Opinion

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The Public Use of Private Interest

In 1929, some 9 percent of the gross national income was spent by federal, state, and local governments for purposes other than national defense and foreign affairs. Between 1929 and 1960, however, the proportion of gross national income spent for domestic programs rose to 17.5 percent. Today, only sixteen years later, that figure is 28 percent.

The growth of federal regulatory activities has been even more striking. There is no good way to quantify regulatory growth, but a few figures will illustrate its speed. Even as late as the middle 1950s, the federal government had a major regulatory responsibility in only four areas: antitrust, financial institutions, transportation, and communications. In 1976 eighty-three federal agencies were engaged in regulating some aspect of private activity.

Even more relevant to my theme is the changing nature of government intervention. Addressed to much more intricate and difficult objectives, the newer programs are different; and the older ones have taken on more ambitious goals. In the field of energy and the environment the generally accepted objectives of national policy imply a staggeringly complex and interlocking set of actions, directly affecting the production and consumption decisions of every citizen and every business firm.

In a society that relies on private enterprise and market incentives to carry out most productive activity, the problem of intervention is a real one. After the decision to intervene has been taken, there remains a critical choice to be made: should intervention be carried out by grafting a specific command-and-control module—a regulatory apparatus—onto the system of private enterprise, or by modifying the informational flow, institutional structure, or incentive pattern of that private system? Neither approach is appropriate to every situation. But our political system almost always chooses the command-and-control response, regardless of whether that response fits the problem.

Once a political battle to intervene has been won in some broad area—environmental control, reduction of industrial accidents, or standards for nursing homes and day-care centers—the extent and scope of the resulting social controls are seldom grounded in an analysis of where and to what extent the private market has failed to meet acceptable standards. Similarly, there is seldom any attempt to design techniques of intervention that preserve some of the virtues of the free market.

Virtues of the Market

We acknowledge the power of economic incentives to foster steadily improving efficiency, and we employ it to bring us whitewall tires, cosmetics, and television sets. But for something really important like education, we eschew incentives. We would laugh if someone suggested that the best way to reduce labor input per unit of production was to set up a government agency to specify labor input in

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detail for each industry. But that is precisely how we go about trying to reduce environmental damage and industrial accidents.

The buyer-seller relationships of the marketplace have substantial advantages as a form of social organization. In the first place, relationships in the market are a form of unanimous-consent arrangement. When dealing with each other in a buy-sell transaction, individuals can act voluntarily on the basis of mutual advantage. Organizing large-scale social activity through the alternative open to a free society—democratic majoritarian politics—necessarily implies some minority that disapproves of each particular decision. To urge that the principle of voluntary decision should be given weight is not to make it the sole criterion. But precisely because the legitimate occasions for social intervention will increase as time goes on, preserving and expanding the role of choice take on added importance.

A second advantage of the market as an organizing principle for social activity is that it reduces the need for hard-to-get information. The more complicated and extensive the social intervention, and the more it seeks to alter individual behavior, the more difficult it becomes to accumulate the necessary information at a central level. Obviously, one does not rush out, on the basis of informational economies alone, and recommend, for example, that simple effluent charges displace all pollution-control regulations. But, where feasible, building some freedom of choice into social programs does offer advantages, either in generating explicit information for policy-makers about the desirability of alternative outcomes or in bypassing the need for certain types of information altogether.

A third advantage of the market is its "devil take the hindmost" approach to questions of individual equity. At first blush this is an outrageous statement and, obviously, I have stated the point in a way designed more to catch the eye than to be precise. To elaborate, in any except a completely stagnant society, an efficient use of resources means constant change. From the standpoint of static efficiency, the more completely and rapidly the economy shifts to meet changes in consumer tastes, production technologies, resource availability, and locational advantages, the greater the efficiency. From a dynamic standpoint, the greater the advances in technology and the faster they are adopted, the greater the efficiency. While these changes on balance generate gains for society in the form of higher living standards, almost every one of them deprives some firms and individuals of income. Under the social arrangements of the private market, those who may suffer losses are not usually able to stand in the way of change.

Dealing with the problem of losses is one of the stickiest social issues. There is absolutely nothing in either economic or political theory to argue that efficiency considerations should always take precedence. And sometimes there is no way to avoid unconscionably large losses to some group except by avoiding or at least moderating changes otherwise called for by efficiency considerations. Nevertheless, in designing instruments for collective intervention that will avoid loss, we place far too much stress on eschewing efficient solutions, and far too little on compensation and general income-redistribution measures. Over time, the cumulative consequences are likely to be a much smaller pie for everyone.

The final virtue of market-like arrangements that I wish to stress is their potential ability to direct innovation into socially desirable directions. While the formal economic theory of the market emphasizes its ability to get the most out of existing resources and technology, what is far more important is its apparent capacity to stimulate and take advantage of advancing technology. Living standards in modern Western countries are, by orders of magnitude, superior to those of the early seventeenth century. Had the triumph of the market meant only a more efficient use of the technologies and resources then available, the gains in living standards would have been minuscule by comparison. What made the difference was the stimulation and harnessing of new technologies and resources.

From a long-range standpoint, the effectiveness of social intervention in a number of important areas depends critically on heeding this lesson. Much of the economic literature on pollution control, for example, stresses the role of economic incentives to achieve static efficiency in control measures—that is, the use of existing technology in a way that reaches environmental goals at least cost. In the long run, however, the future of society is going to hinge on the discovery and adoption of ever-improving technologies to reduce the environmental consequences of expanding production. If, for example, we assume that per capita living standards in the United States improve from now on at only one-half the rate of the past century, the gross national product a hundred years from now will still have risen more than threefold. Median family income, now about $14,000, will equal about $55,000. Only if the amount of pollution per unit of output is cut by two-thirds can we maintain current environmental performance, let alone improve it—even on the assumption that the rate of economic growth is halved. There is simply no way such reductions can be achieved unless the direction of technological change is shifted to minimize pollution.

The point is not that the unfettered market can deal with the problem of environmental quality—or other problems for which some form of regulation already exists. Indeed, the problems arise precisely because the market as it is now structured does not work well. But the historically demonstrated power of market-like incentives warrants every effort to install such incentives in our programs of social intervention.

The Causes of Market Failure

Within the sphere of activities not excluded from the market by considerations of liberty and dignity, there remain many situations in which private enterprise operating in a free market as we now know it does not produce efficient results. Where the deviations are serious, a prima facie case arises for collective intervention on grounds of efficiency alone.

Every modern society is based upon a set of property and contract laws that specify a highly complex set of does and don'ts with respect to owning, using, buying, and selling property. The structure of the private enterprise system and the efficiency with which it operates depend on the content of this system of laws. How efficiently that system works at any point in time is strongly conditioned by how well it matches the underlying technological and economic realities.

A second basic proposition underlies an identification and analysis of market failure: to be an efficient instrument for society a private market must be so organized that buyers and sellers realize *all* the benefits and pay *all* the costs of each transaction. In other words, the price paid by the buyer and the costs incurred by the seller in each private transaction must reflect the full value and the full cost of that transaction not only to them, but to society as a whole.

As a rough-and-ready generalization, the body of laws governing property rights and liabilities is likely to yield inefficient results principally when dealing with the side effects of private market transactions. The problem is not that side effects exist, but that the benefits they confer or the costs they impose are often not reflected in the prices and costs that guide private decisions.

Where side effects are confined to the parties to a transaction, proper specification of the laws governing private property can sometimes ensure that they are properly reflected in the private accounting of costs and benefits. Under these circumstances, establishing some continuing mechanism of social intervention is unnecessary. Individual buy-and-sell arrangements can efficiently reflect social values. In many cases, however, the very nature of the situation is such that merely redefining property rights will not resolve the problem; markets can be organized by purely private efforts only at great cost, if at all.

There are essentially four sets of factors that lead to market failure: high transaction costs, large uncertainty, high information costs, and, finally, what economists call the "free rider" problem.

Transaction costs. Markets are not costless. There are expenses of money, time, and effort in setting and collecting prices. Sometimes transaction costs are virtually infinite: there is no conceivable way that a market can be formed to deal with side effects. Sometimes transaction costs, while not infinite, exceed the benefits that a market could otherwise confer, and so it does not pay to set one up. Very often the scope and nature of the transaction costs strongly limit the range of effective social intervention and force society to organize markets in less than an ideal way.

Uncertainty and information costs. It is easier to treat the problems of uncertainty and information costs together since it is through information that we can, at least sometimes, reduce uncertainty. Market transactions cannot be an efficient method of organizing human activity unless both the buyer and the seller understand the full costs and benefits to them of the transactions they undertake, including any side effects that impinge on their own welfare.

However, in the case of hazards that are highly complicated, the provision of technically complete but neutral information may not be very helpful. Evaluating the significance of such hazards may itself require more technical ability and judgment and more time than it is reasonable to expect from most consumers. Where the potential harms from a product feature are serious and where the technical difficulty of evaluating information is very great, regulation may be the best alternative despite its inefficiencies—and in some cases a ban on certain types of products may be required. But in all cases the comparison should be between an imperfect market and an imperfect regulatory scheme, not some ideal abstraction.

The "free rider" problem. Where the side effects of private transactions have a common impact on many people—for example, in the discharge of sulfur into the atmosphere from coal-burning utilities—the possibility of purely private action is severely limited. In theory, if the rights to the use of the clean air were assigned by law to the polluter, those affected might band together and pay the polluter to reduce the emissions. But any one individual would enjoy the benefits of the improvement whether he paid his share of the cost or not. He could be a "free rider" on the efforts of everyone else. How could cost shares be decided and enforced? Without the coercive power of government, purely voluntary arrangements could not be successful.

Changing Attitudes

Relying on regulations rather than economic incentives to deal with highly complex areas of behavior, as we do for control of air and water pollution and industrial health and safety, has a built-in dynamic that inevitably broadens the scope of the regulations. Under an incentive-oriented approach—effluent charges, injury-rate taxes, or improved workmen's compensation—the administering agency does not itself have to keep abreast of every new development. The incentives provide a general penalty against unwanted actions. But if specific regulations are the only bar to prevent social damages, the regulating agency must provide a regulation for every possible occasion and circumstance. First it will take twenty-one pages to deal with ladders and then even more as time goes on. Social intervention becomes a race between the ingenuity of the regulatee and the loophole closing of the regulator, with a continuing expansion in the volume of regulations as the outcome.

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We try to specify in minute detail the particular actions that generate social efficiency and then command their performance. But in certain complex areas of human behavior, neither our imagination nor our commands are up to the task. Consistently, where social problems arise because of distorted private incentives, we try to impose a solution without remedying the incentive structure. And equally consistently, the power of that structure defeats us.

Market-like instruments can supplant current command-and-control techniques only gradually. But not much thought has been devoted to dynamic strategies that, step by step, mesh a dwindling reliance on regulations with a cautiously expanding use of market instruments.

When social intervention into new areas is considered, we start with a more or less clean blackboard. We do not have to erase an existing maze of command-and-control laws. But a different kind of problem then confronts us—impatience. Major political initiatives come only after the public has been persuaded that an important problem exists. A sense of urgency has developed. How can politicians then put before the public a ten-year plan for gradually developing a new market structure? Instead, the inevitable strategy is to enact ambitious legislation stipulating sharp and immediate results, and then to erode the regulations piecemeal with postponements and loopholes as problems develop. The very rhetoric and political process that moves us finally to get something done often puts us in a position where that something is done poorly.

The American political system has been a marvelously effective tool for providing both freedom and governance. Its institutions have been well suited for generating the compromises and accommodations about national issues needed in a large and heterogeneous society. But those institutions were especially designed to settle conflicts of value. As society has intervened in ever more complicated areas, however, and particularly as it aims to influence the decisions of millions of individuals and business firms, the critical choices have a much lower ideological and ethical content. For economic or social reasons, we may still want to move some area of decision-making completely out of the market and into the sphere of specified rights and duties. And the necessity will remain to form political battle lines around the very real question of whether to intervene at all. We cannot abandon the standard techniques and institutions for forming consensus and negotiating compromises among groups with widely different values.

But how does an ingrained political process which stresses value adjustments come to grips with the critical choices among technically complicated alternatives when some of the very political techniques that move society toward a decision themselves make it difficult to pursue workable methods of intervention? Identifying heroes and villains, imputing values to technical choices, stressing the urgency of every problem, promising speedy results, and offering easily understandable solutions which specify outputs and rights—these are the common techniques of the political process whereby consensus is formed and action taken.

There is no obvious resolution to this dilemma. The suggestion that the political debate be confined to ends, while technicians and experts design the means once the ends have been decided, is facile and naive. Ends and means cannot and should not be separated. In the real world they are inextricably joined: we formulate our ends only as we debate the means of satisfying them. No electorate or politician can afford to turn over the crucial question of how social intervention is to be designed to supposedly apolitical experts.

The only available course is a steady maturing of both the electorate and political leaders. How to intervene, when we choose to do so, is ultimately a political issue. I am convinced that the economic and social forces that flow from growth and affluence will continue to throw up problems and attitudes that call for intervention of a very complex order. How we handle those questions not only will determine our success in meeting particular problems, but cumulatively will strongly influence the political and social fabric of our society. Even if it were politically possible—which it is not—we cannot handle the dilemma by abjuring any further extension of interventionist policies. But, equally, we cannot afford to go on imposing command-and-control solutions over an ever-widening sphere of social and economic activity.

I believe—I have no choice but to believe—that the American people can deal intelligently with issues painted in hues more subtle than black and white. Indeed, the political winds of the last few years can be read as a sign that the electorate is somewhat ahead of many of its political leaders. Voters are not disillusioned with government per se. But they are fed up with simple answers to complicated problems. They are ready, I think, for a more realistic political dialogue. Almost two centuries ago the arguments for the ratification of the Constitution were laid out in *The Federalist* papers—perhaps the most sophisticated effort at political pamphleteering in history. I have good reason to hope—and to believe—that voters can accept the same high level of political argument as the farmers, mechanics, and politicians of the eighteenth-century colonies. ■

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