Reconciling the false dichotomy between public administration and market efficiency

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INTRODUCTION

Markets and governments (including public policy and public administration) have been the subject of considerable discussion and dispute among analysts, researchers and policymakers since Adam Smith published “The Wealth of Nations” in 1776. The notion that markets could self-organize without government intervention and that capitalistic economies could be a means of social governance, and a desirable end to seek for social organization was given widespread support and promotion by economists and businesses (see Wolf 1993). Karl Marx (1906) and Joseph Schumpeter (1934; 1942) are the most notable and influential economists who challenged the outcomes of a capitalistic system, particularly as it relates to a means of social organization. In the U.S., the argument about the roles of markets and government evoked considerable discussion beginning in the late 1970's with John Kenneth Galbraith's television series “The Age of Uncertainty” was aired (1977), followed by Milton Friedman’s (1980) “Free to Choose,” seen as a response to Galbraith. The demonstrated failures of the socialistic countries–saturated with government intervention–and the modern trend to internationalize nation-state policies in the face of globalization have reinvigorated and intensified the debate surrounding the roles of governments and markets (Boyer and Drache 1996).

In the current climate of globalization, nations/nation-states around the world are emphasizing efficiency, decentralization, and devolution, and are taking measures to reinvent the role of government, and public-policy, including functions and functionaries (see Amin 1997, Dasgupta 1997, and Pretense 2000). There exists ample literature addressing the general issue of market and government efficiency and inefficiency, limits and reaches, intents and outcomes, and trust and premonitions. Yet, attempts to recognize the complementary roles of markets and governments, however, are few and far between. The close correspondence between government and markets remain unattended. Indeed, it is the case that markets and governments are generally viewed to comprise of substitutable goals, functions and functionaries with very little complementarity. In particular, there is very little literature identifying the indispensable nexus between economic order and public administration agents. Further, there exists widespread debate within the scholarly public administration literature as to which direction the profession should take (see, e.g., Simon 2000 and Frederickson 1999).

Institutional economists have made some compelling arguments about the institutional
connections between markets and governments (Galbraith 1977; Bromley 1997; Commons 1968; Simon 1991), but they have been marginalized by the popular press and outspoken market economists. A few non-economists have also argued persuasively that markets function within a broader institutional setting (see, e.g., Boyer and Drache 1998; Dierckxsens 2000; Mizruchi and Schwartz 1987; White 1981; and Williamson 1985, 1986). Further, government is often seen as sluggish, inefficient and corrupt, and as an adversary of the market. Thus, many economists (e.g., Friedman and Friedman, 1980) have argued against government intervention of any kind as it is often seen as unnecessary to achieve market efficiency. If anything, transaction costs are expected to increase because of government intervention. These observations raise important questions concerning the role of governments and market efficiency. (1) Do markets function independent of government intervention or oversight? (2) Are the roles of government and markets mutually exclusive—bi-directionally? (3) Do government and market institutions and agents function independent of each other? Discussing the answers to these penetrating questions form the theoretical core of this paper. This paper explores the idea that market efficiency is attainable only under a set of public policies and regulations that minimize high transactions costs in the long-term in an exchange economy, and that bureaucrats (public administrators) and entrepreneurs play complementary roles in a modern democratic society.

MARKET EFFICIENCY AND ANTI-GOVERNMENT ARGUMENTS

Economic efficiency is defined either by Pareto Optimality—a largely theoretical concept, or Potential Pareto Optimality—an operational Kaldor (1939) - Hicks (1939) criterion or compensation principle (Varian 1992). An economy is said to have achieved Pareto Optimality if there exists no means to improve one or more individuals’ utility without decreasing another’s. Potential Pareto Optimality is a condition under which there exists a potential to compensate the individual(s) that lose by the individual(s) that gain from a movement from a Pareto efficient state to another (Johasson 1991). In particular, market efficiency is defined by a state where Pareto Optimality is achieved in production and exchange.

The equilibrium conditions characterizing a system of competitive, well-functioning or efficient markets, under assumptions about technology, tastes, and producers’ motivations, will precisely correspond to the requirements of Pareto Efficiency. This notion asserting the duality between markets and Paretian efficiency forms the central theorem of welfare economics (Johansson 1991) and the basis of economists’ claims in general that the best means to achieve Pareto Optimality is through market mechanisms.\(^1\)

The idealized model of a perfectly efficient (competitive) market is expected to have optimal use of resources by individuals and firms (microeconomic efficiency) and full-employment equilibrium (macroeconomic efficiency). Further, prices can emerge from voluntary transactions between buyers and sellers in a free market (Debreu 1960). From these price regimes millions of individuals’ activities can be coordinated, each acting individually and independently in pursuit of her/his self-interest, in such a way to make everyone better off (Friedman and Friedman, 1979). Friedman and Friedman (1979) identify government’s role as merely attending to tasks related to the protection of citizens from coercion from within or outside the country, administration of justice, preserving and strengthening, and ensuring responsible behavior that does not threaten the community and its members.

Even most public services currently provided are expected to result from individuals acting voluntarily to promote their self-interest, setting forth different requirements, goods and services

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\(^1\) It is important to note that market is just one institutional mechanism to achieve Pareto Optimality. In fact, Pareto optimality as a concept is without an institutional bias. For instance, a political means of achieving Pareto optimality is through voting mechanisms (Bromley 1997).
that will be provided by other individuals seeking their own self-interest. An economic and social order is expected to emerge for the unintended consequences of many individuals acting in their own self-interest (Friedman and Friedman 1979). While it is possible to envisage this in a theoretical and abstract level, there are two other important roles of the government that Friedman and Friedman do not outline, but are generally agreed upon by most pro-market economists. The two roles are the allocation of property (assigning property rights) and definition of liability rules—especially important in the presence of negative externalities (see Wolf 1993).

**MARKET FAILURE AND PRO-GOVERNMENT ARGUMENTS**

One important reason why markets do not always function efficiently is that the assumptions required for competitive equilibrium to achieve efficiency are rather exacting and do not stand the test of real world situations. For instance, transactions costs are often greater than zero in the real world. Additionally, assumptions such as homogeneous products and symmetric and perfect information are often violated.\(^2\)

Market failure is attributable, at least in allocation theory, to inefficiency in the system of price-market institutions to either maximize profits or utility. Market inefficiency can result from several conditions: (1) a failure of existence—no price or price-like constants exist; (2) failure by signal—local producers’ profit maxima than global maxima and extra normal producers’ profits; (3) failure by incentive—non-negative producers’ profit; (4) failure by structure—lack of self-policing perfect competition in all markets; and (5) failure by enforcement—presence of arbitrary legal and organizational imperfections or feasibility limitations of input and output accounting.

Theory of market failure is well developed and most economists tend to agree that there may be instances under which government intervention may be required. In fact, pro-government views are well-grounded in the formal theory of market failure. It is widely known that market failure can occur in the allocation of public goods, and presence of externalities, increasing returns to scale, other market imperfections, and preexisting social inequities.\(^3\)

The pro-government view is often based on an idealized model of an informed, efficient, and humane government.\(^4\) Such a government is viewed as being capable of identifying and putting in place solutions to remedy market failure. However, economists are unlikely to tie-in the concepts of efficient markets and government. In other words, market efficiency cannot be attained since all the assumptions required for a competitive market and subsequently for Pareto Optimality, may not hold in the world with numerous and complex transactions. Further, there may be very few markets in existence with perfect information and zero transaction costs. For markets to function effectively, there needs to be proper and well-developed institutions supporting market activities. This point will be discussed and clarified below.

**Society and Governance**

In general and simplistically stated, society is comprised of citizens, their various activities, rules—*de jure* and *de facto*—designed to govern the activities and institutions constructed to

\(^2\) While empirical studies in industrial organization do not show either a violation of marginal cost pricing, or weak axiom of cost minimization or profit maximization, the econometrics behind these inquiries are still being developed. Further, there is no consensus in the literature as to whether the conditions of profit maximization (or its dual-cost minimization) are maintained or violated in various market sectors (see Jean Tirol’s (1988) *The Theory of Industrial Organization* for an excellent discussion.).

\(^3\) Ronald Coase (1964) argued that even when externalities are present, agents may be able to arrive at optimal resolution of the externality given that there is no transaction cost or wealth effect. Both of these assumptions are unlikely to hold in the real world.

\(^4\) While many economists that take a pro-government stance are for government intervention, they may not necessarily be anti-market.
facilitate and optimize their citizen’s activities in particular and sustain civilization in general.\(^5\) Most individual activities occur within a geo-political boundary and quite often each is affiliated with a particular family and community more than any other. Personal and local considerations often triumph over societal and global considerations. Each society, however, appears to be engaged in the trading-off of tastes and preferences, attitudes and behaviors, desires and outcomes, so as to maximize individual interests for the benefit of most citizens for the longest term. Most individuals live and function within the rules that society establishes in its attempt to balance the private (business) interest with that of the public’s interest. Essentially, most activities of individuals occur within the broader setting of a society. Individuals or groups of individuals create systems or institutions to facilitate their activities while minimizing conflicts arising from contradictions and competing interests. Political and economic systems are two such important institutions that define modern societies.

**Growing Complexities Within Societies**

Political and economic systems are two institutions that have become quite meaningful and consequential, and importantly, more complex in contemporary society. Each individual within a society engages in a wide range of activities other than just being a consumer or producer. However, it is argued that the majority of an individual’s time is utilized attending to economic activities. While a citizen within a tribe or village could represent himself or herself in the political setting of traditional and so-called primitive societies, this may no longer be possible. Not only do most contemporary societies consist of a large number of institutions, but also the time, effort and resources required to be a direct participant in the political process has changed. As a result, the costs have increased considerably. Also, there have been substantial changes in the political system and processes, and nature of politics itself as the expanses of a society grows. Further, what has also changed are the goals of societies and what is required to provide for its citizens. Suffice it is to say that individuals in modern society are perhaps less involved in the political process due to problems of access, opportunity, and growing demands from competing tasks he/she has to undertake as a consumer or producer. In other words, the modern individual is more of a consumer and less of a citizen. This sort of a transition can also be observed on the economic front as well.

As noted above, individuals are both consumers and citizens. Thus, more and more time is expended working and earning to be able to acquire more material wealth. For example, workers in the United States work more hours, take fewer vacation days and have more saved for retirement. The traditional economic activities undertaken to support survival and purchase of essentials has been overcome by the desire to increase the standard of living measured in terms of income and acquired wealth. These two indicators have come to signify social status in contemporary society. What has resulted, especially in advanced democratic societies with mature economies, is a high degree of mass consumption.

Given the increased emphasis on indulging in activities that increase income and wealth, the role of each individual in a society has been transformed substantially from that of a citizen to consumer. In the light of political differentiation and the various levels of the political processes in place, and coupled with more time being devoted to economic activities, less and less time is being devoted to each stage of the political process. Another interesting development in the society is the time spent on recreation and entertainment. Both have progressively increased in costs. The relevance of this situation to the current discussion is that individuals have less disposable time and income to be informed about each product and transaction. On the one hand, the public interest is always in the back seat.

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5 While there are much more complex and appropriate definition of society, this simplistic definition of society will suffice for our discussion here.
hand, it is important to note that disposable income is required to obtain information, enter into a contract, enforce the contract and transaction. On the other hand, the transaction costs associated with each exchange have substantially increased. In other words, there has been a parallel increase in the price of information, contracting and policing each transaction because of the complexity and nature of exchanges. For instance, the points of production and consumption are often quite wide apart. In most instances, the origin and composition of many of the products are often unknown to the end-user or consumer, and the destination and end-user is often unknown to the producer. Contributing to this asymmetry in information is the advanced storage capacities and facilities, and multiplication of means and modes of transportation, their complexity, how specialized the means have become, coupled with the increased diversity in the different modes of transportation.

**PUBLIC ADMINISTRATION, GOOD GOVERNANCE AND MARKET EFFICIENCY**

The definition of public administration has moved beyond mere management values such as efficiency and economy to include the values of citizenship, fairness, equity, justice, ethics, responsiveness, and patriotism—and thus ennoble the day-to-day practices of public servants (Frederickson 1996). Public administrators manage public organizations and institutions to enhance the prospects for change, responsiveness, and citizen involvement—and serve other organizations/institutions in a fair and efficient manner. According to McKinney and Howard (1998), public administration includes activities that require one or more of the following activities: mobilize private and public organizations and human resources; translate public policy into programs and projects; permit managers to translate ideas into actions; and improve the quality of citizens’ lives. Many of the functions of a private manager are similar in nature to that of the public manager. However, there are very distinct principles that govern or guide their activities. In a general sense, while the business manager is driven by the profit maximization, her/his public counterpart is motivated by *service regardless of cost considerations* (McKinney and Hoard 1998). The public manager has to ensure efficiency and equity in terms of the quantity and quality of services provided without any underlying profit motives. In contrast, a private manager has to provide goods and services to maximize profits, i.e., as efficiently as possible regardless of equity considerations. The value system that a public administrator embodies and the goals that they work towards are, however, in contrast with that of a private functionary like an entrepreneur (see McKinney and Howard 1998). Insofar as public and private managers are trying to facilitate activities that maximize the services offered by their respective organizations, their roles are similar. The complementary arises from the various functions a public manager undertakes to provide an environment conducive for business to occur.

*Good Governance and Market Efficiency*

In Western contemporary societies, an exchange economy operates that is neither quite under the grip of one or two individuals or agencies, nor is it overtly transparent to the individual consumer and producer to ensure perfect information. While private interests are working independently and individually to maximize their interests, there are rules and codes of conduct that must be followed and obeyed. These rules and regulations are often *de facto* in nature in traditional societies. Moreover, most agents engaged in exchange of goods and services know what these rules were. However, in modern society the exchange of goods and services transcend local communities, and often involve a complex route of transfer from point of production to consumption. In such a setting, economic agents in one region will quite often not be aware of the *de jure* rules of another region, let alone the *de facto* rules. Thus, for an efficient exchange to occur, there needs to be minimal transaction costs. One way to minimize these
transactions costs is to have an institutional setting that frames the rules, makes them available, enforces them and establishes means to reprimand violators. The role in establishing and implementing the rules that govern activities of the exchange system is one example of illustrating the increased responsibilities of a public administrator.

Recent literature suggests that good governance determines economic development (see Kaufmann et al., 1999). Good governance can be defined as the traditions and institutions by which a government organizes and exercises it powers and duties. Three important components of good governance are identified by Kaufmann et al.:

1. the process by which governments are selected, monitored and replaced,
2. the capacity of the government to effectively formulate and implement sound policies, and
3. the respect of citizens and the state for the institutions that govern economic and social interactions among them (p. 1).

Kaufman et al. examined three hundred indicators categorized into six aggregate groups. In a cross-section of over 150 countries, they find a strong causal relationship that good governance leads to better economic development results.

Bureaucratic efficiency is often a reflection of the political system and stability of a nation. In other words, a state or country with a more stable political system often has a stable and efficient bureaucratic system. This can be illustrated by considering the case of United States and India. While a number of factors are involved in comparing the two countries, in the United States there has been long-term, sustained political stability, and the bureaucratic system functions at more efficient levels. The bureaucratic efficiency manifested in good governance has led to the United States achieving better economic success than India. The particular impact of the lack of governance can be illustrated in the loci of competition that is optimal determined by the government in the United States. For instance, written into contracts are the provisions to prevent identical businesses from locating within a certain distance from each other. There is an optimal distance between competitors of homogenous products. However, in India, one would find streets lined with shops selling only luggage, utensils, groceries, or medicines. The locus of competition between homogeneous products is sub-optimal. There is excessive competition because of either price collusion or gouging leading to positive or negative profits. Businesses usually do not exit the market due to limited opportunities. Instead they survive on credit and may operate in a seasonal pattern of profit-making and loss.

Additionally, in the United States local public decision-making bodies determine the type and size of businesses that starts operation within its jurisdiction. Obtaining a permit to start a business is quite rigorous with local public bodies taking particular interest in who comes and goes. Through a mechanism of public comment, review, planning, stakeholder meetings, the city council is able to weigh interests of competing businesses with the that of the new one and consequently approve or disapprove its location. An example of attracting a business could be providing competitive tax breaks. Writing into a zoning ordinance the nature of land use is an example of preventing businesses from locating. Essentially, public rules enforced by public administrators are determined at local levels to ensure appropriate functioning of market agents, exchange and rules.

Therefore, it does appear that public administrators are indirectly establishing market boundaries to ensure that the role of the markets is well defined. Checks against rent-seeking should be put in place. There are specific functions that individuals can and cannot do. Public policies make sure that human greed is maximized within acceptable boundaries. Greed is

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6 Although there are several contributing factors for the development achieved in the U.S. and the lack thereof in India, this illustration will merely bring out the discrepancies in governance and market consequences.
maximized while fraud and social costs need to be minimized. Competition is maximized while conflict minimized. Profit is maximized while total transaction costs are minimized. Public administrators, as the implementors and enforcers of the public polices, serve important roles as functionaries in maximizing market potential.

The seemingly high value of the transactions cost imposed due to the regulations could indeed be lower in comparison to costs resulting from market failure or inefficiency. Many times ignored are the long-term consequences and future costs of market failure and the lack of regulations that could have built safeguards. In the absence of appropriate institutional settings markets do not function efficiently despite claims economic theory. Additionally, public administrators who influence public policymaking along with the executive, legislative and judicial branches, are even more instrumental in making sure that the policies and regulations are enforced, monitored, and evaluated. This is how the role of the public administrator has grown and not diminished, and that public administrators have important roles in monitoring the market.

CONCLUSION

We have argued that without effective governance there is no efficient or well-functioning market. Markets and market agents are not able to self-organize, sustain and perpetuate as transaction costs increase, especially as the time and space dimensions of a market grow beyond its traditional boundaries within the conventional geo-political setting—a village, town or small city. In the contemporary marketplace, the type, complexity and amount of transactions have increased and diversified enormously transcending jurisdictional limits of the reach of markets themselves or local governments. The cost—information, contracting and policing—associated with each transaction has augmented beyond the self-organizing local market and beyond the individual market agents’ endowments and entitlements. At the micro level, the necessary conditions for a competitive (efficient) market are not fulfilled without good governance, and consequently, market efficiency is not achieved. Without proper monetary, fiscal, or trade policies, countries and businesses within each country have essentially no direction or signals to develop plans or strategies of any kind—be it short- or long-term—vis-à-vis other businesses, and other countries and overseas businesses. The conditions that may result in the face of poor governance may in fact lead to sub-optimal competition.

The role of government is being redefined. As a result, the roles of bureaucrats and entrepreneurs are becoming similar. They both have to be efficient managers. They both have to synthesize large amounts of information (data) and provide goods and services in a timely and cost-effective manner. Further, there is an increasing need for public administrators to provide the services that a complex and dynamic exchange economic system like the ones under globalization requires. Without the availability and provision of the optimal amount and type of public services, private activities may not produce optimal outcomes. Public administrators have to ensure that there is good governance at all levels to maximize the interaction between the various institutions. The complementary relationship between governments and markets has been further reinforced by the internationalization of policies and services. Good governance has become the cornerstone of successful economies and societies. Increasingly, market efficiency can only be attained and maintained under a regime of good governance in which public administrators have substantial roles.

REFERENCES


