

The Worldview Informing the Work of the Productivity Commission: A Critique

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Looking through the list of Commission publications over the last two to three years indicates that the Commission's remit has broadened a great deal from the days of deregulation, privatization and trade liberalization. This broadening has meant a dilution of the hard-line neoclassical foundations of the Commission's analysis in that era.

Gone are the bad old days of the 'thought police', the Commission's unit that vetted reports and papers for deviations from the correct line. Glenn Withers told me that he was once discussing with members of this unit a paper he'd prepared for the Commission. At one point his junior colleague raised the question of the social equity implications of the issue. The chief enforcer of the unit pulled an atomizer from under the table and sprayed him with water. When the shocked colleague asked 'why', he was told that that is what they do to anyone who says something wet.

This growth of eclecticism is to be welcomed, yet in some reports we still see the influence of textbook economic thinking. Of course, the mainstream economic approach can be interpreted more or less rigidly, and it has often seemed to me that the place where an economist comes down tells us quite a bit about their personality. But I will argue that this approach is of diminishing usefulness in understanding contemporary consumer capitalism. Let me explain why, bearing in mind that these are only initial thoughts developed over the last few days.

First and second-order preferences

The view of the world that underpins much of the Commission's work takes as its starting point a peculiar conception of the human being. The world — interpreted as meaning the economy, sometimes with extra bits such as the environment added on — is made up of atomized individuals each with their own endowments, capacities, incentives and preferences. The focus is then on the choices that these individuals make in pursuit of their own welfare, subject to various constraints.

This idea of consumer sovereignty underpins mainstream economics. It justifies policies that promote competition, market liberalization and greater choice. Indeed, the transition from a set of preferences to an optimal outcome defines the notion of rationality itself. The Commission is familiar with various forms of market failure — externalities, spillovers and asymmetrical information — but these are all variations on a theme. I would like to suggest that there is a more fundamental problem with this view of the world that means that increasingly the promotion of 'choice', as it is commonly understood, may be reducing social welfare.

The core of my argument draws on the distinction between first and second-order preferences. First-order preferences are the ones mainstream economics recognises, the

ones that are revealed by our behaviour in the marketplace. Second-order preferences are the preferences we have about our own preferences. This has been explored by US economist David George in a series of papers and a book titled *Preference Pollution* (University of Michigan Press, 2001).¹

George gives the example of his consumption of fast food. As he sits eating a greasy hamburger he is wishing that he was eating something healthier. His second-order preference is a preference for his food preferences. It is not just another preference but a deeper order of preference. One reason for his first-order preference prevailing is the circumstances under which we make decisions. Snap decisions are more likely to follow first-order preferences while more considered judgments are more likely to see us following our second-order preferences.

We all at times succumb to temptation to put aside moral qualms or longer-term life goals. The Greeks referred to moral weakness as *akrasia*. I will argue that modern marketing is aimed at cultivating and exploiting it.

Let me illustrate with another example. I received a glossy brochure in the letter box for Fox pay TV. The service offered in the brochure was alluring and I said to my son: “Let’s get this so we can watch the Brumbies”. He replied: “Or we could give the money to a charity to help impoverished Africans.” My second-order preference – to prefer to spend more on worthwhile causes than improving my entertainment options – kicked in.

In an affluent society, producers of consumer goods have a strong influence on our preferences, especially our first-order preferences. They often set out to tempt us to allow our first-order preferences to over-rule our deeper preferences. They increasingly provide opportunities for instant gratification by appealing to our weaknesses.

I think the modern obesity epidemic can be understood in precisely these terms. Most obese people would prefer to be thinner; they prefer to prefer less food. Some go to extreme lengths to ensure that their second-order preferences prevail, such as by checking themselves in to sanatoriums where their cravings for junk food cannot be met. Yet it is the single objective of suppliers of junk food to persuade us to allow our first-order preferences to prevail.

Choice and free will

This raises the question of how the market shapes the circumstances in which we express our preferences. Before considering this, George points out (following the philosopher Harry Frankfurt) that only animals consistently act on the basis of their first-order preferences.² A dog wants to eat so it eats. Humans have the unique capacity to reflect on the desirability or otherwise of their preferences, in other words, to prefer to have one set of preferences over another. Thus we are capable of reflecting on the sort of person we want to be, the sorts of likes and dislikes we think are in our interests. On that basis, we can desire to be different, even a different sort of person.

We often train ourselves to acquire certain tastes, such as wine appreciation. We go to wine appreciation classes not because we desire wine, but because we desire to desire wine. We might want to become a sophisticated person and set about cultivating or

¹ See also Lanse Minkler, ‘Preference Pollution, Reasons, and Other Murky Motivations: on some hidden costs of the market’, *Review of Social Economy*, Vol. LXII, No. 2, June 2004

² David George, *Preference Pollution*, University of Michigan Press, 2001, p. 16

creating the tastes and lifestyle of that sort of person. In so doing, we use our will-power to resist some urges and cultivate others. In other words, we substitute one set of first-order preferences – one that is in conflict with our second-order preference – for another.

Yet conventional economics understands humans as, in essence, no different from animals. This is not contradicted by the capacity of humans to experience altruistic motives. Economics can easily incorporate altruism into a preference set, even a utility function. But it then becomes just another first-order preference to be traded off with others. You can see why most non-economists see this as cheapening or distorting the altruistic motive. After all, a dog may stay by his dying owner and starve to death.

In truth it is the existence of second-order preferences that makes us human, because it is they, and not our immediate urges, that prove we have free will. Thus the promotion of choice in itself – the holy grail of mainstream economics and neoliberal policy – tells us nothing about freedom. A dog may be able to choose from amongst six different dog foods, but that does not make it free; it only means it has choice. I can choose from among 49 different types of olive oil at my local supermarket, but that does not make me free. I am free only if I have the self-control, the will and the intellectual capacity to select my preferences.

Citizens and consumers

Let me give another example much closer to the sort of work that the Commission does. When energy retailers were thinking about introducing greenpower schemes – under which customers could choose to pay extra for electricity generated from renewable sources – surveys indicated that 60-70 per cent of customers would opt for it. After a few years of offering the product the actual take-up has been only 2-3 per cent.

The mainstream economist might conclude that people were not expressing their true preferences in the surveys and when it came to actual market decisions their real preferences were expressed. Yet, I assert, on the basis of extensive evidence, that if electricity consumers were asked to vote on whether the government should mandate that the share of electricity from renewables should be rapidly increased over time then a majority would vote yes.

In other words, people can express different preferences for the same thing in different circumstances. Indeed, people often attempt to change the circumstances under which they are due to make a decision so as to favour their second-order preferences. They may turn off their computers so that they do not check their emails as often, ask others to hide their cigarettes, or vote for governments that promise to stop them engaging in certain behaviours. Compulsory superannuation enjoys very wide support because people want the government to force them to save, knowing that without that compulsion they are likely to fritter away their surplus income.

Thus the preference to prefer greenpower is for most a second-order preference, but one that is often ignored in favour of a first-order preference. Following George,³ this way of understanding preferences helps us to resolve an apparent paradox, according to which it is possible for an electricity consumer to hold the following three beliefs.

1. I am a rational person who selects what is optimal from the choices available.

³ George, *op. cit.* p. 10

2. Although other choices are available, I have currently selected to buy electricity from polluting coal-fired plants.
3. In the best of all possible worlds, given currently prevailing prices and given my income, I would be happy to pay more for greenpower.

For mainstream economics, the third belief cannot hold if the first two are true. A rational person who has expressed a preference in the market cannot prefer something else. But, I maintain, it is common for a rational person to hold all three beliefs, and to do so consistently.

The 60 or so per cent of Australian electricity users who say they would prefer to buy greenpower but in practice buy dirty power are allowing their immediate preference to over-rule their higher-order preference. Myopia is one explanation of why I might opt for dirty power instead of favouring my second-order preference for greenpower. If I focus only on my short-term interests I am more likely to look at minimising what I pay for electricity. Yet when I reflect on it and consider the long term, the benefits of reducing greenhouse gas emissions may prevail.

Long-sightedness takes us to a different decision-making realm in which broader considerations than my own immediate material comfort are relevant. There are also moral considerations to be taken into account. Instead of asking “What is in my interests?” the consumer is asking “What is the right thing to do?” When 60-70 per cent of consumers say they will buy greenpower they are saying that buying greenpower and reducing emissions is the right thing to do.

To argue that their ‘real preference’ is to get the cheapest power they can, and that’s that, is to trivialize the moral considerations and to reduce ethical values to economic ones. As I have suggested, such a reduction is possible only by privileging one set of preferences even though different circumstances may see us acting on our preferred preferences. From this perspective, behaviour in the marketplace may not so much *reveal* preferences as conceal them.

This is why the distinction between the consumer and the citizen – between the self-interested customer and the social actor – is so critical. Although of course voters often respond to self-interested considerations, and ethical factors influence the decisions of some consumers, there is a distinction between supermarket behaviour and ballot box behaviour. It is the error of mainstream economics to reduce every situation to the equivalent of a real or hypothetical market and to characterise the citizen as a slightly more complicated consumer. This is a category error.

I think these ideas help us understand why the Commission’s report on energy efficiency – *The Private Cost Effectiveness of Improving Energy Efficiency* (August 2005) – was so heavily criticized for failing to accommodate the environmental or public benefits of improving energy efficiency. The Commission justified its exclusive focus on private costs and benefits by reference to its circumscribed terms of reference.⁴ If the Commission

⁴ ‘Furthermore, the inquiry terms of reference direct the Commission to examine and report on the broader economic and environmental costs and benefits arising from privately cost-effective energy efficiency improvements. Thus, although the Commission is constrained to look at only a subset of all possible energy efficiency measures, it is required to have regard to the public benefits of those measures.’

could not examine measures that are not cost-effective for private individuals but do have net benefits for society as a whole, this did not prevent it from making judgments about the desirability of a range of policies and measures, some of which may well have failed the private benefit test but would pass the public benefit test or vice versa. Surely, policy measures can only be recommended on the basis of net social benefit?

But, more importantly, I think that there is a deeper problem with the Commission's approach, one that is reflected in the energy efficiency report and which is illuminated by the distinction between first and second-order preferences. The Commission reduces second-order preferences to first-order ones. This is made explicit in the following apparently innocuous statement from the report.

If it is difficult to overcome the barriers to the adoption of privately cost-effective improvements in energy efficiency, then it will be even more difficult to drive the adoption of measures that will require private sacrifices for the greater public good.

In general, I maintain, private cost-effectiveness is an assessment method appropriate to first-order preferences, while the public good is a motive more likely to inform second-order preferences. Most people, or at least some people, would prefer to prefer that they engage in more energy efficiency; yet the report makes the public good contingent on private financial calculation.

How the market shapes preferences

Why should the market create or widen the conflict between first and second-order preferences?

The idea of consumer sovereignty assumes that first-order preferences are just given; they are exogenous to the system. But in modern consumer capitalism this is no longer a tenable assumption; a vast marketing industry exists to create and shape our tastes. In fact, it is true to say that a large part of the growth of income over the next decade will be spent on goods the craving for which has yet to be created by marketers.

Second-order preferences, while not immune to outside influence, have much greater claim to be exogenous. Let me comment on this contention.

One reason for this is the role of moral considerations. I think a case can be made that first-order preferences are more likely to be founded on personal benefit – the sort of motive that is customarily assumed in economics texts – while second-order preferences are more likely to be influenced by moral considerations. It can also be argued that the market, not exclusively but as a rule, acts to encourage us to favour self-interested behaviour instead of morally motivated behaviour.

An example is that of the child care centre that decided that the best way to discourage parents from picking up their children late would be to impose a fine. A costless activity (getting 10-15 minutes of free childcare) suddenly became costly. Much to their astonishment, the child care workers found that parents began picking up their children even later. Why? What was previously a decision made with a strong element of moral suasion – “It's unfair to freeload and to exploit childcare workers who want to go home on

time” – had become an economic transaction – “How much extra time am I willing to pay for?” Putting a price on being late made parents consume more of it.⁵ The demand curve slopes upwards, at least over a range of prices.

Economists often attempt to explain ‘moral’ behaviour by reference to some personal benefit – such as the good feeling we get for acting morally. In other words, there is some compensation for giving up something. Certainly much giving behaviour can be understood in these terms. (If you have had any contact with the philanthropic community you will know how much ego gratification is sometimes bound up in charity.) But to characterise moral behaviour as conferring some form of utility is a perverse way of seeing it, one confined largely to economists. Any number of philosophers have understood moral acts as ones undertaken for their own sake, not because the actor expects or receives any benefit, psychic or otherwise. As Minkler writes:

The moral principles must become one’s own for the person of integrity ... To violate one’s own moral principle would be to confuse one’s identity.⁶

Market transactions are not, of course, devoid of moral considerations. Often, elements of trust, loyalty and fairness enter into them. For example, although billed for \$150 by window cleaners, I paid \$175 because they had done such a good job. But a strong case can be made that over time the spread of pure market values drives these moral elements out of transactions. This I suspect will be the hidden cost of recent changes to Australia’s workplace laws. By removing a framework that provided for greater procedural fairness, workplaces are likely to be characterised by less loyalty and less commitment on the part of both employees and employers.

Impulsiveness

Another reason, considered by George, to expect the market to bring our first and second-order preferences into conflict is that the market allows us to satisfy our desires more quickly than might otherwise have been the case. Indeed, a large part of the efforts of marketing are directed at persuading us to act immediately, to buy impulsively, and for the sales person to ‘close the deal’. The dangers of impulsiveness are reflected in laws that require ‘cooling off’ periods for transactions involving real estate or items purchased at the front door or over the phone. There is a clear recognition by our legislators that we are prone, particularly when under some pressure, to act on our first-order preferences – our unpreferred preferences – when, if we had more time, we would have made a different decision.

George also considers the example of why we watch so much trash on television. This is the result of channel surfing and instant decision making and it often leads us to ask ourselves: Why am I watching this crap? The answer is that we are acting according to first-order preferences, ones that we would prefer not to have. If we were required to nominate the programs we wanted to watch at the beginning of the week and then locked them in, it is a fair bet that the quality of television we watched would be higher and we would be more contented at the end of the week. This suggests that the ABC caters to people more capable of ensuring their second-order preferences prevail.

⁵ It is likely that if the Red Cross began paying donors for giving up a litre of blood the supply of donors would decline. Certainly the quality of blood provided would deteriorate, as new donors in need of the money, but more likely to be infected with Hepatitis, would turn up at the door.

⁶ Minkler, *op. cit.*, p. 269

The same applies to our consumption of junk food and a range of activities that, according to our better judgment, we should undertake less frequently. Smoking, driving when we could easily walk and indulging our children come to mind.

The effect of marketing

It is here that we must consider the role of marketing directly. Some time ago, advertising shifted from being predominantly informative to predominantly persuasive. But that is now old hat. Over the last decade or two marketing has been transformed. Now successful producers set out to create a brand which is endowed with a series of attributes denoting a particular lifestyle. When we buy these brands we are buying into the type of person we want to project onto the world.

Today's consumer is not just sold products but persuaded over and over that spending money is an effective means to relieve them of their anxieties, self-doubt and the drudgery of their lives. Shopping is accepted as an antidote to the daily stresses of life, a phenomenon captured in the term 'retail therapy'. In fact, psychologists now recognise a new compulsive disorder known as oniomania, or compulsive shopping. Most compulsive shoppers are visited by feelings of regret when they arrive home with bags full of items that they actually don't want and the regrets are redoubled when the credit card bill arrives. The effect on families can also be severe. There is little doubt that the second-order preference of compulsive shoppers is a preference to prefer to shop less.

It is not just compulsive shoppers who have a second-order preference to consume less. This is precisely what that class of citizens known as downshifters have done. Accounting for around a fifth of adult Australians, downshifters have made a conscious decision to earn less and consume less. Yet the pressures to continue to consume at ever-higher levels are intense. Consumption is one of the predominant markers of social status and a successful life, one reinforced by advertisers and governments many times a day.

It could be argued that the rapid increase in availability of consumer credit over the last two decades has been aimed at encouraging most of us to buy more by shopping impulsively and even compulsively. If we did not have credit cards, we would almost certainly buy less because the time lapse between the generation of desires and acting on them would, for many items, be much longer.

The contrast with the model of the neoclassical economist could not be starker. Consumers are imagined to go to the market to buy a particular good that will satisfy a need arising out of their pre-given preferences. This process of 'choice' is the quintessential justification of free market economics. In fact, it is more accurate to say that the modern consumer goes to the market a needy mass of confused, self-doubting and neurotic urges looking for a salve. At least, this is what the marketers assume and the basis on which they work. They are masterful at creating our 'preferences' for their products, but are the first to appeal to the sovereignty of 'consumer choice' the instant anyone suggests any restriction.

Unlike the political defenders of the market and so-called 'free choice' by consumers, the advertisers and marketers are much more sanguine about the way they manipulate consumers into doing things they don't want to do and exploiting their weaknesses to do it. For example, in an analysis of the growth of luxury goods markets, the *Financial Review* noted last year that the boom reflects not so much the growth in prosperity but

“the stress and isolation of modern life”.⁷ The head of planning at the advertising agency Grey Worldwide, Mary Winter, said:

Most people don't have a sense of self-worth. Buying luxury goods makes us feel special and successful. They make us feel valuable in a world that often tests our sense of self-worth.

In conclusion

It is for these sorts of reasons that the market is more likely to influence first-order preferences so that they conflict with our deeper, second-order preferences. Second-order preferences have greater ‘authority’ in the sense that they are more likely to represent our best interests, because they are the rulings of our ‘better judge’.

The social problem that arises from this analysis is not that the market, through advertising, changes our tastes, but that the market has a tendency to create a conflict between our first and second-order preferences, an ‘inefficient’ outcome.

If this is so then the presupposition of mainstream economics – that we go to the market to express our preferences and thereby advance our welfare – is turned on its head. Increasingly, it is only by shunning the allure of the market that we can give expression to our true preferences.

⁷ Neil Shoebridge and Rochelle Burbury, ‘White leather gives a pink glow of self-worth’, *The Weekend Australian Financial Review*, February 19-20, 2006, p. 24