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WELFARE ECONOMICS AND THE THEORY OF THE STATE[1]

The most general attribute that distinguishes government from other organizations is its coercive role, circumscribing the activities of all of its citizens and the other inhabitants of its territories. Laws and their enforcement require members of the public to behave in certain way and preclude them from engaging in actions that some of them would otherwise undertake. Explicitly in a democracy and implicitly in any government that operates under some sort of social contract, this means that the governed must have chosen voluntarily to be subjected to coercion that prevents them from behaving as they would otherwise choose to do. Such a paradoxical arrangement nevertheless can constitute rational behavior on the part of the public. The theory of the state, in essence, entails resolution of this paradox. It will be shown that welfare economics deals with an entirely parallel issue. Indeed, the policy measures that welfare theory suggests are particular examples of coercive public sector acts that it would serve the interests of the public to support and accept voluntarily. The logic of the analysis applies to issues as varied as taxation, finance of national defense, counter-cyclical measures and programs to counteract congestion problems in road traffic and urban dwellings, among many others.

1. How Acceptance of Government Coercion can Serve the Interests of the Coerced

Acceptance of government coercion by the coerced can serve the self interest of the latter in only one of two circumstances: (1) where the coerced fear that they will not otherwise make decisions that really serve their best interests and (2) where acceptance by the individuals of rules circumscribing their own conduct is a prerequisite for adoption of rules coercing others. The first has been illustrated by Ulysses' request to be tied to the mast of his ship to prevent him from succumbing to the Sirens' song. Individuals may feel that they lack the strength of character to undertake an act that denies them an immediate pleasure but will be very beneficial to themselves later. Compulsory saving for retirement, as imposed by social security laws, are a clear example. This role of government, then, is recourse by citizens to the paternalism of government, with the latter assigned to make decisions for the individuals that are superior for their welfare than the decisions they would make themselves. Seat belt laws for automobile passengers, laws against consumption of narcotics or dangerous foods and taxes on cigarettes are all illustrations.

What is noteworthy here is that all of these are examples of a type of market failure that is usually omitted from the standard listings (see, e.g., Bator, 1958). In all of these cases, the reason the free market does not work is that individuals can sometimes be guided by transitory or illusory incentives to make decisions that do not really serve their interests and that, in many cases, even they themselves would concede to be self damaging. In such cases the market will sometimes compound the imperfection by offering rewards to those who tempt people to act self destructively, for example, via the profits that can be earned by the supply of tobacco products or drugs. But this brings us to a second category of coercive government acts that it may serve the self interest of the individual to accept.

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This second category, which it will be convenient to divide further into two subcases, arguably encompasses the major tasks of government. These are cases in which the individual, A, would be better off if left free to make her own decisions, but in which no constraining rule will be applied to others unless it also holds for individual A as well. That is, the individual in principle is faced with three levels of welfare, $w_1 < w_2 < w_3$, with the last of these obtainable only if everyone else in the world is subject to some constraining rules but A is exempted from them. Welfare level w_2 is attainable if the rules are uniformly applied to everyone, while the absence of the constraining rules yields only welfare level w_1. As a practical matter, the w_3-yielding option is not really available, so the individual must choose between only the other two. In that case the reason for agreeing to be coerced is clear, at least in the abstract terms so far considered. It is convenient to refer to this situation as one that entails beneficial nondiscriminatory coercion.

The most widely recognized nondiscriminatory subcase entails protection of the individual from actions by others that damage the individual's interest. Laws against burglary, false advertising and monopolistic behavior are clear illustrations and other examples are easily cited. Most but not all[2] of these involve redistributive activities in which an agent seeks to benefit at the expense of others. Most often, this involves an attempt by the former to take away income, wealth or property of others, without compensation.

In many such cases it is not clear that the individual would benefit if that person alone were exempted from the constraining rules. Few of us would be likely to pursue the profits of bank robbery if the rules against this activity became inapplicable to us. But that is, arguably, because we live in a society in which it has become customary to deplore acts of violence and to take measures against them. History suggests, however, that in a society where there is little or no legal constraint upon violent behavior, it becomes not only acceptable but actually honorific, with status conferred upon those who are most successful in such activities. In any event, the point is that in these cases, at worst, the individual does not lose by being included among the universally coerced, and benefits to the extent that protection of private holdings against arbitrary takings is beneficial to all.

2. Generalized Externalities and the Theory of the State

The third and very significant category of circumstances in which self interest dictates acceptance of coercion is a generalization of the externalities phenomenon that plays a critical role in welfare economics (Pigou, 1932; Buchanan and Stubblebine, 1962). The issue arises when the individual's immediate self interest is served by a course of action that has more than offsetting effects upon others, so that if all individuals are left free to act in accord with their immediate interests there will be a net reduction in the product of the economy or the benefits of any sort available in the society, with the possibility that each and every person will end up worse off. This is not a matter of redistribution, as when a pickpocket obtains someone's wallet. Rather, it is a situation in which the entire inventory of benefits that is available for the members of the society to share is reduced by the self-interested actions of every individual.

What is critical here is the fact that such damaging actions do not constitute irrational behavior on the part of the individual. *In the absence of a rule that precludes everyone from the socially damaging behavior in question, the best course open to each and every individual is to behave in such a detrimental fashion.*

A standard example will make this clear. Consider the case of automotive emissions that are very harmful to health, and suppose that they can be avoided if an expensive suppression device, costing D dollars, is installed on every vehicle. In a city with 2 million autos the contribution of any one of them to deterioration of air quality is negligible. If no other person installs an emission suppressor, it would be a quixotic act of some one person to spend the D dollars to install the suppressor on his own vehicle, since this would make no discernable difference to air quality. Moreover, even if a law requiring suppressors on all vehicles were adopted and enforced, any one car owner could benefit by being granted a special and unique exemption, since his emissions would hardly affect the purity of the air. Yet, if the additional medical bills and cleaning cost resulting from failure to suppress everyone's emissions add up to more than D dollars per vehicle owner, failure to adopt the coercive suppressor installation law will clearly be damaging to all. There is no redistribution issue here. No one is in need of protection from the predation of others. Nor is any individual protected from inability to make rational decisions. Rather, it is only the community as a whole that effectively has the option of choosing between rational and irrational behavior, that is, behavior whose consequences the individual herself considers to be undesirable.

It is important to recognize, as is emphasized in the economic literature, that externalities can be as damaging to the interests of society when the affected activities are themselves beneficial as when they are detrimental. The example just discussed involves pollution emissions that are inherently damaging to others, and the problem is that, though some level of emissions is unavoidable, or further suppression beyond some low level is impractical, in the absence of

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rules individuals will end up emitting far more than is consistent with the public interest. The opposite result occurs where the externality-generating activity is beneficial. Here society's interests will be harmed because without coercion too little of such an activity will be undertaken.

A clear and important example is expenditure on the R&D that is plainly of crucial importance for economic growth. It has long been observed that much of the benefit from innovative activities goes to persons other than the inventors or those who invested in the process. This beneficial externality may, indeed, be far greater than generally recognized. If the bulk of the more than 10-fold rise in per capita GDP in the U.S. and much of Western Europe since the beginning of the industrial revolution is attributable to innovation, and one can estimate that less that 10 percent of GDP goes to persons who participate in the innovation process, it follows that the bulk of the beneficial externalities deriving from the efforts of the latter ultimately go to others. This means, and many studies confirm, that the incentives for innovative activity provided by the market are likely to be inadequate to induce a voluntary level of investment in innovation that is optimal in terms of the social interest.[3] This suggests that coercive collection of taxes by government to provide additional resources for innovation facilitating activities, such as basic research, can be beneficial to the entire community, particularly in the long run.

3. Size of the Community and Private Steps to Deal with Externality Issues

In a classic article, Ronald Coase (1960) shows, among other things, that where only a small number of decision makers is involved, a process of voluntary bargaining and compensatory payments by those affected by an externality may be able to provide an optimal result. In effect the "victim" of a detrimental externality can bribe its generator to cease and desist, or at least to cut back on the damaging activity to an optimal degree. Here, because only a few persons are involved, the need for governmental coercion patently is limited, and may even prove to be too much of a good thing.

That numbers make the difference for the rationality of voluntarily accepted coercion has long been recognized. For example, more than two centuries ago Hume, with his powerful insight wrote

> Two neighbors may agree to drain a meadow, which they possess in common; because it is easy for them to know each other's mind; and each must perceive that the immediate consequence of his failing in his part, is the abandonment of the whole project. But it is very difficult, and indeed impossible, that a thousand persons should agree in any such action; it being difficult for them to concert so complicated a design and still more difficult for them to execute it; while each seeks a pretext to free himself of the trouble and expense, and would lay the whole burden on others. Political society easily remedies both these inconveniences …[4]

In these few words, Hume lays out much of the welfare economics that underlies the theory of the state, and brings out the importance of the presence of a substantial number of inhabitants for its rationale.

4. Government Activities that Fall into the Category of Externalities

Economic externalities are widespread, indeed arguably ubiquitous. The literature of welfare economics provides a profusion of illustrations. However, here it is more to the point to offer several examples in areas not usually cited in this arena. The illustrations are inflation, recession and unemployment and defense against terrorism.

Hyper inflation brings the point out most dramatically. When inflation proceeds at the fantastic rates experienced in Germany after the First Word War or, more recently, in Latin America and Israel, clearly money loses its value as it is being pocketed by the recipient. In such an economy, in the absence of governmental intervention, it is plainly in the interest of the recipient of any cash to spend it as quickly as it can be get rid of, before it becomes virtually worthless. But that is precisely the pattern of behavior most likely to exacerbate the inflation. And no one individual can afford to do otherwise or can achieve anything by doing so. Only strong and essentially coercive governmental action can bring the explosion of prices to an end, and has repeatedly done so in the past. This is clearly an example in which voluntary acceptance of coercion may be the only rational response by members of the public. Any one individual would be irrational to undertake unilaterally to curb hasty spending, yet it would be perfectly rational to vote for a government that coerces that person, along with everyone else, to do so.

The opposite argument clearly applies to an effort to counteract recession and unemployment. The enhanced risk of loss of jobs and investments in such circumstances provides a powerful incentive for the individual to curb spending and save as much as possible for the imminent rainy day. But, at least from the point of view of a Keynesian, this is the reverse of what the situation requires. By taking such defensive measures the individuals collectively do as much as they can to bring upon themselves the very problems against which they seek protection. Acting individually, they can do nothing to help bring the problem to an end. But if they vote support for a government that

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adopts appropriate and universally applied coercive measures they can achieve what unconstrained behavior makes impossible for them.

Finally, it is appropriate to end with an issue that is entirely removed from economics and that thereby underscores the broad pertinence of the externalities analysis. This is the issue of defense expenditure, in particular in its most recent form, defense against the threat of terrorism. Economists recognize the role of externalities here, and refer to such defense preparation as a public good, meaning that if it protects the society it protects all of its members, without an increase in cost resulting from an expansion in the number of recipients of its benefits. Once again, the individual is powerless to act effectively in this arena, and an isolated outlay by the individual for this purpose cannot be expected to achieve anything. Only by agreeing to use of the coercive powers of government to collect the required resources can the public obtain the benefit that it may value far higher than the cost.

5. Conclusion

The essential feature that defines a democratic government is voluntary agreement by the members of the public to subject themselves to its coercion. As is true of any paradox, despite its appearance there are good and logical reasons for them to do so. The logic of externalities analysis that is provided by the economics of welfare is a critical component of that explanation. Moreover, the phenomena to which this explanation applies are neither rare nor unimportant. Military defense, measures to counteract inflation and recession and the encouragement of innovation are hardly minor issues, and there are many more, including environmental protection, congestion in transportation and residences and a host of others. If this is not the full story of the logic of intervention by the state, it certainly is a good part of the tale.

WILLIAM J. BAUMOL

NOTES

1. On the general subject see (Baumol, 1952), (Downs, 1957), (Buchanan and Tullock, 1962) and (Olson, 1965).
2. Protection of the law against random and irrational violence is an example in which redistribution is not involved.
3. The market, however, does provide a higher share of the rewards to innovators than this suggests. A very substantial number of firms, many of them major enterprises, engage voluntarily in licensing and trading of their privately owned technology, thereby internalizing at least part of the externality. For example, newspaper reports suggest that in 2001 approximately 20 percent of IBM's net profits derived from technology license fees. On this subject see Baumol (2002 chapters 6 and 7).
4. (Hume, 1739). Olson (1965) also brings out the importance of the number of the governed.

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WHY GOVERNMENT SUCCEEDS

Government accomplishes some ambitious goals but fails miserably in meeting others. If government can send a man to the moon, why can it not eliminate poverty? If government can bomb the Taliban with deadly precision, why can it not control medical costs?

1. Special Interests

Most explanations for such differences focus on the explicitly political, highlighting two related themes:

(1) A policy succeeds only if government officials really want a program to attain its stated goals. Policy fails when the goals of politicians differ from those formally stated. The intent behind pork barrel projects, for example, may be to spend money in a legislative district, rather than to control floods or to protect the environment.

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