Economics: Notes: Government Failure & Public Choice Theory

Key Terms & Ideas: Market Failure & Government, Government Failure, Rent-Seeking Behavior, Rational Voter Ignorance, Inefficient Voting, Paradox of Voting and Dynamic Consistency Problem

Market Failure – Economic Need for Government

Economic theories of market failure justify a legitimate role for the government to work as an economic agent to
- Correct for externalities by forcing private agents to pay the full cost of their actions
- Regulate markets to correct for the market failure of asymmetric information
- Provide public goods to correct for the market failure caused by the free rider problem

Identifying cases and causes of market failure provides a government a reason to intervene in markets to act as an economic agent to prevent or correct for market failure.

However, there is no guarantee that the government will work effectively as an economic agent. In fact, there are many ways the government can fail to create economically efficient outcomes.

Government Correcting Markets

Market failure does not mean that the government should intervene and replace markets. Government programs and bureaucracy aimed to address market failure can create other types of economic inefficiency. Instead or replacing markets, government action can support markets (such as “lemon laws” for used cars) or create markets (such as pollution permits).

Governments can also change situations so people will act in ways that are more beneficial. Richard Thaler and Cass Sunstein proposed an idea called “Nudge” for use in issues like organ donations and funding retirement accounts where people have to “opt in” to participate in the programs – with the result that too few participate. They argue that by switching the choice to having people “opt out” of the program

Government Supply of Public Goods – Cost vs. Benefit

A primary role of government as an economic agent is to supply public goods. Because of the free rider problem, there is no market that will supply public goods, such as roads, police and fire protection.

The optimal quantity of a public good should be based on a “cost-benefit” analysis of that good. The public good should be supplied in the amount that will yield the greatest net benefit (benefit minus cost).

However, in reality, the cost-benefit ratio is only one consideration that a society uses in deciding the amount of public goods to be supplied. The other considerations that are used in political decisions, while they may matter greatly to the individuals involved, may result in policy decisions that may not be very economical – the socially best use of resources.

Public Choice Theory & Government Failure

American economist James Buchanan won the Nobel Prize in economics for his work in Public Choice Theory which is the economic analysis of government decision making. At the core of Public Choice Theory is the recognition that the government is not a unified force in the economy, but is instead an organization made up of self interested individuals. Buchanan has described Public Choice by saying that it is “politics without romance” – basically, it does not see government as a noble force, just another imperfect institution.

Public Choice Theory means that government officials think about more than just the social impact of policy, but on how the policy will impact them personally and professionally.

The implication of this is that economists recognize that government policies intended to correct for market failure, or for any other reason, have to be enacted in such a way as to not to create government failure.
Rent Seeking Behavior

Rent seeking behavior refers to the actions by persons, firms, and other special interests to gain special benefits from the government at the taxpayers or someone else’s expense.

Rent seeking behavior is seen in a range of political activities from lobbying and making campaign contributions up to bribery. The goal of action is to make it so the individual politicians that form the decision-making process for the government will reward a special interest group at the expense of society.

For people engaging in rent seeking behavior, the action of currying favor is costly, but they calculate the benefits are greater than the cost – they do not consider the social cost (except in how it might affect them personally).

Government Institutions – Extractive & Inclusive

Government institutions (governing, legal and financial systems) can either support or corrode economic growth depending on how they interact with the economy and the actions of government officials. Economist Daron Acemoglu has said that societies that have inclusive institutions that encourage innovation and investment will have faster growth. However, societies in which those in power can take for themselves or distort the economy for their benefit will have slower – or even no – growth.

Economist Dani Rodrik has argued that it is very hard to reform societies with extractive institutions because powerful groups (that will lose benefits from reforms) will resist changes or distort reforming policies so they are not properly implemented. The result is that beneficial reforms fail and the extractive institutions stay in place.

Rational Voter Ignorance & Logrolling

Clearly democratic governments should be opposed to rent seeking behavior. Either, the social cost of rent seeking behavior should cause democratic governments put a stop to it or the cost of engaging in rent seeking behavior with an entire government should exceed the benefits. However, democratic governments suffer two problems in confronting rent seeking behavior:

• The benefits of rent seeking behavior are concentrated on a few people, while the costs are dispersed over the whole population – hence, there is little economic gain for average citizens to campaign against rent-seeking behavior.

• Politicians collude to promote their own special interests. While no piece of special interest legislation will pass on its own, it will pass if bundled together with special interest legislation. This process is known as logrolling.

Tyranny of the Majority Problem

One of the problems with democracy is the ability of a majority group to extract benefits from a minority or push costs onto a minority. Simply put, a democratic decision reflects the cost-benefit choice made by the majority group – which may not be the most economically efficient choice.

This is the reason it is important that a democracy be backed up with a strong rule of law system that protects the rights of minority groups, so that they cannot be exploited by the majority. For example, property rights protect the rights of individuals to own, enjoy and profit from their property.

However, it should be noted that the majority can take the property of the minority if it done in a manner that respects the legal rights of the minority and the “social contract”.

Inefficient Voting

Democracy is considered a fair, equitable and just form of political decision making. However, economists note that there are flaws in democratic decision making that can result in economically inefficient outcomes.
A primary problem is that voters decide on personal self-interest and not “social” benefit. For this reason, a policy that will yield large benefits to a minority in society can be rejected by the majority if it results in a small cost (with no benefit) to the majority.

It is the median voter who cast the deciding votes most in elections, and for this reason their interests matter. This means policy caters to them even if it is not the most beneficial policy.

A second problem is that all votes count the same – they do not reflect the amount of a voter’s interest in an issue or understanding of an issue. In essence, the vote of an apathetic voter unaffected by an issue is equal to a politically active voter who may be greatly affected by an issue.

**Economic Inequality and Economic Growth**

The work of economists Alberto Alesina and Dani Rodrik looked at how the issue of economic inequality can result in slower economic growth because of government actions. They built a model in which economic growth is based on accumulated capital and that government services are funded by taxes on capital. The idea is that the higher the tax on capital, the less incentive there will be to own capital (less profits), which will result in slower economic growth.

In this case, those who own capital (rich) want a low tax rate – which will result in faster growth. However, those that do not own capital (poor) will want a high tax rate because they benefit from government services.

In this case, if the majority of a society do not own capital then they will want a high tax rate – which will cause slower growth. Economic inequality is an economic problem.

**Dynamic Consistency Problem**

The dynamic consistency problem describes the difficulty a government has in binding itself to a defined policy in a world where situations are currently changing.

Consider the problem of a country holding to a policy of “not negotiating with terrorists” or a police department having a policy of “not paying ransom to kidnappers”.

Having these stated policies is good for discouraging acts of terrorism or kidnapping.

However, it is hard to hold to these policies when dealing with the threat of terrorism or a real kidnapping.

In essence, this is a problem of a conflict between short term benefits and costs versus long term benefits and costs.