

# **OVERHEADS on Market Failure and Government Failure**

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## **Abstract**

### Overheads on Market Failure

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### **3 Market Failure and Economic Regulation**

Let us return to the single-transaction case as a running example.

Smith is willing to pay up to \$15 for a bottle of whisky and Jones is willing to accept as little as \$8.

Our conclusion earlier was that the government should allow the transaction to take place, because it benefits both buyer and seller.

**1 Enforcing Property and Contract Rights**

**2 Property Rights and Creation of Goods**

**3 Market Power**

**4 Imperfect Information**

**5 Externalities**

**6 Coordination Problems**

# 1 Enforcing Property and Contract Rights

A certain amount of government regulation is needed even to support free market transactions. If the government has no rules forcibly constraining anyone's actions, Smith faces no government penalties if he steals the bottle of whisky from Jones instead of paying for it.

Laws against theft are a form of regulation and a constrain on our liberty.

(1) If Smith can steal the bottle at low cost, he will steal it even if his value is less than Jones's value.

(2) Jones will use time, energy and resources in trying to prevent theft; and Smith will use time, energy, and resources in trying to overcome Jones's precautions.

(But sometimes, self-help –guns, locks– is the efficient way to protect property rights)

Often, the government goes a step further and provides for clear markers of who owns what—automobile registration, land title records.

Closely related is government's role in enforcing contracts.

## 2 Property Rights and Creation of Goods

I said in the previous section that the most important thing is to provide clear rules as to who owns what, and the precise rules matter less. That is true, but “mattering less” does not mean “does not matter.” Particularly important is that the property rules award enough ownership to someone who creates something new.

This is most obvious if someone creates a new physical good. Suppose Jones has distilled the whisky using his own labor and corn that he grew himself. Who should own it?

Slavery is not value maximizing.

The usual rule is that Jones has the right to keep most of what he produces, but must give some of it to the government (taxes).

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### 3 Market Power

A somewhat different form of market failure: value maximization requires that the government restrict someone's right to freely decide whether to buy or sell his property.

Determining the price.

Easy when there is a competitive market.

Hard when there is just Smith and Jones (bargaining).

Hard when there is a monopoly.

PROBLEM TWO: Profits give people an incentive to create monopolies.

That is good if they are creating new goods, but bad if they are just devoting effort to monopolizing existing goods.

PROBLEM THREE: Monopolies have higher production costs.

## 4 Imperfect Information

Suppose Jones claims he is selling whisky, but might actually be selling colored water.

1. It is colored water, Smith buys, his value is not \$15, but \$0, and value has not been maximized
2. Jones actually does have real whisky. If Smith knows the legal rule, though, he might refuse to buy anyway.

## 5 Externalities

Smith, after buying whisky from Jones for \$10 and drinking it, will throw the bottle onto the sidewalk in front of Brown's house, where it will shatter and cost Brown \$20 to clean up.

The transaction between Smith and Jones has indeed created value of \$7 as far as those two are concerned. External to the transaction is Brown, a third party, who suffers a value loss of \$20. This more than wipes out the gain of \$7.

## Negatives versus Positive Externalities

A NEGATIVE externality is one which hurts the third party.

A POSITIVE externality is one which helps the third party.

If Smith smokes a pipe in class, It creates a negative externality for people in the class who hate smoke. It creates a positive externality for people who like the smell of pipe smoke.

Positive externalities gives rise to inefficiency too.

Suppose that Smith would get revenue of \$10,000 per year from operating a tree farm next to Jones's house, and Jones would get a benefit of \$2,000 per year from having such a pleasant neighbor, but Smith's cost for the farm would be \$10,500 per year. Smith would go out of business, an inefficient outcome.

## Real vs. Pecuniary Externalities

The shattered whisky bottle is an example of a **real externality**: a spillover in which one person's action affects the utility of someone else without any payment being made, and affects the utility directly rather than just through the action's impact on prices.

If the spillover results from the prices, it is called a **pecuniary externality**.

A REAL externality is one which has a direct effect on the third party.

A PECUNIARY externality is one which has an effect only via prices.

If, for example, Jones has been regularly selling whisky at \$10/bottle to Smith, making a profit of \$2 per bottle, and then Anderson begins selling at a price of \$7/bottle, Anderson has inflicted a negative pecuniary externality of \$2/bottle on Jones.

## 6 Coordination Problems

When expectations matter, there may exist a number of stable configurations of behavior, each with its own set of expectations, and some of these equilibria may lead to better results than others.

In the whisky example, Jones will not expend the \$8 to produce the whisky unless he expects Smith to buy it. But Smith will not waste time visiting Jones unless he thinks Jones has whisky to sell.

MONEY: Medium of exchange, unit of account

## **Government Failure: Bad Objectives**

Government failure occurs when the government does things that reduce efficiency.

Suppose Congress is thinking of passing a new law affecting a business. How should we think about the new law?

From the viewpoint of the public good, a big question is:

**IS THE LAW EFFICIENT?**

which means:

Does it help the winners from the change more than it hurts the losers?

From the viewpoint of a business or individual, though, the big question may be

**WILL THE LAW HELP ME?**

Whether an executive should support a law (e.g., tariffs on foreign steel) which helps his company some but hurts the public even more is a good and hard ethical question. But he should certainly be cognizant of the law's effect.

Whether a law will increase efficiency depends first on whether there is MARKET FAILURE. If there is not, no law is needed to attain efficiency. If there is, then a law COULD be helpful, but might still be a bad idea because of GOVERNMENT FAILURE.

Markets generally work very well. A good default position is to believe that no government intervention will increase efficiency unless you learn that the market is special in some way.

If the market price of chocolate ice cream cones is 2 dollars, for example, then price or quality regulation would hurt more than it would help. Some people might benefit if the price were required to be 1 dollar, or 3 dollars, or if only the flavor strawberry were legal, but more people would be hurt. Most conceivable regulations are inefficient, even though some people would argue strenuously for many of them.

## RESULTING INEFFICIENCIES:

1. Inefficient regulations
2. Costs incurred to obtain regulations (proactive rentseeking costs)
3. Costs incurred to prevent regulations (defensive rentseeking costs)

## WHEN DOES RENTSEEKING OCCUR?

Much of government failure arises because some people pay more attention to what the government is doing than other people do.

If you see a new law, or a need for a new law because of market failure, and wonder whether government failure is likely, ask the following questions:

1. Is it easy to see who is hurt and who is helped by the law? If it is not easy, politicians will not have the right incentives.

2. Are the benefits concentrated and the costs diffused? (or vice versa) If the benefits are concentrated, the beneficiaries have a strong incentive to lobby for the law. Even if it is inefficient, it may well be passed.

3. Are the benefits short-term and the costs long-term? Politicians are elected for the short-term. Even the 6-year term of a U.S. Senators is not very long. Thus, they are tempted to go for short-term gains.

All this is not to say that politicians and bureaucrats are bad people. Any person will respond to the incentives provided him. Politicians, however, have a special problem. If a politician votes only for efficient laws, but the conditions for government failure are present, he will not last long in office. Voters will not understand that the law is efficient, the businesses on whom the costs are concentrated will work hard to defeat him, and nobody will see the benefits of the law until years after he has left office. It's ok to blame some politicians, but blame the system too.

Reform is difficult because the three features listed above are inherent to any government action. The basic problem is the FREE RIDER PROBLEM: that for public goods the benefits are diffused by definition, and each voter would like to get the benefit without doing the work of learning about politics.

## **Government Failure: Poor Performance**

Even if the government is motivated by the public interest rather than the pressures of rent-seekers, it is not necessarily intelligently motivated.

Since the costs and benefits of government actions flow to third parties rather than the government decisionmakers, there is little incentive for the decisionmakers to expend effort to make good decisions.

The government falls between the Scylla of interested rentseeking and the Charybdis of disintererested incompetence.

Incompetence may arise from MORAL HAZARD.

Government workers include elected officials and civil servants.

Elected officials are not monitored as carefully as business administrators and are not so sure to be rewarded for good performance, so they have less incentive to find the best policies.

Civil servants are monitored by the elected officials (a problem in itself, given the lack of incentive for the elected officials to exert monitoring effort), and what is more important, ‘company policy’ makes it difficult to punish them for poor performance. The rigid civil service rules, however, are themselves a rational response to the moral hazard problem, because they prevent abusive firings and demotions by elected officials. It is worth reducing the incentives for hard work to reduce the amount of politics in government offices. There is a tradeoff between politicians being able to fire incompetent workers and politicians being able to fire workers because of their politics.