

Government is a referee who also plays the game. It is government courts, agencies and legislatures that set the rules by which the economy operates, but governments are also major economic players in their own right. They own and operate businesses and generate and spend vast amounts of income; in fact, in every economy the government (pulling together all its levels and branches) is by far the largest single economic entity.

Figure 9.1 on the next page, which tells us what portion of the economy's output of goods and services was purchased by government in several countries, is clear on this point. It is never less than 10 % and may approach a fourth. In this chapter we will not come to any conclusion about whether any of these numbers are too small or too large, but we will look closely at how governments go about their business and what problems their activities pose for economic analysis.

9.1 State Capacity

At the time Adam Smith wrote *The Wealth of Nations*, governments had few of the resources we take for granted today. The annual revenue of the British crown, for instance, was just 10.7 million pounds in an economy estimated at 125 million pounds. There were no government agencies to regulate finance, shipping or other commercial activities, beyond keeping an official set of weights and measures. There were no departments of public health, no government-financed or -operated schools, and no income tax either. There were courts to interpret the laws and constables to enforce them. Above all, the government of Smith's day was optimized for war and conquest: His Majesty King George III kept about 50,000 men under arms during peacetime (many more in periods of combat) and maintained a navy of about 500 vessels. (He also outsourced some of his military needs to foreign mercenaries, such as the soldiers from the German principality of Hesse who were surprised by George Washington's men on the day after Christmas in 1776.)

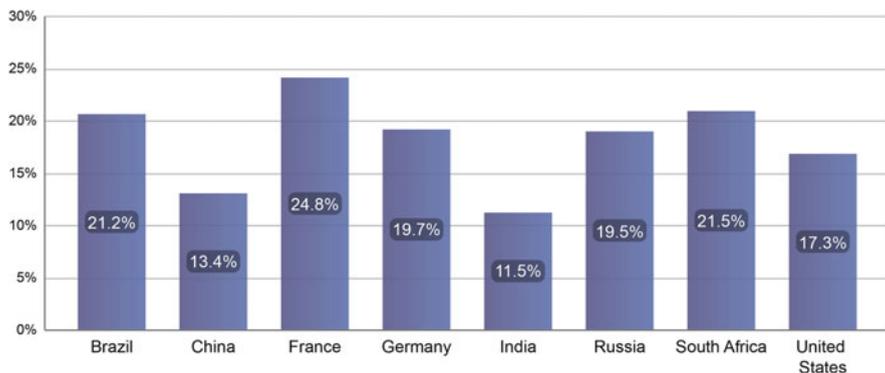


Fig. 9.1 Government consumption as percent of GDP, selected countries, 2010. (Source: World Bank World Development Indicators)

Thus far we have looked at the emergence of modern capitalism as encompassing the rise of markets and ever-larger business organizations, but the gradual development of modern forms of government is equally a part of the story. The concept that sums up this aspect of government is **state capacity**; it refers to three factors that determine how much government can accomplish alongside, and often explicitly against, markets and firms: its autonomy, its revenue base and the competence of its workforce.

1. **Autonomy.** King George could not do exactly as he pleased. There was a long tradition in England of constraints on the monarch, punctuated by the Magna Carta in 1215 and the compromise known as the Glorious Revolution of 1688; both established rights of the lesser nobility that the king was obligated to respect. Indeed, by 1776 the Parliament, which was elected by men of landed property, was the more powerful force. This changed what government was—it was now Parliament and its ministers and commissions and not just the monarch—but it also changed which social groups had influence over policy. Landowners could use the government as an instrument to promote their interests, even if the king was opposed. Given the rules under which the system operated, as well as the nature of the British economy of the time and its main sources of wealth, there could be no other force as great. The landowning class could, and did, disagree amongst itself, of course, and this led to competition between political parties.

As the British and other economies grew and diversified, and as the right to participate in governance was extended to new social classes, there was no longer a simple relationship between social class and government power. Soon industrialists, financiers and merchants, and after a while ordinary urban workers and farmers, began to have a voice. Government was no longer the direct instrument of any one group, and by playing them off against one another (appealing to shifting coalitions on different issues) it could attain a high degree of independence. In this way, the British government evolved to be an autonomous force in society.

Autonomy is easier to see when it isn't there. In many Latin American countries the landowning class remained preponderant well into the twentieth century, and government never established its independence. Policies, whether they involved education, urban services or international trade, were not adopted unless the landowners approved. Governments in such societies had great power over other social classes, of course, but they were powerless to take any action that landowners perceived as against their interests. This greatly reduced the scope of potential government activity and warrants the judgment that such states lacked an essential aspect of capacity.

2. Revenue. Governments must purchase the services they require, and so, like the rest of us, they depend on their sources of income. Early governments often depended on **tax farming**, a system in which officials were granted a territory and could retain a portion of any taxes they raised there, using almost any means they might impose. This not only created injustices for the local people, it also limited the control of the king over his own income: it was the tax farmer, not the king, who decided in practice how much would be extracted from the population and what the method would be. (The Roman Empire, incidentally, was stronger because its revenues did *not* arise from tax farming; there were fixed percentages of produce or revenues that subjects were required to pay.)

A major advance occurred with the growth of international trade. Governments began to impose **tariffs**, which are taxes on the value of imports into the country. These have the convenient property that they are paid by foreigners, at least directly; hence all governments came to rely on them. The biggest breakthrough, however, was the invention of the income tax in the nineteenth century. (Nearly 20 years elapsed between the first federal income tax law in the US, which was struck down by the Supreme Court in 1894, and the passage of the Sixteenth Amendment to the constitution, which overturned the Court and authorized income taxes, in 1913.) Even so, there is a great variation in the ability of governments to actually collect such taxes. Tax avoidance is a problem everywhere; in some countries this is a nuisance, in others a serious limit to state revenues.

There is an important linkage between the taxation system and state autonomy. Governments have more freedom of action if their revenue does not tie them too closely to any single social group. A country with a single major industry, for instance, will have a single revenue source for government, which means that those who control that industry have control over state finances. This gives them influence which can weaken the independence of government authority.

When their spending needs outgrow their tax revenue, governments borrow money. This can have contradictory effects on their autonomy. To the extent that borrowing frees them from the grips of any particular economic interest it promotes autonomy, but debt gives rise to a new class of creditors who can take this autonomy away. We see this now in an extreme form in Europe, where indebted

Eurozone countries are being pressured by creditors to take measures that are sometimes highly unpopular. There is no general rule about deficit spending and state capacity, then; it depends on the circumstances.

3. Competence. Governments didn't emerge into this world with innate abilities to regulate and manage; these skills had to be acquired slowly, often through trial and error, and this process continues to the present. An example of a current search for competence is the regulation of the internet. No one quite knows how to do this, and governments are experimenting with different approaches. It will be several years before effective means of regulation are found, or until the limits of regulation become clear.

The single most important element in the development of government competence is the creation of an independent, professional civil service. The hallmarks of such a force are formal qualifications and a high level of job security. Without them, there is no accumulation of know-how, nor will government functions be carried out according to professional rather than political criteria. In every society there is a tug of war between the immediate political interests of those in temporary control of government and the permanent employees who staff the apparatus. The political motive seeks to remove as many posts as possible from civil service jurisdiction and to exercise as much control as possible over the work of the bureaucracy. The maintenance of state capacity depends on institutions that safeguard civil service prerogatives and keep political forces at bay.

9.2 Powers of Government

Very generally, we can speak of three types of government involvement in the economy: its judicial function, public enterprise and regulation of the private economy.

1. The judicial system. Courts have the function of applying laws to cases. Many of the laws they deal with are passed by legislatures, but, in the Anglo-American tradition a majority are not. They are descended instead from the **common law** tradition, so named because it was carried on by magistrates in England whose job it was to make the administration of law common throughout the country. Three branches of this law are particularly relevant to economic questions:

- Property law. This governs who owns what, and what rights ownership entails. Some economists argue that a system of secure property rights is the single *sine qua non* of successful economic growth and point to the early emergence of this law in England as an example. Hernando de Soto, a Peruvian economist, thinks that the lack of such rights for poor people's property in much of the developing world is responsible for economic stagnation. On the other hand, China is at the forefront of current economic growth, and it has one the world's least defined systems of property. Another paradox is that it was not until the turn of the twentieth century that property in ideas (intellectual property), such as copyrights and patents, received general support from industrialized countries,

yet there is no evidence that economic growth before that time was impeded on this account.

- **Contract law.** This is the realm of law that governs agreements between consenting parties; like property it is essential to the development of a market economy. Specifically, the law of contracts addresses such matters as when a contract comes into force, what performance each party can demand of the other, what obligations, if any, parties have to one another outside the explicit terms of the contract, and in what manner contracts can be dissolved. Why do the parties to a contract expect the backing of the courts for what is essentially a private agreement? One reason, as we saw in Chap. 7, is that legal enforcement greatly reduces the costs of using markets, with large returns to society as well as to the private parties themselves. Another is that a contract, once it is guaranteed enforcement, enables each party to make secure plans based on the presumption that the other will come through as promised. A world of such planning will be more secure and more productive than one of uncertainty and shorter time horizons.
- **Tort law.** Property rights can be infringed not only by outright seizure but through actions that damage individuals and their assets. I can violate your right to land that you own by taking control of it to plant my own herb garden, but also by dumping toxic chemicals on it or even setting up a bee-keeping business next door, if my bees take to stinging you. The law of torts governs damages of this sort; its remedy is generally to require the individual causing the damage to compensate the victim in proportion to the harm. This has traditionally been the least settled and most controversial aspect of the common law as it relates to the economy, because most tort situations describe a conflict *between* property rights. That is, the damage to one person or her property is the result of the free exercise of someone else's property rights. Pollution, for instance, destroys property, but it also results from the use of property. For this reason, property-oriented legal systems are always somewhat ambivalent about the extent to which torts should be pursued. We will take up this issue in more detail in Chap. 15.

2. **Public enterprise.** In a sense, all government employees are engaged in the production of goods and services. Factory inspectors provide factory inspection services, teachers provide teaching, soldiers provide fighting, and so on. In practice, two distinctions are important. First, some services are provided from the government to the government and are not experienced as benefits to the public. Federal marshals, for instance, protect government officials and installations, generally remaining out of sight. Services like these are *intermediate goods*, deriving their value from other goods to which they contribute. If a service is a *final good*, however, the public benefits from it directly in some way. As an example, consider the pollution monitors who test lakes and rivers for the presence of contaminants. If they do their job properly they make most of us better off by giving us useful information about our water supply and by discouraging those who would pollute it. We normally don't think of these sorts of services as having economic value, because we don't purchase them; nevertheless they *are* valuable in the same way

that things we buy are. (People sometimes buy filters for their own private water supply.)

This suggests a second distinction, between the government services we pay for and those we receive “for free” (putting aside our tax payments). If end users pay for what they get, the government activity that produces it has all the trappings of a business, and the term used to describe it is **public enterprise**. The Postal Service is such a business, as we have seen, and so are public colleges and universities, at least in part—the part they sell to students and other users.

In principle, any business can take the form of a public enterprise. Communism as practiced in the Soviet Union, China and eastern Europe prior to the 1990s placed nearly all businesses in public hands. Until recently many developing countries, like India and Brazil, had public enterprises in most important sectors of the economy. Even in the private enterprise-oriented US there is a long history of publicly owned and operated businesses. Railroads, insurance companies, mining and many more—all have been run as public enterprise.

3. Regulation and policy. The final general function of government is to tell others what to do. (Most government activities do this, of course, but now we are interested in pure rule-setting.) The principle vehicle for this is the regulatory agency. Generally speaking, legislatures pass broad, goal-setting laws and administrative agencies interpret and implement them. The Clean Air Act, for instance, mandates certain general health standards that should be met throughout the country, and the Environmental Protection Agency translates this into specific maximum allowable concentrations for a precise list of pollutants. The EPA also establishes a monitoring and enforcement apparatus, making case-by-case judgments concerning how to respond to violations.

Economists have become deeply involved in debates over regulation. Their favored instrument is **cost-benefit analysis**, a procedure that identifies all the social costs and benefits of a proposal, estimates a monetary value of each, and then compares the sum of the costs to the sum of the benefits. The procedure itself is controversial, both in its core assumptions and its operational methods. There is still plenty of uncertainty how, or even whether, to attach monetary values to outcomes like changes in public health and environmental quality, but the last six presidents have all mandated cost-benefit tests for major public regulations, and so the studies pile up.

The other large area of government intervention concerns economic policy-making in all its dimensions. Here the list is long, but anti-trust (competition) policy, trade policy, industrial policy, monetary and fiscal policy are the main spheres of activity. In Box 9.1 there is discussion of risk management, an area of government activity that overlaps many of these. We will discuss government programs in greater detail as they arise in the course of this text. For now it is enough to say that the public has come to hold governments accountable for their success or failure in meeting economic objectives—this in spite of the fact that the weight of a capitalist economy falls predominantly on the private sector, and it is not clear that governments always have the capacity to play a determining role.

Box 9.1: Government as Risk Manager

All life, and certainly all economic life, is inherently risky, but government is uniquely positioned to reduce the burden of risk on members of society, either by addressing the sources of risk or by reallocating it.

Governments can do this through regulation. We saw in the previous chapter, for instance, how limited liability for corporations shields shareholders from the risk of losing more than the amount of their investment, thereby encouraging larger-scale and more ambitious projects. Of course, by granting limited liability, governments are not reducing the risk of financial losses by corporations; they are shifting part of the cost from owners to other parties, such as workers and suppliers, who can no longer demand that investors fulfill all the obligations of a corporation in bankruptcy proceedings.

Many government agencies set performance and safety standards for products. This imposes a greater burden on producers, but it reduces the need for consumers to do extensive research to find out whether certain minimal criteria are met. The Food and Drug Administration, for instance, requires drug companies to show that their products are effective for the purposes they are supposed to serve. The tests demanded by the FDA have been criticized for slowing the introduction of potentially beneficial new drugs, but they reduce the risk that doctors will prescribe ineffective drugs without knowing it.

Perhaps the largest risk management program of government, however, is **social insurance**. Its purpose is to remedy some of the limitations of private insurance by using the power of government to place everyone in the same system. Here's how it works:

The purpose of insurance is to reduce the element of risk in life by pooling together the fortunes of large numbers of people who don't know in advance who will incur an expense and who won't. Health insurance is a familiar example. Getting sick can be very expensive, beyond the means of most people if the problem is serious enough. Few would want to take the chance that they will be the unlucky ones who will need kidney dialysis or an extended hospital stay to battle lymphoma. Instead they will want to pool their risk with a large population, each paying a modest amount into a fund that is then used to pay the extraordinary expenses of a few. Rather than have a small risk of financial catastrophe, most of us find it is better to have the certainty of a smaller payment we know we can afford. (Economists refer to this preference as risk aversion.) One problem with private insurance, however, is that insurers competing with each other to offer lower premiums are in a position to select only those customers in the safest risk categories. Thus, it makes financial sense for a private health insurance company to allow young healthy people to place themselves into a separate insurance pool and be offered lower rates. As more companies get better at doing this they will

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succeed in dividing the population into many separate groups, each with its own risk level and financial cost. *This violates the original purpose of insurance, which was to spread individual risk across a diverse population.* Rather than everyone making the same payment, the situation reverts in the direction of few costs for some and high costs for others. (As soon as someone is diagnosed with kidney disease, they will be taken out of the lower-cost pool and be forced to pay very high insurance premiums—if they can find insurance at all.)

Social insurance can solve this problem by putting the program in the hands of government and applying a common set of rules to everyone. With no competition, there is no need to offer anyone lower premiums than anyone else. True, some social insurance systems do set different rates, but in situations in which people have the power to *change* their risk. For instance, workers compensation, which insures workers for some of the costs of occupational accidents, charges higher premiums for roofers than for bookkeepers. That's because these risks are chosen by workers and employers, and reducing all premiums to the same level would eliminate the incentive for dangerous jobs to become safer. Catastrophic health insurance provided to the elderly by the government, on the other hand, does not distinguish between individuals at lower and higher risk of cancer due to their family history; there isn't much chance that charging people more for health insurance will lead to better histories!

In general, industrialized countries have more extensive social insurance programs, but the United Nations and the international financial institutions—the World Bank and the IMF—have signed on to a Social Protection Floor initiative, one of whose main elements is the extension of basic insurance to all people, even the poorest people in the poorest countries.

9.3 Democracy

To what extent are governments the instruments of the people governed by them? In fact, by what criteria would we answer such a question? Who are “the people” and what does it mean for them to exercise control over government?

These are questions posed by *democratic theory*, the branch of political theory devoted to explaining what democracy is or could be and how it does or could work. Economists have long been interested in these questions, since a core issue for them is how individual preferences are combined to yield social outcomes. It is not an accident that several of the prominent contributors to democratic theory, such as John Stuart Mill and Kenneth Arrow, have been economists.

Actually, there are two general types of democratic theory. One we can call *constitutive*: how can a people constitute itself as a democratic polity, with democratic government included among its attributes? This view, adumbrated by a tradition extending from Jean-Jacques Rousseau to John Dewey and Jurgen Habermas, examines modes of interaction between people that can give rise to jointness of purpose. Popular control over government in such an approach is a byproduct of popular self-determination more generally.

We will not pursue this direction but instead survey some of the ideas in *procedural* democratic theory: given a society with a range of political preferences and a set of social groupings (classes and interests), what is the likely effect of different rules for voting, financing, constraining or otherwise shaping government affairs? Once a particular set of rules is in place, how responsive can we expect government to be to the preferences of citizens? To be even more specific, we will take majority voting rules as a point of departure and consider a series of problems that will affect the ability of government to achieve popularly desired economic goals.

9.4 Majority Rule

The most common procedural definition of democracy is majority rule: to be adopted, a proposal must garner at least 50 % plus one of all the votes cast. There are many potential methods for electing candidates, however, such as majority, plurality and proportional representation. In what follows we will assume, unless stated otherwise, that elections are contested between two candidates, with the one getting the most votes being declared the winner. This is not an accurate description of most electoral systems, but it is simpler and corresponds to the majority voting rule for proposals. (Keep this excuse in mind when sweeping generalizations are later made on the basis of winner-take-all majority voting.)

Economists are very interested in the similarities and differences between political and market mechanisms for aggregating (combining) the preferences of large numbers of individuals. There is a sense in which every purchase made in a market is a ballot, adding to demand and altering society's mix of what is produced for whom. Of course, market choices are made on the basis of one dollar (or other currency unit), one vote, since the more income a consumer has, the more votes he can cast. The differences between political and economic regimes are still greater than this, however.

When citizens vote in a two-way contest, they have only two options, or at most three if we include abstention. There is no way to apportion a part of one's voting power to one proposal or candidate; each vote goes all one way or the other. (Some proportional representation schemes do permit this, however.) In a market, by contrast, people can decide to pay more or less money for something, thereby registering the intensity of their preferences. A good will be produced if a small number of consumers is willing to pay a high price for it.

This difference between political and market mechanisms is thought to encourage stronger representation of minorities in the economic sphere. If 60 % of the public wants to spend money on more roads for cars but none for railroads, and the other 40 % wants to spend it all on railroads and none for cars, the political process is likely to produce an outcome approaching 100 % spending on roads. If these options were presented to people in a market, however, the result would be split, since each group can spend independently of the other, and differences in willingness to pay would also have an effect. For instance, if the railroad-lovers are willing to pay more on average than the road-lovers, more total money might well be spent on trains. To the extent that differences in willingness to pay depend on differences in income, a democrat might recoil, but if they reflect different levels of interest and commitment their impact is consistent with democratic principles.

Yet there is another argument that suggests that political systems will reflect highly concerned minorities even better than markets will. Suppose there is a cost to political participation. This could be measured in time spent volunteering, money spent to promote candidates or policies, or simply the cost of paying attention. A self-interested individual in the economics mold will get involved only if the potential benefits outweigh these costs. Now imagine a proposed policy that will have a large positive impact on a few people but a very small negative impact on everyone else. This might be a tax loophole that saves a few businesses billions of dollars but increases the tax burden on the rest of the population by just a small amount. According to our assumptions, few if any of the lightly-affected taxpayers will bestir themselves to actively oppose this measure; its impact is too limited to overcome the cost barrier. Each of the business owners, however, will be putting as much energy as possible into lobbying for the loophole. In this way, the ultimate decision may well go in favor of the highly interested minority. In fact, there is plenty of evidence that this is the way most political systems operate. The difference between the political and the market systems, from this perspective, is that the all-or-nothing character of political decision-making can be harnessed (or even hijacked) by a strongly motivated minority.

These two effects do not cancel each other out. Rather, they coexist, leading to the tendency of political systems to both over- and under-represent minorities. The question that has to be answered in any actual situation is, which minorities will benefit from the biases of the process, and which will be suppressed?

Now consider the forces at work in a two-candidate election for office. Suppose voters are lined up along a single ideological continuum; for convenience we can call this left-to-right (following a convention first established during the French Revolution), but it could just as easily be hawk-to-dove, secular-to-religious or some other range of views. Suppose there is an odd number of voters, say 91. Somewhere in the middle of the pack is a voter who exactly holds the balance. To her left are 45 voters, and to her right are 45 more. By joining one side or the other, she determines where the majority lies. The term used to describe her is the **median voter**, and both candidates will pursue her; this prediction is called the **median voter rule**. After all, if it takes only 46 votes to get elected, it doesn't matter how

many additional votes a candidate can get; he or she still wins. It is the 46th vote that really matters.

If this analysis is correct, candidates will have a powerful incentive to pitch their appeal to this voter. If a candidate comes from the right, for instance, if voter #46 can be wooed, presumably those to her right will be even more supportive. The same logic, but from the opposite direction, holds for the candidate from the left. The result will be a centrist political campaign, with arguments tailored to the median voter. Stronger views on the fringes of the spectrum will be ignored.

The calculation changes somewhat when the role of money is taken into account. Modern political campaigns are expensive; to reach voters, candidates need to draw on the contributions of wealthy supporters. If the political spectrum of the wealthy coincides with that of the general public, the median voter rule still holds. If the wealth spectrum is skewed one way or the other, however, so will be the political stance of the strategically-minded candidate. The degree of skew (left or right of the median voter) will depend not only the political views of potential campaign contributors, but also the effectiveness of money in influencing votes.

Adding money to the analysis also changes what we might say about the representation of minorities. Recall the argument about highly-interested minorities versus slightly-interested majorities; the claim was that the former will be disproportionately represented in political, compared to market, systems. That conclusion is reinforced if money influences votes, since a minority with a high willingness to pay for a policy change can, in effect, purchase other votes as well as cast its own. This state of affairs is sometimes defended on the ground that, in practice, there are a great many well-heeled, concentrated interests, and competition among them produces a political balance not too far from the democratic ideal. (This position is called interest group pluralism.) Whether this is true or not depends on whether the diversity of special interests is reflective of the larger social diversity, and also whether the process of competition itself permits a consideration of each claim on its merits.

Thus far we have been considering two-way choices, but there is a world of difference between two options and three. This was proved over 200 years ago by French thinker the Marquis de Condorcet (1745–1794), in his celebrated voting paradox. Suppose there are three voters, 1, 2, and 3, and three ballot options, A, B, C. Individual 1 prefers A to B and B to C; individual 2 ranks B over C and C over A; individual 3 agrees that C is better than A but likes A better than B. This state of affairs is summed up in Fig. 9.2 on the following page. If A and B are put to a vote, 1 and 3 will vote for A and only 2 will support B. By majority rule, then, $A > B$. Similarly, if B and C are put on the ballot, B wins by a vote of two to one. But if the choice is between A and C, the tables are turned; C wins two to one. This is clearly an inconsistent set of results: if $A > B$ and $B > C$, how can $C > A$? What we might expect is an unstable succession of coalitions, now proposing one course of action, now another, paralyzing the political process. Writing his PhD. thesis in 1951, later published as the book *Social Choice and Individual Values*, Nobel laureate Kenneth Arrow demonstrated that this is not a figment of a specially cooked example; it is impossible for a political process that obeys democratic

		INDIVIDUAL		
		1	2	3
RANK ORDER	A	B	C	A
	B	C	A	B
	C	A	B	C

Fig. 9.2 The Condorcet voting paradox. Individuals 1, 2 and 3 are choosing among proposals A, B and C. A is preferred to B by 1 and 3, so it would win a two-way vote. B is preferred to C by 1 and 2, so it would also win. But C is preferred to A by 2 and 3. This third result is inconsistent with the combination of the first two

norms to guarantee a rational, consistent set of social preferences; this is called the Arrow Possibility Theorem, although it actually establishes the *impossibility* of finding a perfectly satisfying set of voting rules (Fig. 9.2).

While Arrow's analysis is striking (and has spawned a large literature exploring the consistency of slightly different voting rules), it has had a limited role in explaining real-life political events. What we would expect to see, if the paradox holds, is a form of **political cycling** in which first one proposal, then another, then a third, and so on are successively adopted; there would be no stable majority preferences. In fact, such instability does occur, but it may well be due to fluctuations in political influence rather than inconsistent preferences.

9.5 Government and Society

In democratic rhetoric we often describe government as the servant of the people, but in practice the relationship may be reversed. Government has powers of coercion and may use them to extract economic resources or political submission from those it governs. Economists are particularly concerned about the first possibility, **government predation**.

If the incomes or prestige of government officials are tied to the size of the assets or income of the agencies to which they are attached, they will have an interest in using their political power for institutional aggrandizement. There has been much concern, for instance, about laws that permit police departments to seize the property of individuals accused of selling illegal drugs. Police officers benefit when these items are auctioned off; the proceeds are used for better equipment and more personnel, which in turn provide better working conditions for police department employees. The problem is not that working conditions improve, of course, but that the rules in place create an incentive for exercising more rather than less power over the public. Similar concerns are raised when the salaries of officials employed by regulatory agencies are tied to the numbers of citations they issue, or by the possibility that some in government may have an interest in increasing tax revenues.

The difference between the public and private sectors in this context is worth considering. Many workers in the private sector are paid partially or entirely on commission. No one worries too much about this, since market exchanges are voluntary; to sell more to the public is normally to do a better job in finding out what the public wants and getting it to them. Government, however, wields the power of coercion. More “business” for government agencies does not necessarily reflect more social demand; it can be the result of a more determined exercise of power.

A related issue is bribery. This is a two-way connection between government officials who are using their influence for personal gain and private interests who purchase government favors. The likelihood that bribery will be a significant problem depends on several factors: the presence of self-interested minorities with enough money to spend (already a problem for democracy, even under an honest regime), enough scope for discretionary action on the part of government employees or politicians for them to have something of value to offer, insufficient monitoring by parties with an interest in suppressing corruption, and the weakness of social norms that would otherwise restrain public officials and private interests alike.

A fascinating example of these factors at work is what observers have called the “natural resources curse”. There is some evidence that, other things being equal, countries with endowments of highly valuable natural resources, particularly petroleum, suffer from slower economic growth—just the opposite of what might be expected. Indeed, a recent report to the World Bank found that investments in energy development often actually made developing countries worse off. (See Box 9.2) It should be added, however, that the overall evidence is mixed, and that it may be a mistake to leap to generalities.

Box 9.2: The Extractive Industries Review

In 2001 the World Bank, responding to criticism of its loans for energy resource development, created an Extractive Industries Review panel to examine the evidence and report its findings. The report, *Striking a Better Balance*, was completed at the end of 2003. They concluded that further loans in this sector should not be extended until reforms were made in governance, environmental protection and human rights. Here are some selections that exemplify the natural resources curse:

In a number of countries, extractive industries have been linked to human rights abuses and civil conflict. Such abuses have been documented, for example, in cases where the army has been called in to guard extractive industries projects. Indigenous peoples and local communities may be forced off their lands to make way for projects, and those protesting the development may be locked up or physically harmed. The large economic rents generated by extractive industries may help provoke or prolong civil conflict. Indigenous peoples are particularly vulnerable. They have a strong connection to their land, and their unique way of life can be

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Box 9.2 (continued)

destroyed if they are displaced by a project. While indigenous peoples' rights are recognized in international law, they are often in a weak position in negotiations with governments and industry over proposed extractive industries projects—assuming they even get the chance to participate in negotiations at all. (p. 6)

Data on real per capita gross domestic product (GDP) reveal that developing countries with few natural resources grew two to three times faster than resource-rich countries over the period 1960–2000. Of 45 countries that did not manage to sustain economic growth during this time, all but six were heavily dependent on extractive industries, and a majority of them also experienced violent conflict and civil strife in the 1990s. (p. 12)

Twelve of the most mineral-dependent nations and six of the world's most oil-dependent states are classified as Highly Indebted Poor Countries, with some of the worst rankings on the Human Development Index prepared by the U.N. Development Programme. The *Human Development Report 2002* shows the highest levels of mismanagement and failed development in many of these countries, as indicated by the discrepancy between a country's place in the Human Development Index and its GDP ranking. Many of these same countries also show a high level of misappropriation and diversion of resource revenues. (pp. 12–13)

Why might there be a resource curse, at least in some cases? One possible explanation is that the wealth generated by oil and similar resources goes primarily to those who control them, not to those who provide productive services. Competition quickly develops between groups with insider influence for access to the wealth stream, and this typically involves payoffs of various sorts. Before long, government has become steeped in corruption and is unable to fulfill its positive role in the economy. Meanwhile, those who capture the resource wealth have little incentive to “reinvest” it, since it was not the result of productive investment in the first place. This income is likely to leave the country for other, more honest economic environments where it can earn a higher rate of return.

Even when governments are immune to corrupt practices, competition for their favors can be economically wasteful. Every regulation issued by a public agency creates winners and losers, which means that all those potentially affected have an interest in trying to influence the agency. They will hire lawyers and lobbyists, finance advertising campaigns, perhaps even pay economists or other policy professionals to construct more sophisticated arguments supporting their cause. Each private interest is hoping to capture the benefit of the regulation and shift the cost to someone else. Insofar as the resources they devote to this are rendered unavailable for more truly useful activities, they create an opportunity cost with no corresponding social benefit. Economists call this **rent-seeking**, and it is seen as one of the chief drawbacks of any regulatory program, no matter how much it is otherwise justified.

It is difficult to determine just how much is lost to rent-seeking. The visible expenses on lobbying and issue advertising are very small relative to the size of the overall economy and also relative to commercial advertising in general, which may

be a more significant source of economic cost, as we will explore in Chap. 11. Nonetheless it has loomed large in recent economic debate, perhaps reflecting the antipathy felt by some economists toward most forms of state intervention in the economy.

Thus far we have been treating society and the state as if they were two entirely separate, independent entities. This is, in principle at least, the Anglo-American tradition. It is an expression of liberalism, defined as before to emphasize the maximum possible independence of the individual from government authority. There is another tradition, however, that is arguably more important worldwide, and which focuses on the interconnection between government and social institutions at all levels, from overall policy formation to the daily interactions people have with public employees. A full treatment of this perspective is beyond the scope of this text, but one particular version of the “embedded state” has special relevance to political economy; so we will discuss it here: **corporatism**.

Corporatism is an approach to government which is premised on the existence of social organizations representing all or most citizens. These can be labor unions, business associations, ethnic groups, religious bodies or clubs promoting particular philosophies, like environmentalism, or activities, like sports or playing music. Each group selects its own representatives, and these representatives meet in larger councils to advise government policy-makers. An example that is important in many countries is having an economic council composed of union and business leaders. They meet in three-way negotiation with government economists to set policies on matters of common interest, such as wage rates. In return for its seat at the table, each side is expected to sign onto the compromise that ultimately ensues. This is quite different from the liberal approach in which the independence of each group is treasured, and conflict and litigation replace negotiation and compromise. Most continental European countries have a system of interest group representation, as well as some in Latin America and Africa. The situation in Japan, China and elsewhere in east Asia is less clear, but many would say that their systems, which of course differ greatly between countries, share some of the features of corporatism.

The corporatist approach also operates at lower levels of government activity. Social groups expect to be consulted in the implementation of laws and regulations; here too there is less reliance on the courts and more on negotiated cooperation. When Denmark, for example, wanted to extend its occupational safety and health system to the newly-recognized problem of ergonomics (the effect on the human body of postures, movements and strains), rather than issuing new requirements, it called on business managers, workers and public health officials to meet at both the national and local levels and formulate mutually acceptable action plans. These plans were to be revisited on a regular basis by the same groups that devised them, to see if they needed updating.

Corporatism, by reducing the friction surrounding economic policy, promises gains in efficiency. Rent-seeking is minimized, and the specific knowledge of groups in society most affected is incorporated into decision-making. Cooperation is enhanced, as is the recognition that groups with contrary interests can learn from one another. There are also costs to bear in mind, however. Individual points of

view are sacrificed in order to promote the collective views of organized groups. Each group gives up the freedom that comes with *not* being represented in the final decision; in this way corporatism enforces moderation and dampens dissent, which often serves a vital, creative role.

Evaluations of the pluses and minuses of corporatism may soon be moot, however, since it is becoming increasingly difficult for corporatist structures to survive under the impact of globalization. The necessary precondition for bargaining and compromise between competing groups is the belief that they will face each other again and again. Crushing or humiliating the other side is a less attractive option if you can expect to sometimes be on the receiving end in the future. At the heart of the globalization process, however, is the ability of at least some interests, those representing internationally mobile capital, to opt out of any national system viewed as too hostile or restrictive. If the Danish employers, for instance, tell the workers and health officials that there is nothing to negotiate because they can move to another country that doesn't demand ergonomic concessions, the system collapses. Thus far this hasn't happened in Denmark on the issue of working conditions, but the potential is there. The viability of corporatist arrangements in the face of globalization is a much-debated question; observers agree that there is pressure to weaken them, but there is also resistance to this pressure, and the situation remains in flux.

The uncertain fate of corporatism typifies a distinction first introduced by Albert Hirschman and subsequently embraced by many economists and political scientists, between **exit** and **voice**. Each is a way of influencing a situation, but largely at the expense of the other. To threaten to leave (exit) a relationship is to gain a measure of power over it. This is the power that consumers have over the sellers of goods and services, for instance; by threatening to take their business elsewhere they induce companies to pay attention to their preferences. The alternative approach is to maintain a relationship but try to use one's powers of persuasion (voice) to make the other party more responsive. Students do this, for instance, when they urge a professor to change the due date of an assignment or substitute one reading for another on the syllabus. To threaten to leave (exit) is to reduce one's commitment to the relationship and therefore one's standing in it, and this reduces the effect of voice. To become more engaged in a relationship by exercising one's voice is to take credibility away from the threat to exit.

The liberal model of governance is predicated above all the role of exit. Candidates are made accountable by the threat of voting for someone else. If a government official is seen as too aggressive in enforcing a regulation, the party being regulated will threaten court action or some other form of obstruction. Markets, which are largely based on the power of exit—taking business elsewhere—are held up as the ideal mechanism for allocating resources. Corporatism is based on the primacy of voice. Social groups are expected to maintain cooperative relations with one another and with the state; rather than threaten to drop out of the system, they try to make it enough to their liking that they can remain within it. Who wins an election does not necessarily determine what policies

will be adopted, because intergroup negotiation also plays a key role. Obstruction and litigation are strongly discouraged.

These are ideal types; the real world is much more ambiguous. Most systems have some elements of both voice and exit. Nevertheless the differences between liberal and corporatist approaches to government are apparent to anyone who has lived in both types of societies, and the general drift toward exit-based strategies, under the influence of globalization, is widely recognized. This is a point we will return to often in the chapters to come.

The Main Points

1. Governments play a large role in every modern economy. They consume at least a tenth of total output even in countries with relatively “small” governments, and their share is as large as a fourth in some cases.
2. The ability of government to manage and control—state capacity—cannot be assumed; it takes time to develop this capacity, and its level can go down as well as up. State capacity has three main components, the autonomy of the state from any single interest group, the ability of the state to raise large amounts of revenue, and the competence of its officials. The last of these depends on the maintenance of an independent civil service.
3. Governments perform three main functions in an economy: they provide a judicial system that defines and regulates property, contract and damage (tort) obligations; they provide goods and services to the public, often in the form of public enterprises; and they create and enforce regulations limiting the freedom of private participants in the economy in various ways.
4. Government plays an important role in risk management. Its regulations often have the effect of reallocating risk from some individuals and businesses to others, and it is in a unique position to provide social insurance, under which everyone pays a modest contribution to reduce the risk of an extreme loss due to an unpredictable event.
5. A major concern of economists is the difference between majority-rule voting and market “voting” in the extent to which outcomes reflect the preferences of the people who make up the system. Markets allow minorities to have a greater voice insofar as they permit split decisions (changing the shares of production and consumption rather than setting an all-or-nothing outcome) and provide opportunities for those with more intense preferences to have a greater voice (through greater willingness to pay). Majority rule, on the other hand, may give the most influence to the median voter, or it may empower small minorities who have concentrated interests in a particular issue or more money to invest in political clout, or all of the above.
6. The Arrow Possibility Theorem demonstrates that, once there are at least three voters and three options, majority rule voting can lead to collectively inconsistent preferences, raising the possibility of political cycling through unstable coalitions. This has not been seen so often in practice, however.

7. Government involvement in the economy carries with it several risks that may flare up into significant problems. If those who set government policy benefit personally from the income that can be extracted from the private economy, government can become predatory. A dramatic case of this is the “resource curse”. In addition, the resources devoted to influencing government policy by potential winners or losers—the cost of rent-seeking—can be a drain on society. Corporatism, a system of institutionalized compromise based on participation by private interest groups, can reduce these costs, but pressuring all sides to compromise has its own set of costs and benefits.
8. A useful dichotomy in thinking about individuals and organizations is the choice between exit and voice. One gains influence by threatening to leave—stop buying a product, voting for a different candidate—or by participating more actively in order to have one’s views heard. Each impinges on the other to some extent. Liberalism relies primarily on the threat of exit, corporatism on the role of voice and persuasion.

► Terms to Define

Constitutive vs procedural theories of democracy

Contract law

Corporatism

Cost-benefit analysis

Exit vs voice

Government predation

Insurance principle

Median voter rule

Moral hazard

Political cycling

Property law

Public enterprise

Rent-seeking

Risk pooling

Social insurance

State capacity

Tariffs

Tax farming

Tort law

Questions to Consider

1. The United States has a lower profile for government than many other industrialized countries, as indicated in Fig. 9.1. What might account for this?
2. Which aspects of state capacity are likely to be promoted under a liberal regime, and which under a corporatist one? Can you think of examples from countries you are familiar with?

3. One of the abiding political questions in the United States concerns how much policy-making and enforcement should occur at the Federal level, and how much should be left to the states. In general, which level of government has the greater capacity as defined in this chapter? Does this differ by type of policy—for instance, economic versus social regulation? Should authority normally be delegated to the level of government that has the greatest capacity?
4. Federal judges are appointed for life, which insulates them from popular sentiment, whereas state and local judges must often stand for election. Given the economic role of property, contract and tort law, do you think they are best interpreted by judges who are more responsive or less responsive to outside pressure? Why?
5. The Iraq and Afghanistan Wars have drawn attention to the greatly-increased role of private, for-profit security forces in American military policy. The armed forces contract out much of the work formally performed by soldiers, such as guarding public officials and staffing military prisons, to these businesses. What are the advantages and disadvantages of shifting this work from the public to the private sector? Overall, is it a wise or an unwise policy?
6. Most schools in the United States are owned and operated by the public sector. At the high school level and below they are largely in the hands of locally elected school boards. What are the advantages of maintaining this system of widespread public enterprise? What are the disadvantages?
7. One of the problems with any insurance system is that it reduces the incentives for those covered by a policy to reduce the risk being insured against; economists call this **moral hazard**. Insuring individuals against the risk of poverty in old age, as public pension systems like Social Security do, poses the moral hazard that individuals will reduce their savings. How strong an argument is this against retirement insurance? What have governments done, or what could they do, to retain the advantages of social insurance without the costs of moral hazard?
8. Make a list of policy areas in which, in your opinion, self-interested minorities in the US have too much power. What changes in the procedures by which our democracy operates would counteract this power? Can you think of examples in which similar minorities have too *little* power?
9. Would you expect corruption to be a greater or lesser problem in corporatist, rather than liberal, political systems? Why?
10. If you haven't already done this, use the exit versus voice framework in your analysis of question 6, on the pluses and minuses of a mostly-public school system.