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ORIGINAL ARTICLE

Saving government failure theory from itself: recasting political economy from an Austrian perspective

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Abstract The economic approach to politics revolutionized the way scholars in economics and political science approached the study of political decision-making by introducing the possibility of government failure. However, the persistent and consistent application of neoclassical models of economics also seemed to suggest that once the full costs were accounted for, this failure was an illusion. This paper counters these arguments, typically associated with George Stigler, Gary Becker and Donald Wittman, by focusing on the underlying economic theory. We develop an alternative model of political economy grounded in the Austrian conception of the dynamic market process.

Keywords Entrepreneurship · Government failure · Market failure · Market process · Public choice

JEL Classification B52 · B53 · H11

1 Introduction

The development of the economic theory of politics by Anthony Downs, Duncan Black, James Buchanan, Gordon Tullock, and Mancur Olson revolutionized the way scholars in economics and political science thought about non-market decision-making. The traditional theory of public economics (the economic role of the state) was best summarized by Baumol's (1952) *Welfare Economics and the Theory of the*

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State. According to this theory, market failures, such as positive or negative externalities, would be identified and government officials would create the appropriate tax and subsidy scheme to bring social marginal cost and private marginal cost into alignment. In short, government was the corrective to market failures identified by the economist.

Keynesian macroeconomics argued along similar lines. As aggregate demand failure was identified, appropriate fiscal policy would be followed to ensure that aggregate demand would meet aggregate supply at the full employment level of output. Again, government circa 1950 economics was seen as the corrective to the shortcomings of the private market economy.

Prior to the "public choice revolution," economists viewed deliberations over public policy as if public-spirited autocrats were carrying out the process. Neither political nor material considerations would impede the selection of policies, which served the public interest. Later developments in microeconomics, such as property rights economics, would challenge market failure theory while leaving intact the conception of the state as a benevolent dictatorship. The policy debate became one where the economist would expose the unintended consequences of government intervention assuming that the intent of the policy was to advance the public interest. But the incentives that political actors faced in making policy choices were left unexamined.

The economic theory of politics challenged the literature on economic policy by demonstrating that if we allow for behavioral symmetry between market and political actors, government failure is a distinct possibility. Behavioral symmetry merely asserted that if we are going to assume self-interest on the part of market participants, we must also assume self-interest on the part of political participants. Similarly, if we are going to assume that participants in the market are cognitively limited, then we should assume cognitive limitations in politics as well. Allowing for motivational and cognitive symmetry in both the political and market spheres meant that "market failures" could not be taken as *prima facie* evidence for government intervention, as was previously believed. Self-interested, informationally-constrained rulers may be unwilling or unable to remedy market imperfections. Indeed, if political actors are modeled realistically instead of romantically, giving power to the state for this purpose may actually result in a worse outcome than before the intervention. Assuming behavioral symmetry opened the possibility that the cure could be worse than the illness.

The tale of the Roman Emperor, often invoked by Gordon Tullock, summarizes the problem of pre-public choice political economy. According to this tale a Roman Emperor is asked to judge a singing contest between two contestants. Upon hearing the first contestant sing, the Emperor awards the prize to the second singer under the assumption that she clearly cannot be any worse than the first. But the Emperor's assumption is quite possibly off the mark; the second singer could in fact be much worse. This parable highlights the proposition that imperfect markets do not necessarily justify government intervention. The consequences of this methodological demand for behavioral symmetry were damaging to the government-as-corrective conclusion of the previous generation of public economists, and augmented the unintended consequences critique of government intervention.

The first generation of the economic theory of politics in political science and economics tended to focus on the perversities in democratic decision-making. Voters can be divided into groups of those who are rationally abstinent, rationally ignorant, and specially interested. Politicians are seen as seeking campaign contributions and votes. Voters are demanders of policy and politicians are suppliers. In the interaction between voters and politicians, the tendency is for politicians (in their effort to secure contributions and votes) to introduce public policies, which concentrate benefits on the well-organized and well-informed specially interested voters in the short run, and disperse the costs among the unorganized and ill-informed voters in the long run. Voter preferences would enter one end of the political process and go through a series of political manipulations, producing public policies at odds with those voter preferences at the other[1] (See Fig. 1).

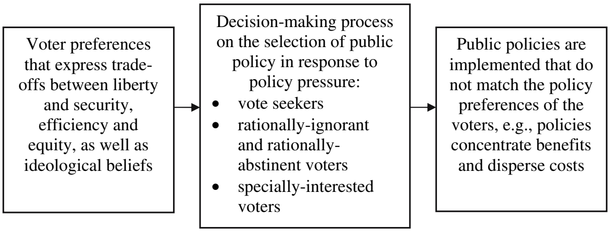
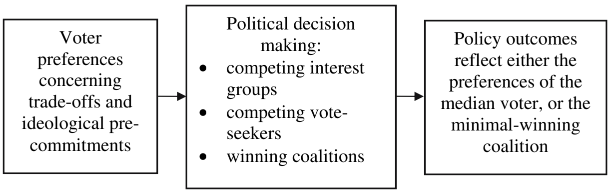


Fig. 1 First generation of the economic theory of politics

Olson first used these arguments to explain the logic of collective action (1965, 1982) and then the rise and decline of nations, focusing in particular on the demosclerosis produced when the narrow interests of well-organized groups out-competed the encompassing interests of society. Buchanan and Tullock (1962) used these arguments to demonstrate the decline of the constitutional order in modern society and the rise of a rent-seeking society in its place. Modern democratic politics were run by interests, not principle, to the detriment of the classical liberal state of the Founding Fathers. A solution was to be found in the constitutional craftsmanship of the political economist who took as his task to find the binding rules that constrain interest group logic so that a free and prosperous society could be established (see Buchanan, 1975, 1979).

As the constitutional political economy project associated with the Virginia School emerged in the 1960–1980 period, the economic approach to politics also developed in alternative directions in the hands of Chicago economists such as George Stigler and Gary Becker, and Rochester political scientists, such as William Riker. This Chicago-Rochester strain of work tended to focus on the equilibrium properties of political affairs (see, e.g., Stigler, 1988; Riker, 1962). Under the right conditions this work leads to a different vision of Fig. 1, one where voter preferences are accurately reflected in policy choices (See Fig. 2).

Fig. 2 Chicago-Rochester theory of politics



[1] This is a different criticism from, though not inconsistent with, the pure economic critique of public policy in terms of unintended undesirable consequences.

Ironically, the economic approach to politics, after challenging the conception of politics as benign, ends up in the Chicago–Rochester variant with a picture of the political system (under conditions of open competition) that is ruthlessly efficient in a manner analogous to the perfectly competitive market. Consumers in the market and voters in politics will get what they desire constrained by technological and political feasibility, and some approximation of a willingness to pay criterion.[2]

There is, however, something strange with this picture that we hope to correct. The problem as we see it is as follows:

(1) Economic theory informs us that $20 bills (unexploited opportunities) cannot persistently lay on sidewalks without being picked up;
(2) The very same economic theory that informs us about the non-persistence of inefficiencies is also what we use to identify inefficiencies (gains from trade that are currently unexploited);
(3) When we examine policy reality in light of that economic theory we see inefficient policies all the time, e.g., protectionist legislation.

How do we square propositions (1)–(3) without abandoning economic theory? We see the choice as pushing in one of two directions. On the one hand we could argue that (2) and (3) are illusions that economists must pierce through. The $20 bill is not there because it would actually cost $25 to reach down and pick it up. In other words, if a lower cost alternative were available it would be employed; and since it is not, the policy reality must reflect the political economy reality efficiently. No unexploited opportunity for mutually beneficial action remains in the political process.

On the other hand, if we reject this approach, as we do but Stigler (1992) does not, then we have to explain why these $20 bills are lying on the sidewalk and actors are not picking them up. This paper takes this alternative approach as a starting point. In doing so we rely on a theory of *structural ignorance* to go hand in hand with theories of rational ignorance to describe the political environment in which actors make choices (see, e.g., Kirzner, 1985). In short, the knowledge required to alert participants in the process to the existence of $20 bills to be picked up is the result of a specific institutional context.

Although in the private property market economy this knowledge of unexploited opportunities is revealed through the lure of pure entrepreneurial profits, in the political process *this* knowledge is not produced.[3] This does not mean that no knowledge is produced in the political process. On the contrary, clearly the political process produces some knowledge relevant to *political actors*. But this knowledge

[2] The move from preference induced equilibrium to structure induced equilibrium associated with Shepsle and Weingast (1981), while an important analytical step, does not solve the problem we are concerned with in this paper. The problem is that the analysis in Shepsle and Weingast leads to the position that given the constraints of the institutional structure agents find themselves acting within, they are still pursuing the optimal course of action.

[3] "What the official knows, he knows, and what he knows he does *not* know, one may imagine him diligently undertaking to find out, through appropriate cost–benefit-calculated search. But one can hardly imagine him discovering, except by the sheerest accident, those opportunities for increasing efficiency of which he is completely unaware. The official is not subject to the entrepreneurial profit incentive, which...appears continually and successfully to inspire discovery of hitherto undreamed of possibilities for eliminating unnecessary expenditures. Nothing with the regulatory process seems to be able to simulate even remotely well the discovery process that is so integral to the unregulated market" (Kirzner, 1985: 141).

leads to superfluous discoveries from the point of view of economic efficiency. In other words, knowledge generated in the political context may enable individuals to survive in the competitive environment of politics, but it does not lead them to exploit the opportunities for gains from economically beneficial trades and eradicate economic inefficiencies. The knowledge necessary to alert actors to these possibilities for entrepreneurial profit simply does not exist because the entrepreneurial context is absent. Instead, actors are alert to alternative possibilities that generate an entirely different pattern of consequences than what would appear in the unregulated market economy. Our argument is not that the cost of acquiring relevant knowledge is too high; it is that knowledge generated is always context specific, and in the political context this knowledge of entrepreneurial profit opportunities is necessarily absent.[4]

Thus, in addition to the distinction between economic (cost–benefit) and technological efficiency (input–output), we introduce the notion of political efficiency (winning coalitions). And just as technologically feasible projects must be sorted for their economic efficiency through the process of rational economic calculation (see Boettke, 1998), the set of politically efficient states must be examined in light of economics to judge whether political choices are economically beneficial or not. The persistence of economically inefficient policy is not an illusion because it is possible for politically efficient policies to be economically inefficient. Whereas within a market system technologically possible projects are subjected to the economic test of profit and loss, the economic test of profit and loss is not employed in assessing political choices.

This critical distinction between economic and political efficiency is blurred in equilibrium states where all profit opportunities are exhausted. We therefore propose a recasting of political economy that makes this distinction readily apparent. We argue that the necessary recasting is best informed by the Austrian theory of the entrepreneurial market process and the Virginia School of political economy with its focus on rent-seeking and constitutional craftsmanship.

The current theoretical orientation in political economy was explicitly built on the value theory of neoclassical economics and the core concept of maximizing behavior and market equilibrium. Compared to the normative theorizing and psychological explanations of 1950s political science this was a major step forward; but it did not come without a cost. The value paradigm in economics tends to turn a blind eye to the exchange activity that drives an economic system (see Kohn, 2004). We see the Virginia School as the lever by which we can recast political economy while maintaining the strengths of the economic approach to politics precisely because James Buchanan and Gordon Tullock always saw their effort in the context of the exchange behavior that is exhibited in political life.

2 Policy as efficient

The critical responses to the theory of market failure came in four kinds of arguments. The first variety was to deny that the so-called market failures could in fact be

[4] The reason why this idea has been under explored in the economics literature is because of the difficulty of operationalizing contextual knowledge, as opposed to the ease of operationalizing information as a commodity. On the distinction between knowledge and information in economics see Boettke (2002).

identified using sound economic theory. Rothbard (1962: 765–890) held perhaps the most uncompromising position in this regard. However correct this position may be judged in retrospect, we will not emphasize it here because it did not impact the evolution of economic argumentation in the subsequent professional discussion.

The second variety insists that while the concept of ‘‘market failure’’ may have some logical coherence in positive theory, the transition from positive to normative theory is problematic for a number of reasons—not the least of which is that the ideal belies a nirvana fallacy and the invoking of an unexamined alternative commits a ‘‘grass is always greener’’ fallacy. Demsetz (1969), for example, in his now-famous piece entitled, ‘‘Information and Efficiency: Another Viewpoint,’’ points out that Kenneth Arrow, in following a nirvana view, commits the ‘‘grass is always greener fallacy’’ by invoking an unexamined alternative—in this case a government corrective—to a so-called market failure. ‘‘To say that private enterprise is inefficient,’’ Demsetz argues, ‘‘because indivisibilities and imperfect knowledge are part of life, or because people are susceptible to the human weaknesses subsumed in the term moral hazards, or because marketing commodity-options is not costless, or because persons are risk-averse, is to say little more than that the competitive equilibrium would be different if these were not the facts of life’’ (1969: 19).

According to Demsetz, perfect competition and Pareto optimality are not useful for the main task before political economists, which is not irrelevant comparisons to an ideal world populated by non-humans, but instead ‘‘the design of institutional arrangements that provide incentives to encourage experimentation (including the development of new products, new knowledge, new reputations, and new ways of organizing activities) without overly insulating these experiments from the ultimate test of survival’’ (1969: 19).

Ronald Coase similarly condemned the traditional market failure approach. ‘‘It is my belief,’’ Coase wrote, ‘‘that the failure of economists to reach correct conclusions about the treatment of harmful effects cannot be ascribed simply to a few slips in analysis. It stems from basic defects in the current approach to problems of welfare economics.’’ (1960: 153). Of course, the defects Coase is referring to are those resulting from the standard welfare economics assumption that correcting identified deficiencies is costless. Coase advocates an ‘‘opportunity-cost’’ approach to examining alternative policy solutions to economic problems. In doing so, he insists ‘‘we have to take into account the costs involved in operating the various social arrangements (whether it be the working of a market or of a government department) as well as the costs involved in moving to a new system’’ (1960: 156). Failure to do so leads to erroneous conclusions regarding the efficacy of state correction.

An important point to stress is that this Coase–Demsetz style of argument, while damaging to the Samuelson-Bator-Arrow presentation of market failure, led to the Panglossian fallacy that we will deal with later. Consider, for example, the argument concerning monopoly that emerges from a consistent application of the Alchian-Demsetz style of reasoning. The standard monopoly diagram yields a deadweight loss—gains from trade are unexploited because of monopoly power. But the question asked by the property rights economists was: why wouldn't the monopolist perfectly price discriminate and capture the surplus, eliminating the deadweight loss? The standard reply to this query was that the monopolist cannot perfectly price discriminate because the monitoring costs of preventing resale among consumers are too high. But these monitoring costs, the property rights economists concluded, are transaction costs. If these costs are seen as transaction costs, they should be included in the marginal cost curve. Once we shift to the new representation of the marginal cost curve to reflect all relevant costs incurred in making additional transactions, the monopoly-competitive distinction disappears and price will equal marginal cost.[5]

The only time monopolies generates negative welfare effects is if a deadweight loss is due not to transaction costs, but to political barriers to entry that prevent individuals from realizing the gains from exchange (Demsetz, 1982). Either the system is ideal, or it is blocked by legal restrictions from achieving the ideal. In other words, markets do not fail to produce optimal results, but government restrictions may prevent markets from working effectively, for instance when government grants monopoly privileges to certain firms.

The third type of argument that emerged in the 1960s and 1970s against the standard welfare economics of market failure theory is what could be called the dynamic adjustment model of markets.[6] From this perspective, most closely associated with Hayek (1969) and Kirzner (1973), markets process information effectively and are continually adjusting to changing circumstances. In this world, inefficiencies at any one point in time are admitted but recognized to be the source of entrepreneurial action and subsequent market correction. Today's inefficiency is tomorrow's profit opportunity. The imperfections identified in the nirvana approach are actually the factors that drive markets in the discovery of new ways to meet consumer demand, new and better products, and new and cheaper production techniques. For instance, Klein and Foldvary (2005) have recently published a collection of articles examining how changing technologies explode previous arguments for market failure by finding ways to fence externalities, erode market power, and improve the structure of incentives and the flow and quality of information.

The fourth kind of argument raised against traditional market failure theory was the public choice critique of government. The welfare economics of Pigou through

[5] The analysis conforms to what Reder (1982) refers to as the Chicago "tight prior," where the equilibrium conditions of: (i) the market price being equal to marginal cost of production, or (ii) that the market price of any input is equal to the value of its marginal product, or (iii) that the marginal cost of producing any product is the least cost method of production, are imposed on the world to make sense of it. The construction of the thought experiment being conducted requires that theory dominates any evidence to the contrary, and that the way to make sense of the evidence is to fit it to the theory. Scientific explanation in economics, in this framework, results from describing any social phenomena in a manner consistent with these equilibrium conditions.

[6] In *Capitalism and Freedom* (1962), Friedman did not emphasize dynamic adjustments nor did he emphasize public choice issues, but in dealing with the charge of market failure due to monopoly he argues that an unregulated monopoly will outperform a regulated monopoly in satisfying consumer demand. The argument he provides is mainly focused on the insulation from survival tests that regulation provides. In addressing other public policy errors, e.g., in the area of fiscal and monetary policy, Friedman's argument in the early 1960s was one of intellectual error—analytical error and error in historical interpretation. The Great Depression, for example, was not a product of the inherent instability of the capitalist order but a consequence of policy errors on the part of the government authorities. In the late 1960s, Friedman also developed an argument that this policy task was too cumbersome to leave to discretion. Given the long and variable lag between the recognition of a problem in the economic system, the devising of an appropriate response, the implementation of the response, and the impact of the policy change on the economy, it could very well be that the original problem would have already been corrected by market adjustments. Discretionary policy, rather than a cure, could in fact destabilize the situation. Finally, by the publication of *Free to Choose* (1980), Friedman had started to rely on public choice explanations of interest group manipulations to explain the disjoint between demands for government as a corrective and the reality of government as a disturbance to the economic order. Friedman is exempt from the criticism of the Chicago style of political economy we will offer.

Samuelson assumed government provided a costless solution to market failures. But upon examination, the theory of government failure had to be set up alongside the theory of market failure. Public choice did not challenge the standard theory of market failure as we saw in the first three responses. It is not that Buchanan and Tullock did not follow these arguments (in fact, in different writings they contributed to them). But for the sake of argument they were content to admit that markets fail while questioning government policy as a reliable corrective. When government actions are critically examined for the incentives generated and the information utilized in assessing policy trade-offs, they argued, government failure would exacerbate whatever problems might have been identified as market failures.

By the 1980s the public choice critique was absorbed into the mainstream of economic teachings. The link between the original Demsetz critique of the nirvana fallacy and the Hayek–Kirzner discovery notion of the market was all but forgotten in the preoccupation with equilibrium analysis. In fact, the Demsetzian critique of Arrow was swept aside in the 1970s and 1980s by the ascendancy of powerful arguments from Joseph Stiglitz, who developed a new theory of market failure that emphasized the informational inefficiencies of market economies. Instead of spurring on an equal ascendancy of the market process and discovery answer to imperfect information, the Coase–Demsetz ‘‘whatever is, is efficient’’ aspect of comparative institutional analysis was pursued in political economy.[7]

In the hands of economists less consistent than Chicago economists, the Coase–Demsetz demand that we examine alternative arrangements considering the cost of transition perfectly complemented the public choice critique of government laid out by Buchanan and Tullock. But this is only because the full implications of the Coase–Demsetz line of argument were arbitrarily cut short. Their argument complemented the Buchanan–Tullock argument only if the former was not fully teased out to its logical conclusion. In the hands of George Stigler and Gary Becker, however, cutting short the full implications of the Coase–Demsetz line of reasoning was not going to happen.

Stigler (1982, 1992) pursued the Coase–Demsetz reasoning to its logical end. Whatever current arrangement is in practice must by definition be the most effective, or a lower cost alternative would be in use instead. In competitive equilibrium this would be as true for the production of legislation as it is for the production of widgets. The economist could abandon his role as a scientist and instead address the preferences of the populace, but in so doing he ought to admit that he is now ‘‘preaching’’ and not engaged in ‘‘science’’ (1982). Subsidies, protectionism, regulation, legal decisions, etc. are all rational responses to political realities by various actors. The traditional theory of government failure suffered from the ‘‘grass is always greener fallacy’’ in the same way that the traditional theory of market failure did.

Unless the costs of transitioning to a new arrangement are accounted for, the analysis is incomplete. And when those costs are accounted for, many so-called government failures disappear, as the costs of transition to the new arrangement would exceed the benefits that would follow from the new institutional setting

[7] The ‘‘survivorship’’ principle was invoked to provide any *status quo* with the efficiency presumption. Contrast that with Buchanan’s position on the *status quo*, where the current arrangement of affairs is given no normative weight except that it is, and must form, the starting point for any theory of reform through political negotiation and compensation. For a discussion of Buchanan’s position see Boettke (2001).

(Stigler, 1992). In other words, while it may appear that a $20 bill is lying on the sidewalk in the policy world, it would cost $21 or more to pick it up. The survival of sugar subsidies in the competitive environment of politics demonstrates that no lower cost alternative has been forthcoming. The survivorship principle is the ultimate bottom line in social affairs. Stigler's view of the political operation of democracy emerges from an application of the Coase theorem to this realm of human interaction, and an insistence that scientific economics be grounded in maximizing behavior and equilibrium theorizing.

Becker (1983) developed a sophisticated treatment of this question in his model of pressure groups under conditions of open democratic access. What Becker demonstrates is that under these conditions, pressure groups serve to efficiently deliver public policy to the median voter. Egregious government failure does not emerge in situations where pressure groups simulate the conditions of competitive markets. Instead, just as in the competitive market, competitive politics will yield the best delivery of goods and services available given technological constraints and voter preferences. Politics is about transfers, but politicians have every incentive to conduct these transfers as efficiently as possible and thus political allocations under democracy are analogous to resource allocations in competitive markets. Maximizing and equilibrium entail zero profit conditions—all the gains from trade have been pursued to exhaustion—and this is true for democratic politics just as it is for competitive markets.

Wittman (1995) has taken this argument even further, arguing that democratic failure is an outright myth. Voters get what they want under democracy, just as consumers get what they want under perfectly competitive markets. Voters have very effective disciplinary devices in place to penalize politicians who do not conform to their will.[8] Consider the basic Ferejohn principal/agent model of politics (Ferejohn, 1986). The agent is the politician, the principal are the voters and the voter decides to hire or fire the politician. The voter will pick an aggregate proxy for a job well done, e.g., per capita GDP. If in the current term per capita GDP goes up, the voter will rehire the politician. But if per capita GDP goes down, the voter will fire the politician come election time. This simple exercise is enough to discipline the agent to act in the interest of the principal. And since there is a fiercely competitive market in politicians seeking election, the market for politicians serves as effectively as the market for managerial labor to discipline deviant behavior.[9]

[8] Wittman distances himself from the Stigler–Becker claims of efficiency and makes a bolder claim to democratic efficiency. It is not that democratic politics is ''efficient'' when we include the transaction costs associated with policy change. Instead, Wittman argues that democracy is efficient in the sense that voters cast informed votes and politicians are effectively disciplined so that wealth maximizing policies are introduced and sustained. His argumentative strategy is to demonstrate that any argument for government failure requires an empirical assumption (e.g., the existence of extreme voter stupidity; the lack of competition in the political sphere; high negotiating costs which prevent political bargains from being struck). Market-oriented economists reject similar types of assumptions all the time in examining market-failure, and so Wittman insists they should be rejected in the political setting as well.

[9] But note that in the standard analysis of the principal/agent the market for corporate control also plays a major role in disciplining market participants. The stock price of a firm reflects the expected profitability of the firm, and if market participants believe that earnings of a firm do not represent the capabilities of that firm, a take over will clean out the ineffective management and replace it with a more effective management. Profit and loss accounting serve the vital function of providing necessary knowledge to market participants. But what is the equivalent in the realm of politics?

Wittman's argument can be seen as flipping the symmetry argument employed in the first generation of the economic theory of politics back on itself. As he puts it: "nearly all of the arguments claiming that economic markets are efficient apply equally well to democratic political markets; and, conversely, that economic models of political-market failure are no more valid than the analogous arguments for economic-market failure" (1995: 2). The claim that emerges in Wittman is that political allocations under democracy are wealth maximizing. The intellectual energies of political economists, Wittman argues, should shift from efforts to identify government failures to a focus on optimal organizational design, or how various organizational mutations in governmental institutions (such as political parties, candidate information, and governing structures) serve to ameliorate potential problems in the political marketplace.

How do we respond to the Stigler–Wittman challenge to the economic approach to politics? It is our contention that we must go back to the earlier passages quoted from Demsetz and pursue the economics contained in his parenthetical clause about dynamic adjustments, discovery, the inapplicability of competitive equilibrium and Pareto optimality as it relates to questions of public policy. In doing so, we can recast political economy in a manner that retains the critique of government, and does not devolve into the Panglossian fallacy for either the market economy or the democratic polity.

3 Overturning the Chicago/Rochester/Virginia alliance

The Stigler–Wittman critique of government failure has not gone unchallenged in the political economy literature. Representatives of the Virginia School of political economy, however, have been far more vocal in this regard than any Chicago political economists or Rochester rational choice political scientists. The reason for the paucity of response from Chicago and Rochester is due to their intellectual commitment to maximizing behavior and equilibrium theorizing. As mentioned above, these intellectual approaches are committed to the value paradigm versus the exchange paradigm (see Kohn, 2004).

The Virginia School, however, has always been grounded in the exchange paradigm rather than the maximization approach (see Buchanan, 1964). Economic analysis is not about Crusoe's allocation decisions as an isolated actor battling the scarcity of his environment. Nor is market analysis about competitive conditions and a system of simultaneous equations that provide a unique price and quantity vector that will clear all markets. Buchanan's conception of the market *process* is summarized as follows:

> A market is not competitive by assumption or by construction. A market *becomes* competitive, and competitive rules *come to be* established as institutions emerge to place limits on individual behavior patterns. It is this *becoming* process, brought about by the continuous pressure of human behavior in exchange, that is the central part of our discipline, if we have one, not the dry rot of postulated perfection. A solution to a general-equilibrium set of equations is not predetermined by exogenously determined rules. A general solution, if there is one, *emerges* as a result of a whole network of evolving exchanges, bargains, trades, side payments, agreements, contracts which, finally

> at some point, ceases to renew itself. At each stage of this evolution toward a solution there are *gains* to be made, there are exchanges possible, and this being true, the direction of movement is modified (1964: 29, italics in original).

The ''equilibrium always'' vision of economic activity is focused on that state of affairs where action has ceased, and thus it tends to blind us to the processes by which such a state could ever be achieved. In fact, in the Walrasian conception of the market all plans had to be *pre-reconciled* before exchanges could be transacted, lest 'false' prices would lead economic actors astray. But in the exchange paradigm the focus is on the *reconciliation process* between economic actors and the institutions within which their efforts to truck, barter and exchange take place.

Both the value and exchange paradigms are grounded in the neoclassical framework of the pure logic of choice. The crucial distinction in the approaches can be found in the (a) cognitive capabilities assumed for actors, and (b) the institutional infrastructure required to achieve a coordination of plans in a manner which tends toward wealth maximization. In the value paradigm, the cognitive capability of actors is usually heroic and does the vast majority of the heavy lifting in the analytical explanation about how order emerges in society. In the exchange paradigm, however, the actors are imbued with very limited and sometimes even crippling cognitive capacity, and the institutional environment (and the structure of incentives it possesses and the learning of existing opportunities and new possibilities for mutual gain it engenders) does the intellectual heavy lifting. As can be seen in the Buchanan quote, the market order is seen as an emergent process unfolding through time as the gains from trade are continually identified and pursued.

Rational choice, as if the choosers were human, substitutes for lightening calculators of pleasure and pain, and institutional settings in which property and contracts (and their enforcement) are examined in detail for their incentive effects and learning properties substitutes for the institutionally antiseptic theory of general competitive equilibrium. This is why the Virginia School serves as the lever we rely on in our narrative about the recasting of political economy. But the reader should be clear that the sort of economic theory we have just described is most closely associated with the Austrian school of economics as evidenced in the writings of Carl Menger, Ludwig von Mises, F.A. Hayek and Israel Kirzner. Of course, the non-Ricardian British economists, such as Richard Whately can be invoked as well, but the exchange paradigm was explicitly developed in the work of Mises (1949) and Hayek (1948, 1976).

Our effort is to save the Virginia School from the pull of Chicago by presenting the Austrian school as the appropriate foundational theory of economic interaction. Once we recognize the different underlying economic framework, the critique of the Stigler–Wittman conjecture that democratic policy is efficient in the same way the market competition is, sharpens. Critiques inspired by the publication of Wittman's study have been offered by Boudreaux (1996), Buchanan (1996), Rowley (1997), Rowley and Vachris (1994, 2003), Sutter (2002), and Wagner (1996). At one level the debate can be boiled down to a metaphysical faith in, or rejection of, the proposition that whatever is, is efficient. But each of these authors also offers good reasons to believe that a critique of this proposition can be offered without resorting to metaphysical squabbling.

If we do not imbue actors with cognitive capacities beyond that of humans, and we examine not only the incentive structure, but also the learning properties of alternative institutional arrangements, then we can identify crucial differences in the behavior of markets within an environment of private property and freedom of contract, and the democratic political process of voting and policy deliberation. The political process generates incentives and learning that are entirely different than what is exhibited in the competitive market process. The bundled nature of political goods creates problems that are solved in market exchange by unbundling; the political process tends to concentrate benefits and disperse costs, whereas the marketplace tends to concentrate costs and disperse benefits; decisions in the market to either buy or abstain from buying are a direct signal to sellers, whereas in the political process voters do not have the same extent of feedback opportunities with respect to public policy offerings because they vote only periodically for representatives and their vote is rarely decisive.

Relying again on the description of how markets prod us toward continually realizing the gains from trade, the institutional environment of politics does not present us with the continuous feedback opportunities we experience in markets for mutual adjustment, nor does the political process require us to continually learn about the best opportunities available. The nature of the choice problem in politics is simply different than the one we are confronted with in markets. As Fernandez and Rodrik (1991) point out, this goes a long way to explaining why there is a status quo bias in politics that does not exist in markets. Policies once rejected never get reconsidered, and policies once accepted are rarely challenged due to uncertainty over the distribution of the gains from policy change. In the market process, errors are continually identified and acted upon, if not by the individual entrepreneur who made the initial error, then by his entrepreneurial counterpart who is continually looking for a way to realize profits (Leeson, Coyne, & Boettke, 2006).

Once political economy is recast along these lines, then the distorting impact of public ignorance, voting behavior, ideology, and the distributional battle of pressure groups on the *economic system* can move to the center stage of political economic analysis. Policies may in fact be adopted for very sensible political reasons and reflect political efficiency, but they can simultaneously deviate significantly from efficiency-enhancing economic policies that would be adopted if politics were able to operate on economic criteria.

The Wittman contention that democratic policy-making is wealth maximizing is a consequence of confusing political and economic processes. Survivorship of perverse policy does not indicate, as Stigler thought, that we are wrong to identify it as perverse. The coin of the realm in politics is different than that in economics. And thus the knowledge feedback that would be discovered in that process to identify a politically efficient policy choice but an economically inefficient one is not in operation. The context for efficient decision-making has shifted. The market context within which entrepreneurs are prodded to discover errors and act in a manner less erroneous than before in the hope of securing entrepreneurial profit is non-existent in the context of politics. ‘‘There is no entrepreneurial process at work,’’ writes Israel Kirzner, ‘‘and there is no proxy for entrepreneurial profit and loss that easily might indicate where errors have been made and how they should be corrected...No systematic process seems at work through which [politicians] might come to discover what they have not known’’ (Kirzner, 1985: 140).

Structural ignorance is a different concept than rational ignorance, in that it stresses the link between useable knowledge and specific institutional contexts. Sanford Ikeda (2003) has discussed the difference between ‘‘neoclassical’’ and ‘‘Austrian’’ political economy perspectives in relation to the connection between intentions and outcomes in policy space. Neoclassical political economy infers intentions from outcomes, while Austrian political economy does not presume that such an inference is possible. Instead, Austrian political economy focuses on the unintended and undesirable consequences from the point of view of the proponents of government action.

But Ikeda's analysis incorrectly characterizes all public choice analysis as grounded in the perfect knowledge assumption and equilibrium analysis. As such, while Ikeda is completely aware of the issue of structural ignorance, he does not address the issue of structural ignorance in politics in the same way that we do.[10] In his rendering of neoclassical political economy, policies emerge that are the intended outcome of favored interest groups, but leave deadweight losses in their wake that nobody has an incentive to remove.

The distinction we have drawn between political efficiency and economic efficiency explains this state of affairs. The economic inefficiencies are not dissipated because the knowledge necessary to act in a manner to eliminate the deadweight losses is not generated within the political context. Richard Wagner makes this point when he states: "The incentive to acquire knowledge and the judgment to identify something as knowledge in the first place depend upon the institutional setting within which people act" (1989: 56). To illustrate this point Wagner invokes the classic story of a business error—the Edsel—and he asks his readers "what if the Edsel had been a government product...Would production have been halted as quickly?" (1989: 54). The profit and loss calculations made in the market direct production and force market participants to adjust their plans quickly and ruthlessly. In the democratic process, however, the incentives/knowledge for error detection and correction, and the guiding function of this knowledge for necessary adjustments, are not necessarily grounded in the economics of profit seeking and cost minimizing.

As we have seen, Wittman insists that politics is as competitive as the most efficient markets. But what Wittman does not address is the different knowledge that is generated within the contexts of private property markets and democratic politics. Mitchell and Simmons may provide the most succinct statement of the basic point we are trying to make when they state that since, "government officials are not permitted to sell their official service or goods...they never learn the precise values citizens place on activities and goods" (1994: 68). Without a market, the *economic value* of political goods and services is impossible to ascertain. In the context of the market economy, comparative costs and relative prices continually provide guidance to market participants on the least cost methods of production, the most urgent consumer demands and the opportunities for mutually beneficial exchange. "Political actors have no such guidance, and without it efficient choices become, as Ludwig von Mises and Frederich A. von Hayek argued, impossible" (Mitchell & Simmons

[10] Ikeda instead focuses on government failure resulting from an examination of means-ends and the demonstration that policy often results in outcomes which are undesirable from the point of view of the policy advocate. While we do not dispute the unintended and undesirable consequences of government action, we also do not want to push aside the cleavage between the policy preferences of the voting populace and the policy consequences that result because of clash of group interests in political decision making. In short, there are indeed deadweight losses that are not removed because the political process not only fails to provide the incentive for their removal, but also because the political process has no way to provide participants with the *economic* knowledge required to eliminate the inefficiency.

1994: 68). Neither the production nor provision of public goods can be carried out in an economically efficient manner.[11]

The analogy between the market economy and democratic politics is broken. It is not just that each institutional setting has its own structure of incentives, but both also have unique epistemic properties.[12] To insist that markets are not identical to politics is not to violate the symmetry assumption, as Wittman suggests. We can assume identical behavioral postulates, but we must recognize that context matters. The unique structural context of choice provides a structure of incentives that actors face, and a flow of information that actors utilize, in making their choices. All we are insisting on is the recognition that political calculations are wholly different from the economic calculations made by entrepreneurs in the market place. And if this is so, then there are at any given point in time opportunities for improvement with regard to economic policy that are not being pursued because the signals that alert economic actors to potential gains from trade are not being generated within the context of politics.

To give one example, politicians are concerned with minimal winning coalitions, but businessmen do not need majorities to operate a successful business. The number of votes matters more than the intensity of any one vote because each vote is equally weighted. In the market process, though, the entrepreneur is concerned with the intensity of buyer preferences because it determines the willingness to pay. Economic actors need to know *how much* buyers want this or that particular good or service; political actors need to know *how many* voters desire this or that particular policy. The two questions are categorically different from one another.

Other factors leading to the break down of the analogy between politics and markets are scattered throughout the writings of economists in the Austrian tradition.[13] These factors all raise serious doubts about the veracity of Wittman's insistence of a tight argument from analogy with respect to the disciplinary mechanisms that ensure the adoption of wealth maximizing policies. Boettke and Leeson (2004) provide a survey of this literature from Bohm-Bawerk to Mises and Hayek to Schumpeter, and highlight the issues of public ignorance, ideology, interest groups, dynamics of interventionism, and unintended consequences. Boettke and Lopez (2002) introduce and collect a series of essays devoted to exploring the areas of commonality between Austrian and Virginia political economy. Wohlgemuth (1999) has argued that democratic politics is not organized as an ongoing market process.

[11] Wagner (1997) develops this argument further in the context of discussing the contributions of the Italian economist Maffeo Pantaleoni.

[12] Hayek (1937) challenged economists to augment their incentive based arguments with an analysis of the learning properties of different social environments. Human ignorance, limited cognitive capacity, and how alternative institutional environments work to ameliorate the problems generated due to these issues becomes of the main theme of Hayek's work from that article forward throughout his long career. Hayek, rather than offering either a ruthless efficiency or a natural rights based defense of the liberal order, offers a humility based one: "Liberty is essential in order to leave room for the unforeseeable and unpredictable; we want it because we have learned to expect from it the opportunity of realizing many of our aims. It is because every individual knows so little and, in particular, because we rarely know which of us knows best that we trust the independence and competitive efforts of many to induce the emergence of what we shall want when we see it" (1960: 29).

[13] Rothbard (1962, 1977) made the case for a categorical rejection of any similarity between the two realms insisting that markets are the arena of *voluntary* exchange whereas politics is the domain of *power* and *coercion*.

This is because competitive politics more resembles a natural monopoly where exclusive control over the means of legitimate coercion is granted to the state for the production and provision of political goods. Voters are in a different situation than buyers, and politicians are confronted with an array of choices categorically different than the ones an entrepreneur must face.

4 Conclusion

We have argued that a recasting of the economic theory of politics along Austrian or entrepreneurial market process lines can retain the argumentative structure of public choice theory while not succumbing to the logical straightjacket of the Panglossian fallacy. The key idea is to base the economic foundation of political analysis in a theory of exchange as opposed to a theory of value maximization. Once exchange, and the institutions within which exchange takes place, moves to the forefront of the intellectual enterprise, the idea that context matters follows naturally. Behavioral symmetry does not result in symmetry in performance provided we do not assume pure benevolence and pure omniscience. Incentives prod individuals to behave in one way rather than another. We are attentive to that which is in our interest to be attentive to in whatever setting we find ourselves. Cognitively limited actors must learn not only to be attentive, but also what it means to be attentive within specified contexts.

We have argued that much of the confusion over the ‘‘efficiency’’ of democracy is due to semantic confusions. Democracy may very well tend to generate politically efficient decisions, but in the context of democratic politics, the knowledge required to ensure economically efficient policy choices is absent. Political actors are *structurally ignorant* of the knowledge of comparative costs and the relative prices that would guide the production and provision of public goods and services in an economically efficient direction. Instead, deadweight losses abound. Even if we could remove the problem of rational ignorance and guarantee competitive politics, the structural ignorance problem would remain as a result of the different context of choice in politics and the market.

Whereas market failures, if allowed to exist, spur entrepreneurial discovery so that wealth-enhancing exchanges are continuously being brokered, the existence of economically inefficient (wealth destroying) policies does not automatically yield political ‘‘profits’’ for politicians to grab. Instead, it is conceivable, and in fact likely, that such policies will garner a minimal winning coalition under democracy even though they will fail to deliver on their promises, and distort the pattern of resource allocation.

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