PRIVATE AND POLITICAL MARKETS BOTH FAIL

A Cautionary Tale About Government Intervention

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Contents

David Friedman 5

Private and Political Markets Both Fail: A Cautionary Tale About Government Intervention – David Friedman 7

Questions 21

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PRIVATE AND POLITICAL MARKETS BOTH FAIL: A Cautionary Tale About Government Intervention

One problem in any technical field is that some technical terms sound like ordinary language, and people outside the field, familiar with their ordinary meaning, mistakenly assume they understand them. Consider all the people who think they really understand the theory of relativity – except for the details. “Everything is relative. That makes sense.” The term ‘market failure’ raises the same problem because it sounds as though it means the failure of markets. Market failure is a real phenomenon, a real problem in the organisation of human societies, but it has nothing in particular to do with markets – or at least, it has no more to do with markets than it has to do with governments, battles, families and much else.

My purpose is to explain what market failure means, why its existence is commonly employed as an argument for government regulation of markets, and finally why, while it is an argument against free markets, it is a stronger argument against the alternatives. As we will see, the problem described by ‘market failure’ occurs both in private markets and in the political and regulatory systems that are the usual alternatives to the private market, but is very much more common in the latter.

What is a market failure? A market failure is a situation where individual rationality does not lead to group rationality, where, if each person calculates correctly their own interest and acts accordingly, everybody will be worse off than if they had all acted in a different way. Consider the following simple example – involving neither a market nor a government.

It is about 800 years ago, somewhere in Europe, and I am one of a line of several thousand men with spears, on foot, facing north. The reason we are facing that way is that directly ahead is another bunch of men – on horseback with spears – heading south. It is clearly time for me to do a rapid cost-benefit calculation. If we all stand and hold our spears steady, with luck we can break their charge and only some of us will die. If we start running, their horses will run faster. So I should stand.

That is the wrong answer – and the mistake is the shift from ‘me’ to ‘we’. I do not control the men to left and right of me, I only control me. If everybody else stands and

I run, my running has little effect on whether the line breaks. If it does not, I get away unharmed. If it does, at least I will be ahead of everybody else. If, on the other hand, everybody else runs and I stand, I am dead; if I run I have at least a small chance of survival. So whether the rest of the men in the line are going to run or stand, I should run. Everybody in the line makes the same calculation. We all run and most of us die.

Welcome to the dark side of rationality.

There are, of course, a lot of other examples. The standard one in textbooks, other than mine, is a story called the 'prisoners' dilemma', which many of you are probably familiar with. Two men have been arrested and accused of jointly committing a crime. They are separately interrogated. The prosecutor tells each: "If you confess and your fellow criminal doesn't, I'll let you off lightly. If you both confess I'll let you off less lightly. But if he confesses and you don't I'm going to throw the book at you." It is easy to set up the situation in such a way that each criminal concludes correctly that he is better off confessing than not – because if the other criminal is not going to confess, not confessing might get them off, but confessing is sure to, and if the other criminal is going to confess, his best chance is to confess too.

An example that gets us closer to arguments for the modern regulatory state is the decision by somebody in London 120 years ago to burn coal in their fireplace. Burning coal in a fireplace contributes to the famous, and occasionally lethal, London fogs. But one fire's contribution to the fog is very small, and by burning coal they keep themselves and their family warm. You can easily set up the numbers so that if everybody chose to burn less coal and be colder, or to use some cleaner but more expensive fuel, they would all be better off, yet each person correctly believes that they are better off continuing with their present use of coal.

Sometimes, whether market failure exists depends on how you set up the game. Consider an old solution to the market failure I started with – an army running away. It is called 'burning your bridges behind you'. If the army knows there is nowhere to run, the least bad alternative may be to stand. There are many other examples of ways in which, in creating laws, in structuring firms, or just in running your own life, you can engineer around market failures – set up incentives designed to make individual rationality lead to group rationality. One of the reasons to understand market failure is in order to understand how to keep it from happening.

I have a riddle, which provides an example. Two Bedouins are riding their camels through the desert side by side. One of them starts complaining about how slow their camel is. The other Bedouin responds that theirs is slower still – the slowest camel in Arabia. They get into an argument, and finally make a bet on which camel is slower. The oasis is three miles off and the Bedouins agree that whoever's camel gets to the oasis last wins the bet.

If you think about it you can see what happens. One of the Bedouins goes slowly, the other goes more slowly because they do not want to lose the bet, the first one goes more slowly still. An hour later there are the two Bedouins sitting on their camels, stock still in the middle of the blazing hot desert, with the oasis still two miles off.

At this point, a wise man comes by and asks them why they are sitting stock still in the hot sun when the oasis is only two miles off. The Bedouins get off their camels to explain the situation to him. The wise man whispers two words to them – and the Bedouins leap back on the camels and race for the oasis as fast as they can. The riddle is: what are the two words?

The answer, of course, is "switch camels". The bet was which *camel* got there last, so if each is riding the other's camel they want it to go as fast as possible instead of as slowly as possible. That is my favourite example of how changing the details of the game, and so the incentives, can sometimes eliminate the problem of market failure.

Why does market failure have that name? Possibly because economists often offer it as a rebuttal to what is, for them, the obvious argument for free markets. Economists, if nobody else, believe in individual rationality. If you believe that individuals are rational it is tempting to conclude that if you only leave people alone to make their own decisions, they will do the right thing. That looks, at first glance, like a simple knock-down argument for a completely free market.

The existence of market failure shows that argument, in general, is not correct. In some circumstances, individual rationality does not lead to group rationality; we would all be better off if we did something other than what it is individually rational for each of us to do. So why not have the government impose group rationality, make us do what is in our joint interest? That too looks like a straightforward argument, and it is one that is often made, sometimes in the form of separate arguments for the different categories of market failure.

'Public goods' is the name of one such category – and another deceptive term. A public good does not, as one might assume, mean a good the government produces; there are a lot of public goods produced privately and a lot of private goods produced by governments. It means a good such that, if it is produced at all, the producer cannot control who gets it. That is the essential feature, not the only feature but the one I will focus on.

Our normal approach to producing goods is that the producer says to the consumer: "If you don't pay me for this good, you won't get it". The consumer, if they value the good at more than the money, pays, and that money is then available to cover the cost of producing the good. So private goods get produced if, and only if, their value to the consumer is at least as great as the cost of producing them.

In the case of a public good this does not work, because if you produce it at all, all the members of a pre-existing group of people will get it. An example would be a radio broadcast. Everybody within range of your transmitter can listen to it whether or not they have paid you.

That raises the problem of how to make sure that public goods, like private, get produced if, and only if, their value would be greater than their cost of production. It is not always an insoluble problem; radio broadcasts do, after all, get privately produced. But there is no way to be sure that it will always be solved on the private market.

Another kind of market failure is an externality, a cost or benefit that my action imposes on you. An example would be my earlier one of burning coal in London. Another would be my running away when the enemy attacks. That increases the chance that the men on my right and left will get killed, which is a cost for them, and their running away increases the chance that I will get killed.

There are ways in which people get around these problems – and not just in the Arabian desert. If my activity imposes costs on you, a solution is for one of us to buy the other out, combining the two activities in a single firm. That firm then bears all of the costs and receives all the benefits, so it is in its interest to maximise the net benefit. Part of the reason firms are created is in order to get under one roof all the people whose actions impose costs and benefits on each other in order to get them to take account of those costs and benefits in deciding what to do.

Similarly for public goods. Radio broadcasts are produced privately, despite the theoretical impossibility of doing so, and they are done that way because some very clever person thought up the idea of producing not one public good but two. One public good has a positive cost of production and a positive value to the consumer and is called a radio programme. The other good has a negative cost of production and a negative value to the consumer and is called an advertisement. Tie those two together and give away the package. As long as the sum is a positive value to the consumer and a negative cost to the producer, you are in business.

Similarly, many externality problems can be solved by private contract. A famous example in the literature concerns bees. An economist by the name of Meade, who later got a

Nobel Prize, offered as an example of the kind of externality that could not be handled by market mechanisms those associated with beekeeping. Bees browse on flowers, so a farmer whose crop produces nectar produces a positive externality for the beekeeper next door. In addition, some crops are more productive if pollinated by bees. So there are externalities in both directions: farmers sometimes produce external benefits for beekeepers and beekeepers sometimes produce external benefits for farmers. Because we are dealing in this instance with external benefits rather than external costs, the conclusion is that there will be too few crops suitable for bees to browse on and too few bees in places where they can pollinate crops.

Meade recognised that if only bees were people, private property would solve the problem. The farmers would tell them that if they wanted to come in and feed off their crops they would have to pay an entry fee. But how do you charge an entry fee to a bee?

Long after Meade made the argument, two economists at the University of Washington investigated the history of the beekeeping industry and discovered that contracts between beekeepers and farmers went back as far as we have data on the subject, something like 80 years before Meade said it could not be done. It turns out that although bees have no respect for property rights, they are lazy, and therefore browse on the closest crop they can find. At the time of the year when the bees benefited from the crops, the beekeepers paid the farmers for permission to put their hives in the farmers' fields. At the time of the year when the crops benefited from the bees, the farmers paid the beekeepers to put their hives in their fields. So that particular problem of market failure was solved by the market at least 80 years before it was discovered to be insoluble.

Although these examples suggest that market failures are often less intractable than they might seem, it does not follow that the problem does not exist. It is easy enough to imagine situations – I am sure real ones exist – where voluntary activity on the free market will fail to produce the right outcome because of problems of the sort that I have been discussing. That means that under a pure laissez faire system there will be some goods worth producing that are not produced and there will be some goods not worth producing that are produced. In that respect, the result of laissez faire is less satisfactory than the result of government regulation would be – if you had available perfectly wise and benevolent government regulators.

The problem with this as an argument against laissez faire is that the real-world alternative to the unregulated private market is not perfectly wise and benevolent government regulators. The alternative is the political market – a collection of people interacting under the rules of democratic politics, each, just as in the private market, trying to achieve their own objectives. When we consider that situation, we discover that market failure is not limited to private markets. Indeed, it is much more common in political markets. I will run through a few examples.

Consider first the question of why anybody would expect democracy to work. We start with the civics class model of democracy: politicians have to do good things because if they do not we will vote them out of office. The problem with that model is that, in order for it to work, the voters have to know both what politicians have done and what they should have done, and determining those two things turns out to be quite costly.

When I reach this point of the argument in class, I ask my students to raise their hand if they know the name of their congressional representative. Usually fewer than half do. I usually do not raise my hand either. It is hard to keep track of what your representative is doing if you do not know who they are. And, it is made harder by the fact that politicians practically never introduce Bills labelled 'a Bill to help farmers and hurt city folk'. Instead, they use what in other fields would be called misleading labelling to claim that whatever they are doing is good for everybody. It is costly – mostly in time – for the individual voter to figure out what is really going on and what part of it is the responsibility of a particular candidate they might vote for or against. That raises an obvious question: why would a rational person bear this cost? The answer is that a rational person would not bear this cost, because there is almost no benefit to doing so.

The benefit of being a well-informed voter is probably higher in New Zealand than in the United States, because it is a smaller country. In the United States, my estimate of the chance that my vote will determine the outcome of a presidential election is about one in five million. In New Zealand, the equivalent probability is likely to be higher, perhaps as high as one in 50,000 or one in 100,000. But it still takes a very large payoff to justify spending a lot of time and trouble in order to get an extra one chance in 100,000 of having the better rather than the worse person elected.

The result is what economists analysing the political market refer to as rational ignorance. It is rational to be ignorant when the value of the information is less than its cost. In the case of voters, the value of being well-informed is almost always less than its cost. The exceptions are people who benefit from being well-informed in other ways, people who like arguing politics, or find politics an entertaining game, or who are professional lobbyists in a position to have a significant effect on the particular political outcomes they care about.

Suppose the person standing for election is really good, someone good for the country as a whole, against someone who is not. By figuring out who is the good person and voting for them, I make it a little more likely that they will win and the country will be better off. I pay all of the cost of doing that and get (in the United States) about one in two hundred and eighty millionth of the benefit. Making myself an informed voter is producing a public good, which is why it mostly does not happen. The civics class model of democracy does not work, and the reason is market failure.

That is one example of a market failure in the political system. For an entirely different one, think about how you get people to engage in long-term planning. Consider the market for black walnut trees, which produce very pretty timber. Black walnuts are slow-growing trees. Suppose it takes 40 years to grow one. If I am 60, why would I plant black walnut trees, knowing that I am likely to be dead before they are harvested?

The answer is that when I am 70 I can sell my land with ten-year-old black walnut trees to somebody who is willing to wait a little longer. They can sell it in another ten years to someone else. That is why, in ordinary private markets, rational people make investments where the payoff is expected to take longer than they expect to live.

There is one critical assumption here: secure property rights. Suppose I believe that each year my black walnuts are growing there will be a significant chance that either the government will decide the trees are a national resource and expropriate them or some private entrepreneur will decide that the black walnuts are more valuable in their hands than in mine and come in the dead of night with a chainsaw and a truck and drive off with my trees. The higher that probability is, the greater the payoff has to be before it pays me to invest in black walnuts.

We sometimes have problems with insecure property rights in private markets. But that is nothing compared with the problem in the political world. President Clinton could rent out the White House but he could not sell it. A politician, when in office, has very real powers, very real political property. They can control what the government does to varying degrees. But they lose that as soon as they go out of power. That makes it rational for a politician to be short-sighted. The rational politician says to themself: "If I do something that is politically expensive today, which will produce vast benefits in 20 years time, I will bear all the political costs now and 20 years later some other politician will take credit for the benefits."

In political systems where politicians have insecure property rights in their political property, it is rational for them to make decisions on the basis of short-term effects only. And, when we move away from high-minded rhetoric about avoiding global warming 100 years from now and consider practical discussions of what matters in politics, we observe that the inflation or unemployment rate at the next election has a much greater weight than the inflation or the unemployment rate ten or 15 years down the road. That is another example of the way in which a form of market failure – in this case, short time horizons as a result of insecure property rights – undercuts the behaviour of the political market.

There are a variety of forms of market failure having to do with information problems that I have not discussed yet – those familiar with the literature will associate them with terms such as 'adverse selection'. They exist in the political market too.

Consider the regulation of medical drugs. Suppose I am the commissioner of the Federal Drug Administration (FDA), or the New Zealand equivalent, and a new drug is being submitted for approval. I know from past experience that there is a very small, but not zero, chance that it will have extremely bad side effects. If I permit the drug to be introduced and two years later there are photographs on the front pages of newspapers of babies with missing limbs, or some equivalent catastrophe, my career is over.

What if I play safe and postpone approval for another four years of testing? The result may well be that hundreds of people die who might have lived if the new drug were to have been released. However, none of those deaths would be front page news. They are only statistical deaths – excess mortality because of the cure rate being lower with the old drug than it would be with the new. You cannot photograph a statistical corpse.

As evidence of this problem, I like to cite the news release that the FDA put out almost 30 years ago in which it confessed to killing 100,000 people. Oddly enough, that is not the way it was put. The news release was about the FDA's approval of the use of beta-blockers to prevent second heart attacks. It estimated that the result would be to save 8,000–10,000 lives a year. It had been failing to approve this use, which was already common in other countries, for about ten years. That adds up to an excess mortality of 80,000–100,000 lives over the period, based on the FDA's own figures. For some reason that is not how it was described.

So that is another case of market failure in the political system. Because of informational problems, certain costs and benefits get weighted much more heavily than other costs and benefits. The result is to produce decisions that impose net costs but that prevent net benefits.

I will discuss one more general and rather interesting application of the public good problem to the political market. I attribute it to Nobel laureate Gary Becker, although he may not be the first person to have pointed it out.

Consider the market for legislation. The buyers are interest groups. Suppose I am the president of General Motors; my interest group is the automobile industry. I try to decide what I am willing to offer, in money or other things that politicians value, to congressmen in exchange for their vote in favour of high auto tariffs.

I do so knowing that I am facing a public good problem. The public, the set of people benefited by my lobbying, consists of the members of my interest group. If we get high auto tariffs they will not just be protecting General Motors cars, they will be protecting Ford and Chrysler too. If I spend my political resources lobbying for high auto tariffs, I am producing a public good for the auto industry.

Some of the benefit will go to the members of the United Auto Workers Union, to the mayor of Detroit and the governor of Michigan, because those are places where a lot of cars are made. They are all part of my public as well. So, while General Motors will do some lobbying – the auto tariff is worth a good deal to them even if we ignore the effect on other people who are helped by it – the public good problem means that they will do less than if they got all the benefit.

How about lobbying against the tariff? The cost of auto tariffs is borne most obviously by consumers of automobiles in the form of higher prices, less obviously by producers of export goods, because the less we import the less we export. If you think the auto industry had a public good problem raising money to support the tariff, just consider the public good problem faced by the people opposing it.

If we are willing to treat a firm or a union as a single actor for these purposes, the public who benefit from the auto tariffs consists of only about ten people: along with the auto companies and auto workers' union, there might be a governor, a mayor and a few senators and congressmen. The opponents of the tariff are more like a 100 million people. Getting ten people together to produce a public good on the basis of 'if you chip in, I'll chip in' is a whole lot easier than getting 100 million people together to produce a public good on the same basis. Even if they cannot get together, it is easier to get someone to pay for something when they get a tenth of the benefit than when they get one hundred millionth of the benefit. So the smaller the public, the more likely you are to get the good produced.

To put it differently, the smaller the public for a particular public good, the larger the fraction of the value of the good that can be raised to pay for it. In the limiting case where the public is one person, you have an ordinary private good and the consumer is willing to pay anything up to the value of the good to get it. Where the public is a hundred million people, on the other hand, even if the good, such as blocking an auto tariff, is worth a great deal to them, very little will be offered to buy it.

Suppose that auto tariffs favour the beneficiaries by $1 billion and hurt the losers by $2 billion. The beneficiaries raise, let us suppose, 20 percent of a billion dollars, so they offer $200 million to get the tariff. The victims, being a much more dispersed interest group facing a much more difficult public good problem, raise 1 percent of $2 billion, which is $20 million. The auto tariff sails through Congress with no difficulty, even though its net effect is to make the country a billion dollars worse off.

This suggests a simple pattern: political systems tend to redistribute from dispersed interest groups to concentrated interest groups. Farm policies around the world provide an example, again because of Gary Becker. The nations of the world can be divided into two groups. One consists of countries such as the United States and those of western Europe, where farmers are a very small fraction of the population and the purpose of farm policy is to make farmers rich at the expense of the rest of us. The other consists of countries like those in the third world where farmers are the bulk of the population and the purpose of farm policy is to hold down food prices, thus buying the support of the urban mob at the cost of the disorganised mass of poor peasants. It turns out that this simple picture, which is a prediction of the theory, describes the world pretty well.

Yesterday, I might have said that it describes the world perfectly, but I have now discovered that, sadly for economic theory, New Zealand is apparently the sole country in the world that does not fit this pattern. As I understand the situation, New Zealand ought to be subsidising its farmers at the expense of everybody else in order to buy farmers' votes. Yet I am told that the New Zealand farm industry is more or less private and unregulated. I will have to inform Gary Becker next time I see him that New Zealand, alas, is an experimental error. On the whole, however, Becker's analysis is quite a good predictor for outcomes on the political market.

Indeed, the predictions of public good theory for the political market fit the evidence better than those of the same theory for the ordinary private market. One of the clear predictions for the private market, after all, is that there are no privately produced radio broadcasts, since a radio broadcast is a pure public good provided to a large public.

Before I stop, let me point out that, politics aside, all of us face market failure problems of various sorts in many different contexts. If you are organising a firm, part of what you are trying to do is to minimise market failures within the firm, to create an incentive-compatible system where it is in the interests of the people in the firm to do the things that make the firm prosper.

The same is true in many other contexts. Consider the silent student problem. I am teaching a class and at one point I pause for a moment – something I do not do nearly often enough – and ask, "Did everybody follow that?". Nobody raises a hand and so I continue. Only when I grade the final exam do I discover that, in fact, nobody at all followed it.

You can see why this happens. The student who has not followed what I said and does not know whether others followed it or not is afraid they will look bad to their friends, perhaps even get a lower grade from me, if they tell me that they are totally lost. That is a cost, all of which goes to the student. The benefit from the student's telling me that they did not follow what I said is that I explain it again – a benefit shared equally with everybody else in the class.

I have a solution to this problem; it is a technological solution, although a rather low-tech one. You set up a classroom so that underneath everybody's foot is a button that can be unobtrusively pushed. At the back of the classroom is a sign that shows how many buttons are being pushed at the moment. When I come to the appropriate point in my lecture I say, "Now, would everybody who did not follow that last explanation please push your button". The number 2 lights up on the screen and I go back and explain it again. I have not implemented this solution, but I recently heard about other people who have used a more elaborate version.

Let me give another example that many of us have faced – all of us who live in households with two cooks. It is the question: "If I cook the dinner, who cleans up?" It might seem, on the basis of justice and how tired I am after cooking dinner, as though if I cook, you should clean up.

That is probably the wrong answer. The reason, which will be obvious to those people who actually cook dinners, is that the amount of cleaning up that has to be done is not an exogenous variable. The amount of cleaning up depends in large part on decisions you make when cooking dinner. Do you use the same pan for three things, or do you say, "I'm not going to clean up, let's get a fresh pan"? Do you take advantage of the two minutes while the water is coming to the boil to clean up from the previous stage by wiping gunk off the stove before it gets burned on? Because you have choices to make about how you cook the dinner that affect the cost of cleaning up, there is much to be said for the rule: "Whoever cooks cleans up the resulting mess". That is fair, too: we just take turns on who does both. And that way, whoever does the cooking has the proper incentive to minimise the mess.

A similar analysis applies to our interactions with children. On the face of it, making children clean up their own mess looks like a mistake, because, especially when they are young, they are likely to make a bigger mess in the process. The reason to do it anyway is that knowing that if they make a mess they will have to clean it up is a strong reason not to make a mess. In each of these cases, what you are doing is trying to structure your arrangements in ways that reduce rather than increase the problems of market failure – the real-world equivalent of switching camels.

To sum up, market failure is a general problem in human organisations. It is the problem that arises in situations where individual rationality fails to lead to group rationality. To some degree, it can be solved it by arranging life differently. To some degree you simply live with it. It is a problem that shows up in private and political markets, in households, in firms, on the battlefield and everywhere else.

The circumstances that lead to market failure are the rule in political markets and the exception in private markets. Most production in the private market involves private goods; when Apple decides to make a new computer that decision applies only to people who choose to buy that computer from Apple. Practically everything produced on the political market is a public good – the government is making one decision that applies to everybody affected. Because the circumstances that lead to market failure are exceptional in the private market and normal in the public market, the existence of market failure is an argument for the former and against the latter.

A final point is that, throughout this discussion, I have been following an approach that seems natural to economists nowadays but was somewhat heretical 30 or 40 years ago. I am not only assuming that consumers are rational, as economists have been doing for a long time, I am also assuming that voters and politicians are too. I am trying to apply the same assumption, rational action in one's own interest, to all of the alternatives, rather than thinking of rational action in your own self-interest as describing the marketplace and something else, perhaps disinterested benevolence, as applying to the political market.

I will end with one more example of a market failure. I have a very small collection of economics jokes, because what I mean by an economics joke is one that teaches economics. This is one of my favourites.

Jose had robbed a bank in Texas and fled south across the Rio Grande with the Texas Rangers in hot pursuit. They caught up with him in a town in Old Mexico, only to discover that Jose spoke no English and none of the pursuers spoke any Spanish. They drafted one of the locals – the school teacher – to act as a translator.

"Tell Jose that he must tell us where he has hidden the loot from the bank robbery."

"The gringos say to ask where you have hidden the loot."

"Tell the gringos I will never tell them."

"Jose says he will never tell you."

The Rangers pull out their six-guns, cock them, and point them at Jose.

"Tell Jose if he does not tell us where he has hidden the loot, we will kill him."

"The gringos say if you do not tell them where you have hidden the loot they will kill you."

Jose begins to tremble with fear.

"I buried it by the old oak tree on the other side of the bridge."

"Jose says he is not afraid to die."

Questions

The question of term limits is not an issue in New Zealand politics but it is in an American context. From what you suggest, time limits would actually reduce the incentive for politicians to work in the long-term interests of voters.

Yes, that is correct. I think term limits have both advantages and disadvantages. The advantage is that they add additional friction to the political market, which might reduce the amount that governments do. The disadvantage is that they give you an even shorter time horizon because a politician is now limited to a single term instead of having some hope that they can get a political benefit in the next term to balance political costs in this term. That is an argument against it.

I am only half joking when I say that hereditary monarchy is one solution to this problem. A king might decide that although he will have a less pleasant reign if he does things that are costly now but produce long-run benefits, his son will get the profit – rule a richer and more powerful kingdom. Parents care about their children, so that gives a king at least some incentive to engage in long-run planning.

Hereditary monarchy has certain problems as well, of course, but it does have that advantage. So does dictatorship, although with a somewhat shorter time horizon. I do not know how many of you read historical novels but there is a very good one by Mary Renault, who wrote about classical Greece, called *The Praise Singer*. One of the things the novel is about is tyranny.

'Tyranny', as the Greeks used the term, was not a pejorative term. A tyrant was essentially a popular dictator. Renault seems to have considered tyranny the best form of government – provided you have the right tyrant.

The book provides portraits of three different tyrannies. In one of them the tyrant is a man who is clearly in it for himself, but is also competent. In order for him to be rich and powerful and live the good life, the island he rules has to be safe and prosperous. He is corrupt and not a very attractive person, but when he dies the system collapses and everybody else is worse off.

The second example, Pisistratos, is a tyrant who is benevolent as well as competent. He is an old man. In Renault's version he was the younger lover of Solon, the Athenian lawgiver. As he explains to the protagonist, when Solon wrote the laws everyone agreed with all of them except for one thing. Everybody wanted the laws changed in some way to benefit themselves. Solon left Athens so that they could not make him change the laws. And, as Pisistratos says, "They kept the laws. They keep them still. I see to that, who could have given them laws they would have liked less." He is portrayed, in the novel, entirely positively – a good tyrant. But eventually he dies. His sons carry on for a little while, but they are not the men their father was. Eventually, they start to misuse their power and the whole thing falls apart.

So if you could only get the right tyrant, that would be another solution to the problem of getting governments to have a longer time horizon. But we do not have any good mechanisms for getting the right tyrants. That is one reason why I would prefer to reduce the power of government rather than to try to find a way of making it work.

You talked about market failure in the political market, referring mainly to the legislature and the executive. Do similar problems arise in the third branch of government – the judiciary?

That is a very interesting question. Yes, I think they do. As you may know, US Judge Posner, who is one of the leading people in my field – economic analysis of law – offered a conjecture many years ago that the common law tends to be economically efficient, that the rules of the common law are the rules that maximise the size of the pie. As far as I can tell, from 1973 when he published that conjecture to the present, he has never offered any adequate explanation of why it would happen that way.

Suppose you are a judge and you set a precedent that happens to be a bad one, an inefficient legal rule. Suppose the effect of that precedent is that in the next few years the gross national product of your country is 1 percent lower than it would otherwise have been. That is an enormous amount of damage for one human being to do; in the US context it involves costs in the many tens of billions of dollars. But you will never know you did all that damage, and there will never be any way in which you have to pay those tens of billions of dollars.

I have one real-world example of such a decision. There is a fairly important US case in which the court, as I read it, made an arithmetic mistake involving a factor of between ten and a hundred, an error that a smart high-school student would be ashamed to have made. The result of that case was to make it harder to get companies to produce vaccines. I do not think anybody is ever going to sue those judges for the damage they did.

So, as far as I can tell, the problem with the Posner thesis is that he has never offered a plausible reason why it would be in the interest of judges to make efficient law or how they would know how to make efficient law if they wanted to. Knowing whether the legal rule you are making is the right rule is not a trivial problem. Posner himself is one of the smartest people on the bench and he sometimes gets it wrong. He has offered evidence that the common law is efficient, although I find the evidence less persuasive than he does, but have no good explanation of why.

I think economists have done a good deal more thinking about the incentives of the executive and the legislature than about the judiciary, but the same kind of arguments ought to apply to the judicial branch as well.

Perhaps in the same vein as that last issue, do you have a preference for legislation over common law? What is your own view about the rival positions of these two sources of the law?

That depends on whether the legislator is making good law or bad. One of the things I do in my book *Law's Order* is examine the evidence for the efficiency of the common law. There are parts of the common law that seem to have got it right, but there are others that seem to have got it very strikingly wrong.

My favourite example is the question of the value of life. If you look at English tort law in the early nineteenth century, you find that it, in effect, assumes the value of life to be zero. If you tortiously kill me my claim dies with me, so you do not owe anybody anything. That was changed to some degree in the course of the nineteenth century, I think by statute, not by judges. The changes took the form of survivor statutes under which, if you tortiously kill me, you still do not owe any damages for what my life was worth to me, but you might owe damages for the value of my life to other people. My life may be valuable to other people, but it is also worth a lot to me, so that cannot be the economically right answer.

One of the historical legal systems I am fond of is the one of saga-period Iceland. It was a system where there was no criminal law, where, in effect, everything was tort. If you killed somebody their relatives sued you. In their system, tort claims were marketable property. Instead of my claim for damages for being killed dying with me, as it did under English common law, it was inherited by somebody else.

If you think about it, it would make a lot of sense to make tort claims transferable to private property in our society. For one thing, you could do away with class action suits, because if tort claims were marketable you could have people who bought up very large collections of small claims in order resell parts of them.

Suppose that, in the course of some other transaction, such as hiring someone or selling them insurance, I offer to buy from the other party all tort claims they have for amounts of less than a hundred dollars. I collect a lot of these. Now you, the entrepreneurial attorney, discover that millions of people have been injured by something, say asbestos. Instead of trying to start a class action case, you go to me and to other people who own large collections of potential claims and you say: "I want you to sort out just the asbestos cases and I'll buy all of them". Now the attorney is litigating for themself, because they own the claims they are trying to collect on, which eliminates the conflict of interest problem between attorney and 'clients' in the current class action system.

Making tort claims marketable solves other problems as well. Consider someone who has been injured in an automobile accident. If tort claims were transferable you would have law firms bidding for the claim. That would tell the injured person its real value. They could cash it out a week after they were injured and use the money to pay the doctor instead of having to litigate for however many years it takes. The closest we come to that now is having a law firm sue on behalf of the accident victim with a contingency fee – but the person has no way of knowing which firm will do best for them.

The Icelandic legal system was set up in the tenth century. I like to say that transferability of tort claims is one respect in which the tort system of the United States, and I assume of New Zealand, is only a thousand years behind the cutting edge of legal technology.

Because it is easier to solve the public good problem the smaller the public, doesn't that suggest that smaller states would end up with better government policies than larger ones?

Yes. The problem, of course, is that even New Zealand is much too big. I think it suggests that the ideal arrangement might be a world market and very small polities. A second reason why that is desirable is that the smaller the polity is the more easily you can vote with your feet. So, the closer you are to a situation where there are lots of small governments ruling fairly similar places, the greater the incentive for them to do a good job; if you do not like it here, you move there. That is how we currently provide hotel accommodation, after all – competition not democracy – and in my experience the average hotel is run a good deal better than the average state.

Of course, from the standpoint of the government it is the other way around – competition, the ability of people to vote with their feet, is a bug, not a positive feature. My first published article in economics was *An Economic Theory of the Size and Shape of Nations*. In that article, the rational actors were not the individual voters – there were not many democracies in 1000 AD – but the governments. The government, in my analysis, viewed the taxpayers essentially as cattle, a source of income.

The question I looked at was what pattern of national borders would arise if the governments were all trying to maximise their net revenues. One of my conclusions was that, as incomes rose, so that labour income became something you could tax, you would tend to shift to ethnically homogeneous nations as a way of raising the cost of migration. Because, if my country and your country are very similar, each a mixture of French and German speakers for example, if I raise taxes, people go to you, if you raise taxes they go to me. That will tend to force both of us to keep taxes down – we are competing for taxpayers.

We solve that problem by making a deal: I get all the German speakers and you get all the French speakers. No French speaker wants to live in a place where they do not speak French, so now France can raise its taxes as high as it likes and similarly for Germany. It did not happen in that tidy and explicit a fashion, but I have some empirical evidence showing that you get a shift towards ethnically homogeneous nations not only in the nineteenth century, which everybody knows about, but also after the Black Death, when the population dropped sharply, making rents fall and individual incomes rise.

As this example suggests, the question "what would you like to have happen?" and the question "what will happen?" are very different and sometimes have opposite answers.