DO FREELY COMPETITIVE MARKETS MISALLOCATE CHARITY?
A COMMENT ON TULLOCK'S ANALYSIS

By

Earl A. Thompson (1)

In a recent paper, (2) Gordon Tullock produced an insightful and valuable descriptive analysis of the economics of charity. Rather than remaining content with a positive economic analysis, Professor Tullock ventured forth to argue that a free market equilibrium -- apparently competitive, but not perfectly competitive because of the presence of information costs -- contains misallocations of resources towards both charitable contributions and the promotional activities of charitable institutions.

In the first part of this note, I argue that the competitive equilibrium allocation of resources in a world with imperfect information and charity does not imply a misallocation of resources. Assuming that compensated demand and supply curves are somewhat elastic, and leaving aside the usual sources of possible inefficiency of a competitive equilibrium (i.e., non-pecuniary externalities, collective-type-goods, or costs of certain transactions that can be reduced by changes in government policy), the competitive equilibrium amounts of both charitable contributions and promotions by charitable institutions (promotions of both the deceptive and non-deceptive types) correspond to Pareto optimal amounts. Tullock's inefficiency, which is a special case of a more general type of inefficiency, holds only (a) when the supply curves for all of the attributes for which charity is granted are completely inelastic or (b) in a very special kind of disequilibrium.

The net benefits of charity and, more generally, the net benefits resulting from any redistribution, may be a collective good. Therefore in order to complete an analysis of the role of government in allocating charity and redistributing wealth, we examine -- albeit briefly -- the efficiency of the free market's competitive equilibrium amounts of collective-good-charity and similar "transfers." This is done in the second part of this note.
It should be noted at the outset that since information costs are considered, Pareto optimality cannot be taken in the utopian sense in which it is usually taken by economists. That is; there are real costs of transactions, costs which include the costs of gathering information about the nature of the goods in the transaction, and there are real, social values of transactions; and such costs and values must be accounted for and equated at the margin in order to describe the Pareto optimum. The introduction of transaction costs into the usual model of welfare economics gives the government, the institution which sets up and enforces some system of property rights and thereby determines the costs of each possible transaction, a possible role in that it may reallocate or abridge the initial private property rights in order to reduce the costs of certain transactions. We assume throughout that the government has fulfilled this role, as apparently did Tullock, before we examine the efficiency of a competitive general equilibrium in which charity is one of the products.

I. The Case of Private-good-charity

Imagine a world in competitive equilibrium with charitable contributions being allocated through competitive, private firms called "charities." The world contains none of the technical or psychological interdependencies which can create non-pecuniary externalities or collective-type-goods. Now imagine that there is an increase in promotion by any charity so as to increase the total amount of donations to the charity by one dollar. Can this increase, complemented by suitable lump-sum compensations from gainers to losers, make everyone better off?

Tullock would answer in the affirmative. His argument is that since the charities must divert at least some of their contribution revenue to the ostensible recipients of the contribution, the social value of the extra contribution (the value to the contributor since his contribution in this case is a private good) exceeds the real social cost of the charity -- what Tullock tacitly assumed equal to the firm's promoting and other operating costs -- by the amount of the contribution that was turned over to the ostensible recipients. But even if it were true that some of the marginal contribution had to be turned over to the ostensible recipients of the contribution, (3) this argument completely ignores the decision functions of the recipients. If (a) there were no economically relevant way to produce the attributes for which the contribution was granted (attributes which include the ability to inform some contributor of the recipients' actual income from the charitable organization) or (b) the recipients had entirely no expectation of the contribution, then the argument of Tullock is valid. For then the payments to the ostensible recipients of the charity