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THE INTEREST FREE SOLUTION

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The Interest-Free Solution

How to Stop Special Interests From Choking Economic Growth

By Mancur Olson

WILL THE United States under a Clinton presidency begin to recover the economic preeminence we used to take for granted? Those who think that things will get better and those who expect things to get worse often share the assumption that the pivotal decision was made on election day when the Democrats were voted into the White House.

In fact, the ideology of the party in power is by no means the major determinant of economic performance. The rhetoric and ideologies of Presidents Bush and Carter were different, but the record of both was poor. Neither Conservative nor Labor governments have been able to make the British economy grow with any regularity. By contrast, both the German and Japanese enjoyed economic miracles for quite some time after World War II—no matter who was in charge. The victory of one party over another does not explain much of the variation in economic performance in either the United States or other advanced democracies.

Two factors are much more important in determining economic growth: the extent to which special interests, whether through lobbying of the government or collusive and cartelistic action that obtains monopolistic prices and wages in the market, get their way; and whether the government avoids the lure of the free lunch, the belief that you can get something for nothing.

The way in which special-interest organizations proliferate and then stifle growth has not been understood until recently. These interests only coalesce and gain power during long periods of political stability. The reason is that it pays for each beneficiary of a special-interest lobby or of a collusive arrangement to be a free rider. That is to say, the benefits of lobbying or of the higher prices and wages brought about by collusion go to every firm in the favored industry or occupation, regardless of whether that firm or individual has paid dues or not. Thus a special-interest organization needs to work out selective punishments and/or rewards that induce its beneficiaries to support it. The closed shop of labor unions is an obvious example. Other large organizations use more complex and subtle mechanisms to achieve the same ends. Over long periods of stability, many such organizations emerge and devise ways to enlist people or competitors who would otherwise be free riders into lobbies and collusive agreements.

Countries in which special-interest groups have been eliminated by catastrophe, like Germany and Japan after World War II, enjoyed remarkable economic growth while long-stable countries, such as Great Britain, suffered the "British disease" of slow growth. The United States has also enjoyed a long period of stability, especially in the Northeast and the Midwest, and it has a correspondingly dense network of special-interest organizations.

These organizations do so much damage to the economy because their clients, while reaping the gains from special interest legislation and price-fixing, bear only a minuscule share of the costs to society. Thus they redistribute wealth to themselves even when society loses far more than they gain.

Lobbying is especially harmful in this country because each member of Congress faces similiarly perverse incentives. Given geographic representation and weak political parties, individual representatives need be concerned about little else besides their personal popularity in their districts. The typical member of Congress comes to realize, however reluctantly, that his or her political interests are usually best served by seeking pork for the district and campaign contributions from the special interests. The constituents of a con-

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gressman obtain 100 percent of the pork for the district but pay only about 1/435th of the taxes that finance the project. The result is what Jonathan Rauch of the National Journal has called "demosclerosis"—the hardening of the arteries of the body politic.

There is only one person in our political system who has an incentive to do something about this problem: the president. To win reelection, a president must leave a plurality of voters feeling better off, and there is normally no way that this can be done without making the country as a whole more prosperous.

The second determinant of economic performance in advanced countries is the extent to which governments succumb to the lure of the free lunch. It was partly the promise of costless gains from hyper-Keynesian fiscal and monetary policies that led to the damaging and pointless inflation that helped to terminate Carter's presidency. Under the cover of a diametrically different ideological rhetoric, Ronald Reagan promised the same free lunch in the form of "self-financing" tax cuts. The resulting budget and trade deficits and the ever larger national debt have destroyed confidence and raised real long-term interest rates. This has made the current recession more tenacious and intractable.

Demosclerosis and the illusion of the free lunch are intimately related. Lobbies and cartels establish prices and wages so high they create unemployment. Economic stimulus can cure this unemployment only temporarily because the special interests will, by indexation or other means, set money prices and wages even higher than they would be otherwise when they observe the government pursuing a continuing Keynesian policy. So unemployment continues and there is inflation as well.

The Reaganite argument that tax cuts will generate huge increases in economic growth also fails because it assumes that taxation to fund the welfare state is the main factor in distorting market incentives and blocking greater economic activity. In fact, there are 1,001 other distortions of incentives. Some of these take the form of tax loopholes and many are due to lobbying and collusion by business interests. Thus so-called supply-side tax cuts do *not* finance themselves. Instead, they generate deficit borrowing that distorts interest rates and destroys confidence.

Whether the United States regains the economic dynamism of an earlier era therefore depends substantially on how well Bill Clinton faces down the demands of special interests and resists the offers of free lunches. The test of Clinton will come soon. The special interests that will do the most damage in any administration are those that have *supported* it, and they demand their spoils promptly.

We will learn a lot from the new president's first choices about these demands. He will soon choose whether the new programs to improve the nation's infrastructure are designed to increase the efficiency of the economy or to please the contractors and construction unions. He will soon determine whether the main harvest of the investments in education and human capital will be reaped by the students or by the organized teachers. He will before long decide whether a new health care plan will subject even the politically strongest providers to severe competition, or only to administrative and political cost controls that organized providers will dominate. He will soon decide whether the North American Free Trade Area and other measures to increase international trade will be promoted vigorously or whether that classic disguise of special-interest politics, protectionism, will prevail. He will soon either insist upon the autonomy vis-a-vis organized labor that he maintained as governor of Arkansas or else concede to the demands of unions. He will quickly decide whether appointees in the new administration work only for the president and the country or whether some will in effect be insider lobbyists for one organized interest or another. He will also decide early on whether to yield to the temptations of a large, free-lunch, fiscal stimulus that can yield only temporary benefits, or whether to take immediate credible action to deal with the deficit.

The prospects of the American economy—and paradoxically even Clinton's chances of re-election in 1996—may be better if he makes some unpopular choices over the coming months. As President Bush's experience demonstrates, even exceptional popularity long before the election is no guarantee of victory. It is the record of economic performance four years from now, and the degree of confidence the American people will then have in their futures, that will probably be politically decisive in 1996. If the new president fails to stand up to the organized interests, or if he succumbs to the lure of the free lunch, the country will ultimately lose, and probably he will too.

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