Viewpoint

Repairing Capitalism *Roland Vaubel*

ONCE UPON A TIME there was a king who needed a new court singer. He advertised a singing contest, and two singers applied. The first contestant to perform had hardly finished his song when the king announced, to the astonishment of his court, that the other singer would be hired. The first had sung so badly, he declared, that the second could only be better.

The parable is not new but it highlights our problem admirably. We may shake our heads over the king's rashness, but do we not make the same mistake ourselves, again and again? Do we not conclude — automatically, whenever imperfections show up in the market economy — that, of course, the government could do a better job?

Welfare Economics and Market Failure

It may be comforting to recall that when economists developed the theory of economic value judgments ("welfare economics"), they made the same mistake. Starting from a biologically and socially determined distribution of goods and abilities, they asked how human desires could be best satisfied through free contractual agreements. They determined that the optimal condition, where no one could be made better off without hurting someone else (the "Pareto-optimum"), presupposes a certain price structure that naturally results from *perfect* competition. Since nothing in this world is perfect, however, it was easy to show that a policy of complete laissez faire would not necessarily be optimal. Consequently, a "theory of market failure" was developed in which two phenomena stood out:

- In some areas, the cost advantage of mass production is so considerable that strong tendencies to concentration make perfect competition impossible. In the extreme case of a so-called natural monopoly, the desired amount of goods can even be produced most cheaply by a single firm.
- The economic activities of producers and consumers often have side effects on other economic entities (external costs or benefits) that are not the result of prior agreements. In the extreme case of production of a "public good"—say, a good such as information, not subject to private ownership — the external benefit could be as large as the internal benefit to the producer.

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There had been general agreement for some time that the government should counteract monopolistic tendencies and external costs by enforcing competition and private ownership. But then the view became increasingly accepted that the government—at least in the case of natural monopolies and public goods—should become active as a producer and—in all other cases—should try to compensate for external effects through taxes and subsidies. This economic theory of market failure has been under increasingly heavy attack since the 1960s —unnoticed by much of the public and, even today, by a large part of the economics profession.

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Earlier critics of the theory of market failure had pointed out its logical and empirical weaknesses. It can be shown logically, they argued, that the concept of "market failure" is misleading: Monopolistic tendencies and external effects (due to imperfect private ownership) may militate against a policy of laissez

faire, but are surely not a sign of market failure. For, where competition and private property rights are deficient, one can no longer speak of a market economy. Thus the surprising conclusion: It is not an overabundance of, but rather a lack of, markets that leads to "market failure." Nevertheless, the conclusion was perhaps only a Pyrrhic victory for free-market economists. How viable, after all, is the market economy if the state itself has to enforce it?

The free marketeers' second line of defense, therefore, was empirical criticism emphasizing that cases of so-called market failure are the exception. However, because empirical analysis in the social sciences—to the extent that it reaches final conclusions at all—presupposes considerable technical knowledge on the part of both the researcher and his audience, this line of argument could arouse little public interest. The development of the economic theory of government failure has changed the situation.

Asking the Right Questions

Today, criticism of the theory of market failure is no longer primarily a matter of examining its answers for their logical precision (a quarrel over definitions) and empirical relevance (a quarrel over numbers). The new objection is that the theory does not ask the right questions—or, more precisely, it overlooks the central question. That is, it fails to consider the imperfections of the alternative, the deficiencies inherent in the economic activity of the democratic state.

With the discovery of this question and with the economic analysis of government that followed, free-market economists went from the defense to the offense. It is not surprising that this focus upon the imperfections of the alternative did not occur earlier, since it was only extensive experience with a growing government sector that provided the necessary impetus and gave corresponding impact to the analysis. That impact was heightened by the fact that the new theory used the same methods and assumptions for analyzing democratic government that economics had always used for analyzing the market and its imperfections.

As is well known, the economist presupposes for simplicity's sake (without this abstraction a systematic and general analysis would be impossible) that market participants typically are guided by self-interest in their buying and selling decisions. This is not to say, contrary to popular opinion, that people have no altruistic motives. My search for more income or lower-priced products in the marketplace may arise precisely from my desire to acquire or retain as much as possible for altruistic purposes. But it is most unlikely that the person to whom I sell something or from whom I buy something is also the one to whom I most strongly wish to be charitable.

If market agents generally follow their own self-interest, then it is difficult to explain why the same should not also hold true for the political agents in a democracy. What makes us assume that politicians, voters, and civil servants will not try to feather their nests? What makes us assume as a matter of course that the people whom we appoint to prevent "market failure" will act in the public interest rather than their own—like some kind of deus ex machina? What conclusions would result if we assumed, instead, that politicians, voters, and civil servants are people who — at least in decisive questions — rationally maximize their own welfare? Would the theory help us to explain reality?

Bureaucracy

The behavior of civil servants is the subject matter of the theory of bureaucracy. Although that science already has a long history—even outside the field of economics—it is still full of surprises.

Civil servants have relatively little control over their income. The government employee's salary depends on his age, length of service, and—to a certain extent—his superiors. The rational civil servant tries to stay in the good graces of his superior by transmitting only "favorable" information, and the rational superior tries to obtain more information by setting up a system of overlapping jurisdictions. This, as well as the coordination of these overlapping activities, leads to an expansion of the bureaucracy.

Since the civil servant has few possibilities for increasing his income—except by "outside activities"—he directs his energy toward other goals: prestige, power, security, comfort. His

prestige and his power increase with the number of subordinates he supervises and the size of his budget. Thus he has a vested interest in the expansion of government administration. He is not concerned with reducing the number of positions in his own department, for that could result in slower promotion or even demotion. On the other hand, if he succeeds in expanding his authority, not only does his prestige increase, but the possibilities for promotion in his entire department also increase; this puts him in a position to improve the quality of his co-workers.

Thus, when a government program proves ineffective or outright detrimental, the rational civil servant will not recommend that it be simplified or abolished, but rather will ask for more bureaucrats to correct its "weaknesses." The rational civil servant will also want the goods and services provided by government to be offered at the lowest possible price—preferably for free—since the lower the price, the higher the demand, and the greater the chance to expand his sphere of authority. The result: high deficits in the government sector and a waste of resources.

In seeking to maximize his department's budget allocation, the civil servant profits from the ignorance of the administration and the legislature. He requests not the sum that is necessary to produce the goods and services the legislature seems to desire, but rather the maximum that the legislature seems willing to pay. This allows him to appoint additional co-workers without necessarily raising his production. The civil servant will then do everything in his power to spend the entire amount allocated to him (if necessary, in a pinch, shortly before the end of the year); for if he fails to spend all of it, he will probably be allocated less next year.

The search for security leads the civil servant to avoid everything that might attract attention or precipitate controversy. As a rule, bureaucratic omissions are not conspicuous, but innovations, deviant behavior, and price increases are. Inevitably, therefore, the civil servant tends to be less interested in technical progress and economic efficiency.

Many of these problems also arise in the bureaucracies of large private firms, when management becomes independent of the owners. But there are important differences. Unlike the civil servant, the private manager is controlled by the market, and failure in that market (insufficient profit) quickly leads to dismissal. Moreover, the private manager generally has a financial stake in succeeding in the market.

Redistribution

Government bureaucracy is active not only in production, but also in redistribution of wealth.

When democratic governments engage in coercive transfers from richer to poorer, they thereby reduce private charity. What happens is that, as transfers cause disposable income after tax to decline, the willingness to give also declines, probably even more than proportionately. This is the more serious as state-enforced transfers can be shown to be less efficient than private voluntary transfers. At the root of the inefficiency of government transfers is the anonymity that they necessarily involve. It relates to both the donor and the recipient.

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The donor wants to see and enjoy how the recipient of the transfer is being helped; and, ordinarily, he wants the recipient to be aware of his beneficence, so that the recipient will feel grateful and obliged and may return the help in the future. Since the voluntary donor has these incentives to help and obligate the recipient as much as possible with any given transfer, he also has a stronger incentive to give the right thing (or amount of money) to the right person than has a state-run bureaucracy, which administers the taxes of anonymous citizens. The fact that the direct private feedback works better is especially important in the case of transfers; for since such transfers are unrequited, the price mechanism cannot signal relative utilities in the way it does in the market for goods and services.

From the standpoint of the recipient, anonymous government transfers create serious problems because they must be embodied in laws and regulations. Since the recipient receives a legal right to assistance, he no longer regards himself as a supplicant, but assertively

stands on his rights. As a result, his moral impetus for self-help is reduced and a "dependency trap" is created.

All the above applies to direct redistribution, through the overt process of taxing and spending. Redistribution can also be achieved, of course, through government regulatory prescriptions — requiring, for example, certain classes of freight to be carried at a rate below what the market will bear and thus to be subsidized by shippers of other goods. This form of redistribution is less visible and less directly traceable to the government, so that it is particularly appealing to politicians as a means of transferring wealth to the less needy portions of the population. Apart from the distortion of democratic processes which this invisibility produces, redistribution through regulation can (and usually does) create inefficiencies beyond those associated with the mere anonymity of government beneficence, resulting in a further reduction of total wealth.

Majority Rule

In a democracy, it is the majority that decides about redistribution as about everything else. Majorities can impose their will on minorities, and if they are rational, they will do so. Thus, majority voting institutionalizes a procedure for the generation of negative externalities. Does it make sense to justify government intervention in the market by the need to eliminate all the little externalities that occur in the economic process if much larger externalities are generated by the political process?

Moreover, it cannot even be said that at least the externalities generated in this fashion are those desired by most of the population. It is well known that, under majority voting, the median voter and the median political view receive a disproportionate share of influence because they hold the key to power. This explains why not only the poor but also the "middle class" tend to be favored by democratic redistribution. Indeed, more often than not such redistribution in favor of the median-income earners is the result of coalitions between the middle class and the rich, because the middle class has no interest in sharing with the poor what it can get from the rich.

Even if majority voting is direct and confined to a single ballot, it does not, unlike the market price mechanism, allow for differences in the intensity of preferences. Only logrolling among the democratic representatives can help remedy this defect, and that generally occurs only among the legislators of the majority party or the ruling coalition. If a coalition has to be formed, it tends to be no larger than is necessary to secure a safe majority. Since politicians want to share power with as few people as possible, they prefer the smallest coalition of similarly minded people that will yield the necessary majority. That is, simple majority voting results in the maximization of the minority.

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The deficiencies of democratic government are caused not only by rational behavior on the part of bureaucrats and politicians; the rationality of voters has undesirable consequences as well. In a large modern democracy, the rational voter knows that the weight of his vote is minuscule. With a turnout of 100 million, one vote is worth a one-hundred-millionth, and this only if the race between parties seems close. This explains why it is less rewarding for the voter to be informed about controversial political issues than it is for the consumer to be informed about the marketplace. As Joseph Schumpeter remarked,

> The typical 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. . . . Without the initiative that comes from immediate responsibility, ignorance will persist in the face of masses of information however complete and correct. . . . The reduced sense of responsibility and the absence of effective volition. . . . explain the ordinary citizen's ignorance and lack of judgment in matters of domestic and foreign policy which are if anything more shocking in the case of educated people and of people who are successfully active in nonpolitical walks of life than it is with uneducated people in humble sta-

> tions. . . . The private citizen . . . expends less disciplined effort on mastering a political problem than he expends on a game of bridge [*Capitalism, Socialism, and Democracy*, 1952, pp. 261–62].

In the marketplace, by contrast, every "vote" has its full weight (the weights being given by the decision maker's income). Moreover, it is much easier to understand the price signals of the market mechanism than the abstract issues and complex interdependencies that are typical of the political macro-sphere.

In the absence of a sufficient incentive to acquire political information, the rational voter will react in three ways: he will collect only the most easily accessible information; he will collect information only with respect to issues that are of overriding importance to him; and he will forget very fast. Each of these responses has important implications.

The voter's collection of only very cheap information means that he will pay more attention to the personalities of the candidates than to the issues. The politicians respond to the demand for cheap information by engaging in confetti-type "good-will" election campaigns. Instead of providing substantive discussion on the issues, they offer a ready-made package of generalities: an ideology. Among these bundles the voter may choose every four or five years. (Just imagine, if this were also the interval at which he could choose where and what to buy or eat.)

The voter's concentration on only a few issues that are of overriding importance for his personal well-being helps to explain the disproportionate power of certain minority interest groups and the spectacular growth in government's share of national expenditure. Interest group associations provide relevant information to their members, focusing on their special concerns and helping them to economize on political information cost. Since the members absorb little other political information, the association has a strong influence on the voting behavior of its members, and this increases its bargaining power vis-à-vis the politicians. On the other hand, interests that are widely diffused and relatively unimportant for the individual citizen are difficult to organize—for example, the interests of consumers and taxpayers. The logic of collective action thus implies an asymmetry of democratic power, and it can easily happen that the damage to voters from the sum of all the little unperceived burdens that politicians impose on them is much larger than the gain from the few programs on which their lobbying concentrates. Good cases in point are the subsidies that are paid to various producer groups (such as farmers) and the tariffs that protect uncompetitive industries against competitive industries (in the same country!). To the extent that this redistribution toward the strong and well-organized professional interest groups operates through the government budget, it tends to increase government expenditure.

Forgetfulness, the third reaction of the rational voter, explains why democratic governments increase this sort of public expenditure before an election while "consolidating" afterwards, and why they conduct "expansionary" monetary and fiscal policies to achieve temporarily high employment before an election while fighting inflation, which always follows with a lag, after the election is over. Indeed, as the theory of the political business cycle has demonstrated, there are good reasons to believe that economic instability is largely, if not primarily, the result of the democratic election process.

More generally, forgetfulness is at the root of the politicians' preference for programs whose benefits are available immediately but whose costs appear only at a later stage. Politicians are not interested in public investments that have to be financed now but do not pay off (fully) before the next election. After all, the probability is high that the opposition will win that election and that the voters will attribute the benefits of the program to the new government. Is long-term planning only possible in the private sector?

THE ECONOMIC THEORY OF GOVERNMENT FAILURE should not be misunderstood. It does not suggest that we can do without government, or that representative democracy is not the least imperfect form. The point is merely that governments seem to have taken over many activities that the market could handle more satisfactorily. Not every imperfection of the marketplace justifies the assumption that government can do better. We must think in terms of alternatives. The second singer turns out to be frightfully unmusical. ■