

V COLÓQUIO INTERNACIONAL DE EPISTEMOLOGIA E SOCIOLOGIA DA CIÊNCIA DA ADMINISTRAÇÃO

FLORIANÓPOLIS - SC - BRASIL (MARÇO/2015)

Market failure as ignored determinant of the choice between public and business administration: a preliminary statement

Gaylord George Candler¹

John Paul Randle²

Abstract

In the *epistemologia da ciência da administração* one of many important dimensions has been the different subfields of the study of administration. At our university alone, we have graduate programs in business administration, global business administration, health administration, public administration, nonprofit management, educational leadership, sport management, and higher education administration. It is often relatively simple to identify social realms in which these different sub-fields should apply: in a health setting, the Master of Health Administration; in a higher education setting, the Master of Higher Education Administration. Perhaps the biggest, longest running ‘turf’ battle between these different areas of administrative knowledge is that between public and business administration. This is a controversy that goes back at least to Adam Smith, with his specific limitation of the role of ‘the sovereign’ (government, or public administration) to justice, defense, and public works (Smith 1776, p.). Implicitly these were market, or ‘invisible hand’ failures: areas where the ‘invisible hand’ would not yield the specific purpose Smith identified for market exchange: the good of society. Contemporary discussions of the relative role of market and state are generally framed in terms of the role of the State, with market provision the default option. We will argue that even discussions of the role of the State can best be assessed through the concept of market failure.

¹ g.candler@unf.edu

² n00662480@ospreys.unf.edu

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Introduction

In the *epistemologia da ciência da administração* one of many important dimensions has been the different subfields of the study of administration. At our university alone, we have graduate programs in business administration, global business administration, health administration, public administration, nonprofit management, educational leadership, sport management, and higher education administration. It is often relatively simple to identify social realms in which these different sub-fields should apply: in the provision of health and in managing hospitals, the Master of Health Administration; in the provision of education in universities, the Master of Higher Education Administration. Perhaps the most important, and longest running ‘turf’ battle between these different areas of administrative knowledge is that between public and business administration. That business administration should apply to business, and public administration to government, is relatively well accepted (though it is a commonplace in the USA to hear politicians tout their small business experience as qualification for public office³). What is more contentious is what each institution should do: should government or business produce and distribute bread, education, hair cuts, defence, electricity, and water? This is a controversy that goes back at least to Adam Smith, with his specific limitation of the role of ‘the sovereign’ (government, or public administration) to justice, defense, and public works (Smith 1776, p.). Implicitly Smith suggested that these were market, or ‘invisible hand’ failures: areas where the ‘invisible hand’ would not yield the specific purpose Smith identified for markets: the good of society.

Contemporary discussions of the relative role of market and state are generally framed in terms of the role of the State, with market provision the default option. We will argue that even discussions of the role of the State can best be assessed through the concept of market failure. Market failure has, though, been marginalized even within the field of economics. Instead, equilibrium theory is applied without recognition of these limits (Finer, 1945; Galbraith, 1973, pp. 11-50). Instead, general market equilibrium is reified. Consumer and producer surplus are identified as shaded areas in the left quadrant of the ‘x’ formed by the intersection of supply and demand curves, and any deviation (especially as a result of public action!) from market equilibrium is shown as reducing this surplus, and so resulting in “deadweight loss” (Samuelson and Nordhaus, 1985, p. 431-2; Krugman and Wells, 2009, pp. 180-2), in which “economic efficiency would be violated and inefficiency would result” (Gwartney, Stroup and Sobel, 2000, pp. 75-6). Again, the limits of market equilibrium, and the importance of non-economic factors, are ignored in these efficiency judgments. This, again, is in the business administration literature. In public administration, at least in English, market failure is ignored. By way of contrast, in academic public administration, some of the seminal texts in the field are criticisms

³ As this paper is being prepared, an election campaign is underway in our home city of Jacksonville, Florida. The party-endorsed Republican candidate has no experience in government service, but touts himself as “a job creator,” having “co-founded a Jacksonville-based professional services firm” (Curry 2015).

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of government, and advocate markets (see Simon 1945 and 1969; Ostrom 1973 and Osborne and Gaebel 1992; Wilson 1989).

Economics textbooks structurally perpetuate this conception. The first few chapters present, and justify the conceptual usefulness of the assumption of ‘perfect markets’. The supply and demand curves are then derived, and the point at which they cross is equilibrium. As indicated: no deviation from this position is permitted. Some chapters later, most economics texts present a few chapters on a handful of market failures: public goods, monopoly, asymmetric information, etc. But the texts do not, then, return to that initial assumption of perfect markets, and correct the inviolability of market equilibrium.

Market failure

This paper has its origins in part to the approach taken by one of the authors (Candler), at the beginning of introductory classes in public administration. As a way of illustrating why societies have government, market failure is presented (see, for instance, Candler 2014, pp. 4-6). This, then, is followed up with a discussion of government failure (see pp. 7-9). The purpose of this approach is to suggest to students that

“Too often decisions about whether, and how to provide public services get made on ideological (what we believe), rather than pragmatic (what the evidence shows) grounds. Knowing the relative strengths and weaknesses of government, market, and nonprofit provision of goods and services can help reduce the poor policy outcomes that result from the former decision-making process.” (Candler 2014, p. 11)

This paper focuses on market failure, in large part because the authors, as North Americans, live in one of the most market-friendly societies in the world, in which the role of government has, arguably, long been under attack (see Galbraith 1973, p. 4-9; Dimock 1990, p. 22), even though the size of government has been decreasing for much of the past 30 years (see *The Economist* 2012). By most accounts, the Brazilian situation is considerably different. In a recent article in *The Economist* newsmagazine, it was argued that:

“At the University of São Paulo, the loftiest of Brazil’s ivory towers, microeconomics courses dwell on market imperfections while neglecting government failures, laments Fabio Barbieri, who teaches the subject.” (*Economist* 2015, p. 30)

We will return to this contrast in closing the paper. The discussion that follows will present nine broad categories of market failure that, we argue, go at least half way (with government failure being the other half) to giving those interested in *a vida humana associada*, a better understanding of how to choose between public, private, nonprofit, co-produced, or self production of goods and services. These nine market failures are:

1. Institutions (or justice?)
2. Public goods
3. Monopoly

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4. Asymmetric information
5. Externalities
6. Substantive issues
7. Principal/agent problems
8. Irrationality
9. Implications of creative destruction

Institutions

That contemporary economics has ignored market failure is especially odd given that a number of these were identified as long ago as Adam Smith's *An Inquiry into the Nature and Causes of the Wealth of Nations*, widely considered the first systematic discussion of market economics, at least in English. Smith especially addressed the concept of market failure in terms of his 'Three Duties of the Sovereign'. The first of these was justice. Smith described this duty as

“...that of protecting, as far as possible, every member of the society from the injustice or oppression of every other member of it.” (Book II, p. 231)

Further on the subject of institutions, Smith's third duty of the sovereign was “public works and institutions.” Public works will be described in the next section. By “public institutions” Smith meant public education:

“After the public institutions and public works necessary for the defence of the society, and for the administration of justice, both of which have already been mentioned, the other works and institutions of this kind are chiefly those for facilitating the commerce of the society, and those for promoting the instruction of the people. The institutions for instruction are of two kinds: those for the education of youth, and those for the instruction of people of all ages...” (Book II, p. 244)

That justice is fundamental to, indeed for the ancients like Plato and Saint Augustine foundational to, government is a point that requires little elaboration. More recently it is worth noting that even the World Bank, hardly a staunch advocate of government, has stated that:

“An effective state is vital for the provision of the goods and services – and the rules and institutions – that allow markets to flourish and people to lead healthier, happier lives. Without it, sustainable development, both economic and social, is impossible.” (World Bank 1997, p. 1)

Public goods

Smith's third duty of the sovereign also identified infrastructure: roads, bridges, harbours and the like. Smith's 1776 case for public goods was a bit vague, arguing that some infrastructure that benefits the economy greatly, might be such that the private provider of the work would not be able to profit from this (Book II, p. 244).

Paul Samuelson went on to develop the logic of this further, through first distinguishing between private and collective consumption goods. As examples, think of bread versus clean air. While

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both are desirable, in the former case the buyer enjoys the full benefit of a loaf of bread. In the latter case latter case clean air can be enjoyed even by those who have not contributed to its preservation (Samuelson 1954). Or, in the evocative phrase that has come to be associated with this phenomenon, “if a good is nonexcludable, rational consumers won’t be willing to pay for it – they will take a ‘free ride’ on anyone who *does* pay. So there is a free rider problem” (Krugman & Wells 2009, p. 462).

The concept of public works as market failure has been a very topical issue in our city of Jacksonville, Florida. JAXPORT, the City of Jacksonville’s shipping port, is currently working with the US Army Corps of Engineers to dredge the main shipping channel to accommodate the larger container ships that now have access through the Panama Canal. Despite huge projected economic benefits to the region, the nearly \$1b cost is such that it will be public funded (Army Corps of Engineers 2014, pp. 83-97).

Monopoly

As Cassidy put it: “The problem of monopoly is as old as economics” (2009, p. 128). The danger of monopoly and, implicitly, the need for something to combat this, is more implied than openly stated in *The Wealth of Nations*. In his discussion of the wages of labour, he notes that bargaining between masters and workmen is inherently unfair, as “the masters, being fewer in number, can combine more easily; and the law, besides, authorizes, or at least does not prohibit their combinations, while it prohibits those of the workmen” (pp. 74-5, see also p. 69).

Economics has not necessarily handled the topic of monopoly well. Harberger’s 1954 study argued that the cost of monopoly to the US society was a fraction of a percent of GDP. Rather than regulation as a solution to this problem, it is often seen as the cause. For the Friedmans, “a monopoly can seldom be established within a country without overt and covert government assistance” (1979 p. 45). Still, the topic has long been a topic of interest among economists (Pigou 1920, pp. 250-380; Schumpeter 1942, pp. 87-106; Samuelson and Nordhaus 1985, pp. 502-27; Krugman and Wells 2009, pp. 355-81).

Asymmetric information

The classic work on asymmetric information was Akerloff’s “The Market for ‘Lemons’: Quality Uncertainty and the Market Mechanism.” The central message was that the seller of a good often knows more about the quality of that good than does the buyer. Given the assumption of perfect information in perfect markets, this creates an obvious, utility-reducing market failure. The problem goes beyond used cars. As Cassidy notes,

“In the labor market, employers know much less about the skills and diligence of job applicants than the applicants themselves. In banking, lenders know less about borrowers’ ability to repay their loans than the borrowers do. In health care, the providers of medical insurance know less about the health of their customers than the customers do.” (2009, pp. 153-4)

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The U.S. Food and Drug Administration (FDA, the equivalent of Brazil's Agência Nacional de Vigilância Sanitária) regulates all matters relating to food and pharmaceutical commerce in the United States. Its mission includes the monitoring of food sources and alerting the general public of safety recalls and nutritional values contained in commercially available foods. The latest controversy that the FDA has been involved with surrounds a debate regarding the safety and necessity of vaccinations for children. While the FDA has hard scientific evidence proving the safety and benefits of a properly administered vaccination regiment, a minority in the American public have begun a debate over the safety of these drugs and possible, though not yet proven, linkage to autism. Most recently an outbreak of measles, believed to originate from the theme park Disneyland in California, has illustrated the hazards of not following the FDA's recommended vaccination policies. The numbers associated with this outbreak are relatively small, yet startling in comparison to the incidences prior to this recent push in shunning the vaccination of children. Had the government not stepped in to correct this market failure, disclosing the evidence derived from scientific research and experimentation, the general public would be left to decipher the ramblings of celebrities turned epidemiologists (Measles Returns, 2015b).

Externalities

Coase's "The Problem of Social Cost" identified externalities as a form of market failure. The term 'external' refers to costs borne (or benefits received) that are outside of the immediate exchange between buyer and seller. For market economic theory, equilibrium is the point at which both buyer and seller maximize their utility, with the benefits of an exchange greater than costs (purchase price for the buyer, production costs for the seller). In the case of externalities, a third party *external* to, or outside this exchange, bears costs.

Coase emphasized, especially, the importance of weighing the costs of the externality against the benefits produced, with the agent suffering the effects of the externality adequately compensated if benefits exceeded costs. He was also, somewhat ironically, generally skeptical of the ability of government agencies to resolve such conflicts through regulation, indeed these were likely to protect those causing the externalities (p. 26-8). He was much more confident of the ability of the Courts (and their government agents Judges) to do so (pp. 19).

This market failure is also illustrated through the proposed dredging of the Saint John's River in Jacksonville. Opponents of the dredging project state that the project will allow for more sea water to flow upstream, causing the salinity in the river to change drastically, affecting the aquatic animal and plant life. There is already cause for concern as residential pesticide and herbicides, which enter the river through storm drains via lawn runoff, have caused spikes in nutrient levels. This change in pH has led to annual algal blooms in the river. According to the US Environmental Protection Agency, a governmental organization tasked in dealing with

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externalities that affect the environment, these algal blooms cause dead zones within the water, spike water treatment costs, pose significant health hazards for anything coming into contact with them; including humans (Army Corps of Engineers 2014, pp. 170-263).

Substantive issues

What we are referring to as ‘substantive issues’ is not a major focus of the little research mainstream contemporary economists have done on market failure. However a number of people (of all political leanings) argue that government should be about more than just efficiency and the provision of goods and services. Alberto Guerreiro Ramos argued that in contemporary public administration "...questions like the 'good' of man or society have no place in the area of rational debate. Rational man is unconcerned with the ethical nature of ends per se. He is a calculative being intent only on accurately finding adequate means to accomplish goals" (1981, p. 106). And so instead, for Ramos public administration needed to concern itself with issues like "love, trust, honesty, truth, and self-actualization" (p. 112).

More broadly, ‘substantive issues’ would include contemporary topics like social capital, patriotism, and concerns over inequality. Again, there are roots of these concerns going back to Adam Smith. As indicated, the famous ‘invisible hand’ quote identifies the interest of society as the end to which self-interest is harnessed (1776, pp. 477-8). Smith also raises the issue of equity:

“It is but equity, besides, that they who feed, cloath and lodge the whole body of the people, should have such a share of the produce of their own labour as to be themselves tolerably well fed, cloathed and lodged.” (p. 88)

Candler argues that “contemporary economics” has “sought to remove egalitarian normative considerations from economics” (2010, p. 329). Candler especially sees the roots of this trend originating in Alfred Marshall’s seeking to remove normative considerations from economics, especially notable given A.C. Pigou’s counter perspective which sought to maintain social welfare in the center of economics (Candler 2010, pp. 333-5; Marshall 1961, p. vi; Pigou 1962, pp. 11-20).

Principal/agent problems

When the people hired to manage firms put their own interests ahead of the firm, market distortions result. Berle and Means’ (1932) *The Modern Corporation and Private Property* is generally considered the seminal statement of this problem. In an analysis based on business management, the central issue is what has come to be termed the separation of ownership (i.e. by shareholders, the principal) and control (i.e. by executives, their agent). If the interests of (and incentives faced by!) the latter are inconsistent with the interests of the former, owners may lose (pp. 112-16).

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These issues have been developed in a number of directions, both in the business management and broader social science literature, that are far beyond the scope of this short paper. For our purposes, Fama and Jensen especially emphasized Berle and Means' reference to different (principal v. agent) attitudes to risk (1983, pp. 305-11), and also, it should be added, extended principal/agent tensions to nonprofit organizations (pp. 318-21). Jensen was to return more recently. In contrast with Berle and Means' characterization of one interest of shareholders as "that the company should be made to earn the maximum profit compatible with a reasonable degree of risk" (p. 114), Jensen describes as "managerial heroin" the use of stock options as an incentive for (mis)management (2005, pp. 8-14). This, too, was before the global financial catastrophe that was the Bush recession of 2007 and beyond, attributed in large part to executive risk taking (Greenspan 2008; Cassidy 2009, pp. 205-98; Roubini and Mihm 2010, pp. 61-85).

Finally, it should be added that while the discussion above is set in the private sector (both business and later the nonprofit sector), principal-agent problems occur in government, as well. Indeed, government regulatory failure (encouraged by lobbying on the part of the private interests who benefit from either regulation or, in the case of the recent global recession, deregulation that favors them) is widely cited as a contributing factor in the recent recession (Roubini and Mihm 2010, pp. 68-76, and 211-37). More, government can also be captured from within. It is concerns like this that have led to Bresser Pereira calling for

"os direitos dos cidadãos de que o patrimônio público sefa efectivamente de todo a para a todos... contra aqueles que buscam capturer privadamente os bens que são ou devem ser de todos." (1997, p. 109)

Irrationality

An underlying assumption of (especially micro-) economics has been rationality. As Samuelson & Nordhaus put it: "People have rational expectations when their forecasts are unbiased and they use all available information" (1985, p. 335). This belief was reinforced by Austrian economics. Von Mises, for instance, especially sought to "convert the theory of market prices into a general theory of human choice" (1949, p. 3). Central to this was methodological individualism (pp. 41-44) with its assumption that "human action is necessarily always rational" (p. 18) to the individual actor, and so government intervention was less likely to lead to outcomes that benefit the public than would the aggregated private decisions of citizens themselves (Galbraith, 1958, pp. 11-18; Hayek, 1944, pp. 75-79).

While even *The Wealth of Nations* offered examples of irrational economic behavior, Herbert Simon is generally credited with the first systematic refutation of these assumptions. He especially identified limited information and computational capacities (1955, p. 99) as leading to "actual human rationality-striving can at best be an extremely crude and simplified approximation to the kind of global rationality that is implied" by contemporary economics" (p. 101). More recently the 'behavioral model' identified by Simon has been taken up by a range of economists (*The Economist*, 1999). Identifying Von Mises' ideas above as part of the problem,

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Cassidy argues that “It was in the aftermath of World War II that economists began to focus almost exclusively on *Homo economicus*, elevating rationality to a near-sacred principle. By the 1970s, economists had locked themselves in straitjackets” (2009 p. 193). Even after the Bush Recession and onwards, which occurred despite even conservative thinktanks ranking the US as one of the most free economics in the world in 2008⁴, mainstream economists blamed the financial meltdown on government (Cassidy 2010).

Implications of creative destruction

Austrian economist Joseph Schumpeter famously defended the logic of capitalism as follows:

“The opening up of new markets, foreign or domestic, and the organizational development from the craft shop and factory to such concerns as U.S. Steel illustrate the same process of industrial mutation—if I may use that biological term—that incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one. This process of Creative Destruction is the essential fact about capitalism. It is what capitalism consists in and what every capitalist concern has got to live in.” (1942, p. 83).

This is all well and good, so long as the costs of the destruction do not overwhelm the benefits. So if your favourite bakery goes broke: no worries, you can get bread elsewhere. But if your child’s for-profit school is shut down, your child could lose, or experience severe disruption to, a year of education. Another dimension of the creative destruction of capitalism can be seen more broadly. The basic logic is that the inefficient is swept away, to be replaced by the more efficient. Resources idled by the destruction of inefficiencies are (it is implied) taken up by the more efficient production methods. A number of problems can result, though:

- The idled worker may not have the skills needed by the more efficient production methods (see Bessen 2014, Schumpeter 1942, pp. 134-9).
- Idled regions that lose their industry may not see something comparable (or much of anything) replace this. In Brazil, think of mechanization in the sugar industry. In the United States the textile industry shifted from New England to North Carolina, then from North Carolina overseas. Neither region has recovered (see Kennedy 1954; *The Economist* 2005).
- Whole countries may be left out of the global trading system (see Cardoso 2001).

By way of conclusion

In closing, we would like to return to the question raised earlier about differences in the relative utilization of markets versus government in the US and Brazil. Too often, discussions of what Hood (1986) termed “the tools of government” suffer from a number of maladies. One of these is the tendency to think in ideological, rather than pragmatic terms. A second is that it is often

⁴ The libertarian Cato Institute’s Economic Freedom of the World: 2010 Report, using 2008 data, had the US ranked sixth, behind only Hong Kong, Singapore, New Zealand, Switzerland and Chile. The über-conservative Heritage Foundation’s *Index of Economic Freedom 2008* similarly had the US ranked fifth, with Hong Kong, Singapore, Ireland and Australia ahead.

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implied that there is ‘one best way’, or one best model. Instead, as Guerreiro Ramos argued, the social scientist and public manager needs to think in terms of “a multidimensional model of for social systems analysis and design in which the market is considered a legitimate and necessary, but limited and regulated social enclave” (1981, p. 121. Implementing such a model will have a greater likelihood of success if based on a balanced understanding of market failure, along with an appreciation of the limits of government action.

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