3 Government Failure

"There are two opposite reasons for being a democrat. You may think all men so good that they deserve a share in the government of the commonwealth and so wise that the commonwealth needs their advice. . . . On the other hand, you may believe fallen men to be so wicked that not one of them can be trusted with any irresponsible power over his fellows."

The **Robert C. Byrd Bridge** crossing the Ohio River between Huntington, West Virginia and Chesapeake, Ohio.

Robert C. Byrd served 51 years in the U.S. Senate, the longest in history. Why? See "List of Places Named after Robert Byrd," *Wikipedia*.

3.1: Government As a Solution to Market Failure

One way to think of government is as a machine to fix market failure. Markets ordinarily maximize surplus. Voluntary trades work as if pushed by an Invisible Hand to generate prices that serve as signals for what to produce, who is to produce, and who is to consume. The process reveals information about how costly it is to produce the goods and how much consumers are willing to pay, information that a government planner would not know. In the end, total surplus is maximized. The result may still be bad— Bangladesh would still be a poor country even if it maximized surplus— but we should not blame the government for not doing something about it.

On the other hand, the market's aggregation of information and use of it for incentives does break down in the specific contexts we call market failure. When that happens, we should think about whether the government might do something to fix market failure. When there are problems of monopoly, we can ban price-fixing; for asymmetric information we can ban fraud; for externalities we can limit the output of pollution. All of these government actions can increase surplus beyond the free market level. The combination of the free market for ordinary transactions and government regulation for the special cases where markets fail seems ideal.

It is not enough, however, to find market failure and conclude that the government should take action. We must also consider whether the government will take the right action. If it won't, then maybe we shouldn't allow it even to try. Governments are no more perfect than markets. A first problem, of course, is that governments are not as good at aggregating and using information as the Invisible Hand is. What we will look at in this chapter, though, under the heading of government failure is that use of the government involves some people making decisions for other people. Like markets, governments are made up of people who are pursuing their own objectives rather than trying to maximize the country's wealth. Unlike markets, those people are making decisions for the rest of us. If there is market failure and we are thinking of asking the government to fix it, we must ask whether that will push us into **government failure**: an outcome where the government actually destroys wealth compared to even an imperfect market.

The sociologist Max Weber said that what characterizes government is "a monopoly on violence." For the market to work to maximize surplus, society needs for people to engage in voluntary trade rather than using force— to make rather than take. There are two ways to stop people from using force. One is to instill them with moral principles against doing wrong to other people. The other is to use force to stop force. The essence of government is that it is allowed to enforce rules by the threat of force. If Brown tries to steal Smith's whisky, the police will stop him, by force if necessary. Force is also behind the government effort to reduce forms of taking that are more complicated than simple theft. If two companies are thinking of conspiring to agree with each other to keep prices high, the regulating agency will use the threat of fines and prison to stop them.

We ordinarily do not think of our government as violent, to be sure, but in a sense all laws are enforced by the death penalty. Even speeding! If the police catch you driving 80 miles per hour, the court will not put you to death, of course. But what happens if you refuse to stop? The police will chase you until they can run you off the road or your gas tank goes dry. What if you refuse to open your car door then? They can force it open. What if you pull out a gun? The policemen will pull guns too, and the government has authorized them to kill you if they have to. Thus, at the end of the day, the death penalty stands behind even a speeding ticket. The government is, to be sure, very reluctant to kill violators, and it very carefully regulates when the police can use force, but deadly force is always in the background. Indeed, even those of us who are against the death penalty largely agree with using deadly force to impose the will of the state. Few people would say that the government should give up if someone who disobeys the laws takes resistance all the way to deadly force.

One of the sources of market failure that we have already discussed is monopoly. It is not surprising, then, that we have government failure. The government has a monopoly on violence, as Max Weber says, and a monopoly on laws that need to be enforced by violence. Private monopolies lead to market failure because firms take actions that maximize producer surplus at the expense of total surplus. In addition, the government, like any big organization, has information problems in running the organization, and asymmetric information like that is a source of market failure.

The sources of government failure can be divided into two categories: **bad objectives** and **bad performance**, the unwillingness of the government on the one hand and its inability on the other to maximize surplus. Governments are made up of people, and people have their own objectives. Government officials have personal objectives besides maximizing total surplus for the good of the country. In addition, the structure of government makes it harder for the top leaders to efficiently manage government agencies than for a private company's officers to manage its employees. This does not mean government failure is always or even usually bad enough for us to give up on trying to fix market failure, but it does mean that we have to look at the particular circumstance. Just as there are particular contexts where markets fail, so there are particular contexts where governments fail.

Bad objectives are the natural result of the fact that when the government exerts force to restrict behavior it is not limited just to maximizing wealth: it can redistribute wealth, which means taking it from some people to give to others. That provides private parties an incentive to expend resources to get the government's help in extracting wealth from other people, a form of the **rent seeking** that was mentioned in Chapter 1. Recall that rent seeking is resource use spent trying to redistribute surplus rather than to create it, like the gun that a robber buys to take wealth away from his victim. Political campaigning and lobbying are ways to get the government to use its gun to redistribute surplus, not just ways to get policies that are good for everyone. Since wealth is just redistributed, not created, and people use resources for attack and defense rather than wealth creation, society's total wealth diminishes. The government itself becomes an instrument of taking rather than making.

Bad performance, the second big category of government failure, is the problem that even if the objectives are right, it is harder to get policies implemented efficiently in governments than in private organizations. The costs and benefits of government actions flow to the citizens, a large group of poorly informed people whose main interest is not in how well the government is managed. To the extent that citizens are so affected by a policy that they do care a lot about how the policy is managed, they also want to influence the policy to help themselves— and the result is more rent-seeking. The government falls between the Scylla of interested rent-seeking and the Charybdis of disintererested incompetence.[1]

3.2: Government Failure: Bad Objectives

How Politics Ought To Work— The Ideal

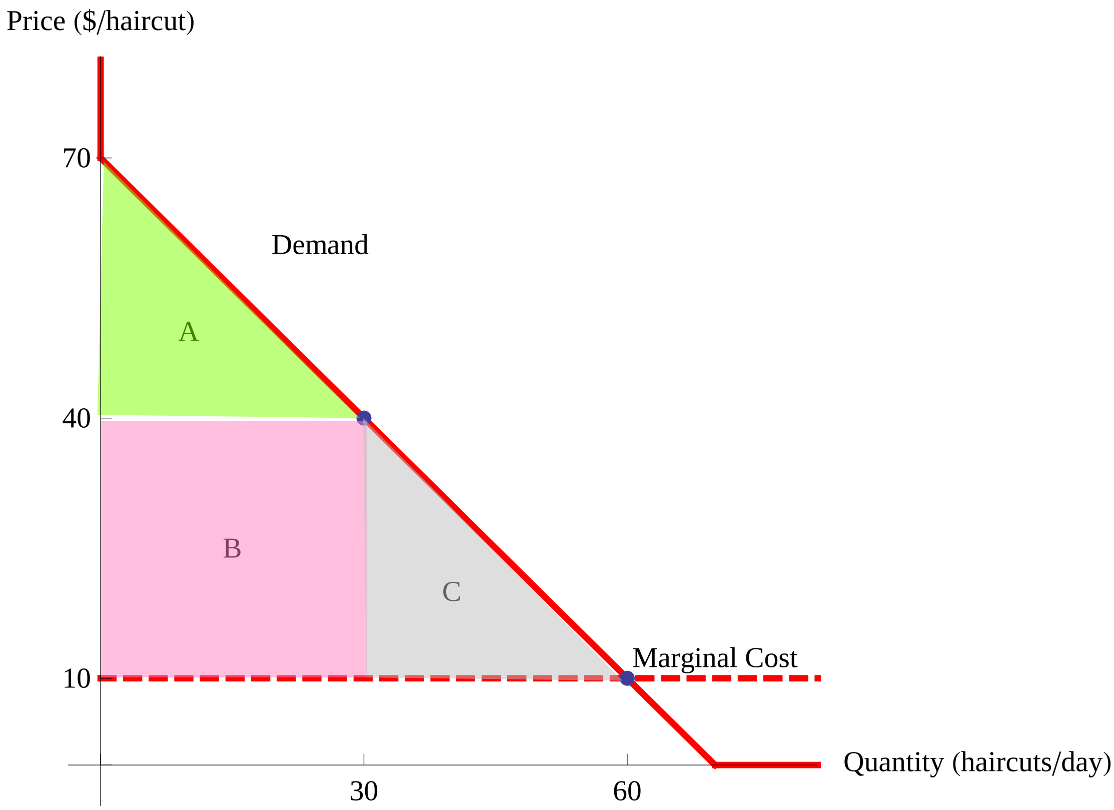
We will start with bad objectives. Suppose Congress is thinking of passing a new regulation— for example, a tightening of automobile emission standards. The regulation will have costs and benefits. In this case, it will make cars more expensive but it will reduce air pollution. The surplus maximization approach asks whether the benefit of regulating the negative externality of air pollution exceeds the cost. A government whose objective was surplus maximization would act accordingly.

Is the government's objective surplus maximization? Since not everybody is identical, they disagree as to what the government should do. Some people bear more cost from a regulation and others receive more benefit. People who are buying new cars will bear more of the cost. People who don't live in cities already have unpolluted air so they receive less benefit.

If the government is a democratic one, it is ultimately controlled by the voters, so its goal is to please them. This goal has a rough correlation with surplus maximization. Other things equal, we would expect that if the benefit exceeds the cost then the winners would outnumber the loser, and the regulation will please a majority of the voters and be enacted.

[1] The Greek hero Odysseus had to sail his ship between two monsters to get through a narrow strait. Charybdis ("karibdis") made a whirpool that could engulf a whole ship. Scylla ("silluh") had six heads at the end of long necks. Odysseus's choice was to play it safe and lose six sailors to Scylla.

FIGURE 3.1
THE BARBER'S GUILD

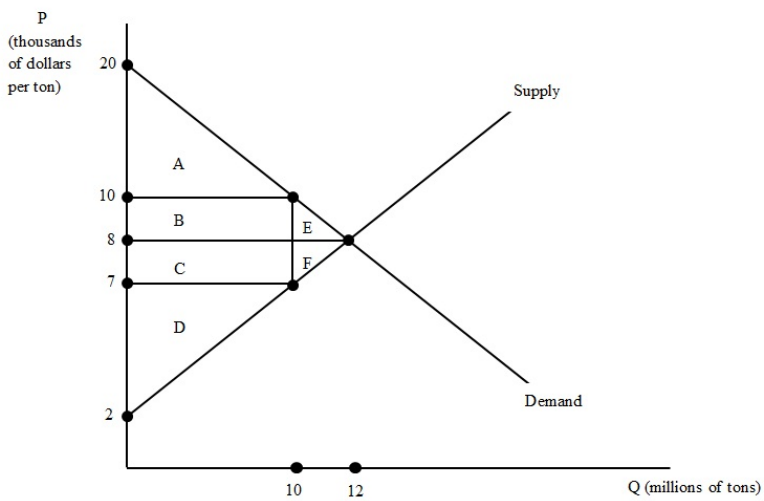


As an example, suppose the market for mens haircuts in a town has been monopolized. Currently all the barbers have combined into a guild that charges $40 per haircut, and the resulting quantity is 30 haircuts per day. As shown in Figure 3.1, the marginal cost of haircuts is constant at $10 per haircut, and the demand curve is $Q^d = 70 - P$. A city councillor proposes that the guild be blocked from setting prices or punishing barbers who charge low prices, a policy which will reduce the price to the marginal cost of $10/haircut. What will be the forces on each side of the fight over his proposal?

Under the monopoly, consumer surplus is A = .5(30)(30) = 450 dollars per day. Producer surplus is B=(30)(30) = 900 dollars per day. Once the monopoly ends, consumer surplus will be A+B+C = .5(60) (60) = 1,800 dollars per day, and producer surplus will be 0. (Recall that this means that producers will still cover their opportunity cost, but barely—the return to being a barber will be the same as for similar jobs.)

Thus, consumers gain 1,350 dollars per day from ending the monopoly, while producers lose just 900 dollars. Since consumers win more than producers lose, we would expect consumers to fight harder for the policy change than producers would fight to stop them. The policy change is efficient and we would expect it to happen.

FIGURE 3.2
THE COPPER PRICE FLOOR



As a second example, suppose the supply and demand curves for copper are

$$Q^s = \begin{cases} 0 & \text{if } P < 2 \\ -4 + 2P & \text{if } P \geq 2 \end{cases} \tag{1}$$

and

$$Q^d = \begin{cases} 20 - P & \text{if } P \leq 20 \\ 0 & \text{if } P > 20 \end{cases} \tag{2}$$

as in Figure 3.2. The current equilibrium has a price of 8 thousand dollars per ton and a quantity of 12 million tons. Copper mining corporations lobby the government for a price floor of 10 thousand dollars per ton. Copper consumers naturally oppose the higher price. How much would producers be willing to pay to get the price floor imposed, and how much would consumers pay to block it?

We need to see how consumer and producer surplus change. Once the price floor is imposed the price will rise above the free market level and there will be excess supply. The quantity traded will be the smaller of quantity supplied and quantity demanded, which will be quantity demanded. At the new price of 10 thousand, quantity demanded will be 10 million tons.

With no price floor, consumer surplus is A+B+E = .5(12)(12) = 72 billion dollars. Producer surplus is C+D+F = .5(6)(12) = 36 billion dollars.

With the price floor, consumer surplus is A = .5(10)(10) = 50 billion dollars. Producer surplus is (B+C)+D = (3)(10) + .5(5)(10) = 30+25 = 55 billion dollars.

The price floor reduces consumer surplus by 22 billion dollars, while increasing producer surplus by only 19 billion. Consumers would pay up to 22 billion dollars to block the proposal, while producers would only pay up to 19 billion to get it through. Other things equal, we would expect the government to listen to consumers and the price floor proposal would fail.

Democratic governments have to worry about elections, so they are subject to political pressures that will reflect the amount of surplus at stake on each side. What about a dictatorship? There, too, we can think of the government as selling laws to the highest bidder. There are no elections, though, so the dictator can take his profits directly rather than in the form of help to win elections. We would still expect the side with the most surplus at stake to bid the highest to get the law they want. Or, if the dictator is in completely control of the country and can take whatever property he wants, he will himself do the surplus calculations directly— if he has control of the entire surplus, he of course will want it maximized for his own sake. Dictators do need to worry about unrest and revolution to a greater or lesser extent, though, and the intelligent autocrat is careful to budget enough of the nation's wealth to keep unrest at a low level, as illustrated by the boxed story about Saudi Arabia. If his country has more surplus, it is easier for him to keep his people, army, and businesses content while taking a comfortable amount of the surplus for himself. We might expect dictators to have more trouble keeping their countries prosperous, however, because without the rule of law— property rights and contract enforcement— they are tempted to take too much for themselves, killing the goose that lays the golden eggs. In addition, just as the free market for steel brings out information on the costs of sellers and benefits of buyers and leads to an efficient price, so in the market for laws, political pressure shows which law maximizes surplus. Although if he knows economic theory the dictator will know that price controls on copper reduce total surplus, if the law involves something like balancing the cost of a pollution externality against the cost of controlling it, he will have a harder time than a democratic government of arriving at the wealth-maximizing policy.

Box 3.1
Pareto- Improving Transfers

"Saudi King Abdullah returned home on Wednesday after a three-month medical absence and unveiled benefits for Saudis worth some $37 billion (23 billion pounds) in an apparent bid to insulate the world's top oil exporter from an Arab protest wave . . . Before Abdullah arrived, state media announced an action plan to help lower- and middle-income people among the 18 million Saudi nationals. It includes pay rises to offset inflation, unemployment benefits and affordable family housing.

Saudi Arabia has so far escaped popular protests against poverty, corruption and oppression that have raged across the Arab world, toppling entrenched leaders in Egypt and Tunisia and even spreading to Bahrain, linked to the kingdom by a causeway." (Reuters, 2011)

Our first step is therefore to conclude from surplus analysis that other things equal, a policy which helps the winners more than it hurts the losers will be adopted. Governments, like markets, tend towards surplus maximization. Pressure from interest groups will push on both sides, for and against a policy, but the side with more at stake will push harder and win.

Other things are not equal, however. The problem is that some interest groups are better than others at exerting political pressure. Surplus analysis is a good start for political analysis, but it is only a start, because just as markets can fail because of flaws such as externalities or poor information, so can governments. Although this shows up most clearly for democracies, where the leaders are most sensitive to political pressures, it also applies to autocracies, whose pressures take other forms such as outright bribery. We shall see that for a number of reasons we should expect governments to be more prone to failure than markets. Consider the following two scenarios:

Regulation 1. *1 million people each lose $100 from Regulation 1, but 1,000 people each gain $2 million. Total cost is $100 million. Total benefit is $2 billion.*

Regulation 1 maximizes surplus, but it loses massively, by a vote of 1 million to 1 thousand. The voter cares about the impact on himself, not the overall impact. Or, he might even ask himself about the impact on "the average person," which in this case is a loss of $100. (Note that this is quite different from "the average gain per person," which is $1.9 billion divided by 1.001 million, about a $2 gain per person.)

Regulation 2. *1 million people each lose $1 from Regulation 2, but 1,000 people each gain $200. Total cost is $1 million. Total benefit is $200,000.*

Regulation 2 reduces surplus, but it wins by a vote of 1,000 to 0. The voter cares about the impact on himself, but for the 1 million people who lose, the loss is so small it is not worth going to the trouble to vote.

The reasoning behind these two scenarios is contradictory, of course, but I laid them out this way to illustrate two common reasons why the government chooses inefficient policies, origins of the bad objectives half of government failure.

1. The Tyranny of the Majority. Regulation 1 illustrates what happens with one-man one-vote decisions. If it comes to a straight vote, and intensity of feeling does not matter, the majority will win even when it feels less strongly. Our examples of the barber and copper regulations were based on political pressure corresponding to the amount of surplus at stake. If all that counts is the number of people on each side, though, the minority will be outvoted even if it has much more at stake. This is the most obvious shortcoming of democracy, a shortcoming emphasized in Alexis de Tocqueville's book, *Democracy in America*. De Tocqueville was a French aristocrat who toured America in the 1830s and thought deeply about its government, customs, and morals. He wrote,

> The very essence of democratic governments is that the dominion of the majority be absolute; for, in democracies, nothing outside of the majority can offer resistance. ... So in the United States the majority has an immense power in fact and a power of opinion almost as great; and once the majority has formed on a question, there is, so to speak, no obstacle that can, I will not say stop, but even slow its course and leave time for the majority to hear the cries of those whom it crushes as it goes. (Vol. 2, Part 2, ch. 7)

De Tocqueville also noted, however, that the majority has limited attention, for which reason many matters of government will escape its notice. By our time almost 200 years later, government is so large that this means *most* matters of government will escape its notice. The result is that we have the opposite problem too— the tyranny of the minority.

2. The Tyranny of the Minority. The ordinary citizen follows almost none of what government does. When a government agency sets new standards for energy-efficient dishwashers or Congress revises the rules for capital depreciation, most of us are entirely unaware. If that is so, however, then we also are not exerting any political pressure. It will be the dishwasher manufacturers, the environmentalists, the accountants, and the corporations that are paying attention. The attentive minority will determine what happens on these low-profile issues. A name for such voters is **special interests**: those who want a special advantage for their group that is not available for the country as a whole.

It is not that we do not realize the power of special interests and are fooled when we let them control policy. If a policy has only a small impact on a voter, it is individually rational for him not to incur costs to do anything about it. He should remain ignorant of exactly what is happening rather than spend his time learning about every issue. Economists use the term **rational ignorance** to describe the result: ignorance someone chooses because he judges that the cost of becoming informed is not worth the expected gain from his acting on the information. Consumers in the market for laws have poor information, and we have seen that poor information about product quality is one source of market failure: the marginal benefit curve does not match the demand curve.[2] Voters do not know which laws to buy, and even if they did, they have to decide which issues to prioritize for their votes. This is why political campaigning and advertising are so important. Just as companies with good products need to advertise them so consumers know they are good, so politicians have to advertise how good their policies are relative to their opponents. Just as existing companies have an advantage over entrants because consumers know and trust them, so do incumbent politicians, those already in office, have an advantage over newcomers.

The result of voters' rational ignorance, though, is that they lose to other voters who are better informed. A voter with enough at stake will not remain ignorant and passive. Ignorance is not rational for him. Rather, he will take on the cost of learning about the issue and lobbying the government. Tyranny of the majority assumes that each voter has equal weight. In actuality, voters who are informed and active have far more influence. Often, their desire will carry the day. If hardly anybody cares about policy X and hardly anybody decides to vote for a politician depending on whether he supports X or opposes it, the few people who do care about X will be the ones the politicians have to listen to on that subject if they want to stay in office. Thus, we get the **tyranny of the minority**, a situation where most voters are rationally ignorant. The minority of voters who care about an issue get the policy they want even though most people would oppose it if they knew what was going on.

Even if learning were free, the voter might still remain inactive because he will balance the personal effort of political action against the benefits. Any voter who gives thought to the effect of his vote realizes that he probably won't make any difference to who wins the election. Why should you spend half an hour voting when you could be playing a videogame or raking your leaves instead? A 2003 study found that only one of 16,577 federal elections between 1898 and 1992 was decided by a single vote— a 1910 New York congressional election which was won by 20,685 to 20,684.[3] If the probability your vote will break a tie is 1 in a million and the benefit to you of breaking the tie and getting your candidate elected is $100,000—a gross overestimate for most people— then the "expected value" of the benefit from voting is ten cents, .000001*$100,000. If

[2] Rational ignorance includes not just ignorance of information, but lack of analysis. To be able to properly analyze regulatory policies, every voter would have to read and understand the concepts you are learning now, but very few do. See Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies*, Princeton University Press (2007).

[3] Two others were decided by four votes, one by five, and two by nine. "The Empirical Frequency of a Pivotal Vote," Casey B. Mulligan & Charles G. Hunter, *Public Choice,* 116: 31-54 (July 2003).

your time is worth $10/hour, spending a half-hour voting is a waste of time. Thus, it seems nobody should vote— but if nobody else did vote, then your vote would determine who won the election. This is known as the **Paradox of Voting**.

Yet people do vote. One explanation is that voters understand the paradox of voting, but they aren't voting just to make themselves richer. If you care about other people, then you care about the effect of who wins the election on them too. If our hypothetical voter cares about the entire country, the impact of who wins can be a lot bigger than a million dollars. It isn't implausible that electing the right candidate for President would increase the country's material wealth by $100 billion—that is, $100 thousand million. In that case, the expected value of your voting rises to .000001*$100 thousand million, which is $100,000. That value makes it worth spending that half-hour of time voting. When it comes to social and foreign-policy issues, you may think the outcome even more important and be even more willing to try to help out your country.

Or, even if you don't care about the country as a whole, you may care about some large group of people in it. We care more not just about their own families, but about other special groups of people, particularly those with whom they identify. I am an American, but also a Norwegian-American, a scholar, a Midwesterner, a Yale man, a father, a right-hander, and brown-eyed. I am not likely to vote for a policy just because it benefits brown-eyed people, but I might be especially sympathetic to the interests of scholars, even apart from the direct benefit to myself. A big part of the art of politics is **identity politics**: trying to manipulate voters to think of themselves as members of a particular group, with loyalty to that group. Race or ethnicity is a commonly chosen form of identity. Strom Thurmond's 1948 presidential campaign tried to focus white voters on their identity as whites (at a time when blacks effectively could not vote in many parts of the South), while Jesse Jackson's 1984 campaign tried to focus black voters on their identity as blacks. Once the identity group is formed, it can lobby for surplus creation or transfer particular to some or all of the group members. As with particular issues and rational ignorance, if some group is successful in getting people to care about their group identity but people who aren't in the group don't care enough about their identity to base their vote on it, the identity group will be able to lobby for surplus to be transferred to its members.

The tyranny of the majority explains some of the inefficient regulation we see, but tyranny of the minority is usually a better explanation. Much of government failure arises because some people pay more attention than other people to what the government is doing. If you see a new law, or a need for a new law because of market failure, ask the following questions to help decide whether government failure is likely.

1. Is it hard to see who is hurt and who is helped by the law?

If it is hard to see who is hurt by a law, those people will be less likely to notice, and the political pressure will be unbalanced, so the law may succeed despite having overall negative effects. If consumers of copper in the earlier example are not paying attention to politics and do not notice that a price floor might be imposed, they will not know they are going to lose consumer surplus and they will not fight the new law. If consumers of haircuts do not realize that the barbers' cartel is what is making prices high, they will not know to reward the city council for passing a law eliminating the monopoly.

Similarly, if it is hard to see who is helped by a law, that law is not likely to be passed by a legislature, because it would not have enough political support behind it. Even if it would help most people for health insurance fringe benefits to be taxable and the extra revenue used to reduce their tax rates, whether the tax rates would fall enough, and who exactly would fall on each side of the balance is complicated enough for such a proposal to lack the votes to pass.

Supporters of a law or regulation will deliberately try to hide its effects from those groups who would lose from it. This is easiest with complex matters such as corporate tax law or environmental regulations, and so we should expect to find more government failure there, other things equal.

2. Are the benefits concentrated and the costs diffused?

If the benefits are concentrated, the beneficiaries have a strong incentive to lobby for the law. Even if the law is inefficient, it may well be passed. The United States has quotas on the quantity of sugar that can be imported, for example. There are not many sugar producers from sugar cane in Florida and sugar beets in Idaho, but this law is crucial to protect them from cheaper sugar coming from the West Indies. There are millions of sugar consumers, but the cost to each of them from more expensive sugar is so small that they are rationally ignorant of U.S. sugar import policy. Even if they know about it, the amount at stake is too small for consumers to use this issue to determine their vote and their voicing of opinion.

Similarly, if the costs are concentrated and the benefits are diffused we can expect government failure. Nobody wants a county garbage dump to be located next to their property. The costs are concentrated on the neighboring landholders and the benefits are diffused among everyone in the county. Even when there is urgent need for garbage dump expansion, the expansion is delayed by the opposition of whoever's neighborhood is targeted. In real estate the problem is so common it has a nickname: **NIMBY**, or **"Not in My Backyard"**.

3. Are the benefits short-term and the costs long-term?

Politicians are elected for the short-term. Even the 6-year term of a U.S. Senator is not very long compared to the time horizon for major policies. Thus, politicians are tempted to opt for policies with short-term gains and long-term losses.

All this is not to say that politicians and bureaucrats are bad people. Any person will respond to the incentives provided them. Politicians, have a special problem. If a politician votes only for efficient laws, but the conditions for government failure are present, he will not last long in office. Voters will not understand that the law is efficient, the businesses on whom the costs are concentrated will work hard to defeat him, and nobody will see the benefits of the law until years after he has left office. We can blame politicians for responding to the pressure but the problem is more one of government failure than politician failure.

BOX 3.2: THE LOUISIANA COFFIN CASE

After Hurricane Katrina's damage, the 38-member Saint Joseph Abbey in Louisiana decided to make and sell coffins to support the monastery. The Louisiana State Board of Embalmers and Funeral Directors told the monks stop unless they hired a licensed funeral director, built a funeral parlor, and installed embalming equpment. In court, the Abbey argued that the regulations had no **rational basis** because their stated purpose to protect the public was false. The actual design of coffins was completely unregulated. The State admitted that the real reason was to help funeral directors, but said that was a legitimate reason. That argument had won in Oklahoma, where the court said that if courts struck down special-interest laws, then:

> "besides the threat to all licensed professions such as doctors, teachers, accountants, plumbers, electricians, and lawyers, . . . every piece of legislation in six states aiming to protect or favor one industry or business over another in the hopes of luring jobs to that state would be in danger. While the creation of such a libertarian paradise may be a worthy goal, Plaintiffs must turn to the Oklahoma electorate for its institution, not us."

The Louisiana federal trial court disagreed, and the monks won.

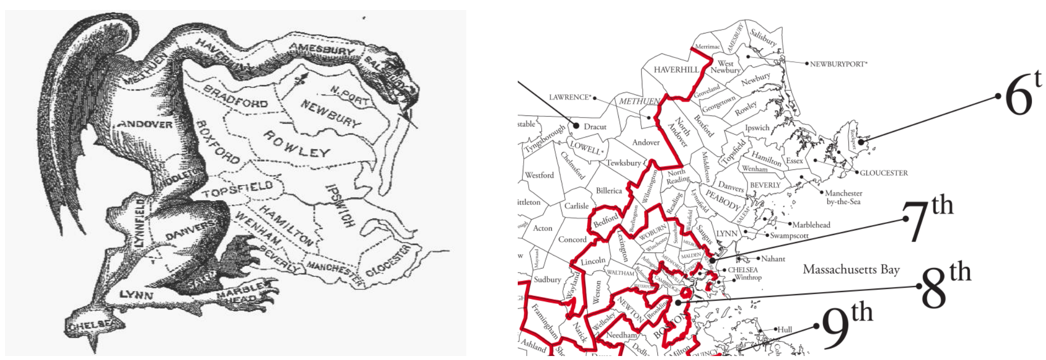
In fact the more you look at it the more you will realize that law making is a market too, not quite like the market for corn or flyswatters but a market nonetheless. Politicians are trying to sell themselves to us, and trying to sell packages of laws. They compete for votes, and consumers of laws provide them with votes, campaign contributions, and door-to-door canvassing.[4]

Since politics is a market, however, it is subject to market failure. Monopoly is an obvious problem, though at least people can choose which city, state, or country's laws to live under. Imperfect information is a huge problem. People do not know exactly what they are buying when they vote for a politician, and rational ignorance means they will not devote the time to monitor him once he is elected. Campaign promises are not enforceaible in court, unlike explicit promises made by businesses that advertise. It would be unwise to make them enforceable. Imagine if President Wilson's 1916

[4] A pleasant essay on this topic is "Public Choice," by J. Mark Ramseyer as the 1995 Coase Lecture (February 21, 1995).

campaign promise not to enter World War I had been enforceable in court. Conditions had changed by the time he broke the promise in 1917, so some voters would have changed their minds. He could have pretended to keep the promise while actually not trying hard to keep out of the war. And the decision was not just up to him: Germany and the Congress also played large parts. The political market is inherently impossible to regulate with product quality laws.

FIGURE 3.3
GERRYMANDERING IN 1812 AND 2011



We have already talked about poor information. Joseph Schumpeter goes even further and says that the problem isn't even availability of information: it is the lack of incentive to absorb the information already at our fingertips:[5]

> Political questions take their place in the psychic economy of the citizen with leisure-hour interests that have not attained the rank of hobbies and with the subjects of irresponsible conversation. These things seem so far off; they are not at all like a business proposition; dangers may not materialize and may not prove so very serious; one feels oneself in a fictitious world.

The citizen's incentive to be informed and take action on any but the local scale is small: "He is a member of an unworkable committee, the committee of the whole nation, and this is why he expends less disciplined effort on mastering a political problem than he expends on a game of bridge." The problem is not so much intellect as effort, rational effort in the presence of differing incentives.

> The reduced sense of responsibility and volition explain the ignorance and lack of judgment in domestic and foreign policy which are if anything more shocking in educated people and people who are successful in non-political walks of life than with uneducated people in humble

[5]Schumpeter, Joseph, *Capitalism, Socialism and Democracy* (1942) pp. 258–262. I have removed many words from this quotation for conciseness.

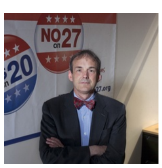
> stations. Information is plentiful and readily available. But this does not seem to make any difference. Nor should we wonder at it. We need only compare a lawyer's attitude to his brief and to statements of political fact in his newspaper. In the one case the lawyer has qualified by years of labor under the definite stimulus of interest in professional competence. Under a stimulus no less powerful he then bends his intellect, his will to the brief. In the other case, he does not care to absorb the information or apply the canons of criticism he knows so well, and he is impatient of long complicated argument. Without the initiative that comes from immediate responsibility, ignorance will persist in the face of masses of information however complete or correct.
>
> The citizen drops down to a lower level of mental performance as soon as he enters the political field. He argues and analyzes in a way which he would readily recognize as infantile within the sphere of his real interests.

Indeed, someone may choose their political impressions just to impress other people. One's political views are often, like one's choice of clothing, meant to express one's personality rather than to affect the nation. A voter may get utility just from declaring his political views to others. A classic example is the young man who says he supports increased financial aid for the poor not because of genuine beliefs, but only to signal his compassionate nature to members of the opposite sex.[6] In aggregate, this kind of posturing will affect the nation, even though that is not the intent and may be contrary to the desire of the voter who is using his politics to impress other people.

Externalities, too are a problem. In fact, unlike in ordinary markets, externalities are pervasive in the political marketplace. Any government law or regulation that raises or reduces public spending has a spillover effect onto taxes and the public debt. Any new law potentially affects everybody, not just the voters who lobbied for it.

BOX 3.3: A REFORM ENTREPRENEUR

"Charles T. Munger Jr., wearing a smooth herringbone blazer and a bow tie, sat in a downtown Palo Alto office one recent morning and discussed his decision to give $7 million to support Proposition 20, a ballot initiative that would wrest Congressional redistricting powers from legislators and hand that control to a citizens panel....



Munger, the son of the billionaire Charles T. Munger, has built a coalition in support of Proposition 20 that is an unlikely collection of election-reform groups, civil rights nonprofits and former officials from both major parties who say that the current system of redistricting has left politicians unaccountable." (*New York Times*, October 7, 2010)

[6] See Randall Calvert "Identity, Expression, and Rational Choice Theory," *Public Choice* (2008). Or recall this joke. *Sam:* "In my family I make the big decisions and my wife makes the small ones, so there's no conflict." *Friend:* "What is it your wife gets to decide?" *Sam:* "Oh, what school our kids go to, which house we buy, whether I'll switch jobs. That kind of thing." Friend: "Then what are the big decisions?" *Sam:* "Tax reform, whether to bomb Libya, how to solve global warming..."

Thus, we should expect government failure to be the norm, not the exception. Worse yet, it is hard to think of how to regulate market failure in the government. Do we need a government for regulating the government? That takes us into an infinite regress, since then have to worry about government failure in the new supervisory government. Constitutions are a little like a supervisory government, as we will discuss in talking about government design, but at some point there is always the need to have real people make decisions, subject either to supply and demand by other people or, if nobody else can punish or reward them, subject just to their own principles, whims, or special interest.

Reform is difficult because inherent in government action is not knowing the effects of policies, caring too little because the costs or benefits are diffused, and short-sightedness becauase costs or benefits are far off in time. Public goods are subject to **the free rider problem**: the benefits are diffused by definition, and each voter would like to get the benefit without doing the work of getting involved in pressuring the government officials.

It can happen, in fact, that a government agency intended to regulate an industry to protect consumers becomes, over time, controlled by the very industry it is meant to regulate. This is known as **regulatory capture**. The standard example is the Interstate Commerce Commission, set up in 1887 and abolished in 1995. The Interstate Commerce Commission was established to keep railroad shipping prices low, but critics charged that it became an agency to protect railroads from competition from each other and from trucks.

BOX 3.4: CONTRACTING OUT GOVERNMENT

Dear W. Gladstone,

. . . As we heard here that you are the chief man in the House of Commons, so we write to tell you that we want to be under Her Majesty's control. We want our country to be governed by British Government. We are tired of governing this country ourselves, every dispute leads to war, and often to great loss of lives, so we think it is best thing to give up the country to you British men who no doubt will bring peace, civilization, and Christianity in the country. . .

King Bell and King Acqua
of the Cameroons River, West Africa

6 November 1881 (U.K. Foreign Office, *Correspondence Respecting Affairs in the Cameroons*, p. 86)

Rational ignorance leads to another source of surplus reduction besides bad legislation: rentseeking costs. Not only does the legislative process result in surplus-reducing regulations: it does so at a cost. The cost includes the lobbying costs to obtain regulations (proactive rentseeking costs) and the lobbying costs incurred to prevent regulations (defensive rentseeking costs). Another cost is the cost of disguising regulations so that the losers will not overcome their rational ignorance. A small part of this is the care given to the wording and explanation of regulations so as to mislead the public as to their costs and benefits. The bigger part, however, is the need to actually change the form of the regulation to disguise its effect. A company might, for example, pay a lobbyist to persuade a politician to block any company from producing new products in its industry. That helps the company by blocking competition. But it is an inefficient way to help the company, because it also stops that company from introducing new products. The company would prefer a regulation that simply gave it a monopoly by making it illegal for anyone to operate a competing firm. Or, better yet, it would prefer a regulation that gave the company a lump sum grant of money from the government each year. Those monopoly and the lump-sum payment, however, are too obviously special-interest legislation, even though they would hurt the public less than blocking new products. Thus, the company presses for the new product regulation instead, and both the public and the company lose out.

Another source of rentseeking costs is the cost of organizing an interest group. Often such a group is organized by a few **political entrepreneurs** who try to mobilize an interest group in exchange for the power, glory, ideals, or money they will attain if they supply a political product that people are willing to pay for. This kind of entrepreneurship has costs, just as business entrepreneurship does, and the costs continue even after the interest group's organization is well established. Much of this arises from the principal-agent problem we discussed in chapter 2 and will discuss in the next section.

3.3: Government Failure: Poor Performance

If government officials are completely insulated from rentseeking, that means they must also be completely insulated from punishment for poor performance or reward for good performance. Thus, to the extent that we design a system of government to discourage special interests, we also have designed a system that fails to punish incompetence, laziness, or dishonesty, and one that allows the officials to govern according to whim rather than the desires of the citizenry. To use the terms from Chapter 2, the public faces a **principal-agent problem**, with the public as principal and the government official as agent.

On the other hand, to the extent that we design a system that rewards or punishes government officials, we make them vulnerable to the blandishments or threats of special interests. An elected official who is barely confident of re-election is one who will pay the most attention to every vocal constituent; a bureaucrat whose promotion depends on public feedback will pay the most attention to the people he is regulating.

The most common system in the modern West is to create three categories of officials: elected officials such as the United States President, bureaucrats who are appointed by the elected officials and who can be fired by them (e.g., the Secretary of the Treasury, whom the President can fire), and bureaucrats who spend most of their careers in government service with little prospect of either punishment or reward by the appointed bureaucrats who are their superiors (e.g., customs agents, whom the President cannot fire without great difficulty). Elected officials and appointed bureaucrats naturally are quite responsive to the citizenry and to special interests, but this means they have to care about appearances as well as substance if they are to keep their jobs. Career bureaucrats, on the other hand, have little reason to be responsive to the citizenry or to work hard, but to the extent that principle or pride makes them try to maximize surplus they can do so without fear of losing their jobs.

Bureaucrats may be usefully divided into three categories. **Careerist bureaucrats** intend to spend their lives working for the agency. They worry about promotion within it, about the future of the agency, and about the power of the agency relative to other agencies. They are the classic bureaucratic type. **Politician bureaucrats** intend to use their government jobs as a stepping stone to something else: to elected office, becoming a consultant, an academic administrative job, or a job in private industry. Many of them gain their jobs by political appointment rather than in the civil service. **Professional bureaucrats** look to their professions for esteem and value that esteem more than achieving policy results or than advancing their careers within government. They are not to be confused with professional bureaucrats in the sense of people who are paid to be bureaucrats and who carry out their duties smoothly—indeed, they often take pay cuts to be bureaucrats and do not fit smoothly into the government machine.[7]

The types of bureaucrats differ in their career concerns, but any of them could be motivated by principle. The careerist bureaucrat often is devoted to the goals of his agency, even to the extent of being blind to the tradeoffs with other goals such as low cost or liberty. The politician bureaucrat often is motivated by a desire to achieve a policy goal but does not care whether the best way to do that is within the agency or outside. The professional bureaucrat often sincerely wants to advance the beliefs members of his profession generally share. Within the Environmental Protection Agency, for example, we would find all three types of bureaucrats who are devoted to reducing pollution at all costs: careerists by expanding the power of the agency, politicians by increasing the influence of environmentalist groups that would back them for future promotion, and professionals by publishing reports which will impress experts within

[7] James Q. Wilson's *Bureaucracy: What Government Agencies Do and Why They Do It* (1989) is a very readable scholarly book on bureaucracy. Just as illuminating, but written as humor is Jonathan Lynn and Tony Jay, *The Complete Yes Minister* (1987) and the TV series associated with it.

their professions. At the same time, there will be others who do not care about policy at all: careerists who just want a promotion and a raise, politicians who want to become Beltway lobbyists, and professionals who want to acquire contacts in government and then become private-sector lawyers, economists, or scientists.

BOX 3.5: GET THEIR NAMES

Suppose you've met a frustrating official in government or in business who is holding you up by not doing his job properly. What can you do? Don't waste your effort complaining. Instead, turn the principal-agent problem to your advantage. Calmly ask for his name and make it clear you are going to write a letter to his supervisor. He may not care about you or about what you think of his organization, but he will care about his own career.

Any large organization faces the problem of giving incentives to its employees to work hard for the organization's objectives instead of just their own. The problem is not just that the government is large and bureaucratic. Many U.S. corporations are larger than many countries. Rather, a corporation has the great advantage that its goal is simple and its owners agree on it: to make profit. Measuring the profit of a company is much easier than measuring the success of a government in maximizing surplus. Accounting is by no means a trivial or easy subject, but it is easier to keep track of a company's money than a nation's happiness. What is harder is to keep track of how each division of a company contributes to its profit. Is the marketing division doing a good job, or is its weakness being masked by the hard work of the manufacturing division? Even that is easier than keeping track of how each division of government is contributing to the success of the whole. Moreover, all the shareholders agree that higher profit is a good thing. Revenue is good, costs are bad, and profit goes up whether it is from one more dollar of revenue or one fewer dollar of costs. A government, on the other hand, has a harder time measuring costs and an infinitely harder time measuring benefits, partly because the citizens disagree on how these are to be measured. What is the cost of a lower speed limit? What is the benefit of a decline in marijuana use?

Because of its simple goal of profit, a corporation can adopt an organizational structure aimed at that simple goal. The shareholders elect a board of directors which has the power to make company decisions, subject to the corporate by-laws and the laws of the nation. The board of directors delegates almost all of their power to an executive who will actually run the company with the subordinates he chooses. If the executive is displeased with a subordinate, he fires him. If the board is displeased with the executive, they fire him. If the board fails to do its job properly, the shareholders elect a new board, or someone buys out enough shareholders to acquire enough votes to choose a new board. This makes all subordinates highly responsive to the goal of maximizing profits.

Box 3.6
A Practical Implication of Government as a Group of Individuals

You may be frustrated because you've run into a petty bureaucrat who insists on following official procedures when a slight deviation obviously wouldn't hurt anything. "How stupid he is!" you mutter to yourself. But step back and think about it, and you'll feel better. If he is that stupid, wouldn't he do something even worse if he didn't follow rigid rules? You don't want to him to try to use his limited intellect. And you should be happy that society is not making a genius waste his talents in that job. Society has to have rule-bound mediocrities in some job or other, so why not in low-level government employment?

A government cannot be run like a corporation. No country would choose a government consisting of an elected board that delegates absolute power to one man to run the country according to his will. Even if the result were not a dictatorship by the executive, the result would not be happy. Such a government would have little reason to maximize surplus instead of oppressing a minority of citizens to enrich the majority. Instead, governments are designed to try to balance responsiveness to public opinion against ease of capture by special interests. The failures of government is not due to its particular structure in the United States, but to the complexity and difficulty of its task. Even the best government organization, optimized to regulate as well as any organization can, will be worse suited to perform the more specialized moneymaking tasks of a private company.

Thus, regulation is to be generally avoided for two reasons. First, the Invisible Hand does a generally good job at making markets work. Second, even when regulation could help, the helpful regulation may not be what we get when the government actually chooses what to do. The unregulated market does not aim at maximizing surplus, but that is what it ordinarily does, with the exceptions we know as market failure. The regulating government, too, does not aim at maximizing surplus. Rather, it responds to political influence. This often results in government failure, but we should keep in mind that the government as a market for laws does have a general tendency to maximize surplus, even if that tendency is often sidetracked by rentseeking.

Having looked at how markets work, market failure, and government failure, we can summarize using the Three-Part Test in the box.

THE THREE-PART TEST FOR REGULATION

1. Is there market failure?
2. Is there a regulation that would solve the market failure?
3. Would there be government failure if we tried to pass a regulation?

What is important about this test is that it goes beyond step 1, finding market failure. Even if the market fails to work well, one must worry about whether the government will do any better. Maybe it will, but that is not guaranteed.

The lesson of this chapter is best summarized by the Three-Part Test. First, see if there is market failure. Second, see if in theory there is some practical way the government coudl act to fix that failure. Third, decide if the danger of government failure is high enough that regulation would likely just make the situation worse. Even the first step of the test rules out most possible government interventions, because problems such as externalities and asymmetric information are usually not severe. Even when that kind of market failure is found, however, that is not enough for us to jump to recommend government involvement. We need to move to the second step, of whether there does exist some regulation that would help, and then to the third step, of whether that is what a government agency would do if it were let loose on the problem. It is not enough to stop after finding market failure. Governments have many of the same problems as markets, and anyone who treats the government as a team of angels will be severely disappointed.

REVIEW QUESTIONS ON GOVERNMENT FAILURE

1. What is government failure?
2. Distinguish between bad objectives and poor performance as categories of government failure.
3. How do rent-seeking, the tyranny of the majority, the free rider problem, and rational ignorance contribute to government failure?
4. How do the concentrations of benefits and costs affect government failure?

5. Why should we expect governments to have more trouble keeping costs low and productivity high than private companies?

6. What is the three-part test for determining whether regulation is appropriate?

Readings

1. "'Chairman's Flight' Offered by United Draws Federal Scrutiny," *The Chicago Tribune*.

2. Has the D.C. Cab Commission Forgotten Who It Serves?" *The Washington Post*, Joshua D. Wright.

3. "Six-Figure Bus Shelter Stirs Cries to Stop It," *The Wall Street Journal*.

4. "Agencies Cant Always Tell Whos Dead and Whos Not, So Benefit Checks Keep Coming," *The Washington Post*.

5. "Scandal Serves Up a Civics Lesson— Bell Officials' Arrest Turns Shaken California Town into a Hive of Community Activism," *The Wall Street Journal*.