

### III. PUBLIC CHOICE AND GOVERNMENT AS A SOLUTION

- This is part IC of the course syllabus:
  - IA: Some basic concepts from economics
  - IB: Some basic concepts from game theory
  - IC: Public choice and government as a solution.
- The problem of public choice is the problem of how to make collective *decisions*, or take collective *action*.
- So we will be looking –in the abstract – at issues in using government to make collective decisions.

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### Problems of collective action

- A standard method of analysis in social sciences is to predict actions of a group from the interests of the individual members of the group.
  - By that reasoning,
    - Farmers who want higher corn prices would lobby the government to require ethanol as a gasoline additive.
    - Consumers who want lower sugar prices would successfully lobby the government to abolish protection for US sugar beet producers.

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### Problems of collective action

- That prediction ignores the free rider problem
  - what we have analyzed as a prisoner's dilemma game.
- Some groups can overcome the free rider problem.
  - Public TV does get a significant share of funding from listener supporters.
  - Farmers have successfully lobbied to require ethanol in gasoline, boosting the demand and therefore the price of corn.
  - Consumers have never succeeded in having their interests considered in trade policy on sugar.

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### Problems of collective action

- The groups that successfully overcome the problem are usually either small ...
  - Personal interactions encourage contributions
  - Cooperation by all might become rational, as in the iterated prisoners' dilemma game (Hardin, p. 13)
- ... or they finance their joint efforts with profits from direct services they provide their members.
  - AARP provides discounts on hotels and other services in exchange for membership fees
  - And they finance their lobbying as a side activity from those membership fees.

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### Problems of collective action

- Most large groups with low commitment to the group cause cannot organize for joint purposes
  - Consumers can't get sugar quotas increased for low-cost cane growers (e. g., Cuba).
    - Their group is large, diffuse
      - with a relatively low level of interest in the issue of sugar quotas
  - The sugar beet producers, on the other hand, represent a small group
    - intensely interested in the issue of sugar quotas,
    - with interests opposed to consumers.

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### Government as a solution

- For large groups, government is a device for overcoming the free-rider problem.
- Collective actions that are in "everyone's" interest are carried out by government, with forced contributions by everyone, through taxes.
- A problem: Government officials respond to individual incentives too.
  - In the issue of sugar quotas, government ends up as a tool of the better-organized beet producers rather than the unorganized consumers,
  - even though the social cost of quotas is high.

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### What activities might be appropriate for government?

- 1. Enforcement of contracts
- 2. Public goods
- 3. Quasi-public goods, shared goods, or collective goods
- 4. Goods with substantial external effects
- 5. Control of monopoly (not mentioned in this part of the lecture notes.)

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### Government as a solution

- We will discuss the list on the last slide in turn.
- A problem: Government officials respond to individual incentives too.
  - Who will guard the guardians?
  - Separation of powers does not solve all incentive problems.
- First topic: Enforcement of contracts

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### Enforcement of contracts

- We start from a 17th century English philosopher:
- Thomas Hobbes
  - 1588 - 1679
  - And his most famous book, *Leviathan*.



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The Destruction of Leviathan (Gustave Doré, 1865)

Out of his mouth go burning lamps, and sparks of fire leap out. Out of his nostrils goeth smoke, as out of a seething pot or caldron. His breath kindleth coals, and a flame goeth out of his mouth...His heart is as firm as a stone; yea, as hard as a piece of the nether millstone...He esteemeth iron as straw, and brass as rotten wood. The arrow cannot make him flee: slingstones are turned with him into stubble...He maketh the deep to boil like a pot...he is a king over all the children of pride." (Job: 41)



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### Thomas Hobbes' vision of anarchy\*

- Consider a society without government, in which the only property rights are determined by brute strength:
- The economy would then not flourish, for lack of a link between effort and reward.
- Here is Hobbes' analysis:
  - "During the time men live without a common power to keep them all in awe, they are in that conditions called war; and such a war, as if of every man, against every man.

\**Leviathan* (1946, original 1651)

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### Thomas Hobbes' vision of anarchy

- "Whatsoever, therefore, is consequent to a time of war where every man is enemy to every man, the same is consequent to the time wherein men live without other security than what their own strength ... shall furnish them.
- "In such condition there is no place for industry, because the fruit thereof is uncertain: and consequently no culture of the earth; no navigation nor use of the commodities that may be imported by sea; ...

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### Thomas Hobbes' vision of anarchy

- “no instrument of moving and removing such things as require much force; no knowledge of the face of the earth; no account of time; no arts; no letters; no society; and which is worst of all, continual fear, and danger of violent death: and the life of man, solitary, poor, nasty, brutish and short.” (Ch. 12)

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### Thomas Hobbes' vision of government

- The fundamental reason for government is to enforce property rights, so society can be economically productive.
- **Government is an organization with a comparative advantage in violence. It protects property rights in exchange for tribute.**

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### Thomas Hobbes' vision of government

- Hobbes' analysis in *Leviathan* could see no stopping point for the power of government.
  - Leviathan, the monster from the ocean depths, was his metaphor for all-powerful government.
- Given its limitless power, Hobbes concluded that the only proper government authority would be a religious one (preferably Christian): beneficent, but with no limits on its power.

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### Leviathan



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### Other visions of government

- “Who will guard the guardians?” goes back to Plato.
- Plato's answer: Lie to them, persuade them that they are better than others and so have the duty to protect weaker ordinary citizens.

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### John Locke (1632 - 1704)

- Locke, going over the same ground, concluded that Hobbes looked at the problem wrongly.
- The government is empowered by the governed, who give up power to their government only in exchange for a fair return:



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### U. S. vision of government

- Inspired by Locke:
- "Nor shall private property be taken for public use without just compensation" (eminent domain, or "taking," clause of the U. S. Constitution).

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### Summary of argument so far:

- Without law and order there is little incentive for people to work.
- The free rider problem means that we can't expect people to all pay voluntarily to support law and order, or any other joint project.
- But if we turn power over to the government, "who will guard the guardians"?

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### What if government is self-serving and greedy?

- Government then has the delicate task of balancing their greed against economic efficiency:
  - the old conflict between the size of the pie and the share of it you can claim.
- If the governed have any power, or choice, their chief challenge is to design restraints to limit the tribute they must pay to the government.
- They will try to devise limits on government taxing and spending.
  - Balanced budget amendment to the constitution
  - Campaigns for lower taxes.
- We'll discuss further below under heading of "constitutional economics".

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### Writing assignment

- Why did Thomas Hobbes think it is impossible to limit the power of government?

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### Slide 7 repeated: What activities might be appropriate for government?

1. Enforcement of contracts (see 9/20 notes)
2. Public goods
3. Quasi-public goods, shared goods, or collective goods
4. Goods with substantial external effects
5. Control of monopoly (not mentioned in this part of the lecture notes.)

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### Public goods

- Goods that
  - (a) can be provided at zero marginal cost to other users if they are provided for one user,
  - (b) and users cannot be excluded if they don't pay (?)
- Examples (there are problems with all of these)
  - Sidewalks
  - Radio and TV signals
  - National defense
  - Weather forecasts
  - Information, knowledge
  - Digitized music

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### Public goods

- (a) and (b) above lead to different problems:
  - a: ( $MC = 0$ ) means that it is inefficient to deny access to anyone who wants to use the good
    - therefore should not charge a positive price if it would discourage any user.
  - b: (Can't exclude potential users) means that it is impossible to prevent "free riding"
    - therefore they can provide examples of prisoners' dilemma.

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### Quasi-public goods, shared goods, or collective goods

- When usage is low,  $MC = 0$ .
- Crowding means that more for me does mean less for you ( $MC > 0$ ).
- Examples
  - Roads, streets, sidewalks
  - Parks
  - Libraries
- Before crowding sets in  $MC = 0$  so efficiency says we should provide to everyone.

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### Goods with substantial external effects

- Examples
  - Control of air and water pollution
  - Public health
    - Vaccinations
    - Public sanitation
  - (Urban) fire protection

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### Control of monopoly

- (Not mentioned here in the lecture notes but it should be)
- Remember that the issue with monopoly is that it leads to (static) economic inefficiency because  $P \neq MC$ .
  - $P > MR = MC$ .
  - Price is too high so not enough is produced.
  - We'll see later that when we think about change in the economy, monopoly may have some advantages that offset the inefficiency.

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### Control of monopoly

- Choices for government response to monopoly:
  - When feasible, encourage competition and discourage mergers.
  - Regulate the monopoly.
  - Have the government take over the monopoly.
- We'll see that all have drawbacks.

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### D. Constitutional economics (McKenzie)

"The fox knows many things, but the hedgehog knows one big thing."

Archilochus (Greek poet, b. 675?, BC, d. 635?, BC)

- Think of the fox as government:
  - Lots of different agendas
  - Tries to meet lots of different goals
  - Tries to balance wants of different groups
- The market is the hedgehog
  - It only knows how to maximize profits
    - In the process it often produces economic efficiency
    - Sometimes instead produces the problems we have discussed

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### Constitutional economics

- Objective of constitutional economics is to devise rules for government so that
  - The worst problems caused by markets are solved (or at least limited)
  - The worst problems caused by government are also limited.
- Argue that to do so must limit goals
  - Don't try to control outcomes of each individual event.
  - Simply set rules so that outcomes are generally appropriate: efficient and generally equitable
    - in terms of opportunity
    - Probably not in terms of outcomes

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### Constitutional economics

“Agreement, not efficiency calculated by way of cost-benefit studies, is the hallmark of constitutional economists, because ultimately we must agree to maintain the semblance of a stable society.

“Constitutional economics seeks reform that will generate the necessary agreement for social stability.”

(McKenzie, p. 14).

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### Constitutional economics

- Basic argument:
  - There is continuous pressure to expand government spending and government regulation.
  - To fight these pressures, we need to make it hard to increase spending or to spend without taxing, and hard to impose new regulations.
  - That is what a constitution does: Puts laws in a place where it is very hard to change them.
- Therefore we need an economic constitution.

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### Constitutional economics

- McKenzie identifies the 4 main elements of an economic constitution, (in the opinion of US constitutional economists):
  - Balanced budget amendment
  - Limit growth in taxes to no more than growth in national income
  - Limit the “power of inflation taxation” by limiting money growth to a rigid rule, say 3% or 5% per year
  - Return as much fiscal power as possible to states and communities.

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### Constitutional economics

- Once the rules are set, you live with the outcomes.
  - You can't judge whether the outcome should be changed.
- You must judge whether the rule leading to the outcome should be changed.

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### Answer this question:

- In the following quote, if the fox and the hedgehog represent government and markets, which is which, and why?
- “the fox knows many things, but the hedgehog knows one big thing”.

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### E. The role of government in a free society (Friedman)

- “To the liberal, the appropriate means [for collective action] are free discussion and voluntary cooperation, which implies that any form of coercion is inappropriate. The **ideal** is unanimity among responsible individuals achieved on the basis of free and full discussion.” (Friedman, Ch. 2, pp. 220 - 23 ; boldface added).
  - This does not sound like a “liberal” in the current US political spectrum.
  - It isn’t. Friedman uses the term “liberal” the way it was used in the 19<sup>th</sup> century.

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### The role of government in a free society

- Historians have defined liberalism in a variety of ways. Here are a few:
  - Liberalism can best be explained negatively, as opposition to excessive state power.
  - A coherent body of principles based upon the idea of individual freedom. A coherent philosophy based upon the principles of the moral primacy of the individual in relation to the state or society, and the moral equality of individuals.

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### The role of government in a free society

- A distinction is made between "positive" and "negative" liberty.
- During the course of the 19th century the nature of liberalism changed from a defense of "negative" liberty
  - (i.e. hostility to all state activity)to a defense of "positive" liberty
  - tolerated much greater state intervention especially in the area of welfare
  - the so-called New Liberalism in the late 19th century.

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### The role of government in a free society

- When Friedman refers to the views of a liberal,
  - he means the “negative” liberal that wants government out of our lives,
  - not the “New Liberal” that is closer to what is labeled a liberal in the 20th and 21st centuries.

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### The role of government according to Friedman

- Only where markets don’t work:
  1. Government as rule-maker and umpire
  2. Action through government on grounds of technical monopoly.
    - Technical monopoly: Costs are lower with just 1 or a few producers
    - His view: Must choose among imperfect instruments: private monopoly, public monopoly, or public regulation of the private monopoly.
    - Argues for private monopoly on grounds of how we adapt to technical change

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3. Action through government on grounds of neighborhood effects (*i.e.*, external effects)
  - Pollution
  - Highways
  - Parks: Local, not national“Every act of government intervention limits the area of individual freedom directly and threatens the preservation of freedom indirectly” (Friedman, p. 32).
4. Action through government on paternalistic grounds
  - Care of the insane
  - Children

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Government actions not justified by liberal principles

1. Agricultural price supports
2. Trade restrictions and tariffs
3. Government control of output
4. Rent control, price or wage control
5. Legal minimum wage rate or legal maximum price
6. Detailed regulation of industry (ICC, FCC)

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Government actions not justified by liberal principles

7. Social security programs
8. Licensure provisions
9. Public housing and other subsidy programs for housing
10. Military draft in peacetime
11. National parks
12. Legal prohibition on carrying mail for profit
13. Publicly owned and operated toll roads.

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