A public choice analysis of some recent UK government policies

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This article uses public choice theory to examines the ability of political entrepreneurs to generate popularity by generating redistributions of income in which gainers perceive their gains more clearly than losers perceive their losses. The popularity of privatisation and the unpopularity of poll tax in the UK are explained in this framework of differing perceptions of gainers and losers.

The purpose of this paper is to set out some ideas from public choice theory and to apply them to two current issues of public policy in the UK: privatisation and poll tax. Whilst public choice theory and neo-Austrian economics are different, they are closely related in some of their fundamentals.

They are both similar enough in spirit to be placed under the heading of the political economy of the new-right (Thompson, 1990). Public choice theory shares one of the underpinnings of neo-Austrian theory: methodological individualism. Methodological individualism consists of taking the individual as the basic unit of analysis when trying to understand human action. Under this approach, if one wishes to understand the behaviour of groups such as »society», a crowd or a nation, explanation is to be sought by analysis of the choice between alternatives open to the *individuals* involved. This view stems from the observation that only human individuals can think and act. Under this view the contrasting approach of *holism* is seen as being misguided (Shand, 1984). Under *holism* a crowd is thought of as having a purpose. By contrast, methodological individualism would explain the behaviour of a crowd by examining it from the viewpoint of the individuals it comprises. The approach is analogous to the way physicists explain the properties of a gas by considering the actions of individual molecules (Shand, 1984, p.5).

Essentially the public choice approach consists of taking some of the basic ideas of economic theory and applying them to the analysis of politics. When a few basic ideas of economics are applied to the analysis of politics, the conclusions reached are strikingly different to the usual *economists*' vlew of politics.

The early triumph of economics is the understanding of the market — an understanding which neo-Austrian economics has sought to return to and deepen. Having sought to understand the market, economists then turned to an examination of situations where the market might not work: *market failure*. The market was judged to fail when an idealised — neo-Austrians would say over-idealised model of performance was not met.

Economics tells us that evaluations are to be seen in terms of alternatives, and at this stage, economics posited a naive alternative to market failure: benevolent action by the government to correct the failure — the so-called benevolent despot model of politics. In a typical journal article of the 1960s the main energies of the author would be used in a technical analysis of some aspect of how markets might fail. In the last few paragraphs attention would be turned to the question of a solution to this failure. This would turn out to be the suggestion that the government step in to make matters right.

Yet this approach involved a schizophrenic view of human nature, for as public choice theorists would argue, implicit in this approach was the view that those same self-interested individuals whose actions in the private sector led to market failure were not to be found in the public sector where agents were presumably motivated by altruism, and primarily concerned to benefit the public.

Public choice theory replaces this strained combination of assumptions by a unified view of individuals acting from self-interest, whether in the private or public sector. The government then ceases to be a benevolent despot; government as well as the market may fail, and the door is opened to a public choice analysis of government action.

The classic work on public finance (Musgrave, 1959) sets out the distinction between government action in the *allocative* branch and the *distributive* branch.[1] To illustrate this distinction with a simple example of harvesting from the land, the allocative branch is concerned with arranging to get the harvest efficiently and concerns itself with incentives to get work done, systems of reward that maximise productivity, etc. From the individual point of view the process is one of working hard and contracting well to benefit from the harvest. In distinction from this are distributive questions, or, when the government is involved, *redistributive* questions.

From a position of self-interest an alternative to labouring in the fields for income is to *argue* that proceeds from the harvest be re-distributed towards oneself. Thus *harvesting* corn, or *arguing* for corn both yield income. The government can intervene in either of these areas, and economists have sought to advise the government on how to intervene. The argument has been that efficiency can be improved by intervention in allocation (a view that has been cynicically received by neo-Austrian and public choice theorists) and also that *justice* can be improved by intervention in redistribution.

Under the benevolent despot model, government is seen as intervening in allocation as a disinterested engine for Pareto improvements and intervening in distribution according to some normative view of economic justice.

Public choice theory constructs an alternative to the benevolent despot model of government from a consideration of the self interest of voters, politicians and bureaucrats that interact to determine government policy. Major contributions to a hitherto neglected area of examining government re-distribution have recently been made by Tullock (1983). Empirical study has found that most re-distribution is not from the rich to the poor as theories of justice usually suggest, but from the rich and the poor to the middle classes. (Stigler 1970, Le Grand, 1982).

The public choice explanation is that re-distribution driven by self-interest will be from the politically weak to the politically powerful. There are natural limits to this, however, as people know that re-distribution threatens survival. In terms of the harvest, the priority is eventually seen to be gathering in the crop rather than arguing about its distribution. It is sensible to try to prevent too much selfish re-distribution because in the limit it threatens starvation for all, as the available time is all devoted to arguing rather than harvesting.

This realisation is no doubt the source of a general animosity to selfish redistribution. Because of this animosity those involved are more successful if they hide their actions, or re-define them as being for the public benefit with a *cover story* (Tullock, 1983, p.11). This leads to the (albeit philosophically treacherous) proposition that although there may be a great deal of self-interested redistribution, it will be hidden and difficult to substantiate. The more hidden is selfish redistribution, the more successful it is likely to be.

How is such self-interested redistribution likely to occur? One way is for politicians to act as political entrepreneurs and trade redistributive policies for votes. A well designed redistributive policy will satisfy the self-interest of voters by transferring resources to them and satisfy the self interest of the politicians involved by transferring power to them in the form of votes.

Redistributive policies normally create *gainers* and *losers* and if no change in efficiency results from the policy then the total of gains will equal the total of losses in a zero-sum game. At first sight it might seem that the sum of votes gained would also equal the sum of votes lost, but this is not the case as will be argued below.

In fact redistributive policies will very often *decrease* efficiency in a negative-sum game between gainers and losers — a so-called *deadweight* loss. It might seem that this kind of redistribution would be uncommon because of a desire to avoid deadweight loss. However, this is not the case. Redistributive policies that decrease efficiency are very common. The reason is that the deadweight loss is usually associated with concealment of the redistributive objective of the policy and it is this cocealment that prevents the policy from being rejected by those not benefitting. Thus, the European Community common agricultural policy is a redistributive policy aimed at raising farmers' incomes by agricultural price support. Enormous deadweight losses are involved, with their physical manifestations as butter mountains, wine lakes, etc. A simple cash payout to farmers would obtain the same redistributive aims at a fraction of the cost. However, this would not work because it is too obvious. Too obvious to whom? The losers, who have a self-interest in preventing such redistributions occuring.

Thus a key to a successful re-distributive policy is to make sure the recipients know they are gaining whilst at the same time making sure the losers do not know they are losing. The closer the policy can get to this ideal, the more successful it will be. Following this theme, if both the gainers and the losers will be aware of the redistribution, it is better if the losers are few and the gainers are many. However, this requirement is in conflict with a desire for concealment as diffuse losses are more easy to conceal than concentrated losses.

To sum up, politically successful redistribution policies involve an asymmetry of information, with the gainers being more aware of their gains than the losers are of their losses.

A PUBLIC CHOICE ANALYSIS OF PRIVATISATION

A majority of privatisations by the British government have been carried out by fixed-price offer at below the market price. Table 1 gives some examples. Of course it is not possible to know the market price in advance of a fixed price offer, but it is unlikely that the tendency to underprice is the result of poor estimation. Underpricing these issues has involved substantial gains for the gainers and losses for the losers, and can at the same time be judged to have generated popularity.

TABLE 1: Premiums on Privatisation New Issues

Amersham International	142	192	35
Associated British Ports	112	141	26
BAA (Fixed price portion)	245	280	14
British Aerospace	150	178	19
British Airways	125	169.5	36
British Gas	135	149.5	11
British Telecom	130	172.5	33
Cable & Wireless	168	198	18
Jaguar	165	177	7
Rolls-Royce	170	288	34

(Prices grossed up for all future instalment payments)
Source:H. Hyman (1989)

The pattern of gains and losses from the privatisation can be analysed by examining the pre- and post privatisation structure of property rights. It is convenient to take the particular case of the privatisation of British Telecom as an example for the purpose of analysing gainers and losers as this sale has been examined in some detail by Mayer and Meadowcroft (1985). Before privatisation, British Telecom was a nationalised company. One way of looking at the benefits of ownership is to say that they are spread equally between all British citizens. When British Telecom was privatised, shares were sold for £ 0.50[2] each. These were valued on the stock market on the first day of trading at £ 0.93. Hence, as a result of government underpricing the buyers of shares gained £ 0.43 per share and the sellers lost £ 0.43 per share. In fact, the sellers lost slightly more than this, as there were issuing costs of £ 263 million. Table 2 shows the difference between the market value and receipts at £ 1.558 billion. These losses work out at about £ 30 per head of the British population.

TABLE 2: The Privatisation of British Telecom

No of Shares	3,012,000,000
Market price	0.93
Market value	£ 2,801,160,000
Receipts	
Sale of shares £ 0.50	£ 1,506,000,000
Issuing costs	£ 263,000,000
Net Receipts	£ 1,243,000,000
Difference between market value and receipts	£ 1,558,160,000
Approx popn	51,500,000
Losses per head	£ 30.26

A member of the British public who took no active part in the privatisation would therefore lose £ 30 as a result of the underpricing. Realising this, however, would involve constructing an analysis of the effects of the privatisation along the lines of the above paragraph. In practice most losers would not know they could be seen as making a loss, and *a fortiori*, would have no idea of its magnitude.

Becoming a gainer from the privatisation would involve purchase of shares. The gain was £ 0.43 per share, so by purchasing £ 30/£ 0.43 = 70 shares one could avoid loss, and any purchase of shares above 70 would involve gain. Only about 4% of the population bought shares

(Mayer and Meadowcroft, 1985), therefore about 96% of the population lost as a result of the underpricing of the British Telecom privatisation. Of course, neo-Austrians would argue that the reason for privatisations is to reduce X-inefficiency in nationalised industry. Accepting this however does not imply that the offer should be underpriced.

Because demand exceeded supply of shares at the issue, rationing was used and this limited the size of individual gains. Shares were rationed out to those who applied on the published application forms.

The privatisation of British Telecom can be seen under this analysis as being likely to lead to government popularity. Losses of £ 30 per head were imposed on all members of the population who did not buy shares. These individuals were largely ignorant of the losses involved because of the need to construct an economic argument to demonstrate them. Any individual who was aware of the losses they were likely to sustain could either a.) complain or b.) order some shares in order to become a gainer. Provided, with self-interest, those in category b. were more numerous than category b. the privatisation policy can be seen as contributing to the net popularity of the government. The redistribution has produced a large number of unaware losers, and a smaller number of aware gainers. More popularity could be gained by increasing the numbers of the gainers and reducing the size of their gains. This was achieved in later privatisations by advertising the sale of shares more widely, and imposing quite low ceilings on the numbers of shares that could be bought by each individual.

POLL TAX

The analysis of gainers and losers under the switch to poll tax leads to a very different story. The poll tax, or as it is officially termed, community charge, was introduced in April 1990. The new system of local taxation changed from a property tax to a *per capita* tax. At the same time the business property tax system was reformed, though this will not be discussed here. Changing to a new system of local taxation of essence creates a large number of gainers and losers, and this process alone is likely to generate unpopularity. The mechanism was pointed out by Prest (1982, p20) as being the

> "familiar pattern of the shrill cries of the losers from the new . . . arrangements drowning out the contented purrs of the gainers"

TABLE 3: Households (thousands) gaining and losing with full replacement of domestic rates by the poll tax, England, (£ per year, 1986/87 prices)

Losers: Loss per year	Single Pensioner	Other Single Adult	Two Adults	Three Adults	All Households
£520 +				90	90
£260—520			100	645	740
£104—260	10	70	1665	1010	2750
£52 —104	35	120	1445	275	1870
£0 —52	340	285	2950	195	3765
All losers	380	475	6160	2215	9225
Gainers: Gain per year					
£520+	15	20	130	15	185
£260—520	160	165	510	40	880
£104—260	365	575	1320	90	2350
£52 —104	240	275	975	50	1545
£0 —52	1330	695	2035	85	4145
All gainers	2110	1740	4925	280	9105

Source: Parliamentary Written Answer, 13 Jan 1988, quoted in Gibson, 1990, p86.

The redistributive effects of the poll tax have been analysed in depth by Gibson (1990). The previously existing property tax system was called the rates system. An individual's payment was determined by the "rateable value" of their house, multiplied by the local tax rate or "*rate*". The rateable value of the house is an assessment of the annual rent that could be charged for the house. In fact these rateable values were rather poor indicators of rental value due to the extreme thinness of the rental property market (as a result of regulation) and the fact that rateable values were last assessed in 1973[3] (Gibson 1990, p8). Under the poll tax, a household's rates bill, based on the value of their house was replaced by a per capita tax, the same for all members of the household over 18[4].

The change meant that essentially every individual gained or lost. Gainers were those who lived in expensive houses in small houses. Because property values are in general higher in the south of England, those in the south also tended to gain. Losers would tend to live in the north, in low value houses. Having a large number of adults in the household would tend to make the household lose because the poll tax was levied *per capita* rather than per house. Table 3 shows the distribution of gains and losses predicted by the government's analysis as a result of the introduction of poll tax. As expected, small households are generally seen to gain with the introduction of poll tax, and large households to lose, and considerable sums of money are involved.

The redistributions generated by the switch to poll tax are in marked contrast to those involved in privatisation. The important difference is in the awareness by the losers of their loss. Before the change, the head of the household would receive the annual rates demand each year. With the introduction of poll tax, this would be replaced by an annual poll tax demand addressed separately to each member of the household. With this framework it would be very easy to perceive loss. Gainers would similarly be clear about their gains, and overall the effect described by Prest (1982) above of complaints drowning out satisfaction would tend to operate.

In political terms, poll tax is clearly seen to be a mistake. The policy was inseparably linked with Margaret Thatcher, and was the "flagship" of her third term (Gibson and Watt, 1989). It is generally thought of as being the most important cause of her downfall in November 1990.

Why did Margaret Thatcher make the mistake of introducing poll tax? One possible explanation is that in many areas she had gained long term popularity by enduring the sharply-directed short term unpopularity that resulted from undoing previously erected redistributions. As argued above redistributions offered by political entrepreneurs generally involve substantial deadweight losses that are necessary to hide the redistributive essence. Thus for example a political entrepreneur may wish to redistribute income to miners. To do this a simple cash transfer would be most efficient in economic terms, but would be too transparent. As a cover story for the transfer it is necessary to run a large number of uneconomic pits. Thus the losers have to bear not only the pure redistribution costs but a substantial deadweight loss as well. Undoing these redistributions involves short term unpopularity with the recipients of the redistribution, but may in the long term generate very substantial efficiency gains to the economy, and long term popularity.

However, with the poll tax, efficiency gains due to possible long term improvements in accountability were too notional and slow to arrive to outweigh the massive unpopularity generated by the vast number of fully aware losers.

Curiously enough the proposed replacement of the poll tax by its supposed "cure", the council tax, will, by the time it arrives, itself generate a new series of gainers and losers and thus be a further engine of unpoularity. By the time it is introduced, the cure may come to be seen as worse than the disease.

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NOTES

1. The distinction was first drawn by Wicksell (1896), as pointed out by Mueller (1989).
2. This is a partially paid price. The price inclusive of future instalment prices was £ 1.30, hence the offer price of Table 1.
3. The reluctance of governments to update rateable values is another effect of the gainers and losers problem.
4. In fact the new system was more complicated than this because poll tax could be reduced for cases of need. However we do not go into this here because it does not affect the basic argument.