



## Market Inefficiencies and Government Transaction Costs

by Arlan DeBlicek

In “Federalism and Agricultural and Resource Policy,” Dr. B. Delworth Gardner tackles the “gray area” of government regulation as it relates to federalism. When discussing externalities (such as air and water pollution), safety of the nation’s food supply, and the use of natural resources common to multiple state jurisdictions, legitimate arguments can be made for justifying a centrally managed system of uniform policies regulating property use. However, when the costs of “rent-seeking” and the inefficient allocation of resources are considered, a system of well-defined and marketable property rights is ultimately the most cost-effective way of managing “common” property.

Federal land-use regulations have generally derived from concerns over market inefficiencies. Specifically, free-markets have a tendency to ignore third party stakes in property use resulting in calls for government action to remedy this exclusion. A common example is the call by environmentalists to consider the environmental impacts of property uses. Since environmentalists believe harm to the eco-system is ignored, the true costs of production are under-stated, thus creating an overuse of resources. Dr. Gardner argues that the inefficiencies associated with remedial regulations are ignored as well.

In a representative democracy, the will of the people is acted on by politicians. In order to be heard, people with common goals form groups that communicate their interests to the politicians for action. These groups are generally called “special interest groups.” Getting government to grant subsidies, special tax breaks, or generate regulations that place competitors at a disadvantage, create a system called “rent-seeking.” In return for special consideration, politicians get these special interest groups to donate money to their re-election campaigns or render services to political organizations. This is called “rent-extracting.” Rent-seeking and -extracting, in addition to the direct inefficiencies associated with the special favors, are transaction costs that are rarely included in the cost of government action. These transaction costs are a drag on the nation’s overall ability to efficiently produce and distribute wealth. In the end, these costs need to be balanced against the costs generated by market inefficiencies to determine whether the market or the government is more cost effective.

Rent-seeking occurs at all levels of government, but the costs seems to diminish the closer government is to the people. One reason for this is that local government is better able to match what people want with what they get from government. Second, the cost of government action is more closely associated with the benefits allowing the electorate to make better-informed decisions between competing priorities. This tends to allocate resources more efficiently. Third, the further removed politicians are from their constituencies, the more likely they are to act in their own interests (through rent-extracting), increasing the transaction costs of government action.

When considering food production, there are areas where a national government is more efficient than free markets alone, or state and local governments. One area that affects the entire

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nation is trade. The Constitution, under the Commerce Clause, gives Congress the power to regulate trade — not just foreign trade, but trade between the states. Economies of scale favor the federal government in negotiating trade, tariff, and price-support deals with foreign governments. Some of the problems associated with international trade, such as embargoes or high tariffs, could occur between states if not for a central government ensuring goods traveled freely between the states.

When considering land and natural resource management, the federal government causes a misallocation of resources, increasing the transaction costs of government action. In the case of managing public land, revenues are considered separately from the cost of management. This creates a misallocation of resources. Since it does not cost politicians any personal wealth, it is not a priority to maximize revenues and minimize costs. This is not the case for state or local land trusts, or private property owners if public lands were sold. In both cases, benefits and costs are borne by the holders of the property rights, creating an incentive to care for the land and maximize profits. Federal politicians tend to act in their own interests (rent-extraction) creating benefits for others that may not be in the best interests of their own constituencies. Those granted grazing rights on public land have no incentive to care for the land because there is no guarantee they will recover their costs.

The allocation of water in the western United States is another area where rigid government policies cause a misallocation of resources. By promoting a “use-it-or-lose-it” policy of water allocation, precious water is wasted by some, while others experience shortages. If holders of water rights were allowed to trade excess water to those who value it most, shortages and surpluses would evaporate. Additionally, expensive water projects act as subsidies for the select few with access to water, causing an inefficient use of taxpayer money. The misallocation of water and the inefficient use of taxpayer money are further examples of high transaction costs that are not considered in government action.

When factoring in costs of externalities created by some transactions in a free market, and the transaction costs associated with government action, more times than not, it is more cost effective for private markets to allocate resources. Even when some government intervention is inevitable, transaction costs will tend to be less with lower levels of government.

*This Institute Brief is one in a series on the chapters of a just published book, FEDERALIST GOVERNMENT IN PRINCIPLE AND PRACTICE, edited by Dr. Don Racheter, President of Public Interest Institute, and Dr. Richard Wagner, Economics Professor at George Mason University and Chairman of the Institute’s Academic Advisory Board. FEDERALIST GOVERNMENT IN PRINCIPLE AND PRACTICE looks at the relationship between federalism and liberty and explores the substantive practice of federalism, particularly the centralizing processes at work and the opportunities for decentralization.*

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