

Public Choice and the Extent of the Market

I. Introduction

The extent or size of the market can be examined as a choice variable in a private or public context. We can examine the relationship between the extent of the market and the several separated supply-side and demand-side choices made by participants in an economy, as they act in their ordinary capacities as sellers of inputs and buyers of outputs. The institutional parameters within which such private choices are made may be assumed to be exogenous to these choices.

By contrast, this paper is exclusively devoted to examination and analysis of choices made among the institutional parameters themselves, as these choices may influence the effective size of the production-exchange nexus. In the parlance of modern public choice, the focus is on constitutional choices among sets of rules or constraints within which private choices must be made.

In Section II, we discuss the distinction between the behavioral positions of the individual in the two settings, that is, between the private and public choice roles.

Sections IV, V, and VI distinguish among three familiar categories (prohibition, regulation, taxation-public spending) of institutional constraints that are significant in the limits imposed on the trading process, whether directly or indirectly.

Section VII relates the chapter's discussion with the normative vision that informed Adam Smith's enunciation of the relationship between the achievement of the twin goals of liberty and economic growth in part through his theorem that makes economic productivity dependent on market size.

II. Choice Within and Choice Among Constraints

Two-stage choice setting in public choice paradigm.

The first concerns choices made by persons within an exogenous structure of constraints or rules;

the second involves choices among alternative sets of rules themselves , the latter often referred to as “constitutional choice”¹.

A person’s ‘market’ activity proceeds on the presumption that the choices made prompt action that brings the result chosen into being. For illustration, if a person enters the marketplace that displays oranges and apples, each at \$1 per unit, he or she selects the desired quantities as if realization is assured.

In some vague, and indirect, sense the demander or supplier may understand that the terms of the offer, along with the availability of the goods in question, depend on the aggregated behavior of all participants , but this generalized understanding forms no part of the choice process under normal circumstances.

The demander-supplier is not conscious that his or her own choice behavior indirectly influences the constraints within which choices are confined. Instead, the choice is treated as being directly among alternative end-states.

The situation becomes quite different when the individual confronts choices among alternative sets of constraints, rules, or institutions within which the in-market choices are to be exercised. Here the individual recognizes, and does so explicitly, that he is acting as a single participant in a collective process, from which an end-state will ultimately emerge from some amalgamation of “votes” from all participants. There is no direct linkage between individual choice behavior and the emergent end-state, as is the case with market choice. Buchanan 1954.

In collective choice, the individual is participating in a process that involves the selection of a constraint upon his or her own behavior in post-rule periods, but in the knowledge that the constraint, so selected, will also be binding on others. Indeed, the primary purpose of imposing generalized constraints, or laws, is that of insuring against undesired behavior of others in the collectivity rather than against deviations on his or her own behavior.^{2 3}

¹ For the basic argument here, see Buchanan and Tullock (1962)

² For extended treatment of the differences between the constraints in the two situations, see Brennan and Buchanan (1985).

As subsequent discussion will indicate, the particular constraints chosen and put in being must be important determinants of the size of the market. However, as noted above, the extent of the market, as an explicitly included choice variable in the individualized calculus should not be overly emphasized. The institutional parameters do determine many dimensions of the market relationship, but at the same time, these institutions, although explicitly chosen, may not be selected because of any predicted effect on market size, and, indirectly, on the value productivity of the economy.

As subsequent chapters will discuss, the motivation for institutional-constitutional construction may originate from many sources, and often the emergent collective result has effects that counter that which would be aimed for in primary emphasis on economic productivity. That is to say, the market may be restricted below its value potential because the collectivity, as it acts, places non-economic objectives higher in the scale of effective priorities. There will also be collective choice settings from which outcomes may emerge without conscious recognition on the part of participants that there are genuine opportunity costs measured by the shortfall of market value.

It is also necessary to emphasize here that many of the institutional-constitutional constraints that impose boundaries on private market behavior are not themselves chosen, as such, in any explicit political-collective-legal context but which are generated through cultural evolution. This category obviously applies to the whole set of informal conventions and traditions that are, nonetheless, binding on individual behavior patterns. These evolutionary, and hence non-chosen, elements of rules of almost any social order, extend to many legal practices, and notably those that find their origins in common-law countries. Further, there may be a generalized acceptance of the existence of a “higher” law that limits ordinary politics from which statute law emerges, the unwritten British “constitution” offering the familiar example.

Hayek, especially in his late-career writings, (;) stressed the evolutionary origins of constraints , and he was critical of arguments that allow for institutional constitutional construction.

³ There is a significant research program that examines in detail choices involving self-imposed constraints. Examples are dieting, ceasing smoking, forced saving, addiction. See Schelling (); Becker and Murphy ().

In this stancy, Hayek was influenced by the work of Bruno Leoni ().

To the extent that the rules that set the limits for market choice are not explicitly through political-collective action, regardless of motivation, there is no relevance for the directed discussion in this chapter.

III, The Limits of the Market

To examine how public or collective choice-action determines the effective extent of the market nexus it may be useful to define stylized structures at the two ends of an imagined spectrum. **We may first consider a model in which market exchange is as unlimited as possible, and second, a model in which collectively-imposed constraints on private behavior are maximal.**

Imagine a setting in which there are no explicitly enforced limits of the activity of producing and exchanging goods and services. Anything and everything is marketable, at any time, and between and among anyone, regardless of location or classification as a member of a defined polity. **In a preliminary assessment, this setting would seem to be one where the extent of the market, however measured, would be maximal. But more careful consideration suggests that the effective limits on market dealings, even here, would be widely divergent and would depend critically on the predictability and stability of the legal-political structure, notably as involving private claims to property along with the enforceability of contracts.**

In a setting of total anarchy, there are, by construction, no collectively-imposed limits on market activity, or indeed on any other activity. It is clear, however, that market activity would here be severely restricted, perhaps to exchanges between in-tribe members, along with some intertribal dealings in observable goods.⁴ **For market activity to become meaningful, as a source of value creation, a legal order must be in place, an order that minimally allows persons to engage one with another under conditions that allow for generalized understanding of, and respect for, defined claims to property, both in persons and in goods.**

⁴ For extended discussion, see Buchanan (1975).

Two parties find it advantageous to trade only if they mutually acknowledge that each of them holds that which in his or her possession pre-trade as a claim to be respected.⁵

A legal order that serves to protect private property and enforce mutual agreements between and among parties must be in place for an effective market to function. The maximal extent of the market , therefore, even as a stylized model constructed for purposes of analytical comparison, is attained only upon some presumed existence of a minimal or protective state, that is, on the presumption that the Hobbesian problem has been resolved, that the initial leap from the chaos of anarchy has been made.

Given any enforceable assignment of property rights along with enforcement of contractual agreements, between and among members of organized political communities and also between inside and outside political limits (see Chapter 8 for further treatment), the market's extent is set only by the aggregate results generated from supply and demand choices discussed in Chapter 6. Aside from the threshold requirements for the protective state, in this stylized setting, there is no explicit "public" choice that involves the inclusive size of the production-exchange nexus.

The other extreme of the imagined spectrum that measures the extent of the market is described by a society in which trade or exchange is totally prohibited in any and all goods and services, at all times and among all potential traders. Persons(or family units) are prohibited by enforceable legal-political constraints from engaging, one with another, in and exchange. In such circumstances, each unit would, by necessity, remain fully self-subsistent. The only possible exception would be unilateral transfers of valued end-items. There could be no specialization, as such , since each person would find it necessary to allocate his value producing capacity to several preferred end-items . Hence, even if the legal order protects property in person and goods, there would be no contractual dealings in claims. The aggregate value of total product, by whomever evaluated, must remain very low relative to the potential that more effective utilization of natural capacities might make possible. The lives of persons would be poor, solitary, and short, even if the other Hobbesian descriptive terms "nasty" and "brutish" might be absent. There would be no market, as such.

⁵ The looting in Baghdad in 2003 and in New Orleans in 2005 offer examples of behavior when property claims fail to be respected.

(Working hard does not introduce further specialization and there are no generalized increasing returns.)

There have not ever been, and there are not, any social orders that could be empirically described by either of the extreme models briefly outlined here. There have been, and are, no societies in which markets are permissible in everything, just as there have been, and are, no societies in which trade and exchange in everything is prohibited. Any observed society, whether historically or currently, may be located somewhere along the imagined extent of market spectrum between the two extremes, between “everything goes” and “nothing goes”, as applied to interpersonal exchange dealings.

Location along this spectrum, the location that defines the extent of the market, is determined by the public or collective choices that operate to impose limits on activity, and, through such limits, affect the degree of specialization that is exploited. These constraints can be discussed in three distinct categories, treated below in three sections.

IV. Prohibition

The most direct means through which political-collective action affects the extent of the market is outright prohibition. Persons and organizations may be coercively prevented from entry into voluntary exchange agreements that involve specifically designated goods and services, or rights to those goods and services. **The most obvious example is human slavery. Persons, even those who might be willing to do so, are prohibited from selling themselves as chattel slaves to others who may be potential buyers, who are also prevented from any such purchases. The near-universal modern prohibition of slavery prevents any full capitalization of productive capacity(human capital) that might be comparable to that which is possible for non-human capacities to produce value. Since exchange that involves irrevocable temporal commitment is prohibited, specialization is reduced. The sale and purchase of babies (or children more generally) may be treated as a special case here, in the sense that voluntary agreements that include involuntary subjugation others than the contracting parties are also prohibited.**

The aggregate value generated through markets is lower than it would be if enforceable slave contracts should be permissible.

More familiar, and more controversial, prohibitions on market-like exchanges are exemplified by prostitution, trade in bodily organs, and addictive substances. In a generalized analytical framework, collective prohibitions may extend from those that have commanded almost universal assent over time and place through prohibitions that reflect collective expressions of “meddlesome preferences”, then all the way to the discriminatory prohibitions on exchange in some goods by designated groups.

We emphasize again that our concern here is not with the moral or ethical support or opposition to collective prohibitions on voluntary exchange dealings between and among persons and organizations. Nor is our concern with the processes through which collective decisions are made or with the degree of support by the relevant population. The collective actions examined may be imposed by and supported by an overwhelming majority, by a bare majority, or even by a minority elite. **These factors become relevant for any moral or ethical assessment of collective action. But, for our purposes, regardless of the means through which a prohibition on market exchange is effectuated, the impact on the potential for exploiting specialization is clear. Prohibition shrinks the extent of the market and thereby reduces the total value productivity of economic interaction. (Chinese adoption of son to take care of eunuch’s old age.)**

A seeming exception to this generalization must, however, be identified. Wholly voluntary agreements on exchanges in goods and services tend to expand the prospects for specialization. But agreements that themselves are aimed at restricting exchange cannot be brought under the same justificatory argument. Such agreements create no added value, as such, and indeed must guarantee reductions in value through forestalling or closing off market operations. **Rather than extending the size of the market, all such actions are aimed at reducing the size. This basis for collective-political intervention into the contractual process has been long recognized, and it is reflected in long-standing legal-constitutional structures that promote the openness of markets, as witness the United States anti-trust laws.**

V.Regulation

A less direct but widely observed means through which public choice, that is, political-collective action, operates to modify the extent of the inclusive economic nexus is summarized under the rubric “regulation”. As with prohibition, the motivations behind regulatory action may be

varied, and the effects on the size of the market may, in many instances, be by-products rather than any reflection of primary intent. By comparison with prohibition, regulation changes the conditions within which private market exchanges are made, and thereby changes the range of potential mutual gains.

In one sense of course, the effective presence of the minimal or protective state, the whole set of institutions that enforce property and contract, operates as a regulatory framework for market activity. The legal structure that insures against fraud may be interpreted in this way. The conventional usage, however, does not extend the term “regulation” to include these basic parameters, but, instead, refers to more specific efforts by the collectivity to channel or redirect the allowable activities of potential trading parties,

As a familiar example, consider rent controls, which are often imposed after major disruption in elements of the economic environment, such as war or natural disaster. The normal setting for voluntary exchanges between tenants and owners is shifted, and considerations other than individual freedom of contract may intervene and produce collective constraints on terms.

The effects of such political actions on the extent of the market are not immediately clear. If the governmental action is intended to, and succeeds, in a straightforward reassignment of property rights, in this case from owner to sitting tenants, there may be no change in the aggregate market value attributable to the rights, as reassigned. The sitting tenant, now in possession of rights with enhanced value potential, finds that the opportunity cost of occupancy has increased. In consequence, the tenant will dispose of the property in roughly the same pattern as might have been the case without the imposition of the controls.⁶

In most cases, however, political efforts to impose ceilings, on rents or anything else, do not allow for any post-control transfer of newly acquired rights. As a result, the enhanced value generated by the changes in the economic environment may never come into being. Specialization that might have been possible does not emerge, and, indeed, the extent of the market is effectively reduced by the regulation. Note that it is not so much the imposition of the ceilings, as such, that affects the extent of the market, but, rather, the failure of such imposition to effectuate a clear transfer of rights that may be traded.

⁶ As postulated, this example becomes an application of the Coase (1962) theorem.

The enhanced value potential disappears as if into an economic “black hole.”

Essentially the same analysis, and results, would be generated by other regulatory action aimed at modifying the operation of the voluntary exchange processes of the inclusive market. **As a second example, consider minimum wage legislation. The intent here is not to prevent exchange of work for wages, but rather to restrict the terms upon which such exchange, even if wholly voluntary, may be consummated. Clearly, any such regulation forestalls some exchanges that might otherwise be made, thereby reducing the value generated in the exchange nexus. The market is smaller, and hence the range for economically viable specialization is reduced below its value potential.**

In effect those who might be willing to market their services on terms below the imposed legal limit are being deprived of exercising rights to their own productive capacities. A share in this capacity is claimed by the collectivity, a share the value potential for which is not utilized.

VI. Taxation and Public Outlay

Prohibition, and to a large extent, regulation normally represent the deliberative effort of a political entity, no matter how inclusive and no matter how decisions emerge, to change or redirect the operation of the market exchange process, that is, to place constraints on voluntary agreements between and among persons and organizations. The third category of political action that impacts on the extent of the market, taxation and public outlay, differs from the others in this respect. Except for sumptuary taxes(positive and negative), where the explicit objective is to affect the terms of trade for designated goods and services, taxes are normally imposed for the more general purpose of raising revenue to finance programs of governmental outlay. To the extent, however, that there exists any supply response to the fiscal action, there will be effects on the size of the market. And such a response must always be present, save in the limiting case of lump-sum taxation and outlay, which remain empirically and logically unrealistic, but which have proved useful for analytical purposes. By definition, a lump-sum tax or program of spending exerts no behavioral effects, and hence cannot modify the market activity of those who are taxed or subsidized.

In one broad and general sense, a tax reflects one side of an “exchange” between the taxpayer and the governmental provision of benefits from services. The “exchange” is, however, coercively imposed, and rarely, if ever, is the incidence of the two sides of the account matched. Neither the taxpayer nor the recipient of benefits is conscious of the ultimate *quid pro quo* in the fiscal process. The taxpayer behaves as if the coerced payment is exogenous, and, similarly, for the recipient of benefits, including cash transfers.

If tax revenues are used for financing direct transfers, thereby becoming what is often referred to as negative taxation, the combined effect on the size of the market is clearly negative. Taxes provide an incentive for the reduction in the supply of inputs to the market, and the transfers induce behavioral responses in the same direction.

The direction of effect on the size of the market produced by taxes and outlays is predictable. But the composition of the fiscal budget, on either one or both sides of the account, is also of major significance in this respect. To the extent that both taxes and governmental outlays are generally applied, the effect on the extent of the market is minimized. With taxes, if the rate is uniformly applied to all units of the particular base, e.g. income, without exemptions, credits, or deductions, persons will respond negatively in supplying inputs to the market, but they will not shift the allocation of these inputs so as to secure relative tax advantages. The same conclusion applies to the distribution of benefits on the spending side. Discrimination creates allocative distortions, and thereby reduces value potential for the economy, and, importantly, any fiscal discrimination sets up incentives for investment of rent-seeking.⁷

If tax revenues are used to finance programs that are, in themselves, productive, the extent of the market may be positively affected. For example, the use of tax revenues to finance the services of the minimal or protective state, that is, the basic structure of the legal order, may be necessary to bring any effective market into being. Despite the possible negative effects of taxation, considered in isolation, the combined fiscal process expands the size of the exchange nexus, and allows the advantages of specialization to be exploited.

Difficult issues of evaluation are presented with those programs of governmental outlay that are beyond reasonable minimal-state limits, but are not properly classified as direct transfers, either in intent or in practice. How much observed government activity is correctly reckoned

⁷ For extended discussion of fiscal generalization, see Buchanan and Congleton (1998).

as genuinely “public” goods and services? Are the activities observed to be collectivized superior to those that would be provided under market operation? Answers to these questions depend on some assessment of the complementarity-substitutability relationships between the two organizational arrangements in supplying properly valued goods and services.

No simplistic inferences may be drawn between the relative market and governmental shares in a polity for the extent of the market in any sense relevant to Adam Smith’s theorem. One country may exhibit a very small public sector, in some relative measure, but the economy may not exploit potential specialization due to the absence of basic institutions of order. At the other extreme, a country with a relatively very large public sector, which includes large welfare transfers, may include a market that is relatively much smaller than its potentially more productive capacities would allow.

VII. Adam Smith’s System of Natural Liberty and the Growth of Market Size

As we have noted several times, our purpose in the analysis of this chapter is not to make evaluative judgments as to the appropriateness or inappropriateness of collective-political actions that either reduce or increase the extent of the effective market. Our concern is limited to that of tracing the predicted effects of such actions.

When he propounded the relationship between the division of labor and the extent of the market, however, Adam Smith was not bothered by the methodological niceties of modern social science. We must recall that Adam Smith was living and working in a poor and undeveloped country, by modern standards, and that his whole effort was motivated by an interest in demonstrating how the wealth of his nation might be increased, while at the same time the natural liberties of persons would be expanded. Smith was, indeed, concentrating attention on the aggregate value of goods and services that might be produced through free markets.

Smith’s system of natural liberty required the presence of the necessary “laws and institutions”, which the government provides. Beyond these, Smith also allowed for collective provision of elements of infrastructure. His target was the whole maze of regulations and prohibitions that he observed, governmental measures that were motivated by a profoundly misguided set of mercantilist ideas, which included little or no understanding of the coordinating properties of open markets. Smith sought to demonstrate that the economy would grow if these regulations could be

taken off; it would grow because the advantages of further specialization could be realized.

Replacement of the mercantilist world of monopolies and cartels by competitive markets would increase aggregate value not only through reallocations of resource inputs , but also because the increase in value itself, the expanded market, would make new specializations economically viable. An understanding of the linkage between the size of the market, as such, and the value productivity of the inclusive economy offered the basis for a normative vision that included furtherance of the joint objectives of natural liberty and the generation of economic value.

