moral framework. To do that, we do not need to spend a lot of time discussing such issues. We simply need to create a policy framework that acknowledges their importance. One way that I have found to do so in my classes is to devote some discussion to policy views of heterodox economists such as libertarians and Marxists. Translating their views into textbookese means that their ideas are forced into a simplicity that belies the subtleties of their positions but which are testable (i.e., they can be made into test questions) and which are easy to remember: Libertarians tend to believe that most everything should be saleable; Marxists tend to believe that almost nothing should be saleable. Marxists view the labor market as a type of temporary slavery; libertarians believe that if consenting adults want to sell something, it is immoral for the government to say they can not.

I do not agree with either of these moral positions, but they are logical and reasonable positions for an economist to hold. I want students to understand that and to understand that before we can talk about policy, we must decide on our moral stance on such issues.

The argument I am making is not novel. Good economists of all political persuasions recognize that the policy choices they make involve broader issues than are allowed within our current market-failure framework. The current framework of principles textbooks encourages professors to avoid these issues; they are presented as side, not core, issues. Textbooks accomplish this by selectively choosing examples and focusing on those policies that are consistent with the conventional moral view, which means that the moral issues do not show up in the discussion. Conventional policy proposals do not highlight the moral issues in the same way that more unconventional policy views do because they are based on policy compromises that do not push moral buttons for a majority of the population. Good politicians carefully avoid policies that push the boundaries of conventional morality. In my view, good teachers should follow an opposite approach. They should focus on policies that push the boundaries, because it is by pushing the boundaries that students develop a deeper understanding of issues.

When the discussion concerns less conventional policy issues—a radical animal rights advocate's or an ultra-property rights advocate's view of environmental issues—the market-failure framework is no longer sufficient. That is why I spend a lot more time than most economists talking about unconventional policy proposals. By highlighting the extremes, students become better able to deal with the shades of moral gray that actually characterize most policy issues.

THE DUAL-POLICY FRAMEWORK

Let me briefly summarize what I see as the market-failure policy framework that structures micro courses. Instructors present supply/demand analysis, social and private costs, opportunity costs, and externalities and drill students on their understanding of how policy can correct externalities, thereby equating marginal social costs with marginal private costs. That framework is excellent for shedding light on many economic policy problems where broader issues are of secondary importance, but it is not useful for shedding light on policy problems where moral issues, psychological issues, and distributional foundations of efficiency issues enter in. Because these three issues are important for many policy issues but do not fit the current framework, I propose a dual-policy framework that includes the standard market failure but also includes a broader category that includes the possibility of failures-of-market outcomes.

The dual-policy framework provides a much broader framework for discussing economic policy. For example, if you believe that markets are morally wrong, then the correct social policy is not to allow markets. In the market-failure framework, there is no room for morally questioning markets. If you believe that people do not make choices in their own interest, then you may need policy to direct people to make choices in their interest. That, too, does not fit in the market-failure approach. If you do not believe that the existing income distribution is in some sense fair, or that tastes are relatively homothetic, then market prices in the absence of externalities do not necessarily represent socially desirable outcomes.

In my proposed dual framework, there are two types of justifications of intervention in the market: the traditional market-failure and failure-of-market outcomes. With a failure-of-market outcome, the market is doing precisely what it is supposed to be doing—supply equals demand—and there are no externalities. The market outcome is nonetheless seen as undesirable by society. In the dual framework, society must determine its moral stance on issues before policy positions can be arrived at, something our current failure-of-market-outcome framework does not require.

I believe that three issues—moral issues, psychological failures, and income distribution/efficiency problems—belong in the broader policy framework.

Moral Issues

In the introductory section of my principles textbook, I raise a number of moral issues such as the selling of babies and human eggs, as well as the Lady Astor story. They always provoke student interest and involvement in the class. I can do this in the beginning because there I am talking more broadly about economic policy and have not yet developed the formal framework. Presenting such issues becomes more difficult when I get into the formal presentation of micro, because such issues do not fit into the market-failure framework. Once I have developed that framework, I can not raise such issues without undermining it. Where is the market failure in selling babies? You have a willing buyer, a willing seller, and a clear case of comparative advantage. It is more "efficient"—in the normal way we interpret efficiency—for individuals to specialize—baby producers and baby consumers. Yet, most people would oppose such efficient solutions. The same argument holds for indentured servitude, prostitution and the selling of body parts.

Textbook authors generally avoid discussing the problem that such issues pose for the market-failure framework. They stick to issues such as smoke pollution that, for many, do not raise the moral flags that the above issues do. Even here there is a problem; the reality is that a large percentage of the population believes that pollution has a moral dimension—that it is morally wrong to pollute and that it is morally wrong not to recycle. The typical author of principles textbooks, generally implicitly, dismisses such moral arguments in discussions of the policy solutions it presents and argues that efficiency should rule. Because the total pollution will be less if society introduces pollution permits or regulates pollution with taxes, these solutions are preferable to outright bans or other alternative solutions. Market-based solutions leave individuals free to choose the amount of pollution they will generate, as long as they internalize the cost of that pollution. The implicit presumption of the textbook authors is that moral issues should not enter into discussions of pollution. They suggest that to not accept the efficient solution is to impose your own normative view on the issue, whereas the economic solution avoids making any moral judgment and hence avoids imposing its normative views.

That position, in my view, is a clear misunderstanding of how normative issues fit into policy and is a violation of the normative neutrality that economic policy tries to maintain. It is not for economists to say whether moral issues should enter into the solution; the economist's job is to provide a framework within which economic issues and normative issues can be considered.[3] Baumol (1982, 1006) nicely captured this sentiment when he commented that

> as a profession committed to the position that we should not tell people what they ought to want, and that the utility functions, which we usually accept as given data, are what would enter the social maximand, it ill behooves us to reject such beliefs out of hand. If people feel that putting a price on something demeans it, then we cannot tell them that it should not. In positive economics we simply accept their views.

His point, which I agree with, is that if individuals believe that there is a moral dimension to pollution, it is not for economists to tell them they are wrong. Our job is to figure out policies that best achieve their desired goals, given the moral preferences of society.

One can bring up many examples to get students thinking about these issues. A nice one is the giving of gifts for Christmas. Using the standard economic policy framework, Christmas is inefficient. This follows because people are receiving gifts that were chosen by someone else, and hence people are unlikely to receive what they would have chosen. The result: dead weight loss of 20 percent or so of the value of the gifts (Waldfogel 1993). Economists who have looked at the issue have concluded that giving money would be much more efficient. It would, but would it be a better outcome? Would we really be better off without Christmas? Most people believe that the answer is no; they believe that Christmas should be judged on criteria that go beyond the standard economic interpretation of efficiency.

Examples can be expanded widely, but the point is that moral elements and the methods of allocation—gift or market—play an important role in people's judgments of the value of goods. Hence they need to be considered carefully in any policy discussion.

Psychological Failures

A second cause of failure of market outcome is psychological failures. The example I use in my book is of Joe Drunk, who is an alcoholic. He is addicted to alcohol and spends all his money on booze. He is unhappy, but he is freely making choices. The standard framework says to put restrictions on his ability to buy booze decreases efficiency. And it does, as long as one accepts that he is doing what is in his best interest. But is that a reasonable assumption? Is he doing what he really wants to do?[4]

Similar issues arise with smoking, eating chocolate, or any of the other infinite major or minor vices that we all have. If there are psychological failures, it is possible that a person will be better off if his choices are reduced. A large percentage of the population believes that individuals do not always do what is in their best interest; and it is not for economists to tell them that that view is wrong. We can show them through experiments, but when we have done experiments, we find that people often act in ways that violate our rationality assumptions.

The possibility of psychological failures means that we must consider the possibility of endogenous tastes in our discussion of policy. The reality is that people's tastes are not fully exogenous; they are partially endogenous, and with endogenous tastes, all bets are off as to what policy is the best policy. How do I know that tastes are endogenous? The market tells me so. When I see firms spending billions of dollars on ads to change people's tastes, I have a clear indication that tastes are endogenous. Marketing campaigns such as "Wassup," "The power of Cola," and "Just do it" have become central elements of our culture.

Endogenous tastes undermine the efficiency argument in favor of markets. Businesses are not fulfilling given wants but are creating wants and then filling those created wants. Now we economists know the difficulty that dealing with this issue raises—who is to say what people want if we do not accept their revealed preference? But do the textbooks discuss that? No. They avoid the issue, and in doing so, do not give students a framework for thinking about the policy issues that might follow if we decide that tastes are not fully exogenous.

The point is that there are a set of policies that follow from semi-endogenous tastes—sin taxes, such as the recent tax on smoking, and policies that supercede those of the market—and encourage the consumption of merit goods and discourage the consumption of demerit goods. To talk about such policies meaningfully, we need to specify those goods where tastes reflect basic needs (primitives), and those goods where tastes are more socially constructed. Only having done so can we talk about policy.

There are a range of policy issues currently being discussed that fit under the psychological problem heading—taxes on cigarettes, subsidies of the arts, positional or conspicuous consumption, and luxury goods. Students are thinking about such issues and the principles textbooks should provide a framework for dealing with them.

I am not arguing that justifications based on psychological problems are correct. I am an economist and share with most economists a strong belief in consumer sovereignty—that is why I have argued that we have to consider people's moral beliefs carefully. I believe that in our teaching we should be neutral in our presentation of policy and not let our views shape the way we present issues to students. There are legitimate arguments about consumer sovereignty that need to be discussed when discussing policy options. These arguments do not fit into the market-failure framework. Frank's (2000) positional goods (and Veblen's earlier conspicuous consumption goods) offer the possibility of a twofer—a tax that improves people's welfare without reducing someone else's welfare. Such win-win policies are impossible with standard economic assumptions but can be found in a variety of places when psychological problems are considered. As demonstrated in the work of economists such as Frank, modern micro is considering such issues. I argue that we need a textbook policy framework that allows such issues to be presented as legitimate.

Income Distribution/Efficiency Problems

I have saved distribution/efficiency problems for last because they are the subtlest type of failure-of-market outcome with which economics must deal. We all know how we handle income distribution problems within standard welfare theory—we assume that costless lump sum transfers and homothetic preferences exist. So much for income distribution problems. The former means that we have a policy tool that solves the problem, and the later eliminates the preference problem for efficiency when the market does not solve the distribution problem. We also know that such assumptions do not fit reality, and that distribution is a central policy issue in many policy discussions. Most authors of principles books discuss such issues, but most do not discuss the implications of an existing undesirable income distribution for measures of efficiency.

The market summation of preferences that the market builds into decisions of what to produce, and into the social surplus measures we teach students, weights the importance of preferences of various individuals by the existing income distribution. Alternative income distributions could lead to a quite different set of social preferences, and the efficient result, which the market leads to given the existing income distribution, could be one we abhor. Consider the following example from my textbook concerning the demand for the AIDS drug cocktail. That cocktail can stop AIDS from killing people; thus the desire for the AIDS cocktail among individuals with AIDS is high. The desire for the drug among those without AIDS is minimal.

In some African countries, 30 percent of the population has AIDS. Because consumer surplus reflects desire, a student might think that in Africa the consumer surplus from the desire for the AIDS drug cocktail would be enormous. But it is not. Most people in Africa have relatively little income; they cannot afford the cocktail. In fact, for a large majority of them, because the price of the cocktail is above their total income they get no consumer surplus from the cocktail at all. In our current textbook supply/demand market-failure framework, it would be inefficient to supply it to them. In the supply/demand framework, one can have a demand for a good only if one has the desire *and the income* to pay for it. Most textbooks do not make the argument in favor of such an efficient solution in medicinal drugs because the result would be unacceptable to most students and teachers. In not making it, they miss the opportunity to show students the more general limitations of a policy that focuses on efficiency and on policies designed to maximize consumer surplus.

Notice that the problem here is that according to most people's social welfare function, income is not acceptably distributed, and preferences are nonhomothetic. In such a case, market prices do not reflect social values, even when there are no externalities. The issue is not a market failure—the market is doing precisely what it is supposed to be doing; the problem is a failure of market outcome. Most people do not like the market result.

THE DUAL-POLICY FRAMEWORK AND PEDAGOGY

None of these issues are deep insights of mine; they are well known and many professors present them in their classes in various ways. My point only concerns pedagogy; it is that our current textbook policy framework does not make the presentation of these issues easy. They must be presented as outliers, and as outliers they are usually given little coverage. In a dual-policy framework, it will be much easier to introduce these issues. Goods and issues can be arranged along a spectrum of the three issues that they raise. Goods that raise few such issues fit nicely within our market-failure framework. Goods that do not must be dealt within the broader failure-of-market-outcome framework.

I am not suggesting enormous changes in the way we teach micro principles. Essentially, what I am suggesting is the addition of one lecture on failures-of-market outcomes, with examples of each type, and a recognition of such issues in other discussions. In my principles textbook, I have devoted five pages to it. In my class, as a class exercise, I have the students classify policies that raise significant moral issues and those that do not and, in doing so, get them thinking about these broader issues.

I want to be clear about what I am proposing by emphasizing two points. First, I am not saying that we should spend lots of time discussing these broader issues—we have neither the expertise nor the time to do so. What I am saying is that the policy framework we present to students should be broad enough to let them know that all policy answers do not come from economic theory alone. My suggested dual-policy framework does that. Second, I am not saying that more government intervention is good. To make such decisions one must discuss government failure and failures-of-government outcomes. If one believes such government failures are major, then little intervention is called for even if failures of market outcomes exist. But the justification for nonintervention is government failure, not the fact that the markets automatically lead to desirable results. It is a choice between undesirable alternatives, and government intervention may lead to even worse results than the market. In this argument, public choice moves front and center into the policy debate, which is where I think it should be.

HOW WE GOT TO WHERE WE ARE

In an attempt to understand how economists came about teaching the way they do, I have been studying the evolution of welfare economics. As economists struggled with moral issues and distinctions between normative and positive issues, they started focusing on a subset of issues where they felt that economics could shed some light on the problems. The focus of microeconomics was narrowed to allocation theory. If one goes back to classical economics one will see such broad issues discussed. Adam Smith set the framework for the *Wealth of Nations* with his *Theory of Moral Sentiments*, and Mill structured his policy discussions within a much broader discussion of morality. But moral issues are fuzzy, and as economists attempted to avoid the fuzziness and formalize welfare theory, they limited the domain of the field. Initially they did so with appropriate caveats about how the domain was being narrowed. Good policy economists understand these caveats well. Somehow in the pedagogical presentation of policy issues to students, the pressure of teaching the technical issues pushed aside these broader caveats—and the micro presentation came to focus on teaching students an allocation framework where those issues are not discussed.

Initially, that focus worked, because it was taught as a technical constrained-optimization issue and was not related significantly to policy. Over the years, there were calls for relevance and policy applications, which textbook authors tried to follow. The authors focused less and less on technique and more and more on policy. As they did so, the problem developed because they were forced to fit policy into a narrower framework than it could be fit into.

If we were teaching only a technical constrained optimization course and were not teaching a policy-oriented course, this would present no problem. The cost-benefit framework is an extraordinarily powerful tool, which I strongly believe all students can usefully learn. I want every student to know that there is no such thing as a free lunch; that there is a cost for everything and that constrained optimization is a useful framework within which to think of issues.

Market pressures force textbook authors to do more than that—students want policy relevance, so professors and textbook writers are continually applying the tools to policy issues. Herein comes the problem: A large number of policy problems are not market-failure problems—they are policy problems that include some degree of failures-of-market outcomes. One cannot adequately relate the tools to the policy unless one acknowledges these broader dimensions of policy.

CONCLUSION

Goethe said that all theory is gray; to that can be added that all policy is even grayer. Policy issues are seldom easy or clear cut. To present them as such is to do an injustice to one side or another. If we are going to teach policy issues in principles, and I think we should, we should do it within a framework that is open to issues that the population thinks are important. Only by engaging those issues and placing economic policy discussions within a framework that allows them, can we provide students with a framework that can actually deal with policy issues, rather than with a subset of issues. We should make the economics we teach as simple as possible but not more simple than it actually is.

I make this argument both for those professors who believe deeply in the market and those who are highly skeptical. If one's goal is to indoctrinate students with the view that markets are generally good, then the dual-policy framework will not be useful. But if one's goal is to show economists' reasoning about markets and place that reasoning in a context where students can make their own decisions about what issues should go within the market, and which should not, then it is a preferable framework. I strongly believe that the purpose of the principles course is not to indoctrinate students into believing in the market; the purpose is rather to teach them about the benefits and costs of markets.

The dual-policy framework allows us to discuss policy issues that present conundrums that are not fully worked out. Doing so helps grasp students' attention and creates a passion for economics. It gives them puzzles to think about—where do markets work, and where do they not. The current framework concentrates on structuring examples in principles that emphasize cases where markets work, which gives the skeptical student a sense that we are stacking the deck. The dual-policy framework gives students an unstacked deck and, by doing so, gives them a better sense of both the strengths and weaknesses of markets.

NOTES

1. The issue is the textbook framework, not what teachers actually do. Many principles teachers already incorporate these issues within their courses.
2. This story has been attributed to a variety of others as well.
3. I have discussed such issues in Colander (2001b).
4. See Schelling (1999) for an insightful discussion of such issues.

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