

Lecture XI: Government Failure, Policy Uncertainty, and Theory of Public Choice (I)

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1 Government Failure and Policy Uncertainty

2 Theory of Public Choice I

- Organization of Human Activity
- Economic Theory of Constitutions
- A Little Modern Welfare Economics – More Later
- Rule of Unanimity

Government Failure and Policy Uncertainty

- Governments are limited in their ability to maintain long-term contracts with farmers.
- Thus, farmers make production and marketing decisions under policy uncertainty.
- Gross Revenue Insurance Program (GRIP) in Canada; the policy was sold to farmers as a long-term program to stabilize income, but it was quickly abandoned for political and economic reasons.
- The important point, however, is that farmers were faced with increased government-induced uncertainty.
- This government failure was costly to farmers who committed resources to their farms based on promises made under the 1991 GRIP program.

Government and Market Failure

- One argument that favours government intervention is that there is a need to reduce resource misallocation, societal losses, and market failure resulting from the fixity of agricultural assets. Johnson and Pascur (1982), however, have cast doubt on the efficacy of government intervention for this purpose. They argue that where institutions of the real world are concerned, government failure is as inevitable as market failure. Consequently, market failure does not warrant public intervention unless it can be demonstrated that there would be a superior outcome after allowing for the likely degree of government failure (Roberts et al. 1989: 150).

Public Choice Theory – Buchanan and Tullock

- Buchanan, J.M and G.Tullock. 1962. *The Calculus of Consent: Logical Foundations of Constitutional Democracy* Ann Arbor, Michigan: University of Michigan Press.
- Basic question – why do we “vote” on government (corporate) action?
- First, let us assume that there exists a outcome that imposes a cost on individuals which is cannot be addressed in the “market” (free interpersonal exchange).
- Assume that there are three different types of action with different costs:
 - a – personal action
 - b – a collective, but voluntary action (i.e., form a group to make a contract)
 - g – government action

Six Different Rankings

- | | |
|-----------------------|-----------------------|
| 1. $\{a \leq b < g\}$ | 4. $\{b < g < a\}$ |
| 2. $\{a < g < b\}$ | 5. $\{g < a \leq b\}$ |
| 3. $\{b < a < g\}$ | 6. $\{g < b < a\}$ |

- First, we assume that $a > 0$, if $a \leq 0$ there is no real question.
- Anytime a is the smallest cost – choose a (e.g., 1 and 2).
- $\{b < a < b\}$ – “Here the costs from the organization of the activity through voluntary arrangements are expected to be less than those imposed by purely individualistic action, which are, in turn less than those expected by collective organization.”

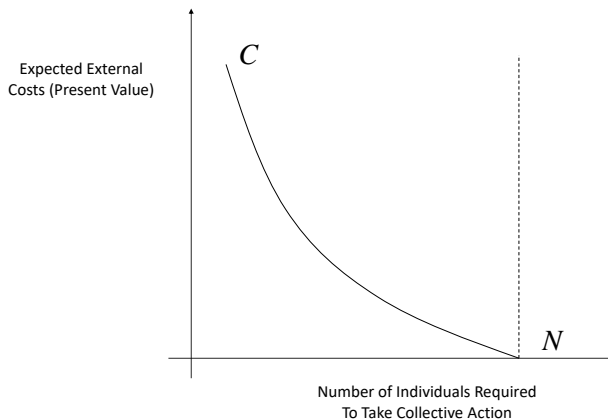
Six Different Rankings, Continued

- “The fourth ordering ($b < g < a$) describes the individual assessment This set is perhaps more important than the third for our purposes, since more controversial issues relating to possible collectivization may be expected to arise in the discussion of activities falling within this set. The individual expects that voluntary co-operative action will be the most efficient means of organization, and also that arrangement will tend to arise which will prove sufficient to remove or reduce the external effects of private behavior, effects which may be slightly more serious here than in those activities described by the third ordering.”

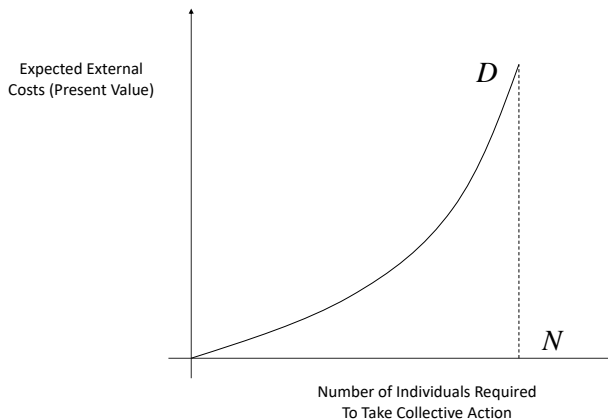
Six Different Rankings, Continued

- “The individual, at the time of the ultimate constitutional decision, should choose collective decision-making only for those activities that he describes by the fifth ($g < a \leq b$) and sixth ($g < b < a$) orderings.”

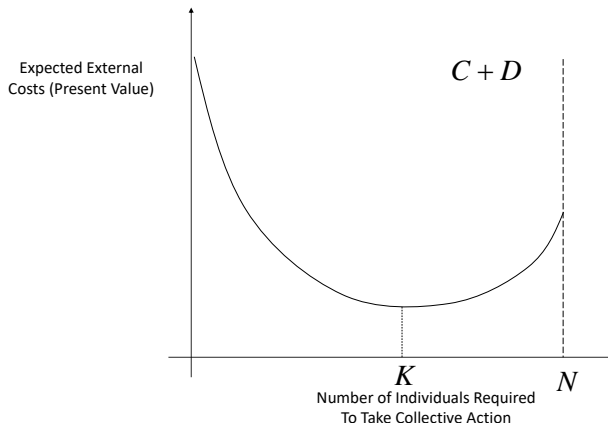
Cost of Outside Actors – Cost imposed by Non-Participants



Cost of Decision Making



Total Cost of Collective (Government) Action



A Little Modern Welfare Economics – More Later

- Pareto Principle – A Pareto improving action is one that makes at least one individual better off without making anyone else worse off.
- Compensation Principle – An action is welfare improving if the gainer could potentially pay the loser for the change.
 - In Agricultural Policy – if the farmers are made better off by a sufficient amount that they could pay the losers (consumers and tax payers) enough to offset their losses and still be ahead.

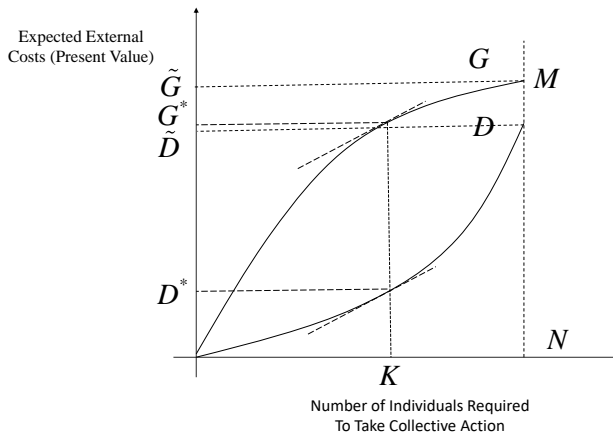
Initial Conclusions of Buchanan and Tullock

- “First of all, the analysis suggests that it is rational *to have a constitution*. By this is meant that it will be rational for the individual to choose more than one decision-making rule for collective choice-making under normal circumstance.”
- “Second, and most significant, implications of our analysis is that at no point in the discussion has it seemed useful or appropriate to introduce the *one* particular decision-making rule that has traditionally been associated with theories of democracy.”
- We have not found occasion to refer specifically to the rule of majority decision, or, in more definite terms, to the rule described by $(N/2 + 1)/N$.

Rule of Unanimity

- First, there is a similarity between the Pareto principle and a “Rule of Unanimity.”
- If everyone agrees to the action one could conclude that the vote makes at least one person better off, but no one worse off.

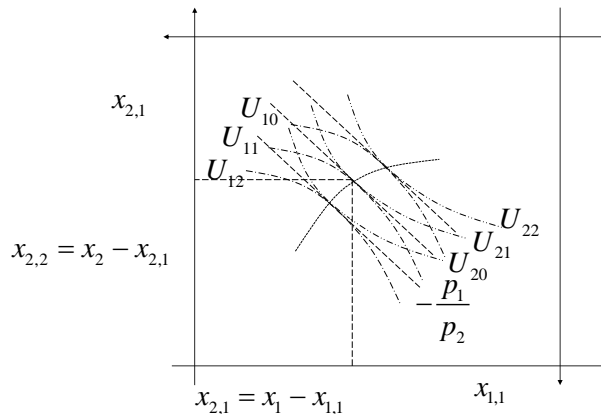
Cost of Unanimity



Some Side Comments on Unanimity

- “This single decision-maker rule acquires a unique position in our whole analysis which suggests that if costs of decision-making could be reduced to negligible proportions, the rational individual should always support the requirement of unanimous consent before political decisions are made.”
- The member of the dissident minority suffers external effects of collective decisions enforced on him, and, so long as there remains any possibility that the individual will be a member of such a minority, expected external costs will be positive, although collectivization may reduce the expected costs substantially below those that might be expected from unrestricted private action.

Edgeworth Box – Efficiency and Distribution of Income



Bargaining Core – No Price

