

On the robustness of laissez-faire

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Abstract

This paper considers a model economy in which agents are privately informed about their type: their endowments of various goods and their preferences over these goods. While preference orderings over observable choices are allowed to be correlated with an agent's private type, we assume that the planner/government is both uncertain about the nature of this joint distribution and unable to choose among multiple equilibria of any given social mechanism. We model the planner/government as having a maxmin objective in the face of this uncertainty.

Our main theorem is as follows: Once we allow for this kind of uncertainty and assume no wealth effects in preferences, the uniquely optimal social contract is laissez-faire, in which agents trade in unfettered markets with no government intervention of any kind.

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“Primum non nocere”—medical aphorism.

1. Introduction

In economies with privately observed effort levels or privately observed endowments, skills, or preferences, decentralization is problematic. To achieve efficiency in such economies, every observable aspect of an agent's life must generally be monitored or controlled. That is, one lesson of modern information economics is that the optimal system in the presence of information problems appears as centrally planned as one can imagine.

For instance, suppose society wishes to provide insurance against wealth shocks, and a hidden source of wealth is apples. Then, by taxing the selling of apples, economies can achieve at least partial insurance. Similarly, Townsend [9], Green [6], and Atkeson and Lucas [2] describe how a social planner can exploit observable choices over current and future consumption to provide social insurance.

In this paper, we re-examine this result. We consider a model economy in which agents are privately informed about their wealths and over their preferences over goods. There is a social planner who would like to transfer goods from some agents (say, the wealthy) to other agents (say, the less wealthy). We assume that agents' preferences exhibit no intrinsic wealth effects. However, the cross-sectional distribution of tastes and wealths may be such that they are correlated with one another in the population.

As argued above, if this distribution of tastes and wealths is known to the planner/government, it is generically possible to design an interventionist mechanism that improves, from the perspective of the planner, on laissez-faire. We instead assume that, while agents know this joint distribution, the planner/government is *uncertain* about its nature. Here, by uncertain, we mean that the planner/government is unable to form a Bayesian prior over what this correlation might be. We also mean that, if there are multiple equilibrium outcomes to a mechanism, the planner/government cannot form a Bayesian prior over these outcomes. We model the planner/government as having a maxmin objective in the face of this uncertainty.¹ Thus, the social welfare function is minimized over possible joint distributions and possible equilibrium outcomes.

Our main theorem is that once we allow for this kind of uncertainty, the uniquely optimal social contract is laissez-faire, in which agents trade in unfettered markets with no government intervention of any kind. The logic behind our result is as follows. Suppose the planner wishes to transfer resources from the wealthy to the less wealthy, and consider an environment (Environment 1) such that preference orderings are correlated with hidden wealths. Then, there is an interventionist mechanism that achieves this kind of socially desirable redistribution. Now take another environment (Environment 2), in which the marginal distribution of tastes across agents is the same as in the original environment, Environment 1. However, in Environment 2, wealths and preferences are independent across agents.

We prove that in Environment 2, the laissez-faire outcome is the best possible, and that it provides as much social welfare as the laissez-faire outcome in Environment 1. We then prove that under the interventionist mechanism, there is an equilibrium outcome in Environment 2 that is essentially equivalent to the one in Environment 1. But since there is no correlation between

¹ Segal [8] uses a similar objective when analyzing the informational complexity of various mechanisms.

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