

Government Failure

In welfare economics, a *market* failure is not simply a market outcome that someone does not like. Rather, it is when the competitive price system fails to allocate resources efficiently, where this usually refers to a violation of Pareto optimality. One example might be the provision of goods that are systematically underpriced in a competitive market because not all the costs associated with private transactions are internalized. Other market failures include the under-provision of certain goods in a competitive market because of the lack of adequate monetary incentive, or because of collusive agreements among market providers to restrict supplies in order to extract economic rents. Similarly, a *government* failure is not simply a government outcome that someone does not like. Rather, it occurs when government decision-making about whether or how to allocate social resources violates Pareto optimality. An active government failure occurs when government intervention leads to an outcome that is less efficient than if the government had done nothing. A passive government failure occurs when the government's failure to act leads to a Pareto inferior outcome. Therefore, the existence of a passive government failure may suggest the existence of a market failure, as well.

"Market" and "government" in market and government failures identify where the failures happen. The Pareto inferiority is the result of an institutional structure: either one making use of a free, competitive market or one that involves a government process, like bureaucratic deliberation and voting. It is probably misleading, however, to suggest that they necessarily identify the type of decision-making or allocative processes at work. This is because it may be possible to have market outcomes that result from bureaucratic processes, like those in a large hierarchical firm, and government outcomes that result from the operation of a price system, like competitive wage rates for government functionaries.

The development of theories of government failure was closely aligned with the development of public choice theory. Public choice economists apply the tools and assumptions of economic analysis to understand and explain the behavior of government actors. Their ideas developed in response to two kinds of arguments about government action. The first assumes that government actors are genuinely benevolent and reliably motivated to promote the common good. Public choice theory shows that you can generate better predictions of government behavior by assuming that people holding government offices are people of normal good will and largely motivated by self-interest. The second argument is based on microeconomic models that identify market failures and present centralized government interventions to correct them. In response, public choice theorists identified sources of inefficiency in government decision-making processes, or government failures. Arguments dealing with the efficient provision of goods and services under different institutional arrangements – where either a market, the government or some collective hybrid mechanism accounts for their provision – have also featured in new institutional economics.

While there are analogies between them, the idea of a government failure does not derive from market failure. Rather, markets and governments attempt to organize various aspects of human activity. Sometimes those attempts lead to failure. Government failures are therefore a range of problems that arise in governments' attempts to organize groups of people. The somewhat surprising upshot of this body of scholarship is that the failure of individual characters in governments are significantly less important than the failure of the system of organization that stems from the logic of choice, incentives and constraints characteristic of that system. This means that we can expect that almost anyone who occupied the same role to act like "bad" government actors do.

There are several well-theorized sources of government failure. Each of the following are thought to raise problems for governments' attempts to organize human activity: aggregating a set of individual preference rankings into a coherent social welfare function; the logic of collective activity that either prevents a group from securing a common interest or allows a well-organized minority to dictate to the majority; informational constraints on the political process that prevent rational centralized decision-making; principal-agent problems between the public and elected officials or between elective officials and high-level bureaucracies that make it difficult to hold them in check; other institutional barriers to the efficient allocation of society's resources; and a dynamic that leads to inefficient levels of government intervention and power and ways that this power can be used to secure illicit rents.

There are several well-theorized examples of these sources of government failure. Cases of corruption involve government officials using their control over public resources to advance private ends. For example, an official may be in charge of some project and solicit bribes in exchange for granting the government contract supporting it. The problem with this and any other case of government failure is not that it is immoral, though it is. The problem is that, e.g., extending a contract on the basis of someone's willingness to provide a bribe will almost certainly violate Pareto optimality.

Similarly, principal-agent problems will allow government officials to either avoid performing their duties or prioritize their own interests over those they have a responsibility to. The same phenomenon is seen in large private hierarchical organizations. In corporate firms this problem is primarily the result of the separation of ownership and control and the difficulty of effectively monitoring the behavior of the agent or aligning her interests with those of the principal. Public choice theorists argue that, in a similar way, ineffective monitoring permits politicians to benefit themselves at the expense of their constituencies. Individual losses among members of the public may be quite small. In fact, that they are small explains the ineffective monitoring since their losses escape their notice. Therefore, their ignorance about who it is best for them to vote for, what policies are best for them to support, or who might be taking advantage of them is rational. But in the aggregate, their total losses will tend to be much greater than the benefit their agent consumes in the form of rents.

This dynamic of concentrated benefits and dispersed costs figures into accounts of regulatory capture and other forms of rent-seeking behavior. When political actors have a great deal of discretionary power, this generates powerful incentives for an industry or some of its members to use whatever means available to influence the decision-making process. They might convince the regulatory agencies to permit certain profit-enhancing externalities or provide economic protection from foreign or domestic competitors. These high stakes provide incentives to win influence that are much stronger than anything that would induce an individual citizen organize with others to help keep the regulatory agency's activities in line with the public interest.

One major thrust of public choice analyses of government failure is to be on guard against committing the Nirvana fallacy. This is where someone makes use of a comparison between an ideal representation and the real world in an argument for some position. Gordon Tullock would use an ancient fable to present the problem: a Roman Emperor is asked to award a prize to one of two contestants in a singing competition. The first contestant sings and the Emperor immediately awards the prize to the second contestant because, the Emperor argues, she obviously could not be any worse a singer. The problem is that this is not obvious at all. Just like the first singer's poor performance does not necessarily justify giving the award to the second, the fact that a market is functioning imperfectly does not necessarily justify introducing a government intervention. The fact that a policy, if expertly tailored and benevolently administered, would make things better is not, by itself, a good reason to implement it.

The following syllogism makes the mistake in the Nirvana fallacy even more obvious:

1. In a range of circumstances, markets constrained by interventionist policies administered by morally and informationally perfect people would have better outcomes than markets free of any interventions.
2. In those circumstances, actually implementing those interventionist policies administered by morally and informationally perfect people would have better outcomes than the market free of any interventions.
3. Therefore, we should implement the interventionist policies.

This risks caricature, but public choice and new institutional economists have simply pointed out that 3 does not follow from 1 and 2.

This lesson, and even many sources of government failure, was acknowledged by, of all people, Cambridge welfare economist A.C. Pigou, who is the patron saint of market failure theorists. As early as 1912 in *Wealth and Welfare*, he wrote, "It is not sufficient to contrast the imperfect adjustments of unfettered private enterprise with the best adjustments that economists in their studies can imagine. For we cannot expect that any State authority will attain, or even whole-heartedly seek, that ideal. Such authorities are liable alike to ignorance, to sectional pressure, and to personal corruption by private interest." Obviously, government failure theorists do not argue that market failures never occur. The claim is that even when markets fail – even when real-world markets do not meet the standard modeling assumptions that ensure

perfect competition and Pareto optimality – government intervention may make things worse. The government is, at best, another tool societies can sometimes use to good effect. It is not a Deus ex machina that societies can rely upon to swoop in, resolve a problem and bring about a happy ending.

The possibility of government failure should militate against the tendency to compare the reality of unregulated markets with an idealized implementation of government control in order to argue for interventionist public policy. The Nirvana approach presents a false choice between an ideal and whatever status quo institutional arrangement is being criticized. The relevant choice requires thorough investigation of alternative real-world institutional arrangements to determine which one, among those that are feasible, is likely to have the best welfare effects. A world of perfectly competitive markets where the price of things is equal to their marginal cost is not available to us. Neither is a world where perfectly benevolent and wise politicians fix every market failure. Therefore, the relevant choice is between the messy real-world outcomes of unregulated markets and the messy real-world outcomes of regulated markets.

The new institutional economics proposes a potential third way. Examples of real-world institutional arrangements might actually surprise some economists in the way outcomes sometimes do not cooperate with standard microeconomic models. For example, the standard microeconomic analysis of public goods provision suggests that things like lighthouses would be under-provided by the market because of people's propensity to free ride. Someone might notice that ships need lighthouses and build with the hope of signing up paying users, but this arrangement would certainly fail because lighthouses are non-excludable and non-rivalrous. None of the ship owners would pay for the service. But, in fact, in 1820 about 75% of lighthouses on the English coast were built and operated by private parties because they could effectively limit access to their service by tying its use to entry into harbors. There, berths were excludable and fees were easy to collect. This example, first presented by Ronald Coase, has been challenged. Yet it, and many more like it, may suggest a sort of market resiliency where cooperative solutions to market failures emerge without government intervention because solutions are incentivized by mutual gains from trade.

Government failures do not seem to have this self-correcting feature, which may make them more serious problems. To correct a government failure there must be someone with the insight to devise a solution and the benevolence, courage and skill to see it through in the face of highly motivated political opposition.

– Kyle Swan

See also Buchanan, Jr., James McGill (1919-2013); Capitalism; Deadweight Loss; Ethics in Government Act; Externalities; Market Failure; Perfect Market and Market Imperfections; Pareto Efficiency; Political Economy; Public Choice Theory; Public Goods; Regulation and Regulatory Agencies; Rents, Economic

Further Readings

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