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Public Choice

How We Choose Bad Policies and Get Stuck with Them, or Not

The diversity in the faculties of men, from which the right of property originate, are not less an insuperable obstacle to uniformity of interests . . . Those who hold and those who are without property have ever formed distinct interests in society. Those who are creditors, and those who are debtors, fall under a like discrimination. A landed interest, a manufacturing interest, a mercantile interest, a moneyed interest, with many lesser interests, grow up of necessity in civilized nations, and divide them into different classes, actuated by different sentiments and views.

—James Madison, *Federalist #10*

The U.S. federal government protects domestic sugar growers from competition through a combination of subsidized loan programs, price supports, and import controls called the "sugar program." Each year, the Department of Agriculture (USDA) sets a number for total sugar production in the economy. It then divides the work between cane and beet farmers. Having negotiated a minimum price with Congress in advance, the farmers are guaranteed a market for their crop. Domestic sugar prices are generally between two and three times higher than the global average, so the policy would seem to have its intended effect of supporting domestic sugar growers.

Yet USDA regulators cannot control the program from imposing unplanned, unintended consequences on the rest of society. And understanding *all* effects of a policy—both the beneficial and the harmful—is the essence

of neoclassical welfare economics. Thus, when we look more broadly, we see that, according to the Government Accountability Office (GAO), the sugar program costs U.S. consumers almost $2 billion a year, and it harms producers in sectors like food and candy that buy sugar as an input. Over the decades of the program's life, those sectors have steadily laid off thousands of workers while moving operations overseas. The program also closes the world's wealthiest market to sugar growers in poor countries, especially in the Caribbean, worsening poverty and unemployment in the places where economic development is needed most. In short, the sugar program is a net loser; it harms domestic consumers and poor foreign farmers to benefit relatively well-to-do workers and stockholders in America's concentrated sugar industry. It is wasteful and unjust.[1]

The unintended consequences of government policy do more than raise the cost of a candy bar. Consider sick people who need a kidney or liver transplant. In 2011, over 100,000 patients were on the vital organ waiting list in the United States. About a quarter of those patients will get matched with donors and receive a transplant. Another quarter will be removed from the list within a year of getting on it. Relatively few patients stay on the list more than two years. "Removed" could mean the person gets better and goes home. It could mean they got worse and couldn't survive an operation. Or it could mean that they simply died waiting. According to the United Network for Organ Sharing (UNOS), 81,822 people died waiting between 1995 and 2007.[2] A branch of the Department of Health and Human Services, UNOS describes the problem in the language of supply and demand: "This large waiting list is in part due to the cumulative effect of the imbalance between supply of organs and demand (need) for organs over past years."[3] For some organs, the demand is not very high. But for kidneys, livers, and pancreata—which combined make up 97 percent of the list—demand is growing faster than supply. So the waiting list grows, waiting times get longer, and more people die waiting. Despite this injustice, economists have estimated the price for kidneys that would eliminate the shortage. It's approximately $15,000.[4] In other words, if donors could be paid something like the value of an economy car, then the supply of kidneys would catch up, and there would be no more waiting and dying. Of course, it doesn't matter what price would emerge on the market. There is no market because it is illegal for donors to be compensated under the 1984 National Organ Transplant Act.

We suggest sugar and vital organs as examples of wasteful and unjust policies. There are other examples. We talk about some of them in this book. In

this chapter, we suggest a set of ideas that can account for and explain these and many other failed policies from government. This set of ideas is known as public choice theory. The basic message is that, just as markets may fail to allocate resources according to some theoretical ideal, so may government fail to achieve what we hope to get from it. In short, society cannot easily empower government to correct market failure without those powers also being used for other, perhaps very costly, purposes as well. By examining politics and democracy, public choice theory found that the processes lend themselves to programs that concentrate benefits on a relative few in society while the costs of the transfers are borne by many diffuse groups of people. There is no question that certain U.S. sugar growers benefit from the sugar program, and many hospitals and organ procurement organizations benefit from the ban on donor compensation. But the whole point about neoclassical welfare theory is to count the welfare of *all* groups in society, not just a privileged few.

Policies that are net losers for society—benefitting some while imposing even greater harm on others—aren't supposed to occur under the Pigou-Keynes-Samuelson paradigm. It's not supposed to work like this. Instead, as benevolent and omniscient public servants, policymakers are supposed to care about economic efficiency and use their discretion only to grow the size of the social pie, not to privilege certain groups in society. Perhaps neoclassical welfare theory just doesn't explain politics very well. Yet, as we saw in Chapter 3, perhaps this is unfair to the Pigou-Keynes-Samuelson paradigm because it was never an *attempt* to explain democratic politics. It merely assumed that government would capably fulfill the market corrections that economists would recommend. The experience of history, plus a little common sense, would suggest there are some problems with that point of view—all of which brings us back to our three motivating questions from Chapter 1:

1. Why do democracies generate policies that are wasteful and unjust?
2. Why do such failed policies persist over long periods, even when they are known to be socially wasteful and even when better policies exist?
3. Why do some wasteful policies get repealed (for example, airline rate and route regulation), while others endure (such as sugar subsidies and tariffs)?

In the public choice view that took shape from the 1950s to the 1990s, all these wasteful policies are the routine products of ordinary democratic politics. Rather than pursuing efficiency as the public interest model suggests,

policymakers strike deals (they *exchange*), creating concentrated benefits while dispersing the costs widely. Because these policies restrict market competition, they cause resources to be allocated inefficiently, thus harming losers more than helping winners. Another way of saying this is that political exchange transfers wealth between groups in society, from amorphous groups like consumers to concentrated groups like certain labor unions, industries, and other organized interests. Furthermore, once the policies are in place, there is a vested interest attached to the continuation of the policies. So, as we'll see in this chapter, public choice theory builds on the last two chapters to pose answers to our first and second motivating questions. We see much more clearly why government sometimes produces unjust or inefficient policies and then maintains them. Yet because public choice emphasizes *equilibrium* in politics, just as neoclassical theory does in markets, the school of thought evolved in ways that made it relatively incapable of answering our third question. To understand political change, we must go beyond the main message of public choice theory, that "incentives matter" in politics, and introduce the influence of ideas—which is our subject for Chapter 5.

The Public Choice Revolution

When James Buchanan won the Nobel Prize in 1986, the usual press inquiries followed. Each fall the Nobel committee announces six prizes over several weeks, and reporters get into full-blown geek mode, knowing they'll have to quickly write informative summaries of complex science for the general public. When Paul Samuelson won the economics Prize in 1970, the *New York Times* asked whether it was even possible to explain his work to readers and insisted that Samuelson would say no, not possible.[5] The paper nonetheless found it possible to convey Samuelson's philosophy of government intervention, and it went on to describe him as "the Hollywood image of a Cambridge professor." Other Nobel Laureates are easy to write about because they already have a public image when they win the prize, like Paul Krugman in 2008 and Milton Friedman in 1976. But this Buchanan character—he didn't fit the mold.

The Nobel committee's official notice recognized Buchanan for "a synthesis of the theories of political and economic decision-making (public choice)."[6] When Buchanan was asked by his local paper, *The Washington Post*, to explain "exactly what public choice is,"[7] Buchanan said public choice is

studying politics with the tools that economists use to study markets. Public choice treats voting, lobbying, regulating, and all other political decisions as made by self-interested individual people, working within agreed-upon rules. The *Post*'s reporter was nonplussed. Well, isn't that just common sense, the paper asked? And why would the Swedes award common sense with a Nobel Prize? Perhaps recognizing a language barrier, Buchanan agreed, saying it probably wasn't much more than common sense. But he reminded his interviewer that most economists didn't see it that way.[8] Unsatisfied, *The Post* ran a guest column ten days after Buchanan's prize. "What it all boils out to is that Buchanan's economics represents a particular ideology: leave the economy alone and everything will be all right."[9] A *New York Times* op-ed of exemplary candor upped the ante: "To put it bluntly, the Nobel Committee's choice is far more a testimonial to the fashionable popularity of conservative politics in the United States and elsewhere than a tribute to Mr. Buchanan's rather modest achievements."[10]

The Nobel committee fired back. Its selection chairman later told the *Post*, "That's stupid, that we think about people's political opinions. It's a very superficial interpretation. No, no, we're not that simple-minded."[11] Nonetheless, the spin continued even at the heights of the profession. The previous year's Nobel Laureate in economics, Samuelson's colleague at MIT, Franco Modigliani, told the *Times* that "Dr. Buchanan says very emphatically that the government should get out, and this fits very nicely with the Swedish view right now."[12]

This was how the establishment of the time received the news of Buchanan's Nobel Prize. What got them so riled up?

Foundations of Public Choice Theory

Buchanan says that public choice theory begins with three presuppositions about politics: (1) methodological individualism; (2) rational choice; and (3) politics-as-exchange. The first two assumptions are the same starting points that we encountered in the last chapter with neoclassical economics. We've used the metaphor about shifting the lens of economic theory onto non-market situations, namely politics. The way public choice did this was to model people in politics as rational-choice individuals engaging in political exchange, as voters, parties, politicians, bureaucrats, regulators, and other political decisionmakers. Over the next few pages, we'll "unpack" Buchanan's

three suppositions to see what they mean and how they form the foundation of our understanding of political change.

Rational Individuals Exchanging in Politics

The best discussion of methodological individualism in politics is in the book most often identified with public choice theory, *The Calculus of Consent* (1962) by Buchanan and his cofounder of public choice theory, Gordon Tullock (born 1922).

In the early chapters of *Calculus of Consent*, Buchanan and Tullock defend the approach to politics as the collective action of rationally self-interested individuals. They talk about many of the philosophers we met in Chapter 2 and how at least since the time of the Scholastics the human individual has been the primary unit of inquiry. They talk about what factors cause people to hold government in high or low esteem. And they talk about how the rules of politics shape the incentives of those people at the center of the political game:

> The Scholastic philosophers looked upon the tradesman, the merchant, and the moneylender in much the same way that many modern intellectuals look upon the political pressure group. Adam Smith and those associated with the movement he represented were partially successful in convincing the public at large that, within the limits of certain general rules of action, the self-seeking activities of the merchant and moneylender tend to further the general interests of everyone in the community. An acceptable theory of collective choice can perhaps do something similar in pointing the way toward those rules for collective choice-making, the constitution, under which the activities of political tradesmen can be similarly reconciled with the interests of all members of the social group.[13]

Rational self-interest motivates the butcher, the brewer, and the baker as well as the politician, the voter, and the bureaucrat. In other words, public choice begins by adopting a symmetric stance between markets and governments: People are assumed to be rationally self-interested in both settings. Only with this consistency, with this symmetric treatment, can economic science truly compare how government and market institutions perform.

But why *also* presuppose that rational individuals *exchange* in politics? Because in both the market and in politics, as Mick Jagger reminds us, you can't always get what you want. Adam Smith says that in the market, rational individuals—the butcher, the brewer, the baker, as well as consumers—pursue their own interests and find ways to cooperate via exchange. At least, that's

what happens when there are effective rules, such as those that protect property and allow the price system to work without interference.

Buchanan and Tullock are reminding us that something similar happens in politics. The butcher, the brewer, and the baker, as well as consumers, have different political interests. These and many more groups of what Buchanan and Tullock call "political tradesmen" have different things they want from government. In a political market based on a democratic-republican form of government, people work together to make decisions about how to allocate resources. They set tax rates, approve construction projects, hire first responders, educate children, and so on. They engage in political trade. And they do so from different sets of interests. Notice in this chapter's opening quotation the many lines of political interest that James Madison sketches for us. Buchanan and Tullock also remind us that in both market and political exchange, the public interest is on the line. So it is important to establish appropriate rules of exchange in both settings, markets and governments. For example, most people are not happy with the political rule set known as dictatorship because no one gets what he or she wants except for the dictator. Most intuitively prefer something like democracy, with all of the good and bad that this arrangement entails.

Early work by Tullock sets the tone for looking at majority rule in a representative democracy. His papers show how majority rule quickly turns into logrolling—that ancient act of political back-scratching also known as vote trading.[14] In many political bodies, decisions about spending on public goods are put up for a vote, with a simple majority deciding the issue and with taxes to pay for that spending levied on everyone in the community. Oftentimes, no one group has enough votes to get what they want by themselves. That is, there simply aren't enough butchers to vote for their preferences and win a majority without the help of either the brewers or the bakers. Here is where logrolling comes in. It allows the butchers to get the spending they want, albeit at the cost of supporting something the brewers want. The benefit of this type of political exchange is that more people get what they want. The cost is that there is more spending than the majority desires, at least if the majority could evaluate each issue individually, without policies bundled by coalitions.

Tullock's logrolling analysis is therefore an economic response to Paul Samuelson's public goods argument. It is one thing to point out that markets fail to produce certain types of collective goods. It is another thing to analyze how a democratic republic would step in and supply those goods. Tullock argues that rational people will engage in logrolling, forming coalitions and

blocks when voting under a majority rule. Unfortunately for Paul Samuelson, nothing guarantees that the outcome of this political process will come close to what economic theory would say is efficient.

The contrast between Tullock and the welfare economists can also be viewed in terms of externality. Like Pigou arguing that market transactions create externalities and market failure (too few public goods), Tullock shows that logrolling through voting also creates externalities and government failure (too many public goods). The externality in this case is called a *fiscal* externality, and it takes the form of too much spending on government services, which ultimately must be paid for through taxes. (This is why legislatures often spend beyond their means, even when the politicians who work there claim to be fiscally prudent. It also helps explain why President Reagan oversaw deficits while negotiating with Congress for the policies he wanted.) In short, against this public interest standard called economic efficiency, Tullock shows that government failure is at least as plausible as market failure. And so the tip of the public choice iceberg comes into view.

When early public choice scholars shifted the lens of economics onto politics, what they found was a theoretical explanation for the messy downsides of democracy. As German Chancellor Otto von Bismarck said, "Laws are like sausage. It is better not to see them being made." Perhaps public choice riled up so many people for having the gall to show how sausage is made.

Voters

When Gordon Tullock taught at George Mason University in the 1980s, "Tullock votes" was rumored to have adorned the economics department bathroom wall. The graffito (which is false, by the way) pays homage to Tullock's argument that a wealth-maximizing agent will never choose to vote. Think about that for a minute. The way a rational agent decides whether to vote (like anything else) is to compare the expected benefits to the expected costs. Known as Tullock's voting paradox, the idea is that the costs of voting exceed its benefits in all but the rarest of circumstances. Thus the act of voting is itself irrational, which raises the question: What kind of system is it that relies on the judgments of irrational people? This is the kind of stark reasoning that irked many traditionalists and solidified Tullock's iconoclastic status, winning him many fans. Tullock and others have much more to say about voters. As we'll see, the voter is the most controversial figure in public choice theory.

Majority Rule with Rational Voters

While the public choice school of thought gained real momentum in the mid-1950s, some early papers pioneered the economic study of voting, treating voters almost exactly like neoclassical consumers. A 1943 paper by an economist named Howard Bowen is a pioneer in the twentieth century (French economists had studied the mathematics of voting in the early nineteenth century).[15] Bowen's paper "The Interpretation of Voting in the Allocation of Resources" was published while Bowen was leaving a successful career as an economics professor for a new career as a tax economist on Capitol Hill. In Bowen's model, the government is a supplier of some valuable good, such as national defense or homeland security. Voters differ in how much value they place on the public good, but everyone winds up with the same quantity because it's a nonrival good. To model things, we pretend that something as complicated as homeland security can be collapsed into a single variable; perhaps it's dollars of spending or the number of homeland security officers.

Each of Bowen's consumer-voters is also a taxpayer. The tax is like a flat tax on income, so each voter pays a "tax price" that increases with his or her own income and with the number of homeland security officers. Each individual's ideal number of officers is where the increase in income taxes (the marginal cost to the voter) just equals the marginal benefit of the added security. Because income and preferences vary, voters' ideal points for officers also will vary. And because we have collapsed everything into one variable, it is easy to line up all taxpayers according to their ideal policies, as in Figure 4.1.

Suppose we have five voters. Each has an ideal quantity of a public good, such as homeland security officers hired per 1,000 people. Person A wants one officer, person B wants two, person C wants four, D wants five, and E wants thirteen. How will this vote turn out? With these types of models, it helps to think of voting as occurring head-to-head between two choices,

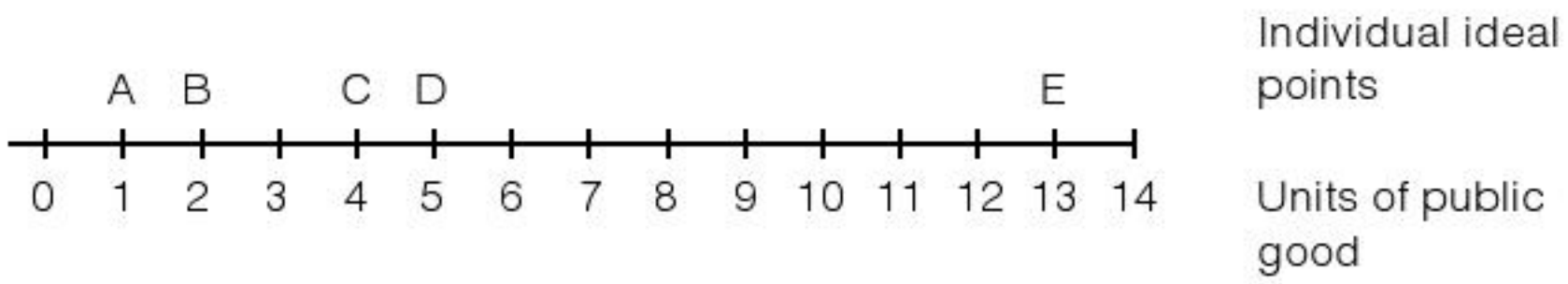

Figure 4.1 Voters as consumers of public goods (for example, homeland security officers per 1,000 population).

like a round-robin tournament in sports. For starters, if these folks were voting whether to increase from zero units to one unit, then this move would win a unanimous vote. Next, if we vote whether to move from one to two, everyone except Voter A will vote yes, and the measure wins four to one. Similarly, moving from two to three will win yes votes from C, D, and E, bumping Voter B off her ideal point.

As we increase from three units, the voting coalitions get interesting. Moving from three to four wins by a three to two vote, with Voters A and B losing to the C, D, and E majority. But on the vote from four to five, the majority changes sides with A, B, and C teaming up to keep the quantity at four and Voters D and E now on the losing side. Any quantity above five will similarly lose to four. And that's how this vote will go.

It's no coincidence that Voter C is on the winning side in all head-to-head votes. She is the median voter. This means that there is an equal number of voters wanting a position to the left on the spectrum of possible positions (those wanting fewer officers) as there are voters wanting a position to the right (those wanting more officers). As a general rule, in any situation resembling Figure 4.1 the outcome will arrive at whatever quantity the median voter prefers. This is called the Median Voter Theorem.

The median voter was first seriously studied by a Scottish economist named Duncan Black (1908–1991). Half a century after Wicksell, Black sets out to demonstrate the usefulness of majority rule as a political institution. He succeeds in part, but not exactly as he intends. Black finds that majority rule works well, but only under limited circumstances, when two very specific conditions hold. First, voters decide on a single issue at a time, like the number of officers to hire. And, second, each voter has "single-peaked" preferences over the issue. "Single-peaked" means there's one position on the number line that is ideal to each voter, and movements away from that point in either direction are progressively worse. When these conditions hold, Black shows, then the Median Voter Theorem holds.

Every four years the U.S. presidential elections present a nice example of the Median Voter Theorem. During the primaries, the successful candidate has to appeal to the party base while inspiring confidence that he or she can beat what the other party has to offer in the general election. Once nominated, that same candidate now must reach the median of the entire electorate, not just the party. This explains why presidential candidates run to the center after the primaries. The same goes for any office elected under two-party primaries, including Congress and the state legislatures.

A fundamental question is whether the median voter's preferred outcome, such as the quantity of homeland security officers, represents an efficient outcome. In other words, does majority rule allocate resources optimally through the political process in the same way that the Fundamental Welfare Theorem proves that markets allocate resources optimally through the economic process? This is one of the core questions that welfare economists began taking up in the 1950s. Soon it would become apparent that the answer is no. The same Kenneth Arrow who gives us the Fundamental Welfare Theorem of markets also proves another theorem about voting. Arrow's voting theorem says there is no method of voting that is even *theoretically* ideal. To prove this, Arrow has to entertain a more complicated model than our simple number line. First, Arrow's model lets multiple issues be voted on at once. Next, he develops certain reasonable conditions that an ideal voting process ought to meet. In simplified form, the conditions are:

1. The voting system must represent the wishes of multiple voters. No single voter can dictate the outcome.
2. The voting system must represent all preferences of the voters and rank them for the society as a whole.
3. The voting system must rank preferences among a subset of all options just as it would if all options were considered. Thus, if voters prefer A to B and B to C, then the voting rule must have B win over C even if A is not an option.
4. The voting system must rank group and individual preferences identically when there is unanimous agreement. Thus, if everyone in the group prefers A to B, then the system must rank A over B.

Arrow concludes that no voting system can satisfy all four of these reasonable criteria. Hence the name: Arrow's Impossibility Theorem. For an economist trying to suggest democratic rules that improve social outcomes, this is a pretty pessimistic result.

Several other problems with majority voting were exposed, as a flood of scholars became attracted to the mathematics of voting. Stability became a major issue. Outside the familiar confines of Black's two conditions—single-issue, single-peaked preferences—models show that majority rule voting is prone to shifting coalitions and wild swings from one election to the next. This point has been intensely debated because scholars despise models that lack determinate solutions and also because it suggests that governments are volatile relative to markets. But a fair comparison would say that market

exchange depends on institutions like property and contract, so perhaps the stability of political exchange also depends on institutions. For example, if it's agreed that instability in voting is socially undesirable, then one way to counter instability is to be very careful about what items actually come up for votes. This explains why political traders use committee structures to spread agenda-setting and gate-keeping powers. Another counter is to make sure the votes are there beforehand, which explains why political traders make regular use of logrolling and why party leaders appropriately called "whips" are appointed to line up the rank-and-file votes ahead of time. Simple majority rule is unstable (when Black's two conditions don't hold), but institutional structure can suppress that instability and induce equilibrium in voting.[16]

Another issue arises because voting assigns equal weights to voter preferences, except under logrolling, as Tullock points out. In other words, majority rule voting has been shown to ignore the intensity of voters' preferences. In Figure 4.1, a statistician might call voter E an "outlier." In politics he would be an "extremist." But in economics, Voter E's subjective value matters as much as anyone's value does, and the theory used to measure social welfare must count it. Voter E is like the homeowner who sincerely (rather than strategically) doesn't want to sell out to the new development. The city council imposes the interests of the majority by forcing out the homeowner with eminent domain. Like Knut Wicksell, a consummate outlier and extremist in the eyes of some, an ousted homeowner will likely come to adopt strong opinions about majority tyranny.

Rational Ignorance

Duncan Black didn't initially succeed in the marketplace of economic ideas. Because he was an outsider looking in, Black's work was initially undervalued by the mainstream of the profession. Working from remote outposts, he had difficulty getting his work published and gaining interest from his fellow economists. It helped that Ronald Coase was a friendly connection, and William Riker (another major figure in early public choice) wrote favorably of Black's work. But for some time, the median voter model would brew in fairly small circles. Then Black's idea was picked up.

A newly minted Stanford PhD economist named Anthony Downs (born 1930) made the median voter model a core part of his doctoral dissertation, which was then published as the landmark 1957 book, *An Economic Theory of Democracy*. Downs's dissertation advisor at Stanford was none other than Kenneth Arrow.

As an undergraduate, Downs successfully ran for student body president at Carleton College. While serving, he discovered that most of the student body didn't know or care about the job he did as president. Downs saw his classmates paying as much attention to student body politics as it was in their interest to do so and no more. Downs knew his classmates were making rational choices with their time and knew they weren't the only ones. Across the board, Downs surmised, voters economize on information costs and wind up being rationally ignorant about the functions of government, what kinds of jobs their representatives are doing, and even who is in power. Throughout his career, Downs would anchor all his analysis of politics to the assumption that voters are rationally ignorant. He would not be the only one.

Perhaps ignorance isn't personally costly in politics, but it is in markets. As in the case of Tullock's farmers, consequences are more individual in markets, more shared in politics. To illustrate, let's say you are buying a new car or smartphone. This thing that you wind up buying will be with you almost every day of your life for the next couple of years and perhaps longer. You have the incentive to educate yourself on all the available features, think about how important certain features are to you, and familiarize yourself with how everything is priced. You'll probably shop around a little bit, check out *Consumer Reports* and some online user reviews, and maybe sleep on it.

Suppose instead that you're going to the voting booth. The consequences of choosing poorly at the voting booth don't fall directly on each voter. They get shared with all other citizens. People thus have less of an incentive to make the right decisions in politics than they do in markets. So they have little incentive to diminish their ignorance about much of what happens in politics. Even if people do inform themselves dearly about politics, their vote still only counts as much as someone who is completely oblivious. And we are back to the Tullock voting paradox.

Downs motivated generations of scholars, mostly in political science, to find out what voters know. A vast amount of evidence overwhelmingly confirms that voters know very little about government. People are just as given to wild conspiracy theories as to reasonable explanations for government. Majorities of voters incorrectly answer questions about the basic organization of government. Most cannot even name their representatives aside from the president and perhaps one senator.

Voters are even less informed about the effects of policies and seem to take stated intentions on face value. For example, observe what happens in the days following a damaging earthquake, tornado, or hurricane. Many

states have antigouging laws, which legally prevent sellers from increasing their asking prices on ice, plywood, batteries, portable generators, and so forth. The intent of an antigouging law is easy to understand: The legislature is protecting people from getting ripped off. The effects, however, almost never work out that way.

Antigouging laws actually make it *harder* for disaster victims to find ice and plywood at all, much less at prices deemed exorbitant. After Hurricane Fran in 1996, for example, almost a million people in Raleigh, N.C., were without electricity and badly needed ice. In response, four men from a town about 100 miles away paid $1.75 each for 500 bags of ice, trucked them into the disaster area that was Raleigh, and started selling to willing but complaining buyers at about $8 per bag. The police showed up, discovered the state's antigouging law was being violated, and hauled away the four men *and* the remaining bags of ice. You might think the people standing in line would scream, "Hey, bring back the ice!" But instead they cheered.[17]

In short, people can be cognitively biased. Behavioral psychologists tell us that people naturally find ways to conserve on brainpower. For example, we all have "anchoring" and "availability" biases that affect the way we interpret novel circumstances. When disaster victims know that the price is $1.75 under normal conditions, people default to $1.75 as their perceived appropriate price, even though supply and demand conditions are radically changed during the disaster. So, whether locals cheer or boo depends on which of two narratives people believe: Is $8 a fair price for providing a badly needed service, or is it an exorbitant price that takes advantage of the situation?

In the supply-demand model, $8 is the price that motivates sellers to take on the added effort, expense, and risk of supplying ice to disaster victims living in another state, and $8 is the price that buyers are willing to pay because their food, baby formula, insulin, and other vital items are spoiling by the minute in their powerless refrigerators. As Alfred Marshall taught us over a century ago, when supply decreases and demand increases, prices will go up. On the other hand, the "gouging" narrative says that $8 is the price charged by greedy, opportunistic sellers whose attempts to rip off the public must be stopped, even if that means no ice is made available. Unless people have studied the supply-demand model, the gouging narrative will be more cognitively available, and people will anchor to it when they see the police hauling away the bad guys. And so they cheer.

These cognitive biases often mutually reinforce rational ignorance. The supply-demand reasoning is opaque; it takes mental effort and a willing-

ness to think in terms of general rather than their own individual interest. In contrast, the gouging narrative is vivid; it is easily grasped and satisfies a cognitively available sense of fairness. Just as rationally ignorant voters have little incentive to gather and evaluate information about politics, cognitively biased voters support antigouging laws because it is easier to see them as a good idea.[18]

People hold similarly erroneous views on trade restrictions, minimum wage laws, occupational licensing laws, and scores of other market interventions. By "erroneous," we mean that the policies people support fail to achieve what most supporters think they achieve and in fact do great harm. These beliefs affect how political parties take shape, how interest groups acquire influence, and how politicians ultimately respond to voters and vice versa. When voters don't understand the basic structure and functions of government, much less the causes and consequences of policies enacted by government, it is both easy and common for voters to support wasteful and unjust policies. It seems a whole theory of politics could rest on Downs's idea.

Political Parties

In simplest terms, political parties are coalitions that seek control over the policy levers that set the political rules of the game, to accomplish their specific goals, and to advance their particular interests. In Downs's uncertain political world, political parties are a way to communicate ideological and policy stances between voters and politicians.

It's a lot of work for the average voter to come up with an opinion on exactly what government should do, how to resolve all those messy questions about what to regulate and what to leave to the market, how to spend tax dollars in one area compared to another, and so on. Most of us have better things to do.

If you want someone who would vote as you would vote or someone you can count on to "do the right thing" (as you conceive it) in Congress, and if the costs of monitoring the most basic political activities is high, what do parties do to help? They provide inexpensive signals on how political candidates think, otherwise known as their ideology.

Party affiliation helps politicians, too, including the benefits of branding for voters, and an easy way for a politician to do that is to be a "proud Democrat" or a "proud Republican." This is simply the mirror image of the benefit to voters—lowering information costs. In addition, party affiliation allows a politician to be part of a coalition that can jointly produce political benefits.

Finally, political parties can be a convenient means for politicians to limit competition (we didn't say it was good for the voters). For example, in the United States, the vast majority of the members of Congress belong to either the Democratic or the Republican Party. While this usually guarantees two fairly different ideologies in a given race, it also makes it hard for a third point of view to emerge.

Interest Groups

In the passage from *Federalist #10* quoted at the chapter opening, James Madison articulates how people in a geographically representative republic naturally fall into groups of common sentiments and views. However, being of common sentiments is not the same as being of common interests. If you and I are both landed interests (say, sugar farmers) or manufacturing interests (say, steel mill owners), then we both would benefit from interventions that protect us from competition. Yet it would be in my interest to enjoy the benefits of protectionism while letting you pick up the political tab for convincing policymakers to provide the protection. Lobbyists are not cheap. Intervention is a nonrival good to us, which we share equally with other sugar farmers or steel mills. And just like Samuelson's public good problem, there is a free rider problem that every interest group needs to solve to be politically relevant.

Mancur Olson (1932–1998) was a public choice pioneer whose work suggests that much of politics comes down to which interests groups are good at solving free rider problems. His most famous book is *The Logic of Collective Action* (1965), where the starting point for analysis is to ask: How big is the group? An industry with four firms will find it easier to monitor and punish free riding than will an industry with 4,000 firms. Furthermore, there is more at stake for each individual in small groups (a political favor worth $4,000 to the four-firm industry will get split into $1,000 chunks instead of $1 bits). So Olson predicts, all else being equal, that smaller groups will be more politically relevant than larger groups.

A second criterion for collective action is the uniformity of interests. An industry of four firms that make widgets and widgets only is one thing. A four-firm industry where each firm makes widgets and 100 other goods is another. The latter group won't be as motivated to lobby for protection from imported widgets, for example.

Third, even if groups are relatively small and cohesive so that free riding isn't a big problem, a group must still incur startup costs to lobbying. Here

Olson distinguishes between groups that are already formed for nonpolitical purposes, like private clubs, and groups that share a common political interest but are not preformed. Olson argues that already formed groups will be more politically relevant as a byproduct of the fact that they were already formed for other purposes.

And, fourth, Olson develops a theory of voluntary public goods based on the concept of "selective incentives." A *selective* incentive is a way to reward contributing members but not free riders, to encourage individuals to supply the public goods they care about. Selective incentives take all forms, like group discounts at major retailers, magazine subscriptions, logoed swag, or group insurance premiums. Groups vary in their effectiveness of applying selective incentives, and so groups vary in their ability to get members to voluntarily contribute.

Putting all this together, Olson describes politics as adhering to a logic of concentrated benefits and diffuse costs. Wealth will be redistributed from groups that can reduce free riding only at high cost, toward those groups that are able to reduce free riding at lower costs. Government favors will be acquired by small, cohesive groups that were already formed and can effectively use selective incentives. The cost of government favors will be borne by large, disparate groups that are not already formed outside politics and therefore cannot easily apply selective incentives to members. Typically the most important factor is group size. Thus, Olson describes interest-group politics as the "exploitation of the great by the small."

Mancur Olson never writes about the U.S. sugar program, but it's a clear illustration of the logic of collective action driven by rationally ignorant consumer-voters and rationally self-interested policymakers. Sugar farmers are a small, cohesive group. According to a 2006 study by the U.S. Department of Commerce, there are about 61,000 full-time equivalent workers in growing and harvesting sugar. By contrast, almost a million people work in sugar-using industries like food, breakfast cereal, and chocolates. And even though the aggregate cost of the program to consumers is anything but small at $2 billion, if one spreads this cost over 300 million Americans, the average cost per consumer is less than $7 per year. This is why you don't see "Citizens against High Sugar Prices"; the costs of consumers organizing outweigh the benefits of lower-priced sugar. Meantime, according to the Center for Responsive Politics, a watchdog group that tracks money in politics, sugar growers spend tens of millions of dollars each year lobbying regulators and contributing to political campaigns.

Olson studies the pernicious effects of concentrated interests accumulating greater political clout over time. In his second most famous book, *The Rise and Decline of Nations* (1982), Olson observes that revolutions and significant upheavals can destroy some of these special interests, which may create opportunities to limit future inefficient, wealth-destroying transfers within economies. He cites as examples the experience of Germany and Japan following World War II, with political institutions being dramatically rebuilt, followed by the opportunity for economic growth as fewer special interests were in place, at least at first.

In short, Mancur Olson's theory of collective action helps us understand why it is that some interests are well represented and others are not, and he hints at some of the implications of this for political change.

Rent Seeking

The investment of valuable resources into activities that are counterproductive is what economists call "rent seeking." Theft is a particularly vivid example. So is much of politics.

If you have ever been a victim of identity theft or a computer virus, you have personal experience with the socials costs of rent seeking. Hackers invest time, money, and resources into mastering the ability to disrupt and steal other people's property. And when people invest in becoming better thieves, there is a net loss in the economy because this effort could have been directed at producing something that creates value for others. On the defense side of things, all sorts of resources go into stopping hackers. But it's arguably all a waste, because antimalware products would have zero value were it not for hackers.

Theft is the opposite of mutually beneficial exchange. It is not a mere transfer from the victim to the one doing the stealing. In theft, the loss to the victim is greater than the gain to the thief because the thief has to deduct the time and effort he or she put into being a good thief from the bottom line. In politics, interest groups compete to win sway over the levers of policy. The cost of the policy to society is greater than the gain to the winning interest group, because the winner must deduct the lobbying costs that were sunk into becoming the winner in the first place. In both arenas, theft and politics, people invest resources into activities that are counterproductive.

Gordon Tullock first raises these issues in his most famous paper, a nine-page explosion of ideas entitled "The Welfare Costs of Tariffs, Monopolies, and Theft." In this paper Tullock responds to the predominant view in the profession at the time that there didn't seem to be much waste involved when

government sets up monopolies and tariffs because the consumers' loss was assumed to be the same as the producers' gain. This troubles Tullock, partly because he seems to think it is the unique duty of the economics profession to point out that, indeed, government monopolies and tariffs are costly on net. Otherwise we might return to the protected and poor days that motivated Adam Smith to argue against mercantilism. "The classical economists were not concerning themselves with trifles when they argued against tariffs," Tullock insists in this paper.[19]

Tullock sets out to show that the predominant view is nonsense. Government tariffs and monopoly are enormously costly in practice, and the predominant view exists only because of flawed measurements that understate these costs. There are, Tullock shows, several categories of socially wasteful behavior that are encouraged by government interventions but that are not being accounted for by the work of economists.

In the case of tariffs, for example, economists predominantly recognized that it is wasteful to require goods to be made by high-cost producers. They just argued that the magnitude of this waste was small. Having spent nearly two decades working in various bureaucracies across America and Asia, Tullock merely observes that governments tend not to take steps like imposing tariffs on their own:

> They have to be lobbied or pressured into doing so by the expenditure of resources in political activity. One would anticipate that the domestic producers would invest resources in lobbying for the tariff until the marginal return on the last dollar so spent was equal to its likely return producing the transfer. There might also be other interests trying to prevent the transfer and putting resources into influencing the government in the other direction. These expenditures, which may simply offset each other to some extent, are purely wasteful from the standpoint of society as a whole; they are spent not in increasing wealth, but in attempts to transfer or resist transfer of wealth.[20]

Tullock makes a parallel argument for monopoly, and the argument extends out to all regulations that limit competition: tariffs, quotas, price controls, entry controls like occupational licensing, and all other seemingly well-intentioned policies that draw applause from people like Raleigh denizens after a hurricane. In all these instances, some political decision alters the rules of the economic game in such a way as to create an opportunity to redistribute wealth. Tariffs, for example, redistribute wealth away from consumers (a dispersed, large group) to the protected industry (a concentrated, small group). Rational people will compete to have their industry protected

in this way. And Tullock's basic point is that the resources consumed in that sort of competition are a social waste, so economists need to count these costs when measuring the welfare losses of government policies.

Tullock struggled to get his most famous paper published. By his own account, it was rejected at all the major journals where he usually published his articles. Finally an obscure (at the time) journal, the *Western Economic Journal*, agreed to publish it, and a new way of looking at the world came about. Interestingly, Tullock actually never used the phrase "rent seeking" in this first piece. It is not until seven years later, in the prestigious *American Economic Review*, that World Bank economist Anne Krueger dubs Tullock's concept "rent seeking." The name stuck, and the rest is intellectual history.

Also interestingly, some economists invested their scholarly resources into coming up with a better name for Tullock's concept, one that presumably would be adopted as the standard term and therefore associated with their name. The Columbia economist Jagdish Bhagwati termed it "directly unproductive profit-seeking," or DUP, in 1982. A bit later the New York University economist William Baumol called it simply "unproductive entrepreneurship." As we'll see in the housing bubble case study in Chapter 6, when unproductive entrepreneurship becomes systemic it can take a heavy toll. On Tullock's side, his colleagues in Virginia also spent a good deal of their time in defense of Tullock's claim. Robert Tollison, for example, in 1981 published a lengthy paper called simply "Rent Seeking: A Survey," to document the lineage of Tullock's idea. As we heard from Tollison in Chapter 3, economists are maximizing agents. And apparently there is rent seeking in the marketplace of ideas, too.

Rent seeking is often thought to be synonymous with lobbying politicians, but clearly that is only a slice of the broader concept. Rent seeking is investment in unproductive activity, whether in theft or in politics or elsewhere. Ultimately, the rules of the game encourage people to compete in socially destructive or socially beneficial ways. The constructive message of public choice is that, by introducing good rules for politics, society can achieve better outcomes, less waste, and improved justice. Otherwise, societies with significant amounts of rent seeking tend to use scarce resources in ways that do not create net benefits, which leads to depletion rather than growth over time. Societies that use their resources more productively have rules that promote cooperation *and* competition. In other words, the right rules help promote Adam Smith's model, in which the pursuit of private interest leads to the public interest.

Politicians

What do politicians want? To begin, we assume politicians wish to be politicians. In doing so they seek to advance the well-being of themselves and their families and friends, just like the rest of us. And like the rest of us, they have their own views on how the world would be a better place. But if politicians want to do anything, they have to get elected—and then reelected. To do that requires beating the next guy before the voters.

If you are a politician, it is easier to please voters if your ideology nicely lines up with the majority views of the electorate. For example, if you are a fiscal and social conservative, life is much easier if you represent a district with similarly minded voters as compared to, say, a politically liberal district in San Francisco. Similarly, if you believe aid to U.S. agricultural interests (such as ethanol subsidies or the sugar program) hurts consumers at home and impoverishes farmers abroad who otherwise would sell to us, you probably should not be a farm state senator. In this way, politicians who believe that farmers need subsidies are most likely to represent farmers who want subsidies.

In short, if you and your constituents have very similar ideologies, not only do they get what they want—someone who thinks just like them—but it is much easier to vote your own preferences once in office. That's a good thing because, as we know, it is rational for voters to be ignorant of many policies. They are counting on you.

But from the perspective of the economic well-being of your society, this also presents a challenge. If you are a politician, and you know that voters are rationally ignorant and cognitively biased, what should you do when voters get it wrong? One option is to simply accept the erroneous views of the public and give your support to the policies they want. A different strategy would be to support the policies that *you* want. So a basic question is: Do politicians support policies favored by the median voter or their own preferred positions? In broad terms the job of a politician is like any other job. You produce something, you get paid. If you don't do your job very well, you get fired.

In the public choice approach—in the world of rational ignorance, rationally self-interested policymakers, and concentrated benefits and diffuse costs—the job of politicians is to broker wealth transfers between groups in society. For example, as a politician, you may support a defense contract or a farm subsidy that would directly benefit only a small fraction of the voters in your district. So why do it? The answer, of course, brings us back to Mancur Olson's concentrated benefits and dispersed costs. The many who will not

benefit may not care very much, and they probably won't even know about it. The few who benefit will be keenly aware of your support, and they likely will help get you reelected. And if you can get reelected, you can go on to do great things for everyone else in the district, help advance world peace, or further some other lofty goal. The benefits of helping the rent-seekers are high, and the costs are few. In short, as a politician (and as a rational human being) you respond to incentives. Those incentives may change over time as a consequence of the many individual ideas, beliefs, and attitudes held by the electorate, and the many special interests that make you keenly aware of the concentrated benefits that you may be able to bestow on them, in return for political support, of course.

The Economics of Regulation

Capture

George Stigler (1911–1991, Nobel Prize 1982) is the Nobel Laureate who did more than any other scholar to fuse public choice into the mainstream orthodoxy of economic thinking. A fixture at the University of Chicago during the second half of the twentieth century, Stigler was rivaled only by Milton Friedman as the face of Chicago during their day. Awarded the Nobel Prize for his work in industry and regulation studies, Stigler was a great synthesizer, a great theorist, and perhaps an even greater igniter of controversy. He coined the term "Coase theorem," despite the fact that Ronald Coase himself never claimed to prove anything. He once argued that only active scholars can be good teachers, yet he condemned intellectual hubris. Reviewing Samuelson's *Foundations* in 1949, Stigler does little to conceal his distaste for that particular form of intellectual elitism. "He dismisses translations into words as 'mental gymnastics of a peculiarly depraved type.' I disagree. There is no depravity, nor is there virtue, in telling other competent economists things in a language they all can understand—there is simply responsibility to the canons of scholarship."[21]

From the beginning of his publishing career in 1937, Stigler shared Downs's intent on understanding the effects of information costs on economic and political behavior. He wrote fine technical papers as well as historical essays on long-neglected economists. In the 1960s he began to turn more attention to such regulatory issues as electricity, trucking, labor, and securities. Culminating in a landmark 1971 paper, "The Theory of Economic Regulation," Stigler applies public choice theory to the executive branch, specifically to the people making the decisions that regulated these indus-

tries. Stigler's paper forges a theory of regulation that would become the antithesis of the Pigou-Keynes-Samuelson public interest model.[22]

According to Stigler, regulatory agencies tend to get captured by the very industries they regulate. Regulators, like the rest of us, respond to costs and benefits in their decisions. Voters are rationally ignorant. By contrast, the regulated businesses have every incentive to know the regulators who oversee their business. In practice, they tend to know the regulators quite well, along with their spouses, their children, their favorite restaurants, their golf scores, and more. Bribes and junkets are monitored, but to have the information needed to do their jobs, government regulators do have to meet with those they regulate, and they need some way of sorting the legitimate concerns from tall tales. With all this contact, relationships form between the regulators and the regulated.

Stigler poses an explanation for regulation based on supply and demand. Politicians and regulators have access, through political exchange among their colleagues in representative bodies, to a supply of wealth that could be transferred to a worthy group in society that is willing to pay the right political price. Firms are willing to pay up to a certain amount for regulations that limit their competition. They'll hire the best lawyers who will make the best arguments. They'll rent office space close to government buildings and host events with good food and lots of wine. And they'll put the best spin that public relations can muster. Being an influential interest group exacts a heavy price. Regulators will be responsive to the "price" paid, even though the regulator may not be its recipient. Nonetheless, the regulation passes, competition is stifled, firm profits go up, and consumer welfare goes down.

For all these reasons and more, interest groups and their government benefactors want to attract very little attention to their political exchange deals. Thus, they package favors in ways that will resonate with rationally ignorant voters and will keep other interests at bay. Stigler explains his point as follows:

> Let us consider a problem posed by the oil import quota system: why does not the powerful industry which obtained this expensive program instead choose direct cash subsidies from the public treasury? The "protection of the public" theory of regulation must say that the choice of import quotas is dictated by the concern of the federal government for an adequate domestic supply of petroleum in the event of war—a remark calculated to elicit uproarious laughter at the Petroleum Club.[23]

The strategic oil reserve is a good enough story for rationally ignorant voters. And the import quota rather than cash subsidy keeps the benefits concentrated on a few businesses without attracting other businesses from suddenly developing the urge to enter the oil business.

In light of Downs's rational ignorance, Olson's logic of collective action, and Tullock's theory of rent seeking, Stigler's account of regulatory capture is a plausible one. His account also extends to other industries besides just energy and to other interest groups besides business. Stigler offers additional examples, such as the Civil Aeronautics Board, which had not approved a single new interstate air carrier in its history, and the Federal Deposit Insurance Corporation, which had reduced the rate of entry into commercial banking by 60 percent. In Chapter 6 we'll see in great detail how these tidy arrangements between regulator and industry play out.

Government entry regulations are popular in part because of what they are supposed to do, namely protect consumers from incompetence. People don't want any idiot providing delicate services. Brain surgeons and airline pilots come to mind. Then again, the state of Florida licenses interior designers, and Washington, D.C., requires tour guides to be licensed before showing visitors around. Where is the line between consumer protection and supply restriction? Rationally ignorant voters aren't likely to know, but we might ask teachers' unions, because Paul Krugman, a Nobel Laureate in economics, cannot legally teach economics at your local public high school without a license, and forget about Maya Angelou leading your teen's creative writing class. There are concentrated interests, and there are dispersed groups from whom small wealth transfers are politically available.

The Interest Group Theory of Government

Stigler's theory can be mistaken for a caricature of government agents hopelessly captured by special interests. While he does talk about some of the limitations that policymakers face, it wasn't until later that this was built into the model. Stigler's student Sam Peltzman (born 1940) builds a model of the policymaker's rational calculations—balancing marginal political gains of a policy decision against its marginal political costs to the policymaker. And Peltzman integrates the interest group explanation of the demand for wealth transfers into his new model. In equilibrium, the policymaker will not simply grant the wishes of concentrated interests. Rather, he or she will weigh the relative political sway of groups supplying the wealth for transfer against the clout of groups demanding the wealth transfer. The winners come down

to Olson's theory of collective action—which groups can better organize for political action. And it's mostly a social waste, according to Tullock's rent-seeking theory.[24]

Peltzman applies the public choice framework to areas of regulation that aren't typically thought of as economic regulation. For example, he studies the Food and Drug Administration. Regulators there have the incentive to prevent incidents with approved drugs. They are less concerned if thousands get sicker and die as new treatments go through the lengthy safety and efficacy approval works. Peltzman also studies the effects of public safety regulations on people's behavior, for example seat belt laws. Seat belts make people safer in the event of an accident, but this added safety makes people drive slightly riskier, adding to more accidents. Peltzman finds that the two effects just about cancel each other out, thus concluding the number of lives saved because of seat belt campaigns was pretty small. In other words, Peltzman pushes the frontier of Stigler's approach into new areas of regulation, areas not typically thought of to be *economic* regulation. He makes Stigler's theory more general, from "a theory of economic regulation" to "an economic theory of regulation."

In the early 1980s the interest group approach was pushed even further to encompass all of government activity, not just regulation of markets and public safety. Robert McCormick and Robert Tollison's book *Politicians, Legislation, and the Economy* (1981) treats policymakers as brokers of wealth transfers. Building on the simple observation that virtually any action taken by a government will involve winners and losers, McCormick and Tollison reason that the winners in any government action would be those same groups that are so effective in Olson's theory of interest groups. When pushed far enough, every group in society (each one of Madison's "distinct interests" from this chapter's opening quotation) can be treated as having some economic cost of influencing legislation. Those with very high costs in politics will be the groups "supplying" the wealth for transfer to those other groups in society with much lower political costs. As a clearinghouse for wealth transfers, it is the legislature's job to match demanders of wealth transfers with those who supply them (we didn't say they were *willing* suppliers, or even aware). So sugar subsidies and import tariffs benefit domestic beet and cane growers, and the war on drugs benefits the worldviews of socially conservative voters. In other words, the interest group model applies not only to Stigler's theory of economic regulation and Peltzman's economic theory of regulation but to virtually all actions that any government undertakes.

Answering Question #1:
Why Democracies May Generate Unjust and Wasteful Policies

When we view politics through the lens of economic theory, a realistic picture of government comes into focus. Politics is a form of exchange, as Jim Buchanan teaches in his famous article, "What Should Economists Do?" Rationally self-interested people want public policies that benefit them and reflect their attitudes, beliefs, and ideas. But voters are rationally ignorant, and competition in political markets creates social losses in the form of rent seeking. Therefore public policies fall into the grip of special interests, and government becomes a game of balancing the relative influence that interest groups have over policymakers. As a result, public policies are not directed at eliminating waste or ensuring justice. Rather, they have the effect of transferring wealth from large, unorganized groups of people to small groups that have invested in political influence. And, in doing so, they often turn out to be wasteful and unjust in the process.

Transitional Gains Trap

If you're a homeowner, then you're familiar with the mortgage interest deduction. In fact, it is an important part of your financial life. It reduces your taxable income, and it supports the market value of your home. It also entices people to overinvest in housing by effectively taxing nonhousing investments more heavily. Hayek would say it distorts relative prices and prevents prices from reflecting people's true time preferences. Tullock would add that this rent seeking is socially wasteful, in part because people invest too little in other areas, namely business and research. With less business investment in the economy over time, less capital is used in production, and this in turn decreases labor productivity. In the end, wages and incomes are smaller than they would be in the absence of the mortgage interest deduction. Economists at the Government Accountability Office estimate the effect is anything but trivial. These distortions ripple throughout the economy and subtract as much as 1 percent from GDP, currently about $140 billion, every year.[25]

If it's such a wasteful policy, then why doesn't Congress repeal it? This, of course, is a version of our second motivating question. The interest group theory of government explains why democracies enact inefficient policies, but it doesn't necessarily answer the question as to why bad policies persist over time. To address our second motivating question, we once again turn our attention to Gordon Tullock.

Answering Question 2: Why Democracies May Get Stuck with Bad Policies

Gordon Tullock's most underrated paper is his 1975 article, "The Transitional Gains Trap." As he does with his original paper on rent seeking, here Tullock begins with a simple observation. On the one hand there are a large number of industries that enjoy the benefits of government protectionism in some way or another. Yet, on the other hand, these industries don't appear to be any more or less profitable than the unregulated ones. "This raises the question of why these special privileges do not seem to do much good," says Tullock in the introduction.[26] And Tullock further extends the interest group theory into an explanation for political stasis.

As Stigler reminds us, political favors to industry rarely come in cash form. Instead, the right to the favor is tied to ownership of some resource. To get the mortgage interest deduction you have to buy a house. To practice law you have to get a law degree and pass the bar. To drive a taxi in New York you have to purchase a taxi medallion. When people get a hold on those assets early in the life of a program, their market prices have not adjusted yet. But the policy artificially increases demand for the assets that are tied to the favor. And the prices for those assets increase as a result. So law school gets very expensive, home prices shoot up, and taxi medallions start selling for big money. In October 2011, two medallions sold for $1 million each.[27] In short, the value of the political favor gets capitalized into the assets attached to the political favor. And people end up paying dearly from the beginning for the right to the political favor.

So Tullock's first point is that the gains to steering policy in one's favor are transitional. His second point is that policy gets trapped. As a result of gains being transitional, people who want to enter these industries must pay significant up-front costs. Once those costs are incurred, a repeal of the program will reduce demand for the assets they've invested in. Prices will plunge. This is why homeowners across America would scream at the sound of politicians threatening to repeal the mortgage interest deduction. And this is why any cab driver who paid six or even *seven* figures for a medallion has a lot at stake in the status quo. Even if people aren't making huge profits under the political privilege, they'll protect their investments by lobbying against the repeal of these inefficient policies. In fact, fully rational economic agents will spend up to the amount of the skin they have in the game.

More broadly, Tullock suggests that things in politics can't easily be reversed. Merely identifying a wasteful policy is not enough to repeal that

policy. Protected firms may not earn high profits due to the policy being in place, but they would suffer huge losses by its repeal. Once market forces capitalize the value of a public policy into the assets tied to that policy, then a strong set of interests becomes vested in that new status quo. These vested interests will oppose reform or repeal and in most cases will be a more potent political force than other groups seeking to roll back the bad policies. Presidents Kennedy and Reagan both sought to eliminate the sugar program, but they were unable to mount the political pressure to break the status quo coalition. So public choice theory explains why democracies may produce wasteful and unjust policies and why we get stuck with those policies.

The Mystery of Deregulation

And then a funny thing happened: Deregulation! Just as public choice theory seemed to be mounting a comprehensive case that inefficient regulations were both inevitable and irreversible, history took the most curious of turns. Starting in the 1970s there was widespread deregulation of markets. In one industry after another, policymakers found occasion to decrease the role of bureaucracy and rely instead on greater competition. According to Brookings Institution economist Clifford Winston, deregulation occurred most intensively in transportation (especially airlines, railroads, and trucking), television, phone service, banking, brokerage, and energy. Winston reports that, in 1977, fully regulated industries accounted for 17 percent of GNP, but in 1988 that share had dropped to 6.6 percent of GNP.[28]

Deregulation was a surprise to some, especially to public choice theorists. From rational voters and parties to the logic of collective action, from capture theory on through to the transitional gains trap, public choice predicted the opposite of deregulation. Public choice predicted that inefficient regulations would persist in equilibrium.

Struggling with Question 3: Ideas, Not Just Incentives, Are Needed

Public choice theory gives us a clear picture of institutions and incentives in politics. But because public choice emphasizes the vested interests side of political change, it assigns relatively little role to the power of ideas in politics. And because public choice is an outgrowth of neoclassical economics it also tends to emphasize equilibrium over process. Interest groups compete for the rights to influence public policy, which concentrates benefits on well-defined and politically powerful groups while diffusing the costs on ill-defined and

politically weak groups. And policy gets stuck in this outcome. Period. But to get a clear picture of political change means introducing a bigger role for ideas, in particular how ideas and interests do battle over shaping institutions. To incorporate ideas, we will have to build even further and go beyond traditional public choice approaches.

Legacy of Public Choice

Like many revolutions, public choice began with a simple idea. According to economic theory, we should assume that politicians, bureaucrats, and voters are rational, maximizing individuals just as we assume that consumers, households, and firms are. That's for starters anyway. As the implications of this point began to be explored, a group of scholars formed, and a school of thought emerged. As theory and evidence began to mount, public choice scholars systematically filled the void left by the earlier, romantic view of government found in neoclassical welfare economics.

Public choice is both normative and positive. It's one thing to ponder "the good" and come up with ways for government to achieve whatever we think is "the good." It's another thing to recognize that collective action is not as simple and clean as it appears on the chalkboards of Pigou, Keynes, and Samuelson. In the real world, when it comes to implementing public-interest policy prescriptions, the process suffers interference from the rational self-interest of the actual people making decisions in government. Self-interest gets in the way of our chalkboard wishes and public interest dreams, so if public choice theory holds a normative lesson it is to adjust our expectations downward as to what government is able to accomplish—and perhaps to view government in an entirely different way normatively, not as a noble pursuit of the good but as an ordinary enterprise of exchange by way of redistributing wealth in society.

But public choice shouldn't be taken only as a counsel of despair, that governments fail, period. It should be viewed as a research program, an approach to doing social science, one that offers both a realistic account of order within politics and a hopeful course for reforming institutions in socially beneficial ways.