WSJ article on Pigou

An Economist's Invisible Hand

Arthur Cecil Pigou, overlooked for decades, provides a guide to the financial crisis

By JOHN CASSID

At the Heavenly Models home for deceased economists, an award is being presented to the resident whose work best explains financial crises, global warming, and other pressing issues of today. The favored candidates include John Maynard Keynes, the patron saint of stimulus programs; Hyman Minsky, an American disciple of Mr. Keynes who warned about the dangers of financial deregulation; and Milton Friedman, the late Chicago economist. (Mr. Friedman's free market principles are out of vogue, but Federal Reserve Chairman Ben Bernanke recently took his advice on how to prevent depressions by pumping money into the economy.)
The winner's name, however, turns out to be much less familiar: Arthur Cecil Pigou (pronounced "Arthur See-sil Pig-oo"). Stepping from the wings, a strapping Englishman with fair, wavy hair and a luxuriant moustache, smiles awkwardly and accepts his prize. A contemporary of Mr. Keynes at Cambridge University, Mr. Pigou was, for a long time, the forgotten man of economics. In the years leading up to his death, in 1959, he was a reclusive figure, rarely venturing from his rooms at King's College. His novel ideas on taxing polluters and making health insurance compulsory were met with indifference: Keynesianism was all the rage.

Today Mr. Pigou's intellectual legacy is being rediscovered, and, unlike those of Messrs. Keynes and Friedman, it enjoys bipartisan appeal. Leading Republican-leaning economists such as Greg Mankiw and Gary Becker have joined Democrats such as Paul Krugman and Amartya Sen in recommending a Pigovian approach to policy. Much of President Barack Obama's agenda—financial regulation, cap and trade, health care reform—is an application of Mr. Pigou's principles. Whether the president knows it or not, he is a Pigovian.

Mr. Pigou pioneered the study of market failure—the branch of economics that explores why free enterprise sometimes. During the 1930s, Mr. Keynes lampooned him as a reactionary because of his suggestion that the economic slump would eventually recover of its own accord.

But while Mr. Pigou believed capitalism works tolerably most of the time, he also demonstrated how, on occasion, it malfunctions. His key insight was that actions in one part of the economy can have unintended consequences in others.

Thus, for example, a blow-up in a relatively obscure part of the credit markets—the subprime mortgage industry—can undermine the entire banking system, which, in turn, can drag the entire economy into a recession, as banks refuse to lend. "The actual occurrence of business failures will be more or less widespread according (to whether) bankers' loans. . . are more or less readily available," Mr. Pigou wrote in 1929. Today, that might seem obvious. But just two and a half years ago, when the subprime crisis began, most economists, Mr. Bernanke included, believed it would have only modest consequences.

The son of an army officer, Mr. Pigou was raised on the Isle of Wight. After attending Harrow, an exclusive private school, he went to King's College, Cambridge. His tutor was Alfred Marshall, the great late-Victorian economist, who regarded him as a budding genius and helped him get a chair in economics—the one Mr. Marshall vacated in 1908. Until the Great Depression brought Mr. Keynes to international prominence, Mr. Pigou was probably the most eminent English economist.

Like many contemporary economic commentators, Mr. Pigou was reacting against laissez faire—the hands-off approach to policy that free market economists, from Adam Smith onwards, had recommended. Such thinkers had tended to view the market economy as a perfectly balanced, self-regulating machine. But "even in the most advanced States there are failures and imperfections" that "prevent a community's resources from being distributed….in the most efficient way," Mr. Pigou wrote in 1920. His goal, he said, was to explore ways in which "it now is, or eventually may become, feasible for governments to…promote the economic welfare, and through that, the total welfare, of their citizens as a whole."

Mr. Pigou drew an important distinction between the private and social value of economic activities, such as the opening of a new railway line. The savings in time and effort that users of the railway enjoy are private benefits, which will be reflected in the prices they are willing to pay for tickets. Similarly, the railroad's expenditures on tracks, rolling stock, employee wages are private costs, which will help to determine the prices it charges. But the opening of the railway may also create costs for "people not directly concerned, through, say, uncompensated damage done to surrounding woods by sparks from railway engines," Mr. Pigou pointed out.

Such social costs—modern economists call them "externalities"—don't enter the calculations of the railroads or its customers, but in tallying up the ultimate worth of any economic activity, "[a]ll such effects must be included," Mr. Pigou insisted. In focusing exclusively on private costs and private benefits, the traditional defense of the free market misses out on a vital element of reality.

To correct the problems that spillovers created, Mr. Pigou advocated government intervention. Where the social value of an activity was lower than its private value, as in the case of a railroad setting ablaze the surrounding woodland, the authorities should introduce "extraordinary restraints" in the form of user taxes, he said. Conversely, some activities have a social value that exceeds their private value. The providers of recreational parks, street lamps, and other "public goods" have difficulty charging people to use them, which means the free market may fail to ensure their adequate supply. To rectify this shortcoming, Mr. Pigou advocated "extraordinary encouragements" in the form of government subsidies.

Economics textbooks have long contained sections on how free markets fail to deal with negative spillovers such as pollution, traffic congestion and the like. Since August 2007, however, we have learned that negative spillovers occur in other sectors of the economy, especially banking. "The financial system failed to perform its function as a reducer and distributor of risk," Treasury Secretary Timothy Geithner and Lawrence Summers, the head of the National Economic Council, wrote in the Washington Post earlier this year. "Instead, it magnified risks, precipitating an economic contraction that has hurt families and businesses around the world."

The mere existence of negative spillovers doesn't necessarily justify government intervention, Mr. Pigou conceded. In some cases, the parties concerned might be able to come to a voluntary agreement about how to compensate innocent bystanders. A landlord, for instance, may reduce the rents for tenants who have to live over a noisy bar.

With spillovers from the financial industry, however, too many parties are involved for private bargaining to provide a practical solution. During the credit bubble of 2002-2006, the entire housing market turned into a speculative bazaar. Mortgage companies that were supposed to apportion credit on the basis of ability to pay distributed it willy-nilly. And banks and other financial intermediaries, which exist to channel capital to its most productive uses, misallocated resources on a vast scale.

When other industries do a bad job, the fallout is usually limited. If Budweiser and Miller marketed undrinkable beers, it would be bad news for those companies and their customers, but the rest of the economy would be largely unscathed.

In banking, the negative spillover can be catastrophic. Many millions of households and firms rely on credit to finance their expenditures. If this credit is suddenly curtailed, spending can fall precipitously throughout the economy. That is what we witnessed at the end of last year.

Even if policy makers have been tardy about citing the influence of Mr. Pigou's analytical framework, they are working within it. Raising capital requirements on banks, urging Wall Street firms to pay bonuses in stock, and forcing investment banks to keep some of the securities they issue on their own books are all efforts to mitigate the spillovers from irresponsible risk-taking.

Although it is rarely presented in such terms, reforming health care can also be viewed as a counter-spillover policy. Sick people who don't have health insurance often end up using emergency rooms, which imposes a cost on the insured, perhaps as much as $1,000 per person per year. A successful reform package would eliminate these social costs, and it could also generate some positive spillovers. Improvements in public health can make employees more productive, Mr. Pigou pointed out, which increases the gross domestic product.

If the administration ends up partly financing health-care reform by increasing taxes on the rich, a proposal contained in a bill that the House of Representatives recently passed, it will be enacting yet another Pigovian policy. "[I]t is evident that the transference of income from a relatively rich man to a relatively poor man of similar temperament, since it enables more intense wants to be satisfied at the expense of less intense wants, must increase the aggregate sum of satisfactions," he wrote.

Global warming presents perhaps the most dramatic example of what can happen if spillovers are ignored. It was the growing public concern over global warming that resurrected Mr. Pigou from obscurity. In 2006, the British government published an official report on climate change by Sir Nicholas Stern, a well-known English economist, which relied extensively on Mr. Pigou's analytical framework. "In common with many other environmental problems, human-induced climate change is at its most basic level an externality," Mr. Stern wrote. And he went on: "It is the greatest and widest-ranging market failure ever seen."

In addition to referencing Mr. Pigou's work directly several times, Mr. Stern recommended the imposition of one of his extraordinary restraints: a substantial carbon tax. This proposal remains controversial, but a number of Republican economists have endorsed it. Harvard's Greg Mankiw has founded an informal Pigou Club for economists and pundits that support a carbon tax.

During the 1930s and 1940s, many economists were pessimistic about the market system's long-term prospects. Mr. Pigou's message, on the other hand, was optimistic, and, in some ways, very American. He believed in progress, the power of rational analysis, and the ability of well-intentioned people, such as himself, to effect meaningful reforms.

He didn't put much store in elaborate mathematical theories. Above all else, he was practical. "We shall endeavor to elucidate, not any generalized system of possible worlds," he wrote in his greatest book, "The Economics of Welfare," "but the actual world of men and women as they are found in experience to be."

—John Cassidy is a staff writer at the New Yorker. His book "How Markets Fail: The Logic of Economic Calamities" was recently published by Farrar, Straus & Giroux.