Welfare Economy

Chapter 2
The Economic Theory of the State

We present what is the economic theory of the State, in particular, in relationship with markets

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The public Sector in an Economy

The economics of the public sector is concerned about the role of the governement and the analysis of its policies.

What are the differing views concerning the economic role of government ? How they changed over the years ?

What are the principal sources of disagreement among economists about appropriate policies for government to pursue ?

Questions to understand

An economy is *mixed* when some economic activities are undertaken by the government, or whenever the government alters the behavior of the private sector through a variety of regulations, taxes, subsidies

- Why does government engage in some economic activities and not others ?
- why does it have different roles in different countries ?
- Could it perform its economic role more efficiently ?

Economic Context

We call market the economic activity in the private sector. It is important to understand the role of the government to develop first a normative analysis of the market

Historically, in the US, the constitution assigned the federal government certain responsibility such as running the post office, printing money and giving the right to grant patents and issue copyrights, to levy taxes and to regulate interstate commerce.

Vocabulary

All of those concepts should be reviewed (in textbooks or in wikipedia)

- Regulation
- Property rigth
- Nationalization
- Altering the behaviour
- Taxes
- (public) insurance programs
- Privatization
- Printing the money
- Subsidies

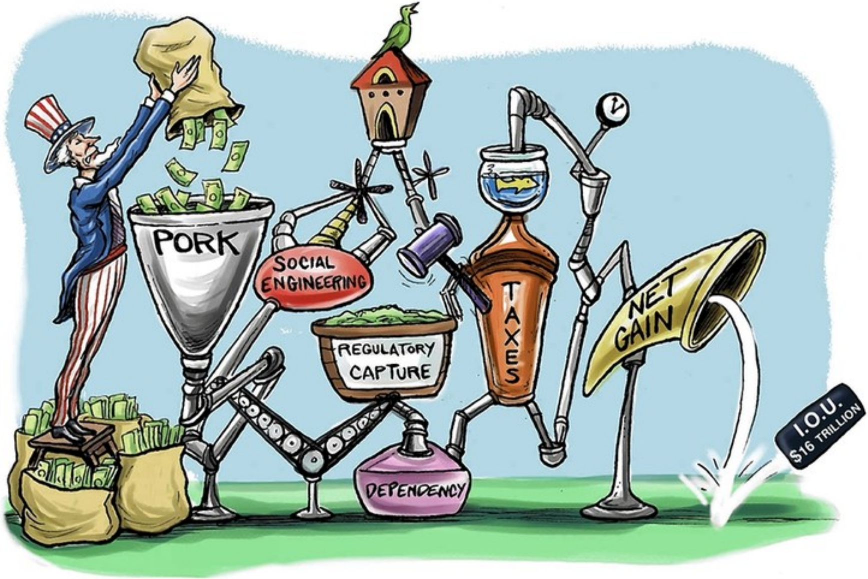
Map of the talk

1) The origin of the role of the government
   - From market failure to government failure
   - Analyzing the public sector

2) The economic foundation of the public intervention
   - Market efficiency and property rights
   - Market failure

1a. The origin of the role of the government

- From market failure to government failure


PORK
SOCIAL ENGINEERING
REGULATORY CAPTURE
DEPENDENCY
TAXES
NET GAIN
I.O.U. $16 TRILLION

Mercantilism : Promoting trade and industry

In eighteenth century the view that the government should promote trade and industry was dominant

Definition

Mercantilism is a national economic policy that is designed to maximize the exports of a nation.

Mercantilism was dominant in modernized parts of Europe from the 16th to the 18th centuries before falling into decline, although some commentators argue that it is still practiced in the economies of industrializing countries in the form of economic interventionism.

Laissez faire doctrine

Smith in the *Wealth of nations* (1776) developed a theory in which the profit motive and the search of private interest serve the public interest, a theory in which there is a limited role of the government.

with the *Invisible hand* "Only firms that produced what was wanted at a low price as possible would survive".

John Stuart Mill and Nassau Senior propose the doctrine known as "laisser faire". In their view, the government should not attempt to regulate or to control private enterprise. Unfetered competition would serve the best interest of society.

Marx, private capital and the working class

Marx, Sismondi and Robert Owen attributed the evil in society to the private ownership of capital. They suggested ways in which society might be reorganised, and particularly a greater role for the state in controlling the means of production.

Also, an abondant literature about the plight of the working class in novels (such those written by Dickens)

The consequence of the Great Depression

The Great Depression had devastating effects in countries both rich and poor.

- Unemployment rate > 25 %
- National output fell by > 15 % (30% for some autors, by comparison, in the 2008 crisis, it fell by 1%).
- International trade plunged by more than 50% and a series of competitive protection measures
- Crop prices fell by about 60 %.
- Wages fell with employment, but instead of generating adjustment and recovery, the crisis deepened and deepened.
- Many lost virtually all their money, Elderly people pushed into poverty, defaults of farmers,

Widespread view that markets had failed in an important way.

- Idea that government should do something about this market failure.

The Keynesian solution

The government could do something about economic slumps

The solution required the active intervention of the state (especially the national government) to stimulate a growth in productivity and output. Partly this could be achieved, Keynes thought, through a high wage policy which would force the restructuring of industry around the firms with the highest productivity (low productivity, high cost firms would be forced out of business). Partly it could be sought through an expansion of government expenditure (with accompanying accommodating monetary policy) which, by enlarging the market, would induce firms to increase investment, employment and output Ñall of which would allow higher wages.

Keynesianism amounted to a generalization and institutionalization at the national level of an insight developed some years earlier by Henry Ford saying that wages were essential to the growth and expansion of consumption oriented production

New Deal and War on Poverty

In addition to the role of stabilizing economic activity, the federal government passed legislation designed to alleviate many risks, among which :

- unemployment insurance
- social security
- federal insurance for depositors
- fixed agricultural prices

Later on, given arising inequalities, President Johnson in the sixties implemented programs either providing a "safety net" or ameliorating education

- Programs to provide food and medical care to the poor
- Job retraining program and Head start

Succes and failure of public policies

Medicaid	narrows the difference in access to medical car, not the gap between the life expectancy between indigent and the population
Medicare	provided the aged economic security but left a national problem of increasing medical expenditure, that casts doubts on whether future generations will be able to enjoy the same benefits
War on Poverty	50 years after the actions began, poverty has not been eradicated from America

- Many programs designed to alleviate the perceived inadequacies of the market economy have had effects markedly different from those their proponents anticipated.

Government failure

Government failure, in the context of public economics, is an economic inefficiency caused by a government intervention, if the inefficiency would not exist in a true free market.

Urban renewal program	...
Homelessness	...
Farm programs	...

The idea of government failure is associated with the policy argument that, even if particular markets may not meet the standard conditions of perfect competition required to ensure social optimality, government intervention may make matters worse rather than better.

- Allegations that government welfare programs have contributed to the breakup of families and to the development of an attitude of dependancy provided part of the rationale for the massive overhaul of the welfare system in 1996

Government failure 's Analysis

Under Stiglitz analysis, “there are four major reason for the systematic failure of the government to achieve its stated objectives :

1. the government’s limited information

   The consequences of many actions are difficult to foresee, for instance the health demand in Medicare

2. its limited control about private responses to its action

   for instance inability to control the health supply in Medicare

3. its limited control about the bureaucracy

   bureaucrats, agencies devoted to implement programs may have bad incentives

4. the limitations imposed by the political process”

   The electorate often has a penchant for looking for simple solutions to complex problems

Balance between the public and private sectors

Principle

The recognition of the government limitations implies that government should direct its energy only at areas in which market failure are most significant and where there is evidence that government intervention can make a significant difference ;

One view is that the government should take an active role in maintaining full employment and alleviating the worse aspects of poverty, but private entreprise should play the central role in the economy.

1b. The origin of the role of the government

- Analyzing the public sector

Methodology to analyze a public policy

There are four stages for analyzing the activity of the government :

1. knowing what activities the public sector engage in and how these are organized

   Understanding the different expenses allocated for some policies, in various sectors

2. understanding and anticipating the full consequence of these governmental activities

   Understanding the different chanels and consequences of the introduction of a tax

3. Evaluating alternative policies

   To analyze the differents objectives of a policy and its criteria

4. Interpreting the political process

   Economists emphasize the importance of economic incentives in the behavior of participants in the political process and therefore of self-interest in determining outcomes.

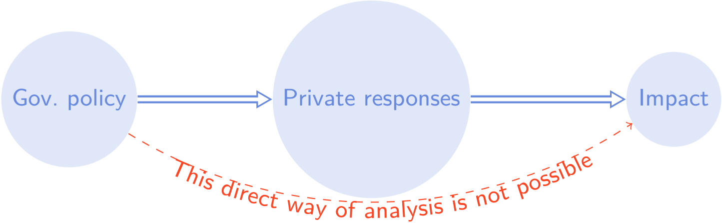
Understanding the economics essential to analyze a public policy

To make predictions about what the consequences of a particular change in policy will be, economics build models.

Definition

A *model* is a theoretical construct representing economic processes by a set of variables and a set of logical and/or quantitative relationships between them.

All analysis involves the use of models, of simple hypothesis concerning how individuals and firms will respond in various change in government policy, and how these responses will interact to determine the total impact on the economy



An analysis example

Consider the positive and normative aspect of a proposal to levy a \$1 per-case tax on beer.

- Positive economics would describe the effect the tax would have on the price of beer – would the price rise by the full \$1 or would producers absorb some of the price rise ?

  On the basis of that analysis, economist would go on to predict how how much beer consumption would be reduced, and who would be affected by the tax. They might find that since lower-income individuals spend a larger fraction of their income on beer, these people would be affected proportionally more. Studies may be have indicated that there is a systematic relationship between the quantity of beer consumed and road accidents. Using this information, economists might attempt to estimate how the beer tax would affect the number of accidents.

- Should the tax be adopted ? This is a normative question.

  In responding to it the economists will weight the benefits of the tax revenue, the distorsions it in consumption, the inequities caused by the fact that proportionately, more of the tax is borne by lower income individuals, and the lives saved in road accidents.

Disagreements among economists

Disagreements arise in two broad areas

- about the consequences of policies (positive analysis)

  Economists disagree about the best model to describe the public policy, and then also, on the magnitude of the effects

- about the values (normative analysis)

  Even if there is a full agreement on the effects of a policy and their size, there may be disagreement about whether the policy is desirable. Indeed, a policy may implement different trade-offs, have desirable consequences and undesirable ones. Individual may weight these consequences in different ways. On those questions there is no more unanimity among economists than there is among philosophers.

  Back to the definition and debates about the SWF

2a. The economic foundation of the public intervention

- Market efficiency and Property right

Pareto efficiency, exchange efficiency, production efficiency

By nature, efficiency includes the link between consumption and production. We broaden the definition of Pareto optimal allocation, by specifying what is exchange efficiency (which concerns the distribution of goods) and production efficiency.

Definition

Given a particular set of available goods, *exchange efficiency* provides that those goods are distributed so that no one can be better off without someone else being worse off.

Definition

An economy is not *productively efficient* if it can produce more than one good without reducing production of the other goods.

- Pareto optimality needs both exchange and production efficiency.

Pure and perfect competition

Pure and perfect competition is a theoretical market structure in which the following criteria are met :

- all firms sell an identical product (the product is a "commodity" or "homogeneous") ;
- all firms are price takers (they cannot influence the market price of their product) ;
- market share has no influence on price ;
- buyers have complete or "perfect" information – in the past, present and future – about the product being sold and the prices charged by each firm ;
- resources such a labor are perfectly mobile ; and firms can enter or exit the market without cost.
  - Perfect competition is a benchmark to which real-life market structures can be compared.

Market equilibrium - First theorem of welfare

Interactions between economic agents are analyzed through equilibrium concepts. Those concepts encompass some idea of stability and compliance of the supply side with the demand side.

Definition

Markets are said *to be at the equilibrium* if the quantity supplied for every product or service, including labor, equals the quantity demanded at the current price.

- Perfect competition provides both allocative efficiency and productive efficiency :

Theorem I

The *first theorem of welfare* states that under pure and perfect competition, a market will tend toward a competitive equilibrium that is Pareto optimal.

Implications of the First theorem of welfare

The first theorem is often taken to be an analytical confirmation of Adam Smith's "invisible hand" hypothesis, namely that competitive markets tend toward an efficient allocation of resources. The theorem supports a case for non-intervention in ideal conditions : let the markets do the work and the outcome will be Pareto efficient. However, Pareto efficiency is not necessarily the same thing as desirability ; it merely indicates that no one can be made better off without someone being made worse off.

However, there can be many possible Pareto efficient allocations of resources and not all of them may be equally desirable by society. It is the reason why we cannot be satisfied by the first theorem, without the second theorem of welfare

Redistribution and second theorem of welfare

Every Pareto optimal allocation can be obtained through markets, provided that there is the appropriate redistribution of initial endowment.

Theorem II

The *second theorem of welfare* states that out of all possible Pareto optimal outcomes one can achieve any particular one by enacting a lump-sum wealth redistribution and then letting the market take over.

This appears to make the case that intervention has a legitimate place in policy – redistributions can allow us to select from all efficient outcomes for one that has other desired features, such as distributional equity. The shortcoming is that for the theorem to hold, the transfers have to be lump-sum and the government needs to have perfect information on individual consumers' tastes as well as the production possibilities of firms. An additional mathematical condition is that preferences and production technologies have to be convex.

Prior condition to efficiency : property rights

For markets to work, there needs to be a government to define the property rights and enforce contracts.

In the former communist countries, property rights were not well defined, so people had inefficient incentive to maintain or improve their apartments. In market economies, the benefits of such improvements are reflected in the market price of the property.

At a primitive level, unless there is protection of private property, people will have insufficient incentive to save and invest, since their saving could be taken away.

Goverment activities aims at protecting citizens and property, enforcing contracts, and defining property rights can be thought as providing the foundations on which all market economies rest.

2b. The economic foundation of the public intervention

- Market failure

There is often dissatisfaction with markets. Some of the dissatisfaction is of "the grass is always greener on the other side" variety : people like to think that an alternative way of organizing the economy might make them better off.

What are the principal reasons why markets fail to produce efficient outcomes ?

What role does government play in making it possible for markets to work at all ?

Why might the government intervene in the market's allocation of ressource, even when it is Pareto efficient ? What are merit goods ? What is government role of redistribution ?

Conditions of market failure

Six conditions under which markets are not Pareto efficient :

1. Failure of competition

   fi when firms are not price makers, they will lower the quantity of produced goods.

2. Public goods

   some goods that are not produced by the market or in insufficient quantity/ npr

3. Externalities

   the ressource allocation provided by the market is inefficient, as individual do not bear the cost of negative externality

4. Incomplete markets

   whenever private markets, doing a poor job, fail to provide some goods and service, even though the cost of providing it is less than the individual are willing to pay.

5. Information failures

   fi when firms are not price makers, they will lower the quantity of produced goods.

6. Unemployment, disequilibrium and inflation