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# 8            The Economics and Politics of               Institutional Change in the               Political Arena

## 8.1 Introduction

By any measure, the federal government and its role in the development of the American economy have grown dramatically in this century. While there were some 100,000 federal civilian employees in 1880, by 1990 there were over 3 million. Concomitantly, federal government outlays, as a share of GNP, rose from approximately 2.4 percent in 1880 to nearly 23 percent in 1990 (U.S. Department of Commerce 1975, 224, 1114; U.S. Department of Commerce 1991, 315, 330). These numbers certainly understate the influence of government in the economy because regulatory policies and transfer programs affect economic behavior far beyond what budgets and staffing levels alone would indicate. It is natural, then, for economists, economic historians, and political scientists to be concerned about the performance of government. Persistent and widespread complaints about a lack of effectiveness and responsiveness on the part of the federal civilian bureaucracy suggest that all is not well in this vital sector of the economy. In this final chapter, we place civil service reform into the broader context of institutional change in the political arena. We argue that transactions costs are a more serious problem for political institutional change than they are for institutional change in the private sector. This condition has important implications if the civil service system is to be made more productive and accountable to voters.

Despite its problems, meaningful reform in the civil service system appears to be an elusive objective.<sup>1</sup> To understand why the federal bureaucracy is so resistant to change, we have analyzed the forces behind the emergence of the civil service institution and identified the key attributes of it that contribute to the current problems of bureaucratic accountability and performance.

Through most of the nineteenth century, federal workers were employed under a system of political patronage. Patronage was a popular institution, one

that carried none of the negative connotations that are associated with it today. Misgivings began to arise after the Civil War as the size of the patronage workforce grew and it became more difficult to manage. With growing scandals and allegations of inefficiency that embarrassed federal politicians, the president and certain members of Congress passed the Pendleton Act in 1883, authorizing merit employment. The gradual replacement of patronage with merit employees illustrates the response of elected officials to an institution that was costing them electoral support.

The development of the federal civil service system, creating a permanent bureaucracy and a vast array of bureaucratic rules, was the result of conscious decisions by successive politicians. The system has, in part, evolved in the way it has because of the objectives of elected officials and the confused political property rights that exist over the federal bureaucracy. As more and more federal workers were placed into the merit service, rules and sanctions had to be devised to limit political conflict over the federal labor force. Bit by bit, federal workers were placed off limits to direct partisan use by politicians. As a consequence, attempts to restructure the civil service that would entail a shift of power either to or from the president will be met by opposition in Congress.

We also have emphasized that institutional adjustments made by the president and the congress to shield federal workers from political manipulation to lessen competition over the bureaucracy have had other important consequences. The emerging structure of the civil service system set the stage for federal workers to emerge as a powerful interest group, one that will, unless sufficiently compensated, resist changes that are not in its interests. In this chapter, we examine another factor that limits the prospects for further civil service reform—incomplete information among voters about patronage and the effects of modifications of the current system of protective bureaucratic rules. Popular perceptions about the evils of patronage have contributed to beliefs about the undesirability of weakening civil service protections, thus aiding the cause of federal unions and contributing to the establishment of an organization that is now resistant to change. As we discuss in the following section, perceptions matter because they affect the cost of transacting. Indeed, consideration of transaction costs is key for understanding the economics and politics of institutional change.

## **8.2 Transaction Costs and Institutional Change in the Private Sector and in the Political Arena**

If we are correct that the civil service system contributes directly to the problem of bureaucracy, then a question immediately arises about the potential for and consequences of institutional change in the political arena. Does the process lead to efficient outcomes as envisioned, for example, by Richard Posner's (1980) description of the development of the common law or by Gary Becker's (1983) analysis of government transfer programs? The claim that the

political process will favor efficient institutional choice is a natural application of the standard Pareto conditions. Assuming, for instance, that the political process mandates the transfer of wealth to a particular interest group, policy instruments that generate wealth transfers at the least cost to voters would seemingly be favored over those that impose higher costs. Indeed, absent transaction costs, this is a perfectly reasonable prediction. But information is incomplete and costly to obtain, making transaction costs positive. This problem is compounded by the incentive that interest groups have to mold information made available to voters in self-serving ways. These conditions suggest that the political process will lead to institutional choices that differ from what one would expect if the notion of neoclassical economic efficiency were the dominating criteria. Moreover, as argued by Douglass North (1981, 1990), institutions that inhibit economic growth and development can persist for long periods of time. These different views of institutional change in the political arena raise important questions because they bear not only on our understanding of the process of institutional change but also on discussions of the functioning of representative democracy and of reforming government (see Wittman 1989; and Osborne and Gaebler 1992).

The literature on institutional change in the private sector provides some guidance on this issue. It is generally argued that market forces, arising from changes in relative prices, will lead to the beneficial creation or modification of institutional structures.<sup>2</sup> That is, markets will erode those institutions that are out of step with the economic environment. In this setting, institutional change occurs through negotiations among self-interested parties, each seeking to maximize the attainment of particular goals within the new structure. Since it takes resources to create, utilize, and guarantee institutions, modifications will be made only when the affected parties anticipate individual net gains from doing so. Lance Davis and Douglass North described the motivation for private institutional change as follows: "It is the possibility of profits that cannot be captured within the existing arrangemental structure that leads to the formation of new (or the mutation of old) institutional arrangements" (1971, 59; see also Demsetz 1967).

Even so, the process of private institutional change is complex and can be derailed by high transactions costs. The bargaining underlying the creation or modification of institutions involves debate over the aggregate benefits of the new arrangement and the distribution of those benefits among the various interested parties. Negotiations can break down if there are serious disagreements about either the net benefits of institutional change or their allocation. Conflicts, blocking cooperative solutions, can arise from, among other things, serious information asymmetries among the parties, bounded rationality, and an inability to devise side payments to compensate those who believe that they will be harmed by institutional change.<sup>3</sup> These problems increase with the size and heterogeneity of the bargaining group. As a result, institutional changes that would be anticipated in an environment free of transactions costs do not

take place, or they emerge only in abbreviated form.<sup>4</sup> Nevertheless, it can be predicted that institutional change in the private sector will most often foster aggregate wealth maximization. It is our contention, however, that this is often not the case for political institutional change.

Although institutional change takes place both in private settings and in the political arena, the literature has not focused enough on the details of political bargaining to explain observed outcomes or to indicate why the process will likely vary between the two settings. North (1981, 1990) has been one of the leaders in analyzing institutional change, particularly as it involves government. He has described a theory of the state that emphasizes the importance of its coercive power for promoting or for hindering socially beneficial institutional adjustments. North has stressed the potential use of government by special interests and politicians to create local monopolies and other institutions that retard economic progress, but he has not addressed the particulars of the political process by which certain groups and institutions predominate.<sup>5</sup>

A key difference between institutional change in the private and political arenas is the lack of a clear principal or residual claimant in politics, who can direct the process toward efficient outcomes. In negotiations for private institutional change, such as the restructuring of a firm, the parties must reach agreement on the size and nature of the aggregate gains from the proposed reorganization and on the effect of the change on the relevant principals, in this instance, equity- and debtholders. If property rights are complete, the negotiating parties represent the residual claimants, and they have incentives to collect data effectively for forecasting the effects of the restructuring. Stock and bond markets provide mechanisms for evaluating the effect of the proposed reorganization on the principals and for determining their incentives for supporting or modifying the plan.

In the political arena, however, there are few parallels to this process.<sup>6</sup> Political institutional change has economic consequences, but there are fewer opportunities for the types of market trades that in private settings sort out the economic effects and channel the process in a wealth-maximizing way. Politicians are the agents of institutional change in the political arena, and they must be responsive to the demands of their constituents if they are to be reelected. Neither politicians nor the organized interests to which they respond, however, bear the full social costs of their actions. Accordingly, constituents are motivated to demand and politicians to provide government services and transfers beyond what is socially optimal.

Although interest groups will not get all that they demand, the costs imposed on others can be significant. The general electorate is usually considered to be so widely dispersed and the effect of transfers for a single interest group so broadly spread that political opposition from taxpayers will be limited. Given organizing costs, there may be no effective means of assembling the political trades needed for socially beneficial policy adjustments. These conditions facilitate the development of powerful interest groups.<sup>7</sup> Moreover, once interest

groups succeed in securing initial legislation, they will be able to seek additional legislation to reinforce their political influence.<sup>8</sup> Importantly, limited or asymmetric information about policy effects can be especially beneficial to an interest group's objective. Indeed, in the case at hand, it is through the selective use of information to influence popular conceptions about patronage that federal unions have been able to strengthen their position and make further civil service reform more costly for politicians.

### **8.3 The Legacy of Patronage**

An example of the importance of molding information to affect popular images is the widely held opinion, promoted by federal unions, that patronage is an inherently evil institution that would be quickly reinstated by politicians given the slightest opportunity. Federal employee unions are not the originators of this view. It comes from histories of the progressive era that discuss patronage. As we show, however, federal employee unions have been skillful in capitalizing on public fears of patronage by labeling reforms of the civil service as returns to the spoils system. Further, these views of patronage have been incorporated into judicial opinions that constrain the actions that politicians might take with regard to government employees. Such judicial rulings serve to raise the political costs of addressing the problems of bureaucratic accountability and productivity.

In histories of the progressive era, the shift to merit is portrayed as a moral crusade (see, e.g., Hoogenboom 1968). Civic reformers fought corrupt politicians, who used patronage to ensure their own and their party's reelection and continued access to the spoils. The overriding goal of reformers was the depoliticization of the federal workforce. Achievement of this goal was possible by eliminating the tie between government employment and party affiliation and creating a politically neutral labor force, with the result that policy administration could be based solely on expertise and professionalism.

Although this is a popular conception of civil service reform, it carries with it a number of myths that federal workers as an interest group have found useful. First, it ignores the fact that patronage was not always considered a problem. The spoils system was popular for a long time. It was viewed as a means of promoting democratic access to government and ensuring accountability between government employees and their political mentors. Those who strayed from the desires of politicians could be (and were) fired. It is true that the institution began to exhibit management problems with the growth of the federal labor force after the Civil War. Even after the Pendleton Act was passed in 1883, however, patronage did not disappear in the federal government. It remained sufficiently popular among enough voters that it was replaced by the merit system only gradually over the following fifty years.

Second, the popular view of civil service reform fails to recognize the incentives that elected officials had to replace patronage when it no longer generated

electoral support. If representative democracy works as efficiently as some claim, then those civil service reformers, who receive so much emphasis in the historical literature, were merely messengers of constituent interests to politicians (see Wittman 1989). As we have pointed out, the constituents involved, urban business groups, were well organized and were particularly affected by inefficiencies and scandals in the large post offices and custom houses in the late nineteenth century. These were also the groups that were providing new sources of campaign funds. Accordingly, federal politicians had incentives to be responsive to the demands of these constituents for institutional change.

Third, the popular assessment of patronage, which is also emphasized by a number of students of public administration, suggests an inherent tension between politicians (especially the president) and bureaucrats over civil service protections and an irrepressible tendency of politics to intrude with a return to the spoils (see Lane and Wolf 1990; Levitan and Noden 1983). As we have argued, the reasons that the Congress and the president replaced patronage with merit after 1883 remain in force today. Although patronage may be effective for relatively small government units, the problems of managing a large patronage labor force are too great, relative to any political benefits that might be obtained from abandoning a merit system.

Finally, the belief that a politically neutral, professional bureaucracy could be installed if patronage were removed and politicians held at bay remains an attractive, if naive, notion. What would motivate bureaucrats to be responsive to constituent demands under those sheltered circumstances remains a mystery. It would seem that accountability and productivity would become even greater problems if political control were further weakened. Nevertheless, the view that political preferences, like gender and race, should not be a factor in government hiring or removal decisions is now part of case law.

These four myths about patronage have helped shape the current institutional environment, and their legacy limits the types of reforms that are possible when dealing with the problem of bureaucracy. The fear of patronage is a convenient ploy to which federal employee unions can turn in responding to criticisms about the performance of the bureaucracy. For example, the National Federation of Federal Employees opposed provisions of the Civil Service Reform Act of 1978 granting supervisors authority to award merit pay. Union representative Sam Silverman claimed that the bill "allows for the ready politicization of the civil service. The bill, in short, represents a return to the conditions of 1883, prior to the enactment of the first civil service legislation" (U.S. Senate 1978, 407). In another example, the 1988 annual report of the American Federation of Government Employees (AFGE 1988, 53), the largest federal union, emphasized that politicians would take away the benefits granted to federal employees under the civil service system if they had the opportunity to do so.

#### 8.4 Judicial Interpretations of Patronage and the Costs of Further Institutional Change in the Political Arena

Misconceptions about patronage have been incorporated in important court rulings that have further weakened the control of politicians over the bureaucracy. These rulings have been generated by cases involving state and local governments, but they have set precedents for what would be possible for civil service reform at the federal level. Although by the early 1950s patronage control over rank-and-file positions in the federal government had essentially been eliminated, it remained a fact of political life at the state and local level until the 1980s. Indeed, while many states and cities passed laws restricting patronage hiring, smaller jurisdictions seemed to function well with patronage (Wolfinger 1972). Nevertheless, the notion that patronage was inconsistent with good government led to judicial challenges to political hiring and firing in many jurisdictions.

Patronage practices were addressed by the U.S. Supreme Court in *Elrod v. Burns* (47 U.S. 347 [1976]) and *Branti v. Finkel* (445 U.S. 507 [1980]), where the Court decided that the First Amendment protects individuals from discharge or threats of discharge solely because they did not support the political party in power.<sup>9</sup> An exception to the judgment was made for positions that involved policy making. Although employees were not to be fired for their political party affiliation, hiring or promotion on the basis of party was not explicitly ruled out by the Court. Nevertheless, these rulings largely abolished the established practice of new administrations coming into office, ousting government workers, and replacing them with party members.

In 1989, the Supreme Court was asked to determine the constitutionality of other patronage practices involving the hiring, promotion, transfer, and recall of rank-and-file government employees on the basis of party affiliation and support. The complaint in *Rutan v. Republican Party of Illinois* (497 U.S. 62 [1989]) involved an executive order issued by the Republican governor of Illinois proclaiming a hiring freeze. No exceptions were to be made without the expressed permission of the governor, and state agencies were to submit hiring requests to an office established by him. The complaint asserted that, in these hiring requests, applicants were screened for their vote in Republican primaries or for contributions to the party. Five individuals who brought the suit alleged that they had been discriminated against because they had not supported the Republican party. In a 5 to 4 decision, the Supreme Court held that such practices violated the First Amendment guarantee of freedom of speech.

The *Rutan* ruling is important because it virtually ended patronage hiring and promotion for most government jobs at all levels. It is also important because the Court's arguments clearly reflected a general distrust of patronage, a lack of understanding of current civil service constraints on politicians, and a failure to appreciate the problems of extending tenure guarantees for employ-

ees in the public sector. Consider the statements of Justice Brennan, who delivered the majority opinion of the Court: “A government’s interest in securing effective employees can be met by discharging, demoting, or transferring staff members whose work is deficient. A government’s interest in securing employees who will loyally implement its policies can be adequately served by choosing or dismissing certain high-level employees on the basis of their political views.” Brennan went on to argue that “the First Amendment is not a tenure provision, protecting public employees from actual or constructive discharge” (497 U.S. 74, 76 [1989]). In a concurring opinion, Justice Stevens went even further in asserting a distinction between politics and administration when he stated that “this defense of patronage obfuscates the critical distinction between partisan interest and the public interests” (497 U.S. 88 [1989]).

Justice Brennan was incorrect in stating that firing civil servants for cause was a readily available management tool. As we have shown, this is not the case at the federal level. Both Brennan and Stevens were also incorrect in arguing that there is a clear distinction between politics and administration, that a few political appointees could ensure that the administration’s policies would be implemented by neutral, career employees. The statements by the two justices ignored the agency problems face by politicians and securing the compliance of government workers in molding and administering policy. Moreover, they did not consider that senior career civil servants are involved in policy determination and that even lower-level career employees are in a position to channel the administration of policy toward particular constituents or toward professional goals that can be inconsistent with the interests of politicians.

Justice Stevens was responding to the dissent of Justice Scalia, who argued that the Court’s opinion assumed away the possibility that the benefits of patronage could ever outweigh its coercive effects, “not merely in 1990 in the State of Illinois, but at any time in any of the numerous political subdivisions of this vast country. It seems to me that categorical pronouncement reflects a naive vision of politics and an inadequate appreciation of the systemic effects of patronage in promoting political stability and facilitating the social and political integration of previously powerless groups” (497 U.S. 103–4 [1989]).<sup>10</sup> Scalia went on to argue that: “[t]he whole point of my dissent is that the desirability of patronage is a policy question to be decided by the people’s representatives” (497 U.S. 104 [1989]).

The Court’s majority differed from Justice Scalia in its view of the responsiveness of politicians to the demands of voters regarding the desirability of patronage. The history of the extension of the federal civil service system, however, seems to make it clear that politicians will choose to reduce patronage whenever they perceive it to be in their political interests to do so. In 1883, the president and the Congress agreed to decrease patronage without any prodding from the Court.

There is another aspect of the *Rutan* case that illustrates a misunderstanding

by the justices both of patronage and of the relative benefits of a very protective merit system. Under patronage, federal employees were forced to pay political assessments. Such practices, however, did not imply that the net income of patronage workers was reduced below what they could earn elsewhere. The evidence presented in chapter 4 indicates that patronage workers were compensated for those contributions in the form of higher salaries, and, when the composition of the federal workforce began to shift toward merit employees, the federal wage fell until the 1920s. In the nineteenth century, political assessments were condemned as unfairly forcing government employees to pay for the campaign costs of their mentors. This view of campaign assessments on government workers remains today, and it was reflected in the *Rutan* opinion. Indeed, Justice Brennan claimed that “political parties [today] are nurtured by other, less intrusive and equally effective methods” (497 U.S. 74 [1989]).

In the late nineteenth century, political parties did have other sources of campaign funding, and that undoubtedly made giving up patronage easier.<sup>11</sup> The suggestion that these other methods of funding are “less intrusive” ignores what politicians are expected to do in exchange for contributions. Special interest-group legislation, as a payback, likely intrudes on the interests of taxpayers. This point seems to have been missed by the Court. Moreover, the Court neglected the role played by public employee unions in providing campaign funds to candidates. At the federal level, patronage may be gone, but federal workers remain a major source of campaign funds. In fact, there may be little difference between patronage assessments and PAC contributions by civil service employees. Rank-and-file federal employees pay for their documented salary advantages through union dues and PAC contributions arranged by their unions. Even though it may have been that politicians were able to extract a greater percentage of any given wage premium under patronage than they are under the current civil service system, federal employees were then, and remain today, a major source of campaign funding.

## 8.5 Concluding Remarks

In an environment of interest-group politics and vague lines of authority over the federal bureaucracy, reform of the civil service system has become exceedingly difficult. For example, one remedy for the problems of accountability and productivity among rank-and-file employees is more hierarchical control. Such changes would allow supervisors more discretion in rewarding and punishing subordinates. Although these incentive structures are common in the private sector, there are obstacles for their adoption in the federal government. Indeed, such arrangements have been proposed, tried temporarily, and then severely curtailed. For example, the Civil Service Reform Act of 1978 authorized performance pay arrangements. Merit pay, however, was opposed by federal unions, and, when it was implemented for senior officials, politi-

cians failed to provide sufficient funds to make the rewards meaningful.<sup>12</sup> Hence, under the existing incentive structure for career employees, the motivation to be very responsive to voters is quite limited. Ironically, under patronage, voters at least had an opportunity to remove bureaucrats from office every few years.

Other popular reform proposals have been superficial. Although David Osborne and Ted Gaebler argued that “we obviously need some protection against patronage hiring and firing” (1992,130), they also recommended that the current civil service system be scrapped and replaced by a new one. They provided no details about the proposed institution, nor did they recognize that the civil service system developed as politicians and labor unions alike sought to replace patronage with merit hiring and other bureaucratic protections. Many parties have a stake in the current arrangement, and significantly changing it will be costly.

Some reform of the civil service system in response to the problem of bureaucracy is possible. The historical record is clear that institutions are modified, usually slowly, in response to changes in the benefits and costs of the groups directly affected by them. In the case of the federal bureaucracy, the existing arrangement is imposing increased costs on politicians. Despite opposition from federal unions, politicians have contracted out to the private sector an increasing amount of goods and services formerly provided by the federal civil service. Moreover, the size of federal bureaucracy has shown only modest growth in the past twenty years. As we have argued, organizational size increases the costs of managing the labor force, and the federal bureaucracy has become one of the largest in the world. There is a growing sense that smaller government units work better and are more responsive to the demands of voters.

Even though politicians will respond in some way to demands for institutional change, that does not suggest that the outcome in the political arena will closely reflect standard economic efficiency criteria. Since there are high organization costs for effective and persistent lobbying, some groups are better able to exert political influence than are others. We have already stressed that federal employee unions are a well-organized and impressive lobbying force. They have succeeded in establishing an institutional structure that benefits their members, and they will devote resources to protect their gains. Added to this is the widely held belief that any major change in the current arrangement invites a return to patronage. If reforms to improve the productivity and accountability of the federal bureaucracy are portrayed as weakening the protections available to government workers, then they will be even more difficult to enact. Although it is always possible to imagine institutional alternatives whereby all parties could be made better off, in practice such outcomes may be impossible in a world of high information and transactions costs.<sup>13</sup> Given the presence of transaction costs that are particularly apparent in the political

arena, institutions that inhibit economic growth and reduce welfare can and will persist.

## Notes

1. The most recent attempt at restructuring the federal bureaucracy is that of the Clinton administration (see Gore 1993).

2. For a summary of a broader literature on institutional change and the role of institutions in economic and political decision making, see Furubotn and Richter (1991). Specific work includes that by Williamson (1975, 1985), North (1981, 1990), Eggertsson (1990), Ostrom (1986, 1990), and Libecap (1989a).

3. For a discussion of some of the issues involved, see Libecap (1989b).

4. Johnson and Libecap's (1982) and Wiggins and Libecap's (1985) analyses of generally unsuccessful private efforts to change property rights in fisheries and oil fields to reduce rent dissipation are cases in point.

5. In their examination of efforts to secure government intervention for unitization of oil fields, Libecap and Wiggins (1985) do examine how private conflicts over the distribution of the gains of unitization spill over and impede political action.

6. In the most extreme case, politics is viewed like a market, and vote-maximizing politicians are viewed like utility- or profit-maximizing individuals in a private setting. Although there are important insights to be gained from modeling politicians as self-interested actors and from incorporating economic theory into analyses of the political process, there are limits to the analogy. The key problem is the lack of a clear principal or residual claimant in political negotiations. At least among some authors, there is a sense that political institutions are an extension of private ones. The notion is one of progression from private negotiations to ones that involve government, whenever private agreements break down. For example, the power of the state to reduce transactions costs through new institutional design has been used by Goldberg (1976) and Williamson (1976) to explain the development of certain kinds of regulatory policies. We, however, emphasize that, in the political process, new transactions costs are introduced that critically affect the outcome of institutional change.

7. The implication is that institutional change in the political arena is unlikely to have the inherent efficiency attributes often associated with organizational change in a private market setting (see Williamson 1985).

8. Johnson (1990) describes efforts that resulted in limited entry regulations in the Alaskan salmon fishery. The irony is that such regulations also created a group that was more effective at exerting political pressure. This group succeeded in restricting the development of a competing sector that had the potential to yield an even more efficient outcome.

9. An implication that follows from these rulings and the discussion presented in chap. 6 is that voter participation rates for state and local employees should decline relative to that of their private-sector counterparts. Johnson and Libecap (1991) provide evidence that those rates have fallen over time.

10. As we pointed out in chap. 2, patronage served a variety of goals, one of which was to democratize government employment. It is likely that civil service reform worked against immigrants and other unorganized groups, who were denied access to government jobs. The tests that were subsequently adopted at the behest of influential business groups emphasized expertise and professionalism, and they likely served the interests of these groups.

11. Moreover, today both members of Congress and the president have their own staffs, and these are large.

12. Moreover, as we have argued, Congress would be wary of providing new opportunities for the president and department heads to influence the bureaucracy in policy administration.

13. As Ronald Coase explains, “The reason why some activities are not the subject of contracts is exactly the same as the reason why some contracts are commonly unsatisfactory—it would cost too much to put the matter right” (1960, 39).