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The Artificiality of Economic Models as a Guide for Legal Evolution

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COMMENT

THE ARTIFICIALITY OF ECONOMIC MODELS AS A GUIDE FOR LEGAL EVOLUTION

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I. INTRODUCTION

Economists have attempted aggressively to influence American legal developments.¹ Yet, the models with which economists organize their analysis have peculiar qualities that make them especially productive for some purposes, but misleading for others.² Although economic thinking is highly precise and systematic, the reality which economic models claim to dissect frequently does not conform to the neatness and logical qualities that characterize these models.³ Those in the legal community who base their decisions upon the advice of economic experts need to be sensitive to the deductive nature of economic thinking. As an intellectual device shaping legislation and judicial decisions, economic models are only as appropriate as the factual base upon which they are built.⁴ Since economics has such a limited empirical base, careful evaluation of economic models necessitates an alertness to the contrived factual foundation upon which specific models are built. There must also be an awareness on the part of those listening that these economic arguments, while purportedly

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¹ R. SOLO, *THE POSITIVE STATE* 39-49 (1982)(particularly important have been the contributions of economists to our thinking about the interaction between business and the consumer).

² See Leontief, *The Distribution of Work and Income*, *SCI. AM.*, Sept. 1982, at 188 and Smith, *The Big Picture*, *ESQUIRE*, Feb. 1981, at 10, 11 (interview with Wassily Leontief for a perceptive critique of the lack of data that characterizes typical economic models).

³ G. MYRDAL, *AGAINST THE STREAM* 133-57 (1973).

⁴ Theoretical abstractions have a tendency to become concrete in the minds of those who deploy them. A model of reality is not reality itself but an image replete with emphasis and distortions.

value-free, really possess numerous normative overtones.

This Comment focuses on the frequent conflict between orthodox economic theory and the direction taken by legislation or the common law. Several specific areas of legal decision making are discussed as illustrations of this conflict with an emphasis on the artificiality of the economic thinking that caused the disagreement. The purpose of this analysis is to caution those who would use economic models as their primary beacon for prescribing future legal developments.⁵ The first section of this Comment looks at three specific controversial areas in which orthodox economic arguments are frequently considered: wage and price controls, comparable worth claims, and minimum wage laws. For each of these debates, the analysis demonstrates the conflict between prevailing economic theory and the eventual legal development and points out the flawed factual basis upon which much of the economic theory rests. The second section then suggests commonalities that characterize the debate and speculates about the reason for the tension between economic models and legal decision making.

II. WAGE AND PRICE CONTROLS

Wage and price controls or guidelines are part of a legislative effort to change the amount of inflation that occurs if workers, businesses, and consumers are allowed to establish wages and prices through market decisions. A definite preference for market decisions characterizes our economy;⁶ hence, wage and price controls have been enacted only during economic emergencies such as wars or hyperinflation. For it is only during such unusual circumstances that supporters of controls can generate enough enthusiasm to attain their objective.

Despite their general reluctance to alter market wages and prices, Americans have experimented with controls or guidelines on several occasions and doubtlessly will continue those experiments in the future. Controls were enacted by Congress during World War II to weaken the inflationary impact from the bursts of consumer spending.⁷ Again during the early 1960's, President Kennedy instituted a program of voluntary wage and price guidelines.⁸ While the inflationary impact of the Vietnam War and the resistance of business and labor to the guidelines eventually led

⁵ See, e.g., Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29 (1972)(use of a fault system of liability to subsidize emerging industries was no longer necessary in an advanced industrial age).

⁶ See E. HUNT, *PROPERTY AND PROPHETS* 165-80 (4th ed. 1981)(analyzing the variations of contemporary "contemporary American capitalism").

⁷ See AMERICAN ENTERPRISE INST. FOR PUB. POLICY RESEARCH, *WAGE-PRICE CONTROLS IN WORLD WAR II, UNITED STATES AND GERMANY* 7-52 (S. Campbell ed. 1971)(analyzing specific United States' efforts to control prices and wages during the 1940's); J. POHLMAN, *INFLATION UNDER CONTROL?* 178 (1976)(discussing more recent governmental price and wage controls).

⁸ See J. SHEAHAN, *THE WAGE-PRICE GUIDEPOSTS* 13-20 (1967).

to their official demise, the guidelines were in effect for six years.⁹ More recently, the Nixon administration froze prices and wages in September 1971; this control program continued until 1974.¹⁰ This cursory review exemplifies the occasional willingness of the executive or legislative branch to impose political decisions on the price and wage determination process.

While the legislative popularity of controls and guidelines has fluctuated, mainstream economists have consistently opposed governmental alteration of wages and prices. Economists tend to prefer solutions to inflation that would preserve the purity of "the market process." The case against controls presented by economists provides that through competition the market exerts the necessary control over business behavior.¹¹ If markets are highly competitive, "the individual firm has little or no choice over the price it will charge for its products."¹² In effect, the firm is at the mercy of consumers and technology and is basically powerless; it must obey consumer dictates or fail. If prices rise, the increase is an indicator that consumers have decided that more societal resources should be channeled to that particular product or service.¹³ In this scenario, price and wage increases serve a vital function by directing scarce resources to their optimal uses.¹⁴

The attack on controls by mainstream economists can be characterized as a defense of profits as a necessary indicator of consumer desires.¹⁵ If prices are controlled by the political process, profits will be directed by nonmarket criteria. The result, economists argue, would be a serious misallocation of resources as the inefficient or obsolete business would be protected by well-meaning, but myopic, government regulators.¹⁶

⁹ See W. HELLER, *NEW DIMENSIONS OF POLITICAL ECONOMY* (1966); A. OKUN, *THE POLITICAL ECONOMY OF PROSPERITY* (1970); Anderson, *Wages and the Guideposts: Comment*, 59 AM. ECON. REV. 351 (1969); Christian, *Bargaining Functions and the Effectiveness of the Wage-Price Guideposts*, 37 S. ECON. J. 51 (1970); Perry, *Wages and the Guideposts*, 57 AM. ECON. REV. 897 (1967); Throop, *The Union-Nonunion Wage Differential and Cost-Push Inflation*, 58 AM. ECON. REV. 79 (1968) for analysis of the rationale and evaluations of the Kennedy-Johnson guidelines.

¹⁰ See Gordon, *Response of Wages and Prices to the First Two Years of Controls*, 1973 BROOKINGS PAPERS ON ECON. ACTIVITY 765 (assessing the effectiveness of the Nixon controls); Mitchell, *The Impact and Administration of Wage Controls*, in *WAGE-PRICE CONTROLS* 36 (J. Kraft & B. Roberts eds. 1975)(same).

¹¹ See Houthakker, *Are Controls the Answer?*, 54 REV. ECON. & STATISTICS 231 (1972). Houthakker takes the position that political decision making lacks the allocative wisdom of market decisions. If governmental solutions to inflation are demanded by political reality, he contends that the government should concentrate on restoration of competition to the marketplace so that market decision making could again function according to the competitive model. *Id.* at 233-34.

¹² R. MCKENZIE & G. TULLOCK, *MODERN POLITICAL ECONOMY* 195 (1978).

¹³ *Id.* at 196.

¹⁴ *Id.* at 195.

¹⁵ See, e.g., Grayson, *Controls Are Not the Answer*, CHALLENGE, Nov.-Dec. 1974, at 9.

¹⁶ See, e.g., *id.* at 10-11.

The controversy surrounding rent controls is a narrow but representative example of the dispute between orthodox economic reasoning and legislative change. Economists attacking rent controls, or those using orthodox economic rationales, assert that the need for such controls is imaginary.¹⁷ The shortage of housing necessitates rent increases and large profits which allegedly assure an adequate number of housing units.¹⁸ Such reasoning is correct to the extent that the model on which it is based is factually correct. *If* owners of housing units are unable to manipulate their prices and *if* the bargaining power of the parties is equal, as the competitive model assumes, then (but only then) can we regard rent controls as futile and misguided.¹⁹

Some courts have recognized at least tacitly the lack of a solid factual basis for the application of this competitive model to the housing situation. At least during times of war, courts have been reluctant to strike down rent controls.²⁰ They have recognized that during wartime, capital, labor, and materials are diverted from the construction of housing to military production, and thus, spiraling rental rates will result only in spiraling profits for landlords.²¹ As a failing economy induces more urban communities to enact rent control legislation, it seems unlikely that the courts will follow orthodox economic wisdom and strike down these controls.

III. COMPARABLE WORTH CLAIMS

According to mainstream economists, markets provide a mechanism whereby each worker is rewarded financially on the basis of his or her contribution to the market value of the good or service which is sold by the employer. Hence, markets distribute incomes fairly, a high wage to productive workers and a low wage to nonproductive workers.²² High wages also serve as a social incentive to attract a greater number of workers to high paying occupations; low wages provide a corresponding disincentive for those who might consider entering such low paying occupations.²³ This incentive pattern accomplishes a useful social task since it provides information to workers about the needs of consumers.²⁴ If a

¹⁷ See, e.g., Owens, *Rent Controls: Solution or Problem*, 41 SASK. L. REV. 3 (1976).

¹⁸ See *id.* at 6-12.

¹⁹ For discussions that question the assumptions of the competitive model, see Baar, *Rent Control in the 1970's: The Case of the New Jersey Tenants' Movement*, 28 HASTINGS L.J. 630 (1977) and Robson & Watchman, *Short Hold: Repealing the Rent Act?* 124 SOLIC. J. 367 (1980).

²⁰ See *Woods v. Cloyd W. Miller Co.*, 333 U.S. 138, 142 n.6 (1948).

²¹ See *id.* at 146.

²² C. LINDSAY, *EQUAL PAY FOR COMPARABLE WORK: AN ECONOMIC ANALYSIS OF A NEW ANTI-DISCRIMINATION DOCTRINE* 4-16 (1980).

²³ *Id.* at 7.

²⁴ See Morgan, *The Deregulation Bandwagon: Too Far, Too Fast?*, 2 J.L. & COM. 2, 2

worker enters a high wage industry, he is responding to consumer signals.²⁵

Apparently, the model that leads economists to these conclusions is the same competitive model that explains their antagonism toward wage and price controls. Wages, the price of labor, move up or down in this model according to consumers' whims. As a result, neither employers nor employees possess bargaining power; each is at the mercy of consumers. Thus the model being used by economists to defend existing wage differentials is one in which bargaining power among employers and employees is nonexistent.²⁶ There are no centers of economic power, only atomistic workers and employers mercilessly directed by consumer choice, and the wage is the auction price agreed to by coequal workers and employers.²⁷

The courts have been somewhat more receptive than many economists to the pleas of certain workers that their market wage was determined in a less pure fashion than that projected by economic orthodoxy. For instance, in recent comparable worth claims before the courts, judges have made wage comparisons between males and females performing dissimilar work. Women in particular occupations have claimed that an equal-pay-for-comparable-work system would result in a male-female wage differential that is much less than the fifty-two percent differential identified in the 1980 census.²⁸ While the United States Supreme Court refused in *County of Washington v. Gunther*²⁹ to approve explicitly comparable worth actions it did make a comparison of wages for dissimilar work.³⁰ Consequently, those who dislike market wage differentials have been enthusiastic about the possibility that the courts soon will regularly recognize comparable worth as a legal doctrine by which wages in dissimilar occupations can be challenged.³¹

The willingness of courts on any legal basis to alter market wages and to honor a discrimination claim is an affront to the market model being used by orthodox economists. That model provides that discrimination of any kind could not long survive since some profit-hungry employer would recognize the discrimination and quickly offer an appropriate wage that

(1982).

²⁵ L. VON MISES, *HUMAN ACTION* 270-72 (1949).

²⁶ See, e.g., Galbraith, *Power and the Useful Economist*, 63 *AM. ECON. REV.* 1, 6 (1973).

²⁷ Hildebrand, *The Market System*, in *COMPARABLE WORTH: ISSUES AND ALTERNATIVES* 85 (R. Livernash ed. 1980).

²⁸ See C. LINDSAY, *supra* note 22, at 31.

²⁹ 452 U.S. 161 (1981).

³⁰ *Id.* at 166-68.

³¹ Particularly promising for comparable worth advocates had been the federal district court decision in *Kouba v. Allstate Ins. Co.*, 573 F. Supp. 148 (E.D. Cal. 1981), *rev'd*, 691 F.2d 873 (9th Cir. 1982). This case, if it had been upheld by the Ninth Circuit, would directly challenge the market defense which employers habitually rely in sex discrimination claims under Title VII. However, the circuit court of appeals reversed the district court on that issue. 691 F.2d at 875-77.

would resolve the short-run discrimination. In such a system of thought, any discrimination claim is suspect in the sense that, in all probability, the claim is just an attempt by an unproductive worker to attain what the market justifiably refused to grant.

IV. MINIMUM WAGE LAWS

The Fair Labor Standards Act of 1938³² created a minimum wage for workers in most nonagricultural industries. Since the enactment of this law, the minimum has been raised regularly.³³ Economists have responded regularly to proposals for new increases with the claim that minimum wages increase unemployment. One popular text points out that economists "universally agree" that such an effect occurs.³⁴

The basis for such unusual accord among economists is relatively straightforward. The model that shapes their conviction begins by supposing that productivity is measurable and that the employer can base wages on productivity differences.³⁵ The model also assumes that all firms in the economy are in the type of situation where none of them has any ability to alter demand or restrict supply.³⁶ Finally, it assumes that each worker is maximizing his productivity.³⁷ The model sketched by these assumptions explains economists' low regard for minimum wages.

The conclusion drawn from the model is that any wage payment that exceeds the current market wage will require the employer to lay off those workers whose lack of productivity does not justify an increased wage. No employer is able to absorb the increased wage into its cost structure since each firm in the assumed market is able to earn only a minimal profit, that is one that just covers costs.³⁸ The employer has no choice but to lay off workers who would have been employed had the legislation not intervened.³⁹

However, a change in one assumption in this typical productivity model can bring out dramatic changes in the resulting policy proposals. Assume, for instance, that businesses respond to minimum wage increases by dis-

³² Ch. 676, 52 Stat. 1060 (current version at 29 U.S.C. §§ 201-219 (1982)).

³³ See R. MCKENZIE & G. TULLOCK, *supra* note 12, at 255-56.

³⁴ R. FREEMAN, *LABOR ECONOMICS* 165 (1979).

³⁵ R. MCKENZIE & G. TULLOCK, *supra* note 12, at 254. See Magdoff, *The Economists' New Clothes*, 234 *NATION* 359-61 (1982) for a recent criticism of the purported precision of productivity statistics.

³⁶ R. MCKENZIE & G. TULLOCK, *supra* note 12, at 254.

³⁷ *Id.* at 256.

³⁸ See R. HEILBRONER & L. THUROW, *THE ECONOMIC PROBLEM* 369-402 (6th ed. 1981).

³⁹ See S. LEVITAN & R. BELOUS, *MORE THAN SUBSISTENCE: MINIMUM WAGES FOR THE WORKING POOR* (1979) for an excellent presentation of the typical defenses and criticisms of minimum wage legislation. Levitan and Belous are particularly effective at pointing out the empirical artificiality of the models used by economists to explain the alleged effects of minimum wages. *E.g.*, *id.* at 52-57.

covering and encouraging productivity improvements. Existing production facilities might be reorganized so that the higher wage payments resulting from a minimum wage increase would have no negative employment effect. Instead, the minimum wage hike would have provided a stimulus for productivity advances that would have otherwise remained unrealized.⁴⁰ Yet, to arrive at this conclusion, it first was necessary to revise the typical assumption that employee productivity is currently maximized.

V. SUMMARY

Several similarities in the economic reasoning that opposes wage-price controls, comparable worth claims, and minimum wage laws can be identified. First, there is the presumption that economic consideration should prevail over criteria drawing their strength from rights or moral principles.⁴¹ However, this presumption results in the derogation of nonmarket decision making in legislatures and courts which are prone to consider competing values that are much broader than the drive for material acquisition.

A second commonality is the lack of factual content in the economic reasoning process that results in the attacks on wage-price controls, comparable worth claims, and minimum wage laws. The competitive markets that are taken as a precondition to model formulation are not necessarily descriptive of our world just because such a world would result in more precise economic analysis. It is questionable whether business is typically competitive. The share of total output of the 100 largest businesses in the manufacturing sector is approximately fifty percent of the total manufacturing output.⁴² Such a statistic is inconsistent with the assumption of powerless businesses in competitive industries. It is more typical for large businesses to plan, manage, and manipulate their prices,⁴³ than it is for them to be the passive recipients of consumer signals.

A third and more general similarity is that the methodology of all three economic perspectives is deductive. If one accepts the assumptions as factually accurate, then the conclusions are correct. Therefore, the divergence between legislators or jurists and economists is often created by the unwillingness of the former to accept a set of suppositions that is ex-

⁴⁰ Lester, *Marginalism, Minimum Wages, and Labor Markets*, 37 AM. ECON. REV. 135, 142-45 (1947).

⁴¹ See Baker, *The Ideology of the Economic Analysis of Law*, 5 PHIL. & PUBL. AFF. 3, 4, 35 (1975) ("welfare economics as currently used by legal writers provides an ideological, and frequently objectionable, basis for policy guidance"); Kelman, *Choice and Utility*, 1979 WIS. L. REV. 769, 796 (the assumption that "free choice" in the marketplace will lead to the well-being of society is hard to justify).

⁴² U.S. DEP'T OF COMMERCE, BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 1982-83, at 543 (103d ed. 1982).

⁴³ J. GALBRAITH, *ECONOMICS AND THE PUBLIC PURPOSE* 110-21 (1973).

tremely artificial. Economic reasoning is typically a set of hypothetical statements followed by the logical result that flows from those assumptions. Only a careful examination of economists' assumptions permits an accurate assessment of the worth of their advice.

Why are legislators and judges resistant at times to this deductive methodology? Perhaps the answer lies in the concreteness of the problems that initiate legal action: inflation is annoyingly high, legislators are pressured, and wage-price controls become more attractive. Women perceive inequities in the pay differential between nurses and tree surgeons; they seek resolution of their concern in the courts. The issues that come before the courts and legislatures focus on a set of existing conditions. Therefore, responses must be directed to specific individuals and entities.

Economists function on an abstract plane; they frequently discuss *the* worker, *the* wage, or *the* business. While economists strive to remove themselves from the idiosyncrasies of particular fact patterns, they run the risk of their work becoming irrelevant to the legislative and judicial processes. The extent to which economists can enrich legal developments depends in large part on their willingness to enlarge the factual foundations of their claims.