



Rational Irrationality and
the Microfoundations of Political Failure

Independent Institute Working Paper #7

Bryan Caplan

October 1999

Rational Irrationality and the Microfoundations of Political Failure

Bryan Caplan
Department of Economics
and Center for the Study of Public Choice
George Mason University
Fairfax, VA 22030
bcaplan@gmu.edu
703-993-2324

October, 1999

JEL Classifications: D72, D62, D84

Keywords: irrationality, collective choice, inefficiency, political failure, rent-seeking, pork, bureaucracy, economic reform

Abstract:

Models of inefficient political failure have been criticized for implicitly assuming the irrationality of voters. (Wittman 1999, 1995, 1989; Coate and Morris 1995) Building on Caplan's (1999a, 1999b) model of "rational irrationality," the current paper maintains that the assumption of voter irrationality is both theoretically and empirically plausible. It then examines microfoundational criticisms of four classes of political failure models: rent-seeking, pork-barrel politics, bureaucracy, and economic reform. In each of the four cases, incorporating simple forms of *privately costless* irrationality makes it possible to clearly derive the models' standard conclusions. Moreover, it follows that efforts to mitigate political failures will be socially suboptimal, as most of the literature implicitly assumes. It is a mistake to discount the empirical evidence for these models on theoretical grounds.

For discussion and useful suggestions I would like to thank Don Boudreaux, Tyler Cowen, David Levy, Pete Boettke, Jim Schneider, Geoffrey Brennan, Bill Dougan, Bill Dickens, Mitch Mitchell, Ed Lopez, J.C. Bradbury, Todd Zywicki, David Bernstein, Robin Hanson, Dan Klein, Alex Tabarok, Nicky Tynan, Timur Kuran, Ron Heiner, Roger Congleton, Fab Rojas, Charles Rowley, Gordon Tullock, an anonymous referee, seminar participants at George Mason, participants at the Public Choice Outreach seminar and the Public Choice Society meetings, participants at the Workshop in Economics and the Law, and members of my Armchair Economists' listserv. Gisele Silva and Eric Crampton provided excellent research assistance. Particular thanks are owed to the Kaiser Family Foundation for creating and sharing the data for the Survey of Americans and Economists on the Economy. The standard disclaimer applies.

Politics consists in directing rationally the irrationalities of men.

Reinhold Niebuhr, in Brussell (1988, p.443)

1. Introduction

In a world of costly prevention, the socially optimal level of political failure - like the socially optimal level of crime - is positive. But in many treatments, the implicit assumption is that democracy with rational voters yields a magnitude of political failure well beyond this optimal amount. (Tollison and Wagner 1991; Rowley and Tullock 1988; Tullock 1980; Buchanan 1980) Paradoxically, democratic outcomes are not only inefficient, but harmful for a majority of voters. (Holcombe 1985) Critics reply that this literature fails on its own terms: Rational voters would avoid inefficient outcomes in the first place. If the failures can be costlessly prevented, or if no relevant actor actually has an incentive to create the failure, they will not happen at all. (Wittman 1999, 1995, 1989; Coate and Morris 1995; Wintrobe 1987)¹ More generally, rational voters will avoid political failures so long as the social cost of their presence exceeds the social cost of their prevention. Mere ignorance is not an obstacle to optimal response: Just as law enforcers are ignorant about many crimes in their jurisdiction, voters are ignorant of many political failures. Both can compensate for their lack of knowledge with probability multipliers for punishments, as the theory of optimal punishment emphasizes. (Becker 1968; Bender and Lott 1996)

Using an economic model of belief formation I term "rational irrationality," this paper re-examines four well-known families of political failure models. It finds that explicitly incorporating simple kinds of *irrational* expectations into the behavioral assumptions provides solid microfoundations for *inefficient* political failure, i.e., a level of political

¹ For some other recent responses to this line of criticism, see Rowley (1997), Boudreaux (1996), and Lott (1997a, 1997b).

failure beyond the socially optimal level. Equivalently, it provides microfoundations for democratic selection of suboptimal levels of political failure prevention. In each instance, the *private* costs of postulated deviations from rationality are trivial: Collectively, people leave \$20 bills on the sidewalk, but individually they do not.

The paper is structured as follows. The next section reviews the basic theory of rational irrationality. Section three summarizes the main inconsistencies the critics have pointed out in models of rent-seeking; it then presents alternative microfoundations that leave the key results unchanged. Sections four through six do the same for pork barrel politics, bureaucracy, and economic reform, respectively. Section seven concludes the paper.

2. Rational Irrationality

Caplan's (1999a, 1999b) model of rational irrationality treats irrationality (in the sense of deviation from rational expectations) as a standard good: agents make a rational trade-off between wealth and irrationality.² The model has three critical assumptions. First, agents have a specific "bliss belief"; they deviate from rational expectations to get closer to this bliss belief, not from a contrarian desire to be as irrational as possible. Thus, agents' wealth/irrationality indifference curves are C-shaped, with the usual negative slope up to the bliss belief y^* (Diagram 1), but a positive slope past y^* . Consuming zero units of irrationality is equivalent to having rational expectations. Second, these preferences yield a standard downward-sloping demand-for-irrationality curve. The "price" of irrationality is just the negative impact on *private* wealth of a given degree of bias under given circumstances. Last, agents always have rational expectations about

² For other economic models of irrationality, see Akerlof and Dickens (1982) and Akerlof (1989).

the price of irrationality. This is the assumption that distinguishes *rational* irrationality from full-blown irrationality. Assuming the negative impact on private wealth is proportional to the degree of bias, the price may be drawn as a horizontal line. The optimal quantity of irrationality is given by the intersection of the demand curve and the price line.

Standard neoclassical agents with no preferences over beliefs demand zero irrationality at all prices. Their demand-for-irrationality curve can therefore be drawn as vertical at $q=0$; this will henceforth be designated as a "neoclassical" demand-for-irrationality curve derived from "neoclassical" wealth/irrationality preferences. While there is nothing in the model that rules out extreme deviations from neoclassical preferences, for the purposes of the current paper it is only necessary to assume that agents have "near-neoclassical" demand curves. (Diagram 2) Agents with near-neoclassical irrationality demand curves consume zero irrationality when the price is significant; but as the price of irrationality approaches zero, the quantity demanded increases sharply. Under most circumstances, then, "neoclassical" and "near-neoclassical" agents think alike, but when irrationality is cheap, near-neoclassical agents will exhibit large systematic biases whereas neoclassical agents will not.

This distinction has practical importance because for a large class of beliefs, the *private* cost of systematic error is effectively zero. This is especially true of political beliefs: As Downs (1957) and Olson (1965, 1982) emphasized, the probability that one vote will change policy is extremely close to zero. The probability that one agent's systematically mistaken beliefs about politics will have a negative impact on his wealth by leading him to vote against his own interests is no greater. However deluded one more person is, democratic outcomes will almost certainly not change. (Akerlof 1989) It is the *marginal*

cost of systematic political error that must be considered: even though protectionist policies tend to reduce the wealth of protectionists, one cannot avoid paying a tariff by changing one's mind about the validity of the law of comparative advantage. The institutional structure of politics tends to peg the price of irrationality at zero. Note that this does *not* imply individuals consume an infinite quantity of irrationality: When the price of irrationality is zero, people adhere to their bliss belief, consuming irrationality until they are "satiated." (Diagram 3)

In contrast, systematic errors about non-political issues often have large private, marginal costs. Over-estimating your job performance while intoxicated makes you more likely to lose your job and ruin your career. Under-estimating the rate of inflation leads to poor portfolio choices. In cases like this, the price of irrationality is strictly positive: the expected wealth of an agent who becomes a little bit more irrational definitely falls. As Diagram 3 shows, this reduces the quantity of irrationality demanded. With near-neoclassical demand for irrationality, a moderate price is sufficient to induce rational expectations.

If people derive utility from holding irrational beliefs, what is the connection between irrationality and political failure? The problem is that for political irrationality, the private and social costs of irrationality are different. Even though the private cost of irrationality is zero, the social cost can be enormous. Just as the divergence between private and social cost of polluting leads a group of identical polluters to a suboptimal, high-pollution outcome, so too does the divergence between the private and social cost of irrationality lead to a suboptimal, high-irrationality outcome. Note further that while rationally ignorant individuals admit they are ignorant, rationally irrational individuals believe that they know the truth. The former admit they have a problem, and can take steps to

compensate for it; the latter, in contrast, make no effort to adjust for a problem they deny exists. For example, if voters are rationally ignorant about the specifics of trade policy, they can still support general procedures to curtail protectionist pressures. But such procedures would win no favor from voters who affirmatively favor protectionism due to their rationally irrational overestimates of the social benefits of protectionist policy.³

The next four sections of this paper use the rational irrationality framework to rebuild the microfoundations of four familiar classes of political failure models.⁴ This is meant to be a complement to, not a substitute for empirical testing. Empirical evidence that these models have some validity should not be ruled out of court on microfoundational grounds; neither should empirical evidence that the marginal social cost of these political failures exceeds the marginal social cost of preventing them.

3. Rational Irrationality and the Microfoundations of Rent-Seeking

a. The Critique

The rent-seeking literature, beginning with Tullock (1967) and Krueger (1974), argues that the existence of redistributive politics prompts special interests to invest real resources to capture a larger share of government favors. A standard breakeven condition implies full dissipation of rents; the political process transforms transfers into deadweight costs. Even efficient auctions or pure transfers at one stage may indirectly

³ While Tullock usually emphasizes the role of rational ignorance, in "Future Directions for Rent-Seeking Research" (1988) he discusses common attitudes more consistent with rational irrationality: "Take a very traditional example, the protective tariff. Anyone who has taught elementary economics knows that it is hard, indeed very nearly impossible, to convince the students that protective tariffs are a bad idea. Students who get an A in your course and regurgitate the standard arguments against protective tariffs may not believe a word of it." (p.476)

⁴ Caplan (1999b) discusses the welfare implications of political irrationality in more detail, showing that under simplified assumptions, the magnitude of political failure is an increasing function of the *median* belief's degree of bias. Caplan (1999c) provides empirical evidence of systematically biased politically-relevant beliefs.

intensify wasteful rent-seeking at another stage: Efficient cash bribes to bureaucrats may just spark more inefficient rent-seeking by would-be bureaucrats, eager to secure an income stream of graft.

There is nothing irrational about the rent-seekers' behavior; while investments in lobbying do not ex ante earn super-normal profits, neither do investments in anything else. From a rational expectations perspective, the main objection to the rent-seeking model is that rational voters would not enact policies with such effects - unless, of course, the problem is so minor that the social costs of preventing it exceed the social costs of the problem. What is the point of "redistributive" programs that transfer nothing and waste real resources? Replies involving rational ignorance in the face of concentrated benefits and diffuse costs are superficially plausible. But those skeptical of the rent-seeking literature have a diverse portfolio of criticisms.⁵

As Wittman (1995, 1989) emphasizes, the fundamental weakness in the causal chain linking rational ignorance to inefficiency is that it confuses ignorance and bias. "[T]o be uninformed about the nature of pork-barrel projects in other congressional districts does not mean that voters tend to underestimate the effects of pork barrel – it is quite possible that the uninformed exaggerate both the extent and the negative consequences of pork-barrel projects." (1995, pp.15-16) Similarly, to be ignorant about the negative side effects of redistributive politics is not equivalent to under-estimating those side effects. Rational voters, however ignorant, can still estimate the overall role of rent-seeking without bias. Armed with this estimate, the electorate would rationally compensate, taking the negative consequences of rent-seeking into account when determining the

⁵ Many of these objections will resurface in the next three sections.

optimal level of redistribution. Economists' calls for anti-rent-seeking reforms, or even more modest appeals to *not* create new rent-seeking "traps," (Tollison and Wagner 1991; Tullock 1980) would be as confused as telling consumers to watch less television, or refrain from buying new televisions. In both cases, actors have already factored any harmful side effects of their choices into their calculation of the optimal decision.

Similarly, rational ignorance about rent-seeking does not imply voters under-estimate the optimal level of effort to devote to its prevention. Voters do not have to passively accept the level of rent-seeking as a function of the magnitude of redistributive programs. Anticipating the rent-seeking problem, they have ways to mitigate it. Criminally punishing corruption is one example. Another is to set up anti-rent-seeking overseers such as the Lochner-era Supreme Court. (Epstein 1985; Rowley 1988) Their job would be to deter rent-seeking by invalidating transfers with high social costs.

What Magee, Brock, and Young call "optimal obfuscation" is still more difficult to reconcile with rational voters. They claim that rent-seeking insiders amplify the severity of political failures by using "roundabout, circuitous, oblique, and labyrinthine" redistributive methods such as non-tariff barriers. (1989, p.258) With rational voters, it is hard to see how this could happen at all, since it is not even in the interest of individual rent-seekers. (Austen-Smith 1991) As Breton and Wintrobe (1982) emphasize, when asymmetric information gets worse, public demand for government action goes down, not up. If insiders make it impossible for voters to tell good programs from bad, rational voters' strategic response is "when in doubt, vote no." Magee, Brock, and Young go on to see perverse effects of better information: "[w]ith increases in voter sophistication, parties must disguise their redistributive activities more effectively." (1989, p.263) This seems to overlook the possibility that voters infer something from the degree of

obfuscation itself. And rational voters *would* infer something. Since the backers of the most socially beneficial programs have no reason to disguise their activities, they won't. Transparency is therefore a signal of high quality, and rational voters would take advantage of it by supporting transparently beneficial programs. Conversely, if the backers of a policy try to confuse the public, the rational inference is that the policy cannot stand on its merits and voters will refuse to support it.

b. The Reformulation

The simplest way to resolve the paradox of inefficient rent-seeking is to admit that voters are irrational: They systematically underestimate the connection between rent-seeking and redistributive politics. Left to their own devices, a large majority will see no connection between subsidies and special interests, regulation and corruption, or protectionism and economic stagnation. (Fremling and Lott 1996; Tullock 1980) This is unsurprising since the private cost of irrational bias about rent-seeking is normally minimal. Such bias then pulls policies away from their optimal position on relevant margins. Voters select an excessive level of redistribution because they ignore one of its main negative side effects; they select a suboptimal level of rent-seeking prevention because they deny the problem exists.

It is just as privately cheap for people to draw *perverse* inferences. Krueger maintains that rent-seeking often increases the popularity of ideas that exacerbate the rent-seeking process:

If the market mechanism is suspect, the inevitable temptation is to resort to greater and greater intervention, thereby increasing the amount of economic activity devoted to rent seeking. As such, a political "vicious circle" may develop. People perceive that the market mechanism does not function in a way compatible with socially approved goals because of competitive rent seeking. A political consensus therefore emerges to intervene further in the market, rent seeking increases, and further intervention results. (1974, p.302)

Once the assumption of citizen rationality is relaxed, there is no reason to a priori reject the claim that special interests and politicians amplify voters' biases by using indirect policies, misleading labels, and other confusion tactics. (Magee, Brock, and Young 1989; Caplan 1999b) The basic problem, though, is not biased information, but rather the fact that voters have no incentive to *process* their information in a rational way. (Caplan 1999a) In standard economic markets, demanders retain the incentive to analyze their situation rationally no matter how misleading the suppliers are. If the asymmetry is severe enough, consumers exit the market, or opt to buy solely from vendors who credibly signal their honesty. This is not true in political markets, where a voter pays nothing at the margin for allowing politicians and special interests to fool him.

One common criticism of rent-seeking is that it is an implausible account of the intentions of political actors. Lobbyists, bureaucrats, lawyers, and other groups involved in the legislative process often sincerely care about the cause they work for. They are not willfully predatory "rent-seekers." (Kelman 1988; Klein 1994) Krueger's seminal article in fact concedes this: "In most cases, people do not perceive themselves to be rent seekers..." (1974, p.293) Tullock similarly observes that, "[N]ot all of this is done by deliberate villains. The student who did not understand the arguments against protective tariffs, and who is later hired as a lobbyist by the cotton textile industry, probably operates with a good conscience when he retains false economic arguments." (1988, p.477) Admitting rational irrationality into the economic toolbox helps make sense of this paradox. People want to believe what is pleasant, but normally the private costs of acting on those beliefs deter them from indulging this wish. Nothing comparable deters the consumption of irrational *political* beliefs. The result: People with irrational political beliefs self-select into rent-seeking jobs they genuinely believe in. In addition, people

without pre-existing commitments who become rent-seekers tend to adopt the irrational political beliefs they need to make their career a source of pride rather than embarrassment. (Klein 1994) Misunderstandings about the "true model" usually imply foregone profit opportunities, but the theory of rational irrationality helps uncover the exceptions to the rule.

4. Rational Irrationality and the Microfoundations of Pork Barrel Politics

a. The Critique

The organization of Congress allegedly puts legislators in a prisoners' dilemma of excess spending. (See e.g. Fiorina 1983; Weingast, Shepsle, and Johnsen 1981; Holcombe 1985; Gilligan and Matsusaka 1995; Bradbury and Crain 1999) Political competition forces each Congressman to focus solely on the interests of his constituents. Congressmen therefore bargain for "pork" to bring back home, and disregard the impact of their efforts on the common pool of taxpayer revenue. This not only makes the total level of spending inefficiently high, but also leads to excessive spending on "local interest" projects relative to projects in the "national interest." The larger the number of legislators, each representing his or her own district, the greater the total level of spending.

Even leaving aside the costs of prevention, is this really a logical result if all political actors are fully rational? Critics wonder why politicians overlook the obvious Pareto superior *unilateral* deviation: bargaining for efficient cash transfers instead of inefficient "pork." (Wittman 1995; Tullock 1988) A single legislator - without reducing anyone else's resources - could bring home more value by bargaining for cash instead of military bases, agricultural subsidies, bridges, and so on.

The sophisticated attempts to solve the paradox of in-kind transfers wind up abandoning most of the orthodox conclusions about pork barrel politics in order to retain the rationality assumption. To take one example, in Coate and Morris (1995), there are "good" and "bad" politicians; good politicians care about voter welfare, but bad politicians also care about the welfare of special interests.⁶ Bad politicians use inefficient transfer methods to conceal their "type." But still, voters must ex ante expect to benefit more from each program than from a simple cash transfer. As with asymmetric information models generally, then, one would expect the total level of spending to be too low, not too high.

Most importantly, the very structure of this putative prisoners' dilemma shows that there is a Pareto superior "omnibus repeal" bill that would do for the overall budget what the base closings bill did for military spending. (Wittman 1995, 1989) If voting for one program at a time leads to inefficient results, why not arrange to simultaneously vote on a broad package of spending cuts? This would admittedly require a joint deviation to the better equilibrium. But a political system with rational actors is well-equipped to orchestrate such moves. Individuals who want national popularity have an incentive to help local representatives get to the nationally optimal equilibrium. The President, prominent party leaders, and/or senior legislators are all potential focal points for joint deviations. This will not occur if the social costs of the omnibus repeal exceed the social costs of the pork barrel; but in that case, as usual, enduring the problem is more efficient than solving it.

⁶ For a quite different but more narrowly applicable theory of efficient in-kind transfers in terms of the "Samaritan's dilemma," see Bruce and Waldman (1991).

b. The Reformulation

What seems so artificial about the preceding critique is that voters are not that rational. As Wittman succinctly but skeptically puts it, "[V]oters would not accept such blatant transfers." (1989, p.1404) While voters pay no attention to "pork-as-usual" politics, cash gifts to political supporters would attract hostile public attention.⁷ Nor do voters individually have any incentive to be more rational: the level of spending will be the same regardless of how objectively one more person decides to think about the fundamentals of welfare economics. Wittman ridicules this as a theory of "knife-edge stupidity" since it posits that "[v]oters recognize efficient transfers but not inefficient ones." (1989, p.1404) His incredulity is misplaced: in politics, this sort of irrationality frequently appears. Attempts to transfer a few million dollars to Congress in the form of pay raises repeatedly sparked nation-wide outcries. (Washington Post 1999) But voters pay little attention when Congress wastes billions in less dramatic ways: for example, with its reluctance to sub-contract or privatize despite the large potential cost savings. (Wintrobe 1987, pp.445-6; Borcharding, Pommerehne, and Schneider 1982)

Page (1996) provides a striking example of "knife-edge stupidity" in his discussion of the Zoe Baird nomination.⁸ Elites showed little interest in Baird's admission that she knowingly hired an illegal alien as a nanny for her children. "[B]y Monday, January 18, four days after the *New York Times* broke the illegal immigrant story, the major media

⁷ Here again, Tullock's (1988) observations are more consistent with rational irrationality than rational ignorance: "There are... in addition to this general lack of information, some fairly strong opinions held by most people. Firstly, they have a 'general image' of what government should do. This general image includes most of the major duties of the government. For example, most people think that the government should repress crime. For a less pleasant example, most Aztecs thought their government should engage in large-scale human sacrifice. For most modern societies, direct payments to well-off people are not part of that public image." (p.473)

⁸ It should be noted that Page generally interprets his findings as evidence for the competence of voters rather than the opposite.

had offered only a sprinkling of serious criticisms of Baird and - relying heavily on Senate Judiciary Committee officials - had almost universally predicted that she would be confirmed as attorney general." (Page 1996, p.88) But much of the general public saw matters differently; large numbers cared enough to complain on talk radio and other outlets for non-elite expression. Nor was this just the intense reaction of a small segment of the public; as Page reports, a national poll of a representative sample of citizens found that 51% thought Baird's action was a "major concern," 33% saw it as a "minor concern," and only 15% said it was not a concern at all. The direct result was that Baird withdrew her nomination; the indirect result was probably a long-lasting negative shock to the supply of political talent. Baird's implicit transfer to herself provoked a large reaction not because it really was quantitatively significant, but because many voters treated it as if it were.⁹ As Page concludes, "[P]opulistic deliberation tends to occur, only when the facts are simple, clear, and uncontested... That is, it may be met only when something apparently very simple and straightforward, like Baird's infractions, grabs public attention. More often, in messy and complicated matters like savings-and-loan regulation, tax breaks, deficits, international trade agreements, or Federal Reserve Board control of interest rates, ordinary citizens - if deprived of substantial elite competition - may be left at sea, unaware of policies that are harming them." (1996, p.101)

Page's caveat about elite competition is probably unnecessary. One need not assume unexploited opportunities for political or economic profit to explain something like the

⁹ Brennan and Lomasky's (1993) expressive voting theory probably also explains a large fraction of the political dynamic of the Baird incident.

Zoe Baird incident.¹⁰ The media and politicians get attention by saying what individual members of the public want to hear, not by lecturing them about their collective interests. News about the "salary grab" makes the front page because individuals want to read it.

As Olson observes:

[E]vents that unfold in a suspenseful way or sex scandals among public figures are fully covered by the media, whereas the complexities of economic policy or quantitative analyses of public problems receive only minimal attention. Public officials, often able to thrive without giving their citizens good value for their tax monies, may fall over an exceptional mistake striking enough to be newsworthy. (1982, p.27)

In sum, while the models of *inefficient* pork-barrel politics cannot be easily reconciled with the rationality of the voters, they can be derived from plausible assumptions: Just replace rational voters with voters who overestimate the significance of "blatant" transfers relative to "non-blatant" transfers. This in turn gives bad incentives to politicians: they can stay in office even though they support the inefficient status quo. For the same reason, politicians who advocate Pareto-improving political deals to buy out special interests can expect public hostility rather than popularity. Unsurprisingly, few bother to try.

5. Rational Irrationality and the Microfoundations of Bureaucracy

a. The Critique

Consider two alleged political failures frequently associated with bureaucracy. The first: Bureaucrats maximize their budget, and have accordingly grown to an excessively large size. The second: Bureaucracies are less productively efficient than private firms that perform the same functions. (Wittman 1995) Both failures typically appeal to the absence of a residual claimant; bureaucracies face the same incentives as natural monopolies with a maximum (and guaranteed) rate of return of zero. Breton and

¹⁰ For more examples of public reactions out of proportion to objective events, see Kuran and Sunstein (1999).

Wintrobe (1982) and Wintrobe (1987) however reply that this analogy is mistaken. Bureaucracies do have residual claimants: the elected politicians who fund the bureaucracy and win votes and popularity if it functions well. The bureaucrats have as much incentive to cater to the politicians' aims as private employees have to serve the interests of their employers. True, there remains some room for bureaucrats (and politicians) to deviate from voters' interests, but such principal-agent problems may also be found in profit-making firms. A positive level of shirking remains in both private and public sectors for the good reason that it is too costly to completely eliminate it. (Bender and Lott 1996)

The puzzle intensifies if one answers that it is ultimately the elected politicians who lack incentives due to lack of political competition. If this gives politicians monopoly power, why do they opt to exercise it inefficiently, or altruistically share it with the bureaucracy? Why not just pay themselves enormous salaries (with perfect information, a salary that makes voters indifferent between them and the alternative candidate), and then run the bureaucracy efficiently in voters' interests? Wintrobe concludes that there is not much substance to the case for bureaucratic political failure:

[I]f the provision of these goods and services is a stable feature of political life, and there is effective competition in the public sector, it is difficult to reject the explanation that politicians provide these services to voters because it helps their reelection chances, and that it helps their reelection chances because voters demand these policies. As Becker and others have pointed out, competition in the political marketplace should lead to the choice of efficient methods by governing politicians, both in production and redistribution. (1987, pp.445-6)

b. The Reformulation

A key implication of the theory of rational irrationality is that Wintrobe's final sentence does not follow: Even when politicians supply the policies that voters demand, the political marketplace may be riddled with inefficiencies due to the divergence between

the private and social costs of irrationality. For the economics of bureaucracy, it is particularly relevant that voters have no incentive to think rationally about politicians' optimal "executive compensation contracts." Many prefer to see politicians as altruistic public servants, a breed apart from the self-interested inhabitants of the non-political world. Given public choice scholars' determined efforts to discredit this viewpoint, they can hardly argue that this mistake is not widespread.¹¹

The social consequence of this private irrationality: *Elected politicians* face almost the same financial incentives as natural monopolies with a maximum (and guaranteed) rate of return of zero. Voters who view politicians as selfless public servants refuse to tie their pay to their performance; government pay scales reflect this belief. Nevertheless, voters' misapprehensions do not change politicians' nature. Politicians rationally respond to the incentives they actually face, not the incentives they *would* face if the electorate were rational. Since their pay does not increase if they make public enterprises run efficiently, politicians exert little effort to monitor bureaucrats or give *them* incentives to innovate.

Thus, the bad incentives voters give politicians "trickle down" through the bureaucratic hierarchy.¹² Bureaucrats respond accordingly. Leading regulatory officials, unable to maximize profits, maximize power instead, constantly pushing to increase their budgets and expand the scope of their authority. Similarly, since elected politicians do not insist on maximal productive efficiency, rank-and-file government employees are able - and

¹¹ See e.g. Buchanan (1984), Tollison (1982), and Green and Shapiro (1994).

¹² Strong dictators, as Wintrobe observes (1987, p.439), act differently, rarely sharing rents with the bureaucracy. My explanation is that such dictators can freely transform their slack into personal wealth, whereas internal rules prohibit elected politicians from doing so. See also Wintrobe (1998).

often willing - to take advantage of the slack. While it is conceivable that this amounts to a pure transfer of wealth to government employees, the public's reaction to *blatant* transfers makes significant inefficiencies the probable consequence.

c. Related Puzzles

Voter irrationality also helps explain two related puzzles: independent agencies and legislative vagueness. Supposedly, politicians can "escape the blame" for unpopular policies by delegating powers to a bureau, and then *refraining* from tightly monitoring it. (Alesina and Summers 1993; Rogoff 1985) With rational voters, it is difficult to make sense of this. If politicians create an agency, give it the incentives that it has, and retain the power to abolish it or change its incentives at any time, in what sense are politicians *not* to blame for everything the agency does? Time consistency explains why voters might *want* policy-makers who will refrain from ex post opportunism. But it does not explain why politicians who directly implemented optimal policies would damage their reputation, or why politicians able to force "independent" agencies to change course with a simple majority vote or an executive order would be any more popular than the policies the agency chooses.

Similarly, politicians often pass vague laws and allow the judiciary to decide what they actually mandate - the Sherman Act being the most famous instance. Benson, Greenhut, and Holcombe (1987) argue that vagueness was a rational strategy for the Sherman Act's sponsors: "The advantage of having a vague statute is that it could be enforced, not only against those viewed as a present threat to small entities but also against any future threats." (p.805) The disadvantage, however, is that a vague statute might fail to apply even to present threats, or might eventually be turned against its initial supporters. It is not obvious that the latter contingencies matter less than the former.

Benson, Greenhut, and Holcombe later add that, "The laws' vagueness also benefits the legislature; due to its oversight capacity, the legislature will be able to influence the type of enforcement in response to the changing power and demands of interest groups, all without writing a new law." (p.814) Yet since it is *current* legislators who exercise discretion, vagueness markedly reduces the political benefit captured by antitrust's *initial* backers. The vaguer a law is, the greater the influence of whoever currently enforces it, and the smaller the influence of the law's initial sponsors. Clear rules, unlike vague ones, may affect outcomes after the legislators who pass them leave office. In sum, even if vagueness did benefit the legislature as an institution, it is unclear how it helps the sponsoring legislators.

The theory of rational irrationality suggests a naive but plausible explanation for both puzzles: Voters frequently fail to rationally assess politicians' connection to political outcomes, and reward or punish them accordingly. For example, even though voters dislike inflation, they may still punish *people* who make anti-inflationary decisions. (Rodrik 1996) Voters want government to regulate the quality of drugs, but may be unhappy with regulators' concrete decisions. (Page and Shapiro 1992) Politicians reduce the risk of populist backlash with a simple expedient. They delegate the job to an "independent agency" such as a central bank and distance themselves from its day-to-day activities; they write laws with obvious good intentions but cloudy specifics. Rational voters would not fall for such tricks. Irrational voters, however, give politicians the credit for "doing something" when they create an agency or pass a vague law, yet refrain from blaming them if policies ultimately become unpopular.

6. Rational Irrationality and the Microfoundations of Economic Reform

a. The Critique

Economists with practical experience in economic reforms often note a peculiar pattern of political feedback. (Rodrik 1996) Reformers only have a small window of opportunity to implement desirable changes before political resistance makes further progress impossible. While initially there is a broad consensus that reforms will be a sharp improvement over the status quo, this consensus erodes as the "pain" of structural readjustments takes center stage. In response to these incentives, economic reformers often halt economic reform to placate populist pressures.

But why do these populist pressures exist in the first place? The resistance of critical special interests is no puzzle, but why would a majority oppose socially beneficial policies? Most observers emphasize the transition costs: There are many seemingly beneficial reforms that are not worth pursuing because the social cost of realizing them exceeds their social benefit. But specialists in economic reform point out that even in the short-term, reform often makes the "pain" less it is *otherwise would have been*: "Once one makes allowance for the likelihood that the counterfactual - no reform - produces even worse results in the short run, the consequences of reform look pretty good." (Rodrik 1996, p.29) Why then would a majority of rational voters oppose economic reforms with negative costs and positive benefits?

Resolving this puzzle without abandoning voter rationality is challenging but not impossible. Theorists raise several possibilities. Voters might simply be risk-averse. Voters and reformers could be playing a complicated game of asymmetric information and signaling. (e.g. Alesina and Drazen 1991) Different voting blocs might suffer from coordination problems. (e.g. Labán and Sturzenegger 1994) Fernandez and Rodrik (1991) show that even with risk-neutral voters, uncertainty about the identity of the gainers and losers could be a sufficient explanation.

b. The Reformulation

Still, the naive theory that many practical reformers stand by is more plausible: Voters are largely irrational, or "myopic." (Ranis and Mahmood 1992) They systematically underestimate the benefits of reform; they oppose better policies not from complicated strategic calculations, but because they don't understand what works. Populism is an international phenomena. (Shiller, Boycko, and Korobov 1991; Caplan 1999b) As Sachs provocatively puts it:

The initial confusion, and the difficulty of forming a consensus, is fueled in most crises not only by inexperience and misconceptions but also by the extravagant fears that accompany a program of fundamental change, no matter how promising the program might be in objective economic terms. While the history of market-based reforms has repeatedly shown that free markets, open trade, and an economy fueled by private ownership are enormously powerful in stimulating rapid economic growth, the general public rarely knows it or believes it at the start. (1994, p.505)

Theories of rational resistance to reform are internally consistent, but empirically they strain credulity: What dominates political debate and public opinion is not subtle strategizing, but elementary economic misconceptions. (Caplan 1999c)

For example, during economic crises the public frequently misunderstands the connection between inflation, rapid monetary growth, and government policy. Though the government is to blame, it may be the emerging capitalist class that receives the blame: "Keynes also stressed the particular insidiousness of the confusion over the causes of inflation. He said that inflation heightens society's antipathy to those who make profits in the turbulent market conditions. Businessmen are converted in the public's mind into 'profiteers.'" (Sachs 1994, p.507) This mistaken positive theory of inflation tends to increase support for price controls, wage controls, and other counter-productive measures. (Page and Shapiro 1992, pp.145-8)

The objections to this conclusion are mostly theoretical: If people are rational economic actors, how can they fail to be rational political actors too? (Olson 1996) As Rodrik puts it, "After all, homo economicus is supposed to be rational and forward-looking, and to process all the information that comes his way in the most efficient way. Sachs' homo politicus is none of these things..." (1996, p.33) Once again, the rational irrationality model can eliminate the apparent contradiction without ad hocery. For economic actors, rationality is a private good; for (most) political actors, rationality is a public good. In politics, the same thing happens to you whether you carefully reason through your economic views, or embrace illogical prejudices. Learning can be analyzed in the same way: In politics, there is no private benefit of learning from experience, so irrationality can persist over time - and socially destructive policy cycles can repeat themselves.

7. Conclusion

If any deviation from rational expectations is microfoundationally impermissible, then it is difficult to argue that ongoing political failures in the public sector are inefficient. Yet when critics of rational expectations theorizing posit irrationalities that arise on a purely ad hoc basis, there is a good reason to be skeptical. Building on Caplan (1999a, 1999b), the current paper tries to avoid both pitfalls. It restructures the foundations of political failure models by appealing to the trivial marginal private cost of irrationality for most of the players. This insight makes it possible to present internally consistent and intuitively plausible accounts of why the equilibrium levels of rent-seeking, pork barrel politics, bureaucratic misconduct, and resistance to economic reform are not socially optimal.

Empirical testing of political failure models remains necessary, as is empirical study of the optimality of efforts to *prevent* political failures. But theoretical critiques of their

microfoundations should be heavily discounted. If irrationality is treated as a good like any other, then basic price theory implies that deviations from rational expectations are especially likely to surface in political games. Previous treatments of the families of models studied in this paper may be faulted for failing to explicitly call attention to their departures from the rational expectations assumption. But each model's validity should be considered on the basis of its empirical merits, without facing the added obstacle of overcoming our theoretical priors.

References

- Akerlof, George. 1989. The Economics of Illusion. *Economics and Politics* 1, pp.1-15.
- Akerlof, George, and William Dickens. 1982. The Economic Consequences of Cognitive Dissonance. *American Economic Review* 72, pp.307-19.
- Alesina, Alberto, and Lawrence Summers. 1993. Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence. *Journal of Money, Credit and Banking* 23, pp.151-62.
- Alesina, Alberto, and Allan Drazen. 1991. Why Are Stabilizations Delayed? *American Economic Review* 81, pp.1170-88.
- Austen-Smith, David. 1991. Rational Consumers and Irrational Voters: A Review Essay on Black Hole Tariffs and Endogenous Policy Theory. *Economics and Politics* 3, pp.73-92.
- Becker, Gary. 1968. Crime and Punishment: An Economic Approach. *Journal of Political Economy* 76, pp.169-217.
- Bender, Bruce, and John Lott. 1996. Legislator Voting and Shirking: A Critical Review of the Literature. *Public Choice* 87, pp.67-100.
- Benson, Bruce, M.L. Greenhut, and Randall Holcombe. 1987. Interest Groups and the Antitrust Paradox. *Cato Journal* 6, pp.801-17.
- Borcherding, Thomas, W.W. Pommerehne, and F. Schneider. 1982. Comparing the Efficiency of Public Production: The Evidence from Five Countries. *Zeitschrift für Nationalökonomie* 2, 127-56.
- Boudreaux, Donald. 1996. Was Your High School Civics Teacher Right After All? Donald Wittman's *The Myth of Democratic Failure*. *Independent Review* 1, pp.111-28.
- Bradbury, John Charles, and W. Mark Crain. (1999) "Legislative Organization and Government Spending: Cross-Country Evidence." unpub. ms., George Mason University.
- Brennan, Geoffrey, and Loren Lomasky. 1993. *Democracy and Decision: The Pure Theory of Electoral Preference* (Cambridge: Cambridge University Press).
- Breton, Albert, and Ronald Wintrobe. 1982. *The Logic of Bureaucratic Conduct: An Economic Analysis of Competition, Exchange, and Efficiency in Private and Public Organizations*. (New York: Cambridge University Press).
- Bruce, Neil, and Michael Waldman. 1991. Transfers in Kind: Why They Can Be Efficient and Nonpaternalistic. *American Economic Review* 81, 1345-1351.
- Brussell, Eugene, ed. 1988. *Webster's New World Dictionary of Quotable Definitions* (Englewood Cliffs, NJ: Prentice Hall).

- Buchanan, James. 1984. Politics Without Romance: A Sketch of Positive Public Choice Theory and Its Normative Implications. In Buchanan, James, and Robert Tollison, eds., *The Theory of Public Choice II*. (Ann Arbor, MI: University of Michigan Press), pp. 11-22.
- Buchanan, James. 1980. "Reform in the Rent-Seeking Society." In Buchanan, James, Robert Tollison, and Gordon Tullock, eds. *Towards a Theory of the Rent-Seeking Society* (College Station, TX: Texas A&M University Press), pp.359-367.
- Caplan, Bryan. 1999a. Rational Ignorance vs. Rational Irrationality. Submitted to *Economics and Philosophy*.
- Caplan, Bryan. 1999b. The Logic of Collective Belief. Submitted to the *Southern Economic Journal*.
- Caplan, Bryan. 1999c. Systematically Biased Beliefs About Economics: Robust Evidence of Judgmental Anomalies from the Survey of Americans and Economists on the Economy. Submitted to the *American Economic Review*.
- Coate, Stephen, and Stephen Morris. 1995. On the Form of Transfers to Special Interests. *Journal of Political Economy* 103, pp.1210-35.
- Downs, Anthony. 1957. *An Economic Theory of Democracy*. (New York: Harper).
- Epstein, Richard. 1985. *Takings: Private Property and the Power of Eminent Domain*. (Cambridge: Harvard University Press).
- Fernandez, Raquel, and Rodrik, Dani. 1991. Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty. *American Economic Review* 81, pp.1146-55.
- Fiorina, Morris. 1983. Flagellating the Federal Bureaucracy. *Society* 20, pp.66-73.
- Fremling, Gertrud, and John Lott. 1996. The Bias Towards Zero in Aggregate Perceptions: An Explanation Based on Rationally Calculating Individuals. *Economic Inquiry* 34, pp.276-95.
- Gilligan, Thomas, and John Matsusaka. 1995. Deviations from Constituent Interests: The Role of Legislative Structure and Political Parties in the States. *Economic Inquiry* 33, 383-401.
- Green, Donald, and Ian Shapiro. 1994. *Pathologies of Rational Choice Theory: A Critique of Applications in Political Science*. (New Haven, CT: Yale University Press).
- Holcombe, Randall. 1985. *An Economic Analysis of Democracy*. (Carbondale: Southern Illinois University Press).
- Kelman, Mark. 1988. On Democracy-Bashing: A Skeptical Look at the Theoretical and "Empirical" Practice of the Public Choice Movement. *Virginia Law Review* 74, pp.199-273.

- Klein, Daniel. 1994. If Government is So Villainous, How Come Government Officials Don't Seem Like Villains? *Economics and Philosophy* 10, pp.91-106.
- Krueger, Anne. 1974. The Political Economy of the Rent-Seeking Society. *American Economic Review* 61, pp.291-303.
- Kuran, Timur, and Cass Sunstein. 1999. Availability Cascades and Risk Regulation. *Stanford Law Review* 51, pp.683-768.
- Labán, Raúl, and Federico Sturzenegger. 1994. Distributional Conflict, Financial Adaptation, and Delayed Stabilization. *Economics and Politics* 6, pp.257-76.
- Lott, John. 1997a. Does Political Reform Increase Wealth?: Or, Why the Difference Between the Chicago and Virginia Schools is Really an Elasticity Question. *Public Choice* 91, pp.219-27.
- Lott, John. 1997b. Donald Wittman's *The Myth of Democratic Failure*. *Public Choice*, vol.92(1-2): 1-13.
- Magee, Stephen, William Brock, and Leslie Young. 1989. *Black Hole Tariffs and Endogenous Policy Theory: Political Economy in General Equilibrium*. (Cambridge: Cambridge University Press).
- Olson, Mancur. 1996. Big Bills Left on the Sidewalk: Why Some Nations are Rich and Others are Poor. *Journal of Economic Perspectives* 10, pp.3-24.
- Olson, Mancur. 1982. *The Rise and Decline of Nations: Economic Growth, Stagflation and Social Rigidities*. (New Haven: Yale University Press).
- Olson, Mancur. 1965. *The Logic of Collective Action: Public Goods and the Theory of Groups*. (Cambridge: Harvard University Press).
- Page, Benjamin. 1996. *Who Deliberates? Mass Media in Modern Democracy*. (Chicago: University of Chicago Press).
- Page, Benjamin, and Robert Shapiro. 1992. *The Rational Public: Fifty Years of Trends in Americans' Policy Preferences*. (Chicago: University of Chicago Press).
- Ranis, Gustav, and Syed Mahmood. 1992. *The Political Economy of Development Policy Change*. (Cambridge, MA: Blackwell Publisher).
- Rodrik, Dani. 1996. Understanding Economic Policy Reform. *Journal of Economic Literature* 34, pp.9-41.
- Rogoff, Kenneth. 1985. The Optimal Degree of Commitment to an Intermediate Monetary Target. *Quarterly Journal of Economics* 100, pp.1169-1190.
- Rowley, Charles. 1997. Donald Wittman's *The Myth of Democratic Failure*. *Public Choice* 92, pp.15-26.
- Rowley, Charles. 1988. "Rent-Seeking in Constitutional Perspective." In Rowley,

Charles, Robert Tollison, and Gordon Tullock, eds. *The Political Economy of Rent-Seeking* (Boston: Kluwer Academic Publishers), pp.447-64.

Rowley, Charles, and Gordon Tullock. 1988. "Introduction." In Rowley, Charles, Robert Tollison, and Gordon Tullock, eds. *The Political Economy of Rent-Seeking* (Boston: Kluwer Academic Publishers), pp.3-13.

Sachs, Jeffrey. 1994. "Life in the Economic Emergency Room." In Williamson, John, ed. *The Political Economy of Policy Reform*. (Washington D.C.: Institute for International Economics), pp. 503-23.

Shiller, Robert, Maxim Boycko, and Vladimir Korobov. 1991. Popular Attitudes Toward Free Markets: The Soviet Union and the United States Compared. *American Economic Review* 81, pp. 385-400.

Tollison, Robert, and Richard Wagner. 1991. Romance, Realism, and Economic Reform. *Kyklos* 44, pp.57-70.

Tullock, Gordon. 1988. "Further Directions for Rent-Seeking Research." In Rowley, Charles, Robert Tollison, and Gordon Tullock, eds. *The Political Economy of Rent-Seeking* (Boston: Kluwer Academic Publishers), pp.465-480.

Tullock, Gordon. 1980. "The Transitional Gains Trap." In Buchanan, James, Robert Tollison, and Gordon Tullock, eds. *Towards a Theory of the Rent-Seeking Society* (College Station, TX: Texas A&M University Press), pp.211-221.

Tullock, Gordon. 1967. The Welfare Costs of Tariffs, Monopolies, and Theft. *Western Economic Journal* 5, pp.224-32.

Washington Post. 1999. "Washingtonpost.com: Congressional Pay Special Report," at: <http://www.washingtonpost.com/wp-srv/politics/special/pay/pay.htm>.

Weingast, Barry, Kenneth Shepsle, and Christopher Johnsen. 1981. The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics. *Journal of Political Economy* 89, pp.642-664.

Wintrobe, Ronald. 1998. *The Political Economy of Dictatorship*. (Cambridge: Cambridge University Press).

Wintrobe, Ronald. 1987. The Market for Corporate Control and the Market for Political Conduct. *Journal of Law, Economics, and Organization* 3, pp.435-48.

Wittman, Donald. 1999. Rational Expectations and Democratic Politics. Unpub. ms. UC Santa Cruz.

Wittman, Donald. 1995. *The Myth of Democratic Failure: Why Political Institutions are Efficient*. (Chicago: University of Chicago Press).

Wittman, Donald. 1989. Why Democracies Produce Efficient Results. *Journal of Political Economy* 97, pp.1395-1424.

Diagram 1: Wealth/Irrationality Indifference Curves

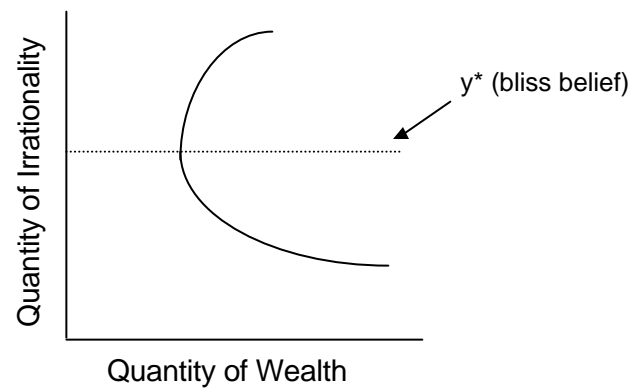


Diagram 2: Neoclassical vs. "Near-Neoclassical" Demand for Irrationality

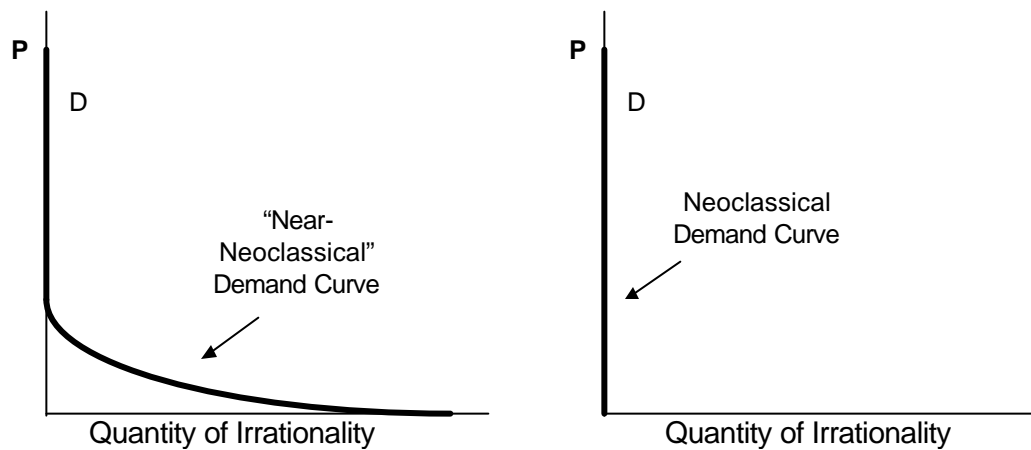


Diagram 3: Price-Sensitivity of the Demand for Irrationality

