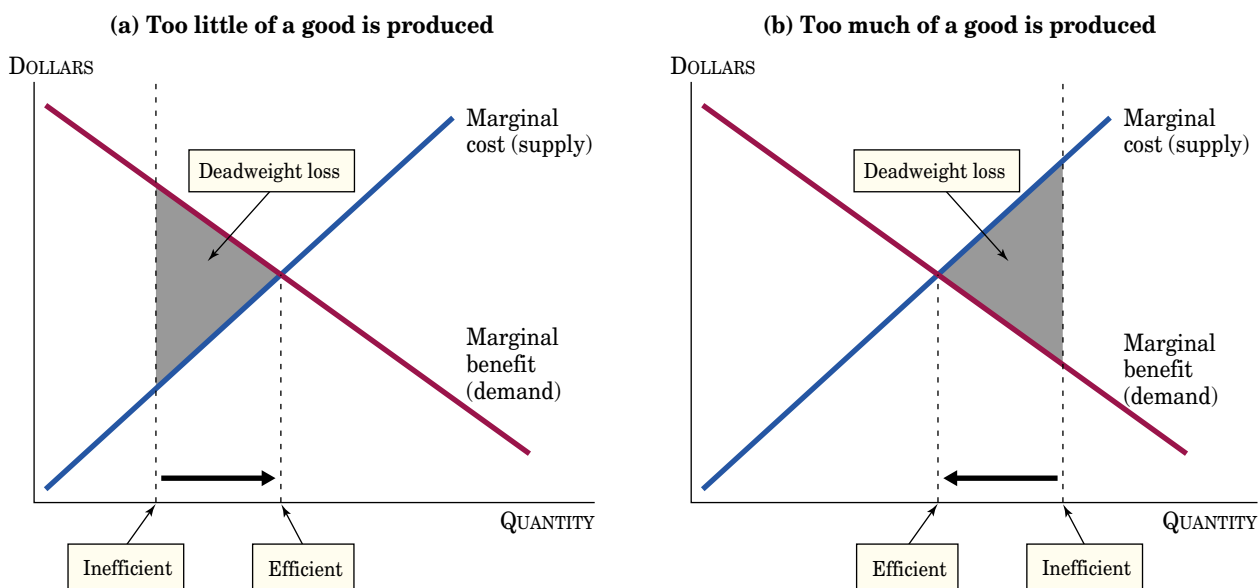


ADDITIONAL TOPICS CHAPTER 15

Models of government behaviour

The previous sections have outlined what government should do to correct market failure. Regardless of the reason market failure occurs, the outcomes are similar: Production may be too little or too much, and producer surplus plus consumer surplus is not maximised as shown in figure 15.1. The result is deadweight loss, and the role of government is to change the level of production or employment so as to increase producer surplus plus consumer surplus. Using economics to explain the role of government in this way is considered a *normative* analysis of government policy. Recall that normative economics is the study of what *should* be done. But there is another way to look at government policy. It falls into the area of *positive* rather than normative economics and looks at what governments *actually* do rather than at what they should do.



One of the reasons for studying what governments actually do is that frequently the normative recommendations are not followed or government performs its role poorly. *Government failure* occurs when the government fails to improve on the market or even makes things worse. Sometimes government fails and sometimes it succeeds. One objective of positive analysis of government is to understand why there is success and failure in different situations.

Public choice models

Government itself is run by people. Government behaviour depends on the actions of voters, politicians, public servants and political appointees from judges to Cabinet officials. The work of government also depends on the large number of people who work in political campaigns, who are active in political parties, who lobby and who participate in grassroots campaigns from letter writing to e-mail messages to political protests. Government organisations exist at the State and local levels as well as the federal level. What motivates the behaviour of all these people?

FIGURE 15.1
Summarising the effects of market failure

Market failure results in (a) too little or (b) too much production of a good. When there is market failure, there is a role for government to provide incentives to change the market outcome and thereby reduce the deadweight loss.

The motivations of politicians and government workers are complex and varied. But the basic principle of economics that people try to improve their wellbeing given limited resources should apply to politics and government, as well as to consumers and firms. Many people enter politics for genuine patriotic reasons and are motivated by a desire to improve the wellbeing of people in their city, State, country, or even the world. Their motivations may be deeper than watching out for their own best interests, narrowly defined. But the desire to get elected, or to get votes on proposed legislation after being elected, is also part of the motivation of all politicians, and this often results in political deal making and compromise.

Economic models of government behaviour are called public choice models. They start from the premise that politicians are motivated by increasing their chances of getting themselves or the members of their party elected or re-elected. And without explicit incentives to the contrary, government workers are presumed to be motivated by increasing their power or prestige, partly through increasing the size of their department or by getting promoted. By understanding this self-interest motivation, we can learn much about government, including the reasons for government failure and the reasons for government success.

Economic policy decisions through voting

Let us first examine how voting is used to make economic policy decisions in a political environment. We will use the assumption of public choice models: that getting elected is the primary motivation of politicians.

Single issues with unanimity

Let us start with the easiest case: there is only one economic policy decision to be made and all the voters agree what it should be. For example, suppose that the issue is spending on national defence, a public good where the government has a key role to play according to the normative economic analysis discussed earlier.

Suppose that everyone agrees that a level of national defence around 4 per cent of GDP in Australia is appropriate, in the absence of major world political changes. In reality, of course, opinions differ greatly about the appropriate level. But suppose that by looking at history or making international comparisons or by listening to experts on defence and world politics, everyone agrees that 4 per cent of GDP is the right amount to spend.

Under these circumstances when there is only one issue on which all voters agree, voting will lead to the actions that everyone prefers, that is, 4 per cent, even if politicians are motivated by nothing other than getting elected. Suppose that one politician or political party runs for election with a policy of 40 per cent defence spending and that the other argues in favor of 2 per cent; clearly, the party with 2 per cent will win because it is much closer to the people's views. But then the other politician or party would see the need to move towards the consensus, to run on a 5 per cent spending platform; if the other party stays at 2 per cent, then the higher-spending party will win. But clearly the other party will then try to get closer to 4 per cent, and eventually 4 per cent will be the winner.

This example shows that the political system yields the preferred outcome. Of course after being elected, the politician might break the promise of the campaign. But if such a change cannot be justified on the basis of a change in circumstances, that politician may have difficulty getting re-elected.

The median voter theorem

What if people have different views? Suppose there is no unanimity about 4 per cent defence as a share of GDP. Instead the country consists of people with many

different opinions. Some want more than 4 per cent; some want less than 4 per cent. Suppose that about half of the people want more than 4 per cent and half want less than 4 per cent; in other words, 4 per cent is the desire of the *median voter*.

If there is only one issue, there will be convergence of positions of the politicians or the parties towards the median voter’s belief. For example, if one party or politician calls for 7 per cent spending and the other party calls for 4 per cent, then the party calling for 4 per cent will attract more voters. Clearly, more than half of the voters are closer to 4 per cent than to 7 per cent. The median voter theorem predicts that the politicians who run on what the median voter wants will be elected. The views of the people at the extremes will not matter at all.

Convergence of positions in a two-party system

An interesting corollary to the median voter theorem is that political parties or politicians will gravitate towards the center of opinion — towards the median voter. For example, in the case of national defence it makes no sense for any politician to run on a 40 per cent recommendation. The parties will gravitate towards the median voter. This convergence of positions may explain the tendency for Liberal and Labor politicians to take similar positions on many issues.

Voting paradoxes

When there are many different issues — defence, taxes, welfare, health-care reform — and people have different opinions and views about each issue, the outcome of voting becomes more complicated. Certain decision-making problems arise. The simple example of the voting paradox illustrates some of these problems.

Suppose three voters have different preferences on three different economic policy options, A, B and C. Ali likes A best, B second best and C the least; Greg likes B best, C second best and A the least; and Esther likes C best, A second best and B the least. The three policy options could be three different levels of defence spending (high, medium and low) or three different pollution control plans (emission taxes, tradable permits or command and control). Table 15.1 shows the three voters and their different preferences about each issue.

RANKING	ALI	GREG	ESTHER
First	A	B	C
Second	B	C	A
Third	C	A	B

In voting on one option versus another, we get:

- on A versus B — A wins 2 to 1
- on B versus C — B wins 2 to 1
- on A versus C — C wins 2 to 1

Paradox because A wins over B and B wins over C, yet C wins over A

Table 15.1
Preferences that generate a voting paradox

Consider three different elections held at different points in time, each with one issue paired up against the other. First, there is an election on A versus B, then on B versus C, and then on C versus A. The voting is by simple majority: the issue with the most votes wins. When the vote is on the alternatives A versus B, we see that A wins 2 to 1. That is, both Ali and Esther like A better than B and vote for it, while only Greg likes B better than A and votes for B. When the vote is on B versus C, we see that B wins 2 to 1. Finally (this vote might be called for by a frustrated Esther, who sees an opportunity), there is a vote on C versus A, and we see that now C wins 2 to 1. Although

it looked like A was a winner over C — because A was preferred to B and B was preferred to C — we see that in the third vote C is preferred to A; this is the paradox.

The voting paradox suggests there might be instability in economic policies. Depending on how the votes were put together, the policy could shift from high defence to medium defense to low defence, or from one pollution control system to another, then to another, and then back again. Or taxes could be cut, then raised, and then raised again. All these changes could happen with nothing else in the world having changed. We could even imagine shifting between different economic systems involving different amounts of government intervention — from communism to capitalism to socialism to communism and back again!

This particular voting paradox has been known for two hundred years, but it is only relatively recently that we know that the problem is not unique to this example. Kenneth Arrow showed that this type of paradox is common to any voting scheme. That no democratic voting scheme can avoid the inefficiencies of the type described in the voting paradox is called the Arrow impossibility theorem.

The voting paradox suggests a certain inherent degree of instability in decisions made by government. Clearly, shifting between different tax systems frequently is a source of uncertainty and inefficiency. The voting paradox may be a reason for government failure to arise in cases where the government takes on some activity such as correcting a market failure.

Special interest groups

The voting paradox is one reason for government failure. Special interest groups are another. It is not unusual for special interest groups to spend time and financial resources to influence legislation. They want policies that are good for them, even if the policies are not necessarily good for the country as a whole. For example, look at the agricultural industry in the European Union, which has a great deal of government intervention. What is the explanation for the intervention? If you look back at the reasons for government intervention — income distribution, public goods, externalities — you will see that they do not apply to the agricultural sector. Food does not fit the definition of a public good, and many European farmers who benefit from the intervention have higher incomes than other people in the society who do not benefit from such intervention. One can thus view this government regulation of agricultural markets as a form of government failure.

Concentrated benefits and diffuse costs

One explanation for government failure in such situations is that special interest groups can have powerful effects on legislation that harms or benefits a small group of people a great deal but affects most everyone else only a little. For example, a subsidy of \$20 million a year to a small number of firms would only cost Australians about \$1 per person per year. Thus, the small cost is hardly enough for each consumer to spend time lobbying the government. However, the payments are certainly worth the firms' effort to travel to Canberra and to contribute to some political campaigns. When the costs are spread over millions of users and the benefits are concentrated on only a few, it is hard to eliminate government programs. Those who benefit have much more incentive to lobby and work hard for or against certain candidates. Thus the process of obtaining funds for election or getting support from the powerful interest groups can have large effects on policy.

Wasteful lobbying

There is another economic harm from special interest lobbying. It is the waste of time and resources that the lobbying entails. Lobbyists are usually highly talented

and skilled people, and millions of dollars in resources are spent on lobbying for legislation or other government actions.

In many less-developed countries, where special interest lobbying is more prevalent than in Australia, such activity occupies a significant amount of scarce resources.

Time inconsistency

Another possible source of government failure is time inconsistency. It occurs when government officials make statements or pass laws regarding future policy actions. People then make decisions and take actions with certain expectations regarding these government policies. In such situations there is frequently an incentive for the government to change the policy in the future from what was stated originally. A change in policy from what was originally announced is called time inconsistency.

For example, a local government might say that it has no intention of building a dam to protect a flood plain, and, therefore, people should not build their homes on the flood plain. But suppose that people start building their houses on the flood plain anyway, perhaps anticipating that the government will not do what it says. Once the houses are built and a community with schools, playgrounds, and offices has been established, a rainy season with flooding will make it likely that the government will build a dam despite its earlier policy. In other words, the government changes its policy. In fact, if you think about it for a while, you will realise that the government cannot commit itself to such a policy, and it makes perfect sense for people to assume that the government will change its mind and in fact build the dam. Whether it is because different politicians will be in charge in the future, or because it is hard to say no in the face of human misery, the government has difficulty committing itself to policies in the future. If the government could commit, then the policy would be much better. People would find almost as nice places to live away from the flood plain and the taxpayers would save millions by not having to build the dam. The challenge of dealing with the time inconsistency problem is to find ways for the government to develop a mechanism of commitment or to establish a higher degree of credibility.

Incentive problems in government

In any large government, many of the services are provided by public servants rather than politicians and political appointees. In fact, it was to avoid the scandals of the spoils system, in which politicians would reward those who helped in a political campaign with jobs, that the public service system set rules to protect against firing and established examinations and other criteria for job qualifications.

But what motivates government managers and workers? Profit maximisation as in the case of business firms is not a factor. Perhaps increasing the size of the agency or the department of government is the goal of managers. But simply increasing the size of an agency is not likely to result in an efficient delivery of services. Profit motives and competition with other firms gives private firms an incentive to keep costs down and look for innovative production techniques and new products. But these incentives do not automatically arise in government. For this reason, it is likely that the government service, whether a public good or a regulation, will not be provided as efficiently as a good provided by the private sector. Rewarding government workers for providing high-quality service, perhaps through performance-related pay, could address this problem by creating incentives.