D. cont. Econ. Role of the State (Stiglitz)

- 2 distinguishing features of government as an economic organization
  1. Membership is universal
  2. State has powers of compulsion
     - Thus there is no right of "exit"
     - So no assurance that a transaction with the state will make citizen better off.
     - What are powers of compulsion used for in US?
       - Federal
       - State
       - Local

Econ. Role of the State

- 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.
  - Examples?

Choice of leadership

- 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 of economic management.
    - Unlikely that vote will determine outcome
      - Stiglitz suggests that can lead to encourage bad policies because voters can base vote on ideology rather than consequences of following that ideology.
    - Quality of economic management of leader is a public good that benefits everyone.
    - Learning about leader’s management skill in order to vote is making a private contribution to a public good.

Consequences of universal membership

2. Fiduciary* responsibilities because payment of taxes is compulsory
   a) Employment constraints
      - Limits on salary (an information problem)
        - Civil service
        - Hie 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.
      - Contrast with private firm

*Fiduciary, noun: a person who holds assets in trust for a beneficiary (Example: "It is illegal for a fiduciary to misappropriate money for personal gain")
*adjective: relating to or of the nature of a legal trust (i.e. the holding of something in trust for another) (Example: "A fiduciary contract")
Fiduciary responsibilities

b) Equity constraints
- Programs must be administered fairly
  - Equal treatment of equals isn’t so hard
  - Equal 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.

Fallacies about public v. private sector

1. 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?

2. 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?
   - 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.

3. Control and planning fallacies
   - Stiglitz’ discussion here is really a repeat of a debate from the 1930s about whether central planning (under socialism or fascism) works better than decentralized markets.
     - Most people find it hard to understand how demand and supply can be coordinated without central planning.
     - Economists find it hard to understand how demand and supply can be coordinated with central planning. And the economists have been right.

• “Control mentality” overestimates the power of direct controls
  - Control requires
    - Information, which is generally widely dispersed.
    - Ability to monitor actions
    - Ability to change initial decisions when wrong.
    - Ability to change initial decision maker when incompetent.

• “Control mentality” underestimates the power of indirect controls.
  - As long as the issue does not involve a huge fraction of the economy, or extremely long-term changes
    - Prices give an enormous amount of information about relative scarcity of goods.
    - Indirect controls tap into the price system to allow decentralized decisions.
Examples of decentralized control
• Problem: Cut use of gasoline.
  – Centralized solution (used during WW II): Ration coupons.
  – Decentralized solution (recommended to respond to global warming):
    • Higher gasoline tax or
    • Tradeable permits

Examples of decentralized control
• Problem: Assure high quality K-12 education
  – Centralized solution:
    • State Department of Education
    • Detailed regulations that all schools must follow
  – Decentralized solution
    • Vouchers to allow parents to choose schools
    • (Maybe) State Department of Education monitors outcomes.

Fallacies about public v. private sector
4. Coase fallacy
   – Individuals can voluntarily resolve inefficiency without government intervention.
   – Free rider problem and transaction costs show that it generally isn’t true.
   – E.g., pollution problem
     • In addition to overcoming free rider problem, need detailed information on differences among beneficiaries, to determine how much each should pay.

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.

Advantages and disadvantages of state economic activity
• A second classical justification for government intervention is to redistribute income
  – By taxes, transfer payments
  – By regulations
  – By subsidy of “merit goods”

Forms of government intervention in mkt
• 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.
Forms of government intervention in mkt

• 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

4 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

4 advantages of the state in correcting market failures

• 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 (next slide)

How govt. can (sometimes) lower transaction 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:

Public failures

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.
Public failures

4. Meddling: 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.

Governments cannot constrain 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, adopt 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.

Public failures

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.

Public failures

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

Public failures

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 makes it possible to redistribute wealth, power to friends, so government may have safeguards to help prevent it.
    - 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.