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The case for liberalism:

Pervasive market failure in the economy and the polity†

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Abstract

We argue to look at the polity with the very same vista with which modern economics looks at markets, as the polity is nothing but the market for political services. Government failure can then be understood as the failure of the market for politics. We show how the systematic application of the economic theory of market failure can provide new insights and perspectives with respect to the underlying causes of government failure. Typical reasons for government failure are linked to externalities, monopoly power, and asymmetric information. Thereby, we can gain valuable insights and new perspectives on how to improve the functioning of political markets and institutions.

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1. Introduction

Classical liberals are convinced that markets most often work better than government. But they are also aware of the theory of market failure according to which markets do not always function properly. Therefore, surprisingly many liberals and liberal economist alike tend to find it difficult to argue against government intervention which is typically demanded by most politicians of every stripe and particularly left-wing parties. Some liberals resort to denying the existence of market failures, others resort to demonizing government. We argue that both strategies are neither well-founded nor necessary. Instead, a highly promising approach is to *reunite* the classical liberal reservations against government with the theory of market failure.

In order to do so, we recommend classical liberals to accept two inconvenient truths: First, markets permanently fail to some extent. Market failure usually depends upon clearly identifiable conditions. Second, the polity itself is a market which is characterized by conditions which lead to a considerable extent of market failures, often termed "government failure" or "policy failure." Indeed, we strongly argue to look at the polity with the very same vista with which modern economics looks at markets, as the polity is nothing but the market for political services. These political services encompass a range of offerings such as the provision of public goods, regulations, subsidies, industrial or environmental policy, and more. Politicians and political parties supply these services not solely for altruistic purposes, but also for their own self-interest. Citizens, special interest groups, and ideological action groups demand political services. Thus, there is a supply of and a demand for political services. Competition exists on both sides of the market. Political services are exchanged for votes, money, information, ideological support, and other means of exchange.

There are three fundamental sources of market failures: externalities, market power, and asymmetric information.[1] They not only affect commercial markets for goods and services, but also political markets where they are associated with an incomplete representation of voters' preferences by politicians. The interests of politicians may even

[1] Of course, markets may also fail in the presence of public goods. But the two defining traits of public goods, that is non-excludability of consumers and non-rivalry in consumption, are equivalent to externalities (if users cannot be excluded from consuming the respective good, there are positive or negative externalities) and natural monopolies (if there is non-rivalry in consumption, average cost are decreasing).

be opposed to citizens' short- or long-run interests. Conceptualizations of representative democracies as markets have a certain tradition in (political) economics and have been discussed by Becker (1958), Buchanan (1986), or Wittman (1995). These and other authors have taken up some of the analogies between competition and principal-agent problems in the political and the economic sphere. But they have not stringently applied the theory of market failure to the market of politics as we recommend doing, making a persuasive case for liberalism.

Governments may in principle be able to cure some failures of markets for goods and services. They can, for instance, try to internalize externalities. However, the market for politics is even more susceptible to failure than the commercial market for goods and services. In the political process, the institutions that help to overcome failures in markets for goods and services, such as binding promises and enforceable contracts, are absent (e.g., Eichenberger 2003).

We consider the three basic mechanisms leading to market failure in politics (Section 2) and discuss how these failures can be mitigated by institutions inspired by liberal. We also suggest new market institutions to foster competition in political markets (Section 3). Concluding remarks are offered at the end (Section 4).

2. The polity – a market for politics which often fails

Politics and Externalities

Government would in principle have the potential to cure market failures resulting from externalities due to its coercive power. Coercion allows governments to redefine the prisoner's dilemma typical for externalities (or for public goods) by guaranteeing individuals that their actions are no longer independent of what others do. Without government coercion, individuals would need to decide whether they want to renounce from producing externalities (or contributing to public goods) independent of what other members of the society do. With effective government intervention, all individuals are forced to behave in the same way, which can eliminate the externalities and, thus, market failure.

However, the collective decision and its subsequent coercive enforcement generates new externalities. On the one hand, government actions usually involve costs that have to be carried directly or indirectly by the taxpayers and the factors of production to which the tax burden is finally shifted. On the other hand, preferences within a polity are likely to be heterogeneous, since citizens differ with respect to characteristics such as income, age, health, or gender, among many others. Therefore, decisions are rarely taken unanimously as they benefit some citizens but disadvantage others. Thus, by implementing political (i.e., collective) decisions, politicians most often create *new* externalities via the utility or disutility created as well as the production cost caused by goods, services, and regulations provided.

These new externalities imposed by collective decisions shape the incentives of all political actors, including the citizens as voters. Those who benefit from a certain collective decision are incentivized to exaggerate their preferences for the respective political project. In contrast, those who do not benefit from the project are incentivized to understate their preferences to prevent the project. As all expressions of preferences are strategically distorted, government does not know what the true citizens' preferences are. Incomplete representation of citizens' preferences is a natural consequence such that the underlying externality issue is not necessarily solved, potentially it is even enhanced by government or a new externality is created by government.

Market power

The concentration of power presents a clear problem, not only within markets for goods and services, where it can lead to abusive practices and detrimental social and economic outcomes, but concentration of power also within political markets. Indeed, a fundamental problem of political markets is the concentration of power. A central feature of autocracies consists of the massive and unchecked monopoly power of politicians in government. Yet, in representative democracies as well, it is a matter of fact that power is given to one person, one party, or a coalition for the term in office. If there were no regular elections and politicians were elected to power for life, intellectuals of virtually all stripes would agree that policy failures due to monopoly power would be rather pervasive. Once elected, politicians have a substantial degree of monopoly power for their term in office, which they can use by deviating systematically from citizens' preferences (e.g., Stadelmann et al. 2013a; Stadelmann et al. 2020). Elected politicians also tend to reinforce the entrenchment of monopoly power by trying to stifle opposing voices and parties, as well as altering electoral rules to their own benefit.

One can object that there is competition for office or power, particularly in democracies and that the power of elected politicians is curtailed by reelection constraints. Thus, the decisive question is whether electoral competition is sufficient to constrain the monopoly power in political markets. At least three mechanisms limit competition in the political market and increase the power of the elected politicians:

1. In many countries, the number of parties is limited as their political systems are designed such that only two parties compete in equilibrium. Notably, certain positive features of the political process may emerge only with strictly two parties competing (Downs 1957). However, competition theory and real-life experience suggest that competition with a low number of competitors does not work well, since they may tend to form a cartel. The alternative to a cartel is also unedifying. The smaller the number of candidates competing, the more it pays for each to sabotage others, which results in negative campaigning or even brute force.
2. Effective competition depends not only on the observed number of participants in a market but also on whether the respective market is contestable. Markets are contestable if there are no relevant barriers to entry and exit. But this is typically not the case in politics. In commercial markets for goods and services, market entry usually occurs across borders, that is, nonlocal or even foreign firms enter other markets. But this is forbidden in most political markets because candidates need to fulfill residence and citizenship requirements (see Eichenberger 2003 and Eichenberger and Funk 2010). Thereby, politicians try to maintain their power and reduce competition.
3. In political markets, trust is even more important than in markets for goods and services because political markets tend to lack institutions that ensure binding commitments. The credibility of politicians and parties depends on large investments in their reputation, which makes market entry difficult. Reputation is at least to a certain extent locality-specific and cannot be easily transferred to other political markets such as other jurisdictions.

An empirical fact that illustrates the importance of monopolies and natural monopolies is the incumbency effect, which is one of the best documented effects in Public Choice and Political Science (e.g., Frank et al. 2023). It implies that those in power have a better chance of being re-elected and extending their power. It is also important to note that political actors may try to seek to maintain some monopoly power even in parliamentary democracies by imposing implicit or explicit entry barriers for new candidates or parties such as diverse registration requirements or electoral thresholds. Thus, political markets suffer from market power.

Asymmetric information

Asymmetric information is a pertinent as well as permanent problem in political markets. Even if electoral competition is fierce and checks-and-balances to political power exist, voters cannot fully control elected politicians. The information problem has two main sources:

1. In commercial markets for goods and services, consumers can usually simultaneously observe and effectively compare the independent offers of competing suppliers. In contrast, it is much more complicated for voters to obtain relevant information on how politicians perform. While there may be several potential suppliers of political services who may engage in competition and who interact, the final outcome is typically a singular policy, shaped by a complex, weakly transparent political decision-making process and a large variety of contextual factors. Voters are often unaware of the precise contributions of the different actors involved in political decision-making, and the characteristics of their services. Furthermore, given that politicians are unable to perfectly monitor the administration, which may pursue its own interests (Niskanen 1968), there exists an additional layer of asymmetric information. Consequently, voters are uninformed about the actions of politicians, and unable to effectively monitor their promises.
2. Voters lack strong incentives to be politically informed or to publicly express their preferences. The resulting lack of information on the demand side is more rampant in politics than in the economy, as voters' influence in collective political decisions is only minute. Since acquiring political information for casting a well-informed vote

is usually associated with costs, it is rational for voters to stay uninformed and to behave expressively rather than instrumentally (see Brennan and Lomasky 1991, Hillman 2010). Thus, politicians, even if they wanted to, do not precisely know what voters want.

Information asymmetric is thus rampant in political markets. Apart from the strong asymmetric information, neither politicians nor citizens fully know what policy would best solve the existing problems. Thus, the principal agent problem is central in politics, which usually leads to inefficient outcomes.

For some political services, there is no market equilibrium due to asymmetric information (like in a lemons market) and in others, results are heavily biased, due to another important factor: There are large asymmetries regarding information and the state of knowledge between the various societal groups, such as comparatively small and well-organized interest groups of producers vs. the large and weakly organized groups of taxpayers and consumers (Olson 1971). Small and well-organized interest groups inform their members about what politicians do and are more knowledgeable about both the problems to be solved and the activities of politicians. Likewise, politicians are better informed about the preferences of these groups in comparison to weakly organized ones. Thus, even the most honorable politicians, who aim at reelection tend to asymmetrically favor the well-organized groups as they know their preferences better and these groups know which politician is responsible for their boons.

3. On curing political market failures

Implicitly, the liberal thinkers and many economists have stressed issues related to failure of political markets for a long time. For instance, there is strong evidence that institutions that prevent politicians from abusing their power, such as effective property rights or the rule of law, lead to favorable societal outcomes (e.g., Acemoglu and Robinson 2012). However, when interpreting the polity explicitly as a market for politics, additional insights for mitigating the related political market failures emerge.

It is often believed that policy failures can be overcome via tight competition between government and an opposition party. This, however, is not enough to gear the government to cater to the citizens' preferences. As the leaders of the opposition usually aim at replacing the current government, they have little incentives to constructively propose better policy alternatives. This would only cause positive externalities for the current government. Taking up these proposals could increase its reelection prospects as the voters tend to attribute good policy outcomes to the government, for they lack the information necessary to judge the contribution of the different political players. Therefore, the opposition parties are incentivized to harshly criticize the government, its policies, and their outcome, independent of whether they are good or bad. If this helps them to achieve governmental power, they have a substantial leeway to follow their own preferences rather than that of the citizens such that the difficulties remain the same as with the previous government.

Therefore, apart from limiting government power directly, effective political competition requires additional forms of competition and numerous checks-and-balances. Moreover, the reduction of politically induced externalities is central. Externalities regularly emerge in politics for two reasons: Some externalities are newly created. Others have already existed in the marketplace and are transferred to politics. At the private level, externalities can be reduced by enforcing the user-pays-principle, which demands that all individuals pay for all external cost for which they are directly responsible, thereby effectively increasing efficiency by inducing behavioral changes, adaptation, and potential innovation. At the policy level, externalities can be reduced by effectively implementing the principle of *institutional congruence*. It stipulates that those who benefit from political action should be those who pay for it and those who decide on it. Institutional congruence, and thus, a reduction of externalities, can be partly achieved by decentralization and direct participation of all affected groups in decision making.

Direct democracy and decentralization, two well-known political institutions, and some lesser-known political institutions can help to mitigate political market failures.

Direct democracy

Direct democracy takes effect on market failure in politics via several channels. First, it is a highly effective mechanism to undermine the monopoly power of the government by intensifying political competition. It allows policies to be evaluated in terms of responsiveness to citizen preferences (Matsusaka 2018) and citizens to react when their preferences are neglected by their representatives. Initiatives and referenda may also serve the opposition parties to effectively provide policy alternatives. As they are formulated as well-defined amendments to the law or the constitution and must be implemented if they win a majority of the votes, they tend to be more credible than campaign promises. Moreover, it is easier to secure intellectual property rights for a proposal when it can be labeled as a referendum or initiative. Therefore, competition through direct democracy also works indirectly: the threat of a referendum may cause the government to choose a different policy more in line with voters' interests from the outset.

Second, direct democracy represents a process in which citizens personally and along with their representatives and experts engage in an open, productive exchange of opinions, information, and arguments. This exchange facilitates the discovery of beneficial policies, and it permits the informed formation of preferences over policies. This is reflected in intensive public discourses in the weeks and months before referenda, which improve the knowledge held by politicians and citizens concerning problems and potential solutions. Thereby, knowledge of politicians about citizens' preferences and of citizens about politicians' positions and activities is generated. As such, direct democracy and the associated processes help to reduce information asymmetries in the market for politics and thus, the asymmetries between the well-organized special interest groups and the non-organized general interest groups. Thus, direct democracy should not be seen as a substitute for representative democracy, but rather as a complement to it.

It is important to highlight direct democracy as a mean to reduce asymmetric information that must preferably be organized as a clearly defined process: In a system of direct democracy, legislative proposals are often formulated by parliament and then presented to citizens in a referendum. Moreover, citizens themselves may propose an initiative which is then discussed in parliament and may be accompanied by a counter-proposal in the final popular vote (Frey 1994). In all cases, the respective law or constitutional changes are known in advance, and there is an intense discursive process on the consequences prior to the vote. Thus, direct democracy is not an opinion poll that is organized in the form of a plebiscite. Instead, direct democracy helps to institutionalize and channel political discussion (Bohnet and Frey 1994). Notably, it helps to unbundle issues (e.g., Besley and Coate 2008) and focus the attention of politicians and voters on specific issues. Under realistic conditions, direct democracy can even outperform a benevolent social-planner (Osborne and Turner 2010) if such an unlikely benevolent social-planner were to exist at all.

Decentralization

Decentralization and federalism can lead to more positive outcomes in the market for political services through various mechanisms. Firstly, they limit the power of single decision makers and represent additional constraints as well as a form of checks-and-balances.

Second, they can increase institutional equivalence by promoting direct accountability of local decision-makers, thereby minimizing externalities of local services for budgets of higher-level jurisdictions.

Third, by increasing the variety of policies and outcomes in different locations, it strengthens the exit option of the citizens and voting by feet as a form of competition (Tiebout 1956). It also intensifies yardstick competition as comparisons become easier and more reliable, as the number of observations and, thus, the opportunities for effective comparative analyses increase. This incentivizes not only local politicians to care for the citizens' preferences, but also the citizens to become informed about politics. Due to decentralization, citizens can use such information for private decisions, such as where to locate their homes or businesses, thus transforming political information from a public good into a private good. Thereby, decentralization reduces asymmetric information.

Forth, decentralization encourages active citizen involvement and allows them to directly participate in improving local jurisdictions with their ideas. Additionally, it strengthens grassroots democracy, leading to greater respect for the will and preferences of ordinary people. For example, in communal assemblies in Switzerland, everyone is allowed to speak, and many use the opportunity to do so. This also implies that in policy battles, competing factions must secure the support of citizens through active engagement in debates and by clarifying their position. Their arguments must be easily understandable and withstand potential counterarguments, as opponents will likely raise various points during the debate.

New measures to mitigate market failures in politics

Audit commissions. Audit offices are an important example of a competing agency that enhances checks-and-balances in politics. They usually criticize politics after decisions have been ma. However, then it is already too late to change anything. It would be better to have public agencies that could inform citizens and make recommendations before the actual political decisions are made. Ideally, they should not have any decision-making power but only a well-defined mission to voice criticism on the government's policy proposals and to develop concrete counterproposals. These counterproposals can then be presented to the citizens in referenda or to the parliament. In a referendum process or in parliament the competing proposals of the criticism body and the government would then be voted on. As the members of these audit commissions want to be reelected into the respective committee, they are effectively incentivized to bring forth constructive criticism and innovative proposals. Such competitive bodies exist, for example, in Switzerland in the form of popularly elected audit commissions at the municipal level (Schelker and Eichenberger 2010).

Open market for politicians. Citizenship currently protects national politicians from foreign competition. Usually, only nationals can run for public office. At the local level, residency requirements are relevant. This and other restrictions are standard in politics. A free market for politics at the municipal, state, and even federal level that is not tied to citizenship would improve choice for citizens and disrupt political market cartels (e.g., Eichenberger and Funk 2009).

Multi-member majoritarian elections. Multi-member majoritarian elections as a special form of an electoral system may gear politicians away from client politics and reduce failure in the market for politics. Multi-seat-majority elections, instead, is a combination of the majoritarian rule and of multi-member districts, that is, voters have several votes and elect more than one politician by majority in their district. While this electoral system remains yet underexplored, it has the potential to foster competition between candidates by increasing their number, provide them with highly effective incentives to converge to the median voter, lead to governments being composed of members from several parties from all over of the political spectrum, reduce negative campaigning, and increase politicians' and citizens' satisfaction with policy outcomes (e.g., Eichenberger et al. 2019).

4. Conclusions

Market failure is pervasive. But this is not at all an argument against market economies, as markets are not only characteristic for the economy, but also for the polity. Politics can and should be understood as a market – the market for political services. Although institutions inspired by liberal thought such as property rights, the rule of law, and democracy are, in combination with free markets, essential for establishing a working and comparatively wealthy society, such institutions are not insufficient to guarantee a successful and free society. Even in fundamentally democratic societies, market failure in the market for politics persists. It is crucial for liberals to emphasize that policy failure caused by the failure of political markets is a primary rationale for liberal institutions that constrain government power.

To improve political outcomes, institutions that reduce government failure due to monopoly power, asymmetric information, and externalities in the market for political services are needed. Such institutions help to better align the decisions of politicians with citizens' preferences.

The market-based view of politics is not only useful in understanding how political markets can fail but also provides tools to address market failures such as monopoly power, asymmetric information, and externalities. This approach can unify the classical liberal call for limiting government power and the economic theory of market failure. By recognizing politics as a market, we can justify constraints on government power, as political markets are not immune to failure like any other market. Quite to the contrary, policy failure is pertinent precisely because of the typical reasons for market failure in politics.

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