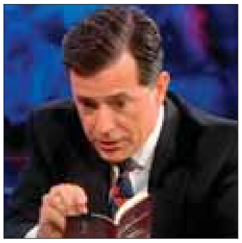

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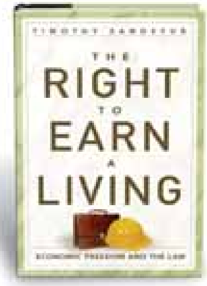

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The Era of Expert Failure

BY ARNOLD KLING

"It's a progressive era, based on the faith in government experts and their ability to use social science analysis to manage complex systems."

—DAVID BROOKS, "The Technocracy Boom," *New York Times*, July 19, 2010

The additional power that is being granted to experts under the Obama administration is indeed striking. The administration has appointed "czars" to bring expertise to bear outside of the traditional cabinet positions. Congress has enacted sweeping legislation in health care and finance, and Democratic leaders have equally ambitious agendas that envision placing greater trust in experts to manage energy and the environment, education and human capital, and transportation and communications infrastructure.

However, equally striking is the failure of such experts. They failed to prevent the financial crisis, they failed to stimulate the economy to create jobs, they have failed in Massachusetts to hold down the cost of health care, and sometimes they have failed to prevent terrorist attacks that instead had to be thwarted by ordinary civilians.

Ironically, whenever government experts fail, their instinctive reaction is to ask for more power and more resources. Instead, we need to step back and recognize that what we are seeing is not the vindication of Keynes, but the vindication of Hayek. That is, decentralized knowledge is becoming increasingly important, and that in turn makes centralized power increasingly anomalous.

THE AGE OF THE EXPERT

Populists often make the mistake of bashing experts, claiming that the "common man" has just as much knowledge as the trained specialist. However, trained professionals really do have superior knowledge in their areas of expertise, and it is dangerous to pretend otherwise.

I have faith in experts. Every time I go to the store, I am showing faith in the experts who design, manufacture, and ship products. Every time I use the services of an accountant, an attorney, or a dentist, I am

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The Cato Institute's expanded headquarters, to be completed in 2012. The upgraded building is part of "Liberating the Future," Cato's $50 million capital campaign. This far-reaching initiative will also add nearly 50 policy, communications, and support staff members. PAGE 3.

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showing faith in their expertise. Every time I donate to a charity, I am showing faith in the expertise of the organization to use my contributions effectively.

In fact, I would say that our dependence on experts has never been greater. It might seem romantic to live without experts and instead to rely solely on your own instinct and know-how, but such a life would be primitive.

Expertise becomes problematic when it is linked to power. First, it creates a problem for democratic governance. The elected officials who are accountable to voters lack the competence to make well-informed decisions. And, the experts to whom legislators cede authority are unelected. The citizens who are affected by the decisions of these experts have no input into their selection, evaluation, or removal.

A second problem with linking expertise to power is that it diminishes the diversity and competitive pressure faced by the experts. A key difference between experts in the private sector and experts in the government sector is that the latter have monopoly power, ultimately backed by force. The power of government experts is concentrated and unchecked (or at best checked very poorly), whereas the power of experts in the private sector is constrained by competition and checked by choice. Private organizations have to satisfy the needs of their constituents in order to survive. Ultimately, private experts have to respect the dignity of the individual, because the individual has the freedom to ignore the expert.

These problems with linking expertise with power can be illustrated by specific issues. In each case, elected officials want results. They turn to experts who promise results. The experts cannot deliver. So the experts must ask for more power.

JOB CREATION

With the unemployment rate close to 10 percent, there is a cry for the government to "create jobs." But the issue of job creation illustrates the increasingly decentralized nature of the necessary knowledge.

A job is created when the skills of a worker match the needs of an employer. I like to illustrate this idea using an imaginary game in which you draw from two decks of cards, one of which contains workers and one of which contains occupations. For example, suppose that you drew "Arnold Kling" from the deck of workers and you drew "fisherman" from the deck of occupations. That would not be a good match, because my productivity as a fisherman would be zero. You could do worse—my marginal product as an oral surgeon would be negative. However, you could do better if you were to draw an occupation card that said "financial modeler" or "economics teacher."

"A key difference between experts in the private sector and experts in the government sector is that the latter have monopoly power, ultimately backed by force."

One hundred years ago, if you had played this game, you had a good chance of finding a match just by picking randomly. Most jobs required manual labor, and for most people manual labor was the most productive use of their working hours.

Today's work force is more highly educated and more differentiated. As a result, the task of creating jobs requires much more knowledge than it did in the past. A New Deal program like the Public Works Administration or the Civilian Conservation Corps would not have much appeal for a recent law school graduate or laid-off financial professional.

Production today is more roundabout than it was 50 years ago. Only a minority of the labor force is engaged in activities that directly create output. Instead, a typical worker today is producing what George Mason University economist Garett Jones calls "organizational capital." This includes management information systems, internal training, marketing communications, risk management, and other functions that make businesses more effective.

When production was less roundabout, there was a tight relationship between output and employment. When a firm needed to produce more stuff, it hired more workers. Today, additional demand can often be satisfied with little or no additional employment. Conversely, the decision to hire depends on how management evaluates the potential gain from adding new capabilities against the risks of carrying additional costs. The looser relationship between output and employment is implicit in the phrase "jobless recovery."

So how does the economy create jobs? There is a sense in which nobody knows the answer. In his essay, "I, Pencil," Leonard Read famously wrote that not a single person on the face of this earth knows how to make a pencil. Pencils emerge from a complex, decentralized process. The same is true of jobs.

What the issue of job creation illustrates is the problem of treating government experts as responsible for a problem that cannot be solved by a single person or a single organization. Economic activity consists of patterns of trade and specialization. The creation of these patterns is a process too complex and subtle for government experts to be able to manage.

The issue also illustrates the way hubris drives out true expertise. The vast majority of economists would say that we have very little idea how much employment is created by additional government spending. However, the economists who receive the most media attention and who obtain the most powerful positions in Washington are those who claim to have the most precise knowledge of "multipliers."

HEALTH CARE

Despite the many pages contained in the health care legislation that Congress enacted, the health care system that will result is for the most part to be determined. The design and implementation of health care reform was delegated to unelected bureaucrats, as was done in Massachusetts.

In Massachusetts, the promises of proponents have proven false, and the predictions of skeptics have been borne out. Costs have not been contained; they have shot up. Emergency room visits have not been curtailed; they have increased. The mandate to purchase health insurance has not removed the problem of adverse selection and moral hazard; instead, thousands of residents have chosen to obtain insurance when sick and drop it when healthy. The officials responsible for administering the Massachusetts health care system are no longer talking about sophisticated ways of making health care more efficient. Instead, they are turning to the crude tactic of imposing price controls.

Once again, we have legislators putting unrealistic demands on experts. This results in the selection of experts with the greatest hubris, shutting out experts who appreciate the difficulty of the problem. When the selected experts find that their plans go awry, they take out their frustrations by resorting to more authoritarian methods of control.

THE SECURITY APPARATUS

In July 2010, the *Washington Post* ran a series of stories on the size and complexity of the national security apparatus that has developed in response to the terrorist attacks of September 11, 2001. Yet with all this manpower and budget, we still have incidents like the Christmas bomber, a would-be terrorist who was stopped by citizens.

There are an infinite number of potential terrorist threats. In response, one could devise an infinite number of agencies and policies. There is little or no scope for anyone to question the relationship between costs and benefits.

More than 10 years ago, scientist and author David Brin wrote *The Transparent Society*, a book that anticipated the problems of surveillance and terrorism in the context of technological advance. Brin advocated making surveillance tools accessible to ordinary citizens. As counterintuitive and potentially disturbing as this sounds, Brin argued that it is better than the alternative, which is giving surveillance tools to government experts only. The latter approach threatens liberty without providing security. Unfortunately, that is the approach that the United States government has adopted, and it has grown out of control.

> "Decentralized knowledge is becoming increasingly important, and that in turn makes centralized power increasingly anomalous."

ENERGY AND THE ENVIRONMENT

The Department of Energy has decided that it has the expertise to select specific energy projects, such as the electric car that is being developed by Fisker Automotive of California, the recipient of a $500 million loan guarantee. In theory, if the economic prospects for this electric car were good enough, venture capitalists would be willing to risk money on its development. Now, with a loan guarantee, private investors enjoy only the potential gains while taxpayers bear the risk. Many citizens who would never have considered investing in this electric car company are now partners in the venture, except that we have only the downside and no upside.

The officials who are putting taxpayer money at risk may or may not have better expertise than venture capitalists who put their partners' money at risk. What the officials certainly have is more power.

The threat of climate change, like the threat of terrorism, can be characterized in such a way as to justify an unlimited attempt at expert control. Regardless of whether experts really can accurately measure, predict, and explain climate change, some will be tempted to exercise power as if their analysis were precise and certain.

FINANCIAL REGULATION

The financial crisis spawned demands for new regulatory powers. However, the crisis itself clearly resulted from the misuse of regulatory power in the first place. It was government policy that attempted to promote home "ownership" by encouraging lending with little or no money down to speculators and inexperienced borrowers. It was government capital regulations that steered banks toward AAA-rated securities, with no need to investigate the true underlying risks. It was the view of leading regulators at the Federal Reserve and the International Monetary Fund in 2005 and 2006 that the financial system had become adept at managing and distributing risk. The regulators were not powerless to stop the risky behavior; instead, they were convinced that they had everything under control.

If the regulatory experts could not prevent the financial crisis of 2008, the most reasonable inference to make is that financial crises cannot be prevented. There is no such thing as a financial system that is "too regulated to fail."

The recent Dodd-Frank legislation gives broad new discretionary powers to regulators. Many of the important rules, such as bank capital regulations, are left up to the experts. The decision to use new authority to break up or take over risky financial institutions is discretionary.

Unfortunately, the resolution of troubled financial institutions requires rules rather than discretion. With discretion, there is a problem of time inconsistency. No matter how loudly the regulators proclaim that they will not bail out failing institutions, history shows that when a crisis comes the officials in charge would rather do a bailout than face the uncertainty associated with shutting an institution down. Large failing banks will only be closed if there are strict rules in place that tie the regulators' hands to make bailouts impossible.

Discretionary resolution authority is authority that will never be used. Banks and their counterparties know this, and they will behave accordingly.

THE KNOWLEDGE-POWER DISCREPANCY

As Hayek pointed out, knowledge that is important in the economy is dispersed. Consumers understand their own wants and business managers understand their technological opportunities and constraints to a greater degree than they can articulate and to a far greater degree than experts can understand and absorb.

When knowledge is dispersed but power is concentrated, I call this the knowledge-power discrepancy. Such discrepancies can arise in large firms, where CEOs can fail to appreciate the significance of what is known by some of their subordinates. I would view the mistakes made by AIG, BP, Freddie Mac, Fannie Mae, and other well-known companies as illustrations of this knowledge-power discrepancy in practice.

With government experts, the knowledge-power discrepancy is particularly acute. As we have seen, the expectations placed on government experts tend to be unrealistically high. This selects for experts with unusual hubris. The authority of the state gives government experts a dangerous level of power. And the absence of market discipline gives any errors that these experts make an opportunity to accumulate and compound almost without limit.

In recent decades, this knowledge-power discrepancy has gotten worse. Knowledge has grown more dispersed, while government power has become more concentrated.

The economy today is much more complex than it was just a few decades ago. There are many more types of goods and services. Consumers who once were conceived as a mass market now have sorted into an ever-expanding array of niches. In the 1960s, most households had one television, which was usually tuned to one of just three major networks. Today, some households have many televisions, with each family member watching a different channel. Some people still watch major networks, but many others instead focus on particular interests served by specialty cable channels. Still others watch very little TV at all.

This increased diversity of consumer tastes in a world of tremendous variety makes the problem of aggregating consumer preferences more difficult. It becomes harder for government experts to determine which policies are in consumers' interests. For example, is a national broadband initiative going to give consumers access to something they have been denied or something

"In recent decades, this knowledge-power discrepancy has gotten worse. Knowledge has grown more dispersed, while government power has become more concentrated."

that they do not want?

The advances of science are leaving us with problems that are more complex. As fewer Americans die of heart ailments or cancer in their fifties and sixties, more of our health care spending goes to treat patients with multiple ailments in their eighties and nineties. Given the complexity of each individual case, it seems odd that health care reformers believe that government can effectively set quality standards for doctors.

In business, performance evaluation of professionals is undertaken by other professionals who are in the same work group, observing their workers directly, and who understand the context in which the professionals are working. Even then, performance evaluation and compensation-setting are challenging tasks. In health care, proponents of government "quality management" propose to evaluate the decision-making of professionals and adjust their compensation on the basis of long-distance reports. Taking into account the knowledge-power discrepancy, this notion of quality management from afar is utterly implausible.

Financial transactions have gotten extremely complex. Some critics blame the use of quantitative risk models and derivative securities. However, removing these tools would not remove financial risk, and in many respects could make it more troublesome.

One consequence of modern finance is that it exacerbates the knowledge-power discrepancy. It is as futile for financial regulators to try to track down all sources of risk as it is for security agencies to try to keep track of all possible terrorist threats.

How can we deal with the knowledge-power discrepancy in government? It would be great if we could solve the problem by increasing the knowledge of government experts. Unfortunately, all experts are fallible. If anything, expert knowledge has become more difficult for any one individual to obtain and synthesize. Analysts of the scientific process have documented a large increase in collaborative work, including papers with multiple authors and patent filings by groups and organizations. Scientists tend to be older when they make their key discoveries than was the case in the first half of the 20th century.

When he was an executive at Sun Microsystems, Bill Joy said, "No matter who you are, the smartest people work for someone else." Joy's Law of Management applies to government at least as much as to business. There is no way to collect all forms of expertise in a single place.

Instead, the way to address the knowledge-power discrepancy is to reduce the concentration of power. We should try to resist the temptation to give power to government experts, and instead allow experts in business and nonprofit institutions to grope toward solutions to problems.

LIVING IN A COMPLEX WORLD

To summarize: We live in an increasingly complex world. We depend on experts more than ever. Yet experts are prone to failure, and there are no perfect experts.

Given the complexity of the world, it is tempting to combine expertise with power, by having government delegate power to experts. However, concentration of power makes our society more brittle, because the mistakes made by government experts propagate widely and are difficult to correct.

It is unlikely that we will be able to greatly improve the quality of government experts. Instead, if we wish to reduce the knowledge-power discrepancy, we need to be willing to allow private-sector experts to grope toward solutions to problems, rather than place unwarranted faith in experts backed by the power of the state.