Chapter 4
Markets, Efficiency, and Governance

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ABSTRACT

This chapter provides an overview of markets and the conditions under which they fail to allocate society's resources efficiently from the perspective of neo-classical economic theory. The sources of market failures discussed are public goods, externalities, poorly defined property rights, high transaction costs, and information asymmetries. In addition to offering standard positive explanations for government intervention in failed markets, the chapter also presents a normative argument for doing so. Market theory is then linked to contemporary public administration through a discussion of alternative strategies for deciding the mode and extent of intervention. Finally, economic efficiency is extended to public management by arguing that managerial decision making is appropriately measured by technical efficiency, or a manager's ability to maximize program outputs given her resources.

INTRODUCTION

This chapter provides an overview of market theory from the perspective of neo-classical economic theory with topics including markets' characteristics and the exchanges that take place within them. Because economic theory is the foundation of modern policy analysis, the connection between markets and public policy is more readily apparent to many than is the connection between markets and public administration and management. The question is thus begged: Why should students of and practioners in public and non-profit administration care about how markets function and perform?

The simplest response is that public administration is policymaking, as Paul Appleby (1949) succinctly stated more than sixty years ago. Backed by varying degrees of administrative discretion, public servants from public managers to street-level bureaucrats are responsible for implementing public policy.

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Their task is largely underappreciated by lawmakers, who often write laws without much concern for the administrative difficulties of implementing, managing, and auditing public programs. Nevertheless, the choices public servants make every day impact citizens' lives, whether it is a customer service representative at the local department of motor vehicles rejecting an application on a technicality or a police officer electing not to issue a parking ticket. These choices, no matter how trivial they seem, are the result of an administrative behavior calculus that impacts how public organizations allocate their resources in pursuit of their policy objective.

A second reason why students and practioners should care about market theory is that they often have (or will have) professional obligations to be stewards of the public trust, which entails allocating resources, to the extent allowable by law, to those tasks most likely to achieve an organization's mission. Evaluating the social costs and benefits of alternative public policies requires not only a thorough understanding of the causes and consequences of less than desired allocations but also an ability to identify when public resources could be better utilized. Indeed, a critical contribution this chapter makes to the dialogue on government efficiency is an argument that the appropriate means of evaluating public manager performance is by their ability to maximize output with the fewest resources possible. Appreciating the logic of this position requires a prior understanding of the theory and mechanics of markets, resource allocations, and economic efficiency.

Because this chapter discusses characteristics of the market from a theoretical perspective, it is tempting to dismiss the matter as having little to no practical relevance to those studying public organizations. Like all theories, neo-classical economics presents an idealized perspective of individuals and political institutions that by definition fails to perfectly match the real world. Nonetheless, for at least two reasons it is too far a leap to conclude that simply because the discussion is theory-based that it is therefore not useful. First, by mastering theory we learn to view the world from new perspectives, thus providing a means to tackle problems in new ways. Mastering a theory's narrative is akin to adding a new tool to the public manager's tool chest, and the more tools at a manager's disposal the better equipped she will be for tackling the public sector's varied and complex problems. Second, a number of influential public administration and public management theories are built upon or use as a starting point economic theories of the market. Consider New Public Management (NPM), an influential public administration theory that presumes a strong link between citizen satisfaction with and trust in government and government's cost efficiency and performance (Van Ryzin, 2007). Notwithstanding the accuracy of its diagnosis of persistent citizen dissatisfaction (i.e. public-sector inefficiencies), evaluating NPM's policy recommendations requires a strong familiarity with the market signals that justify privatization and contracting-out as policy implementation strategies.

The task now turns to the issue at hand—market theory, efficiency, and their relationship with governance. The remainder of the chapter is organized as follows. In the next section, I discuss the idealized market by detailing the conditions under which the market is said to distribute society's scarce resources efficiently. The following section then describes the causes and consequences of the market's failure to allocate social resources in an optimal manner. I then challenge a common opinion that market failures demand government intervention. Finally, I introduce two other dimensions for evaluating public sector efficiency, Pigouvian efficiency and technical efficiency. As noted above, I argue that technical efficiency is the best strategy for evaluating public manager performance. The chapter closes with a brief summary.