Competition and Political Entrepreneurship: Austrian Insights into Public-Choice Theory

Thomas J. DiLorenzo

Public choice can be defined as the application of economic theory and methodology to the study of politics and political institutions, broadly defined. Neoclassical price theory has been one of the principal tools of the public-choice theorist, having been applied to address such questions as why people vote, why bureaucrats bungle, the effects of deficit finance on government spending, and myriad other questions regarding the operations and activities of governments. There has indeed been a public-choice "revolution" in economics. But neoclassical price theory has its limitations, many of which have been investigated by Austrian economists. These limitations have implications for the study of public choice. Namely, if neoclassical price theory is itself flawed, then perhaps its applications to the study of political decision making has produced uncertain results.

In this article, I shall explore two strands of Austrian economics—theories of competition and of entrepreneurship—and their implications for public-choice theory. I do not claim to provide an exhaustive examination of public-choice theory from an Austrian perspective, but only to offer a few insights. The first section notes some limitations of applying the neoclassical competitive model to the study of political decision making. The next discusses the implications of placing more emphasis on the role of political entrepreneurship in the study of public choice. The final section contains a summary and conclusions.

Competition, Entrepreneurship, and Public Choice

One area in which the neoclassical competitive model has been applied by public-choice theorists is the economics of local public finance. There exists a large volume of mostly empirical research purporting that when metropolitan areas are composed of larger numbers of governments, competition among governments for population and, consequently, tax base induces them to be more cost-conscious, thereby putting downward pressures on government spending (DiLorenzo, 1981a, 1981b, 1982, 1983). Thus, on efficiency grounds, public-choice economists often take the position that more governments within a metropolitan area are preferred to fewer. This is a direct application of the neoclassical competitive model, which holds that more firms in an industry leads to stronger competitive forces. It is also derived from the related structure-conduct-performance (SCP) paradigm of industrial organization theory.

Industrial Organization and Public Choice

The SCP paradigm asserts that a more concentrated market structure is likely to be more monopolist because, in such a setting, the cost of collusion is lower. But this assumption has been called into question by research that constitutes yet another revolution in economic theory—a revolution in the field of industrial organization (Goldschmidt, Mann, and Weston, 1974; Brozen, 1982). One of the significant features of the "revolution" in the field of industrial organization is that many researchers have taken a more dynamic view of the market as a process. Thus, they have moved closer to the Austrian view of the nature of competition. By taking a more dynamic view of how industries evolve over time, economists have learned (or relearned, according to DiLorenzo and High, forthcoming) that an important reason why industries become concentrated is the superior efficiency of one or a few firms. "Dominant" firms can only remain that way by continuing to offer competitive products at favorable prices, in the absence of government-imposed entry barriers. Substitutes and potential entry have placed effective limits on monopoly pricing by firms in concentrated industries (Brozen, 1982). Thus, the traditional antitrust prescription of divestiture to avoid monopolization is now widely believed to be sometimes harmful. Focussing attention on the reasons why industries become concentrated has advanced our knowledge over the days when it was simply assumed that market concentration meant monopolization and "market power."

This shift in research emphasis is welcomed by many Austrians, who for decades have criticized the neoclassical competitive model as almost devoid of behavioral content, given its emphasis on static equilibrium conditions rather than the process of competition. "Competition is by its nature a dynamic process whose essential characteristics are assumed away by the assumptions underlying the static analysis. . . . Advertising, [price] undercutting, and improving . . . the goods or services produced are all excluded by definition—"perfect" competition means indeed the absence of all competitive activities" (Hayek, 1948, p. 96). By viewing competition as a static equilibrium condition rather than as a dynamic, rivalrous process, economists are prone to condemn competitive activities as monopolistic.

These developments in the economics of industrial organization are relevant to the study of public choice. If the neoclassical competitive model—and its derivative, the structure-conduct-performance (SCP) paradigm—are themselves flawed, perhaps the model's applications to the study of the local government "industry" are also subject to question. I contend that by relying on static, market structure models of the local government "industry," public-choice economists have often drawn false conclusions. However, by relying on static models, they have not erred in the same direction as the structuralist industrial organization economists. Rather than condemning as monopolist many practices that are inherently competitive, they have done the opposite. By focussing on government structure at a point in time rather than on the dynamic, historical process by which the institutional structure of government evolves, they have sometimes praised as "competitive" government actions that are inherently monopolistic.

Consider, for example, how public-choice economists often interpret U.S. Census Bureau data on local government structure. Among public-choice economists who have studied local government, it is generally agreed that the greater the number of government units in a metropolitan area (the more "fragmented" the governmental structure), the better. Fragmentation creates interjurisdictional competition, which supposedly provides incentives for lowering the costs of service provision. This purportedly lowers expenditures and taxes and also results in higher-quality government services. These conclusions are usually drawn from cross-section data on government expenditure, regressed against several "determinants" of public expenditures, with some sort of proxy for interjurisdictional competition, i.e., number of government units in a metropolitan area. More often than not, the independent variable for government structure reveals that more fragmented metropolitan areas have lower levels of government expenditure, *ceteris paribus*. These empirical studies are similar to the early empirical work in industrial organization that found a positive correlation between market concentration and profitability. More concentrated metropolitan governments are thought to lead to higher levels of *political* "profits" in the form of higher spending than would otherwise occur.

But just as taking a more dynamic or historical view of industrial market structure can yield different interpretations of the causes of market concentration, it can also change one's view of the meaning of a more or less concentrated structure of local government. Consider the example of off-budget government spending at the state and local levels (Bennett and DiLorenzo, 1983).

Off-budget Spending and the Government Process

Historically, tax revolts and fiscal constraints in the form of statutory or constitutional restrictions on taxing, spending, or borrowing at the state and local levels of government have been met by politicians not by catering to "the will of the people," but, rather, by subverting that will by creating off-budget enterprises (OBEs) that permit them to preach fiscal conservatism by continuing to practice fiscal profligacy. The "solution" politicians have for more than a century applied to the "problem" of taxpayer demands for tax or expenditure restraint is disarmingly simple: Separate corporate entities are created by state and local governments, which could issue bonds that are not subject to the legal restrictions on public debt or even to voter approval. These entities are called a variety of names, including districts, boards, authorities, agencies, commissions, corporations, and trusts. Regardless of their title, an essential feature of all such organizations is that their financial activities do not appear in the budget of the government unit that created them. One distinguishing feature of OBEs is that their operations, at least in theory, are not financed from taxes, but from revenues generated by their activities. Because the taxpayer is not deemed to be liable for the financial obligations of OBEs, voter approval is not required for the debt issued by such organizations and, more importantly, debt restrictions do not apply. However, the idea that off-budget finance should not require voter approval because the projects financed are self-supporting is a myth, for billions of taxpayer dollars are used to subsidize OBE activity (Bennett and DiLorenzo, 1983). The array of activities undertaken by OBEs is quite large and includes the financing of school buildings, airports, parking lots, recreation centers, courthouses, subways, bridges, tunnels, highways, parks, lakes, sewer systems, sports arenas, electric utilities, race tracks, outer space programs (in California), and housing, to name a few examples. In short, any activities that are undertaken on budget by state and local governments (or by private enterprises, for that matter) are also undertaken by OBEs in every state.

Even if debt restrictions did not exist, politicians would benefit from off-budget activities. The public sector is constrained by numerous regulations designed to protect the public interest. Virtually none of these applies to any OBE. For example, civil service regulations do not apply, so it is easier for politicians to create patronage jobs off-budget; there are no requirements for competitive bidding procedures on contracts, so campaign contributions can be obtained and loyal supporters can be rewarded; the members of the boards of directors of every OBE are political appointees who are not elected or responsible to voters, so that the will of politicians cannot easily be frustrated by a recalcitrant bureaucracy. OBEs are given wide powers by law. They are granted monopoly franchises, may have powers of eminent domain, can override zoning ordinances, are exempt from regulations and paperwork that impose heavy costs on private enterprises, have no legal restrictions on collective bargaining agreements, and are often specifically exempted from antitrust laws regarding price fixing.

Unfortunately, it is impossible to obtain accurate data on the number of OBEs that exist or on their activities. Most states do not keep statistics on their numbers. One thing is known with certainty, however: There are thousands of OBEs throughout the nation, including more than 2,500 in Pennsylvania alone as of 1977 (Schlosser, 1977).

One implication of this research for public choice theory is that the structure of the local government industry at any one point in time does not necessarily reveal how "competitive" government is. Bureau of the Census data on the number of government units in metropolitan areas includes many OBEs, designating them as special districts, public corporations, statutory authorities, and so on. But an increase in the number of such entities often results in a government that is increasingly detached from the consent of the governed, is not subject to direct voter approval at the ballot box, and grants itself extraordinary powers—even by government standards—of eminent domain, zoning authority, and immunity from civil service, collective bargaining, antitrust, and other laws that others in society must comply with. A strong argument can be made that avoiding taxpayer demands for fiscal restraint is the whole purpose of off-budget spending, which renders government more monopolist. To designate these developments as "competitive" or "efficient" is misleading, at best. But this is precisely the problem public-choice economists experience when applying the neoclassical competitive model to the study of local government (see, for example, Blewitt, 1984).

Efficiency and the Structure of Local Government

Competitive markets are praised by neoclassical economists because, among other reasons, they promote allocative efficiency. Austrian economists, however, have little use for such notions because of their belief that all costs and benefits are subjective. To state that a certain allocation of resources is allocatively efficient and maximizes "social welfare" is to assume that benefits and costs are objective and measurable by some outside observer/social engineer. Moreover, to claim that one allocation of resources is superior to another on neoclassical efficiency grounds requires one to make interpersonal utility comparisons, a sheer impossibility. For instance, if an industry is judged to be producing less than the competitive level, a common policy prescription to promote efficiency is to somehow induce the firm(s) to increase their production (through divestiture, for instance). This may harm the producers since it forces them to do something they did not voluntarily choose to do, but it is said to be efficient because the utility gain to some other group in society—usually called consumers—is said to outweigh the utility loss to the producers.

Policy recommendations based on such efficiency norms often attenuate the rights of political minorities such as "monopolist" producers on the grounds that their utility loss is outweighed by the utility gains of others. This arbitrarily assumes that the property rights of the former group are unimportant. In short, what passes for science is loaded with normative judgments.

There is an alternative (and equally normative) definition of "efficient" institutions that has its roots in Adam Smith's *Wealth of Nations* and embraces the notion of individualist property rights norms: Those institutions are efficient that facilitate mutually advantageous, voluntary exchange (Buchanan, 1964). From this perspective, a "better" allocation of resources can only be determined by people themselves, not by professional maximizers of social welfare functions. The standard of evaluation is ultimately consent among individuals. Also, according to this perspective, the proliferation of the number of local governments cannot be said to be "efficient," since the growth of government embodies a further reallocation of resources from the private to the public sector. The private sector is the exclusive domain of mutually advantageous exchange. Outside of its role of enforcing and protecting private property rights, all government resource allocation is necessarily coercive in the absence of direct democracy and voting rules mandating unanimous consent. The proliferation of local government units, on- or off-budget, represents an expansion of the domain of rent-seeking behavior, which is necessarily coercive, at the expense of a contracted private sector and of the domain of voluntary exchange.

Public-choice economists typically criticize a consolidated local government structure as monopolist compared to the alternative of a larger number of jurisdictions within a metropolitan area. In many instances, this criticism is probably well grounded. One centralized school district, for instance, is likely to be even more monopolist than if there were several to choose from by "voting with your feet." As George Orwell might have said, all governments are monopolist, only some are more monopolist than others.

However, it is not clear that the relevant alternative to a fragmented government structure within a metropolitan area is a more centralized, monopolist government. Another alternative is a return to private-sector provision of the *private goods* now supplied by local governments: education, libraries, hospitals, airport operation, fire protection, parking lot operation, water supply, police protection, sewerage treatment, parks and recreation, operation of liquor stores, mass transportation, and myriad other activities. One thing all these activities have in common is that no strong case can be made that any of them is a public good. They are all divisible in consumption and exclusion is not costly. Moreover, they are all things that are supplied throughout the country by private businesses as well as by governments, leading one to question the existence of any economic rationale for government provision.

Governments usually grant themselves distinct advantages whenever direct competition with the private sector is permitted (which it often is not) by not having to pay taxes or comply with costly regulations imposed on private enterprises. Thus, these are often money-making operations for local governments that have taken over services that would have alternatively been provided by private businesses. Government imperialism is a more likely explanation than market failure for why these activities are carried out by hundreds of local government jurisdictions. Governments are redirecting resources from the private to the public sector as private firms are either banned by law from competing with government monopolies or are driven out of business because of the special advantages that government service providers have. Viewed in this way, it appears that the public-choice characterization of the "efficient" organization of local government is grossly misleading.

Public Choice and Political Entrepreneurs

Austrian economists often claim that neoclassical economics ignores many important economic phenomena by not sufficiently emphasizing the role of entrepreneurship in the economic organization. Ludwig von Mises broadly defined entrepreneurship to encompass capitalists, workers, consumers, and others: "Economics, in speaking of entrepreneurs, has in view not men, but a definite function" (1966, p. 246). The function of the entrepreneur is to react to (and create) change in the market. The efficiency of markets does not depend upon the equality of price to marginal costs, the familiar equilibrium condition of neoclassical price theory, but, rather, "it depends on the degree of success with which market forces can be relied upon to generate spontaneous corrections. . . at times of disequilibrium" (Kirzner, 1974, p. 6). Entrepreneurship is the engine of economic growth and wealth creation in capitalist economies, for according to Robert Tollison:

> When competition is viewed as a dynamic, value-creating, evolutionary process, the role of economic rents in stimulating entrepreneurial decisions and in prompting an efficient allocation of resources is crucial. . . . [P]rofit seeking in a competitive market order is a normal feature of economic life. The returns of resource owners will be driven to normal levels . . . by competitive profit seeking as some resource owners earn positive rents which promote entry and others earn negative rents which cause exit. Profit seeking and economic rents are inherently related to the efficiency of the competitive market process. Such activities drive the competitive price system and create value (e.g., new products) in the economy. (1982, p. 577)

But neoclassical economics does not view competition as a "dynamic, value-creating, evolutionary process." Rather, it is a static equilibrium condition. And in equilibrium, there is no place for the function of entrepreneurship, since in equilibrium, there are no changes in the given data of endowments, technologies, or preferences. By downplaying or ignoring the role of entrepreneurship and of competition as a dynamic, rivalrous process, neoclassical economics has probably underestimated the wealth-creating and welfare-enhancing capabilities of capitalism.

Similarly, by applying the static, neoclassical model to the study of political "markets," public-choice theorists have probably downplayed or ignored the role of *political* entrepreneurship. But this has not led them to ignore the role of entrepreneurship in *creating* wealth and facilitating exchange, as with the study of private markets. The essence of political entrepreneurship is to *destroy* wealth through negative-sum rent-seeking behavior. Thus, adherence to the static, neoclassical model is likely to lead one to understate the beneficial economic effects of private markets while, when applied to the study of public choice, understating the destructive effects of politics.

In much of public-choice theory, interest groups are viewed as entities that coalesce to express a demand for wealth transfers. In seeking political profit, politicians respond by supplying the transfers through legislation and regulation. Politicians are accordingly labeled "brokers" of legislation (Tollison and McCormick, 1981). Thus, just as a perfectly competitive, profit-maximizing firm would cater to consumer demands, politicians passively respond to the wishes of interest groups. But the price theory analogy is not entirely accurate, for in a world of uncertainty, producers are constantly searching for and *creating* profit opportunities by advertising, offering new or different products, and other activities aimed at stimulating the demand for their goods or services. They do not merely respond to changing consumer demands. Similarly, political enterpreneurs do not just passively respond to interest-group pressures; they also try to stimulate the demand for their "services," i.e., the provision of wealth transfers (Mitchell, 1984). Although it has been relatively neglected in the public-choice literature, Richard Wagner (1966) described the importance of political entrepreneurship in a hypothetical example where interest groups are outlawed.

> Consider farm interests after pressure groups are outlawed. It clearly seems contrary to intuition and common sense to claim that farmers would no longer have [political] activities undertaken to increase their real incomes. For a reconciliation we must turn to the political entrepreneur and observe the impact of the outlawing of lobbying upon his profit opportunities. If a political profit existed before the institutional change [i.e., outlawing lobbying], what reason exists for the belief that such profit will not exist after the change? Clearly, for a reduction in the political profit from farm votes,

> either voting or organizational rules must be changed. Since the outlawing of pressure groups is unrelated to either of these two features, the profit must still exist after pressure groups are outlawed. Therefore, some political entrepreneur would carry their cause to congress. (p. 165)

Wagner further stated that various institutional arrangements often emerge to promote individual interests when free-rider problems prevent the formation of effective interest groups. For instance, one role of government bureaucracies is to serve the wishes of political entrepreneurs with whom they share a common objective: an expansion of the agency's activity (and budget). Bureaucracies have strong incentives to promote and stimulate a perceived need for their activities—every bureaucracy is a vigorous lobbyist. Peter Woll (1977) noted the importance of bureaucratic lobbying in his book, *American Bureaucracy:*

> The ability of administrative agencies to marshal support in favor of particular programs is often severely tested, and as a result the agencies have frequently created public relations departments on a permanent basis to engineer consent for their legislative proposals. It has been estimated that the executive branch spends close to half a billion dollars [in 1971] a year on public relations and public information programs. . . . [A]gencies are expending huge amounts of funds, time, and effort on indirect and direct lobbying activities. (p. 194)

As recent examples of bureaucratic lobbying expenditures, the U.S. Department of Agriculture in 1984 officially employed 144 full-time public affairs persons with a budget of $6.5 million. The entire department, including subagencies, employs 704 people involved in public affairs (Palmer, 1985). The Department of Education had 21 public affairs professionals and a $1.5 million budget; and the Pentagon listed 1,066 full-time public relations employees. Similar programs are sure to be found in other agencies as well.

The effect of political advertising is likely to be public acquiescence in the continued growth of the government wealth-transfer process. Unlike private advertising, political advertising does not foster competition and lower prices by facilitating comparison shopping, for no comparisons are permitted. Governments usually grant themselves statutory monopolies in the goods and services they provide. Nor are there strong constraints on false advertising by government because of the absence of competitive pressures. Few private businesses, for instance, would risk criticizing false advertising by government enterprises for fear of regulatory retribution by the government authorities. Nor can one expect government regulatory agencies such as the Federal Trade Commission to crack down on fraudulent claims made by government itself. Thus:

> Politicians cannot be held liable for their promises. If a hot dog manufacturer's all-meat product turns out to be 30 percent chicken and bread crumbs, he will most likely encounter difficulty with the government, even if consumers buy the product. But when the government's comparable product turns out to be 60 percent baloney, no regulatory agency will take action. (Wagner, 1976, p. 81)

Moreover, the principal function of political advertising "would seem to be to promote acquiescence about the prevailing public policies. The purpose of public advertising would be to reassure citizens that the fact that their public goods are composed of 60 percent baloney indicates good performance" (Wagner, 1976, p. 97). In this way, political entrepreneurship in the form of public advertising facilitates the process of rent seeking.

Another example of political entrepreneurship is tax-funded politics (Bennett and DiLorenzo, 1985). Hundreds of millions of dollars per year are doled out by the federal government to special interest groups including Ralph Nader-type consumer groups, environmentalists, welfare rights lobbyists, civil rights organizations, labor unions, senior citizens organizations, and various conservative political activists, to name a few examples. The funds are obtained through grants and contracts ostensibly for helping consumers, the unemployed, the elderly, minorities, the environment, and so on, but then are diverted (illegally) for partisan politics. In these instances, Congress is directly stimulating the perceived demand for its "services" by giving taxpayers' money to special interests to lobby, campaign, register voters, publish books (as well as op-eds and political training manuals), hold media events, and conduct other forms of partisan politics. Politicians use tax-funded politics to fabricate demands for legislation and government activity to stimulate the demand for their services. Interest groups that receive government funding can be more blatant in their political activities than government bureaucracies can since it is illegal for government employees to engage in on-the-job political activity. And, as Gordon Tullock (1983) pointed out, "interest groups normally have an interest in diminishing the information of the average voter. If they can sell him some false tale which supports their particular effort . . . it pays. They . . . produce misinformation" (p. 71).

In sum, focussing on the role of political entrepreneurship is likely to improve one's understanding of the government process. Demand-side models of the political process (such as the median voter model) can be misleading if they fail to incorporate the fact that political entrepreneurs are experts at fabricating false crises to convince the public to acquiesce in their policy proposals. Voters are rationally ignorant, and much of the information about politics they do receive is propaganda issued by self-serving politicians, interest groups, and bureaucracies. It does not pay to be as well informed about politics as about one's own personal affairs, which permits political entrepreneurs to manufacture a false "will of the people." Joseph Schumpeter (1942) recognized this more than four decades ago: "Human nature in politics being what it is, [politicians] are able to fashion and, within very wide limits, even to create the will of the people. What we are confronted with in the analysis of political processes is largely not a genuine but a manufactured will. . . . [T]he will of the people is the product and not the motive power of the political process" (p. 263).

Even though private and political entrepreneurship both serve to transmit information, they produce fundamentally different results. The nature of market activity is to enhance people's propensity to truck, barter, and exchange—generally a positive-sum game—and entrepreneurship facilitates this process. By contrast, the nature of most government activity, including political entrepreneurship, is to promote wealth transfers, which is, at best, a zero-sum game. Mancur Olson (1982) provides evidence that such rent seeking is, in fact, a negative-sum game and a major cause of economic stagnation.

Conclusions

Austrian economics and public choice are two of the most exciting areas of economic research. With its emphasis on competition as a dynamic, rivalrous process and the role of entrepreneurship, Austrian economics clarifies how markets work. Public-choice theory has been absolutely revolutionary in focussing attention on how the tools of economics can be employed to better understand how governments work. This article is, if anything, a plea to consider the two research programs as complementary. Economic reasoning can and will be applied to advance our understanding of the political process, but one need not adopt the entire neoclassical economic framework to do so. The two strands of Austrian economics discussed here—theories of competition and of entrepreneurship—offer some insights into the government process that neoclassical economics ignores, at best, and possibly even misinterprets. One implication of this is that the type of public-choice research conducted might take on a different focus. Specifically, it would be a wise investment of intellectual resources to conduct more historical studies of the evolution of political institutions from a public-choice perspective. Public choice *is* often a study of comparative institutions, but economic history is one research approach which has, unfortunately, been relatively neglected by public-choice theorists. There is much to learn from economic and political history from a public-choice perspective that just cannot be captured by regression equations of the "determinants" of government spending, taxing, and borrowing.

Not only can a careful consideration of the usefulness of Austrian economics to the study of public choice expand our knowledge of government institutions; it can also prevent us from making mistakes. I have claimed elsewhere (DiLorenzo, 1984) that the economics of rent seeking has become confused. One reason for this is the failure to properly distinguish between rent seeking and profit seeking by not viewing real-world competition as a dynamic, rivalrous process. Consequently, some authors have condemned as "wasteful rent seeking" many activities (e.g., competitive advertising, product innovation, research and development, the market for corporate control) that are an essential part of a dynamic, competitive market. This is a step backward in the public-choice revolution, something that might have been avoided by being aware of some of the limitations of the neoclassical competitive model and its applications to public choice.

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