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Political and market transactions share many features, as do political and market institutions. Their main distinction is the degree of exogenous order that can be assumed to support their operation. Markets rely on "solved political problems" (Lerner 1972). These problems are typically solved by political institutions.[1] Markets without states and states without markets are both vanishingly rare throughout history. A more typical pattern has involved state monopolization of violence within a small enough territory to facilitate trust-based market exchange. In this paper, I will stress that states and markets are complementary mechanisms for resource allocation, subject to different but related drawbacks that preclude their exclusive use.

Societies have employed a variety of allocation mechanisms, falling broadly into decentralized and centralized categories. The principal form of centralized allocation is the state, where a single decision allocates for all, and final allocations may involve coercion. In states, one, some or all the people decide the allocation, and the people assembled in this way are called a government. Markets, by contrast, are decentralized allocation mechanisms where actors choose independently and the final allocation results from the choices of each independent agent. Markets involve interaction and exchange between individuals at "arm's length," and coordination is accomplished through price signals and enforcement mechanisms (contracts). Markets contain business firms, which are hierarchies where coordination is accomplished by command and control (Coase 1937)[2]. These hierarchies reduce external transaction costs but create their own internal transaction costs. Governments similarly monopolize coercion and dominate the hierarchy within the territory they control, accomplishing coordination via command and control. They use taxes and subsidies (including Pigouvian taxes targeted at negative externalities) to align private incentives with social efficiency.

Neither markets nor states achieve perfect efficiency or equity. Crudely, markets are subject to market failure and states are subject to political failure. Markets are subject to public good problems and function poorly with ill-defined property rights. Property rights are best understood as a mechanism for shaping incentives, specifically for the purpose of internalizing externalities when the gains of such internalization outweigh its costs (Demsetz 1967). When

[1] Though not always – see Ostrom 1990.

[2] The extent of hierarchical coercion within firms is contested – compare Coase 1937 to Alchian and Demsetz 1972. The disagreement appears to come down to a dispute over the nature of control. Coase called the mere direction of an employee's behavior control, while Alchian and Demsetz emphasize the employee's exit option.

property rights are clearly assigned, externalities are internalized and public good characteristics are absent, rendering markets more efficient. In addition, market transactions are costly for the agents who participate in them, and such transactions often do not account for the negative externalities they generate (Stevens 1993 ch. 5). Finally, market efficiency is impeded by asymmetric information problems (Akerlof 1970) and problems arising from uncertainty about the future (Hardin 1997).

States are subject to political failures such as commitment problems, interest group capture, rent seeking and corruption. They also suffer from principal-agent problems at multiple levels. First, the government must control its agents (Moe 1990), and second, the people must control the government.[3] In addition, even a properly-controlled government will still be subject to problems of credible commitment and time-inconsistency (Drazen 2000). Political failure can result from the heterogeneous interests and asymmetric incentives present in a diverse population. Indeed, when political institutions cannot credibly commit to future, inefficient redistribution may be a useful tool to sustain political power (Acemoglu and Robinson 2001).

States (but not markets) are forced to grapple with equity. The level of redistributive fairness in public policy is not a matter of efficiency, and it is important to remember that the pursuit of efficiency is itself an ethical judgment (Ord 2013). As a result, markets are underpinned by a solved political problem – in areas where markets are permitted to operate, equity questions are suppressed (Sandel 1998).[4] Trade is generally peaceful precisely because it lacks a political component.[5] Parties are prepared to stipulate that the political problem of equity has been shelved, and they can then get on with maximizing their position under the circumstances. At the political level, no such truce is possible, and equity considerations become inextricably tied up with efficiency (Acemoglu 2003).

Consideration of the maximum size of governments and firms illuminates the parallels between political and market institutions. Using markets is costly. To allocate via the market,

[3] Compare Madison – "…the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself." (Federalist 51).

[4] "Society needs to keep the market in its place. The domain of rights is part of the checks and balances on the market designed to preserve values that are not denominated in dollars…society diversifies its mechanisms for distribution and allocation." (Okun 1974)

[5] Though it is worth noting that the ancient antecedents of traders and pirates were the same people, choosing one or the other as opportunity presented itself (Herodotus 440BC).

individual agents must bear the cost of search, measurement, bargaining, negotiation, monitoring and enforcement (Coase 1937). Opportunistic action by market agents can cause holdup problems (Klein 2000), and problems such as asset specificity (Williamson 1981) and metering (Alchian and Demsetz 1972) can only be imperfectly remediated by contracts.[6] Markets are also plagued by information problems which can prevent their efficient operation (Varian 2002, Akerlof 1970).

The transaction costs inherent in the use of the market can give firms an incentive to internalize operations, but overhead costs and mistakes in resource allocation militate against internalizing everything (Coase 1937). Firms balance these costs against each other, and the size of firms is given by the equilibrium point. Extending this analysis to the state is fruitful, and in my view more persuasive than an account based on the rate of redistribution desired by the median voter (Meltzer and Richards 1981). Adapting Coase's model, we might expect government to expand until the marginal cost of internalizing the next operation is greater than the cost of procuring it through the market. However, the state's power to shape the market by fiat greatly complicates this analogy. The exorbitant privilege of shaping the market environment removes market discipline, so we should expect to see states expanding to the point of directing all productive activity. The fact that states do not behave in this way suggests a political mechanism for internalizing the negative externalities produced by command-and-control (see Bates and Lien 1985).

A major difference between governments and firms relates to their capacity to solve commitment problems. Governments cannot credibly commit to take intertemporal actions *by definition* because they are coercion monopolists who cannot be forced to act against their interest. As a result, efficiency considerations are analytically inseparable from distributional considerations (Acemoglu 2003). Firms solve these sorts of credible commitment problems by contract and by appeal to the (exogenously given) assignment of property rights (North 1993), but states by definition cannot assign property rights in their coercion monopoly.[7] We are thus brought back to a reliance on "solved political problems". If the allocation of political power creates an inherent commitment problem, then we might expect people to invent mechanisms to

[6] This is either because of high transaction costs (Coase) or high information costs (Alchian and Demsetz 1972).
[7] Unless of course that's what democracy is – see Bates and Lien 1985.

bind governments. It is possible to interpret the transition from monarchy to democracy as a slow process of self-binding by monarchs (Barzel 1997), and a modern case of self-binding is often said to be the creation of independent central banks (Drazen 2000). This account is supported by research finding that the degree of inflation desired by financial interests affects whether central banks become independent (Posen 1995). However, this may be insufficient to explain the creation of independent central banks in the first place (Draper: Memo #7), particularly as central bank independence appears to have dramatically different results in developed and developing countries (Brender and Drazen 2005). Inefficient redistribution has also been proposed as a mechanism for sustaining political power (Acemoglu and Robinson 2001), but a more likely theory is that actors' expectations about the future are as important as property rights (North 1993, Greif 1994), and that as a result cultures must inculcate the correct mental models and social norms for interacting with institutions before those institutions can be fully effective.

Political institutions and marketplace institutions are likewise both subject to failure. Political institutions are themselves a result of politics, and blend coercion and cooperation (Moe 1990). State bureaucracies can encode the preferences of defunct majorities (McCubbins et al. 1987). As we have seen, even benevolent policymaking can be frustrated by inconsistent expectations across time, and this form of political failure (known as the time-consistency problem) is particularly illustrative of the unique challenges facing governments (but not firms). A government can improve the general welfare by failing to keep its promises, notably in cases where a tax rate is set in one period and then changed in a second (Drazen 2000). However, rational expectations price in the rate change, precluding investment on that basis during the first period. As we have seen, self-binding in the form of institutional independence is a possible solution, but it depends on that notional independence being taken seriously in the market.

Market failure can result from inadequate information, insufficient competition, or high transaction costs, and in these cases collective action may actually increase the efficiency of resource use. Market failure can also be induced by externalities. Because markets only allocate private goods efficiently, public good characteristics (non-rival, non-excludable and indivisible) cause markets to break down because public good characteristics (in the form of positive and negative externalities) are being produced but not reflected in prices (Stevens ch. 3). Finally, market failure can also occur for equity reasons, such as income distributions or consumption patterns that we deem inappropriate. These equity considerations seem to be in some sense conceptually prior to efficiency considerations, because market operations are contingent on stipulating the equity question, as noted above. Different equity equilibria appear to make different levels of efficiency possible.

Rational choice theories view business firms as a set of contracts among factors of production, enabling team production whereby firms compete with other firms (Alchian and Demsetz 1972). This is strikingly similar to an evolutionary theory known as dual-level selection or group selection (Wilson 2008), where humans are said to pursue individual adaptive fitness *and* group adaptive fitness simultaneously. The residual claimant proposed by Alchian and Demsetz might seem to be absent on the state side, but consider the role of tribal chiefs. Small groups of hunter-gatherers lack chieftains and practice collective governance, but once the Dunbar number of about 150 social relationship is exceeded, cooperative governance becomes much more difficult. At that point, a chief who is known to each member of the tribe even if members are not known to one another personally is by far the most common historical mechanism enabling humans to live in large groups (Harari 2014). In a similar vein, Alchian and Demsetz's residual claimant is common to all contracts for joint inputs and has the right to negotiate *ex parte* with each employee. The parallel becomes all the more intriguing when we compare the gradual accretion of mechanisms for replacing the chief with a collective executive with mechanisms for transforming closely-held private companies into exchange-listed public firms. The practical necessity of a residual claimant clashes with our equity intuitions regarding fairness, and there thus exists an impetus on both the political and market sides to replace the residual claimant with a collective without upsetting the mechanism by which the residual claimant makes the organization possible.

States are a confounding variable in the study of markets, and markets are a confounding variable in the study of states. To get an idea of what markets can accomplish without the "solved political problems" that fade into the background in the modern era, consider long-distance trade before the rise of powerful states. While rudimentary market mechanisms existed and goods were sometimes transmitted across Eurasia, such trade was highly uncertain, subject to the extraction of rents at every border, and consisted mainly of preciocities – valuable goods with a high value-to-weight ratio (Greif 1994). By comparison, the virtually frictionless trade of the modern era is the result of innumerable political compromises enshrined in law and enforced by governments. Similarly, to disentangle the state from its market confounds, we could examine the Bronze Age palace civilizations such as Egypt, Sumer or Mycenae. Trade within and among these societies was negligible, and production and consumption were tightly regulated – bureaucrats specified planting and harvest times and set mandatory exchange rates (McNeil 1963).[8] Both types of society seem radically inferior to the blend of states and markets prevalent around the world today.

We have been adequately cautioned against allowing one domain to encroach too completely on the other (Sandel 1998), but what mix of states and markets should we strive for? It seems clear to me that the core elements of civic republicanism can be marked off from the market on a purely instrumental account (Draper: Memo #1), and it also seems clear that for similar instrumental reasons, the allocation of productive resources to firms is best handled by the market (precluding industrial policy or mercantilism, for instance). Beyond this, research indicates that the efficiency implications are nuanced and dependent on transaction costs, with collectivist systems generally boasting more efficient intra-economy agency relations and dispute resolution but allowing substantial poverty, and individualist systems exhibiting efficient inter-economy agency relations and wealth transfers to the relatively poor but costly dispute resolution mechanisms (Greif 1994). I echo Grief's observation that the individualist system seems to have a better track record of wealth creation, but this is tautologous – allocating more of a society's resources via markets is bound to improve efficiency and result in relatively more wealth creation. The more pertinent question concerns happiness. What balance of states and markets will yield the highest sum total of human flourishing?[9] We might answer this question by appeal to the distinction between organic and manufactured demand (Galbraith 1958), and we might attempt to distinguish between the genuine improvements in wellbeing arising from the fulfilment of organic demand from the empty positional satisfaction conferred by the fulfilment of manufactured demand.

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[8] The Soviet Union achieved a similar feat before the introduction of Stakhanovite methods in 1934, but the government's hold on the real economy was tenuous and market exchange doubtless proliferated beyond the reach of the commissars.

[9] Consider James Bryce's advice to the legislature of North Dakota in 1884: "“Gentlemen, why in heaven's name this haste? You have time enough. No enemy threatens you. No volcano will rise from beneath you. Ages and ages lie before you. Why sacrifice the present to the future, fancying that you will be happier when your fields teem with wealth and your cities with people? In Europe we have cities wealthier and more populous than yours, and we are not happy. You dream of your posterity; but your posterity will look back to yours as the golden age, and envy those who first burst into this silent splendid nature, who first lifted up their axes upon these tall trees and lined these waters with busy wharves." (Bryce 1885).

I wish to conclude by giving some thoughts on the circumstances under which the firm-state analogy breaks down. Scholars have cautioned against unreflectively applying models from one domain to another.[10] But can we improve on this guidance? The foregoing analysis seems to indicate that we should not expect states to be particularly efficient, because equity considerations are by definition unresolved. Nor should we expect markets to produce particularly equitable outcomes, because the equity considerations are by convention ignored. In addition, the types of commitments that can be enforced within a market cannot be enforced against a state. Finally, while market transaction costs can be minimized, political transaction costs cannot. On this basis, we can define two unique aspects of politics: it is the organizational level at which equity questions are resolved, and the organizational level at which no commitments are binding.

Both these features relate not to the nature of the problem, but to the means available for its resolution. Political failure cannot simply be remediated like market failure, by assigning property rights and minimizing public good characteristics. Remediating political inefficiency, as we have seen, requires grappling with equity. This gives us some guidance. Political and market transactions seem to be subject to similar general conditions, but the means available for remediating inefficiency are vastly greater in a market context. In general, it seems that healthy societies are able to survive the marketization of many spheres of activity. However, efficient action in the marketplace is predicated on the prioritization of the long term, which is supported and enabled by an equitable social structure.[11] Marketplace efficiency is built on a foundation of widespread equity, which presents an upper limit to both the marketization and the efficiency of society. I am inclined to view this as a good thing.

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[10] "…a weakness in the political economy literature is an overreliance on models from other areas of economics (such as industrial organization) because they are formally attractive, rather than really relevant." (Drazen 2000). "In general, all theories of organization that political scientists have relied on over the years to understand public bureaucracy have been motivated and shaped by the theoretical perspectives and substantive interests of other disciplines. These theories were simply designed to do other things." (Moe 1990). "For a variety of simple, easy-to-measure and important-to-constituent-well-being policies, something like the rational choice model of the new political economy has explanatory value - for transfer payments for example. But the crucial issues that determine the long run performance of economies and polities are complex, subject to contradictory theories that cannot be resolved with the information available even if the constituent did have the incentive to be informed." (North 1993).
[11] A development project that I worked on in 2016 involved calculating intertemporal discount rates in Haiti. They were shockingly low. Long time horizons are a luxury of mass affluence, and perhaps also of mass political equality.

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