Market Failure: Compared to What?

By/Par **Geoffrey Brennan**
Economics Department, RSSS, Australian National University
Philosophy Department, UNC-Chapel Hill
Political Science Department, Duke University

I THE COMPARATIVE DIMENSION

According to John Broome (1999), one important difference between the intellectual habits of philosophers and economists lies in the fact that philosophers tend to think categorically, while economists tend to think comparatively. So specifically in the normative domain, philosophers think in terms of "good" and "bad" whereas economists think in terms of "better" and "worse". Broome thinks that economists have the better end of this distinction: thinking comparatively "… is something that philosophers have to learn from economists." I think Broome is broadly right here on both the descriptive and the normative levels. I think there is such a disciplinary difference[1]; and I think comparative thinking is superior.

In this sense, "compared to what?" is a natural economist's question. When we are engaged in any normative assessment – say, of a state of affairs; or an individual action; or a public policy; or, as here, an institutional arrangement – the specification of the 'relevant alternative' is a necessary piece of the analysis, and ought to be fore-grounded. 'Relevance' in this setting is to be understood in terms of the situation that would prevail if the action/policy/institution under consideration were *not* taken/implemented: hence the centrality of 'opportunity cost' in the economist's analysis of ethical choice.

Specifically, it has been a persistent theme among public choice economists in relation to 'market failure' that the critical question is not whether the market works "well" – still less whether it works "perfectly" – but rather whether it works better than the best feasible institutional alternative. Public choice economists insist on posing the question this way because they want normative analysis to be "choice-guiding". They claim that it is simply irrelevant whether markets work perfectly or not, however exactly perfection is conceived. The issue that is relevant for choice is whether markets work, in the given circumstances, better than or worse than the institutional alternative.

[1] Though I certainly do not think that economists think comparatively as often as they ought to! The 'welfare economics' of market failure analysis provides one example.

Mostly, the institutional alternative in mind in the ‘market failure’ context is government action. The market failure literature was developed quite explicitly in response to the question as to what government should do – what the domain of government action ought to be. As Samuelson puts it in one of his canonical contributions to public goods theory:

> “*We can formulate [the grand Walrasian model of competitive general equilibrium] so stringently as to leave no economic role for government. What strong polar case shall the student of public expenditure set alongside this pure private economy?”* Samuelson (1955)

Samuelson’s strategy is to show that, whereas Pareto optimal outcomes will emerge in competitive markets for *private* goods, Pareto optimal outcomes will not emerge in markets in relation to *public* goods. He does this by demonstrating that the Pareto optimal outcome in relation to public goods is unstable – that rational egoistic agents will have an incentive to depart from that optimum, in a way that they do not in the private goods analogue. Individuals will have an incentive to “free-ride” in the public goods case, essentially identical to the incentive to ‘defect’ in n-person prisoner’s dilemma problems.

But as the “compared to what?” challenge implies, demonstrating market failure in relation to public goods is only half the story. What is needed to complete the account, conceived as a justification for public policy action, – is a demonstration that governments can succeed where market processes fail. And in order to deliver on *that* requirement, we require a fully articulated model of democratic political processes on all fours with the model of markets on the basis of which market failure is first established. Providing such a model of politics represents the original founding impulse of ‘public choice theory’ – or ‘modern political economy’ or ‘rational actor political theory’ as it has come to be called.

One way of putting the conceptual point would be to claim that Pareto optimality itself should be defined by reference to a full specification of all the prevailing feasibility constraints *including institutional ones*. Can we really talk of market failure, when the market despite its inadequacies still generates more satisfactory outcomes than any real alternative?

The need for a comparative focus is, I want to insist, entirely general – independent both of the normative framework used for assessment, and of the appropriate way of modelling politics. So whether “market failure” is conceived in terms of Pareto optimality, or distributive justice, or inadequacies in individual preferences, the same challenge remains: is there good reason to think that political processes as they actually operate are likely to improve on the performance of markets? And that question retains its force whether or not the rational choice approach is seen to be the best approach for the analysis of democratic political process.[2]

[2] It is worth noting that, although public choice economists have directed their challenge to the comparison of markets and democratic politics, that focus might be too narrow. There are a variety of social institutions – voluntary associations of various kinds – that lie outside the market in the sense that they do not depend exclusively on financial incentives for their operation, but also lie outside the

Public choice economists have insisted that the kind of comparative institutional analysis required to establish that markets do indeed fail '*compared with the relevant alternative'* must be conducted according to strict methods. In the first place, it will not be enough to 'wave one's hands' and suggest why the coercive forces of politics might be useful in solving free-rider problems. We need to be able to say something systematic about how that coercive power is likely to be used – and how its use is constrained by democratic processes. And in the conduct of that systematic analysis, everything will have to be held constant – apart from the institutional change itself.

II THE 'EXPRESSIVE' ACCOUNT OF VOTING

On this basis, public choice theory (the economic theory of politics) has imported into the analysis of politics the same presumptions of agent rationality, the same individualistic methodology, the same assumption of predominant self-interest, the same 'equilibrium' method, as is used in market models in general and as used to derive 'market failure' in particular.[3] The motives for adopting this method are clear enough and in principle exemplary. But as it happens, I think the requirements of motivational symmetry have been somewhat mis-applied. It is my object here to suggest how. More specifically, I want to offer a modest defence of a kind of "two-hats" thesis – one that indicates why individuals might weigh moral considerations more heavily as voters than as consumers.

The central argument here has been laid out at considerable length in a variety of places [most notably, Brennan and Lomasky (1993) and Brennan and Hamlin (2000)]. I shall here develop it in terms of a simple example. Suppose there is a policy that consists of redistribution from richer to poorer. You are among the richer – and you stand to pay $5000 per year in additional taxes in order to increase the incomes of the poor. [There are fewer poorer than richer people and the improvement in the poors' incomes will be significant.] In principle, you approve of this policy: you feel some sympathy for the poor, especially the *sick* poor, and you like to think of yourself as a broadly benevolent person. Still, $5000 each year is a lot of money, even for you. The standard public choice story treats the net cost to you of this policy as the thing that primarily motivates you. It predicts, on the basis of the assumption of predominant egoism derived from market behaviour, that you will vote against this policy (or at least, that most people in your situation will vote against it.) But what, if you are truly rational, is the true cost to you of your *voting for* the policy? It is not the $5000 a year that you will pay in extra taxes: rather, it is that sum *times the probability*

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domain of politics in that behaviour within them is not subject to governmental coercion or the direct force of law. The family and the church and the university perhaps all exemplify. Markets and political processes are, of course, important institutional forms, but they are not the only games in town.

[3] The implications of following these assumptions are set out in the substantial public choice/rational choice literature. Mueller (2003) is an excellent extended reference. Hindmoor (2006) provides an elegant and usable introduction.

that your vote will determine the outcome! And that latter case is where there is an exact tie among all other voters[4]. For in all other cases, how you vote will not alter the electoral outcome. If this seems doubtful, conduct a thought experiment in which you happened to make a mistake in casting your vote and vote for the party other than the one you intended to vote for. Ask yourself: what is the chance that this mistake would actually affect who wins?

Now, in a US Presidential election there are upwards of 100 million voters; and the probability of there being an exact tie (call this probability h) is very, very tiny indeed – at least as low as 1/13000 and probably very much lower.[5] So the expected cost to you of *voting* for the policy is at most of the order of 30 cents, and almost certainly much lower than that. So if you obtain a benefit of voting for the policy – of expressing your support for it – greater than 30 cents, it would be entirely rational to vote for it: indeed, rationality will *require* you to vote for it!

Call the benefits (and costs) of expressing your support for the policy in itself the "expressive benefits and costs". It is, I insist, these "expressive considerations" that weigh in the rational voter's calculus. Relative to instrumental concerns (such as the tax cost), these expressive considerations are h times more important at the ballot box than in the marketplace. If you were called on to give $5000 to support the poor when the collector comes to the door, giving the money would indeed cost you $5000. But because of the gap between your vote and the outcome, voting for the policy does not! There is what Hartmut Kliemt has called a "veil of insignificance"[6] associated with choice in the ballot box – a feature that makes voting much more like cheering at a football match than choosing an assets portfolio. When you cheer at the football, you do not determine the outcome: you merely express your preference. Similarly when you vote. So the kinds of considerations that weigh at the ballot box will be who or what you are prepared to cheer for (or boo at) – at least, if you are a fully rational agent. This is what makes voting and market behaviour different.

On this basis, the 'rational actor' theory of voting is concerned with those 'expressive' considerations. And it seems plausible to suggest that these will include your moral values (among other things). You are likely to cheer for the things you think are good; and boo the things you think are bad – and there is no necessary logical connection between these things and the things that affect your total tax payments or your personal benefits from alternative policies. It may be that, either for reasons of cognitive dissonance or other more complicated psychological reasons, expressive and instrumental benefits and costs may be positively

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[4] It simplifies the example to assume that the total number of voters (including you) is odd, because then you can break rather than make a tie. But the effect of this assumption on the arithmetic is negligible.

[5] The standard method of calculating the probability of being decisive involves conceptualising each voter as an independent draw in a Bernoulli trial. This method has some peculiar implications (for example that an expected outcome in which party A is likely to win by say 4% of the voting population almost certainly cannot be beaten!). In any event, the probability of a tie is critically dependent on the (expected) closeness of the election. See Brennan and Lomasky (1993) ch 4.

[6] The veil of insignificance is not the same as Rawls' famous 'veil of ignorance' but it has somewhat the same effect: namely, of backgrounding the role that material self-interest plays in behaviour.

correlated. But in lots and lots of cases they will come apart. People hold very strong views about abortion, and gay marriage, and local and national identity – in ways that do not bear significantly on their own incomes. Such things are likely to play a disproportionate role in democratic politics. And equally, pocket-book considerations are likely to play a rather less significant role (less significant than the stakes involved in alternative policies for individual agents would suggest).

Of course, along with highly charged moral issues, things like one's perception of the "public interest" and "justice" and maybe even "economic efficiency"[7] have symbolic significance and are likely to induce a positive affective response.[8]

If this reasoning is correct, it has three implications that bear on "market failure" issues. The first is a descriptive point about how politics actually operates – about the kinds of considerations that democratic elections tend to foreground. The second is a methodological point about what the axioms of rationality imply: specifically, they do not imply substantively 'rational', ends-means behaviour in all settings – only in those institutional settings where such behaviour is indeed truly rational. Both points run against the grain of most public choice scholarship – though the second is redolent of the notion of 'rational ignorance' which public choice theorists have long recognised. The third is a directly normative point. It does seem likely that moral categories will have more behavioural influence at the ballot box than in the market place. And to the extent that agents behave more morally at the ballot box than in the market, that has to be good news for democracy. At least, it is good news to the extent that popular moral values are themselves normatively defensible – and to the extent that they are not outweighed by other affective considerations of more dubious moral status. The same "expressive" considerations that induce people to vote broadly according to their perceptions of the "public interest" for example, can also lead them to vote for more physically attractive candidates, or more rhetorically gifted ones – or for policies that involve prejudice and xenophobia and nationalist fervour. Voting in relation to defence spending, for example, is more likely to reflect nationalistic enthusiasms than is the aggregation of individual preferences for defence as required by the Paretian calculus.

III POLITICAL SUCCESS?

The foregoing arguments suggest that citizen sovereignty is a rather different animal from consumer sovereignty. If voter preferences and market preferences come apart, then the possibility envisaged in the Samuelsonian approach of developing a justification of government action based on the equivalent of *consumer preferences* for public goods seems rather remote. If the ideal of "success" is to be measured in terms of an institution's capacity to produce outcomes in accord with *consumer* sovereignty principles, then political

[7] "Economic efficiency" is a good example to make the point. In markets, economic efficiency "emerges" (to the extent it does): it is not "chosen" by any agent. In politics, "economic efficiency" is chosen (to the extent it is) by virtue of its expressive character – something to be cheered for.
[8] And things like the appearance and appeal of different candidates. See Leigh and King (2006).

institutions do not seem likely to fare especially well. And this not so much because of exploitation of citizens by their political agents (bureaucrats and politicians) or because of the peculiarities of majority rule as an aggregation device – though those problems, well-known from the public choice literature, are not ruled out – but because the inputs into the aggregation processes are not of the right kind.

This observation returns us though to the normative framework itself – and to the issues surrounding the normative status of market preferences. It seems self-evident that democratic politics, even when political agents are completely constrained to produce the outcomes that citizens want, is unlikely to fare particularly well by the Paretian test. Of course, in cases where market failure is extreme, governments may do better – even where political agents take some share of total rents, and even where voter preferences are distinctly different from (idealised) market counterparts. And government intervention may improve on market performance to a greater extent if there are elements in the policy process (such as cost-benefit analysis) that elevate market-based preferences to a significant role in policy choice. But it is an implication of the expressive account of voting behaviour that the intrusion of market-based evaluative procedures is likely to run counter to citizen-voter sovereignty. And this implication raises the question as to whether market-based preferences are the only ones that have genuine normative authority.

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