

**WHY LIMIT GOVERNMENT?
AN INTRODUCTION TO THE STUDY OF GOVERNMENT
FAILURE FROM PUBLIC CHOICE PERSPECTIVE**

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ABSTRACT

The theory of government failure developed by public choice economists is also called “the non-market failure theory”. The government failure theory in short, explains the negative results of the regulations and interventions made by the state to the economy. As market failure exists according to public choice economists, government can also fail due to various reasons. When the government intervenes in the economy to cure an economic problem only ends up creating more problems. In sum, government failure is imperfection in government performance and explores the deficiencies of political decision making process.

Key Words: Government failure, Government performance, Deficiencies of Political Decision Making Process.

JEL Classification: D7, D8

I. INTRODUCTION

“What institution of government could tend so much to promote the happiness of mankind as the general prevalence of wisdom and virtue? All government is but an imperfect remedy for the deficiency of these. ... The fatal effects of bad government arise from nothing, but that it does not sufficiently guard against the mischiefs which human wickedness gives occasion to.”

Adam Smith

The Theory of the Moral Sentiments*

1759

The theory of market failure developed by the contributions of neo-classical and Keynesian economists dominated to the main teachings of textbooks and literature in economics for many years. Neo-classical and especially Keynesian economists have suggested that the state interference to the economy is essential to correct the market failures. However, between the beginning of the 1950's and till the end of the 1970's, the size and the roles of the state in many nations caused new economic problems. In respect to the negative results caused by the extreme growth of the state, economists have developed an alternative theory for the market failure which is called *“the theory of government failure.”* This is an introductory paper that aims to summarize the main sources of government deficiencies.

II. THE SOURCES OF GOVERNMENT FAILURE

The theory of government failure developed by public choice economists is also called *“the non-market failure theory”*. The government failure theory in short, explains the negative results of the regulations and interventions made by the state to the economy. As market failure exists according to public choice economists, government can also fail due to various reasons. Therefore, while supporting state interventions in economy we should keep

* Adam Smith, The Theory of the Moral Sentiments , see: <http://www.adamsmith.org/smith/tms/tms-p4-c2.htm>

these failures in mind. The main sources of government failure are summarized below:¹

a. Lack of Perfect Competition in Politics

As there are no perfect competition conditions in the market economy, political decision making process also lacks the ideal environment for perfect competition. For example, there may be a political system without any electoral competition. However in plural democracies where electoral competition is partially valid, government failure can be observed mainly because of the following reasons: (Aktan, 1995:67)

-Lack of freedom of thought,

-Lack of political knowledge of the voters that is, not having full information on the matter and likely not being able to make the correct choice in the voting mechanism. This is called “voter ignorance”.

-Voter irrelevance due to the high costs of acquiring knowledge on the matter,

¹ We would like to list the main introductory contributions to the literature of government failure here: James M. Buchanan, "The Achievement and the Limits of Public Choice in Diagnosing Government Failure and in Offering Bases for Constructive Reform", Horst Hanusch (Ed.), *Anatomy of Government Deficiencies*, Berlin: Springer-Verlag, 1983, pp.15-25. ; Buchanan, James M., "Market Failure and Political Failure", *Cato Journal*, Vol. 8, No. 1, Spring/Summer, 1988, pp.1-13.; Horst Hanusch, "Inefficiencies in the Public Sector: Aspects of Demand and Supply", in: *Anatomy of Government Deficiencies*, Horst Hanusch (Ed.), Springer-Verlag, Berlin, 1983, pp.1-12.; Horst Hanusch, (Ed.) *Anatomy of Government Deficiencies*, Berlin: Springer-Verlag, 1983. Alan Peacock, "On the Anatomy of Collective Failure", *Public Finance*, Vol. XXXV, No.1, 1980, pp.33-43. ; Charles K. Rowley, "The Failure of Government to Perform its Proper Task", *ORDO*, Band 34, Fall 1983, pp. 39-58. ; Charles K. Rowley, "Market Failure and Government Failure", in: James M.Buchanan and at all. (Eds.), *The Economics of Politics*, London: The Institute of Economic Affairs, 1978.; Gerald. Sirkin, "The Anatomy Of Public Choice Failure", in: R.D.Leiter And G.Sirkin (Eds.), *Economics Of Public Choice*, New York: College Of City University Of New York, 1975. ; Charles, Jr. Wolf, "A Theory of Non-Market Failures", *The Public Interest*, No: 55, Spring 1979. ; Charles, Jr. Wolf, "A Theory of Non-Market Failure: Framework for Implementation Analysis", *Journal of Law and Economics*, vol XXII, April-1979, pp.107-31.

- The depoliticization of the voters from politics through oppressive state policies,
- Voters are not informed on what is going on in economy since secrecy is valid instead of transparency in the political process,
- Lying and deception in politics,
- Misinformation and overload information in politics etc.

b. Political Myopia

One of the common governmental failure is “*political myopia*” or “*shortsightedness effect*”. According to politicians, the best policies are the policies which ensure winning the elections. When looked in this way, instead of implementing investment projects with important contributions to the economy in the long term, it is more rational to implement projects that will be directly useful to voters in the short term.²

We should note that in modern democracies, economic voting may be a good deal less “rational” than it appears. Voters’ tendency to focus on very recent economic conditions at election time may perversely tempt incumbents to pursue “*myopic policies for myopic voters*” (Tufte 1978, 143).

c. Political External Economies

One of the reasons that cause governmental failure is known as political external economies in the literature. The following examples may be given to externalities named as “political external economies” (Aktan, 1995:68).

² For more information about voter myopia, see: Anthony. Downs, “An Economic Theory of Political Action in a Democracy”, The Journal of Political Economy, Volume 65, Issue 2, April 1957, pp. 135-150. ; Coşkun Can Aktan, “Sources Of Governmental Failure And Imperfect Information As Political Failure”, the International Journal of Economics and Finance Studies (IJEFS). Vol 7. No 2 , 2015.; Roger D. Congleton, “Informational Limits to Democratic Public Policy”, www.soc.nii.ac.jp/jepa/2003/40t2.pdf.

Patronage in politics is an example for political external economies. The governments are always in the tendency of favoring its party members (clients). As a result of these patronage relations called "*clientelistic politics*", economic resources are distributed to the political supporters and partisan groups by the political power.

Another type of political external economies that cause the failure of the government is called "*derived externalities*". Derived external economies may be defined as external effects that can not be estimated before hand. State intervention to modify market failure may cause negative unanticipated side effects that are not expected. "Government intervention to correct market failure may generate unanticipated side effects, often in areas remote from that in which the public policy was intended to operate." (Wolf, 1979).

It must be significantly stated that the most widespread political external economies are rent creation and rent allocation. In short, the rent provided to various sectors via politics is a widespread application of political external economies. In short, efforts of rent creation, rent allocation and rent seeking are indications of governmental failure.³

d. Negative Economies of Scale

Just like in the market economy, there are also negative internal economies (negative scale economies) in the public economy. Negative economies of scale are the negative results of extreme growth of government. Some costs

³ The following papers can be considered as the basic foundations of the rent seeking theory: Anne Krueger, "The Political Economy of Rent Seeking Society", *American Economic Review*, Vol 64, No 3, June 1974, pp. 291-304. ; Gordon Tullock, "The Welfare Costs of Tariffs, Monopolies and Theft ", *Economic Inquiry*, Vol 5, 1967, pp. 224, 232. ;Gordon Tullock, "Rent Seeking", in *The New Palgrave Dictionary of Economics*, Vol 4, pp. 147-149. ; James M. Buchanan, Robert D. Tollison and Gordon Tullock, *Toward A Theory of the Rent Seeking Society*, Texas A-M University Press, 1980. ; James M. Buchanan, "Rent Seeking and Profit Seeking", In:J. M. Buchanan, Robert D. Tollison and Gordon Tullock, *Toward A Theory of the Rent Seeking Society*, Texas A-M University Press, 1980, pp. 3-15. ; Charles Rowley, Robert Tollison and Gordon Tullock, *The Political Economy of Rent Seeking*, Boston: Kluwer Academic Pub. 1988. ; Robert Tollison, "Rent Seeking: A Survey" *Kyklos*, Vol 35, 1982, pp. 575-276.

(bribery, robbery, plundering, etc...) are aroused in governmental organizations because of extreme growth or wide range production (Aktan, 1995:68).

e. Pork Barreling

One of the reasons of market failure is the imbalanced distribution of resources in economy. The geographical and sectoral distribution of resources in a country may not be stable. For example, due to climate conditions and transportation opportunities, the factors of production may become intense in a certain geographical areas. In this case, the intervention of the state in economy and the need of removing this unstableness by different political means are generally supported.

It must be significantly stated that when a corrective and curative function is expected from the state in the distribution of resources unexpected results may occur. For instance, political power will consider its own election area in carrying out the distribution of economic resources and budget resources. The ministers and powerful members of the cabinet may try to provide more investments in their own election area in order to increase their chance of being re-elected. The switch of the budget resources to the election areas of the government is called "*pork barreling*". In short, pork barreling is also one of the reasons of governmental failure.⁴

⁴ The pork barreling is term originated from American politics. Pork barrel was like a personal discretionary fund of the members of the Legislature who belonged to the ruling party. Jesse Burkhead in his treatise Government Budgeting wrote on pork-barreling politics: "*In the application of its local concerns to a national budget, the Congress will necessarily engage in some reshaping and remolding. Very often this process takes the form of increases in specific appropriations for specific projects in a congressman's district. Where individual congressmen are powerful or strategically placed, as on appropriations committees, there is a resultant dipping into the pork barrel. In the semantics of American politics the 'pork barrel' is an extremely sinful kind of thing. But it should be recognized as an inevitable, and, at times, a desirable, device for reshaping national policy*".

(quoted at : http://www.congress.gov.ph/download/14th/pork_barrel.pdf)

f. Political Corruption

Government also fails due to various types of political corruption. The concept of corruption is generally used to mean all actions and behaviors constituting bribery, embezzlement, favoritism etc. It is important to note that, “corruption” is the name given to the certain types of corruption (mainly; bribery, embezzlement, favoritism), which has political characteristics. Political corruption has a wider meaning than corruption. In other words, political corruption is an umbrella concept which also includes corruption (Aktan, 2015:48-49).

In its widest meaning, political corruption is the behavior and action of violating the contemporary laws, ethics, religious and cultural norms of the society by the actors (voters, politicians, bureaucrats, interest and pressure groups) which has a role in the decision making.

It is possible to enlist the basic characteristics of political corruption as follows: (Aktan,1992 ; Aktan,1997:1063-77)

- Political corruption appears in the political process. Political process is the structure where the decision-making of the government takes place.
- Political corruption occurs in the relationship between political actors (politicians, bureaucrats, interest and pressure groups) that possess a role in the political process.
- The political actors which has a right to make decisions due to political corruption, uses their political power and authority to violate the present legislations, norms and ethical rules.
- The public officials that abuses their power and authority provide themselves or others with in-kind or financial “interests”.
- Political corruption is generally confidential.
- Political corruption shows characteristics that extends to all parts of the society. Economic corruption, academic corruption (scientific corruption) etc. are types of political corruptions which appear in institutions and political rules that are not properly formed.

- With the presence of political corruption democratic institutions loses their functionality within time. Interests and pressure groups evolves as a consequence of political corruption.
- Political corruption may be present in the governmental systems such as monarchy, oligarchy, or democracy. Shortly, all governmental systems possess political corruption within varying types or levels. The political systems where political corruption is widespread can be called kleptocracy.⁵
- There is a close relationship between political corruption and the changes and developments that takes place in the socio-economic structure. Parallel with the changes in the socio-economic structure, political corruption becomes more prevalent.

g. Transparency in Politics

Transparency means “active disclosure.” (Oliver, 2004:2) In other words, government transparency is “the availability and increased flow to the public of timely, comprehensive, relevant, high-quality and reliable information concerning government activities.” (Ferranti et al, 2009:7)

In general, there may be no sufficient transparency in the government and secrecy may be dominant in politics. Supervision and auditing in public institutions may not be effective and functional. Consequently it could be said that governmental failure is caused because of these reasons.

h. Inefficiencies and Extravaganza in Government Expenditures

In the market economy, economic units are very careful when they are spending their own money. For example, a firm owner or producer tries to reach the highest profit with lowest costs in production. In the same way, the consumer would like to purchase good quality with low prices. In the public economy, the political actors (voters, politician, bureaucrat and

⁵ Kleptocracy (root: Klepto+cracy) literally means rule by thieves. It is a pejorative, informal term for a form of government which represents the culmination of political corruption.

interest groups) do not allocate and/or spend their own money, instead they allocate and/or spend taxpayers' money. Therefore, the politician, bureaucrat and public officials who spend the state's money in public economy do not act as sensitive as they would when spending their own money.

Milton Friedman, Nobel laureate in Economic science used a simple table to outline four ways to spend money based on whose money is spent, and upon whom it is spent in his famous book of *Free to Choose*.

Milton Friedman, detailed the four ways to spend money with his own words as follows: (Table-1)

“Category I in the table refers to your spending your own money on yourself. You shop in a supermarket, for example. You clearly have a strong incentive both to economize and to get as much value as you can for each dollar you do spend.

Category II refers to your spending your own money on someone else. You shop for Christmas or birthday presents. You have the same incentive to economize as in Category I but not the same incentive to get full value for your money, at least as judged by the tastes of the recipient. You will, of course, want to get something the recipient will like – provided that it also makes the right impression and does not take too much time and effort. (If, indeed, your main objective were to enable the recipient to get as much value as possible per dollar, you would give him cash, converting your Category II spending to Category I spending by him.)

Category III refers to your spending someone else's money on yourself – lunching on an expense account, for instance. You have no strong incentive to keep down the cost of the lunch, but you do have a strong incentive to get your money's worth.

Category IV refers to your spending someone else's money on still another person. You are paying for someone else's lunch out of an expense account. You have little incentive either to economize or to try to get your guest the lunch that he will value most highly. However, if you are having lunch with him, so that the lunch is a mixture of Category III and Category IV, you do have a strong incentive to satisfy your own tastes at the sacrifice of his, if necessary.”

Table-1: Ways to Spend Money and Efficiency and/or Inefficiencies

Whose Money	You are the spender	
	You	Someone Else
Yours	I	II
Someone Else	III	IV

Source: Friedman, Milton and Rose Friedman., Free to Choose, New York: Harcourt Brace Jovanovich, 1980.p.116.

Maybe no other tool better explains why government tends to be an inefficient and wasteful organization than the Friedman table that follows. In sum, government failure comes from spending other's money.

III. MARKET FAILURE VS. GOVERNMENTAL FAILURE

It would be useful to make a short comparison between market failure and governmental failure.

The traditional market failure theory claims that market fails because of the following reasons:

- Lack of competition,
- External economies,
- Economies of scale and natural monopolies,
- Provision of pure and quasi public goods,
- Underproduction and/or overprovision of merit/demerit goods etc.

There are always imperfections in market in terms of competition (monopoly, duopoly etc.) The following ideal conditions for competition may not be met in the market:

- buyers and sellers are too numerous and too small to have any degree of individual control over prices,
- buyers and sellers can freely enter or exit the market,

-buyers and sellers have access to information about availability, prices, and quality of goods

-all goods of a particular nature are homogeneous, hence substitutable for one another.

The presence of external and internal economies also lead to market failure. The following externalities result in inefficiencies in the market:

-Positive/negative external economies in production.

-Positive/negative external economies in consumption.

-Pecuniary external economies

-Technological external economies

The presence of a sector with increasing returns to scale in a "perfect" economy may lead to market failure as well. Both internal economies of scale and external economies of scale result in inefficiencies. Diseconomies of scale occurs when production is less than in proportion to inputs. What this means is that there are inefficiencies within the firm resulting in rising average costs.

One of the sources of market failure is the provision of public goods. Market is not or can not be interested in delivering certain public goods due to free rider problem. Pure and quasi public goods may not be delivered well enough at the market. In the case of police, national defense and judicial services it can be argued that private delivery of these public services would be less desirable for a variety of reasons. On the other hand, quasi public goods (education, healthcare etc.) and merit/demerit goods are also claimed to be some reasons of market failure.

Underproduction of a merit good and overprovision of a demerit good are both reasons of market failure. Underproduction a merit good is a private good that society believes is under consumed, often with positive externalities. Primary education and health are examples of merit goods. A demerit good is a private good that society believes is over consumed, often with negative externalities. Cigarettes, alcohol, and prostitution are some

examples of demerit goods. Overprovision of demerit goods lead to market failure.

Just like market failure that is summarized above, there are also various sources of government failure:

- Lack of competition in political market,
- Political external economies,
- Negative scale economies in the size of government,
- Principal-agent problem and excessive bureaucracy,
- Moral hazard in government,
- The law of unintended consequences,

Lack of competition in political market is one of the main sources of government failure. The following ideal conditions for competition may not be met in the political market:

- Political parties are too numerous to have any degree of control of power. In other words, there is no absolute rule of power (autocracy/ autarchy),
- Political parties and voters can freely enter or exit the political market,
- Voters have access to perfect information. In other words, there is no misinformation, biased information etc.

The second main reason of governmental failure is “political external economies”. Patronage and partisanship, rent creation, rent allocation and the rent seeking activities of interest groups, derived external economies etc. may lead to government deficiencies.

Excessive size of government also results in inefficiencies in government performance. Just like economies of scale in private firms, negative scale economies occurs in government as well.

Bureaucracy is also a potential government failure. This bureaucratic failure is caused by the government when it tries to solve the principal-agent problem.

Moral hazard is also one kind of government failure. There are social costs of social welfare payments by the government. For example, if an individual know that the government will provide unemployment benefit, that individual is less likely to take steps to improve their employability.

“The law of unintended consequences” may be one another government deficiencies. This law is often used to criticise the effects of government regulations. When various types of government regulations are introduced, individuals always find ways to circumvent laws. There are many costs of government regulations and “*unintended consequences*” is one of them. Administration and enforcement costs, regulatory capture are some other deficiencies of government.

Governmental failures are not limited with those. High taxes have always negative distortive effects on market economy. There are negative effects of taxes on labour supply, savings, investments etc.

Democracy as a form of governance has many deficiencies and this may brings various types of failures. Most people consider democracy as an ideal form of government, because they think that they can choose representatives who will serve their best interest. However, representatives do not often act in the best interests of the people who elected them.

IV. CONCLUSION

In the literature of economics, it has been argued that market failure, due to external economies, public goods, scale of economies etc. necessitates government interference with the economy. For many years, economists have advocated government intervention to correct market failures. However, public choice economists have argued that there is also such a thing as "government failure". Public choice economists defend that the fact that the market is inefficient does not imply that government will do any better. Government interference to resolve market failures can also fail and result in various deficiencies. Government failure is a situation where government interference in the economy to correct market failures creates inefficiencies and leads to a misallocation of scarce resources.

It must be significantly stated that the governmental failure theory has quietly changed the point of view towards the state. As a result of the studies carried out by the public choice economists, it has been stated that the state can not always improve the economic and social problems instead it might sometimes cause economic and social problems.

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