D. Transfers, market failure, government failure

Transfer society (Anderson & Hill)

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. 
  – Anderson & Hill mean it makes others better off too.

Productive activity v. transfer activity

• 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.
• That means the production and later sale of the output is a positive sum game.

The argument for productive activities

• Unless someone is cheating,
  • expectations that both buyer and seller will gain are usually fulfilled.
    – Exception: My expectations were wrong
    – Exception: external effects
      • positive sum for buyer and seller but maybe not for society
    – Another exception: When property rights are not exclusive.

Exclusive property rights

• 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.
  – E.g., theft for resale
  – grazing on public land
  – So transfer and production can be combined.

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.
Disadvantage of government defining and enforcing property rights:

• A government that defines property rights can redefine them.
• It can be worth an investment of resources to redefine rights in my favor.
  – According to the American Association of Retired People (AARP), in 2000 pharmaceutical companies spent $197,000,000 wooing politicians, more than any other industry.
  – U of M in Washington D. C.
• It can also be worth an investment of resources by the current owner to make sure rights are not redefined.

Disadvantage of government defining and enforcing property rights:

• (Almost) all lobbying, Federal, state, and local, is intended to persuade government to
  – redirect resources to other uses,
  – or keep resources where they were.
• Expenditure programs
• Tax programs
• Regulations
• We can’t tell which is worse, a priori: private theft or government-sponsored theft.

The constitutional contract

• A constitution could 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?
• As a result of economic growth
  – there is more to fight over
  – there are inevitably winners and losers
    • Losers try to protect their positions

Markets or government?

• Wolf, Ch. 1: The cardinal economic choice
• 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
    • External effects
    • Monopoly
    • Income distribution

Markets or government?

• But just as markets can fail, so can governments.
• Without a theory to predict where governments are likely to go wrong, the theory of market failure does not tell us where government should act.
  – Doesn’t imply that government failures are worse than market failures
    • just says that they exist, too
    • should be considered when deciding to use government to solve a social problem.
  – Ditto for nonprofits (universities, hospitals, cultural institutions like orchestras & museums, charities).
Wolf, Ch. 2: Inadequacies of markets

• Wolf 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 $B$, in the Venn diagram on next slide?

“Market failure ($A$) is only a necessary, not a sufficient, condition for government intervention ($B$).”

Market failure and gov’t intervention

• 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?

• What if market failure were neither necessary nor 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?

Judging 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 quality, or creates new products at a lower cost than other institutional arrangements.

Efficiency — Wolf’s definition (cont.)

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

Judging market failure

• Equity in 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)
    – I think that ‘distributive justice’ may really mean “I am being treated fairly” (or better than fairly).
How should we judge equity?

- If we’re not just being selfish, what criteria should we use for equity?
  - 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)

1. External effects and public goods:
   - If there are “spillovers” (= external effects) — 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 positive spillovers (external benefits) the market will provide too little.
   - When there are negative spillovers (external costs) the market will provide too much.

External effects and public goods (cont.)

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:
- R. H. Coase argued that external effects do not mean that the market will not work.
- Both sides can bargain with each other.

Coase’s argument against gov’t intervention:

- Consider (coal burning) train that sometimes sets farm fields on fire.
  - If farmers have property rights to safety from embers, RR must decide whether it is cheaper to control the embers or compensate the farmers.
  - If railroad has property right to let its embers fall where they may, farmers must decide whether it is cheaper to pay the railroad to control the embers or live with the burned fields.

Coase’s argument against gov’t intervention

- No matter what the distribution of property rights
  - if it is cheaper to control the embers, that will happen.
  - If it is cheaper to let the fields burn, that will happen.

Coase’s argument against gov’t intervention

- 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.
- Moreover, if the 2 sides have already negotiated, government regulation might make things worse.
- But costs of bargaining in fact make this irrelevant in large groups.
  - Consider homeowners on flight path to airport if planes have right to fly over their houses.
  - Why can’t they bribe the airlines to reduce noise?
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<td>2. Increasing returns</td>
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<td>Means that the more you produce, the lower the cost per unit.</td>
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<td>In a market economy, this leads to “natural monopoly,” with only one producer.</td>
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<td>– Means that price is above marginal cost, and not enough of this good is produced for efficiency.</td>
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<td>– May justify government intervention.</td>
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<td>Types of market failure</td>
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<td>Increasing returns</td>
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<td>• Theory of contestable markets says that natural monopolists can’t get too greedy or competitors with higher costs will come in to take some of the market.</td>
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<td>• argues that the threat of potential competition may be enough to maintain relatively efficient level of production (and low prices).</td>
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<td>– Monopolist needs to keep prices down to ward off potential competitors.</td>
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<td>– May even be pressured to innovate to keep potential competitors from leapfrogging their technology.</td>
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<td>• Does this work for gasoline vs. ethanol, wind energy, or solar power?</td>
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<td>Increasing returns</td>
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<td>• For innovation, there is an advantage to monopoly: the firm captures all of the benefits from research</td>
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<td>– So it is more willing to invest in research</td>
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<td>– When there are competitors, they can piggyback your ideas, and you don’t get all of the benefit.</td>
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<td>– Breakup of AT&amp;T offers example.</td>
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<td>• Bell Labs</td>
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<td>3. Market imperfections</td>
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<td>• If buyers don’t have full information about prices …</td>
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<td>• If potential producers don’t have full information about technology …</td>
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<td>• If resources are immobile, cannot be moved easily from one occupation to another …</td>
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<td>• If prices are distorted so that they don’t reflect opportunity costs …</td>
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<td>• … then the market won’t be efficient.</td>
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<td>Market imperfections</td>
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<td>• Sometimes calls for government to intervene to improve information, assist mobility of resources.</td>
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<td>• These imperfections have led many developing countries to rely on massive government control of the economy.</td>
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<td>• But Wolf observes that some developing countries that chose to minimize government intervention have been unusually successful</td>
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<td>– Hong Kong, Malaysia, Singapore, South Korea, Taiwan</td>
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<td>• But so has the rest of China, with much more government intervention in the economy.</td>
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<td>4. Distributional equity</td>
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<td>• Can’t rely on private market to achieve an appropriate level of income redistribution,</td>
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<td>– even if all rich people are compassionate and want to help.</td>
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<td>– Why not?</td>
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Distributional equity

- Government faces problems in redistributing income too.
  - Caused by private information
  - We don’t know if someone needs help or is just lazy and prefers for other people to take care of him.
  - So government must try to design a system that
    - balances 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.

- Those opposed to income redistribution focus on the lazy people who take advantage of the system
- Those who support it focus on those whose need for help is genuine.
- The old communist ideal clearly doesn’t work: “from each according to his ability, to each according to his need.”
  - That is like a 100% tax on income, combined with government handouts with no questions asked.
  - Need incentive for all who are able to work to work.
  - Then end up with some arbitrary rules to decide who is able to work and who is not.

Wolf, Ch. 4: Nonmarket failures

A. Nonmarket demand and supply
- 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 harming 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) demand is higher in environments where it is easier to actively seek favorable transfers.
  - So it is good to put limits on political contributions, and on legal uses for those contributions.

Nonmarket demand and supply

- Supply of non-market activity varies in predictable ways
  - When it is easy to monitor quality of service, price (for a given quantity) 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?

Nonmarket demand and supply

- Absence of a “bottom-line” or termination mechanism means higher cost for non-market goods.
  - 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.

Nonmarket demand and supply

- 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).
Nonmarket failures

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.
  - May be worst with international agencies, far-removed from voter pressure (see FAO example, p. 65).

Internalities and organizational goals (cont.)

- 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.

Sources and types of nonmarket failure

- 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).

Sources and types of nonmarket failure

- 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.
    - Spillovers between decisions made by State Department and Department of Homeland Security
    - Or consider the current Blackwater scandal in Iraq. State Department has been protecting Blackwater, so it was not subject to same rules as other private contractors. Created problem for President in relations with Congress.
  - As with internalities, a problem of suboptimizing, not taking a sufficiently broad view of goals of the entire government.

Sources and types of nonmarket failure

- Distributional inequity
  - Any public policy measure puts power in someone’s hands. And all power corrupts…
  - The summary on the next slide is 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

Markets or government: summary

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<td>4. Distributional inequity (influence and power),</td>
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