

### **XXIII. The Logic of Government Failure**

- A.** One of the main contributions of the Public Choice literature is the concept of government failure.
- i. That is to say, the observation that political processes do not necessarily adopt Pareto Efficient Social Welfare maximizing policies.
  - ii. Government failure helps to explain why policy problems exist--that is to say
    - a. externalities may exist because governments FAIL to act
    - b. excess tax burdens may exist because government chooses to adopt tax policies that have larger burdens in total than necessary given the feasible array of tax instruments
    - c. regulations may be set at excessively demanding levels, inefficiently low levels, or created in a manner that impose greater cost on those within the country of interest than necessary. (command and control rather than effluent markets)
- B.** There are a number of public choice models of political processes that imply government failure--or at least the possibility of government failure--in polities based on majority rule.
- i. For example, the median voter model implies government service levels and tax levels that are higher (or lower) than Pareto efficiency whenever the median voter has different preferences than the average voter.
  - ii. (Illustrating figure: voting over a pure public good given an equal tax price.)
  - iii. Also the median voter may have systematically biased information about the costs or benefits of programs being voted on and so may make systematic mistakes about the policies that "best" advance his or her own interests.
  - iv. (Illustration, fiscal illusion in case where costs are under estimated)
  - v. Electoral cycles allow the possibility that policies outside the Pareto set come to be adopted.
  - vi. The majority has no obvious reason to internalize the external costs that its decisions impose on the minority.
- C.** Many interest group models also imply that policy choices are biased in one way or another.
- i. For example, groups with relatively concentrated and large (net) benefits have an easier time organizing to lobby Congress than groups with relatively diffuse and small benefits.
  - ii. Thus, many agricultural groups gain substantial trade "protection" at the expense of much larger groups of consumers who lose more than the interest groups gain. (For example: the sugar lobby, peanut farmers, and dairy farmers.)

- iii. Interest groups may be able to "fool" voters into voting for programs that are not truly in their interests by subsidizing favorable information while "taxing" unfavorable information. (That is to say, induce fiscal and regulatory illusion.)
  - iv. Factions may exploit the fact that local and regional projects can often be financed using national tax revenues in a manner that produces relatively too many local projects with negative net benefits. (pork barrel and fiscal commons problem).
- D.** There may be principal agent problems between voters and both their elected representatives and the bureaucracy.
- E.** In all, there are a variety of things that can go wrong in governments, just as there are a variety of things that can go wrong in markets.

### **XXIV. Efficiency and Democracy**

- A.** Nonetheless, the mere possibility of government failure does not necessarily imply that democratic (or dictatorial) governments routinely fail!
- B.** There is by now a substantial theoretical and empirical literature on the efficiency of democratic regimes.
- i. There are several aspects of the fundamental question of the normative appeal of democracy, and consequently there are several distinct literatures on this subject..
  - ii. What exactly does political efficiency mean?
  - iii. Are there institutional or other solutions the "efficiency" problems noted above? (It turns out that there are.)
  - iv. If so are these problems all solved by the ordinary course of political decision making? (This is very much debated.)

### **XXV. What does it mean to say that a democratic polity is efficient?**

- A.** Pareto Efficiency and Wicksellian Efficiency. The narrowest and probably most widely used interpretation of economic efficiency are those proposed by Vifredo Pareto and Knut Wicksel at the turn of the last century.
- i. Pareto suggests that a social state is clearly inefficient if a change can be made that makes at least one person better off and not one worse off.
  - ii. Wicksell suggests that public policies clearly improve whenever essentially unanimous agreement can be reached concerning the adoption new policies. That is to say, inefficiency can be directly observed by putting policies to a vote.
  - iii. Efficiency from these points of view may be said to arise when there no such changes are possible.

**B. Utilitarian Efficiency and Wealth Maximization.** The main rival to the Paretian norms are norms that are more or less grounded on Utilitarian ideas about social welfare.

- i. The utilitarian/social welfare maximization approach is similar to that of the Wicksellian and Paretian approaches insofar as the welfare of every individual counts. That is to say, any change that makes one person better off without making another worse off, increases social welfare.
- ii. However, the social welfare maximization approach considers policy alternatives quite different from that of the Pareto and Wicksellian norms insofar as an explicit accounting of welfare tradeoffs among individuals is considered.
  - a. Under Pareto, a move that makes *one person worse off* can not be considered a Pareto superior move.
  - b. However under a utilitarian approach, such a move that harms one person may still increase social welfare if the gains realized by the winners are "larger" than the losses born by the losers.
  - c.  $W$  is a social welfare function,  $U_i$  is the utility level of the  $i^{\text{th}}$  individual, and  $W_{U_i} > 0$  for all  $i$ . It is clearly possible that  $W(U_1', U_2', U_3', \dots) > W(U_1'', U_2'', U_3'', \dots)$  even if  $U_1' < U_1''$ .
  - d. However, generally the final policies recommended by social welfare maximization turn out to be Pareto and Wicksellian efficient

**C. The contractarian approach.** The contractarian approach is very similar to the Paretian and Wicksellian approach. Contractarians regard improvements to be a matter of negotiating new social contracts. State A is better than State B if all affected parties would agree to sign a contract moving them from A to B.

- i. Societies and social states are analyzed as contracts that are only necessarily understood by the participants.
- ii. But generally, contractarians expect to be able to use contract based reasoning to determine which forms of government, etc., work the best.

**D. Feasibility.** All three of these approaches are clearly constrained as a practical matter to choosing policies or institutions that are feasible. That is to say, although the normative systems can rank alternatives that can never be implemented, genuine reforms are limited to what can actually be done.

- i. It is from this perspective that statements like "democracy is the very worst form of government, but for all the rest" make sense.
- ii. This approach suggests that institutions be ranked relative to real alternatives, rather than compared to idealized alternatives.

- iii. That is to say, an institution that fails to achieve Pareto efficient results may nonetheless be the best that can be obtained given the range of alternatives available.

**E. Measures of relative efficiency: gnp/pop and patterns of migration.**

## **XXVI. Theories of Efficient Democracy**

**A. Naive Theories: the benevolent despot**

- i. A good deal of mainstream public economics assumes that the function of an economist is to provide good advice to a benevolent dictator
- ii. Some of the models make this assumption implicit by simply assuming a welfare maximizing state.

**B. Many combined models (Peltzman, Grossman and Helpman, implicitly assume that the government has an objective function that combines a social welfare function that gives special weight to interest group. These models often imply efficient policies.**

**C. The Stochastic Voting Model:** under the conventional assumptions, democratic governments will tend to maximize a (somewhat peculiar) social welfare function because it is in the candidate's interests to do so.

**D. Wittman: Coase and Democracy.** Contractual solutions exist for a wide variety of the agency problems that many critics of democracy point to.

- i. Clearly, if solutions to agency and cycling problems are possible, democracy can be efficient.
- ii. And moreover if these solutions are not always adopted, it is still possible that the result may already be efficient.

**E. Interest groups can lead to efficient outcomes in the Becker model.**

## **XXVII. Evidence of the Efficiency of Modern Democratic States.**

**A. Evidence from Switzerland**

- i. Eli Noam: efficient outcomes
- ii. Bruno Frey: Direct democracies spend less.
- iii. Bruno Frey: Citizens are happier in direct democracies.

**B. Evidence from the US:** Randal Holcombe direct democracy spends less on education than representative democracy

**C. Evidence from the world:** democracies have long been freer and more prosperous than dictatorships.

**XXVIII. Democratic Imperfections**

- A. Evidence of democratic failure?
- B. Informational Problems: Rational Ignorance and Fiscal Illusion
- C. Constitutional Design: Can Democracies be Improved?