Wilfred Dolfsma

GOVERNMENT FAILURE

SOCIETY, MARKETS AND RULES

Government Failure

Society, Markets and Rules

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Contents

1. Introducing government failure

Government, of whatever kind, is supposed to take the interests of all members of society to heart. In a way, that can be seen as the main impetus the *Magna Carta* of 1215 gave society – it curtailed and steered the mandate of a king so he would not govern for his own good only. Indeed, Thomas Hobbes, in his *Leviathan* (1651), claimed that Leviathan, or a government, is the only possibility to prevent man from living in 'continual fear, and danger of violent death' and making 'the life of man, solitary, poor, nasty, brutish and short'. While Leviathan is the biblical sea-beast that many equate to the devil himself, and although Hobbes seemed to favour some kind of despotism, harking back to Plato's *Republic* (268 BC), Leviathan was considered to have a beneficial effect on society. A government, or individual *Principe* (Macchiavelli, 1513) in its place, serving society's interests, can then use whatever means necessary towards both outsiders as well as members of that society itself.

Thomas More's *Utopia* (1516), in identifying what an ideal society would look like, does not seem to agree with Hobbes that any type of government, issuing any set of rules, would need to be welcomed as long as the rules would apply to any and all. Thomas More, revered by the Roman Catholic church, in communist countries and by libertarians, lines up with Karl Popper making his case in favour of an *Open Society* (1945). Mill, in *On Liberty* (1859), similarly believed government, in representing society's interests, can fail to deliver what we may expect of it. His utilitarian approach in making this argument famously entails that such a case is much more difficult to make than a case about possible government failure drawing on individuals' (natural) rights, such as John Locke in his *Second Treatise of Government* (1689).

Arguing that governments may, at times, fail, is a long stretch from Friedrich Hayek's argument, in *The Road to Serfdom* (1944), that government necessarily fails as he 'warned of the danger of tyranny that inevitably results from government control of economic decision-making through central planning'. The horrors of the Second World War, presaging in a way subsequent horrors, and the discussion among economists of the economic benefits of central planning have led to an extensive debate. Siding with fellow Austrian economist von Mises, and in the meantime instigating the field of information economics, Hayek argued that it was impossible for government, per se, to collect and process all the information needed to develop centrally the kinds of plans needed for a communist economy. This is a long stretch from the view the most important association of economists held at least at that point in time.

> 1. We regard the state as an agency whose positive assistance is one of the indispensable conditions of human progress.[1]

While this first rule in the first constitution of the American Economic Association claimed that governments have a beneficial role for society, economists have since come to be highly suspicious of government's role in the economy. Beyond the discipline of economics, the libertarian thinking of, among others, Ayn Rand (for example, *Atlas Shrugged*, 1957) and subsequently the (perceptions about the) governments of Ronald Reagan and Margaret Thatcher have also contributed to this view held by many. Is there no role for government in today's society, representing its interests in the face of economic reality?

Woes in the economy in recent years, the implications and consequences of which the societies of the world are still struggling with (McCarthy and Dolfsma 2009), have indicated at the very least, that there is a role for government in society setting rules that players live by. Without such rules that only government can set, the economy runs amok.

A government, then, is necessary but can fail. However, in all of these discussions of a political philosophy nature, when government fails, and how it fails is not frequently discussed. If government failure is discussed at all, it is discussed with reference to its levels of expenditure (Tanzi 2011): the larger the percentage public expenditures constituents of GDP, the more conspicuous a government's failure. That is a rather crude way of thinking about the proper place and role of government in society. The crudeness of this position, or, alternatively, the fundamental nature of the discussion of how governments may fail becomes particularly apparent in the cases of its involvement in healthcare and in stimulating innovation and technological development. Longer term goals are pursued in these circumstances that can be quite difficult to monetize. Monetizing such goals may even be opposed.

However crude the idea of measuring a government's failure by the public expenditure or debt it maintains might be, it is correct in one respect: conceiving of government failure makes most sense when one considers how government, as a representative of society, relates to the economy. The relationship between market and society is a hotly debated issue in the social sciences, as Chapter 2 explains. At the level of theory, this discourse dates back to considerations of social order in which Thomas Hobbes, Adam Smith and David Hume were among the most important early contributors. The discussion has considerable ideological overtones as well, where the contribution of the market to welfare and well-being is at stake. Welfare is usually conceptualized in material terms, and I surmise that both market and society can contribute to welfare, and well-being too. There are spheres outside of the domain of the market that contribute to well-being, and a certain accomplishment in the market can contribute to well-being that is not captured in welfare – in this chapter I do not deny that. I conceptualize the relation between market and society, focusing more specifically on periods of reform. Reforms in the healthcare sector are a case in point.

Chapter 3, presenting research by Killian J. McCarthy and Tao Zhu, indicates how influential government can actually be. This is a unique piece of research that empirically shows how big the 'G-Factor' is – the market may often be referred to as the invisible hand exerting an influence, but much of what government does has real effects on the economy that are often less visible than the workings of the market. A government relying on monetary incentives playing into the extrinsic motives of its subjects may thus not work as expected by many economists, even enlightened ones such as Nobel Laureate Amartya Sen.

Economists tend to see the market as a default option for social order and a role for government only when markets fail. Developing a convincing analysis of the role of government in economic processes, however, needs to start by considering government failure in its own terms. Drawing on insights from institutional economics, law and economics and the philosophy of law, emphasizing the necessity of rules for the economy, Chapter 5 develops the concept of government failure. I identify and discuss four different types of government failure. Government can set rules or institutional structures[2] for economic processes and actors that are (1) too specific, (2) too broad, (3) that are arbitrary, or (4) that conflict with other rules it has set out to address other related issues (possibly primarily non-economic). Government failure is illustrated in the context of Intellectual Property Right (IPR) law as it relates to anti-trust law. Chapter 6 extends the fourth type of government failure, policy conflict, in the context of healthcare, while Chapter 7 indicates how policy conflict, endemic to the policy field of IPR has a real, dynamic impact on technological and economic development as well.

Chapter 8 tracks the attempts by (the Dutch) government to re-institute the system of healthcare provisioning along lines in which 'the market' plays a bigger role. Even though healthcare in this country is of high quality and provided at relatively low cost, this does not seem to be due to the recent re-institutionalization attempts by government. The outcome of introducing market-like rules into the system of healthcare provisioning has been a rather confused market, due to a government that did not sufficiently realize that markets need to be infested with appropriate rules. Rather, rules from different domains or systems were brought together without consideration of their fit, creating a situation in which support for them and their reproduction – which was not obvious to begin with – was not made endemic. These rules thus have been vulnerable from the start. The vulnerability of rules and institutions is discussed conceptually at length in Chapter 9. Institutional vulnerability mainly arises through communication between actors in a common language. To apprehend this requires an elaboration of John Searle's (1995, 2005) argument that language is the fundamental institution. Language delineates and circumscribes a community. A community cannot function without a common language, and language at the same time constitutes a community's boundaries, allowing for focused and effective communication within a community. Communication through language introduces ambiguity as well, however, and thus institutional reproduction, mediated by language, is a deeply contentious process (Luhmann1995).

Knowledge plays an increasingly important role in shaping the dynamics of an economy. A static, Paretian welfare economics is therefore inadequate, and may need to be supplemented by a dynamic (Schumpeterian) welfare theory. A dynamic welfare perspective acknowledges the role of knowledge and communication – Chapter 10 suggests ideas that can be used to establish more carefully whether to what extent the rules government introduces and maintains should be considered cases of its failure or success. As knowledge develops cumulatively in a social environment, knowledge may not be readily diffused or exchanged. Different costs of communication need to be considered, each affecting the creation of new knowledge. Developments in IPR law are evaluated to determine the extent to which they affect communication costs and thus future economic welfare: are these cases of government failure or success?

NOTES

1. From: Article III (Statement of Principles) of the Constitution By-Laws and Resolutions of the American Economic Association, *Publications of the American Economic Association,* **1**(1), March 1886, 35–46.
2. I will use the terms rules and institutions interchangeably. An institution is a generally recognized, possibly informal, prescription for people to behave in a particular way in particular circumstances (Dolfsma 2009). Someone may chose not to behave according to an institution or rule, and may show agency in other respects as well (Dolfsma 2009, Chapter 4). In addition, any particular domain or practice is likely to involve multiple rules or institutions.

2. How market and society relate[1]

Views on how market and society relate to each other may be classified according to Figures 2.1 through to 2.3. There are three broad ways in which to perceive the relation between the two spheres. First is to see market(s) and society as two separate realms (Figure 2.1). Obviously, the neoclassical economic view, specifically the Walrasian approach, is an example of this.[2] Market and society remain separate at all times. Indeed, the view of the market one finds in this literature is a highly abstract one – markets are 'conjured up', as Frank Hahn expresses – and the realistic nature of it might be questioned. As the market encroaches on society, a sense of alienation in the sense of Karl Marx might start – for some at least. This may be due to the differences in what motivates people in the two spheres, how they view the world in different terms when perceiving themselves in one sphere or the other (van Staveren 2001; Le Grand 2003). Another view captured in Figure 2.1 is the one Talcott Parsons and Neil Neal Smelser (1956) presented on the relation between market(s) and society. They argued that distinct markets (*nota bene*: plural) emerge at the boundaries between different spheres, such as polity and other sub-spheres in society, effectively insulating these spheres from one another (Finch 2007).

The second way in which to conceptualize the market in relation to society is probably best associated with the works of Karl Polanyi (1944) and Mark Granovetter (1985). The market is perceived as thoroughly and necessarily embedded in society at large, including in such institutions as money and the firm. Growth of the market domain may be interpreted as an increasing ellipse within the wider social boundary depicted in Figure 2.2. A growing market interacts with society, and the two change in the process, even when, conceptually, the market has generalized traits (Rosenbaum 2000). Establishing the effects of a growing market on society is not unambiguous. Indeed, drawing the boundaries between market and society is haphazard, as social and institutional economists acknowledge

(Waller 2004; Dolfsma and Dannreuther 2003b). Thus, the effects of expanding markets are not so clear cut, even when usually the increase in material welfare may be obvious. Institutional and social economists would then, however, ask: at what cost? As society changes due to a growing market, comparing the situation that has arisen with the previous one will be complicated. Certainly doing so in Pareto welfare terms is impossible as his framework entails the view of the relation between market and society as separate realms, such as is depicted in Figure 2.1.[3]

The perspective underlying the Keynesian welfare state views the market as part of, and regulated according to, dominant social or societal values such as norms of distributive justice (O'Hara 2000; Fine 2002) – as in Figure 2.2. The process of liberalization and privatization ('reform') boils down to an attenuated role for the state, certainly in terms of distributive justice, and there is a shift in values toward those centering on the individual and toward negative freedom. The state is viewed in such a perspective as a force of coercion, whereas the market is viewed as the domain of freedom (van Staveren 2001).

Alternatively, the market may be perceived not as a pure entity but as heterogeneous (Hodgson 1999).[4] Figure 2.3 clearly relaxes the Parsons-Robbins boundaries between the economic and social domains by arguing that nonmarket elements need to be present in a market context in order for the market system to function. Such 'societal' elements would not emerge from within the market, nor

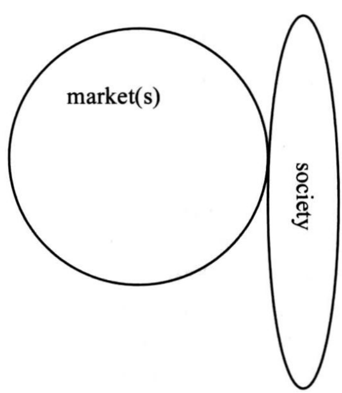

Figure 2.1 The 'separatist' view: market and society as separate

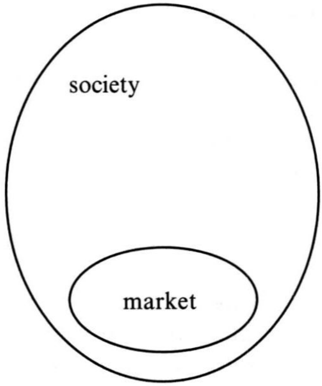

Figure 2.2 The 'embedded' view: market embedded in society

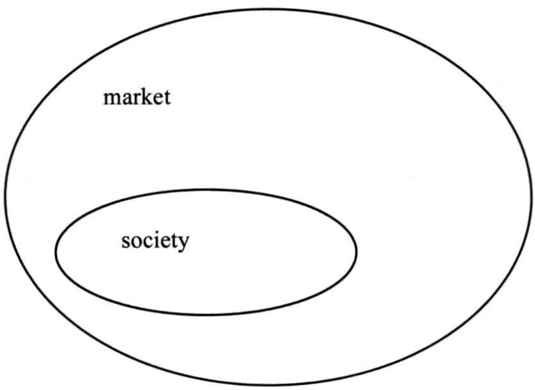

Figure 2.3 The 'impure' view: society within market

does this mean that society is completely subordinated or eclipsed by the market. This view strongly hinges on how one defines a market and seems to entail a strict definition consistent with a 'contractual' view, where market-type relations between agents are presumed to be ubiquitous (Hodgson 1999).[5] Growth of the market in this view is of a different nature to that of the previous two views. The argument is not just about how concrete markets impinge on other domains in society but on how market-like thinking expands into other domains with their associated ways of thinking and perceiving. Such an expansion, Hodgson and others argue, may occur but can never completely eclipse all elements of 'society' within the market without jeopardizing itself. Even when Hodgson does not define impurity precisely, or explicitly indicates what impurity refers to, we take this to mean impurity with regard to the motives of actors and their relations among each other. This seems consistent with Hodgson (1999).

One's stance on the contribution of markets to welfare hinges on the conceptualization of the relation between market and society. A perception of the economy (the economic domain) as a sphere entirely separate from society would be accompanied by a belief that markets necessarily contribute to welfare. Given that markets are presumed to be ubiquitous in mainstream economics, we argue that the foregoing is a reasonable representation of economic orthodoxy. Conceptions of the market in economics tend to be functionalist – in the appropriate conditions the market is an efficiency conduit and hence generates welfare as well as well-being. Creating these appropriate conditions then drives policy. This 'separatist' view is not the only conceivable view of the relation between society and economy, however, as we have argued. There are two more views – views stressed and developed in the fields of institutional and social economics, as well as elsewhere. The three views of the relation between economy and society can also be used to clarify interactions between market and society.

2.1 CHANGING RELATIONS BETWEEN MARKET AND SOCIETY

We acknowledge that markets can increase both welfare and well-being. This has been argued on a number of occasions and has been substantiated by empirical material. Rather than challenging this view, in this chapter we mean to point to the darker aspects of markets. In processes of change or reform, there is a distinct way in which the relations between market and society are presented by both sides of the argument. We focus on the side of those advocating the change. The example of reforms in healthcare serves to illustrate and clarify our position.

In stable circumstances, actors involved in a particular practice recognize that economic aspects of that practice are embedded in a broader social context; this view is that of Figure 2.2. They also