What The Nobel Economists Missed

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On Wednesday, the Nobel Prize committee announced this year's winners for economics: Berkeley's George Akerlof, Stanford's Michael Spence and Columbia's Joseph Stiglitz. Americans all, they won the award for their path-breaking contributions to the economics of "asymmetric" information. The awards may well be justified, especially for Messrs. Stiglitz and Akerlof. But unfortunately the Nobel committee, and economists in general, are missing the big picture on information economics. Let me explain, first by highlighting the three economists' contributions.

Mr. Akerlof, in a famous 1970 article, gave a new explanation for a well-known phenomenon: the fact that cars barely a few months old sell for well below their price when new. He pointed out that although a certain proportion of new cars are lemons, once they are sold people are more likely to keep the good ones and less likely to keep the lemons. Potential buyers of used cars, knowing this fact, will pay substantially less for a used car because of the higher probability it's a lemon. Why is this a problem? Because the potential sellers of good used cars can't get a price that reflects their quality and, therefore, hold on to them even though potential buyers would gladly pay a higher price if they knew the car was high quality.

Similarly, economists had long understood that if insurance buyers have better information about their health than do the companies that sell them insurance, "adverse selection" can result. To the extent the insurance company cannot distinguish the sick from the healthy, it will set the same price for both. The sick will find the insurance a good deal, the healthy a bad deal, and so a disproportionately high number of sick people will buy insurance. The insurance company, knowing this, prices accordingly, driving out even more of the healthy, and raising prices even more, and so on. Mr. Stiglitz, in a 1976 article co-authored with Princeton University economist Michael Rothschild, showed that, in theory, the insurance market could break down completely.

Michael Spence made his reputation with an article in 1973 on job-market signaling. He argued that when employers hire workers, information about those workers' productivity is very costly and they therefore need some indicator of the workers' productivity. One such indicator, he argued, is whether they finished college. Potential employees, knowing this, invest time and money in completing their degree in order to "signal" to employers that they are productive. By Mr. Spence's reasoning, people might learn close to nothing in college, but their investment pays off in a better and higher-paying job.

Mr. Akerlof, who, in 1973 was one of my senior colleagues on President Nixon's Council of Economic Advisers, was especially careful not to conclude that government intervention is necessarily a solution to the problem of asymmetric information. He pointed out, in fact, that two free-market solutions to the "lemons problem" are warranties and reputations. Mr. Stiglitz, on the other hand, who was chairman of the Council of Economic Advisers under President Clinton, seems to have more confidence in government. Unfortunately, in discussing government solutions, Mr. Stiglitz has been vague about the kinds of solutions he has in mind and has never, to my knowledge, specified the incentives that would motivate government officials to do the right thing. Mr. Stiglitz, in fact, is often guilty of what UCLA economist Harold Demsetz calls the "nirvana fallacy": calling a problem with the market an imperfection while not having a clear government solution that would make things better.

Which brings me to the big thing missing in the work of all three: the central insight that Friedrich Hayek, co- winner of the 1974 Nobel Prize in economics, had in the 1930s and '40s. Mr. Hayek pointed out that almost all information that matters is decentralized, that it exists in the minds of the millions of participants in an economy. Hayek first made this point in a 1935 article explaining why socialism couldn't work. In focusing on the information asymmetry between buyers and sellers and between employers and employees, Messrs. Stiglitz, Akerlof and Spence ignore a much more crucial asymmetry: the one between decentralized, private information and centralized government information. The former tends to be very useful; the latter tends to be almost useless.

With free markets, each person can use the particular information he or she has, what Hayek called "knowledge of the particular circumstances of time and place." Modern Hayekian economists often call this "local knowledge." But in the Soviet Union, buyers couldn't communicate what they wanted through the market because there were no markets, and sellers produced to satisfy the central planners, not the ultimate users. Result: chaos and widespread poverty. And if centralizing a whole economy makes information problems even worse, the same is generally true for centralizing parts of it. Consider the rush to federalize aviation security. Mr. Stiglitz relied on his economic theories to endorse precisely this after winning the prize, saying, "There are certain activities like airport security that should not be in the private sphere. That market is not self-adjusting." Yet America's state-controlled system failed miserably on Sept. 11.

By contrast, private contractors at Israeli and European airports seem to do a pretty good job with less government oversight. The Federal Aviation Administration is a centralizing organization that moves slowly. If it fails, its employees are rarely fired and virtually never have their pay cut. But a private airport owner, with profits on the line, might use his "local knowledge" and flexibility to come up with more imaginative ways to weed out hijackers or to protect against them if they do get on board. Chemical plants and oil refineries, either of which, if exploded, could cause many deaths, seem to be well protected by their private owners.

Could private airports do as well? They do in Britain. Here's an important case where markets, with admittedly imperfect information, may do a better job than governments, which have even less to go on.