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TESTIMONY

WHY GOVERNMENT INSTITUTIONS FAIL TO DELIVER ON THEIR PROMISES: THE PUBLIC CHOICE EXPLANATION

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House Oversight and Government Reform Committee

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Chairman Issa, Ranking Member Cummings, thank you for the opportunity to testify today regarding the limitations of government intervention.

Despite Washington's recent focus on the disastrous Affordable Care Act website rollout, policymakers are missing what the rollout glitches symbolize: the fundamental flaws that imbue government intervention.

The work of public choice economists such as Nobel laureate James Buchanan, Gordon Tullock, Mancur Olson, and William Niskanen has shown that, despite good intentions and lavish use of taxpayer resources, government solutions are not only unlikely to solve most of our problems—they often make problems worse.

PUBLIC CHOICE ECONOMICS: POLITICS WITHOUT ROMANCE

Congress spends a great deal of time discussing the need to address market failures such as monopolies and pollution. However, even when such a problem *does* exist, the policies implemented to address it are often ineffective or undesirable.¹ That's because, as public choice economists have pointed out, while there may be market failures, there are also government failures. In his Nobel Prize acceptance speech, popularized in his famous essay "Public Choice: Politics without Romance," James Buchanan explains why looking to government for solutions often results in more harm than good.²

Public choice theory applies economic analysis—or the study of how incentives influence behavior—to politics. For instance, economists assume that people interacting in the marketplace are mostly driven by self-interest. That doesn't mean that people aren't concerned about others, or can't act charitably. It simply means that their dominant motive—whether they are employers, employees, or consumers—is a concern for themselves. Public choice economists make the same assumption about government actors. As Jane S. Shaw writes in a primer about public choice economics, "although people acting in the political marketplace have some concern for others, their main motive, whether they are voters, politicians, lobbyists, or bureaucrats, is self-interest."³

1. Kenneth Arrow mathematically demonstrated how political consensus is generated through rule manipulation rather than careful consideration of the issues or constituent needs. See Kenneth Arrow, *Social Choice and Individual Values* (New Haven, CT: Yale University Press, 1951).

2. James M. Buchanan, "Public Choice: Politics without Romance," *Policy Magazine* 19, no. 3 (Centre for Independent Studies, Spring 2003), <http://www.cis.org.au/images/stories/policy-magazine/2003-spring/2003-19-3-james-m-buchanan.pdf>.

3. Jane S. Shaw, "Public Choice Theory," *The Concise Encyclopedia of Economics* (Library of Economics and Liberty, 1993), <http://www.econlib.org/library/Enc1/PublicChoiceTheory.html>.

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In other words, unlike many economists before them, public choice economists revolutionized the field of economics by having symmetric assumptions about humans in public and private settings and replacing “romantic and illusory notions about the workings of governments” with more realistic ones.

GOVERNMENT INCENTIVES

In the marketplace, scarcity guarantees that people compete for resources. In that environment, the price system and the risk of losses, combined with the prospect of potential profit, are powerful signals that guide people's decisions to prudently buy, sell, invest, and save.

But unlike in the marketplace, the incentives for good management in government are very weak. For instance, even though lawmakers are expected to pursue the “public interest,” they make decisions that use other people's money rather than their own. This means that their exposure to the risk of a bad decision is fairly limited, and there is little to no reward for spending taxpayers' money wisely or providing a service effectively or efficiently.

Furthermore, because each voter bears a very small part of the cost of these bad decisions, and they have their daily lives to manage, voters lack the incentives to sufficiently monitor the government.⁴ And, as Shaw explains, voter ignorance can be quite rational:

Even though the result of an election may be very important, an individual's vote rarely decides an election. Thus, the direct impact of casting a well-informed vote is almost nil; the voter has virtually no chance to determine the outcome of the election. So spending time following the issues is not personally worthwhile for the voter. Evidence for this claim is found in the fact that public opinion polls consistently find that less than half of all voting-age Americans can name their own congressional representative.

That is not, of course, the case in the private sector. Consumers have great incentives to make sure the car or the house they buy is worth the price they will pay for it. Employers also have great incentives to make sure they hire the best employees, as there is a high and direct cost for employing someone who can't perform the job he or she is hired for.

Yet lawmakers—however well-intentioned—face serious difficulties in making the right decision. Many factors come into play, but it is worth highlighting the following two. First, the government does not have better information than private agents operating in the market, whether this be the health care market or any other market (financial, housing, etc.).⁵ Making matters worse, government decision-makers are usually insulated from market signals, and thus often lack important information about the problem at hand and the market itself.

Second, the resources government provides are often so enticing that companies may switch their focus from meeting the needs of customers to meeting the wishes of government officials—thus producing a less effective outcome.⁶ These effects lead to the malinvestment of taxpayers' money and often of private capital as well.

THE UNHEALTHY MARRIAGE BETWEEN GOVERNMENT AND INTEREST GROUPS

Economists Mancur Olson,⁷ Gordon Tullock,⁸ and others have also shown that government agents receive more benefits when they act on behalf of special interests (often under the guise of working on behalf of the public good).

4. One of the first public choice economists to point this out is Anthony Downs in *An Economic Theory of Democracy*. A modern exposition of this “rational irrationality” was produced by Bryan Caplan in his *Myth of the Rational Voter*. Anthony Downs, *An Economic Theory of Democracy* (New York: Harper and Row, 1957); Bryan Caplan, *The Myth of the Rational Voter: Why Democracies Choose Bad Policies* (Princeton, NJ: Princeton University Press, 2008).

5. F. A. Hayek, “The Use of Knowledge in Society,” *American Economic Review* 25, no. 4 (1945): 519–30.

6. William Niskanen, “Bureaucrats and Politicians,” *Journal of Law and Economics* 18, no. 3 (1975): 617–43.

7. Mancur Olson, *The Logic of Collective Action* (Cambridge, MA: Harvard University Press, 1971).

8. Gordon Tullock, “Rent Seeking,” *New Palgrave Dictionary of Economics*, ed. Steven N. Durlauf and Lawrence E. Blume (Palgrave Macmillan, 2008).

In politics, decisions aren't driven by the profit motive as they are in the marketplace. Instead, they are for the most part driven by the desire to get reelected. One important element in the pursuit of power is the role played by interest groups. First, as I mentioned before, lawmakers face little to no cost for conferring benefits on interest groups, even when it imposes large costs on the majority. In addition, interest groups can provide electoral support (through their votes) and funding for electoral campaigns (through donations), which may be key to winning an election. With so much government money up for grabs, interest groups also have a strong incentive to organize and lobby the government for a piece of the public pie.

Combined with the weak incentives for lawmakers to be good stewards of taxpayers' money, strong incentives to cater to interest groups can explain why government program mechanisms tend to be organized around picking winners and losers instead of rewarding success or punishing failure in the same way as the market.

This behavior explains why Congress continues to vote for sugar tariffs that increase the price of sugar and the profits of US sugar producers at the expense of consumers. It also explains the existence of corn-based ethanol subsidies, which create an artificial market that diverts the grain away from being used for food and toward the subsidized market, and has been widely blamed for increases in global food prices—and seems to make the environment even worse.

In the case of the Affordable Care Act, public choice explains why the program was designed to expand health care insurance coverage rather than to improve health outcomes—a choice that benefits the insurance industry without necessarily producing a better and more affordable health care supply—and how the companies that are well connected usually stand to benefit the most from government interventions.

It also explains why this health care law, like Medicare and Medicare Part D, is yet another law that concentrates benefits on older Americans (who are relatively richer than the rest of the population and more active voters)⁹ at the expense of young and healthy ones (who are often relatively poorer and aren't as active voters).¹⁰

REGULATORY CAPTURE

Public choice economists have also explored the role that bureaucrats play in this cycle of bad decision-making. Economists know how potent this type of lobbying can be. In his seminal 1971 article, "The Theory of Economic Regulation," Nobel laureate George Stigler introduced so-called capture theory.¹¹ Stigler argued that regulatory agencies are subject to pressure from both interest groups and the electorate at large. But, because interest groups are better able to organize and promote their interests, they hold greater power over what regulations are implemented.

A corollary to regulatory capture is the revolving door phenomenon, where agencies hire from firms they oversee, because, as Stigler also pointed out, regulation requires in-depth industry knowledge. Consider the former secretary of the Treasury, Henry Paulson. The former chairman and chief executive officer of Goldman Sachs played an important role in shaping and directing the government rescue of the financial industry, including Goldman.

GOVERNMENT INSTITUTIONS ARE INHERENTLY PRONE TO BAD DECISION-MAKING, OFTEN INDEPENDENTLY OF WHO IS IN POWER

The problem with the Affordable Care Act rollout is far greater than the website glitches or the fact that millions of Americans cannot—as had been promised—keep their current health insurance policies. Rather, it's

9. According to the combined data on population trends, economics, and health issues from 15 federal agencies, Americans over the age of 65 are in remarkably good shape compared to those of previous generations. Their average net worth has increased almost 80 percent over the past 20 years; they form a larger share of the high-income group and a smaller share in lower-income groups than their predecessors; they are far better educated, and they live longer and healthier lives. They are also doing much better than younger Americans. If anything, the recent financial crisis has only made the gap between older and younger generations wider. Federal Interagency Forum on Aging-Related Statistics, *Older Americans 2008: Key Indicators of Well-Being* (Washington, DC: US Government Printing Office, March 2008), http://www.aoa.gov/agingstatsdotnet/Main_Site/Data/2008_Documents/OA_2008.pdf.

10. US Census Bureau, table 399, "Voting-Age Population—Reported Registration and Voting by Selected Characteristics: 1996 to 2010," from *Statistical Abstract of the United States: 2012*, <http://www.census.gov/compendia/statab/2012/tables/12s0399.pdf>.

11. George Stigler, "The Theory of Economic Regulation," *The Bell Journal of Economics and Management Science* 2, no. 1 (1971): 3–21.

that government institutions themselves are inherently prone to low-quality decision-making, with a strong incentive to choose the interest of politically favored groups.

Being willing to acknowledge that government intervention often fails is important, but understanding why it fails is far more important for designing better policies. That often means that the government should abstain from intervening altogether. As my colleague Matt Mitchell explains,

James Buchanan, Gordon Tullock, and the other founders of Public Choice and its close cousin, Constitutional Political Economy, didn't stop their analysis after they found that politicians sometimes behave badly.

Like James Madison before them, they thought of constructive ways to make political actors behave better, sometimes by placing certain decisions beyond their reach.¹²

When the government fails to deliver on the promises it made, many are tempted to argue that if only more money had been spent or if only someone else had been in charge, the promise could have been met. That's unlikely, mostly because the institutions of government themselves are inherently incapable of performing certain tasks well even when the people in power are smart, compassionate, and well-intentioned.¹³

For instance, a massive takeover of the health care market was bound to fail from the start, regardless of who was in charge or how much money the program had been given. It also explains why so many government policies not only fail to fix the problems they confront—the solutions are often worse than the problems. It doesn't mean, of course, that those who hold power don't have some influence on the outcome; it's just that it often isn't the most important factor.

CASE STUDY: THE DEPARTMENT OF ENERGY'S 1705 LOAN PROGRAMS

With that in mind, government officials should understand that the problems with the healthcare.gov rollout are not unique to this particular law. In fact, we can expect these types of negative consequences when the government intervenes in any market—not just health care.

For instance, I have attached a copy of testimony I gave before this committee back in July 2012, that looks at the Department of Energy's 1705 loan guarantee programs. This is what I found:

The 107 loan guarantee program is the program that extended \$535 million in loan guarantees to Solyndra, a solar company that went under in 2011 leaving taxpayers with the tab. Since then, two additional companies—Beacon Power Corp and Abound Solar—have announced that they would suspend operations and filed for bankruptcy. Abound had used about \$70 million out of the \$400 million it got through the DOE program, which is likely to result in a cost of \$40 million to \$60 million to US taxpayers after Abound's assets are sold and the bankruptcy proceeding is completed.

Despite this, lawmakers on both sides of the aisle refuse to end the program, offering two defenses for its continuation. First, advocates argue that renewable energy companies do not have access to sufficient credit to support new projects. In addition, the DOE argues that encouraging investment in green technology would create up to 5 million jobs.

But these claims don't withstand scrutiny. Although some 1705 loans went to companies that could not get capital without the government guarantee—and clearly shouldn't have in the case of Solyndra—this may be the exception rather than the rule. Indeed, nearly 90 percent of the loans went to subsidize projects backed by large companies such as NRG Energy and Goldman Sachs Group Inc., and would have easily secured access to capital, if the projects were indeed viable.

12. Matthew Mitchell, "James M. Buchanan: Realistic Optimist," *Neighborhood Effects* (blog), January 11, 2013. <http://neighborhoodeffects.mercatus.org/2013/01/11/james-m-buchanan-realistic-optimist/>.

13. Through no fault of their own, government actors lack the means to best aggregate dispersed knowledge and make adequate economic calculations because they lack functioning market feedback mechanisms. See Ludwig von Mises, *Socialism: An Economic and Sociological Analysis* (New Haven, CT: Yale University Press, 1951).

Second, under 1705, \$16 billion in loans were guaranteed and 2,388 permanent jobs were created. That means that one job was created for every \$6.7 million in taxpayer exposure. These numbers dispel the idea that this loan program is an effective jobs program.

However, the real problem with the 1705 loan program lies below these numbers. In fact, the Solyndra failure is the symptom of more fundamental problems that make loan guarantee programs a bad deal for Americans.

First, every loan guarantee program transfers the risk from lenders to taxpayers. This creates what economists call a moral hazard problem: because the loan amount is guaranteed, banks have less incentive to evaluate applicants thoroughly or apply proper oversight. These programs privatize gains and socialize losses—in other words, taxpayers bear the downside risk, but the companies and the banks that receive the guarantees get the upside benefit.

Second, loan guarantees give an incentive to lenders to shift resources toward subsidized projects and away from nonsubsidized ones. This has a cascading effect. For instance, once the government subsidizes a company, that company becomes a relatively safe asset which then attracts private capital, independently of the merits of the projects. That capital is then unavailable to unsubsidized projects, even if they have a much higher probability of success and a more viable business plan. The subsidy can thus hurt the production of green energy, as an unrealistic but subsidized green energy project thrives while other, more viable green energy projects starve.

Finally, every loan guarantee introduces political incentives into business decisions, creating the conditions for businesses to seek financial rewards by pleasing political interests rather than customers. As my colleague Matt Mitchell explains, this can lead to cronyism,¹⁴ and it has real economic consequences.

Whatever the intentions that motivated the program, it just doesn't work. The 1705 loan program does expose taxpayers to Solyndra-like waste. But of more concern are the systematic distortions it introduces into the market and the unintended consequences those can have. Loan guarantees are privileges granted to special interests, and there is no better time than now—as we grapple with mounting public debt—to get rid of them.

14. Matthew Mitchell, "The Pathology of Privilege: The Economic Consequences of Government Favoritism" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, July 9, 2012), <http://mercatus.org/publication/pathology-privilege-economic-consequences-government-favoritism>.

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