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## Externalities and government \*

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In *Whither socialism* Stiglitz (1994) argues market equilibria with imperfect or incomplete information are generally not constrained pareto efficient.<sup>1</sup> A government subject to the same informational limitations can achieve better outcomes. In this he is, of course, following the conventional wisdom. For him this is the central proposition that establishes the merit of policy activism. Of course, this is not perfectly true, but he at least says it *can* achieve better outcomes, not that it will. There are two problems here. The first and least important is that he is implicitly assuming a set of motives which are not exactly likely. He is assuming that the market participants are solely engaged in maximizing their own utility, and the government officials are trying to do good.

We can invert this and assume that the government officials are trying to maximize their own utility, and the market participants, perhaps under the influence of St. Thomas, are attempting to do good. Under these circumstances, the government would not achieve Pareto efficiency, and the market could do better, although once again it is not obvious that it would.

Of course, the incentives implicitly assumed here are not very realistic. Both the participants in the market, and the participants in the government are primarily interested in their own and their families well-being, but both of them to some extent are willing to sacrifice to help the poor and down-trodden, carry out moral duties, etc. From my own experience, I would say that perhaps the government officials are less interested in helping others than the private business men.

This may come from the fact that it is easier for a government official to conceal, even from himself his private interests, than it is for business men. Of course, my perspective may be biased. My initiation into government was

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in the Department of State, and specifically in the Foreign Service, where it is particularly hard to do anything which benefits other people.

The main theme of this paper, however, is not that Stiglitz like many other economists, has got the motives wrong, but that he, and as far as I can see almost everybody else who has written in this field (including myself) has chosen to use the existence of externalities in the market as an argument for government. I do not contest that argument, but I would like to point out that government also generates externalities. Note that I am not trying to change the meaning of “externalities”.<sup>2</sup> Nevertheless, in some cases these government externalities may suggest shifting to the market (see, e.g., Tullock, 1996).<sup>3</sup>

For the purpose of the rest of this article, let us assume that we have a simple democratic government, and the many problems which have been discussed in *Public Choice*, have in one way or the other been overcome, something which in itself is unlikely. Government automatically and immediately does anything that the majority of the population favors, and never things that they disapprove of.

That even such a government will generate severe externalities has been overlooked.<sup>4</sup> The first case is obviously war. All discussion of democratic decision making, etc., carries in it an assumption that the only people who can vote are citizens of the country. This is never justified, but I will not quarrel with it here. Nevertheless, it is clear that there were many inhabitants of Tokyo and Berlin who were subject to severe negative externalities a few decades ago. The bombing of Baghdad much more recently also generated some fairly severe externalities. I presume that most of my readers do not object to the actions which lead to these externalities, but they must admit that they are externalities, and the people who suffered from them did not favor them.

Let us turn to a simpler and more direct case of externality. Suppose that some measure is proposed and a majority favors it. The first thing to be said about this is that the minority clearly suffers an externality from this decision process. It could be argued that since the people could vote against it is not an externality. This is merely quibbling about terms. If you wish to say that people who are injured by government action because they are in a minority suffer something other than a negative externality, that is your privilege, but makes no significant difference for this article.

It should be said that, as in the market, positive externalities may also be produced. To return to the international field, the American government gives fairly large sums of money, a very small part of our GNP, but still in absolute terms quite large, to various people living in various other countries. It is likely that a very large part of these expand the business of Swiss banks more

than they benefit the average citizens in these countries, but it is a positive externality nevertheless. Further, in some cases there is no doubt it is desirable. If we return to war we will find cases in which the American military forces generated large positive externalities for people like the French.

I am primarily interested in the domestic situation, but here we find both kinds of externalities, positive and negative. The first is one that I mentioned before when the government does something which a voter positively objects to and perhaps had voted against. He/she is here suffering an externality. If the voter is benefitted by something which he/she, through ignorance, voted against, this is a positive externality. If I don't bother to vote at all, I suppose whatever happens should be regarded as an externality.

There is another case where externalities may be generated by the government if it is a simple democratic government of the sort I have been assuming. The government's activity can be either badly informed, or, occasionally, a work of genius. Let us assume that citizens of the United States, not being well informed,<sup>5</sup> mistakenly think that some policy is to their benefit when in the outcome they are injured. They will suffer a cost, and whether this is an externality or not is not obvious.

Suppose, as most Public Choice scholars have, the reason that they are badly informed is that the decision process gives them no incentive to become well-informed. This can apply in the market as well. It is not sensible to claim that market is perfectly or even very well-informed.<sup>6</sup> This can lead to external costs or external benefits which are derived out of the decision process even though the person has contributed to that decision. One can raise questions whether this as a genuine externality. Such informational errors can certainly happen in the market, although it is less likely to happen than in the government.

Let us turn to a more realistic government where not everything is voted on, and where decisions are made by civil servants, judges, general officers, and representative voting bodies like congress. We can once again find externalities because of the fact most of these decisions are not directly controlled by all the people who are affected by them. How important this is, is hard to say, but in any event one shouldn't refer to the government as something which will cure some externalities without at the same time pointing out that it creates other externalities.

I am not attempting to argue here that we should abandon the externality argument for government as opposed to the market. What I am saying is that we should include government externalities among the arguments to be taken into account when choosing market of government for some problem. The question is which will work best and one part of this question asks in which case are the externalities the most likely to be negative, and be seriously

damaging. It would be nice if there were a general principal, but one must look at each and every example. Take air pollution as an example. I take it nobody who has thought about this matter carefully would doubt that the government has made a number of rather bad decisions which have had considerable undesirable effects. But no one who has thought about the problem carefully will doubt that the negative effects of unregulated release of all sorts of waste matter into the atmosphere would be much worse than the government's controls. This is true even though the government's behavior has been far from perfect. I would come out firmly for government here, although I wish that the government would behave more sensibly. On the other hand, any one who has seen a Trabant<sup>7</sup> will realize that in some areas the external costs of government behavior can be much greater than the external costs of the private market. It should be kept in mind in thinking about this that the ordinary citizens of East Germany were not permitted to buy anything other than this piece of junk in the way of automobiles.

Our decision would be that air pollution shall be regulated by the government and the production of cars shall be private. It is absolutely clear that in both cases the chosen instrument will generate externalities. They will be smaller externalities than the reverse allocation.

To repeat what I have said before, I am not arguing that we should abandon the argument of externalities for the provision of government services. I am saying that we should not assume that the government, whether it is a democracy or dictatorship, will not generate externalities. To repeat, and strengthen one of the dominant themes of *Public Choice*, we are choosing between two imperfect instrumentalities. Unfortunately, that choice is a government decision, and will also generate externalities.

## Notes

1. Stiglitz (1994), also cites his joint work with Greenwald (1986).
2. Rosen (1995: 577) in his best selling textbook defines it as "An activity of one entity (which) affects the welfare of another entity in a way that is outside the market."
3. See, for example, my (1996) "Provision of public goods through privatization".
4. By myself as well as many other specialists.
5. See Downs, Tullock, etc.
6. In some ways the invention of the perfect competition which normally has the perfect information assumption was one of the big steps backwards in the development of economics.
7. For those who do not remember the wall, the Trabant was a ghastly East German auto.

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