

Special Interests and Government Failure

By Edward J. López



Failure. If asked to boil down the government’s multitude of programs and initiatives to one word, I would choose *failure*. Keynesian economists argue: “Markets fail, use government.”

Free-market economists argue: “Governments fail, use markets.” Count me among the latter group.

Recently, I examined the way that overzealous bureaucracies affect fiscal incentives. From my study a clear pattern emerges: governments discover a *potential market failure* and develop a *potential government solution*, and we see *unintended consequences and additional failure* caused by the proposed government solution.

The problem comes from government’s failure to implement policies that serve the best interests of most people. Instead, government often favors measures that benefit narrow special interests.

Edward J. López is Research Fellow at The Independent Institute, Associate Professor of Law and Economics at San Jose State University, and President of the Association of Private Enterprise Education.

The point is chronicled in the Independent Institute book that I edited, *The Pursuit of Justice: Law and Economics of Legal Institutions*.

In the American legal system, judges and lawyers represent the small special-interest groups. Along with litigants, these parties respond to the incentives embedded in the system in predictable, self-interested ways. The results include high incarceration rates, false convictions, poor access to courts, political interference, and corruption. The Supreme Court’s decision in *Kelo v. City of New London* illustrates similar flaws.

In principle, eminent domain can help in a few cases, such as when a homeowner holds out for a price so high it would put a worthwhile project in red ink. Left to themselves, developers are crafty people with lots at stake and a long history of figuring ways to deal with holdouts. But observe what happens when developers enlist the efforts of aggressive government redevelopment agencies.

The redevelopment agency identifies public works projects blocked by stubborn property owners (*a potential market failure*). The agency then uses the government’s power of eminent domain

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President's Letter

A Gala for Liberty at 25!

Every few years the Independent Institute hosts a gala to present the **Alexis de Tocqueville Award** to select individuals who have made exceptional contributions to humanity by advancing the ideas of liberty.



In this regard I have had the great privilege of organizing events with such remarkable individuals as Nobel Laureates Czeslaw Milosz, Milton Friedman, James Buchanan, Desmond Tutu, and F.A. Hayek; entrepreneurs Sir John Templeton, David Packard, J. Peter Grace, William Bowes, Jr., Walter Wriston, William E. Simon, Sr., and Robert Galvin; historian Robert Conquest; human rights activists Elena Bonner and actor/filmmaker Andy Garcia; and many others.

Since this year the Institute celebrates our **25th Anniversary**, we are organizing a truly historic event to recognize three individuals who have made superlative and far-reaching contributions to liberty (p. 6):

- **Lech Walesa**, former President of Poland, Nobel Peace Prize laureate, and co-founder of Solidarity, led the movement against the Soviet Union and inspired Poland's transition to a market economy.
- The world-acclaimed novelist and journalist **Mario Vargas Llosa** was awarded the 2010 Nobel Prize in Literature. A Marxist in his youth, he broke with leftism and embraced free-market ideas. The author of 27 books and 9 plays, he has been decreed by King Juan Carlos I the 1st Marquis of Vargas Llosa.
- Having pioneered an entire new appreciation for free markets and the nature of government failure, **Robert Higgs** is Senior Fellow at the Independent Institute and editor of *The Independent Review*. Among his many books are *Crisis and Leviathan* and *Depression, War, and Cold War*. A festschrift in his honor, *Government and the American Economy*, was published by the University of Chicago Press.

We hope that you will join with us in this special celebration as an **Independent Associate Member**. With your tax-deductible membership, you can receive a **FREE** copy of *The Pursuit of Justice* (p. 1), *The Enterprise of Law* (p. 5) and other publications, including *The Independent Review* (p. 3), plus other benefits (see attached envelope).

David J. Theroux

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Disaster Relief • Federal Reserve as Central Planner

Here we recap two outstanding articles from the Spring 2011 issue of *The Independent Review: A Journal of Political Economy*.

Disaster Relief as Bad Public Policy

Is disaster relief something that governments necessarily provide more effectively than the private sector? A survey conducted in Mississippi after Hurricane Katrina suggests otherwise: only 25 percent of its respondents identified government as their most important source of aid.

The poor overall performance of government disaster protection and relief resulted largely from the incentives and constraints facing elected officials and their staffs, according to **William F. Shughart II** (Univ. of Mississippi). In other words, New Orleans levees failed due to cracks in the political system.

“The humdrum, largely invisible job of levee maintenance took a backseat to more newsworthy and more politically rewarding lakefront-development initiatives,” Shughart writes. As one levee district board member put it, “We never talked about levees.”

Political incentives fostered government paralysis before and after Katrina made landfall. They also led to post-disaster aid that sets the stage for future catastrophes: Congress has authorized billions in non-repayable grants for homeowners who want to rebuild in flood zones but were not insured. The expectation of getting publicly funded disaster relief may explain why 69 percent of coastal Mississippi residents did not have federal flood insurance when Katrina hit.

“Disaster Relief as Bad Public Policy” is available for free at www.independent.org/publications/tir/article.asp?a=825.

The Fed as the U.S. Economy’s New Central Planner

The Federal Reserve (or “the Fed”) emerged from the financial crisis of 2007–2009 with new powers to allocate credit to specific firms, including

non-bank institutions. It’s easy to treat this development as arcane trivia, but its consequences are monumental: it means the nation’s central bank has become in effect the U.S. economy’s central planner.

Why did Fed Chairman Ben Bernanke lobby for the new lending powers, rather than rely on the Fed’s traditional tools? The answer goes back to his idiosyncratic views about the Great Depression, argues **Jeffrey Rogers Hummel** (San Jose State Univ.).

Bernanke agrees with the late Milton Friedman that the Fed is largely to blame for the bank failures that led to the Depression, but he disagrees about the causal mechanism—and thus about the proper course for the Fed to have followed. Friedman believed the Fed could have prevented the contraction of the early 1930s by injecting enough money and credit into the banking system to keep the level of total spending in the economy unchanged, even if some important banks still failed.

Bernanke, in contrast, has suggested that what was needed was not merely for the Fed to have prevented a sharp fall in total spending, but also for it to have kept credit flowing to the borrowers of important banks, whether or not those banks were solvent. The Fed’s new powers reflect the importance he places on preserving existing channels of credit when key credit providers (banks and non-banks) face severe strain.

According to Hummel, however, the Fed’s responses to three potential financial crises since the late 1980s undermine the case for Bernanke’s brand of activism: the stock-market crash of October 1987, the public’s worries about Y2K, and the terrorist attacks of September 11, 2001. The Fed met each challenge successfully without the use of targeted bailouts.

“Ben Bernanke versus Milton Friedman: The Federal Reserve’s Emergence as the U.S. Economy’s Central Planner” is available for free at www.independent.org/publications/tir/article.asp?a=824.



The Independent Institute in the News

Center on Global Prosperity

“The failure of the Organization of American States to defend the rule of law in Venezuela, Bolivia, Ecuador and Nicaragua stands in marked contrast with the acute awareness of the danger those regimes pose to the future of liberal democracy and economic prosperity of the region.”—Senior Fellow **Alvaro Vargas Llosa**, for the Washington Post Writers Group

Center on Peace and Liberty

“Rumsfeld’s direct role in the unconstitutional excesses of the George W. Bush administration . . . should have probably landed him in jail rather than on the dais receiving an award that is designed to aid his rehabilitation politically and help promote his new book.”—Senior Fellow **Ivan Eland** in *New American*, on Donald Rumsfeld’s 2011 Defender of Freedom Award at the CPAC



Senior Fellow Charles Peña on Fox Business Channel’s “Freedom Watch” discussing Libya.

“We need to learn from our experience in Iraq, not repeat the same mistake. If getting rid of tyrants and dictators who oppress their people becomes the criterion for using U.S. military force, who do we target next: China? The so-called Democratic Republic of Congo? Eritrea? Iran? Kyrgyzstan? Venezuela? Zimbabwe?”—Senior Fellow **Charles Peña** talks about Libya on FoxNews’ “Freedom Watch” with Judge Napolitano

“As revolts demonstrating humankind’s innate yearning to be free erupt around the world, it is deeply ironic that here in the formerly freest nation ever established, Americans are being conditioned to submit to unreasonable searches on top of the warrantless wiretaps and other rights violations that have escalated over the past 10 years.”—Senior Vice President **Mary Theroux** in *The Statesman Journal*

Center on Entrepreneurial Innovation

“Federal spending is out of control because most taxpayers don’t understand the true costs. Politicians talk about billions and trillions, numbers most of us can’t comprehend.

But those huge numbers mean something. As we’re now able to demonstrate, they mean families must struggle not only to pay their own bills, but to pay government’s as well.”—Research Fellow and Director of the Center on Entrepreneurial Innovation **Emily Skarbek**, in *The Birmingham News*

“A substantial, rapid recovery of net private business investment probably won’t occur until the made-in-Washington clouds clear. Meanwhile, overall economic prospects will remain gloomy. If Congress approves billions of dollars in new federal spending for corporate R&D, don’t be surprised if Silicon Valley’s executives lobby for a share of the loot. But they should be careful about what they ask for.”—Senior Fellow **William Shughart** in *The San Jose Mercury News*

Center on Culture and Civil Society

“Everyone accepts that Kyoto, never ratified by the U.S. and due to expire in 2012, would reduce the calculated temperature rise for 2050 by only 0.05 Celsius—an immeasurable one-twentieth of a degree. Programs and policies associated with Kyoto should therefore be scrapped—including uneconomic alternative-energy sources, carbon-capture-and-sequestration efforts and costly emission-trading schemes. All of these schemes waste money and squander scarce resources without in any way impacting on the climate. Humans have adapted to natural climate changes in the past; we should have no problem doing so in the future.”—Research Fellow **Fred Singer** in *The Washington Times*

Center on Law and Justice

“Although ObamaCare and the Dodd-Frank financial “reforms” were approved by Congress and signed into law last year, these massive statutes leave scores of important details awaiting determination by administrative agencies and courts. This doesn’t create a climate conducive to aggressive investment.”—Senior Fellow **Robert Higgs** in *Investors Business Daily* •

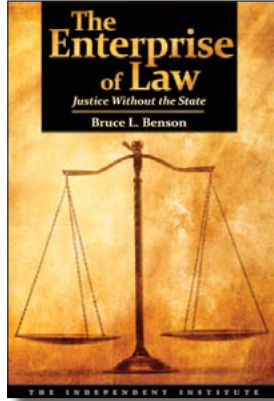
New Book

The Challenge of Market-Based Law and Justice

The provision of justice and security has long been linked in most people's minds to the state. Defenders of the state's monopoly on law-making and law enforcement typically assume that any alternative arrangement would favor the rich at the expense of the poor—or would undermine social order and ignite a war of all against all. But how well do these beliefs hold up to scrutiny?

In *The Enterprise of Law: Justice Without the State*, Independent Institute Senior Fellow **Bruce L. Benson** (Professor of Economics, Florida State University) offers a powerful rebuttal of the perceived view of the relationship between law and government. First published in 1990, Benson's treatise has just been reissued by the Independent Institute with a new preface by the author.

Justice and security, Benson argues, can be provided without a coercive state monopoly on the establishment and enforcement of law. Moreover, non-state institutions would fight crime, resolve disputes, and render justice more effectively than government because they would have stronger incentives to do so.



The Enterprise of Law offers a host of landmark findings, including these fascinating tidbits:

- *The rapid recent growth of private-sector security and conflict resolution is a throwback to an earlier era.* Public police forces did not exist in the United States and Great Britain until the middle of the 19th century, and then only in the face of considerable resistance. Crime victims played the prosecutors' role in England until almost the turn of the 20th century, and they did not yield to public prosecution without a struggle.

- *Protections for individual rights and private property are not the exclusive purview of state-run legal systems.* The tribal customs of the Kapauku Paupuans of Western New Guinea emphasized individual rights, private property, restitution, and reciprocity—as did the voluntary systems of medieval Iceland and Ireland; the

Anglo-Saxons before the Norman conquest; and the western frontier of the United States during the 1800s. The Law Merchant, a private institution begun in medieval Europe, developed and enforced laws that governed nearly all aspects of commerce and facilitated trade across the continent.

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Student Programs

College Students: Study Liberty This Summer!

The Challenge of Liberty Summer Seminar will be held at the Notre Dame de Namur University in Belmont, Calif. (near San Francisco) from August 1 to 5.

With a faculty headlined by Senior Fellow **Robert Higgs**, this exciting seminar introduces college students to the ethical and economic principles of a free society, and their application to historical and current events.

For the first time ever, this seminar session of is reserved exclusively for college-age students. Students who elect to stay at the serene, bucolic campus will have access to its swimming pool and athletic fields, in addition to common rooms, lodging, and meals.

For more information, visit www.independent.org/students/seminars/.

CURRICULUM

Day 1: The philosophy of freedom and moral ethics; the foundation of property rights

Day 2: Voluntary trade and cooperation; the price system; and government central planning vs. free-market entrepreneurship

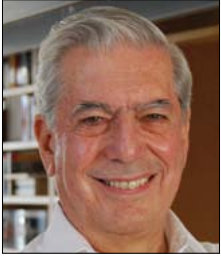
Day 3: Property rights and wealth creation; Adam Smith; economic development; public goods, “market failure,” and “government failure”

Day 4: Monopoly and competition; money and government; housing bubbles and business cycles; and Great Depression and Great Recession

Day 5: Healthcare; war; civil liberties; and the future of liberty



Lech Walesa



Mario Vargas Llosa



Robert Higgs

The Independent Institute Celebrates 25 Years

The Independent Institute is celebrating its Silver Anniversary! Since our founding in 1986, the Institute has been boldly advancing peaceful, prosperous, and free societies grounded in a commitment to human worth and dignity. To celebrate this pivotal milestone, we are excited to announce our 25th Anniversary Gala to be held November 15, 2011 at the San Francisco Ritz Carlton. Join us as we toast an evening to liberty and honor three very important men of freedom: **Lech Walesa**, former President of Poland, co-founder of Solidarity, the first anti-communist movement in the Soviet Bloc, and winner of the Nobel Peace Prize; **Mario Vargas Llosa**, recipient of the 2010 Nobel Prize in Literature for his work examining the perils of power and corruption in Latin America; and **Robert Higgs**, Senior Research Fellow of the Independent Institute, editor of *The Independent Review*, and author of the acclaimed books *Crisis and Leviathan* and *Depression, War and Cold War*.

This night is sure to be extremely special and one you don't want to miss. For more information on this unique event and how you can participate as a sponsor please visit www.independent.org/gala/. We hope you can join us as we reflect on 25 successful years of passionate dedication to civil and economic liberty and look forward to another 25 years of effecting great change!•



From the Independent Institute's "A Gala for Liberty" in 2008



Clockwise from top left: honoree **Andy Garcia** joined the John Santos Sextet during the reception; honoree **Archbishop Desmond Tutu** animates his inspiring address; Dean Allan Jones with Bonnie Moe; Barbara Edwards and Chris Boskin; honoree **Bill Boves** with guests; Bill, Phyllis, and Melinda Draper with Dinner Co-Chair Tim Draper.

Edward J. López: Special Interests and Government Failure

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to take the land by force (a potential government solution). Although it takes the property from the original owner for a fair price, the land may remain undeveloped after it is confiscated (as occurred in *Kelo*). Opportunities to take land cheaply attract investment projects with poor prospects or projects that are politically motivated, such as “affordable” housing. Eventually governments start to offer property owners below-market prices because doing so is more expedient (an unintended consequence and additional failure).

Affordable-housing mandates offer a similar example. For society in general, the mandates decrease the supply of new housing and increase housing prices, which exacerbates the affordability problem. The familiar pattern repeats:

- We have a *potential market failure*: a lack of affordable housing.
- We have a *potential government solution*: laws that mandate below-market housing, so that people with low to moderate incomes can afford to live in the higher-income areas closer to their jobs.
- And we have *unintended consequences and additional failure* caused by the intended government solution: the mandates decrease the profitability of housing construction, which decreases the supply of housing and increases housing prices overall.

These same patterns can be found in sector after sector.

The Fashion Industry. Some designers lobby to

sway policy in a direction that does not necessarily serve the public interest: they seek intellectual property protection from “copyists” who produce and distribute the same or similar designs much faster and cheaper. They have a point: intellectual property in fashion might incentivize innovation. However, the majority of the public that favors inexpensive fashion knock-offs is unlikely to lobby as effectively as the designers who favor protection.

The American Newspaper Industry. Many in the press seem to believe the government can solve problems associated with a declining readership. Some, including FTC commissioners, have proposed policies that would amount to political favoritism or infringements of free speech. The good news is that news organizations are starting to implement fee-for-service policies that mitigate the free-rider problem.

Each of these cases—the American court system, eminent domain, the fashion industry, and the newspaper business—displays a common theme: government failure results from policies that favor narrow special interests, rather than the greater collective good.

As with many medications we take to cure our ailments, the side effects of the treatment can well be worse than the initial cough or head congestion. Some claim that we live in an over-medicated nation. I will leave that for others to debate. However, the evidence of a populace over-regulated by a meddling government is irrefutable. •

New Book: The Challenge of Market-Based Law and Justice

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• *Privatizing security and dispute-resolution services, and contracting out to the private sector, can offer tangible benefits—namely, better service at lower cost.* A fully privatized system of law enforcement would rely on consumer spending rather than tax dollars. Thus it would have strong incentives to: emphasize restitution; create a variety of competing institutions and arrangements; reward judges recognized for their impartiality and clarity; employ ostracism and boycotts as penalties; and foster a prison system that treats inmates well in

order to hasten their repayment of debts. •

Praise for *The Enterprise of Law*

“This is a valuable and interesting book.”

—David D. Friedman, Professor, School of Law, Santa Clara University

“Benson’s book is an important contribution to law and economics literature.”

—Henry G. Manne, Dean Emeritus, School of Law, George Mason University

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Reaching Out to Spread the Message of Liberty

As we mark our 25th anniversary, we continue to rely on our generous supporters like you to help us win the fight to reclaim our full civil and economic liberties and to reverse the tide of government growth and profligacy.

And this is an especially exciting time for the Independent Institute! We are reaching increasing numbers across a broader range, spreading our message through creative new initiatives such as our popular Government Cost Calculator website and media project at MyGovCost.org. The Calculator allows each individual user to determine his or her own, personalized share of federal spending and debt—plus, what the taxes taken to cover that share could have earned had she or he been allowed to keep and invest that money. Innovative projects such as the Calculator leverage the Institute's ongoing, widespread research, conference and media outreach.

In this pivotal moment in history, we have real reason for optimism as more and more people

demand reduced government spending and debt, a more humble foreign policy, and less government intrusion into their daily lives. But there is still much to be done, as the economy continues to flounder and politicians call for increased government "investment." Now is precisely the time to build educated, popular support for the truly

innovative ideas that are the hallmark of the Independent Institute—ideas that can actually solve our nation's ills.

Please help us reach the millions of people now seeking these alter-

natives by using the enclosed reply envelope to make a contribution towards a campaign of truth in the midst of what promises to be an upcoming election cycle of noise and spin. With your help, we can leverage attention-grabbing initiatives like MyGovCost.org to make the next 25 years a period of renewal for the principles and practices of liberty!•



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