

## An Application of Douglass North's Notion of Belief Systems

John N. Drobak

March 2, 2018

(Please do not quote or cite without the permission of the author)

Over his long and illustrious career, Doug North built his reputation with scholarship on a variety of topics, including economic history, cliometrics, property rights, transaction costs, institutions, and violence. At the core of all these topics lay Doug's unending quest to understand how the economic and social worlds worked. Over the decades that we worked together, he was always asking why some countries were rich and others poor. He knew that question could not be answered without an understanding of economics, politics, and society. Over time, this quest led Doug to try to understand how people made decisions, which in turn led to his interest in cognitive science, or as he would put it: in learning "how the mind works." The last book he wrote without co-authors, *Understanding the Process of Economic Change*,<sup>1</sup> is based on his perspectives about human decision-making and its relevance for both economic and social change.

A number of Doug's disciples found this book less useful than his others. I think this resulted from some of the book's analysis being based on "soft" ideas, like belief systems, norms, and culture. I have no doubt that all of us believe that norms (one of the informal institutions, in Doug's parlance) are important to society, but research into norms isn't very productive. It is hard to identify the relevance of norms, to model them, and to use them in economic analysis. Law, as a formal institution, has some of these problems, but at least scholars can compare written law from country to country and try to assess their impact. I think another aspect of the hesitancy to embrace this approach stems from its similarity to sociology, a discipline that some economists find too loosey goosey to be a real social science.

The notion of belief systems is a powerful tool for understanding the world and for understanding why disagreement is so prevalent. As Doug explained:

The "reality" of a political economic-system is never known to anyone, but humans do construct elaborate beliefs about the nature of that "reality"—beliefs that are both a positive model of the way the system works and a normative model of how it should work. The belief system may be broadly held within the society, reflecting a consensus of beliefs; or widely disparate beliefs may be held, reflecting fundamental divisions in perception about the society. The dominant beliefs—those of political and economic entrepreneurs in a position to make policies—over time

---

<sup>1</sup> Douglass C. North, *Understanding the Process of Economic Change*, 2005, Princeton University Press.

result in the accretion of an elaborate structure of institutions that determine economic and political performance. The resultant matrix imposes severe constraints on the choice set of entrepreneurs when they seek to innovate or modify institutions in order to improve their economic or political positions.<sup>2</sup>

The idea of a filter through which a person sees the world has a long pedigree in philosophy. During the entire time we worked together, I never saw Doug express an interest in philosophy, so I do not think that the philosophical literature had much effect on him. As far back as Plato, philosophers were interested in the perception of reality. In *The Republic*, the allegory of the Cave dealt with characters that saw shadows of reality, and not reality itself. These characters, representative of ordinary people, have a view of reality that is “distorted by falsifying media, by their own passions and prejudices and by the passions and prejudices of other people conveyed to them by language and rhetoric.”<sup>3</sup> Ironically, Doug’s concept of the importance of a belief system is a basic tenet of a number of schools of philosophy, including realism, idealism, and pluralism.<sup>4</sup> For example, Emmanuel Kant describes his transcendental idealism as follows:

We have therefore wanted to say that all our intuition is nothing but the representation of appearance; that the things that we intuit are not in themselves what we intuit them to be, nor are their relations so constituted in themselves as they appear to us; and that if we remove our own subject or even only the subjective constitution of the senses in general, then all constitution, all relations of objects in space and time, indeed space and time themselves would disappear, and as appearances they cannot exist in themselves, but only in us. What may be the case with objects in themselves and abstracted from all this receptivity of our sensibility remains entirely unknown to us. We are acquainted with nothing except our way of perceiving them, which is peculiar to us....<sup>5</sup>

As Doug wrote above, a dominant belief system shared by government officials and the media can constrain changes in institutions. Two prominent issues in our society illustrate that phenomenon. First, proponents of gun ownership, who are either ignorant or intentionally in disregard of the Supreme Court’s teaching about the Second Amendment, invoke the amendment to stop virtually all forms of gun control as off limits as potential ways to limit gun violence. Second, although people are appalled by the outrageously high prices of some pharmaceutical drugs, recent proposals to regulate the drugs focus on such things as changes in patent rights and on generic drugs. Virtually no one is advocating direct regulation of the prices of the drugs because they view price controls as not a feasible political solution these days.

---

<sup>2</sup> *Id.* at 2.

<sup>3</sup> R.L. Nettleship, “Lectures on the Republic of Plato” (Second Edition, London, 1901), p. 260.

<sup>4</sup> <https://plato.stanford.edu/entries/realism/>; [http://www.philosophybasics.com/philosophers\\_berkeley.htm](http://www.philosophybasics.com/philosophers_berkeley.htm); [http://www.philosophybasics.com/branch\\_pluralism.html](http://www.philosophybasics.com/branch_pluralism.html)

<sup>5</sup> <https://plato.stanford.edu/entries/kant/> (Part 3)

Perhaps the most important lesson that Doug drew from his use of belief systems was a better understanding of the difficulty of reaching agreement. As Doug wrote: “Individuals from different backgrounds will interpret the same evidence differently and in consequence make different choices.”<sup>6</sup> Applying what behavioral economics label confirmation bias, Doug recognized that the difficulty of reaching a consensus was exacerbated by the tendency to believe only the information that reinforced existing beliefs. As with the idea of belief systems, philosophers long recognized the intransigency of positions. For example, Plato made the same point in the allegory of the Cave when the occupants of the cave would not believe the person who had left the cave but then returned to tell them that they were only seeing shadows.<sup>7</sup>

Rather than looking to philosophy, Doug drew his inspiration from the scientific study of human decision-making. Friedrich Hayek’s emphasis on perception and cognition in his book *The Sensory Order* led Doug to study cognitive science, which forms the basis for his ideas in *Understanding the Process of Economic Change*.<sup>8</sup> There is much in Doug’s book that can help our research today. I would like to focus on three: the concept of belief systems itself, the constraints imposed on change by dominant belief systems, and the difficulty of achieving agreement in society with conflicting belief systems.

I am writing a book titled “The Failure of Economic Theory and the Rise of 21<sup>st</sup> Century Populism.” It takes on two propositions espoused by conservative economists: (1) the U.S. economy is competitive, making government regulation less necessary, and (2) corporations exist for the financial benefit of their shareholders and not for other stakeholders. The final chapter of the book explains why many readers will not agree with my analysis. That chapter uses these insights from Doug to explain the difficulty of convincing readers who have a strong belief in the benefits of a minimally regulated market system. What follows are two chapters from the book, the introduction and chapter 8, titled “Belief Systems and the Rigidity of Beliefs.” The analysis in chapter 8 is relevant to this conference, while the introduction is included to put chapter 8 in perspective.

---

<sup>6</sup> *Understanding the Process of Economic Change*, at 62.

<sup>7</sup> Even Leo Tolstoy noted this proposition in *War and Peace* in 1869: “For the first time in his life, Pierre was struck by the endless variety of men’s minds, which guarantees that no truth is ever seen the same way by any two persons.” Tolstoy, Leo, **War and Peace** 474, Penguin Ed., 2005.

<sup>8</sup> *Understanding the Process of Economic Change*, at 32-33.

# The Failure of Economic Theory and the Rise of Twenty-First Century Populism

(Book MS, Draft August 2017)

## Table of Contents

- Chapter 1 – Introduction
- Chapter 2 – Theory of Competitive Markets
- Chapter 3 – Lack of Competition in U.S. Markets
- Chapter 4 – Effects of Mega-Mergers
- Chapter 5 – Corporate Stakeholders
- Chapter 6 – Outsourcing in the U.S. and Europe
- Chapter 7 – The Legitimization of Greed
- Chapter 8 – Belief Systems and the Rigidity of Beliefs
- Chapter 9 -- Conclusion
- Appendix – Summary of Concentration Studies

## Introduction

Over the decades I have spent with economists, I have grown skeptical about how some economic ideas are not descriptive of the actual economy. There are elegant economic theories based on such unrealistic assumption that they have little to do with how businesses actually operate. This is not just a lawyer's skepticism; it is something I have learned from economists themselves. Many academic economists openly recognize the limitations of their discipline. However, many people use economic ideas to shape public policy without a word about limitations.

The ideas in this book grew out of my concern about two economic “principles” that have shaped our world today: (1) the U.S. economy is competitive, making government regulation less necessary, and (2) corporations exist for the financial benefit of their shareholders and not for other stakeholders.<sup>9</sup> Perhaps the word “beliefs” is a better description than “principles” because neither statement is part of the core of economic theory. There is a core theory of economics that explains competitive markets, but whether a particular market is competitive is an empirical question. A lack of competitive markets does not alter the theory of competition itself, although it means that the theory is less helpful in understanding the actual economy. Similarly, economists take corporations to be actors in a market. They are assumed to act as the theory posits: a corporation, as any business firm, is a producer of goods and services who is

---

<sup>9</sup> I had originally included a third economic notion that I wanted to examine: “trickle-down economics,” a shorthand for the belief that a reduction in taxes leads to economic growth. I soon eliminated it when my research showed that virtually no serious economic scholar believes that the theory has any validity. Not only have many economists debunked the theory as a myth or wishful thinking, they have shown that there is no empirical evidence whatsoever to give credence to the claim that tax reductions lead to economic growth. The politicians and public commentators who still claim that trickle-down economics is an effective way to stimulate economic growth disregard this overwhelming contrary research. As a result, this book focuses on only the first two ideas.

assumed to maximize profits. Whether corporations actually take actions solely for shareholders is irrelevant to the theory. Nonetheless, much of the original—and the continued—impetus for the application of these principles as a way to run the U.S. economy comes from economists. Not surprisingly, there is a substantial difference among economists in their belief in these principles. It is the conservative ones, who have an unshaking faith in the market, who espouse these views. Sometimes they are labeled as members of the Chicago School of economics or, pejoratively, free-market zealots. With a patina of academic legitimacy from these economists, these two beliefs have captured government leaders, policymakers, and media commentators. This intellectual capture has had a strong influence on how the U.S. economy is run.

Economics is an elegant discipline that appears to accurately predict real economic events. Without a doubt, the discipline has led to a better understanding of many economic and social problems. Although it works perfectly on a blackboard, it often fares badly in the real world. An old adage says that economics is perfect at explaining what happened but poor at predicting what will happen. The application of these two economic principles to real-world problems has quietly harmed hundreds of thousands of people in the United States. This harm is justified as the normal consequences of a market economy. Yet the economic principles used to support this result are not inviolate laws, like the law of gravity, even though conservative economists state them to be certainties. When the claim that markets are competitive is not true, consumers are hurt by higher prices and poorer quality products, while semi- and unskilled workers are hurt when firms act as monopsonist buyers of labor. Just as troublesome, the lack of competition undermines the common argument that government regulation is unnecessary because the competitive market already provides sufficient constraints. Uncompetitive markets lack the constraints that come from competition, making regulation necessary. An erroneous belief in the existence of competitive constraints has been a major cause of our recent economic problems stemming from the Great Recession of 2008 and its aftermath: the loss of jobs throughout the economy, the increasing inequality of wealth in the U.S., and the harder it has become to achieve the American dream. There are many causes of these problems, but I believe that faith in the existence of competitive markets has been used to justify opposition to regulation that would have softened the effects of the Great Recession. Two examples of this occurred during the Clinton administration. The economists Alan Greenspan (then Chair of the Federal Reserve), Robert Rubin (Treasury Secretary), and Larry Summers (Deputy Treasury Secretary) advised President Clinton not to regulate financial derivatives, when the Commodities Futures Trading Commission was considering whether to regulate them. Summers, then Treasury Secretary, also advocated the repeal of the Glass-Steagall Act, which had separated investment and commercial banking in the aftermath of the Great Depression. President Clinton accepted both of those recommendations, which turned out to be major causes of the Great Recession of 2008.

Some people consider government regulation to be a four-letter word. With an intuitive sense that any expansion of the government is horrible, they often label it as socialism. Other people are disingenuous in their opposition to regulation because their reasoned arguments mask their desire to become richer free of government interference. However, many people oppose government action out of a genuine belief that the market itself provides sufficient regulation,

making regulation unnecessary.<sup>10</sup> The vast majority of those who believe that the United States has a competitive market economy never consider whether that belief is factually correct. They rely on the experts who say that is true. For over a century, many economists have espoused reliance on the market rather than government. Not only do they teach their students and the public about the desirability of relying on the market, they also influence and make government policy.<sup>11</sup>

Over 50 years ago, George Stigler noted the conservatism of his fellow economists, resulting in a strong preference for an unregulated market:

My thesis is that the professional study of economics makes one politically conservative. . . . I shall mean by a conservative in economic matters a person who wishes most economic activity to be conducted by private enterprise, and who believes that abuses of private power will usually be checked, and incitements to efficiency and progress usually provided, by forces of competition. A gradually increasing role has been assigned to the democratic state even by the conservatives, but they have retained the belief that the individual is normally to be free of public as well as private controls over consumption patterns, occupational choice, and allocation of private-owned resources. . . . The main reason for the conservatism [of economists] surely lies in the effect of the scientific training the economist receives. He is drilled in the problems of all economic systems and in the methods by which a price system solves the problems.<sup>12</sup>

To further reinforce the belief in the existence of competitive markets, politicians, intellectuals, and economists have repeatedly stated that as if it is a truism. The validity of the claim of competitive markets is crucial to the argument that regulation is unnecessary.

---

<sup>10</sup> It is impossible to know whether people really act on the beliefs they express as justifications or whether their statements are just a pretext. For example, in discussing whether law and economics really influenced the development of antitrust law, Richard Posner wrote: “To begin with, it is generally believed that law and economics has transformed antitrust law. It can, to be sure, be argued that all law and economics really did, so far as its impact on the practice of antitrust law was concerned, was to provide conservative judges with a vocabulary and conceptual apparatus that enabled them to reach the results to which they were drawn on political grounds. Even if this is all law and economics has done for (or to) antitrust, or for that matter to any other field of law, it would be far from negligible; to enable is to do much.” Richard A. Posner, *The Deprofessionalization of Legal Teaching and Scholarship*, 91 MICH. L. REV. 1921, 1925 (1993).

<sup>11</sup> There are many economists who are skeptical about the prevalence of competition. However, from my acquaintance with economists in the U.S., I believe that the majority of economists are true believers in a competitive market. It is impossible to know what most economics teach in their classes, but university textbooks emphasize the prevalence of markets. For example, Gregory Mankiw’s textbook, which is the most popular, explains at the beginning of the section on markets: “The market for ice cream [an example he just gave], like most markets in the economy, is highly competitive.” He does soften this statement over the next few paragraphs as he introduces monopoly and oligopoly. He ends the section with this: “Despite the diversity of market types we find in the world, we begin by studying perfect competition. Perfectly competitive markets are the easiest to analyze. Moreover, because some degree of competition is present in most markets, many of the lessons that we learn by studying supply and demand under perfect competition apply in more complicated markets as well.” N. Gregory Mankiw, *PRINCIPLES OF ECONOMICS* xx (x ed. 201X). For an example of failed economics advice leading to the Great Recession of 2008, see text accompanying notes *infra*.

<sup>12</sup> George J. Stigler, *Essay in the History of Economics* 52, 53-54, 59 (U. Chicago Press 1965).

There has never been a purely *laissez faire* economy. A functioning economy requires, at a minimum, laws that protect property rights and exchange. This was just as true in the days of Adam Smith as it is today. The underlying question is not government versus the market but the extent to which government should regulate—or we could say, interfere in—the market. There must be some regulation, but the debate is over the extent of government regulation. That is a debate that depends upon how competitive a market truly is.

Many people have strong beliefs that affect their comparison of the government versus the market. In making this comparison, it is important to recognize the truth in what the Spanish economist Benito Arrunda has written: liberal “idealism errs by comparing imperfect markets with perfect politics. Libertarian idealism makes the opposite mistake, by comparing perfect markets with imperfect politics. In so doing, it makes it impossible to understand the role that the state plays in making real markets less imperfect.”<sup>13</sup> We all bring biases to our comparison of the market and regulation. The data that we have to show the existence of competition are imprecise, so it is impossible to prove definitively whether some markets are competitive. That makes our preconceived notion of the relative benefits of one over the other even more important. It skews how we see the available facts and creates a presumption of the desirability of one over the other.

I think some people express a preference for the market over the government as part of an overarching fear of big government. They have a libertarian philosophy that, all things being equal, people are better off being left alone by the government, whether it concerns economic issues or social matters. In the academic world, the strongest proponents of unregulated markets are the conservative economists. Although the fear of big government has been around for centuries, the modern version has its roots in the aftermath of World War II, when the Cold War raised the fear of the spread of communism and when countries in Europe were embracing socialism. Influential European economists, like Ronald Coase and Fredrick Hayek, lamented Europe’s move toward socialism. Their preference for the market over government influenced economists in the U.S., who then in turn had a large influence on the public’s view of the ideal relationship between government regulation and the market, as well as influencing the law. I think that it is unrealistic today to fear that the U.S. will become a socialist country. Nonetheless, an ideology forged during the Cold War persists today and makes it much harder to use the government to correct market imperfections that have caused tremendous harm throughout society.

The second principle, or belief-- that a corporation exists solely for the financial benefit of shareholders—justifies harm to the other corporate stakeholders. Workers can be laid-off, labor can be out-sourced, plants closed, and communities can be destroyed all in the name of improved profits for shareholders. Acceptance of this principle is a relative recent phenomenon; yet many people accept the principle as a natural result of incorporation. People overlook the fact that the corporate form came about as a way to aggregate capital and to minimize risks, not as a vehicle for maximizing shareholder wealth. They overlook the fact that many corporations served their workers and communities, as well as their investors, for a good part of the twentieth

---

<sup>13</sup> Benito Arrunda, *Coase and the departure from property*, in THE ELGAR COMPANION TO RONALD H. COASE, Claude Menard and Elodie Bertrand, eds, 2016, at 205, 307.

century. Mistreatment of labor is not a prerequisite for a robust economy, as shown by the success of the economies in many E.U. countries, even though those countries have limited outsourcing and protected labor.

I started this book just to criticize these two economic principles. However, the rise of Donald Trump and Bernie Sanders showed me that the consequences of bad economics can result in a sea change in politics. That turned my academic concern into a practical one. It is crucial for us to examine whether economic ideas that work in the classroom can actually work in the real world. We can no longer just assume that ideas expressed by professors from prestigious schools are accurate.

Many readers will not believe my analysis and conclusions. This stems from their perspective on the world, which makes them blind to contrary views. My friend and colleague, the economic historian and Nobel laureate Douglass C. North, culminated his 60 years of economic research by focusing on the importance of belief systems. North believed that we need to understand that different people see the world through different lenses, making it harder to come to agreement on the best approach to resolving social problems. This is not a novel idea, going back at least to Plato's cave, but it is essential to understanding the difficulty in getting people to agree on the ways to resolve social problems.<sup>14</sup> Starting at least from the junk bond crisis in the 1980s, it has become acceptable to many people that getting richer by any means was something to strive for. In effect, greed was legitimized and applauded. One example of this has been the meteoric rise in the compensation to senior management. The media reinforces the legitimacy of this quest for wealth by constantly publicizing the stock market. It is true that many middle class people gain wealth in their pension plans when the stock market rises, but more workers have little or no investments. No one reports that the cause of a rise in the value of a stock was the lay-offs of workers or the closure of plants. The emphasis on increasing the value of capital has been a major cause in the growing disparity in wealth in the U.S. Once the legitimacy of the quest for wealth becomes imbedded in the belief systems of people, it becomes very hard to change that notion.

This book is organized as follows. Chapter 2 explains the economic theory of competitive markets, while Chapter 3 considers how applicable that theory is to the current U.S. economy. Chapter 3 analyzes the competitiveness of U.S. markets in two different ways. First, it examines actions taken by firms in various markets to see if the firms' conduct is what we would expect in a competitive market. It also looks at the concentration of the firms in a market as a way to determine competitiveness, examining the many studies over the past few years that show greatly increased concentration in many markets. The decrease in competitive markets prompted President Obama to release a White Paper last year that stressed the need for the government to encourage competition. At the same time that competition between firms has been decreasing, the power of unions has shrunk drastically, which has diminished the competition between businesses for low- and unskilled labor, resulting in monopsony power in the labor market. I argue that this lack of competition shifts the burden to those who oppose government regulation

---

<sup>14</sup> People seem to forget that different people see the world very differently, although it is not a new idea. Even Leo Tolstoy noted this proposition in *War and Peace* in 1869: "For the first time in his life, Pierre was struck by the endless variety of men's minds, which guarantees that no truth is ever seen the same way by any two persons." Tolstoy, Leo, **War and Peace** 474, Penguin Ed., 2005.

to demonstrate that there actually is viable competition.

Chapter 4 shows that part of the decrease in competition has resulted from the recent wave of large mergers. Mergers are thought to be desirable economically because they benefit consumers with lower prices and better products. However, many mergers are justified by a claim of increased efficiencies in the combined firm, which is usually the result of lay-offs and plant closures. Not only does this cause significant job losses, it also hurts local communities. When a plant closes, it often harms the businesses that had supplied goods and services to the plant. Many studies have shown that the closure or transfer of a corporate headquarters results in a significant decrease in charitable giving and support for local educational and cultural activities. In economic terms, these spill-over effects are externalities. Even though economic theory does not take these kinds of externalities into account, they are nonetheless harmful consequences of mergers. When I first considered this problem, I wondered about the ways to compare the benefits to consumers with the resulting harms to labor and communities. Economic theory teaches that we should not make interpersonal comparisons of utility, the notion that underlies Pareto Optimality. It is improper to harm someone even if we believe that we benefit someone else at the same time. Of course, that is an impractical guide because all business decisions and all economic regulation have winners and losers. Nonetheless, that notion from economics is a reminder that we need to be cautious in accepting the harm imposed on the losers when we balance the gains and losses. Then I learned that numerous recent studies have shown that many mergers do not result in lower prices, while some mergers have even led to price increases. In these mergers, workers suffered not for the sake of consumers but for the financial benefits reaped by the shareholders and managers of the merging firms and by the professionals who put the deals together. Recently, it appears that investment advisors encourage mergers just so that they can profit from the transactions, regardless of the degree of benefit provided consumers. In addition, hedge funds and other similar investors push for mergers solely as way to increase their earnings. With little or no benefit to consumers from mergers, I argue that we should restrict these types of mergers as a way to minimize the harm to labor and communities. The current form of regulatory review of mergers does not take into account the interests of workers or communities because merger review solely examines a merger's effect on competition in the relevant market.

Chapter 5 examines the claim that corporations exist only to increase shareholder wealth. It traces the origins of this idea and explains how it has come to be accepted as a truism by many scholars, judges, and commentators. Chapter 6 analyzes the consequences of this proposition, examining the effects on labor from out-sourcing. It also details the failed attempts in Congress to regulate outsourcing, partly due to lobbying by business but also as a result of the belief that these kinds of activities should be left to the market. The chapter then compares the situation in the U.S. with the protection of labor and the limits on out-sourcing in Germany. Chapter 7 discusses the changes in norms that has made it acceptable to make as much money as possible in any way legally possible, even at the expense of great harm to labor and community. The chapter also considers the role of the media in the constant reporting of the stock prices—which reinforces the belief that corporations exist only for shareholders. Chapter 8 then examines why so many people are locked into their views. The Conclusion deals with political effects, by pointing out that the harm to workers has aggregated over the years, culminating in the popular support for both Donald Trump and Bernie Sanders in the last election. This new populist

movement is the result of years of decisions made by business firms and inaction by the government that caused tremendous harm to semi- and unskilled labor, justified by the intellectual capture by two economic propositions discussed in the book.

\* \* \* \*

## Chapter 8

### Beliefs Systems and the Rigidity of Beliefs

We all see the world through slightly different glasses. In the latter stages of his long career, the Nobel laureate and economic historian Douglass C. North emphasized the importance of recognizing that we all have different belief systems, which change how we perceive things.<sup>15</sup> As a result of our upbringing, education, and life experiences, we are prone to find some things more believable than others.<sup>16</sup> As a result of different perspectives than mine, I am sure that some readers will remain skeptical of the conclusions in this book. Part of the reason for that is the underlying skepticism by some about government regulation, which they see as always worse than the market. I have tried to show that competitive constraints are lacking in many markets, including without a doubt, in the market for low and semi-skilled labor. In moving ahead, we have a choice as a society that is not binary; it is not just an unregulated market versus a heavily regulated one. A little bit of what the countries in Europe do to help their workers would go a long way in the U.S. In the long run, it is not just the adoption of laws that will help labor. As in the countries of Europe, we need to develop a culture of respect for labor and recognize workers as the partners of those who supply capital. However, it is an extremely difficult task to convince people who are locked into a contrary view of how the world works.

#### A. Underlying Fundamental Premises

Three fundamental propositions are important to understanding why people develop and retain beliefs: (1) It is often difficult to identify the “truth” of a claim, (2) the belief systems of individuals and society have a tremendous influence on the receptivity of new information, and (3) the “non-rational” character of human decision-making also affects the processing of new information. These three premises will be explained in order.

##### a. The Difficulty of Determining the Truth

Much of what people know is learned from other people. We begin to learn from our parents in infancy, we learn from our teachers, and we spend our lives learning from others. For the most part, we trust the people who teach us, so we believe them without any need for verification. Of course there is knowledge gained directly from our senses. No one needs to teach us that the sun is in the sky every day, nor that gravity makes things fall down, not up. If need be, we can verify these beliefs by testing. However, most of us did not perform tests to be sure that

---

<sup>15</sup>

<sup>16</sup>

these beliefs are true. We were taught that by our teachers, who probably also taught us that physical truths have been demonstrated experimentally. The same holds for historical facts. We believe that George Washington was the first President of the United States without needing to examine any historical documents. Not only did we learn this from our teachers, historical knowledge is part of the culture that is passed on from generation to generation. Everyone speaks as if these historical facts are true, and we also know that earlier generations also believed them. We believe physical and historical truths firmly, even if a few outliers occasionally try to convince us otherwise.

There is another type of knowledge, however, that is not verifiable or clearly supported by historical record. Theories about how the world works fit into that category. Some theoretical explanations are debatable because our knowledge and processing abilities are limited. As Thrainn Eggertsson has explained,

Theories of social systems which explicitly recognize that actors live in a world of scarce information confront three types of information issues: (i) scarce data and knowledge; (ii) the limited mental capacity of actors to absorb and process data and to make decisions; and (iii) the propensity of actors to economize on scarce data, limited knowledge, and limited mental capacity by making simple and inaccurate models of their environment. I refer to these three issues as incomplete data, incomplete processing, and incomplete models.<sup>17</sup>

There is another, just as serious, problem with the acceptance by the public of theoretical knowledge. Sometimes even theories supported by a strong consensus of experts nonetheless appear to many people to be only opinion. This type of knowledge is more susceptible to be changed by contrary opinion in the minds of some people notwithstanding what experts say. The disbelief in the theory of evolution or in global warming are but two examples of this.

Determining the truth has become more difficult over the past few years with the rise of “alternative facts” and false information on the internet. When President Trump lies or embellishes facts, many people believe him. One example was his constant claim that President Obama was not born in the United States, which made Obama legally ineligible to be President. This is a refutation of an historic fact, which should be relatively easy to determine. Likewise, when President Trump expresses a disbelief in global warming, people believe him. This is a refutation of a theory, which is harder to prove than a fact. Misinformation from government leaders is compounded by websites on the internet that put forth false information as the truth. The fake news websites that proliferated during the last presidential election are well known examples of this. All of this makes the determination of the truth much more difficult for many.

#### b. Belief Systems

The world is too complex for people to rationally analyze every question that faces them. As a result, we create mental models of the world that simplify decisions for us, and we use

---

<sup>17</sup> Thrainn Eggertsson, *The Old Theory of Economic Policy and the New Institutionalism*, 25 **World Dev.**, No. 8, 1187, 1191 (1997).

heuristics and rules of thumb to help us derive answers to problems.<sup>18</sup> Eggertsson has pointed out that “[p]eople (scientists included) respond to complexity by creating simple mental constructs of their worlds. The models are incomplete, sometimes misleading, and actors are often not even aware of relevant information sets.”<sup>19</sup> Moreover, people “are often unaware that they lack the necessary knowledge.”<sup>20</sup>

What people know is the result of the inputs from our five senses, which is then sent to the brain for processing where our belief systems control how we analyze the inputs and make decisions. As Douglass North has explained:

the world we ... are trying to understand is a construction of the human mind. It has no independent existence outside the human mind; thus our understanding is unlike that in the physical sciences, which can employ reductionism to understand and expand comprehension of, the physical world. Physical scientists, when they seek a greater understanding of some puzzle in the physical world, can build from the fundamental unit of their science to explore the dimensions of the problem they seek to comprehend. The social sciences do not have anything comparable to genes, protons, neutrons, elements to build upon. The whole structure that makes up the foundation of human interaction is a construct of the human mind and has evolved over time in an incremental process . . . It is essential to remember that the constructs humans create are a blend of “rational” beliefs and “non-rational” ones (superstitions, religions, myths, prejudices) that shape the choices that are made.<sup>21</sup>

Eggertsson has referred to belief systems as “people’s subjective models of reality.”<sup>22</sup> These belief systems develop from life experiences with a myriad of influences—from parents and family, peers, teachers, religious authorities, government leaders, public commentators, and so on. The shared belief systems of a society are passed on from generation to generation as part of the society’s cultural heritage.<sup>23</sup> Our minds do not reproduce reality; rather, they attempt to interpret the very complex relationships in what are always theories. We may know all the facts and numbers possible about a particular set of events, but to order them and to explain them requires theory, and that theory, obviously, is a construction of the mind.

This does not mean that all results are subjective. Obviously, what we try to do is to test the theories we have against the evidence so that we can arrive at rough, very rough, estimates of the reliability of such theories. But it does mean that all the theories we have are subjective; they are always imperfect and incomplete.

---

<sup>18</sup> Eggertsson (2009), at 147 (“An individual’s social model contains a set of assumptions and relationships—theories—that he or she uses to interpret a complex environment.”)

<sup>19</sup> *Id.* at 143.

<sup>20</sup> Eggertsson (2010) at 713.

<sup>21</sup> Douglass C. North, **Understanding the Process of Economic Change** 83 (Princeton University Press, 2005).

<sup>22</sup> Eggertsson, Norms in Economics, at 93. See Eggertsson (2009), at 149 (“subjective models guide all types of actors”).

<sup>23</sup> *Id.* See Douglass C. North, **Institutions, Institutional Change, and Economic Performance** 37 (Cambridge University Press, 1990) (“Culture can be defined as the transmission from one generation to the next, via teaching and imitation, of knowledge, values and other factors that influence behavior”; *quoting* R. Boyd & P. J. Richerson, **Culture and the Evolutionary Process** 2 (The University of Chicago Press 1985)).

Eggertsson has noted that “individuals with comparable experience and interests usually have faith in similar social models and social institutions: these models cluster.”<sup>24</sup> This clustering of individual models leads to “[s]ocial groups shar[ing] symbols, models, and collective memories of historical events, such as ethnic strife, that people use for filtering data and interpreting current events.”<sup>25</sup> As a result, a society’s culture that is passed down to the next generation includes the shared mental models.

Individuals from different backgrounds will interpret the same evidence differently and in consequence make different choices. Individuals have different systems of beliefs that create different filters through which they perceive the world and its problems and also create different theories to explain the world and devise solutions for the problems. As Eggertsson has written, “mental models and expectations guide the organizations and households when they approach new rules and systems of enforcement.”<sup>26</sup>

In any society, there are large variations in the belief systems among people.<sup>27</sup> As a result, some people see problems and solutions very differently than other people. For example, both private industry and the U.S. government contributed to the housing bubble that led to the Great Recession. The federal government tried to increase homeownership and so subsidized housing through Fannie Mae and Freddie Mac. This led to people owning homes they could not afford. Concurrently, some private mortgage firms tried to get anyone possible to buy a house and obtain a mortgage, regardless of their financial abilities. Those mortgage firms bore no risk from risky mortgages and earned their fees just by processing the mortgages. Investment firms fueled the fire for mortgages because they needed them to back their derivative instruments. Without a doubt, both private industry and the federal government played major roles in creating the sub-prime mortgage crisis. Yet, opponents of government blame the government and never mention private industry, and vice versa, others blame private industry and never acknowledge the government’s role.

### c. Non-Rational Human Decision-Making

All of social science is based on the assumption that people act rationally, in a logical, unemotional fashion. This is true for all disciplines in social science, including both economics and law. Neoclassical price theory assumes that producers and consumers are rational actors, while the reasonable person in law is the rational cousin to the economic actor. As Eggertsson has explained, “rational expectations theory assumes that all actors share common beliefs, without explaining the origins of those beliefs and how they are shared; the problem of knowledge is assumed away.”<sup>28</sup> Today, a large and growing body of scholarship exhibits a willingness to modify the rationality assumption by using cognitive science, behavioral psychology, and experimental economics.

---

<sup>24</sup> Eggertsson, *Imperfect Institutions*, at 39.

<sup>25</sup> *Id.* at 95.

<sup>26</sup> Eggertsson (2010), at 724. *See id.* at 727 (“the final outcome of major social experiments depends on the content of mental models or theories at all levels, the evolution of these models, and how they are eventually coordinated”).

<sup>27</sup> Eggertsson, *Norms in Economics*, at 93.

<sup>28</sup> Eggertsson (2009) at 141.

That human decision-making is not as described by rational choice theory has relevance for understanding the transmission of information to people. There is every reason to believe that people are not open to receive new information and to update their knowledge in light of the new information. That computer-like conduct is too rational to be true. Add into the mix the difficulty of achieving agreement on theories and well-formed belief systems that are resistant to new information, and we should expect information to mean less than social science assumes. There probably is a difference in the receptivity of information by lay people and educated professionals, with professionals taught to be open to certain types of information, ideas, and arguments. Nonetheless, even policymakers are limited by their belief systems and non-rational behavior.

## B. Economists' Faith in the Market

Economists are highly educated people, who spend their lives thinking about the economic system. I think that, in general, the belief systems of economists center around an abiding preference for the unregulated or little regulated market over government regulation. This belief colors the way they view economic issues. Economists are educated beginning in their Econ 1 course that competitive markets are the norm and that monopolies and oligopolies are the exception. During their education, they are taught that what they are studying is relevant to real world markets because markets are competitive. It is hard for them to believe otherwise: if markets are not competitive, their discipline is truly just an academic enterprise. Their long period of education is a socialization process that ingrains in them a belief in the existence of competitive markets. Once they become professors, the process of peer review of their articles reinforces this belief because the referees were also taught that markets work. As a result, the belief systems of economists include great faith in competitive markets.

Over 50 years ago, George Stigler noted that the professional training of economists made them conservative, with a preference for “most economic activity to be conducted by private enterprise” and with a belief that “efficiency and progress [will] usually be provided by forces of competition.”<sup>29</sup> I think that is as true today as it was when Stigler wrote. Douglass North used to poke fun at the effects of economic education by noting a study of how people around the world in various cultures play the Ultimatum Game. The Ultimatum Game involves two players, with one being given a sum of money, say \$20, and the other nothing. The person with the money is then told to share as much as he or she desires with the other person or keep the entire funds. The study showed that virtually all people offer a reasonable share of the pot to the other party, often one-half or something near half.<sup>30</sup> This shows the similar norms of sharing throughout the world. However, North would point out that only two groups play the game like *homo economicus* (by making a very low offer), a tribe in the Amazon and economics graduate students. This is a lesson that training in economics students socializes economists to look at the world as if it actually operates according to the assumptions of economic theory.

---

<sup>29</sup> George J. Stigler, **Essay in the History of Economics** 52, 53-54, 59 (U. Chicago Press 1965). See the full quotation in the Introduction at p.

<sup>30</sup> Lynn A. Stout, *Social Norms and Other-Regarding Preferences*, in John N. Drobak, ed., **Norms and the Law** 13, 19 (2006).

The belief systems of many economists lead them at times to exaggerate the theoretical foundations for their claims about the effectiveness of a market in circumstances in which economic theory does not fit well. They sometimes present conclusions as driven by economic theory, extolling the benefits of a limited “market,” when they are really making normative statements based on their own philosophy or social theory. Although this is only their belief, many people take their conclusion to be factually correct. Some economists do this unknowingly. Others do this with an implicit recognition that the market is far from perfect, but they prefer the known imperfect economic consequences over uncertain results that could come with government regulation. Opposition to government regulation in many non-competitive markets, including limits on the compensation of corporate officers and rent control, probably also reflects a fear that government will continue to intervene in additional markets (including competitive ones) once it intervenes in a few. This is a “slippery slope” argument that government will not be able to limit its tendency to regulate once it gets into the habit. Worse consequences from government action and a slippery slope of regulation may be valid reasons for opposing government intervention in markets, but they are not arguments derived from economic theory. Compounding the problem is the difficulty of really determining if markets are competitive. As this article has shown, the methodology is imprecise and results are often debatable. The dynamic aspect of real world markets makes it even harder to determine whether a market is competitive at a given time. The world changes over time, as does market structure and competitive behavior, so a study one year may give an accurate picture a decade later.

### C. The Public’s Faith in the Market

Much social science theory assumes that voters process the information they receive as if they were rational actors, but as I explained above, people often do not make decisions that way. Established belief systems can make the reception of new information very difficult. To illustrate this point, Douglass North has used the example of the inability of the leaders of the Soviet to accept the information that showed the failing of the Soviet economic system. He explains the phenomenon as follows:

This is a story about the perceptions of reality held by human beings. Those perceptions of reality are translated into beliefs. . . . Actually, if we consider in greater detail what happened in the Soviet Union during the Brezhnev era, we observe that there were two failures of feedback. One of them is that the failures of the Soviet Union—as in agriculture, for example—never could penetrate the top echelon of the Soviet leaders. The second problem is that such information was antithetical to fundamental Marxist tenets about the nature of property. It was widely known in the late 1970s, although not officially admitted, that the one acre private plots in Uzbekistan made up one percent of the arable land and produced about twenty percent of total soviet agricultural output.<sup>31</sup>

The difficulty of conveying political information is compounded by the tendency of many people to put little time and effort into learning about issues and candidates. Walter Lippman reminded us in **The Phantom Public**, a book published more than 75 years ago, that most people are too

---

<sup>31</sup> Douglass C. North, *Cognitive Science and the Study of the “Rules of the Game,”* in John N. Drobak, ed., **Norms and the Law**, 48, 53-54 (2006, Cambridge University Press).

busy with the routine needs of life to have the time to become educated about political issues.<sup>32</sup> It is natural for people to be more interested in their families, religion, sports, hobbies, and the other aspects of ordinary life. Not surprisingly, many people care more about a reality television personality or a sports star than whether markets in the U.S. are competitive. As a result, the vast majority of the ordinary public has only a casual understanding of and interest in economic and political issues. Another scholar has suggested that the problem is more than inattention. He suggests that

[i]t is by now a commonplace belief that the mass of Americans do not have a sophisticated conceptual organization by which politics may be understood. [For that to happen,] a person must: 1) have cognitive skills which allow him to see linkages between ideas and events. Such linkages determine the amount of constraint in his belief system. 2) Have a developed morality which allows him to evaluate consistently the ethical meanings of political events.<sup>33</sup>

There are a number of studies of voting behavior in the United States that suggest that beliefs systems and non-rational action affect the way people form political opinions. Although this type of survey data provides only rough measures of information and is therefore subject to considerable disagreement on some effects, there is enough evidence to draw some plausible, tentative conclusions about how people form opinions on political issues.

Many studies show that political views are strongly influenced by events during childhood and then through secondary school and college. Taken as a whole, the literature on childhood political socialization suggests that the party affiliation of one's parents is largely predictive of one's own party affiliation, though parents' beliefs on specific issues are not predictive of their children's beliefs on the same issues.<sup>34</sup> Of course, political ideologies are a function of more than just family political affiliation and structure. Prevailing community sentiments also help direct children's political worldviews: Children in ethnic- or racial- minority communities develop different political sensibilities than white children, suggesting that views that are widely-held within a community do filter down to children.<sup>35</sup> Education also influences the political views of many young people. The end of adolescence is not the end of political development. It is accepted that adults rarely switch from one political party to another, but they do move from party affiliation to independent status.<sup>36</sup> New challenges facing adults can cause "considerable

---

<sup>32</sup> Walter Lippman, *The Phantom Public* 24-27 (193X). Richard Fallon gently refers to "the public's relative lack of attentiveness." Richard H. Fallon, Jr., *Legitimacy and the Constitution*, 118 *Harv. L. Rev.* 1787, 1830 (2005). See also Walter F. Murphy and Joseph Tanenhaus, *Publicity, Public Opinion, and the Court*, 84 *Nw.U.L. Rev.* 985, 990 (small portion of public have sophisticated understanding of Court.)

<sup>33</sup> Richard H. Merelman, *The Development of Political ideology: A Framework for the analysis of Political Socialization*, 63 *Am. Pol. Sci. Rev.* 750, 750, 753 (1969).

<sup>34</sup> Niemi & Sobieszek, *Political Socialization*, 3 *Ann. Rev. Sociol.* 209 (1977). Some studies they cited suggested that parents and children have extremely high correlations on all political views, whereas others suggested the matching was relatively minimal. They concluded that the most sound research showed high levels of correlation for party and voting preferences, with quite small (though positive) correlations for opinions on specific opinions. Parental politics are apparently strongly predictive of children's party, but not very predictive of children's views on issues.

<sup>35</sup> *See* Niemi and Sobieszek, *supra* note 6, at 212-13 (describing how white children tend to believe that political leaders "know more than anyone" and "almost never make mistakes," whereas Mexican or Black children tend to have very negative views of the political system as a whole.)

<sup>36</sup> Niemi and Sobieszek, at 226.

change in sociopolitical attitudes and behaviors as individuals are confronted with new conditions and contingencies.”<sup>37</sup> Adults “have to cope with a variety of new tasks and assume a variety of new roles for which neither childhood nor adulthood prepares them adequately.”<sup>38</sup> These new challenges can cause “considerable change in sociopolitical attitudes and behaviors as individuals are confronted with new conditions and contingencies.”<sup>39</sup> For example, adults who join the military might find that they are socialized to dedicate themselves to “the nation ... ahead of family and even self.”<sup>40</sup> People who acclimate to such an environment would necessarily re-structure their political views. It is a change in the adult’s own personal experience, rather than an open-minded reading of the news, that causes the holder to change their narrative. Similarly, job pressure, continued exclusion or oppression, or prosperity can all cause an adult to reformulate their political ideas to accommodate their economic or social position.<sup>41</sup>

By adulthood, the vast majority of people have developed a belief system that allows for easy processing of new political information. As adults, citizens accumulate political information through the filter of their previously-existing political outlook. Instead of first understanding facts, considering available information, and then making political choices, we “choose what we like, and only after we have decided what to do, we retroactively try to rationalize our decision.”<sup>42</sup> This method of decision-making presents a significant challenge to democracy because “most American voters lack sufficient information or interest” to rationally evaluate political choices.<sup>43</sup> Instead of relying on facts, events, and careful deliberation, citizens rely on “heuristic cues” to guide their experience of political events. These cues provide “simple pieces of information that can lead citizens to make the same choices that many, complex pieces of information do.”<sup>44</sup> These cues often take the form of party affiliation—voters who hold liberal viewpoints will be predisposed to agree with ideas propagated by a source they know to be liberal. Once a citizen is presented with a narrative from what they consider to be a credible source, the citizen will normally accept that viewpoint. Repetition of a narrative leads the citizen to instinctively agree with it more and more, creating a cascading effect.<sup>45</sup> Even if the narrative is conclusively shown to be inaccurate, informing the citizen of its falseness can serve to engrain the idea even deeper, because revealing its falseness “require[s] repetition of the false

---

<sup>37</sup> *Id.*

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* at 91.

<sup>41</sup> *Id.*

<sup>42</sup> Jeremy N. Sheff, *The Myth of the Level Playing Field: Knowledge, Affect, and Repetition in Public Debate*, 75 MO. L. REV. 143, 158 (2010).

<sup>43</sup> *Id.* at 165.

<sup>44</sup> Michael S. Kang, *Democratizing Direct Democracy: Restoring Voter Competence Through Heuristic Cues and “Disclosure Plus,”* 50 UCLA L. REV. 1141, 1149-50 (2003), quoting Arthur Lupia, *Dumber than Chimps? An Assessment of Democracy Voters*, \_\_\_\_\_.

<sup>45</sup> Sheff, *supra* note 16, at 162. Cass Sunstein has noted the danger of zealots constantly reinforcing views over the internet. He is concerned that “enclave deliberation” can lead to “crippling epistemology,” and “in the extreme, may ... even put social stability at risk.” Cass Sunstein, **Republic.com** 76, 78 (2007), quoting Russell Hardin, in *The Crippled Epistemology of Extremism*, in **Political Extremism and Rationality** 3 (Albert Breton, et al. eds 2002).

proposition.”<sup>46</sup> Presenting a citizen with unexpected facts about a topic—even facts that cast doubt upon the basis of the citizen’s belief—is unlikely to alter the citizen’s position.<sup>47</sup> Behavioral economists have demonstrated these phenomena with their studies of confirmation bias.

This narrative may paint a dismal picture of voters in the United States, but it not a new picture. “Since the 1940’s, when social scientists began measuring it, political ignorance has remained virtually unchanged.”<sup>48</sup> While voters appear to be no less informed than they used to be, there is no reason to believe that modern voters are significantly more rational than their predecessors. After all, voters then and now are people. This means that data and logical analysis will not convince most people that many markets in the U.S. are uncompetitive and that corporations should take the interests of workers and communities into account. Changing people’s attitudes requires a change in culture. A consistent narrative by economists, public officials, and social commentators has a chance of getting people to accept these two propositions. That is impossible today with the common presumption in favor of limited regulation of markets.<sup>49</sup> Another way is through political action that leads to social change. The campaigns of Donald Trump and Bernie Sanders and the rise of the populist movement in the last presidential campaign raised the visibility of the problems of U.S. labor. This has not resulted in any changes to benefit labor or to enhance competition, but at least it is a start in the right direction.

---

<sup>46</sup> Sheff, *supra* note 16, at 162-63. See also Norbert Schwarz, Lawrence J. Sanna, Ian Skurnik, & Carolyn Yoon, *Metacognitive Experiences and the Intricacies of Setting People Straight: Implications for Debiasing and Public Information Campaigns*, 39 *ADVANCES IN EXPERIMENTAL SOCIAL PSYCHOLOGY* 127 (2007).

<sup>47</sup> Sheff, *supra* note 16, at 176-77 (stating that “voters have a tendency to discount information that conflicts with their worldview and to accept uncritically information that confirms that worldview.”).

<sup>48</sup> *Id.*

<sup>49</sup> Even if the vast majority of economists supported the kind of regulation proposed in this book, there is no guarantee that Congress would follow that recommendation. Many elected officials make arguments that support the outcomes they want, even if most experts disagree. One example of that is the advocacy of trickle-down economics by politicians even in the face of consistent economic studies showing no merit to that kind of tax policy. Either these politicians do not believe the economic experts or they do but nonetheless support tax relief for business and the rich for other reasons. See chapter 1, note 1.