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SECOND-BEST THEORY AND THE OBLIGATIONS OF ACADEMICS: A REPLY TO PROFESSOR DONOHUE

Richard S. Markovits*

John Donohue has written a useful and sophisticated Comment on the other articles in this symposium. In addition, his contribution has a subtext that suggests that I have exaggerated the importance of academics’ restructuring their allocative-efficiency-oriented teaching and research to take Second-Best Theory into account. Donohue’s arguments to this effect are at least sociologically significant because I have heard many highly-regarded economists use the same arguments to justify their ignoring The General Theory of Second Best. This Reply responds to the passages in Donohue’s contribution that appear to undercut the implications of Second-Best Theory for the obligations of academics.

The first point that Donohue makes that is relevant in this context is that Second-Best Theory is “paralyzing in that it does not offer a clear replacement for what it purports to destroy.” I disagree. In fact, I believe that my own work refutes this contention. Not only my tort-law contribution to this symposium but also numerous other articles I have written (for example, on antitrust, environmental, admi-

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2. I agree with Donohue’s contention that Second-Best Theory often is not relevant in adjudicative contexts in which common-law, statutory, or Constitutional rights-issues must be resolved. See id. at 261-63. In part, this reflects my rejection of the traditional Chicago hypothesis that the analysis of “allocative efficiency” is an algorithm for the solution of common-law and Constitutional rights-issues. For a comprehensive analysis of the relevance of allocative-efficiency conclusions, see Richard S. Markovits, The Relevance of Economic-Efficiency Conclusions for Moral-Ought, Moral-Rights, and Legal-Rights (unpublished manuscript on file with author, 1996) [hereinafter Markovits, Economic-Efficiency Relevance].
3. Donohue, supra note 1, at 257.

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rality,⁷ and property⁸ policies) have laid out in considerable detail the way in which the relevant allocative-efficiency (and overall-welfare) issues should be approached.

Donohue attempts to support this first observation with two unjustified claims. Thus, he asserts that even I have admitted that Second-Best Theory implies that in an otherwise-Pareto-imperfect world externality-internalization policies are “equally likely” to “hurt” or “help”⁹ (i.e., to decrease or to increase allocative efficiency). In fact, although the footnote Donohue cites does contain the statement to which he refers, the text makes clear that my actual position is that

(1) in an otherwise-Pareto-imperfect world the fact that no externalities is a Pareto-optimal condition makes it no more likely that a policy that internalizes a particular externality or set of externalities will increase allocative efficiency than that such a policy will decrease allocative efficiency and

(2) to be ex ante allocatively efficient, predictions of the allocative efficiency of externality-internalization policies must take into account to an ex ante allocatively efficient extent the variety of ways in which resources are used, the kinds of interconnections and feedback relationships whose importance Second-Best Theory demonstrates, and the myriad of Pareto imperfections in the economy.¹⁰

That is a counsel of work, not of doom.

Donohue also tries to reinforce this first observation by asserting that Second-Best Theory implies (yields “predictions” of) our “inability to make . . . guesses” about the effects of “deregulation in the phone company and airline industry” on product quality and production costs.¹¹ There are two problems with this argument. The first is that the consequences in question are micro-economic as opposed to allocative-efficiency consequences; consequences that must be derived from competition theory as opposed to the kind of theory (welfare-economics analysis of allocative efficiency) to which the type of Second-Best Theory on which this Symposium has focused relates. The second is that, if the relevant consequences were the type to which the

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9. Donohue, supra note 1, at 258.
11. Donohue, supra note 1, at 259.
relevant Second-Best Theory relates, the theory would imply that we are unable to make the relevant "guesses" only if an appropriate third-best-allocative-efficiency analysis yielded a conclusion that the issue was too close to call (which, I suspect, it normally will not and which is different from not being able to yield a "guess" in any event).

Donohue also seems to be suggesting that, to the extent that Second-Best Theory is used to generate (allocative-efficiency) predictions, it does not provide the basis for good predictions. Although this attribution may not be correct, Donohue seems to think that Second-Best Theory is deficient in this respect because it ignores the importance of making "simplifying assumptions." In fact, far from ignoring the importance of simplifications, third-best-allocative-efficiency analysis is designed precisely to structure the analysis of which simplifications to make—which theoretical possibilities and conceivable data to ignore. Donohue tries to support this objection to Second-Best Theory by analogizing Second-Best Theory to the law of gravity. Second-Best Theory is valuable, he suggests, as is the law of gravity, but just as you would not want to use the law of gravity "to predict the consequences of wind acting on an ethereal body" ("whether [a] feather or canonball would hit first if dropped from the Empire State Building,") you would not want to use Second-Best Theory to make various complex real-world predictions. But perhaps I am being unfair here. Donohue may be using this analogy only to make the unexceptionable point that a theory's inability to solve complex, real-world problems does not imply its unimportance or uselessness. Of course, I find this latter point inapposite: the TBLE approach that can be derived from basic Second-Best Theory is the most useful approach to take to allocative-efficiency analysis in our actual worse-than-second-best world.

12. See id. at 263.

13. Admittedly, in the same paragraph, Donohue does state: "If the goal is to give accurate predictions and policy assessments, then Markovits' criticisms [my claims for the importance of Second-Best Theory] are far more telling." Id. Note that this statement fails to distinguish between (1) micro-economic and allocative-efficiency predictions and (2) allocative-efficiency predictions and policy-evaluations. I have already commented on the former failure. The latter is discussed in Markovits, Economic-Efficiency Relevance, supra note 2. Both conflations are typical of economists, who generally assume both (1) that you can move from micro-economic conclusions (e.g., unit output has been increased) to allocative-efficiency conclusions (allocative efficiency has been increased)—an assumption that Second-Best Theory refutes—and (2) that desirability and allocative efficiency are monotonically related. See supra note 2; Markovits, Economic-Efficiency Relevance, supra note 2.

14. See Donohue, supra note 1, at 263.

15. Id. at 263-4.
I am also not sure that Donohue intended to make the next point I will attribute to him—that Second-Best Theory cannot yield useful predictions because it is poorly specified and/or too difficult for people to use. Donohue may not subscribe to these views, but they seem to be suggested by his statements that the theory is "arcane" and that my article in this symposium is "abstruse." If Donohue is using the word "arcane" solely to indicate that the theory is "understood only by a few," I would have no objection—indeed, my agreement with this proposition is what led me to organize this Symposium.

However, "arcane" also indicates that its referent is "hidden" in the sense of being (perhaps intentionally) "obscure" or ill-specified. I have always tried to make my abstract accounts and particularized applications of Second-Best Theory as clear as possible and hope that I have succeeded in this effort.

My concern with Donohue's characterizations is deepened by the fact that the two meanings of "abstruse" are (1) "hidden; concealed" and (2) "remote from comprehension; difficult to be comprehended or understood" in the sense of being "recondite," i.e., "beyond the grasp of the ordinary mind or understanding." For two reasons, I reject the assertion that third-best analysis will always be too difficult to understand to be practicable. First, Second-Best Theory is far less difficult to comprehend than Donohue may be implying. I have been teaching Second-Best Theory for over thirty years. Even students with no background in economics have been able to understand it and its detailed implications for the right way to predict the allocative efficiency of a wide variety of government interventions in the economy. In addition, in most cases, it will be easier to apply the conclusions of Second-Best Theory than to work them out or understand them.

I should add that even if I were wrong in thinking that Second-Best Theory is practicable in that it can be used constructively at non-prohibitive costs, the dismal conclusion that I am wrong in this regard would not justify ignoring Second-Best and basing allocative-efficiency conclusions on first-best analyses. Even if Second-Best Theory cannot be used constructively, its destructive force is unaffected. If third-best-allocative-efficiency analysis is impracticable, policy analysts should ignore allocative-efficiency issues altogether (transaction

16. Id. at 259.
17. Id. at 263.
19. Id. at 8.
20. Id. at 1508.
costs aside) and base their choices solely on distributional considerations (including, of course, moral-rights issues when they are determinative), transaction-cost considerations, and/or procedural-fairness norms.

I have heard many able economists argue: because third-best analysis is impracticable, first-best analysis is worth doing. This is a non-sequitur. The fact that it is impracticable to do it "right" (cost considerations taken into account) does not justify doing it wrong when, absent an argument to the contrary (whose practicability has been ruled out ex hypothesi), the wrong method is as likely to get things wrong as right (to decrease allocative efficiency as to increase it).

Donohue's evaluation of the importance of Second-Best Theory for academics is also affected by his belief that predictions of the allocative efficiency of a government policy can often be made better through undertaking empirical analyses of the actual consequences of similar policies that have been adopted in the past.\(^2\) I have two objections to this argument. First, Donohue's examples involve empirical investigations of micro-economic consequences as opposed to allocative-efficiency consequences. Second, and more basically, this argument seems to reflect an assumption that Second-Best Theory is anti-empirical. Nothing could be further from the truth. A major implication of Second-Best Theory is that, in our highly-Pareto-imperfect world, allocative-efficiency conclusions will often be highly factsensitive; few conclusions can be generated on a purely a priori basis or by combining theory with readily-available factual assumptions that are not contestable. To the extent that it is "cost-effective" to collect some of the relevant facts by doing an empirical analysis of the consequences of past policies, third-best-allocative-efficiency analysis will recommend doing so. Indeed, third-best-allocative-efficiency analysis will provide a structure for determining whether such empirical investigations are ex ante allocatively efficient.

Donohue's apparent belief that Second-Best Theory is not so important for academics as I suppose or not so important as empirical investigations of the consequences of past policies also reflects his conclusion that, regardless of the objective merits of third-best arguments and worse-than-third best arguments based solely on such historical investigations, policy makers and their political constituents will be more influenced by arguments that focus exclusively on the

21. See Donohue, supra note 1, at 258-9.
consequences of past policies.\textsuperscript{22} Even if this empirical assertion were correct and would remain so once economists and others went public with Second-Best Theory, this argument would not affect my conclusions about how scholars and teachers are obligated to and ought to behave in their professional roles—viz., to pursue and teach the truth.

Donohue argues as well that the value of Second-Best Theory (like that of all analyses) is undermined by the fact that "even the conclusions of nuanced and sophisticated analyses may well be overturned by yet more nuanced and sophisticated approaches."\textsuperscript{23} Of course, as Donohue suggests, "humility" is always warranted\textsuperscript{24} and conclusions based on third-best-allocative-efficiency analyses will sometimes have to be "reversed or heavily qualified."\textsuperscript{25} So what else is new? The fact that proper analyses sometimes generate incorrect conclusions and that improper ones may generate correct conclusions comes as no surprise to a Second-Best Theorist. The academic case for doing third-best-allocative-efficiency analysis is not critically undercut by this reality.

Donohue also claims that the academic value of Second-Best Theory is compromised by the fact that its use, by "\textit{weakening} \ldots \textit{reliance on law and economics[,] might lead to greater reliance on even less beneficial modes of analysis.}"\textsuperscript{26} Donohue would undoubtedly readily admit that he has no evidence on the likelihood of this outcome. In my judgment, a shift from FBLE analysis to TBLE analysis is at least as likely to increase our reliance on economics by overcoming the objection that economic analyses are based on unrealistic assumptions. However, my real objection to this argument is that it ignores the obligations of the scholar and teacher: to search for and teach the truth, regardless of the consequences.\textsuperscript{27} Indeed, if I were forced to think in "moral-ought" rather than "moral-obligation" terms,\textsuperscript{28} I would hesitate long and hard before recommending that scholars let their approaches and conclusions be influenced by their personal ultimate values. Once such conduct becomes known, gov-

\textsuperscript{22} See \textit{id.}
\textsuperscript{23} \textit{Id.} at 260.
\textsuperscript{24} \textit{Id.}
\textsuperscript{25} \textit{Id.} at 265.
\textsuperscript{26} \textit{Id.} at 266 (emphasis added).
\textsuperscript{27} Okay. I would admit an exception if the scholar were an applied physicist working for the Nazis, but that is not the domain of my debate with Donohue.
\textsuperscript{28} For a discussion of this distinction, see \textbf{Richard S. Markovits, Matters of Principle: Legitimate Legal Argument and Constitutional Interpretation} at Ch. 1 (forthcoming New York University Press, 1998) and Markovits, Economic-Efficiency Relevance, \textit{supra} note 2.
ernment funding of academic research will be sharply curtailed and the conclusions of academic research will be given far less attention (far less even than they are given today).

Donohue’s evaluation of the importance of Second-Best Theory for academics is also affected by his belief that third-best-allocative-efficiency conclusions will sometimes be misused (“invoked opportunistically”\textsuperscript{29}) by the bad guys to achieve bad results. My response to this contention is the same as my response to its predecessor. TBLE conclusions are as likely to be misused by the good guys as by the bad guys (however you define those groups), the obligation of the scholar and teacher is in any case to seek the truth, and academics’ making bad arguments or not revealing the truth is likely to backfire on the good guys in the medium or long run even if it does generate some benefits in the short run.

Donohue also argues that Second-Best Theory is less important for academics than I argue because first-best-oriented economics “has been largely successful” at “organiz[ing] our thinking.”\textsuperscript{30} Although other statements Donohue makes suggest that he thinks that this assertion implies no more than that Second-Best Theory need not be emphasized in teaching, logically the assertion has equally-forceful implications for research. I do not think that standard economics has “successfully organized our thinking” in any normative sense of that expression. Standard economics has

\begin{itemize}
  \item[(1)] misorganized the way in which we generate allocative-efficiency predictions (by ignoring Second-Best Theory and adopting FBLE approaches),
  \item[(2)] relatedly, has conflated micro-economic conclusions and allocative-efficiency conclusions,
  \item[(3)] has done a bad job of generating even the micro-economic conclusions on which it has concentrated (has derived those conclusions either from simplified models that omit important parts of reality to insure that the conditions required for the use of certain types of mathematics are fulfilled or through mathematical manipulations of models that contain more realistic assumptions whose presence invalidates the use of the mathematics that has been used), and
  \item[(4)] has proceeded on the incorrect and philosophically naive assumptions that allocatively efficient policies are always consistent with if not required by moral rights and are always desirable from any legitimate personal-ultimate-value perspective (when rights-considerations are not determinative).
\end{itemize}

\textsuperscript{29} Donohue, \textit{supra} note 1, at 258.

\textsuperscript{30} \textit{Id.} at 263.
I am not persuaded by any of the arguments that John Donohue and other economists allege undercut the importance of economists' and law-and-economics scholars' taking Second-Best Theory seriously in their research and teaching. These arguments can not justify or even excuse the failure of economists and law-and-economics scholars to base their allocative-efficiency analyses on Second-Best Theory.