

SAE./No.28/March 2015

Studies in Applied Economics

**GOVERNMENT SELF-CAPTURE
AND THE DECLINE OF NATIONS**

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Global Health, and Study of Business Enterprise



Government Self-Capture and the Decline of Nations

by Mark Zupan

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About the Series

The *Studies in Applied Economics* series is under the general direction of Prof. Steve H. Hanke, Co-Director of the Institute for Applied Economics, Global Health and Study of Business Enterprise (hanke@jhu.edu).

About the Working Paper

This working paper was originally presented as part of the panel discussion “Government Self-Capture and the Decline of Nations” at the Carey Business School, The Johns Hopkins University on March 12, 2015 by Mark Zupan. The event was co-sponsored by the Johns Hopkins Business in Government Initiative and the Institute for Applied Economics, Global Health and Study of Business Enterprise.

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Introduction

Nations decline more often from internal and controllable causes rather than from external and immutable factors. The rot of countries from within typically has been attributed to political-economic institutions being co-opted by special interests from the demand-side of the policymaking process—crony capitalists, economic elites, labor unions, consumers, and environmentalists seeking favorable policies at the expense of the general public. Not enough attention, however, has been devoted to a more dangerous and pervasive form of political capture by government insiders who operate on the supply side of the policymaking process—rulers, policymakers, and public sector employees. Government insiders have the motive, means, and opportunity to co-opt the machinery of the state to promote their monetary and ideological interests at the expense of the general citizenry. This malignancy operates akin to how cancer hijacks the body’s own reproductive machinery to grow at its expense.

Politics can be defined as “Who Gets What, How, Why, When, and Where.” It is helpful to keep this definition in mind when thinking about government self-capture: who and what it involves; how it grows both in autocracies as well as in democracies such as the United States; why it is so difficult to counteract and was such a core concern of the Founders when constructing the constitutional foundations of the American Republic; and the numerous settings when and where it has accounted for national decline and failure.

The list of storied civilizations succumbing on account of government self-capture is lengthy. It includes Egypt’s New Kingdom; China’s Han Dynasty; the Roman Empire; the Republic of Venice; the Mamluke Sultanate; France’s Ancien Regime; and the Ottoman Empire.

The lessons to be learned from these historical failures are manifold. While difficult to counteract, government self-capture is not inevitable and there are some important curbs with which it can be combated. Moreover, the current importance of understanding the affliction of government self-capture and its debilitating consequences cannot be overstated.

In today’s developed nations, total government outlays average more than 50 percent of GDP while public sector employment averages more than 28 percent (it exceeds 50 percent in some countries such as China). In the United States, the unfunded pension and health care liabilities of state and local workers and K-12 education provide two compelling examples of the negative effect of government self-capture. If not addressed, the magnitude of these negative effects will continue to grow and threaten the viability of the American Republic.

Government Self-Capture: Who and Why?

Government self-capture involves self-enrichment by government insiders at the expense of the overall body politic. Rulers, political leaders, and public sector employees can benefit from their positions on the supply-side of the policymaking process. The perks or economic rents

that they derive on account of imperfect accountability on the supply-side of the policymaking process may be material (kleptocratic) or ideological.

In building an effective state, one must overcome an important conundrum. Specifically, while political order provides important benefits for a society and its citizens, such monopolization of power also contains the seeds of political decay. This resembles the natural monopoly problem: economies of scale militate toward a sole supplier of the entire market, but the resulting monopoly position affords, if unchecked, the sole supplier the means and opportunity to extract rents at the broader public's expense. The rents derived by government insiders on account of their roles on the imperfectly accountable supply-side of the policymaking process, impose an efficiency cost on society and thereby diminish the wealth of nations.

How Does Government Self-Capture Work?

Government insiders capture rents when the supply-side of the policymaking process is imperfectly accountable. Financial rents can be secured openly or in secret and can accrue from the diversion of public funds or from payments received from other sources (legal as well as illegal) on account of politicians' visibility, status, and/or ability to influence policy outcomes. The various potential channels for material remuneration include campaign contributions, honoraria, in-kind gifts, revolving-door positions in industry, and payments to family members and family businesses. The rents may be derived from relevant interest groups in return for promoting particular policies. They also may accrue on account of politicians' threatening to undertake activities that will make an interest group worse off.

Public employees are lower in the pecking order than elected or non-elected political leaders and thus have less apparent capacity to earn rents. That said, public sector positions tend to be insulated from competitive market forces. This is because government often is the sole supplier or has some effective monopoly power with respect to the provision of a good or service. In addition, public employees effectively get "two bites at the apple" versus the one available to their private sector counterparts. Not only can they organize themselves to collectively bargain with their managers, as can private sector employees, they also have the ability to elect and/or otherwise manage the people who are supposed to be managing them (for the sake of ordinary citizens). Governor Scott Walker of Wisconsin recently learned how challenging it can be to stand up to the collective political power of general state employees.

Government insiders also have the leeway to promote particular ideologies or policymaking ideas. Consider the revolutionary world views that individuals such as Ataturk, Gandhi, Gorbachev, Hitler, Lenin, Mao, Mandela, Napoleon, Tsar Peter the Great, Roosevelt, and Thatcher were able to advance through their respective positions of power, often in the face of well-established traditions and the associated resistance from fellow citizens.

Although it is easier to conceive of autocrats having the means to advance their ideological interests, democratically-elected representatives also have considerable leeway to pursue their world views at the expense of constituent interests. Such leeway is the result of imperfect competition on the supply-side of policymaking and the resulting imperfect policing of politician-agents by their constituent principals.

Because government, moreover, affords relatively unusual opportunities to impose ideologies on the population at large, politics attracts individuals with relatively intense demands for promoting their particular world views. After all, it is much harder to promote one's ideology through private firms than through the unique coercive powers available through government.

What Increases the Likelihood of Government Self-Capture?

Beyond the perks of power, six political-economic factors work to increase government size and thereby the means and opportunity for government insiders to coopt the apparatus of the state for their own benefit. These six factors are: patronage and other political advantages associated with public provision; gains to politicians from providing ombudsperson or facilitation services to constituents; transaction costs associated with government wealth transfers; special-interest group politics; bureaucratic growth incentives; and public goods' political clout.

Notably, while some of the factors behind government growth originate from the demand-side of the policymaking process (e.g., domestic producers seeking government protection from foreign competitors), all are relevant to the supply-side populated by government insiders. By driving growth of the supply side of the political market, all of the identified factors increase the potential for government self-capture and national decline.

What Factors Constrain Government Self-Capture?

Although not without drawbacks, there are six potential curbs on government growth and self-capture. These include: the negative impact of government growth on a nation's productivity; the ability of constituents to vote with their feet; constitutional, legal, institutional, and/or cultural restraints; electoral competition; a market for political control; and benchmarking across polities.

Why is Government Self-Capture Hard to Control?

Due to the perks of power, government insiders have an incentive to hang on to power. Because of the political power that government insiders possess, moreover, they have some unique means and opportunities to hang on to the perks.

Unlike in the corporate world, buy-out packages in politics are rare. The difficulties to be surmounted by those attempting to buy-out government insiders include the collective action problem and risks inherent in organizing an opposing faction (jail or death are possible outcomes). In addition, politicians contemplating relinquishing power confront risks and negative consequences. Specifying, ex ante, all the parameters of an ex post arrangement for a political leader and his or her family and loved ones is difficult. Political positions also provide unique opportunities to promote one's world views. Finally, the attractiveness, ex ante, of any promised ex post arrangement must be discounted due to the fact that one's successor may have an interest in and likely the means to break the promise. Can political leaders trust their well-

being to an ex ante promise in return for ceding power when in doing so they give up the ex post right to enforce it? Rulers such as Charles I of England, Czar Nicholas II, and Louis XVI and Marie Antoinette all ended up paying with their lives after ceding power even though they had assurances of safety beforehand.

An examination of tenure across national leaders provides evidence of the incentive that political leaders have to hang on to power when they have the means to secure perks through their positions. Such congealing of political power exacerbates the negative impact government self-capture has on the wealth of nations.

Note that this congealing of power is the exact opposite of what we expect in market settings where competition promotes consumer welfare: firms and their managers have longer tenures the *better* they serve consumer interests. In the political arena, by contrast, leader tenure is longer in countries with extractive political-economic institutions that benefit government insiders at the expense of more fully promoting the welfare of the general citizenry.

Where and When Has Government Self-Capture Led to National Decline?

Argentina, Cuba, Syria, and North Korea, offer telling case studies of the consequences of government self-capture. Argentina, for example, has gone from being one of the world's most prosperous countries as of the 1920s to an economic laggard due to the sustained dominance of the political party created by the Perons interspersed with several, largely military, dictatorships.

South Koreans now earn more than 15 times per capita and live an average 10 years longer than their North Korean counterparts. No such differences existed prior to the communists coming to power in the North in 1947 and three generations of autocratic rule by the Kim family.

Other analyzed examples of the adverse consequence associated with government growth and self-capture include: the Ming and Qing Dynasties of China; Castilian and Hapsburg Spain; Tsarist Russia; the Philippines under Marcos; the Dominican Republic under Trujillo; and the Congo under Mobuto.

Why Worry? Unfunded State and Local Government Liabilities

One in six workers in the United States is currently employed by state or local governments and the unfunded pension liabilities associated with such public workers total \$5 trillion. Unfunded state and local pension liabilities are the country's second largest fiscal problem—larger than Social Security but not as significant as Medicare/Medicaid/Obamacare. In contrast to Paul Krugman's argument that Detroit is an anomaly over which we need not worry, the Motor City instead epitomizes the fiscal challenge of government self-capture that is ever more constraining the quality of services our state, county, and municipal governments provide.

Why Worry? K-12 Education.

K-12 education, so critical to the development of human capital and thus our nation's future, similarly suffers from government self-capture. Notwithstanding significant increases in real per-student spending over the past half century, high school graduation rates continue to decline as does the preparedness of high school graduates for college studies and professional responsibilities. Until government self-capture in this vital sphere of our society is addressed, we will hamstring our country's ability to: promote broad-based educational opportunity; foster equality; revitalize our cities; and spur entrepreneurial activity and macro-economic growth.

How Can We Form a More Perfect Union?

James Madison in *The Federalist Papers* noted that “the great difficulty is this: you must first enable the government to control the governed; and in the next place oblige it to control itself.” As the role of the state in developed countries has grown over the past century and thereby the risk of government self-capture, what factors can we keep in mind to limit the undesirable consequences of such co-opting of political power at the expense of the general public?

First, certain constitutional/legal restraints on the accumulation of monopoly power on the supply-side of the policymaking process merit attention. For example, given the imperfectness of competition when it comes to the provision of most government goods and services and the ability of public sector employees to manage their managers through their influence on the electoral process, legislative changes over the last several decades that have allowed public employees to engage in collective bargaining do not serve the public interest. Much as antitrust laws are enacted to limit the monopoly power private sector firms can exercise to the detriment of consumers, so too can legislative limits be placed on the monopoly power public employees exert, at the expense of general citizens, through collective bargaining and lobbying.

Second, wherever possible, we should avail ourselves of institutional means to promote competition when it comes to the supply of goods and services that typically fall under the public purview. Much as we are averse to a single firm providing all of our military goods so too we should be wary of the state being the sole or predominant supplier of K-12 education, medical services for veterans, and postal delivery. Options such as vouchers, charter schools, and competitive outsourcing and franchise bidding all diminish reliance on a sole public provider and thereby on the likelihood of government self-capture. Likewise, rethinking the wisdom of ever-larger school districts and municipal service territories is in order. This trend toward agglomeration, often pursued for well-intentioned reasons (for example, desegregation and achieving economies of scale), has resulted in some unfortunate consequences because it has diminished competition on the supply side of government services.

Third, America's Founders realized that electoral competition is a primary means to control government. Over time, Americans and citizens of many other countries have also come to appreciate the value of term limits as an added means to curb political power ossification and the damage done by extractive political-economic institutions. In too many nations, however, the opportunity to be president for life remains open while the ballot box lacks sufficient legitimacy. The negative repercussions of this are significant. Witness on a smaller scale the recent arrest of Sheldon Silver, New York State's second most powerful politician, on corruption charges. Silver, who has served in the State Assembly for nearly 40 years and as State Speaker for over two decades, is well known for the autocratic manner in which he runs the Assembly and for his ability to enrich himself as well as his loyalists through the power that he has accumulated.

Fourth, improvements in technology, transportation, information, and productivity enhance constituent mobility and knowledge about the impacts of government actions while making it costlier for political insiders to engage in government self-capture. Anything that can be done to accelerate the beneficial impacts of such changes is to be championed. A free press plays a key role along these lines. Technological innovations that increase "reporting" by a broader public while better disseminating information to that public, moreover, are bound to foster government transparency while boosting the effectiveness with which citizens police their political agents.

Finally, when it comes to collective action, it is widely recognized that general taxpayers are the most widely diffused interest group. Future taxpayers are even more poorly represented politically. These factors enhance the ability of government insiders, as well as interest groups from the demand-side of the policymaking process, to co-opt political power for their benefit.

Deficit spending makes the present-day cost of government actions less transparent. Moreover, the time horizon of government insiders is much nearer-term than for future taxpayers. In light of such considerations, constitutionally-mandated speed bumps that limit the ability of politicians to over-spend or otherwise slough off obligations to future generations merit consideration (for example, balanced-budget rules requiring two-thirds legislative approval to circumvent).

A Broader Perspective on Institutional Self-Capture

So long as the supply-side of an institution lacks perfect accountability, there is the potential for damaging self-capture by insiders. The foregoing insights regarding government self-capture thus have some broader applicability to other non-profit settings ranging from churches to universities as well as to for-profit firms. While there are additional restraints against corrupt insider behavior in such settings versus the political arena, the curbs are not always perfect. The damage done at various points in time by insiders to organizations such as Kodak, Enron, Satyam, Tyco, Worldcom, the United Way, Bernie L. Madoff Investment Securities, Adelphi University, the Catholic Church, and Kids Wish Network attests to the consequences of imperfect accountability.

In non-political settings, self-capture is most commonly termed the “principal-agent problem”: imperfectly policed agents/managers will not act in consonance with the interests of the organization’s principals.