

## 19. The Theory of Government

### *The Public Interest Theory of Government*

The basic model of government that underlies most of the discussions that we have undertaken so far is called the *Public Interest Model*. This model is based on simple majority voting as the basis for decision making by the public authority. When issues are presented in the public forum and decided by a simple majority democratic process, the median voter casts the deciding vote. Because of this, the Public Interest model is sometimes called the *Median Voter Model*.

The Median Voter model has a simple and congenial interpretation in the context of the demand and supply of public goods. Let the supply of a public good be flat (as this is not central to the argument). The aggregate demand for the public good is the vertical sum of the individual demands. Let the individuals have different demands (heterogeneous demanders) but let them be symmetrically distributed. That is, at every level of the public good, there is a distribution of demand prices for that level of the public good in the vertical dimension by the individuals in the polity. Assume that the distribution is characterized by the normal distribution (one of many symmetric distributions). This means that the average demand price is equal to the demand price of the median individual. There are a lot of people at this demand price (the mode is also equal to the median) and a lot of people nearly identical (67% of the people fall within +/- one standard deviation). Now assume that the government officials present referenda asking for authority and tax funding to provide a given amount of the public good. Assume that the tax revenues will be raised by a uniform per capita tax per unit of the public good provided. The officials continue to present larger and larger proposals until a referendum is voted down. In this fashion, the amount of the public good that is provided by government is determined by the demand of the median voter. The last referendum approved by the voters is the one where the median voter's demand price is exactly equal to his tax price. The interesting characteristic of this model is that the level of the public good chosen in this fashion is the level where the aggregate demand curve is equal to the supply curve. Hence, that is the *optimal* amount of the public good.

The tax prices are not "optimal" in the sense that half the people are willing to pay more and half the people don't want to pay as much as they are forced to. But government gives them no choice in either direction so there is no disequilibrium effect. To the extent that some people pay too much in the provision of one public good, they probably pay too little for another. On average, everybody pays the right amount for each good, and by the central limit theorem, the probability of being taxed too much or too little becomes smaller and smaller when average over more and more public goods.

### *Government Activities in the Public Interest*

The Median Voter/Public Interest model of government has been applied in many settings. I like to outline the public sector with three categories:

1. Public Goods
  - a) National Defense. This is probably the most basic of all goods identified as public. The benefits are nonexclusive.
  - b) Legal institutions including a system of property rights and criminal justice. This good is public inasmuch as it is what keeps national defense from becoming private, that is, a military dictatorship.

- c) Welfare, charity, income redistribution. Again, the publicness is clear. Nourishment of starving children makes all of us who pity them feel better. This is also the public goods rationale for progressive taxation.
  - d) Highways, canals, & other public works projects such as river levies. These have long been provided by government. Much like Coase's lighthouse example the public sector quite often takes over production after the private market has initiated it, which is marginally inconsistent with the public interest notion. We would expect that if the benefits are public and the problem of free-riding<sup>1</sup> stops the private market from providing the good, then public provision would be necessary from the get-go. Even so, the public nature of many of these projects cannot be denied.
  - e) Education. This is similar to highways and public works. The public nature of education is said to be the fact that an educated person makes social interaction easier for all people with whom the educated person comes into contact. The publicness of education may also lie in a charity motive. When Europeans settled in Africa there was a great movement by a minority of the European population to educate the natives. To my knowledge, education of the Africans was never subsidized (at least not extensively) by any European government. All the efforts were carried out by charitable foundations, typically religious missionaries. (Recall the movie the *African Queen*.)
  - f) City services like water, fire protection, sewage disposal, and garbage collection. The public nature of these services is the underlying property rights violations that occur, for instance, when your neighbor's slovenly habits cause a stench that is disgusting to you. There could simply be a law of property rights against offal pollution. However, it may be cheaper to achieve the same end by public garbage collection.
2. Economic Regulation
- In the public interest view, this is the regulation of economic markets where in the absence of government, the market would be monopolized. Antitrust laws control markets that are competitive except for the collusive practices of the suppliers. Economic regulation takes over in markets where technology is said to generate a *natural monopoly*. In natural monopoly markets, regulation attempts to simulate the competitive market result by fixing prices and service levels by government direction. Thus, the public service commission fixes the price of electricity. At the federal level, the numerous regulatory commissions oversee pricing in various markets.
3. Social and Environmental Regulation
- In the public interest, these regulations on things like child labor, cruelty to animals, working conditions (minimum wages laws, OSHA), public decency, and the like, are similar to the provision of public goods. Environmental regulation is a special form of property rights provision.

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<sup>1</sup> Free-riding is the situation where individuals refrain from contributing to a public good because their contribution is marginally insignificant. It is similar to the prisoners' dilemma. In the public good case, if the rest of the group contributes and finances the public good, then the contribution of one dead-beat is not missed terribly. On the other hand, if only a few people contribute, not enough money is raised to finance the project and their contributions are wasted. By this logic, the taxing authority of government is the only way that public goods can be provided.

### *Some Concerns*

While the Public Interest model is simple and direct, it appears to contain some glaring anomalies. For instance, in the outline of the public goods model, two questions come into play: Why is there not private provision of the public goods? And, how much of what is going on is the public provision of private goods? The answers all too often prove embarrassing. Goods that are private like the opera are subsidized by government and public goods that are seemingly well endowed by private contributions are supplanted by government. However, the most exaggerated examples of inconsistency between fact and theory come in the area of economic regulation. As Stigler says at the end of his "Economic Regulation" paper, "So many economists, for example, have denounced the ICC for its pro-railroad policies that this has become a cliché of the literature."

### *The Special Interest Theory of Government*

The model that Stigler proposes as a substitute for the public interest theory is called the *Special Interest Theory of Government*. It takes a theory to beat a theory and for the Special Interest theory to beat the Public Interest theory it should be able to better describe 1) Who wins and loses in the political forum and 2) the form that regulations take. Given that it is able to achieve this task, we can then use the theory to investigate the resource implications of government behavior.

### *A View from the Mountain*

The basic and fundamental principle of the Special Interest Theory is that *regulations are designed to benefit the regulated*. As an example, consider the oil industry. Oil quotas and tariffs clearly cause oil prices to be higher than they would otherwise be. They also ensure that we use vastly more domestic oil than would otherwise be the case so that we truly are at the mercy of foreign oil cartelization. Why is this the case? The public interest theory fails to explain. The Special Interest Theory says that government purposefully bestows wealth on the oil industry at the expense of the average citizen. Government does this because it has the power to do so. It has the power because government is coercion. National defense is not a public good that citizens decide they will jointly provide. Rather, it is ability to muster the force necessary to claim a nation that defines a nation. (Recall the gold rush episode.) Once mustered, the power of coercion exists. It is improbable that it will not be used to effect some redistribution.

### *Methods of Bestowing Benefits*

When the government chooses to bestow benefits on an industry or group, there are four ways that it generally uses. 1) Direct cash subsidies. These are not necessarily efficient because the industry must be able to limit entry in order to make the gains worthwhile per person. 2) Entry limitations. With or without subsidies, entry barriers can be useful. The forces of competition can often be thwarted by limitations on the entry of new competitors. Tariffs and quotas are an example. Here only the foreign competitor are restricted and it is still enough. 3) Control over substitutes. The example of the English tanners comes to mind:

"When charcoal was generally used in making iron, the price of leather depended in some measure on that of iron; and the tanners petitioned for the exclusion of foreign iron in order that the demand on the part of English iron smelters for oak charcoal might cause the production of English oak to be kept up, and thus prevent oak bark from becoming dear."

4) Price fixing. This is cartel enforcement. Even when the number of competitors, potential competitors, and competing products is restricted, controlling the competitive forces within the industry may require direct government intervention in order to benefit the industry.

#### *Costs to the Benefitted*

There are cost to the industry participants that result from beneficial regulation. 1) There is a small firm effect. Small companies in the industry get more of the benefits than their pro-rata size would predict. 2) Regulation is encumbered by procedure. Procedure is necessary in order to create long-term political contracts. What government gives, it can also take away, but not as fast with procedural rules to follow. 3) Outside interests have a say. One way of thinking about this is the old saying: "Politics makes strange bedfellows." In order for a group to win favors from government it may have to link itself with another group. In this way some of its goals may be sacrificed to obtain others. Consider the coalition of bootleggers and Baptists.

#### *The Nature of the Political Process*

Government action necessarily requires voting or collective action. 1) Voting requires a simultaneity of decision making in order to achieve a decision. That is, if we had sequential voting over time, by the time the last person voted, the first to vote may have had a change of heart. (This has been a common occurrence in constitutional amendments where the various states must approve the referendum over a multiple year period.) The simultaneity required in the voting mechanism, necessarily creates a discreteness. This discreteness implies that elected officials must be given a good deal of discretion. 2) Voting does not allow for the exclusion of the disinterested voter. The citizen with no interest in the abortion issue has the same power in the polling booth as the person mortally offended by killing the unborn and as the person with a fundamental commitment to the view that government has no business telling women what they can and cannot do to their bodies. This ability of the disinterested to become involved in all issues creates a wedge that can be exploited by special interests.

#### *The Result of the Political Process*

An organized group (that is, one with a special interest) can obtain enough support from the disinterested to achieve its political goal. Politicians cannot oppose all special interests. The politician that votes against oil import quotas, farm subsidies, airport subsidies, hospital subsidies, navy shipyards, public housing, and rural electrification can count only on the votes of those outside of these groups. It isn't enough. The benefitted industries pay the freight. The politician needs votes and campaign contributions. The special interests supply the latter with which the former can be obtained (bought?).

The result is that the strongly felt preferences of small groups will tend to prevail over the weakly felt preferences of large groups. This is the paradox of special interest government. The majority does not rule in a meaningful sense. Government is mostly involved in weighing and

counterbalancing the interests of minorities. Of course, large groups that are well organized will have a say in government. However, large groups that are not well organized and among whom the benefits or cost are small per capita will wield little sway. As a general rule there is a U-shaped relation between the size of an industry or group and its ability to ply the political process. Small groups have large per capita stakes, but small total winnings. Large groups have organizational costs that are too high. They also tend to negatively impact enough people that some subset can itself organize against them.

### *The Case of Occupational Licensure*

Based on the foregoing theorizing, the following are facts and are consistent with the theory: 1) Licensed occupations have higher incomes. 2) Membership is more stable. 3) Least employed by groups that might organize against them. 3) Not national in scope.