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Treasure system of Uzbekistan

Lecture#12: Efficiency, markets, and the economic basis for government activity

Tashkent

Corrective Function of Government:

- Involves the maintenance of a legal structure within which people interact peacefully and provision of a mechanism for the settlement of disputes while maintaining a competitive market.

Shortcomings of The Invisible Hand

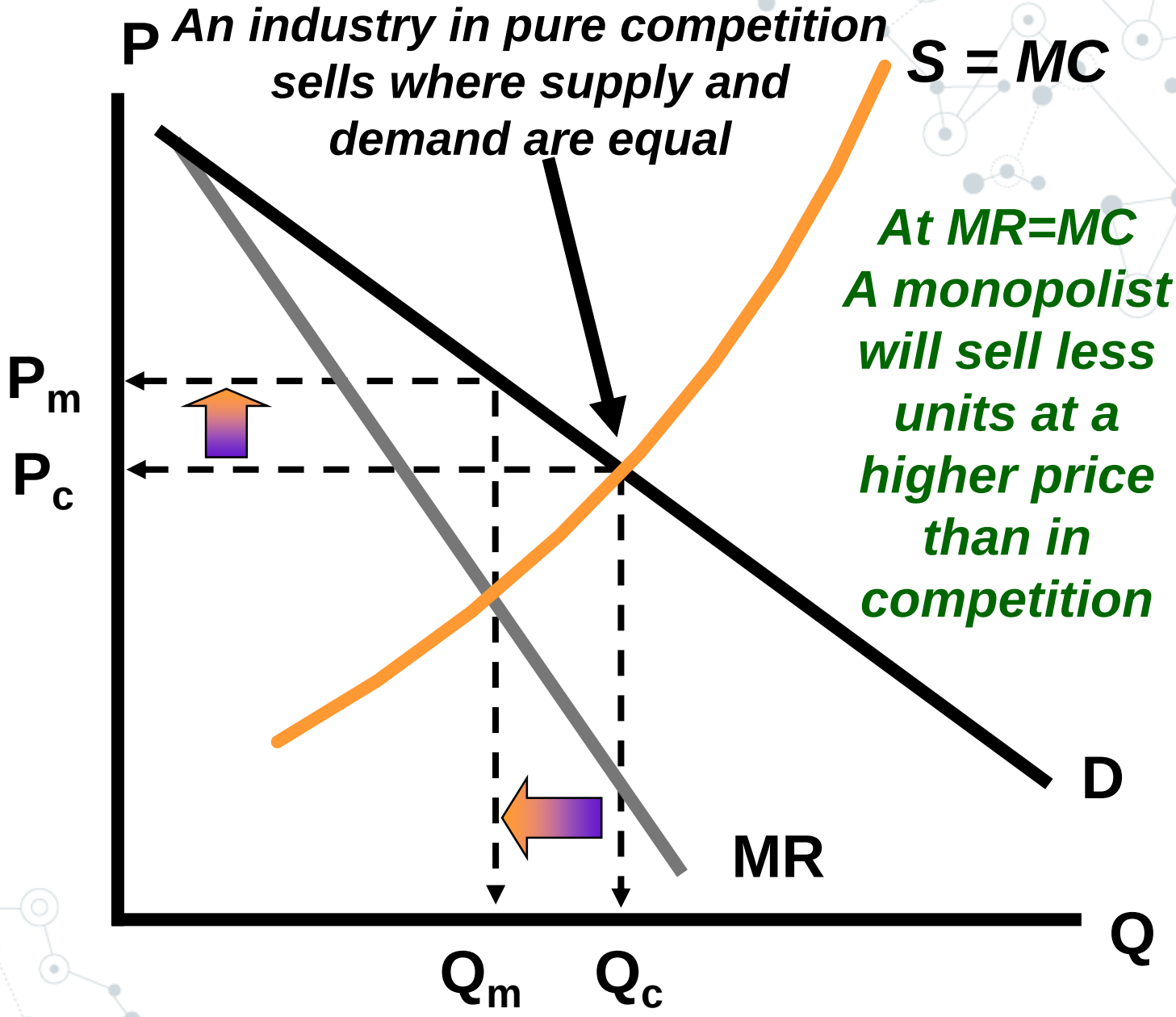
Four Reasons the Invisible Hand May Fail to Allocate Resources Efficiently:

1. Monopoly
2. Externalities
3. Public Goods
4. Asymetric Information

Why the Invisible Hand May Fail: *(1) Monopoly*

- Sellers may gain by restricting output and raising price.
  - Too few units will be produced.

INEFFICIENCY OF PURE MONOPOLY



Why the Invisible Hand May Fail: *(2) Externalities*

- Externalities exist when the market fails to register fully costs and benefits.
  - External Costs:
    - Present when the actions of an individual or group harm the property of others without their consent.
    - The Problem arises because property rights are imperfectly defined and/or enforced.
  - External Benefits:
    - Present when the actions of an individual or group generate benefits for nonparticipating parties.

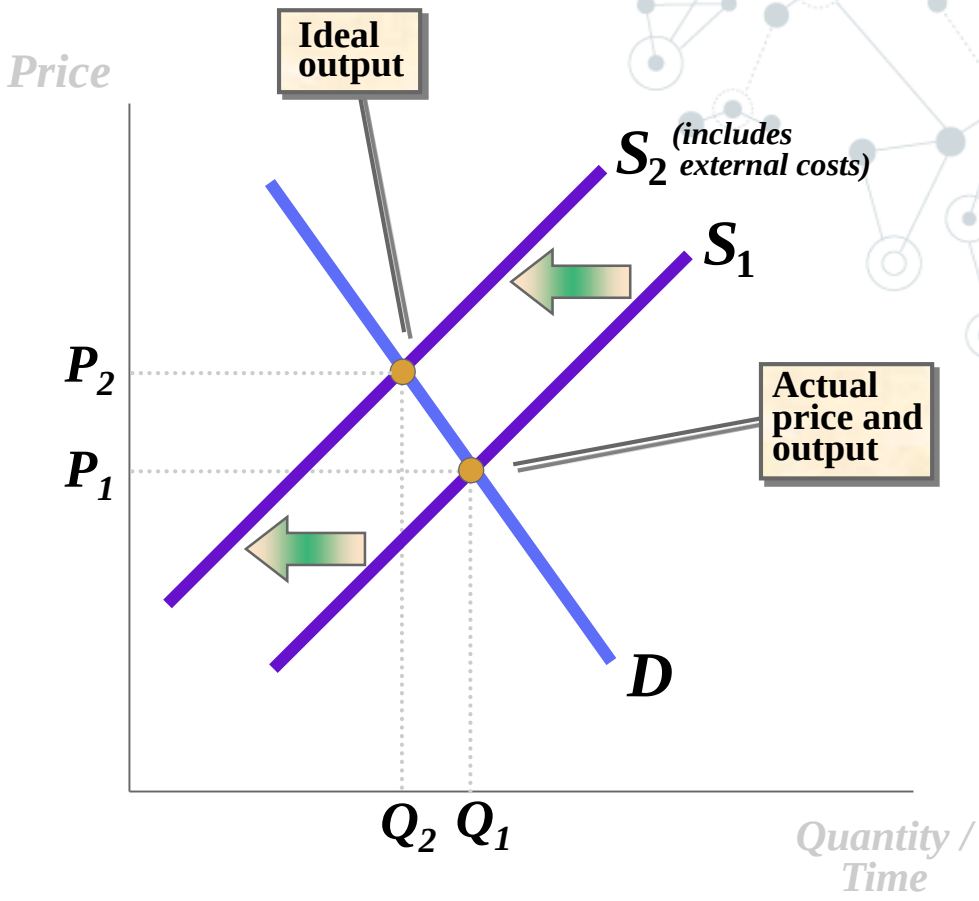
Characteristics of an Externality with
- An External Cost

- Because costs are not fully registered, the supply curve understates the true cost of production.
- Units may be produced that are valued less than their cost.
- From the viewpoint of efficiency, too many units are produced.
- Pollution problems are often a side effect.

External Costs

Failure to register fully costs.

- Consider the market to the right. Under initial supply and demand conditions an output of Q_1 and a price of P_1 exist.
- If, though, all costs are fully identified and measured . . . then the new supply curve (S_2) would result in an output of Q_2 (< Q_1) and a price P_2 (> P_1).
- The result of an ***externality*** with external costs (***a negative externality***) is that too many units are produced at a price below that which would prevail if all the costs of the production, provision, and consumption of the good were identified and factored into it.



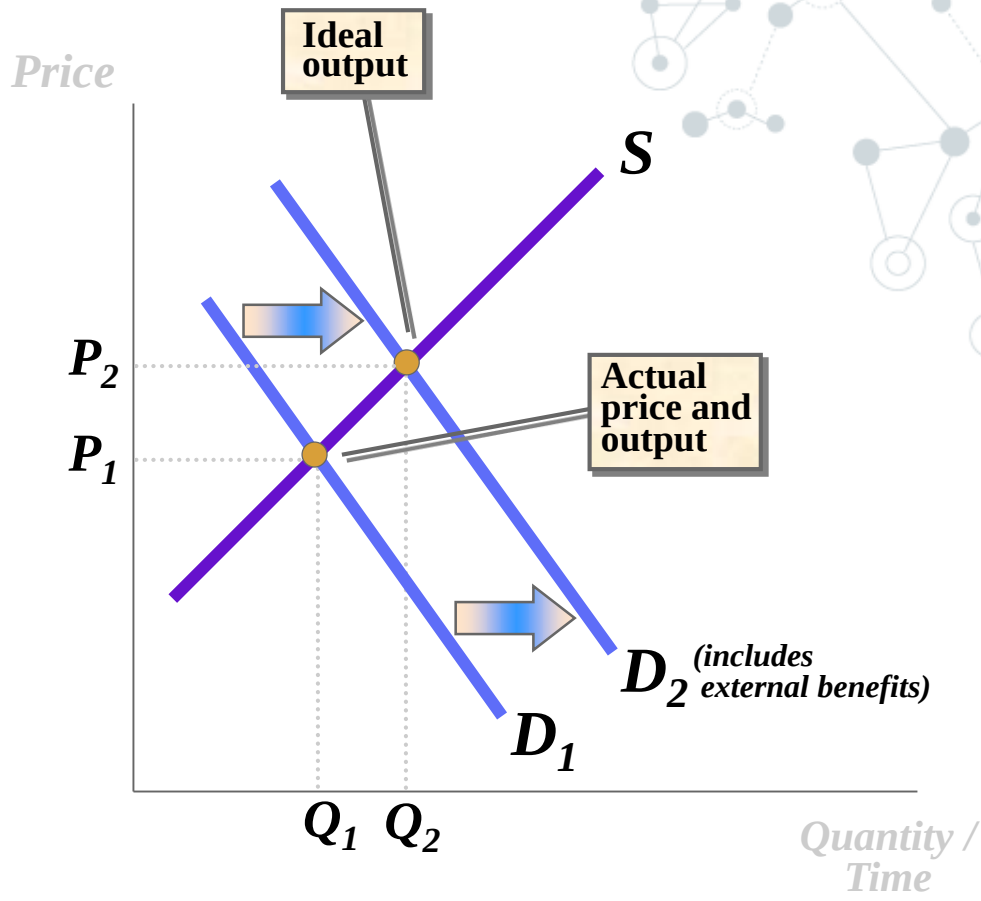
Characteristics of an Externality with
- An External Benefit

- Demand curve understates total value of output.
- Units that are more highly valued than costs may not be produced.
- From the viewpoint of efficiency, too few units may be produced.

External Benefit

Failure to register fully benefits.

- Consider the market to the right. Under present supply and demand conditions an output of Q_1 and a price of P_1 exist.
- If, though, all benefits are fully identified and measured . . . then the new demand curve (D_2) would result in an output of Q_2 (> Q_1) and a price P_2 (> P_1).
- The result of an ***externality*** with external benefits (***a positive externality***) is that too few units are produced at a price below that which would prevail if all the benefits of the good were identified and factored into it.



Why the Invisible Hand May Fail:
(3) Public Goods

Goods that are :

- *jointly consumed*

  Individuals can simultaneously enjoy consumption of same product or service

- *non-excludable*

  Consumption of the good cannot be restricted to the customers who pay for it

Characteristics of a Public Good:

- If a public good is made available to one person, it is simultaneously made available to others.
- Because those who do not pay cannot be excluded, no one has much incentive to help pay for such goods. Each has an incentive to become a ***free rider***
  - a person who receives the benefits of the good without helping to pay for its cost.
- But, when a lot of people become free riders, too little is produced.

Characteristics of a Public Good:

- It is the characteristics of the good, not the sector in which it is produced, that distinguishes a public good.
- Examples of *public goods*:
  - national defense
  - radio and television broadcast signals
  - clean air.
- Markets often develop ways of providing public goods (e.g. use of advertising to support provision of radio and television). Nonetheless, public goods often cause a breakdown in the harmony between self-interest and the public interest.

Why the Invisible Hand May Fail: *(4) Asymetric Information*

Either the potential buyer or potential seller has important information that the other side does not have.

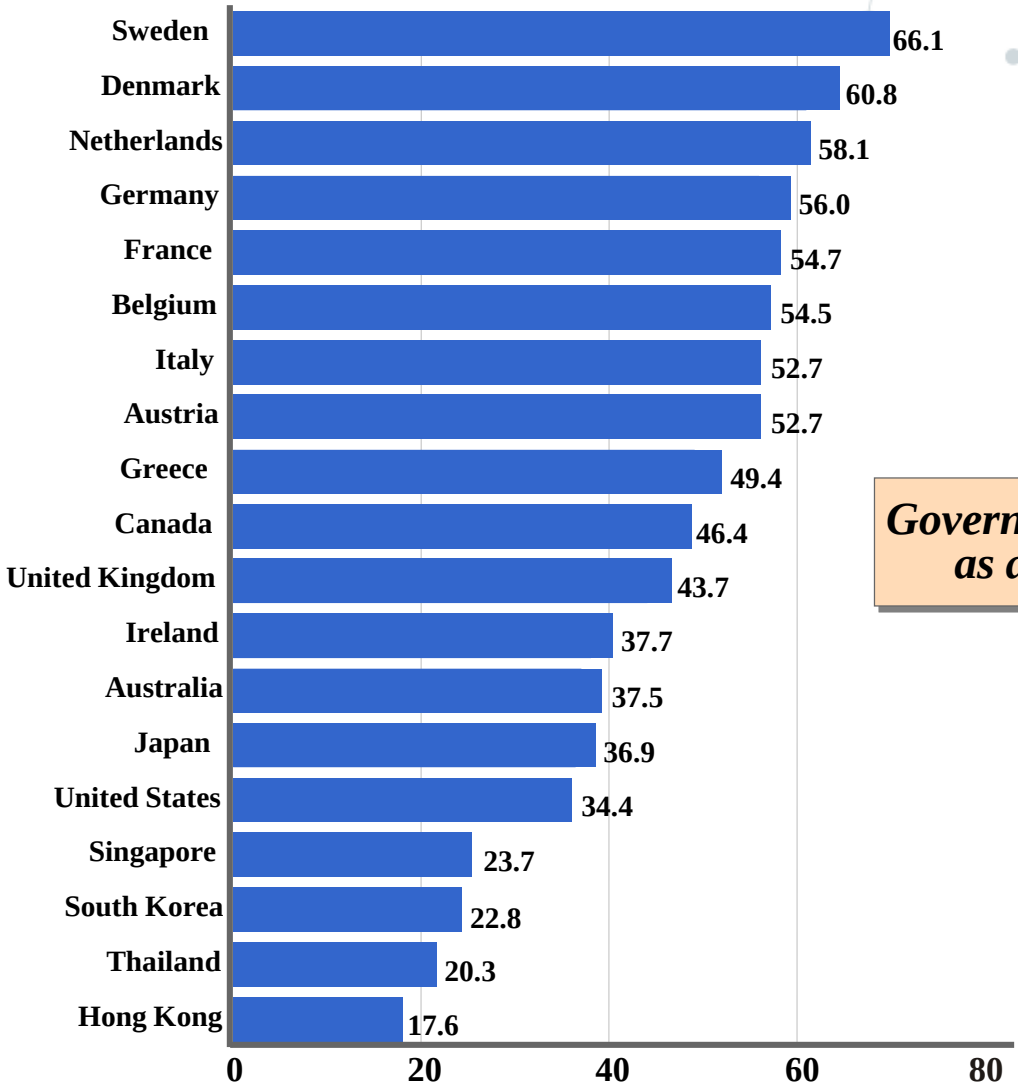
- Major problems of conflicting interests and unhappy customers can arise when goods are either
  - difficult to evaluate on inspection and seldom repeatedly purchased from the same producer, or,
  - potentially capable of serious and lasting harmful side effects that cannot be predicted by a lay person.

Why the Invisible Hand May Fail:
(4) Asymetric Information

- The consumer's information problem is minimal if the item is purchased regularly.
- Brand names, franchises, and product warranties are helpful ways of dealing with information problems

The Relative Size and Extent of Government

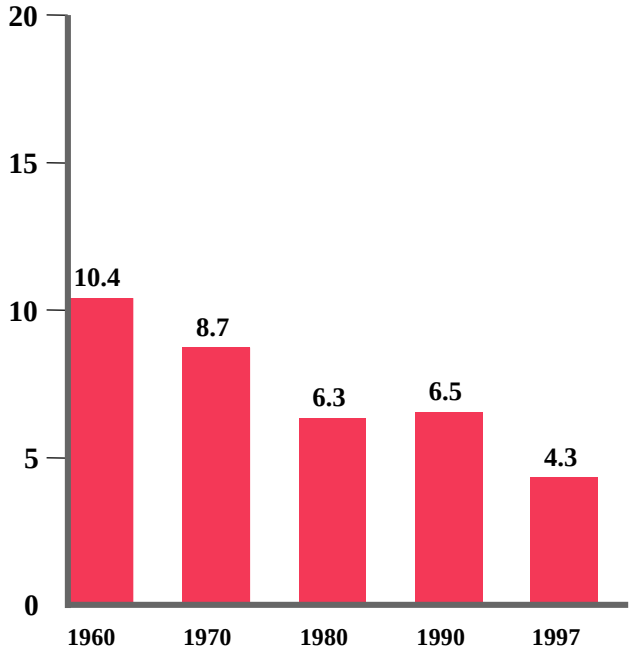
The Size of Government



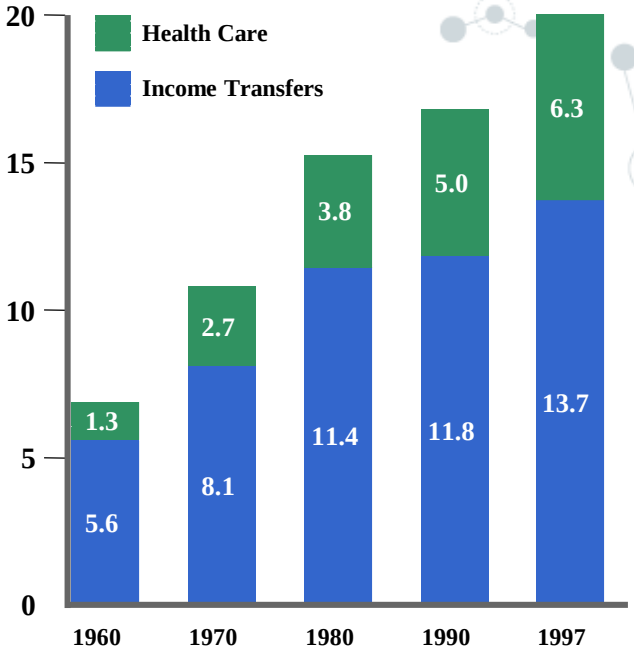
***Government Expenditures as a % of GDP** (1996)*

- The U.S. spends about a third of GDP on local, state, and federal government. This is 3 times what it was in 1930, but not as much as many of its trade partners.

The Extent of Government



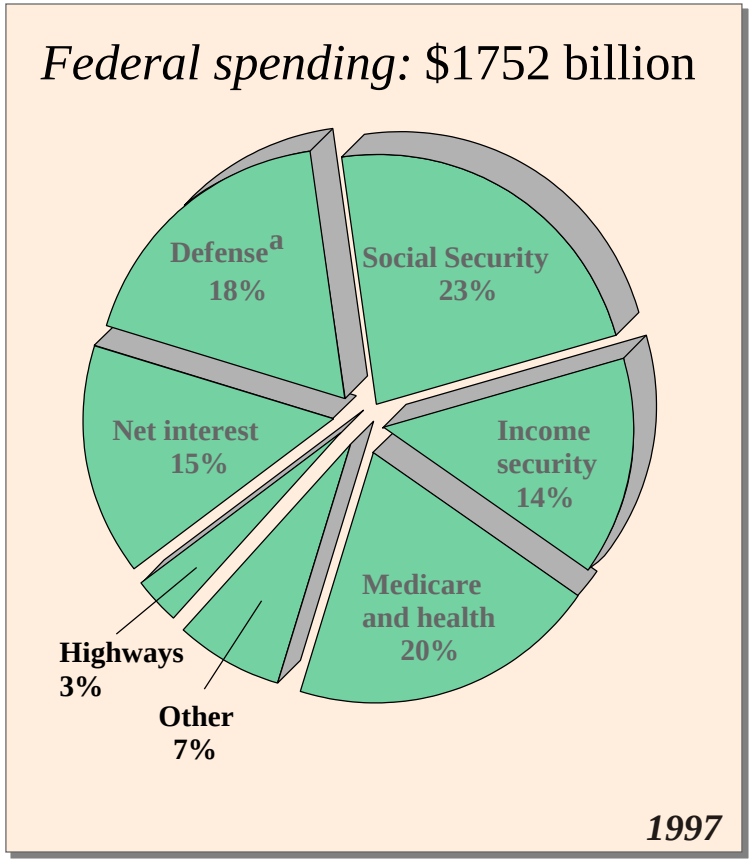
(a) Defense expenditures as a % of GDP

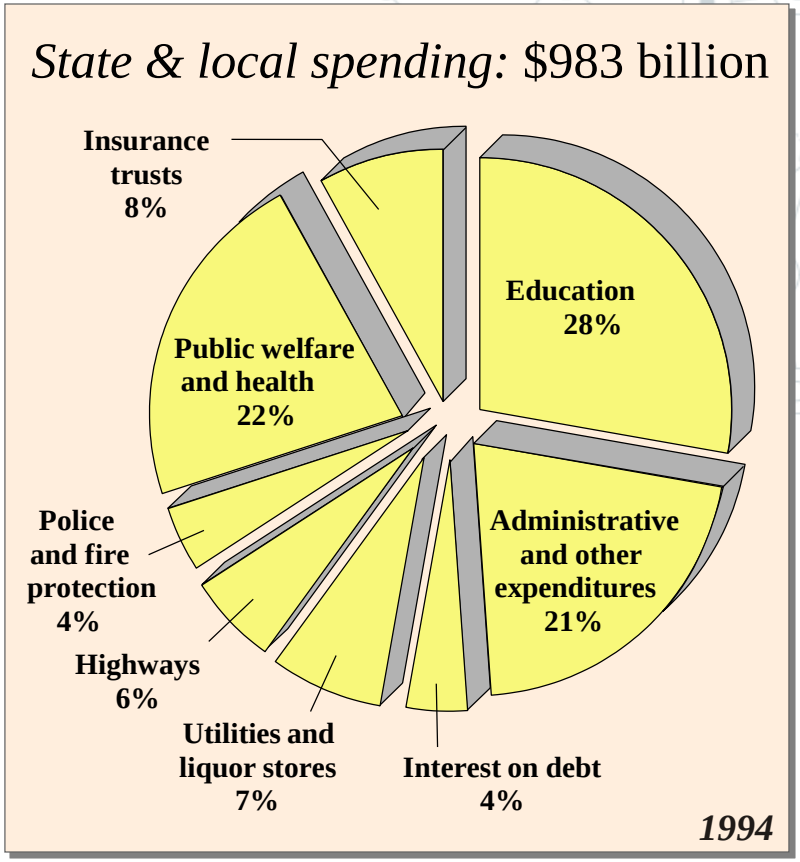


(b) Expenditures as a % of GDP

- Defense spending as a % of GDP has declined sharply since 1960.
- As was seen before, during this period federal government spending increased.
- The increase in income transfers and health care spending during the past 4 decades has more than offset the reduction in defense expenditures.

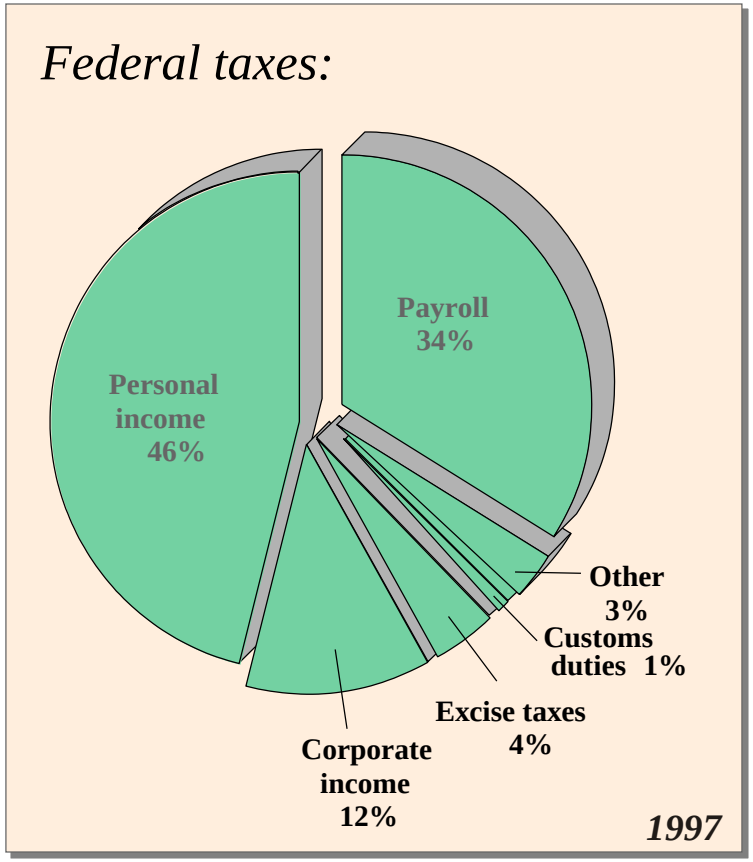
How Government Spends:

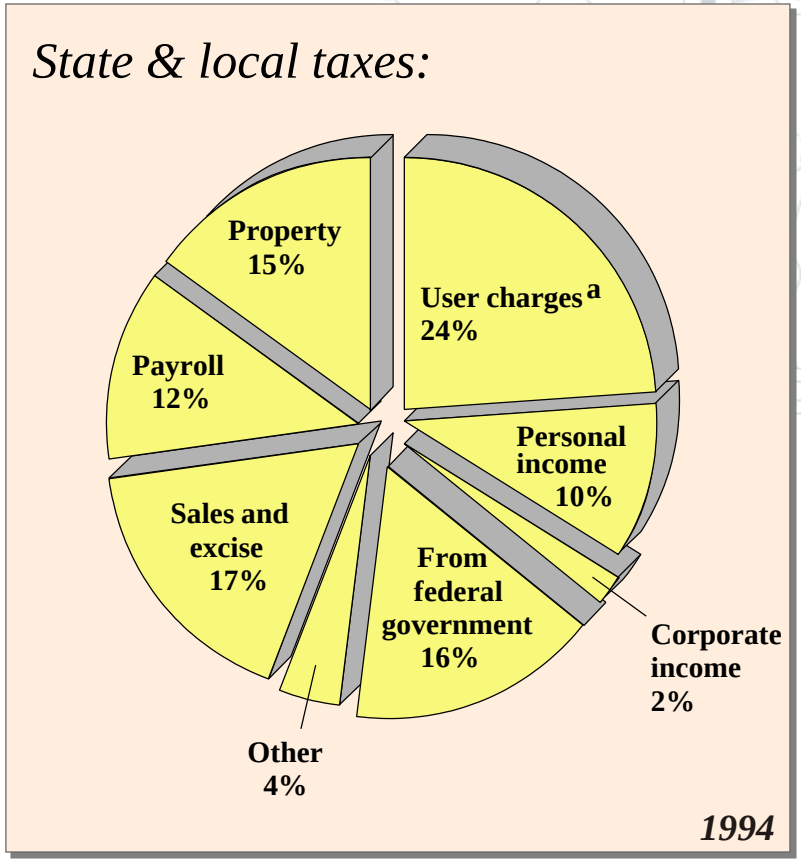




- The way that the respective levels of government spend money differs significantly.

How Government Taxes:





- The way that the respective levels of government tax differs significantly.

Government Revenue

- Taxes
  - Progressive
  - Proportional
  - Regressive

Taxation

- Ability to Pay
- Benefits Received

The Opportunity Cost of Government

The Opportunity Cost of Government Includes:

- Opportunity cost of resources used to produce goods supplied through the public sector.
- Cost of resources expended in the collection of taxes and the enforcement of government mandates.
- Excess burden (deadweight loss) of taxation.

Overview of Collective Decision Making

Public Choice Analysis

-- applies the tools of economics to the political process in order to provide insight concerning how the process works.

- Self-interested behavior is present in both market and political sectors.
- Political process can be viewed as a complex exchange process involving:
  - voter-taxpayers
  - politicians
  - bureaucrats

Public Choice Analysis:

- The Voter-Consumer:
  - Voters will tend to support those candidates whom they believe will provide them the most government services and transfer benefits, net of personal costs.
  - ***Rational Ignorance Effect***:
    -- Recognizing their vote is unlikely to be decisive, most voters have little incentive to obtain information on issues and alternative candidates.
  - Because of the *rational ignorance* effect, voters will be uninformed on many issues; such issues will not enter into their decision making process.

Public Choice Analysis:

- The Politician-Supplier:
  - Political officials are interested in winning elections. Just as profits are the lifeblood of the market entrepreneur, votes are the lifeblood of the politician.
  - Rationally uninformed voters often must be convinced to "want" a candidate.
  - Legislative bodies are something like a Board of Directors

Public Choice Analysis:

- Civil Servants *(Government Bureaucrats)*

  as Political Participants:

  - Bureaucrats (persons that handle day-to-day operations of government) seek promotions, job security, power, etc.
  - The interests of bureaucrats are often complementary with those of interest groups they serve. This is called the CAPTURE problem.
  - Bureaucrats can usually expand their own interests, as well as that of their constituents, by working for larger budgets and program expansion.

When Voting Works Well

When Voting Works Well

Other things constant, legislators will have a strong incentive to support political actions that provide voters with large total benefits relative to costs.

- If a government project is really productive, it will always be possible to allocate the project's cost so that *all* voters will gain.
- When voters pay in proportion to benefits received, all voters will gain if the government action is productive (and all will lose if it is unproductive.) Under these circumstances, there is a harmony between good politics and economic efficiency.

Benefits Derived by Voters from Hypothetical Road Construction Project

Voter	Benefits Received (1)	TAX PAYMENT	
		Plan *A* (2)	Plan *B* (3)
Adams	$20	$ 5	$12.50
Chan	12	5	7.50
Green	4	5	2.50
Lee	2	5	1.25
Diaz	2	5	1.25
Total	$40	$25	$25.00

- Consider the government program above. As with many such programs, individuals receive varying levels of benefits.
- If tax plan ***A*** is adopted to fund this program, it may be simple and *seem* fair, but even as Adams is getting a real deal (values the program at $20 and only pays $5) Green, Lee, and Diaz do not even receive the value of their taxes paid in benefits.
- When each voter pays in proportion to benefits received (tax plan ***B***), each receives more in benefits than it costs them in taxes. If tax plan ***B*** is used, all voters gain and the program would pass unanimously. This example shows that harmony between good politics and economic efficiency *can* exist.

When Voting Conflicts with Economic Efficiency

When Voting Conflicts with Economic Efficiency

- Special Interest Effect
  - *generates substantial personal benefits for a small number of constituents while imposing a small individual cost on a large number of other voters*.
  - Interest group members will feel strongly about an issue that provides them with substantial personal benefits. Such issues will dominate their political choices.
  - Politicians have a strong incentive to favor special interest even if action is inefficient.
  - ***Logrolling*** and ***pork-barrel*** legislation strengthen the special interest effect.

Vote Trading and Passing Counterproductive Legislation

Voters of District*	Net Benefits (+) or Costs (-) To Each Voter in District: Construction of Post Office In *A*	Dredging Harbor In *B*	Construction of Military Base In *C*	Total
A	**+ $10**	**- $03**	**- $03**	**+ $4**
B	**- $03**	**+ $10**	**- $03**	**+ $4**
C	**- $03**	**- $03**	**+ $10**	**+ $4**
D	**- $03**	**- $03**	**- $03**	**- $9**
E	**- $03**	**- $03**	**- $03**	**- $9**
Total	**- $02**	**- $02**	**- $02**	**- $6**

****We assume the districts are of equal size.***

- Consider a composite bill in Congress that would build a post office in district ***A***, dredge a harbor in ***B***, and construct a military base in ***C***.
- The benefits to ***A***, ***B***, and ***C*** voters vary by project. In total, ***A***, ***B***, and ***C*** voters come out ahead despite the costs involved in paying taxes for activities in other districts if they agree to vote together.
- With this bill, there are no direct benefits to district ***D*** and ***E*** voters.
- In total, the sum of benefits for the group of all voters come out negative despite the positive benefits for district ***A***, ***B***, and ***C*** voters.
- In a majority rule voting system, the majority can pass *counterproductive legislation* benefiting themselves but creating negative net benefits for the whole.

When Voting Conflicts with Economic Efficiency

Shortsightedness Effect

-- Issues that yield clearly defined current benefits at the expense of future costs that are difficult-to-identify.

- Political process is biased toward the adoption of such proposals even when they are inefficient.

When Voting Conflicts with Economic Efficiency

Rent Seeking

-- Actions by individuals and interest groups designed to restructure public policy in a manner that will either directly or indirectly redistribute more income to themselves.

- Widespread use of the taxing, spending, and regulatory powers of government that favor some at the expense of others will encourage rent seeking.
- ***Rent seeking*** moves resources away from productive activities. The output of economies with substantial amounts of *rent seeking* will fall below their potential.

When Voting Conflicts with Economic Efficiency

- Lack of Incentive for Operational Efficiency
  - In the public sector, the absence of the profit motive reduces the incentive of producers to keep costs low. Neither is there a bankruptcy process capable of weeding out inefficient producers.
  - Public-sector managers are seldom in a position to gain personally from measures that reduce costs.
  - Because public officials and bureau managers spend other people's money, they are likely to be less conscious of cost than they would be with their own resources.

Economics of the Transfer Society

Economics of the Transfer Society

- There is nothing in positive economics that indicates one distribution of income is better than another.
- A large and growing part of government is devoted to transferring income.

Economics of the Transfer Society

- There are three major reasons why large-scale redistribution will reduce the size of the economic pie:
  - When taxes take a larger share of one's income, the individual reward derived from hard work and productive service is reduced.
  - As public policy redistributes a larger share of income, more resources will flow into wasteful rent seeking activities.
  - Higher taxes to finance income redistribution and an expansion in rent-seeking will induce taxpayers to focus less on income-producing activities, and more on actions to protect their income.

Public Sector Vs. Market Sector: *A Summary*

4 Factors that Weaken the Case for *Market* Allocation:

- Lack of competition

- External costs and benefits
- Public goods
- Poor information

4 Factors that Weaken the Case for *Public* Allocation:

- The power of special interests
- The shortsightedness effect
- Rent seeking costs
- Lack of signals and incentives to promote operational efficiency

Implications of Public Choice:

Getting More From Government

Implications of Public Choice:
Getting More From Government

- Both bad news and good news flow from public-choice analysis:
  - The bad news:
    For certain classes of economic activity, unconstrained democratic government will predictably be a source of economic waste and inefficiency.
  - The good news:
    Properly structured constitutional rules can improve the expected result from government.