

## **The Science of Economics**

By Fred E. Foldvary

### **1. Governance**

"Governance" consists of the enforcement of rules. A "government" is most generally an agency which enforces rules. We normally think of a government as that of a state, which is a government having ultimate authority over some geographic area and over its subjects or citizens. But a voluntary association also has governance, which we can call an "association" to distinguish it from a state.

The state government can play two different economic roles. **The first role is that of marketization: the legal recognition of the rules and rights of the market and their enforcement.** The fundamental ethical rules that markets adhere to were discussed in Chapter 1. Marketization involves the implementation of the following rules:

- 1) All acts and only those acts which coercively harm others are prohibited or penalized. Every individual has the natural and legal right to life, liberty, and property. This includes the right to create voluntary associations.
- 2) Contracts consist of voluntary agreements. If an agreement is violated, the victim may sue for damages.
- 3) People and enterprises that are not able to pay obligations may declare bankruptcy. This does not eliminate the debt, but provides for an orderly priority of payment and the ability of the debtor to preserve the minimal possessions required for life.
- 4) Property rights and boundaries are established and recorded. These include air rights and the division of the electro-magnetic spectrum into frequencies for radio, telephone, and television transmissions.
- 5) The possession of natural resource properties, including surface land, minerals, air rights, and pollution dumps, are subject to the payment of the rents and social costs involved in using these properties.

These fundamental market rules are best inscribed in a constitution. A constitution consists of the supreme rules of a community, such that all other laws and rules are based on the constitutional rules. The constitution sets the organization of the government, the rules that the members follow, and the rights that the members and visitors have. There is a branch of economics called "constitutional economics" which studies the different effects of having various constitutional rules.

**The second role that government plays is intervention.** In contrast to marketization, intervention is an interference into the market process, making the economy less efficient and violating rather than protecting rights. Whether policy is marketizing or interventionist depends on the incentives of public choice.

## 2. Public Choice

A private choice is a decision that only affects the person who does the choosing. When a decision affects others, the choice becomes public. In particular, when people vote or when government officials select policies, these are public choices. Political scientists have studied these decisions, but economists also have studied political choices. This has become a branch of economics called "public choice."

Two of the key issues in public choice involves voting by the citizens and the choices made by government officials. In the democracies we have today, citizens are confronted by candidates and parties seeking the votes of thousands and millions of people. These candidates are total strangers to most voters. As noted by Henry George (1883, p. 174), "a principle should always be kept in mind which we have largely ignored, that the people cannot manage details, nor intelligently choose more than a few officials." An individual voter not only does not know the character of the candidate, but also knows little about the candidate's past political record, how he or she voted on various issues and what kinds of interests have influenced the candidate. Most people are busy with their private lives and don't find it a high priority to invest much time in researching the background of a candidate, since one vote will normally make very little difference in the outcome.

Hence, most voters have what economists call "**rational ignorance,**" **a lack of knowledge about candidates and issues due to the lack of power make a difference in the outcome.** Also, many people are swayed by emotional appeals and the image and appearance of a candidate, how he or she appears on television.

As a result, candidates must project a positive image and appeal to the voters' emotions and ideologies. They get the most votes by appealing the majority views, not to fringe and minority interests. Given a one-dimensional range of views on a particular issues, such as spending a little, a moderate amount, or much on the military, the voter in the middle of the distribution is called the "median voter." Candidates will appeal to this voter, since appealing to the right or left of the median will lose more votes than it gains. **Thus, in a two-party system, the parties will tend to converge on the views of the median voters. Much of the advertising will then be to project an image of good character and to vilify the opponent.** The two-party system in the United States has become a duopoly, or dual monopoly, with laws in most states imposing burdensome signatory requirement for minor parties. With proportional representation, where people vote for parties and minority interests can be represented, the candidates are selected by the party leaders, leaving the voters to choose among parties offering packages of policies which they may not like entirely.

To appeal to thousands and millions of voters, candidates and parties need to spend great amounts of money, unless the law restricts it and provides for media access. The funds for campaigns comes from individuals, special interests, and the government.

**In large campaigns, the bulk of the funds come from special interests rather than individuals.** Unless a voter has a good deal of sympathy with a candidate, party, or issue, he will not tend to pay much attention to politics. The reason is that the benefits to an individual are small, compared to the cost in time and resources, unless he is keenly interested. In contrast, special interests, such as farmers, captains of industry, and religious organizations, receive concentrated benefits from government subsidies, protection, and privileges. They therefore have a strong incentive both to contribute to campaigns to gain influence, and then after the election to lobby for favorable legislation. **The public choices of legislators are therefore heavily influenced by special interests. Since candidate need funds and votes, they cater to special interests and the median voter. The interests of minorities without financial or voting clout will usually be ignored.**

**Non-elected government officials also make public choices.** As James Buchanan has noted, their choices are "cost-influencing" but not "cost influenced." This means that bureaucrats make rules that impose costs on others, but the officials themselves do not have any cost. The head of a government agency will normally seek to increase his power and authority and spend as much as possible.

**The result of these choices by government officials is that much government spending is geared to the desires of special interests and of officials rather than the goods that the public desires.** This is a main reason for government failure. The other major reason is the knowledge problem - that even with good intentions and incentives, a central government lacks the knowledge needed to plan for large economic activities.

Henry George analyzed the impact on public choice of the economic structure of society, of the effect of democracy when there is a great inequality in wealth.

Political equality is not sufficient to promote prosperity and avoid decline. "Equality of political rights will not compensate for the denial of the equal right to the bounty of nature" (1879, p. 545). If the equal right to vote co-exists with an increasing economic inequality, a large class of poor and a small land-owning elite, this "must ultimately beget either the despotism of organized tyranny or the worse despotism" of chaotic revolt (p. 530). The slaughter and wars in Rwanda, Cambodia, El Salvador, Bosnia, and elsewhere testify to the terrible consequences of the failure to establish a just economic and political order.

George recognized the important distinction between form and substance in government and economics: "forms are nothing when substance has gone, and the forms of popular government are those from which the substance of freedom may most easily go" (p. 530). Citizens may still vote, yet the vote can be empty as power passes "into the hands of jobbers who will buy and sell it" or "into the hands of demagogues who will seize and wield it" (p. 531).

**Democracy degenerates when there is a gross inequality of wealth, poisoning the national character.** "To give the suffrage to tramps, to paupers, to men to whom the chance to labor is a boon, to men who must beg, or steal, or starve, is to invoke destruction... To put political power in the hands of men embittered and degraded by poverty is ... to put out the eyes of Solomon and to twine his arms around the pillars of national life." Thus, "in a corrupt democracy the tendency is always to give power to the worst... the worst float to the top, ... transmuting races of freemen into races of slaves" (p. 532). "A corrupt government must finally corrupt the people, and when the people become corrupt there is no resurrection" (pp. 532-3).

George saw in his day what we recognize too well in ours, that it is in our great cities that is found "the greatest wealth and the deepest poverty. And it is here that popular government has most clearly broken down..." Here "are men of power, whose favor the ambitious must court and whose vengeance he must avoid" (p. 533).

### **3. Government structure**

The implications of public choice analysis are that

- 1) a precondition for a sound government is a sound economy, in which gross inequalities, due to the unequal ownership of land, are avoided,
- 2) the efficient provision of collective services is best left to the market process or, if that is not feasible, that government be structured so that the incentive to confer privileges is minimized,
- 3) governance and voting in small groups provides less opportunity for special interests than large groups.

The structure of government needs to be inscribed in a constitution, so that it is not easy to change by legislation. These constitutional restraints are of two types:

- 1) restraints on government activity;
- 2) the division of government power.

Restraints on government include a general rule that government shall not restrict peaceful and honest action. Government must also be prevented from imposing taxes and arbitrary costs. A further restraint is that government be voluntary. Secession from a government jurisdiction is allowed from services such as education and local public works, and from the authority of the government itself. People could then form alternative associations and deduct the cost of substitute services from their taxes or assessments to government.

A division of government power includes horizontal and vertical divisions.

- The **horizontal division** is the well-known separation of powers at some level of government, such as a federal government. **The usual division is into a legislature (parliament or congress), an executive (president, monarch, and/or prime minister), and a judicial branch, each with partial independence with an ability to affect the actions of the others. One possible fourth branch is an agency responsible for elections.**
- A **vertical division** of government power consists of **levels of government**, from local to federal. The United States has three levels: **federal, state, and tribal** for Native American Indians and aboriginal Alaskans. Cities and county governments are actually agents of the states, and only have powers granted to them by the states. Vertical division can be increased by allowing individuals to secede from any jurisdiction and create alternative governance. Many private communities are already providing services similar to those of government (see Foldvary, 1994). A strong vertical division can be created by basing power in neighborhood councils, which then elect higher-level government levels up to the top level in a bottom-up pyramid structure.

The benefit of vertical division is that governance becomes more of a market. With decentralized governance, people can more easily move and join communities with more efficient governance or with specialized services. Bad government becomes less likely if people can secede from it rather than have to engage in costly and unlikely reforms.

Another aspect of government structure is the method of public choice by the voters. As described above, when candidates must appeal to thousands of anonymous voters, there is a strong incentive for special interests to be influential. An alternative is bottom-up voting. A city or county is divided into townships and then into districts of about 500 persons. Each district elects a local council. Each council then elects a representative to the township board, representing about a dozen districts. The townships then elect delegates to a city or county council. These elect the members of the state legislature, which in turn elects members to the federal congress or parliament. At the bottom level, the districts are small enough for the voters to know the candidates personally, so there are no media campaigns and appeals to image. Special interests would find it difficult to sway the elections. Bottom-up democracy is an alternative to the top-down systems that have been an improvement over dictatorships but have let to the rule of special interests and a top-heavy government.

A free and prosperous economy requires governance with a marketizing rather than interventionist policy. The government needs to be carefully structured so that the incentive for government monopolies, privileges, and oppression is minimized. This is done with constitutional rules which restrain government intervention, provide for the collection of rents, and allow individuals to exit from jurisdictions when government becomes abusive.