IV. TRANSFERS, MARKET FAILURE, AND GOVERNMENT FAILURE

A. TRANSFER SOCIETY (ANDERSON & HILL)

1. Productive activity v. transfer activity

- Productive activity “adds not only to the personal wealth of individuals but also to the total wealth of society.” (p. 3)
  - Does that mean “also to the total wealth of other members of society”?
  - Or does it just mean “the one who gets rich is part of society, so society is better off when he is better off and no-one else is worse off”?
  - Both of these are Pareto improvements.

- Transfer activities “add to the wealth of specific individuals … but reduce the wealth of other individuals … in the society… Such activities decrease the total product of society.” (p. 3)
  - Why? Isn’t it a zero-sum game, my loss = your gain?
  - A & H say that productive activity is a positive sum game and transfer activities are a negative sum game.

- The argument for productive activities:
  - You produce only if you expect that what you receive is worth more to you that what you give up.
  - If you sell it, the buyer expects that what she receives will be worth more to her than what she gives up.
  - Unless someone is cheating, those expectations are fulfilled (usually).
    - Exception: external effects
    - Exception: My expectations were wrong
    - Another exception: Property rights are not exclusive.

- To be exclusive, property rights must be
  - Well-defined
  - Enforced
  - Transferable.
    - If not, the owner either is not fully paid for his asset, or paid for use of other assets too, which he does not own.

- The argument against transfer activities:
If property rights are not well-defined and enforced, it is worth investing resources in getting control of property without paying its current owners.

And the current owner will find it useful to invest resources in protecting his property.

With theft, the value to the thief of what he steals might be equal to its value to the owner; but the resources used in the process are a waste.

Moreover, the value to the thief of what he steals may be less than its value to the owner. Consider pawn shops.

So government helps define and enforce property rights.

• The other side:
  - A government that defines property rights can redefine them.
  - It can be worth an investment of resources to redefine rights in my favor.
  - It can also be worth an investment of resources by the current owner to make sure rights are not redefined.
  - We can’t tell which is worse, a priori: private theft or government-sponsored theft.

• The constitutional contract
  - A constitution can make it difficult or impossible to transfer property rights by government action.
  - But that goes too far
    ⇒ Slavery
    ⇒ Public goods (and collective action in general)
  - And once the door is opened to some transfers, it is hard to keep it closed to others.

• The mix of productive and transfer activity
  - Authors claim that we are becoming more of a “transfer society” over time. Why?
    ⇒ Hint: Economic growth is part of the answer.

B. MARKETS OR GOVERNMENT? (WOLF)

1. The cardinal economic choice (Ch. 1)

• Goal of book is to develop a theory of “nonmarket failure”

  ⇒ There’s a theory of “market failure” to explain where markets do not work well:
    ⇒ Regulation of property rights, contracts
    ⇒ Public goods

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According to the American Association of Retired People (AARP), in 2000 pharmaceutical companies spent $197,000,000 wooing politicians, more than any other industry.
⇒ External effects
⇒ Monopoly
⇒ Income distribution

➢ But without a theory to predict where government /nonprofits are likely to go wrong, the theory of market failure does not guide us to where government should act.

⇒ Need to understand the predictable shortcomings of government just as we do those of markets.

⇒ Doesn’t imply that government failures are worse than market failures — just that they are there and should be considered when deciding whether or not to use government to solve a social problem.

⇒ Ditto for nonprofits (universities, hospitals, cultural institutions like orchestras & museums, charities).

⇒ Inadequacies of markets (Ch. 2)

• Says “market failure is only a necessary, not a sufficient, condition for government intervention.”

➢ What does that mean?

⇒ Let \( A \) be the set of all circumstances where the market fails.

⇒ Let \( B \) be the set of all circumstances where the government should intervene.

⇒ Which of the two sets should be labeled \( A \) and which \( B \), below?

(The picture below represents a Venn diagram).

⇒ If market failure were sufficient but not necessary to justify government intervention, which of the two sets should be labeled \( A \) and which \( B \),?
⇒ What if market failure were both necessary and sufficient to justify government intervention?

⇒ Finally, do you believe Wolf’s claim that there is never an excuse for government to intervene if there is no market failure?

• How do we judge whether the market succeeds or fails?

➢ Efficiency and Equity

• Efficiency — Wolf’s definition:
  ➢ Cannot get same benefits at lower cost, or
  ➢ Cannot get higher benefits at the same cost
  ⇒ Is that the same as “Pareto’s criterion”?

➢ Extension — Dynamic efficiency:
  ⇒ Promotes new technology that lowers costs, improves product quality, or creates new and marketable products at a lower cost than other institutional arrangements.

➢ Extension — \( X \) - efficiency:
  ⇒ Lowers costs and raises the productivity of any given technology by stimulating organizational improvement, increased worker and management motivation, and improvement in business practices (hiring and firing, promotions, salaries and bonuses, allocation of space, furniture, etc.) at a lower cost than other institutional arrangements.

• Equity — concern for the distribution of income.

➢ Economists generally try to avoid making judgments about income distribution
  ⇒ No special competence

➢ But actual policy choices are dominated by effects on the distribution of income — not by efficiency.

  “No modern people will have zeal for the free market unless it operates in a setting of ‘distributive justice’ with which they are tolerably content.” (Jacob Viner)

➢ But what criteria to use?
  ⇒ Equality of outcomes
  ⇒ Equality of opportunity
  ⇒ “Horizontal equity” (equally situated people should be treated equally)
  ⇒ Vertical equity” (People who are richer should sacrifice more — how much more?)
⇒ Workers are not exploited (Marx’ criterion)

• Types of market failure (review?)

➢ External effects and public goods:

If there are “spillovers” — benefits that the producer can’t appropriate, or costs that the producer doesn’t bear, then the market won’t be efficient. When there are external benefits the market will provide too little, and when there are external costs the market will provide too much.

**Positive spillovers:**

⇒ Education

⇒ Research and development

⇒ Public goods, such as national defense

**Negative spillovers:**

⇒ Chemical emissions

⇒ Noise

⇒ Public “bads” such as crime.

**Both positive and negative spillovers:**

⇒ Remember Coase’s argument, that people won’t leave big bills on the table: If both sides can be made better off (and if there is no cost to reaching a bargain) bargaining will lead to an efficient outcome.

⇒ But costs of bargaining in fact make this irrelevant in large groups.

➢ Increasing returns

Means that the more you produce, the lower the cost per unit. In a market economy, this leads to “natural monopoly,” with only one producer.

⇒ Means that price is above marginal cost, and not enough of this good is produced for efficiency.

⇒ May justify government intervention.

⇒ Theory of contestable markets argues that the threat of potential competition may be enough to maintain relatively efficient level of production (and low prices).

⇒ Monopolist needs to keep prices down to ward off potential competitors.

⇒ May even be pressured to innovate to keep potential competitors from leapfrogging their technology.

⇒ For innovation, there is an advantage to monopoly: the firm captures all of the benefits from research.
⇒ When there are competitors, they can piggy-back your ideas, and you don’t get all of the benefit.
⇒ Breakup of AT&T offers example.

➢ Market imperfections
⇒ If buyers don’t have full information about prices …
⇒ If potential producers don’t have full information about technology …
⇒ If resources are immobile, cannot be moved easily from one occupation to another …
⇒ If prices are distorted so that they don’t reflect opportunity costs …
⇒ … then the market won’t be efficient.
⇒ Sometimes calls for government to intervene to improve information, assist mobility of resources.
⇒ These imperfections have led many developing countries to rely on massive government control of the economy.
⇒ But Wolf observes that some developing countries that chose to minimize government intervention have been unusually successful: Hong Kong, Malaysia, Singapore, South Korea, Taiwan

➢ Distributional equity
⇒ Can’t rely on private market to achieve an appropriate level of income redistribution, even if all rich people are compassionate and want to help.
⇒ Why not?
⇒ A problem is to balance help for those who are trapped by unfortunate circumstances against incentives for those who are naturally lazy and willing to be taken care of without contributing.

3. Nonmarket failures (ch. 4)

a. Nonmarket demand and supply relationships
- Demand for non-market activity varies much like the demand for goods sold through the market.
  ➢ Depends on perceived usefulness: E.g., once a lot of people are persuaded that industry is raping the environment, there’ll be strong demand for government intervention.
  ➢ Demand grows with income (e.g., for public services)
  ➢ Falls as price goes up (more expensive, or more intrusive regulations).
  ➢ (EF’s addition) higher in environments where it is easier to actively seek favorable transfers.
Therefore attractive to put limits on political contributions, and on legal uses for those contributions.

- Supply of non-market activity varies in predictable ways
  - When it is easy to monitor quality of service, price will be lower (Post Office vs. FedEx)
  - Where there is competition, price will be lower (X-efficiency: public vs. private schools)
  - Where there is technological uncertainty, price will be higher.
    - Unfavorable outcomes lead to requests for more funding; favorable outcomes lead to finding other things to spend the leftover money on.
    - E.g., What will it cost to develop a new weapon system? How much supervision does it take to manage an effective welfare system?
  - Absence of a “bottom-line” or termination mechanism.
    - In private sector, if it doesn’t work you close the operation. In the public sector there is no compelling discipline to quit when the concept doesn’t work.

- Wolf talks vaguely about “equilibrium” between demand and supply, though he does it in an apologetic way:
  - If demand “exceeds” supply legislature will provide more service
  - If supply “exceeds” demand legislature will hold down taxes and pay rates.
  - But he admits: “The mechanism by which nonmarket demand and supply are brought into balance is weak and unreliable. It is essentially a political process characterized by lags, bottlenecks, coalitions, logrolling, and the other fuzzy attributes of political behavior. Consequently, imbalances may persist … for long periods of time.” (pp. 61 – 62).

b. Sources and types of nonmarket failure

- Redundant and rising costs
  - In markets, there is an inescapable link between the cost of producing a good and the income that sustains it.
  - Not so in nonmarket sector, where income depends on persuasiveness in arguing why you need more.
  - X—inefficiency drives the cost up.
  - And personnel practices may reward having too big a bureaucracy: The more employees, the higher the manager’s salary.
  - Maybe worst with international agencies, far-removed from voter pressure (see FAO example, p. 65).

- Internalities and organizational goals
  - The goals that an organization adopts to monitor its own performance (because it lacks a criterion like profit)
⇒ The highway department wants to pave the state
⇒ The Welfare department wants to help everybody.
⇒ Goals are related to internal criteria that ignore the question of tradeoffs between this agency’s objectives and other things that might be done with the money.

➢ Lacking a profit criterion, each agency must develop its own standards and criteria -- a culture that shows it how to act. "Internalities" are the additional costs to meet these internally-set standards (generally higher cost than the minimum needed to meet legislative intent).

➢ Additional problem that the goals might be biased even within the organization, not to maximize output, but to protect rights of important decisionmakers

⇒ The manager wants to maximize the budget
⇒ Senior teachers don’t want new technology that reduces the power of teachers or the demand for them.
⇒ The techies want new toys to play with.
⇒ The manager wants to gather information about other agencies, and keeps it to himself.

• Derived externalities

➢ Effects in other areas of policy that spill over from policy in the area under analysis

⇒ e. g. the political and economic consequences of export controls on soybeans, controls that were intended simply to moderate internal inflation.

• Distributional inequity

➢ Any public policy measure puts power in someone's hands. And all power corrupts …

SUMMARY (Not intended to imply that the non-market failures are just like the market failures at the same point in the list, just that there are equally significant problems facing both systems).

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C. **ECONOMIC ROLE OF THE STATE (STIGLITZ)**

1. **Distinctive nature of government as an economic organization**
   - Two distinguishing features
     - Membership is universal
     - State has powers of compulsion
       - No right of “exit”
       - Therefore no assurance that a transaction with the state will make the citizen better off.
   - For what purposes are powers of compulsion used in US (Federal, State, Local)?
   - Caveat: Government relies on voluntary compliance to large extent.
     - Works if citizens consider laws to be “legitimate”.
   - Qualification: Some private contracts also involve compulsion, but voluntarily entered into.

2. **Some important consequences**
   - Choice of leadership
     - Much more important than in voluntary organizations
       - Because of compulsion
       - Because of universal membership (no right of exit)
     - Quality of economic management is not a major issue for the voter.
       - Other issues vie for attention
       - Voters are (rationally) not well informed on quality
       - Contrast incentives with private corporations: voting is proportional to investment, and major investors have an incentive to become well informed.
       - Difficult to tell who is a bad manager, because it is hard to sort out unlucky circumstances from incompetent response.
   - Fiduciary responsibilities because payment of taxes is compulsory
   - Employment constraints
     - Limits on salary
     - Civil service
       - Hire on merit
       - Protect against firing for political reasons
⇒ Difficult to motivate: Salary limits mean positive incentives are limited, firing
constraints mean negative incentives are limited.

- Equity constraints
  ⇒ Programs must be administered fairly
    ✓ = treatment of =s isn’t so hard
    ✓ = treatment of unequals (people in different circumstances) is challenging.
      E. g., welfare rules
    ✓ Appropriate differences in treatment of people in different circumstances
      is even more so (Medicaid).
  ⇒ Programs must be seen to be administered fairly
    ✓ Leads to red tape, bureaucracy.

3. **Fallacies concerning public and private sectors**

  - Nationalized industries act in the public interest
    ⇒ In fact, simply substitutes one set of private interests (managers and workers) for another
      (owners)
    ⇒ Moreover, employment constraints mean lower incentives for efficiency.
    ⇒ Equity constraints mean that goals other than profit help decide on how output is to be
      distributed.
      ⇒ Pursuit of profit in production means pursuit of efficiency in resource allocation.
      ⇒ Hard to tell if losses are due to incompetence or goals other than profit.
      ⇒ Without investors / lenders, who has the economic incentive to monitor quality
        of management?

  - Government is everywhere and always inefficient (while private firms are efficient)
    ⇒ On efficiency of private firms:
      ⇒ Generally hard to tell from outside
      ⇒ One specific example of inefficiency: Why raise funds by selling stock rather
        than borrowing?
        ✓ Leads to red tape, bureaucracy.
    ⇒ On inefficiency of government-owned enterprises
      ⇒ Cases documented where costs are comparable, e.g. Canadian National Railroad
        compared to Canadian Pacific Railroad
    ⇒ But Stiglitz grants that public sector faces more problems in achieving efficiency.

  - Control and planning fallacies
“Control mentality” overestimates the power of direct controls

⇒ Control requires information, which is generally widely dispersed.

⇒ Also requires ability to monitor actions

“Control mentality” underestimates the power of indirect controls.

Consider education system, pollution control

- Coase fallacy

- Individuals can voluntarily resolve inefficiency without government intervention.

⇒ Free rider problem and transaction costs show that it generally isn’t true.

4. **Advantages and disadvantages of state economic activity**

I. e., where are compulsion and universal membership an advantage, and what disadvantages follow?

- Market failures

⇒ One way to ask the question is to ask where markets fail (public goods, external effects, natural monopoly)

⇒ Of questionable use because market failure is pervasive

✓ Whenever information is imperfect or markets are incomplete

⇒ Refocuses the question from “where are there market failures” to “where are there *big* market failures that can lead to gains from government intervention?”

✓ Problems of imperfect information and incomplete markets are as pervasive in government as in the private sector.

⇒ A second classical justification for government intervention is to redistribute income

⇒ By taxes, transfer payments

⇒ By regulations

⇒ By subsidy of “merit goods”

- Alternative forms of intervention

⇒ Government intervention doesn’t need to mean government production.

⇒ For monopoly, choices include:

✓ Ignore the problem

✓ Set up a competing government firm

✓ Give the government firm a monopoly

✓ Adopt regulations and tax provisions to encourage competition

✓ Regulate the private monopoly.
⇒ For externalities, choices include
  ✓ Use taxes (on pollution) and subsidies (on abatement)
  ✓ Regulation (limit emissions, e.g.)
  ✓ Set up climate to make lawsuits for pollution damage easier, cheaper.

⇒ For public goods and merit goods, choices include
  ✓ Government financing of private production
  ✓ Government production

• Advantages of the state in correcting market failures
  ➢ Power to tax
    ⇒ To discourage undesirable behavior, when government can’t monitor the behavior directly it can still make it more expensive
      ✓ E.g., “sumptuary taxes,” carbon tax
  ➢ Power to proscribe
    ⇒ Prohibit behavior with external costs
      ✓ E.g., drug use, drinking and driving
  ➢ Power to punish
    ⇒ Can discourage bad behavior by punishment far worse than would be agreed to in private contracts.

➢ Transaction costs
  ⇒ Organizational costs
  ⇒ Free rider problems
  ⇒ Informationally imperfect markets
    ✓ Cites example of insurance market where marketing cost can eat up 40% of premiums; social security as alternative has no marketing costs, very low administrative costs.

⇒ Adverse selection
  ✓ Arises from fact that individuals have private information about their need for insurance: they know better than the insurance company how sick they are.
  ✓ We will discuss in class, but main idea is that those who need insurance most are those who will buy it; those who don’t need it as much will be unwilling to pay a premium that subsidizes those who need it more, so the best risks get crowded out of the market, and the premium goes up to reflect the fact that only high-risk individuals are left.
Universal coverage (e.g. for health insurance coverage) avoids this problem, giving everyone protection.

5. **Public failures**

- Have already identified two major sources of public failure:
  1. Severe constraints on employment policy due to fiduciary relationship of government to taxpayers.
  2. Severe constraints on expenditure patterns due to need to be obviously equitable, again because of fiduciary relationship.

  Here are 5 more:

3. Problems of imperfect information and incomplete markets.

   ⇒ Hard to measure productivity, lack of prices for inputs and outputs makes it hard to make good decisions for efficient production.

   ⇒ Decisions about redistribution of income must be based on easily-observed criteria like income. Since income can be varied by choice, this creates incentive to people to work less to qualify for government welfare.

   ⇒ If government wants to make sure that those who benefit from a project (e.g., a bridge) pay for it, can only do that by observing usage, and charging to use the bridge. A positive price means that (if the bridge is uncrowded so that marginal cost = 0) the price will be incorrect, and the bridge will be used less than required for efficiency.

4. Potential for redistribution through government may give rise not only to inequities but to waste of resources as people seek to exploit the opportunity for transfers through government.

   ✓ Government can (and often does) use its power to redistribute, to redistribute income toward the wealthy and special interest groups.

   ✓ E.g., import restrictions to benefit textile producers, shoe makers, sugar producers.

   ✓ Loan guarantees to Chrysler when bankruptcy threatened.

   ✓ Direct subsidy to ethanol producers.

   ✓ Resources used to compete for the government programs to redistribute resources are a social waste.

   ⇒ Some government meddling is justified: e.g., if government undertakes to help aged poor through income redistribution, it is appropriate for government to insist that people save for their own retirement (through social security system).

   ⇒ Imposing requirement that children go to school may be justified, since not all parents will care about their childrens’ future welfare to see that they do.
⇒ But other meddling might be considered by some to be inappropriate: Should government discourage alcohol use? Marijuana? Tobacco (apart from protecting against second hand smoke)?

5. Limitations on the current government to impose binding constraints on future governments can impose large costs.

⇒ Efficient operation of markets requires that binding contracts be enforced, so that in exchange for my payment today I can enforce delivery of the benefit I have contracted for in the future (e.g. right to withdraw funds from bank accounts, get principal and interest back after making a loan, have promised goods/funds delivered after prepayment for construction of a house, purchase of insurance or annuities, exchanges in futures markets).

⇒ But each government is sovereign, and cannot bind its successors. Means that binding contracts with government do not exist. Governments can decide the circumstances where they will allow themselves to be sued for non-performance of a contract.

✓ Government can, however, undertake policies that help to assure that future governments will honor commitments in the future. Legislation once passed can be made difficult to reverse. E.g., hurdles in U.S. include passage by both houses of Congress and signature by President, plus possible review by courts. This gives the status quo greater standing than any alternative policy.

6. Other limitations on property rights transfers in the public sector can limit the design of effective incentive structures.

⇒ Unlike private sector, managers cannot get capital gains (from selling) when they leave. But other “property rights” of public sector managers, to approve or deny a request, can lead to graft, corruption, and inefficiency in operation of the economy.

7. Lack of competition within the public sector further weakens incentives.

⇒ Government enterprises (i.e., businesses run by the government) are usually set up as monopolies, with all of the inefficiencies that the term implies (Post Office, and in other countries telephone, sometimes air transportation, electricity, etc.) At local level, sometimes liquor stores as well as trash collection, water and electricity distribution, are state or city monopolies.

6. Perspectives on some characteristics of government

- Red tape

⇒ Some problems follow from fiduciary responsibilities.

⇒ Some follow from problems associated with monitoring outputs of administrative activities, and assuring that decisions are good and fair.
⇒ But government officials do not bear the cost of delay, while they might bear part of cost of mistakes, and they might bear some cost of being well-staffed to avoid delays.

- Powerlessness and conservatism
  
  Government employees complain of powerlessness; public complains that government often seems powerless to deal with social problems.

⇒ Strength of government – universal membership and power of compulsion – are also greatest liabilities.

  ✓ Government powers make it possible to redistribute wealth, power to friends, so government may have safeguards to help prevent such redistribution.

  ✓ Limited information implies that mistakes will be made. The more important the decision, the more review there will be and the higher in the chain of command the decision will have to go.

  ✓ Those making decisions today might try to make it difficult to have their decisions reversed, so they design structures that make it hard to reverse decisions.

⇒ Helps explain lack of power to fix problems – the conservatism of the institution.

7. Economic Policy

This section summarizes Stiglitz’ argument, and draws his policy conclusions. You will not be responsible for this material but might find it of interest.