

Incentive Economics

John H. Cochrane*

Hoover Institution at Stanford University
United States of America

Abstract

Focusing on incentives rather than distribution solves knotty economic policy problems, offering a radical improvement of our economic life and a way out of left-right debates. However many issues require a Marie Kondo–style cleanup of our legal and regulatory systems, which have grown up in a sequence of patches for unintended consequences. Implementing incentive-based reforms in a democracy requires spreading the ideas of freedom, not trying to get a politician’s ear. We should not tailor advice to amateur ideas of what is politically popular or feasible, and instead speak simple truths clearly and patiently.

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I am deeply honored to receive this award, especially given who it is named after. As a writer, I never know if people read and appreciate what I have to say. You have given me much encouragement.

Why is what I do, what you do, and what the Association of Private Enterprise Education promotes so important?

I am not quite sure what to call us. Private enterprise? Free market? Libertarian? Classical liberal? Or just liberal? As the Left has started to use *progressive*, they are giving us a good word back, which I am happy to see more and more used.

Each is good, but each has some unfortunate connotations to the untrained ear. I am starting to call what I do *incentive economics*. Fundamentally, we want a society and government that are organized to provide the right incentives. Private enterprise and free markets

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are means to that end. And fixing incentives matters even in purely public and nonmarket affairs such as taxes and social programs.

We are not just another ism in the smorgasbord of political philosophies. We are unique. We deserve our claim to a privileged space above “my truth” versus “your truth.” Why? Because we have, and advocate, cause-and-effect understanding of how public policy works.

Consider rent control, a softball in this crowd. The Left and Right argue about what is fair and who deserves to be paid what. We say, if you put in rent control, landlords will stop keeping up apartments. Developers will not build apartments. Current renters who do not want to move will benefit temporarily. But people who want to move, especially the most unfortunate and those seeking opportunity, will be hurt. Business will suffer, as new employees will not be able to find housing. Rent control is indeed the surest way to destroy a city short of bombing.

This is an objective, scientific truth. I did not say what the government should do. I just said *if* you pass rent control, here is what will happen. It is not a philosophy, an ethical judgment, a moral stance. To the extent that it is a theory, that theory organizes long, hard, painful, and sometimes bloody historical experience.

This sort of analysis can unite Left and Right. Left and Right in the US do not actually differ that much on stated goals. To the extent they still might disagree after a rational discussion about cause and effect of policies, that often is because they have not really stated the goals. Their policies tend to be the same answers in search of new questions. “Tax the rich” is always the answer; the why changes with the seasons. But cause-and-effect answers can force them to state goals and construct policies that actually might achieve their goals.

My writing applies this principle to many problems. Focus on and fix the incentives. Taxes? To raise revenue for the government with minimal economic damage, junk the current system and enact a simple consumption tax. If you do not like that answer, let us know the purpose of the tax system and we can construct policies that work to those purposes. Social programs? The main problem is not compassion versus money, “you want to throw grandma from the train” versus “you’ll bankrupt the country.” The main problem is disastrous disincentives. People often lose more than a dollar of benefits for each dollar they earn. Fix the disincentives, and we will help more people with less money. The mess of US health care and insurance? Health care and insurance can be private, fiercely

competitive, and innovative. Provide for the poor with vouchers, but do not screw up your and my health to do it. Financial bailouts? Equity-financed banking and narrow deposit taking can end private sector financial crises forever. Climate? If you must, institute a carbon tax or tradable right, instead of massive crony subsidies and vanity projects, which do not save carbon. (If I buy an electric car, that just frees up gas for you to use.) Housing? Let them build. And more. All the objections to these proposals are easy to meet.

If you state the question, and focus on incentives, a radical simplification and improvement of our economic life is possible. That offers hope to overcome creeping stagnation, which is our actual main economic problem.

Why is this so hard? We have a weakness, my fellow liberals: a tendency to go to the bar, bemoan how dumb it all is, and have another beer. If we want to make progress, we must first understand how our country got in such a mess.

Understand the two central differences between politics and economics. The first rule of economics is: do not transfer income by distorting prices. A price is a signal wrapped in an incentive. If you want to transfer income, send a check—in as lump sum a way as possible. (And quantity restrictions are even worse than distorting prices. Tariffs are not as bad as quotas, because quotas hide the size of the damage.)

The first rule of politics is: transfer income first and foremost by distorting prices! Why not just send current renter-voters a check to pay higher rent? Then all other voters would see what you are doing. (And rationing quantities is better still for hiding the subsidy and trading political support for exemptions.)

Economics is about incentives. We do not really have much to say about transfers. Our expertise, our claim to truth that applies to everyone is the analysis of incentives.

Politics is all about transfers. Government grabs resources from A and gives them to B, or it distorts markets to benefit B. Look at any discussion of taxes. The newspapers are full of who gains or loses \$100 but practically silent on incentives to work, save, invest. In many ways, managing transfers by force is the point of government.

This is all good news. In a discussion that is essentially about transfers, we can pop in, say, “Excuse me, we can all do better by fixing the incentives,” and have something genuinely different to say, rather than just jump on the partisan scales of who gets what.

As we look at a typical regulatory mess, understand too that there is a certain logic to it. Many of our issues follow the old children's rhyme: the little old lady swallows a fly, then a spider to catch the fly, a cat to catch the spider, and on we go until she swallows a horse—and dies. Of course. That is the Dodd-Frank Act, not a new idea but the horse at the end of a century-long patchwork of banking regulation. As I look at taxes, health care, finance, and many other decades-old regulatory tarpits, the lesson applies. There was one decision, one original sin, one somewhat sensible path taken—the income tax, the tax deduction for employer-provided group insurance, bailing out depositors to stop runs. The original idea worked for a while but had unintended consequences and was patched and patched over and over again. Each patch, an expansion of the regulatory state, has a certain logic given how the last one failed. But each inevitably fell apart, requiring more patches.

That insight tells you why smart people looking at the latest fiasco, but without authority or imagination to go back to the beginning and start over, can only come up with more rules that will fall apart just as inevitably. It tells you that the answer has to be a clean-slate reform.

In my list of why things got so screwed up, I de-emphasized interests. Yes, there are a lot of people who profit from the current dysfunction and are able to bend legislation and regulation their way. But if everyone understood clearly what good policy was, and just how much current policy was simply transferring money to those interests at great cost, they would have a much harder time of it. If, say, the editorial pages of the *New York Times* and *Washington Post* along with the *Wall Street Journal* decried a new industrial-policy tariff or subsidy as a brazen transfer from taxpayers to politically connected interests, rather than pass along some obfuscatory bluster about how wise it all is, it would have a much harder time being enacted.

People naturally object to grand simplifications—“that’s not politically feasible.” But the alternative will never cure the problem. I think it is a great mistake for economists to tailor their advice to what we think is politically feasible. We have very little expertise on what is politically feasible and what is not. Many economists playing political analyst get it wrong. It can change quickly. Who would have thought gay marriage politically feasible, until it happened, basically overnight? Who would have thought that Argentina would elect a radical-libertarian president? Should Milton Friedman have shut up about

school vouchers or a volunteer army because in 1955 and 1965, Congress was unlikely to pass such legislation? And great politicians are looking for big ideas. Small plans have no power to stir people's souls.

But most of all, if nobody ever sings praise of the Promised Land, if we confine ourselves to whether we should turn left or right at the next cactus, we shall surely never get to the Promised Land. Our job is exactly to describe the perfect and let the politically feasible catch up with us. Our job is to create a sphere of public discussion that routinely understands the perfect and complains about current policies as imperfect approximations to it. Our job is to have a well-thought-out program ready for the moment, perhaps in crisis, that the politically feasible knocks on the door and wants to know how to fix the mess.

Another weakness is that we are boring. Many politicians want a New Big Idea as a core of their propaganda racket, with a Big New Name. Make America Great Again. Bidenomics. National Conservatism. Anti-racism. In this propaganda cage fight, we say: remove the regulatory roadblocks in real estate permitting. No wonder we lose. "New" on the package is the first lesson of marketing. "Stimulus"—write everyone a check—makes great politics. But our national life is a hoarder's nightmare. We need a patient Marie Kondo cleanup, not stimulus. First the sock drawer, then the kitchen cabinets, and maybe next month we can look inside the garage.

We should stay boring. We should not bend to the desire for power and influence, to serve as the ideological fountain for people who strive for power. That is not the way our ideas will advance. They will find us when the time is right, as Reagan found Friedman.

Our ideas may seem old, and politics demands the fresh and new. But our ideas are better because many are old and well tested. Just because $\text{force} = \text{mass} \times \text{acceleration}$ is an idea from the 1670s does not make it any less applicable today. Just because Adam Smith and David Ricardo showed tariffs were dumb in the 1770s and 1830s does not make them smarter today. Old, well-tested ideas make a lot better policy. One of my greatest annoyances is economists who fly, typically from Boston, to Washington, with a clever new idea for Washington to spend a few trillion dollars—the same Washington that cannot get a vertical supply curve, a budget constraint, or a trade-balance identity ($\text{trade deficit} = \text{capital inflow}$) straight. Policy

should get the simple tried and true right, as boring as that might be for whiz economists.

I have emphasized incentives, efficiency, and historical experience for liberalism over political philosophy because that is where I think we have the strongest objective case. But I am, like many of you, also philosophically devoted to freedom. I would object to large lump-sum transfers. I think freedom does bring happiness, individual virtue, and a healthy society. Good fences make good neighbors. Especially the Left should understand that you cannot have personal freedom without economic freedom, because someday it just might happen that the deplorables vote you out of office and fire you or destroy your business, if they can.

Even in the philosophical realm though, I think we have a case for priority, that we are not just another ism among isms. And that is simple: the free market, liberal or classical liberal view, under constitutional order and rule of law, is the only fundamentally peaceful vision of society. It is the only one that at some point is not based on one group taking from another or forcing behavior by threat of violence. It is the only ism that is not an ism.

If communism and central planning had worked, I would still be a liberal, because philosophically I value personal and political freedom. Fortunately I do not have to make that case. Minding incentives simply works for everyone's goals, and freedom is necessary for an economy to provide the right incentives.

How will we get there?

Howling in the wilderness is not so bad. We liberals are like the Irish monks of the Middle Ages, keeping knowledge alive for when the world is ready to use it. But that does not just mean stashing a few copies of *Free to Choose* in a library where someone might find it. Knowledge has to be used, mulled over, applied, and passed on from person to person, not just written down somewhere. That is what we do.

We should, I think, pay some more attention to the grand question: how can our political system be reformed to produce economic policies more attuned to incentives? The Founders did a great job in the 1790s, but they were concerned with political equilibrium and avoiding tyranny. They did not imagine the regulatory state. If they could travel in time, they likely would be horrified and rush back to add a few clauses to the Constitution. So they did not produce a structure that results in efficient economic policy. There are lots of good ideas: we need to reinforce the system

of rights, not permissions. The process of economic law and regulation, the rules of the game, can be reformed to help Pandora, the voice of freedom and incentives, to get a word in. But this agenda could be clearer.

Many people ask me: that is great, but how do we find a leader who will listen? I think that is fundamentally the wrong question. We are a democracy, and a responsive one. Leaders do what people want them to do. Leaders lead best by giving voice and unity to those desires. I have known a lot of really smart people in power who get it totally. But they say, “John, if I do that I won’t get elected.” We do not elect kings and autocrats. Hoping for a better emperor, or whispering in the emperor’s ear, is not the answer.

Our political system does respond to the chattering classes that surround politics and to the wisdom of ordinary American voters. They need to know—to remember—to ask for freedom.

Recently in my hometown of Palo Alto, a school wanted to rebuild. The usual uproar ensued. “Parking!” “Traffic!” “Gentrification!” “People will want to move here!” “Shut it down!” “Carbon emissions!” “That’s a better site for a homeless shelter.” What nobody said is “It’s their property; they can do what they want with it.” We have met the enemy, as Pogo once said, and he is us.

But I have some hope, even from Palo Alto. A YIMBY movement in the progressive Left has figured out that the answer to our housing woes is simple: let them build. Not just government-provided housing, which costs \$500,000 per room. Not just “affordable” housing, one more income disincentive for a lucky few. Not more subsidies for new homebuyers or other protected classes, which just crash against a vertical supply curve and drive up prices even more without housing any more people. Just let them build housing, even detested market-rate housing, even by detested developers. If it can happen here, common sense can break out all over—at least eventually, and once the catastrophe is undeniable. Retail theft leading to all the stores closing might just be next.

That is why the work of this association, and all of you, is so important. The great advantage of the free market is that nobody has to understand it for it to work. But a democratic political system needs people to understand at least some basics.

Your work is doubly important because economics teaching is such a disaster. Many people say to me, “We need a mandatory economics course in high school.” I say, “Have you seen what high school and college economics courses look like?” Typically there is a

week on the hypothetical optimality of the free market, taught with eyes rolling and extreme attention to every assumption, then nine weeks of market failure, from monopoly to externality to public goods to asymmetric information, each justifying perfectly crafted intervention by prescient regulators, aided of course by economists.

This view that regulation is a minimal technocratic intervention to remedy well-understood market failures explains nothing of our current regulation. The view omits Hayek, who showed why the planner can never do as well as the market. It omits public choice, which describes the two-way capture of regulated industry and politician. And most of all, it leaves out the long historical experience of unintended consequences, bright ideas gone bad, and reformers turned tyrants, as utopia was always around the corner. The one good thing I will say is that the standard course is usually so mind-numbingly boring, focused on moving graphs around and playing with equations, that not much of it sticks.

Not you. Good, practical, historical, experience-based economic education is the most important gift we can give our society. Thank you for doing it, and thank you for giving me this lovely award for my small part in spreading the word.