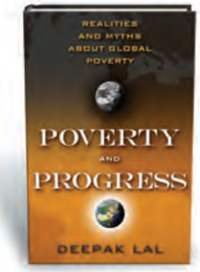
VERNON L. SMITH
Understanding the housing boom and bust
PAGE 5

JOHN MACKEY
In defense of conscious capitalism
PAGE 4



POVERTY & PROGRESS
The challenge of economic development
PAGE 13

Cato Policy Report

May/June 2013 — Vol. XXXV No. 3

The Public Choice Revolution in the Textbooks

BY JAMES GWARTNEY

The 1960s were an interesting time to begin the study of economics. Economics was becoming both more abstract and more mathematical. In macroeconomics, the Keynesian view was challenged by the monetarists, and this debate eventually elevated monetary policy to an equal billing with fiscal policy. The production function theory of Robert Solow was altering the thinking of economists about economic growth, and this analysis provided the foundation for modern growth theory. The theory of market failure was integrated into public finance, and it was widely perceived to provide a powerful justification for more activist government intervention. It was against this background that James Buchanan and Gordon Tullock authored *The Calculus of Consent* in 1962.

The Calculus of Consent focused on how political structures and collective decision-making rules influenced outcomes and the operation of the democratic political process. The book spawned a new body of literature that exerted an impact on a sizeable portion of the economics profession. In time the development of this literature became known as the "public choice revolution." The work of Buchanan and Tullock was central to this new school of thought, and in 1986 Buchanan was awarded the Nobel Prize in Economics primarily for his groundbreaking work in the development of public choice analysis.

In essence, public choice applies the tools of economics to both the market and political processes. Without having knowledge about the operation of both, one is in a poor position to understand how alternative institutions and policies will affect outcomes. I fully expected the public choice approach to transform economic analysis and greatly expand its relevance.

Upon discovering that the topic was totally absent from the available economic principles texts, I undertook to write my own book,

Continued on page 6

JAMES D. GWARTNEY *holds the Gus A. Stavros Eminent Scholar Chair at Florida State University and is an adjunct scholar at the Cato Institute. His books include* Economics: Private and Public Choice, Common Sense Economics: What Everyone Should Know About Wealth and Prosperity, *and the annual report,* Economic Freedom of the World. *A longer version of this article appears in* Public Choice, Past and Present, *edited by Dwight R. Lee. It is reprinted by permission of Springer.*

"I start my new life with you here today," VÁCLAV KLAUS, former president of the Czech Republic, said at a Cato Policy Forum in the F. A. Hayek Auditorium. Klaus joined the Institute as a Distinguished Senior Fellow after concluding his presidential term on March 7.

Continued from page 1

Economics: Private and Public Choice, which used the tools of economics to analyze the operation of the market and political process in a symmetric manner. The following passage from the preface of the first edition (1976) highlights this point and contrasts the approach with that of other texts:

> Most textbooks currently do three things. They tell students how an ideal market economy would work, why real world markets differ from the hypothetical ideal, and how ideal public policy could correct the failures of the market. In addition to these three basic areas of study, this book analyzes what real world public policy is likely to do. . . . Students are often puzzled by the gulf between the ideal theoretical "solutions" of economists and the events of the real world. The economics of public choice explains this gulf. Economic tools can illustrate why "good politics" sometimes conflicts with "good economics" (that is, economic efficiency). It is important that we explain what government can do to promote a more efficient use of our resources. But the tools of economics permit us to do more. They permit us to explain why there is good reason to expect that public sector actions will be counterproductive for certain classes of issues.

PUBLIC CHOICE, MAINSTREAM ECONOMICS, AND ELITE SCHOOLS

Even though *Economics: Private and Public Choice* has been successful—it is now in its 14th edition—I am nonetheless disappointed that public choice has exerted so little impact on mainstream economics. Rather than analyzing how both markets and collective decisionmaking handle economic problems, mainstream economics continues to model government as if it were an omniscient, benevolent social planner available to impose ideal solutions. The highly successful text of Greg Mankiw illustrates this point. Mankiw introduces his discussion of the role of government and the correction of market deficiencies in the following manner:

> "Students are often puzzled by the gulf between the ideal theoretical 'solutions' of economists and the events of the real world. The economics of public choice explains this gulf."

> To evaluate market outcomes, we introduce into our analysis a new, hypothetical character called the benevolent social planner. The benevolent social planner is an all-knowing, all-powerful, well-intentioned dictator. The planner wants to maximize the economic well-being of everyone in society.

Mankiw then asks what the benevolent social planner should do and goes on to consider the ideal solutions that might be imposed through the political process. The other leading mainstream texts follow this same approach. Implicitly, this methodology treats the political process as if it is a corrective device available to impose ideal social outcomes, something like a pinch hitter that always delivers the game-winning hit. But this is a fantasy. A choice between the real world of markets and the hypothetical ideal of government intervention is not an option. The relevant choice is always between the real-world operation of markets and the real-world operation of the political process.

As the public choice revolution developed, other authors also sought to integrate the analysis of political decisionmaking and the comparative approach into principles courses. After Buchanan won the Nobel Prize in 1986, I expected that public choice and the systematic analysis of political decisionmaking would be incorporated into other texts much like, for example, monetarism and rational expectations were integrated into principles texts during the 1970s and 1980s. But, this happened only to a modest degree. Clearly, the public choice revolution is incomplete; it has not altered what is taught in the typical principles course.

The exclusion of public choice analysis is particularly strong at elite schools like those of the Ivy League and the University of California, Berkeley. Buchanan is exceptional among American Nobel prize-winners in that he has never held a teaching or research appointment at an elite school.

The underrepresentation of elite schools among public choice economists is readily observable at the annual meeting of the Public Choice Society, the professional organization of public choice scholars. For example, 296 public choice scholars presented papers at the March 2012 international meeting of the Public Choice Society held in Miami. Only 5 of the presenters were from either an Ivy League school or the University of California, Berkeley. Among the 5, only 1 was a faculty member with an appointment in an economics department.

Underrepresentation of public choice in the economics departments of elite schools has been a major deterrent to the dissemination of the analysis. These departments supply a substantial share of the new faculty members at other departments throughout the nation. They also command prestige, and faculty at other schools often follow their lead. Thus, it is quite difficult for a new theory or methodology to exert widespread impact without attracting support from the top tier of schools.

WHY DOES PUBLIC CHOICE MATTER?

Why does the exclusion of public choice analysis from mainstream economics make any difference? The asymmetric treatment of the political process relative to markets diminishes the relevance of economics and leaves students with a romantic, and highly misleading, view of government and the operation of the democratic political process. There are three major reasons why this is the case.

1. *The omission of public choice from mainstream economics creates a central planning mentality.* For the mainstream economist, economics is about deriving ideal solutions under restrictive assumptions. Essential information such as consumer preferences, costs of production, rate of return for alter-

native investments, and size of spillover effects, are generally assumed to be known. For the proponents of this approach, economic analysis involves the derivation of "optimal" levels of taxation, subsidies, distribution of income, budget deficits, government spending, and dozens of other key variables within models containing known information. In this fantasy world, economics is about deriving ideal solutions to multi-equation mathematical models. This approach makes economics look highly sophisticated and its practitioners appear to be engineering geniuses. No doubt, the sophistication of such models is a contributing factor to their popularity at elite schools.

But, there are numerous problems with this approach. The information incorporated into the models is generally unavailable to any central authority. The supposed "ideal" solutions often alter incentives and generate secondary effects that undermine the validity of the models. Most importantly, as public choice analysis reveals, the real world political decisionmakers will be more interested in votes and winning the next election than the adoption of supposed ideal solutions. As a result, there will often be a conflict between "good politics" and economic efficiency.

The bottom line is straightforward: the real world is dynamic and more complicated than the models, and therefore the potential of centralized government planning is far more limited than mainstream analysis implies. Moreover, even when the models are largely correct, the political incentive structure will often undermine the adoption of productive policies. Real world political decisionmakers are neither saints nor benevolent omniscient social planners. Instead, they are motivated primarily by the winning of the next election, and when pursuit of this goal conflicts with idealized efficiency, the former will dominate the latter. Nonetheless, mainstream economics continues to ignore public choice analysis, and therefore it leaves students with a false impression about the political process and its potential to promote the efficient use of resources.

2. *The democratic political process is shortsighted and, if unconstrained, will lead to excessive debt.* As public choice analysis indicates, there will be a strong incentive for political officials to favor policies that generate highly visible current benefits at the expense of costs that are less visible and observable mostly in the future. This incentive structure explains why politicians will find debt financing and unfunded promises highly attractive. Policies of this type will make it possible for them to provide voters with visible benefits that will enhance their chances of winning the next election, while concealing the cost and pushing its most observable components into the future.

> "Real world political decision-makers are neither saints nor omniscient social planners. They are motivated primarily by winning the next election."

As the dominance of Keynesian economics undermined the balanced budget paradigm during the 1960s and 1970s, James Buchanan and Richard Wagner used the tools of public choice to explain in *Democracy and Deficit* that this approach would lead to perpetual budget deficits. While politicians have a strong incentive to spend money providing "goodies" to voters, they will be reluctant to levy taxes because this imposes a more visible cost. Borrowing provides politicians with an alternative: it allows them to spend now, and push the visible taxes into the future. This is also the case with unfunded promises of future benefits like those of Social Security and Medicare. Like borrowing, unfunded promises of future benefits make it possible for politicians to take credit for the promised benefits now without having to levy the equivalent current taxes.

The historical record is consistent with the Buchanan-Wagner view. During the past 52 years, the federal government of the United States has run 47 budget deficits. During fiscal years 2009 through 2012, nearly 40 percent of federal expenditures were financed by borrowing. The federal debt has grown to levels not seen since World War II. Unless the incentive structure is changed—for example, by requiring a two-thirds or three-fourths majority to approve spending measures or additional borrowing—the experience of Greece indicates that politicians are unlikely to bring spending under control until the situation reaches crisis proportions.

Currently, budget deficits are pushing government debt to dangerously high levels in several countries. Public choice analysis explains why this is happening and what might be done about it. In contrast, because it ignores the shortsighted nature of the unconstrained political process, mainstream economics sheds little or no light on the forces underlying budget deficits, growth of government debt, and the presence of unsustainable transfer programs. Hence, the omission of public choice from the mainstream perspective renders it largely irrelevant for the understanding of the major economic issues confronting countries throughout the world.

3. *Like markets, unconstrained political democracy has deficiencies. The special interest effect and rent-seeking are particularly important sources of political inefficiency.* Political officials have a strong incentive to deliver concentrated benefits to well-organized interest groups at the expense of the vast majority of voters. Typical voters have little incentive to invest the time and effort necessary to inform themselves on many issues because they recognize that their vote will not be decisive. In contrast, organized interest groups often feel strongly about policies that serve their interests and are therefore willing to provide supportive politicians with campaign contributions and other political resources. As a result, elected political officials have a strong incentive to support the position of special interests, acquire political resources from them, and then use the resources to solicit the support of the largely uninformed electorate. This will be the case even if the programs favored by the special interests are counterproductive. The empirical evidence is highly consistent with this analysis.

Tariffs, quotas, business and agricultural subsidies, ethanol mandates, targeted tax breaks, and bailouts of specific industries and highly unionized firms are largely a reflection of the special interest effect.

Favoritism provides politicians with something they can trade for political support. In turn, businesses and other interest groups will seek to obtain more government favoritism via lobbying, campaign contributions and other forms of schmoozing political decisionmakers. Economists use the term "rent-seeking" to describe such actions designed to secure the windfall gains and above normal profits generated by government favoritism. Rent-seeking is a natural outgrowth of government activism. When the government is heavily involved in the granting of contracts, subsidies, tax credits, low-interest loans, regulatory favors, and other forms of government intervention, business firms, labor organizations, and other well-organized interests will compete for the government favors. The result will be a shift of resources away from productive activities and into rent-seeking. Economic inefficiency will increase and growth and prosperity will slow. Rather than the ideal outcomes of the naïve mainstream models, rent-seeking, crony capitalism, and political corruption will emerge.

IMPLICATIONS OF THE IMBALANCED MAINSTREAM VIEW

The tools of economics enhance our understanding of both the market and political processes. They indicate that both have various types of shortcomings— that there is both market failure and government failure. Most mainstream principles courses cover market failure in the form of economic instability, monopoly, externalities, and public goods. Potential ideal solutions to market failures are also provided. But coverage of government failure is absent. Government failures resulting from the shortsightedness effect, the special interest effect, and rent-seeking are ignored. Instead, government action is treated as a corrective device. The real world of markets is always compared with idealized government action. In the world of mainstream economics, market failure is a likely possibility, but there is no such thing as government failure. This asymmetric and imbalanced coverage leaves students with an unrealistic view of how the political process works and the potential of government activism to allocate resources efficiently.

> "Because of its omission of public choice, mainstream economics misses the fundamental causal forces underlying our current problems."

The imbalance of the mainstream approach also deters understanding of the current economic situation. Economics provides considerable insight on the structure of the institutional and policy environment consistent with growth and prosperity. Stable and predictable policies, rule of law, and economic freedom establish the foundation for gains from trade, private investment, and innovation, which are the key sources of the growth process. In contrast, persistent policy changes, temporary tax-and-spending policies, and discretionary regulatory action generate uncertainty and play into the hands of the rent-seeking special interests. Public choice analysis highlights both of these points. However, because of its omission of public choice, mainstream economics misses the fundamental causal forces underlying the excessive debt, constant policy changes, and crony capitalism that are undermining prosperity throughout the world.

CONCLUSION

The public choice revolution is incomplete. It has exerted an impact on a segment of the economics profession and provided insight about how the political process works. It explains the forces underlying today's major economic issues: budget deficits, unsustainable growth of government debt, unfunded pension and transfer programs, political favoritism and inefficient special interest spending, and movement of resources away from productive activities into rent-seeking. It also provides insight concerning structural changes that would help address these problems. In contrast, mainstream economics provides neither understanding nor direction concerning how to avoid the troubled waters ahead. As a result, the mainstream approach is leaving both current students and the general public with a misleading, false, and romantic view of government and the operation of the democratic political process.

Public choice analysis and the work of scholars like Buchanan and Tullock are just as relevant today as they were four decades ago. Hopefully, a new generation of economists will grasp this point and complete the public choice revolution. There are a couple of reasons for cautious optimism. First, a set of 20 Voluntary National Content Standards for Economics has been developed by the Council for Economic Education, the National Association of Economic Educators, and the Committee on Economic Education of the American Economic Association. These standards are designed to reflect the current status of scholarship in the discipline, covering the role of property rights, entrepreneurship, and dynamic competition—topics that often receive little attention in principles courses. More important from a public choice perspective, the standards cover market failure, as well as government failure and special interest politics. This indicates that when economists think seriously about the content of a balanced course in modern principles of economics, they recognize that sound analysis requires examination of the operation of both markets and the political process.

Second, there has been a virtual explosion of literature that is now referred to as the new institutional economics during the past two decades. In contrast with the derivation of optimal conditions under restrictive assumptions that characterizes so much of modern economics, the new institutional approach focuses on comparative analysis. Building on the work of Nobel laureates Friedrich Hayek and Douglass North, the methodology of the new institutional economics examines how alternative forms of economic,

Continued on page 12

A new history of the Supreme Court's monetary decisions

The Devolution of the Dollar

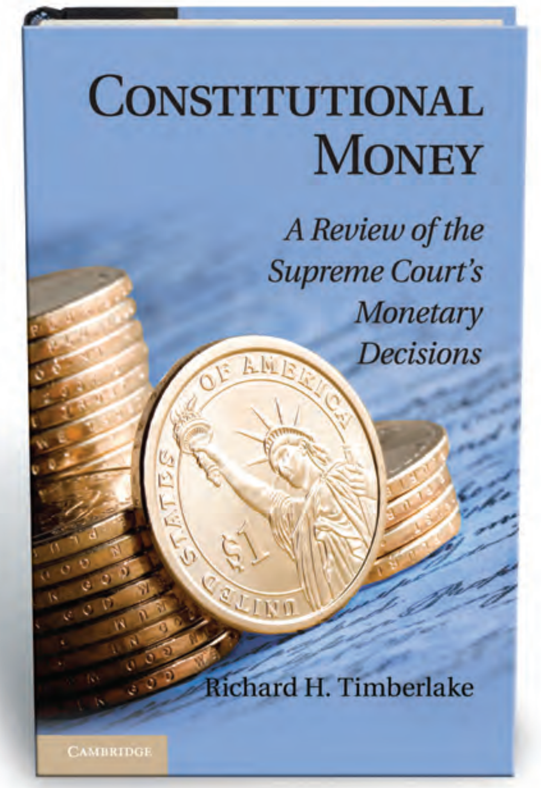
For more than 100 years, from roughly 1800 to 1912, the purchasing power value of the dollar under the gold-and-silver standard was essentially constant. With the creation of the Federal Reserve and its discretionary policies of the last century, however, the dollar's value has declined by more than 95 percent.

"That comparison is difficult to ignore," leading economic historian Richard H. Timberlake writes. In fact, "it amounts to a 50 percent decline in the value of the money-unit every generation." In his new book, *Constitutional Money: A Review of the Supreme Court's Monetary Decisions* (Cambridge University Press, 2013), Timberlake, emeritus professor of economics at the University of Georgia and an adjunct scholar of the Cato Institute, delves into the legal and historical events that underpin today's monetary framework.

Timberlake organizes his analysis around the nine Supreme Court cases that markedly affected the U.S. monetary system, focusing not only on the Court's evolving interpretations of the Constitution, but also on the operations of both the gold standard and the Fed. By grounding these court cases within the context of the government's monetary policies over time, he is able to explain how the Federal Reserve System "has interacted with the later Court decisions to undermine the Framer's monetary constitution." In doing so, he illustrates why this system has promoted continuous inflation and ongoing public uncertainty about the future value of money.

"Prior to the Civil War," Timberlake writes, "no one ever imagined that anything other than gold or silver could be constitutional money. The precious metals were the limited dietary nutrients of the monetary system." Through a series of misguided decisions, the Supreme Court paved the way for fiat money to displace gold—and for central banks to undermine market-based monetary arrangements. The rest, as they say, is history.

"Federal Reserve policies in the twenty-first century have exhibited the complete power over the monetary system that the decisions of the tragically mis-argued legal tender cases sanctioned," he writes. In fact, the system now in place operates without any effective congressional oversight or control. With no exclusive rule to promote price level stability, the Fed's monetary omnipotence is guided by little more than a vague "smorgasbord" of policy goals, according to Timberlake—"in spite of the fact that it cannot produce a toothpick."



The answer to the current regime, he suggests, is to counter the all-powerful banks of the present day with a rules-based system that limits human discretion. This would allow for a framework, Timberlake notes, that "would feature thousands of people and hundreds of institutions spontaneously making millions of decisions for its operation in an unbounded system of markets."

The constraints that accompany a gold standard, for instance, would radiate out into many areas of public policy. They would discourage wars. They would confine fiscal extravagance. "Most to the point," Timberlake writes, they would "provide a constrained—and thus constitutional—monetary system." However, Timberlake is careful to note that a transition forward requires genuine resolve.

"For its re-vitalization, a gold standard must have a serious consensus, a general commitment to its discipline, a public *ethos*, and a practical program for its workings," he concludes. *Constitutional Money* marks an important step toward realizing those preconditions. ■

Continued from page 8

political, and legal institutions impact the performance of economies. This literature and its methodology are penetrating the elite schools and journals to a greater extent than has been the case for public choice analysis, paving the way for greater integration of public choice into mainstream economics.

Economic analysis is equally applicable to market and political decisionmaking. It indicates that there is both market failure and government failure. It is long past time that this realism be incorporated into mainstream economics. George Stigler once remarked that a person who considers only market failure is like the judge of a singing contest who immediately declares the second contestant the winner after hearing the performance of the first. This is precisely what happens when mainstream economics treats government as a corrective device and continues to exclude public choice analysis. It is time for the profession to consider the second singer. ■