Better Living Through Economics

edited by
John Siegfried,
Vanderbilt University
1. Economic research has had a profound effect on our way of life and material well-being, affecting income and wealth, as well as mortality, health, happiness, and welfare.

2. The products of economics research are not widely recognized.

- Expectations are so high for an unfettered economy that reality is almost always interpreted as failure
- Most economic research produces public rather than private goods
- Patents and the history of science do not include economics
- Process of moving from innovative economic science to human welfare improvements via policy change is largely a mystery
# Book documents economic research successes in 12 case studies

<table>
<thead>
<tr>
<th>Case Study</th>
<th>Author(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tradable pollution permits</td>
<td>Tom Tietenberg</td>
</tr>
<tr>
<td>Price index reform</td>
<td>Michael Boskin</td>
</tr>
<tr>
<td>Antitrust reform (entry considerations)</td>
<td>Lawrence White</td>
</tr>
<tr>
<td><strong>Matching physicians and students</strong></td>
<td>Al Roth</td>
</tr>
<tr>
<td>Spectrum auction design</td>
<td>Preston McAfee, John McMillan, Simon Wilkie</td>
</tr>
<tr>
<td>Airline deregulation</td>
<td>Elizabeth Bailey</td>
</tr>
<tr>
<td>Welfare to work reform</td>
<td>Rebecca Blank</td>
</tr>
<tr>
<td>Earned Income Tax Credit</td>
<td>Robert Moffitt</td>
</tr>
<tr>
<td>Trade liberalization</td>
<td>Anne Krueger</td>
</tr>
<tr>
<td><strong>Saving for retirement</strong></td>
<td>David Laibson, Brigette Madrian, John Beshears, James Choi, Brian Weller</td>
</tr>
<tr>
<td>Monetary policy</td>
<td>John Taylor</td>
</tr>
<tr>
<td><strong>Voluntary military force</strong></td>
<td>Jim Miller, John Warner, Beth Asch</td>
</tr>
</tbody>
</table>
Main issue:

• Question in early 1970s: could the airline price and entry regulation of the 1930s be replaced by competition, to create better service at lower prices for both passengers and cargo shippers?
Key research insights:

- Richard Caves (1962) found no evidence of economies of scale in airline systems, undermining “natural monopoly” as a basis for regulation.

- Michael Levine (1965) and William Jordan (1970) showed that unregulated intrastate air passenger fares were lower by half than comparable regulated interstate fares. The carrier (PSA) was profitable.

- George Douglas and Jim Miller (1974) developed a model of airline competition, showing that price regulation without flight frequency controls led to too many flights and load factors that were too low. Customers might prefer lower quality service but with much lower prices.

- Contestability theory (Baumol, Bailey, Panzar, Willig) argued the threat of entry keeps fares low even if actual concentration is high. The carriers have lower sunk costs.
In 1975, Stephen Breyer (on-leave from Harvard, now Supreme Court Justice) organized hearings held by Senator Kennedy, asking whether prices were too high.

Hearings focused on the price differential between the LA to SF route and a comparable Boston to Washington route used by Senator Kennedy flown on the same aircraft. The former was unregulated, as it was intrastate; the latter was regulated. Average fare on the former: $18.75; average fare on the latter: $41.67.

Reform became bi-partisan. Ford Administration CEA chair Alan Greenspan argued forcefully for deregulation in 1975 and 1976.
• Existing regulation often granted duopoly authority over routes, and price setting control by duopolists. Because there was no control over flight frequency, if price was set above costs, flight frequency increased until load factors declined enough to extinguish all profits. Airlines made no money, planes were half full, service was good and prices were twice what they might have been. Douglas and Miller (1974).

• Charismatic economist Fred Kahn chaired CAB in 1977. He added economist Elizabeth Bailey as a Commissioner. Economists Michael Levine and Darius Gaskins were senior staff.

• Cargo deregulated in 1977 because no flight attendants union or passenger groups were afraid of losing jobs or service. Cargo carriers’ stock prices rose, ending passenger carrier opposition.

• CAB provided two experiments: allow discounted fares for up to 35% of capacity, and allow entry to underserved airports like Newark, Baltimore, Midway in Chicago, San Jose. Fares dropped; service expanded.

• Passenger air service was deregulated in October 1978; the CAB disappeared in 1985. Fares are about 30 percent lower than what they would have been under regulation. Consumer welfare gain estimate: $28 billion per year.

• Success of Southwest served as catalyst. Today fares are 40% lower where Southwest is likely entrant (where it is already at one end of a point-to-point route).
The All-Volunteer Military

Main idea:

- **Efficiency:** A conscripted soldier’s military pay does not reflect his or her opportunity cost because the occupation was not chosen voluntarily. A voluntary force, while costing more compensation to attract volunteers, costs less in real terms because it attracts people with lower opportunity costs than conscripts.

- **Fairness:** Because pay must rise to attract volunteers, those who serve do not incur economic losses just because of bad luck to be drafted. Others pay higher taxes to compensate the volunteers, taxes that recognize the opportunity costs of soldiers.
Key economic insights:

1. Opportunity cost of a volunteer force is less than opportunity cost of a conscripted force.
2. A volunteer force eliminates the costs of avoiding conscription.
3. A voluntary force has lower turnover, and lower training costs. Eliminating some training initially saved 6 percent of total force.
4. The change in relative input costs encourages substitution of capital for labor, especially capital requiring fewer operators and less maintenance, which in the long run saves lives.
5. Economic burden of a voluntary force is shared more fairly ex post.
6. The explicit cost of the military rises, discouraging military adventurism abroad (analyses by Tollison, Wagner, 1972)
Controversy over the war in Viet Nam was a catalyst. An economist working at Department of Defense in 1964, Walter Oi, first described the feasibility of a volunteer force in publications (1967).


Martin Anderson, an economist at Columbia, suggested ending the draft to the 1968 Nixon presidential campaign. Impressed by arguments, Nixon advocated ending the draft in an October 17, 1968 campaign speech.
• Once elected, Nixon established the President’s Commission on an All-Volunteer Armed Force. Milton Friedman, who advocated a volunteer military in *Capitalism and Freedom*, Allen Wallis, economist and president of University of Rochester, and Alan Greenspan were members. Economists William Meckling, Walter Oi and Robert Barro were staff.

• In November 1970 the Commission recommended abolishing the draft, increasing military pay, and improving living conditions.

• In 1971 Nixon sent bill to Congress, which held hearings. *Walter Oi’s testimony was persuasive.* “His candor, knowledge, and willingness to challenge DOD’s data about the negative consequences of a volunteer force undoubtedly helped Committee members feel more comfortable with an all-volunteer approach” (John Ford, staff director of House Armed Services Committee at the time, 2004).

• The Committee voted to extend the draft two years, then switch to a volunteer force. The bill passed Congress, was signed in September 1971, and the volunteer military commenced in 1973.
Main idea:

- Traditional American welfare programs administered by states with federal funding assistance focused on single mothers, who received a grant that declined as earnings increased, creating an incentive for welfare recipients not to work. This affected their experience and lifetime earnings.

- Reducing the tax rate on earnings, and requiring labor force participation for eligibility were expected to reduce welfare rolls enough that the cost of the programs would decline, even though working mothers’ benefits increased.
Key economic insights:

- If workers retain a greater portion of their compensation after taxes, they will work more.

- The catalyst for reform was state-level random assignment experiments which produced compelling evidence supporting the hypotheses.
1994 U.S. election led to a conservative Congress, concerned with welfare payments to single mothers not in the labor force, and fatherless families. President Clinton and many Democratic state governors shared these views, creating opportunity for change. Governors saw reform as a way to reduce state spending.

Some states experimented with welfare-to-work programs in the 1980s. Economists conducted randomized assignment experiments. They showed that welfare-to-work programs reduce welfare use and increase work.

The Personal Responsibility and Work Opportunities Act (welfare reform legislation) passed in August 1996. It left design of welfare programs to states, but required states to move a significant share of welfare recipients into work.

Many states imposed reduced benefits or loss of eligibility on recipients who did not participate in welfare-to-work programs. Many reduced the benefit reduction rate, the “tax rate” on earnings.
Figure 2.