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.⁴ 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 downtrodden, 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 the change the meaning of “externalities”. Nevertheless, in some cases these government externalities may suggest shifting to the market (see, e.g., Tullock, 1996).

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. 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