

## Chapter 1

# What was the UCLA School?

No person or group poses detailed questions of how the community is to use its resources, and no one imposes comprehensive answers to the questions. Yet such problems—large and small—somehow are solved daily. No agency is appointed to ensure that adequate food reaches every city and is allocated among competing claimants—and yet the people eat.

— Armen A. Alchian and William R. Allen, *University Economics*,  
3<sup>rd</sup> ed., p. 6.

The UCLA School of economic thinking was a strong free-market tradition in late twentieth century economics. Some who observed it from a distance humorously referred to UCLA as “the University of Chicago at Los Angeles.” In some ways it was almost as strong as the University of Chicago School, whose most notable members in the 1960s and 1970s were Milton Friedman, George Stigler, and Gary Becker. In other ways, the UCLA School was even stronger. Armen Alchian, in particular, was one of a kind. His relentless application of economic analysis, especially analysis of property rights, was not replicated anywhere else. In the area of property rights, Harold Demsetz was a close second. The UCLA School was at its zenith from the mid-1960s to the late 1980s.

The UCLA tradition carries on in the work of dozens of economists who earned their PhDs at UCLA during its golden years. Also, because the work spread beyond UCLA, the tradition lives on in the work of scores of economists who had no formal connection with UCLA.

In this short book, we, who both earned graduate degrees in economics at UCLA during the 1970s (Globerman earned his Masters in 1970 and Henderson his PhD in 1976) lay out the most pathbreaking insights that

various members of the UCLA School had, insights that still influence economics today.

The most important economists at UCLA during the 1970s were Armen Alchian, Harold Demsetz, Sam Peltzman, Benjamin Klein, Robert Clower, Axel Leijonhufvud, Jack Hirshleifer, William Allen, and George Hilton.

A distinguishing feature of most of the UCLA economists' contributions is that they were non-mathematical. This was especially notable in an era in which mathematics had almost taken over economics. The major UCLA School contributors used mainly words and occasionally graphs. Another distinguishing feature is their use of basic economic analysis to understand behaviour that had previously not been understood or had even been misunderstood.

The most important member of the School was Armen Alchian, who died in 2013. Alchian taught at UCLA from 1946 until his retirement in 1984. As you will see throughout this volume, Alchian's insights and writings underlie a distinctive theme of the School's approach to economics: in most productive activity, the profit motive, combined with private property rights, successfully aligns the interests of producers and consumers, often in subtle ways.

As Susan Woodward, a former colleague of Alchian's, has noted, Alchian had no use for formal models that did not teach us to look somewhere new in the known world. Nor had he any patience for findings that relied on fancy statistical procedures. Alchian saw basic economics as a powerful tool for explaining much of human behaviour in both market and non-market settings. Much of Alchian's work was guided by the insight: "You tell me the rules and I'll tell you what outcomes to expect." As Woodward has noted, Alchian believed that a huge amount of human behaviour could be understood if one got straight what the property rights (i.e., the rules) were.

Another major accomplishment of Alchian's was, in collaboration along with his long-time UCLA colleague William R. Allen, the undergraduate textbook *University Economics*. The textbook, the first edition of which was published in 1964, was rare in a way that gave it standing in the economics profession: it taught economics not only to undergraduates but also to graduate students and even economics professors. Many graduate students and economics professors over the years have reported that they learned more economics from that textbook than from any other single book.

Perhaps one quote from a question at the end of a chapter will illustrate how radical (in the sense of going to the root), *University Economics* was:

”Technically speaking, any labor union is a monopoly in the limited sense that it eliminates competition between workingmen for the available jobs in a particular plant or industry. After all, unions are combinations of workingmen to increase, by concerted economic action, their wages, i.e., the price at which the employer will be able to purchase their labor.” (Arthur Goldberg, Justice, Supreme Court of the United States, and formerly Secretary of the Department of Labor and counsel for the United Steelworkers; quoted from AFL-CIO: *Labor United*, New York, McGraw-Hill, 1956, p. 157.) Why did he write “*technically speaking*” and “in the *limited sense*”? Is there some other mode of speaking and is there an unlimited sense of monopoly? (Alchian and Allen, 1972, 3<sup>rd</sup> edition: 449)

And consider this dramatic way of introducing the economic concept of scarcity in the first two sentences of the book’s first chapter:

Ever since the fiasco in the Garden of Eden, most of what we get is by sweat, strain, and anxiety. Two villains—nature and other people—prevent us from having all we want. (Alchian and Allen, 1972: 3)

The second most prominent member of the UCLA School was Harold Demsetz. Demsetz spent most of his professional life at UCLA and at the University of Chicago. Demsetz made major contributions to the study of property rights and to regulation and antitrust policy. As Sam Peltzman has noted, Demsetz fundamentally revolutionized thinking about the prevailing logic underlying antitrust theory. Prior to Demsetz’s work, economists in the area of what’s called industrial organization were suspicious of big firms whose revenues were a large percent of overall industry revenues. Such firms charged above-competitive prices, they claimed, thereby harming consumers and reducing overall economic efficiency. Demsetz argued that market concentration could reflect the superior efficiency of firms with

large market shares primarily resulting from innovation, and he supported his argument with empirical evidence. Government efforts to break up large firms or restrain their growth was, therefore, likely to reduce innovation and economic efficiency, with consequent harm to consumers. Peltzman argues that Demsetz's work fundamentally altered the hitherto mechanical application of legal restrictions on mergers between relatively large firms to a more "rule-of-reason"-based approach, whereby the potential for efficiency gains was weighed in the balance.

The UCLA School was also prominent in the area of economic regulation. Sam Peltzman and George Hilton challenged the conventional wisdom about the objectives of regulators and the consequences of regulation. The traditional economic justification for government regulation of private sector businesses is that regulations are needed to protect consumers against business abuses such as monopoly pricing, cheating on the quality of products sold, the sale of hazardous products, and misleading consumers through false advertising claims or by failing to disclose important information such as the true annual interest rate on an automobile loan. In the idealized view of regulation, the regulators are informed public-spirited people who work only to promote the social good.

Peltzman and Hilton debunked this idealized view of regulatory behaviour by documenting how regulators pursue their own interests in carrying out their activities and showing that the interests of regulators are often at odds with the social interest. In particular, regulation often stifles competition, resulting in higher prices.

Even when enlisting expert advice, it is extremely difficult for regulators to form a complete and accurate picture of how specific regulations will affect the behaviour of the many individuals and organizations affected. It is impossible, for example, for regulators to forecast how new technologies and new uses of existing technologies will undermine the intent of the regulator. Hilton noted that the regulatory experience is replete with examples of how the non-competitive price structures imposed by regulators encouraged the use of new technologies to circumvent, and ultimately render unsustainable, existing regulatory decrees.

The UCLA School was at the forefront in documenting that inefficient regulations create incentives to avoid those regulations, which often results in new ways of performing the regulated activity, although not necessarily

as efficiently as would be the case in the absence of the regulations. It also documented how efforts to protect and perpetuate regulated monopolies contribute to delays in implementing changes that would improve the economic welfare of large numbers of consumers in order to protect the economic interests of a relatively small number of incumbent producers.

For example, Eckert and Hilton (1972) tell the story of electric street railways, which were the main form of urban public transportation in the early 1900s. Most street railways operated one or a small number of lines that ran along main streets and covered a limited area of the city. Furthermore, in virtually every city, the street railway charged a flat 5-cent fare regardless of the distance a passenger traveled. The rigid layout of street railways and the implicit penalty the flat fee imposed on short-haul commuters encouraged the growth of private jitney services, i.e., individuals who would use their own cars or rented cars to provide transportation services to those who wanted to travel off the main routes covered by the street railways. They also provided for flexible capacity, as more jitneys were available during peak hours and charged rates that were responsive to demand conditions, e.g., higher rates during peak commuting hours and lower rates during off-peak periods.<sup>1</sup>

In short order, a large number of privately owned automobiles were competing with street railways. The railways sought protection from municipal governments against this competition. Municipal governments saw benefits to limiting competition. One benefit was the tax revenues they could collect from the monopoly profits earned by regulated street railways that enjoyed exclusive rights to operate on specific routes. Another benefit was that they received political donations and other support from the established and relatively well-funded streetcar owners. For those reasons, they granted protection from competition. Local governments introduced regulations designed to raise the costs of jitney operators and reduce the flexibility of the service they offered. The regulations were especially punitive for short-haul jitney businesses. The result was that most jitneys were eliminated fairly quickly. Eckert and Hilton argue that allowing free entry, while ensuring that jitney operators bore the full costs of their operations, including paying their

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<sup>1</sup> Contemporary readers might see a parallel to the rise of companies such as Uber and Lyft in response to the rigidities and relatively high fares that characterize taxicab services in urban centers.

share for street repairs, would have saved society decades of unsatisfactory experience with inefficient alternatives, including buses that operated in much the same way as street railways.

The moral of this and similar stories is that regulators cannot extinguish the incentives of market participants to create economic gains for themselves by providing cheaper and/or more convenient goods and services for customers, and efforts by regulators to thwart the pursuit of those incentives perpetuate economic inefficiencies that make society as a whole economically poorer. In particular, many consumers pay more for the relevant goods and services than they would have paid if markets were deregulated, while established firms often earn higher profits than they would have earned in an unregulated competitive market.

An overview of the UCLA School would be incomplete without mention of Benjamin Klein's work in monetary theory, and Robert Clower and Axel Leijonhufvud's work in macroeconomics. In the 1970s, Klein was one of the early economists who took seriously the idea of competing money supplies. He also, as will be seen in Chapter 7, contributed path-breaking work in industrial organization generally and on the economics of the vertical integration of firms specifically.

Leijonhufvud did some early work arguing that most Keynesians had misinterpreted John Maynard Keynes's *General Theory of Employment, Interest, and Money*. In follow-on work, Leijonhufvud and Robert Clower argued that when existing market prices, especially wages, depart substantially from prices that would equilibrate supply and demand and there are strong frictions that make this equilibration costly, an economy can remain in disequilibrium for an extended period of time. Leijonhufvud had argued that people misinterpreted Keynes's explanation of less than full-employment equilibrium as a problem of insufficient aggregate demand rather than a problem of inflexible prices.

Not to be missed in a summary of contributions by UCLA economists is the work of Thomas Sowell. He wrote his 1975 book *Race and Economics*, a precursor to his much more extensive work on the economics of various ethnic groups, while at UCLA.

In the chapters to follow, we discuss more of the specific contributions of Alchian, Demsetz, Peltzman, Klein, Hilton, and Hirshleifer. We think you

will find it an exciting excursion through the fundamentals of late twentieth century economic thinking.