



The Economics of Collective Decision Making

Full Length Text — Part: 2 Chapter: 6
Micro Only Text — Part: 2 Chapter: 6
Macro Only Text — Part: 2 Chapter: 6


To Accompany "Economics: Private and Public Choice 12th ed."
James Gwartney, Richard Stroup, Russell Sobel, & David Macpherson
Slides authored and animated by:
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The Size and Growth of Government


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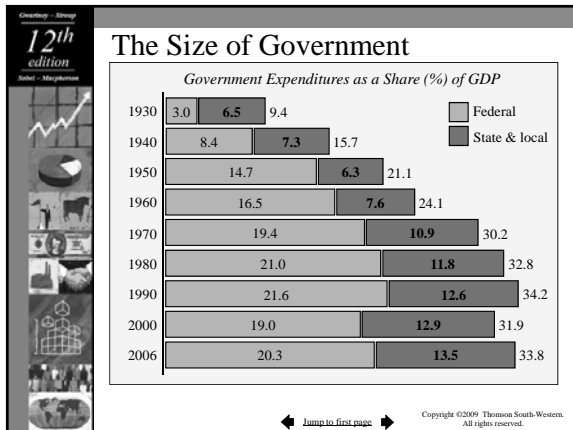


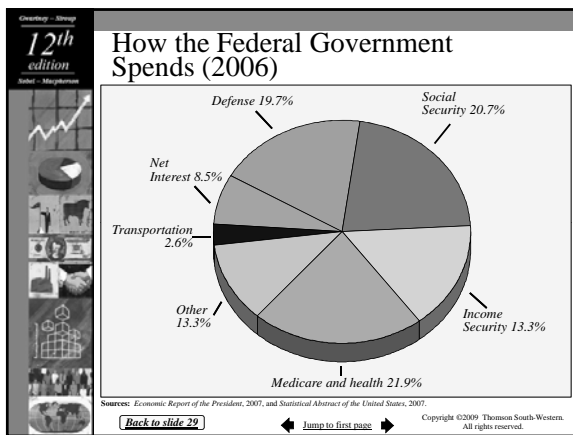
Government Spending as a Share of the Economy, 1930-2006

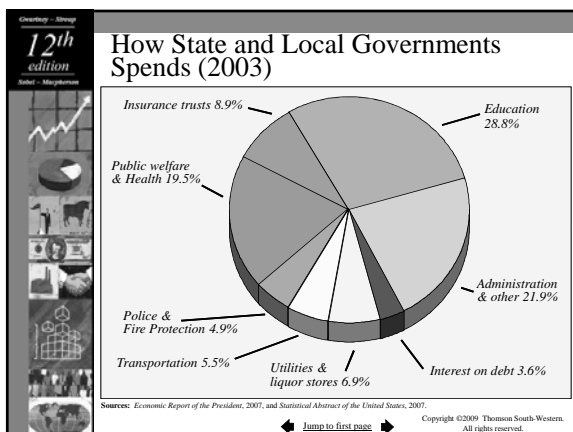
- The following slide shows total government spending (federal, state, and local) as a share of the economy.
- Total government spending accounted for only 9.4% of GDP in 1930, and only one third of this spending was at the federal level.
- Government spending, particularly at the federal level, soared from 1930 to 1970.
 - Total government spending rose from 9.4% of GDP in 1930 to 30.2% of GDP in 1970.
- Since 1970, government spending has been relatively constant at about one-third of the U.S. economy.

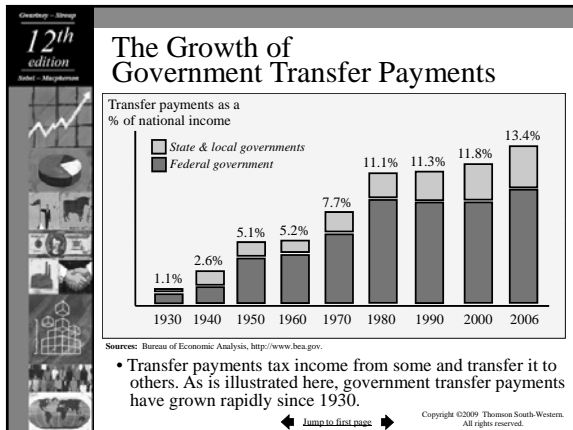
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Differences and Similarities Between Government and Markets


- Competitive behavior is present in both the market and public sectors.
- Public sector organization can break the individual consumption-payment link.
- Scarcity imposes the aggregate consumption-payment link in both sectors.
- Private sector action is based on mutual agreement; public sector (*when democratic*) is based on majority rule.

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Differences and Similarities Between Government and Markets

- When collective decisions are made legislatively, voters must choose among candidates who represent a bundle of positions on issues.
- Income and power are distributed differently in the two sectors.

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Political Decision Making: *An Overview*

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Public Choice Analysis

- **Public Choice analysis**
– applies the tools of economics to the political process in order to provide insight concerning how the process works.
- Self-interested behavior is present in both market and political sectors.
- The political process can be viewed as a complex interaction among:
 - voter-taxpayers
 - politicians
 - bureaucrats

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Public Choice Analysis

- The **Voter-Consumer**:
 - Voters will tend to support those candidates who they believe will provide them with the most government services and transfer benefits, net of personal costs.
- **Rational Ignorance Effect**:
Recognizing their vote is unlikely to be decisive, most voters have little incentive to obtain information on issues and alternative candidates.
- Because of the **rational ignorance** effect, voters will be uninformed on many issues; such issues will not enter into their decision making process.

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Public Choice Analysis

- The **Politician-Supplier**:
 - Political officials are interested in winning elections. Just as profits are the lifeblood of the market entrepreneur, votes are the lifeblood of the politician.
 - Rationally uninformed voters often must be convinced to "want" a candidate.
 - Legislative bodies are something like a Board of Directors. They ...
 - establish the general direction of policy,
 - appoint and supervise bureaucrats who carryout the day-to-day operations of government, and,
 - set the budgets of agencies and bureaus.

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Public Choice Analysis

- Civil servants (*government bureaucrats*) as political participants:
 - Bureaucrats (*persons that handle day-to-day operations of government*) seek promotions, job security, power, etc.
 - The interests of bureaucrats are often complementary with those of the interest groups they serve.
 - Larger budgets and program expansion generally serve the interests of both bureaucrats and their constituent groups.

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When Voting Works Well

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Benefits and Costs Among Voters

		Distribution of <i>benefits</i> among voters	
		Widespread	Concentrated
Distribution of <i>costs</i> among voters	Widespread	Type 1	Type 2
	Concentrated	Type 4	Type 3

- Consider how the 4 possible distributions of benefits and costs among voters affect the operation of representative government.
- When benefits or costs are either **both** widespread or concentrated (type 1 or type 3), representative government tends to undertake projects that are productive and reject those that are unproductive.

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Benefits and Costs Among Voters

		Distribution of <i>benefits</i> among voters	
		Widespread	Concentrated
Distribution of <i>costs</i> among voters	Widespread	Type 1	Type 2
	Concentrated	Type 4	Type 3

- When benefits are concentrated and costs widespread (type 2), representative government is biased towards the adoption of counterproductive (inefficient) activity.
- Last, when benefits are widespread but the costs are concentrated (type 4), the political process often rejects productive projects.

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When Voting Works Well

- Other things constant, legislators will have a strong incentive to support political actions that provide voters with large total benefits relative to costs.
- If a government project is productive, it will always be possible to allocate the project's cost so that *all* voters will gain.
- When voters pay in proportion to benefits received, all voters will gain if the government action is productive (and all will lose if it is unproductive). Under these circumstances, there is a harmony between good politics and economic efficiency.

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Benefits Derived by Voters from Hypothetical Road Project

Voter	Benefits received	Tax payment	
		Plan A	Plan B
Adams	\$ 20	\$ 5	\$ 12.50
Chan	12	5	7.50
Green	4	5	2.50
Lee	2	5	1.25
Diaz	2	5	1.25
Total	\$40	\$25	\$25.00

- Consider the government program above. With such programs, individuals receive varying levels of benefits.
- Plan A (each voter pays the same amount) is simple and may *seem* fair, but even as Adams is getting a deal (she values the program at \$20 and pays \$5) others do not even receive the value of their taxes.
- When each voter pays in proportion to benefits received (plan B), each receives more benefits than costs. If tax plan B is used, all voters gain and the program would pass unanimously. This example shows that harmony between politics and economic efficiency *can* exist.

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Questions for Thought:

- "The average person is more likely to make an informed choice when he or she purchases a personal computer than when he or she votes for a congressional candidate." -- Evaluate this statement.
- Does the motivation for political action differ from market action? Are people more greedy when they make market choices than when they make political choices?
- "Government action is based on majority rule, whereas market action is based on mutual consent." Is this statement true or false? Is this point important? Why or why not?


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Questions for Thought:

- Will efficient projects necessarily be favored by a majority of voters? Why or why not?
- When the cost of a project is allocated among voters in direct proportion to the benefits derived, will democratic political decision making tend to accept projects that are efficient? Will it tend to reject projects that are inefficient? Discuss.

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Questions for Thought:

6. (Which of the following is true) Market allocation and political process differ in that:


- (a) Competition is present in the market sector, but not in the political sector.
- (b) Scarcity is a constraint in the market sector but not in the political sector.
- (c) There is a one-to-one link between payment for & receipt of a good in the market sector, but this is not necessarily true in the political sector.
- (d) Political decision makers are generally well-informed, but market decision makers are not.
- (e) Money influences market outcomes, but not political outcomes.

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When Voting Conflicts with Economic Efficiency

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Special Interest Effect

- A *special interest* issue generates large personal benefit for a small number of constituents while imposing a small individual cost on a large number of others.
- Interest group members feel strongly about issues that provide them with substantial personal benefits. Such issues will dominate their political choices.
- *In contrast*, voters bearing the cost of such legislation often are uninformed on the issue because it exerts only a small impact on their personal welfare and because of the rational ignorance effect.

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Special Interest Effect

- Politicians have a strong incentive to favor the views of special interests even if action is inefficient.
- **Logrolling** and **pork-barrel** legislation strengthen the special interest effect.

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Vote Trading and Passing Counterproductive Legislation

— Net Benefits (+) or Costs (-) to the Voters in Respective District —

Voters of district*	New Post Office in <i>A</i>	Dredging harbor in <i>B</i>	New military base in <i>C</i>	Total
A	+\$10	-\$03	-\$03	+\$4
B	-\$03	+\$10	-\$03	+\$4
C	-\$03	-\$03	+\$10	+\$4
D	-\$03	-\$03	-\$03	-\$9
E	-\$03	-\$03	-\$03	-\$9
Total	-\$02	-\$02	-\$02	-\$6

* Assume the districts are of equal size.

- Consider a bill in Congress that would put a post office in district *A*, dredge a harbor in *B*, and construct a military base in *C*.
- Benefits to *A*, *B*, and *C* voters vary by project. In total, voters in *A*, *B*, & *C* districts come out ahead despite the costs of paying taxes for activities in other districts – if they agree to vote together.
- With this bill, there are no benefits to voters in *D* and *E*; further, the sum of benefits & costs for all voters together is negative.
- With majority rule, representatives from districts *A*, *B*, and *C*, can, and often will, pass **counterproductive legislation**.

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When Voting Conflicts with Economic Efficiency

- **Shortsightedness Effect:**
Issues that yield clearly defined current benefits at the expense of future costs that are difficult to identify.
 - The political process is biased toward the adoption of such proposals even when they are inefficient.
 - The shortsightedness effect explains why politicians will find debt financing and unfunded promises attractive -- they make it possible for politicians to provide current benefits to voters without levying an equivalent amount of taxes (to pay for them).

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When Voting Conflicts with Economic Efficiency

- **Rent Seeking:**
Actions by individuals and interest groups designed to restructure public policy in a manner that will either directly or indirectly redistribute more income to themselves.
 - Widespread use of the taxing, spending, and regulatory powers of government that favor some at the expense of others will encourage *rent seeking*.
 - *Rent seeking* moves resources away from productive activities. The output of economies with substantial amounts of *rent seeking* will fall below their potential.


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Income Transfers and Rent Seeking

- Income transfers are a large and growing part of the U.S. economy (see exhibit 6.3).
- There are three major reasons why large-scale redistribution will reduce the size of the economic pie:
 - When taxes take larger shares of one's income, reward derived from work is reduced.
 - As public policy redistributes a larger share of income, more resources flow into *rent-seeking*.
 - Higher taxes to finance income transfers induce tax payers to focus less on income-generating activities and more on actions to protect their income.


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Economic Inefficiency and Government Operated Firms

- The structure of incentives and the efficiency of government operated firms and agencies:
 - In the public sector, the absence of the profit motive reduces the incentive of producers to keep costs low. Neither is there a bankruptcy process capable of weeding out inefficient producers.
 - Public-sector managers are seldom in a position to gain personally from measures that reduce costs.
 - Because public officials and bureau managers spend other people's money, they have less incentive to be cost-conscious.


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The Economic Way of Thinking about Government

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The Economic Way of Thinking About Government

- Both markets and the political process will sometimes fail to allocate goods & resources efficiently.
- Public choice analysis suggests that there is sometimes a conflict between winning elections and following sound policies.
- For some types of activities, there is reason to believe that the political action that will help one get elected will, at the same time, encourage counter-productive activities that reduce income levels.
- Understanding the strengths and weaknesses of both sectors is important if we are going to improve our current economic institutions.

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The Role of a Constitution

- Constitutions establish the procedures used to make political decisions. They can also limit the activities of government.
- The framers of the U.S. Constitution incorporated restraints on the economic role of government.
- Public-choice study highlights the importance of constitutional rules and procedures capable of restraining government activities to those areas where it will promote prosperity.
- The challenge before us is to develop constitutional rules and political institutions more consistent with economic efficiency and prosperity.

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Questions for Thought:

1. "Political officials will be led as if by an invisible hand to support legislation that provides concentrated benefits to interest groups at the expense of disorganized groups such as taxpayers and consumers."
– Is this statement true or false? Why?
2. What is the shortsightedness effect? How does the shortsightedness effect influence the efficiency of public sector action?

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Questions for Thought:

3. Why does representative democracy often tax some people in order to provide benefits to others? When governments become heavily involved in tax-transfer activities, how will this involvement affect the size of the economic pie? Explain.
4. What is rent seeking? What types of government activities encourage rent seeking?

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Questions for Thought:

5. "Since government-operated firms do not have to make a profit, they can usually produce at a lower cost and charge a lower price than privately owned enterprises."
– Evaluate this view.
6. The United States imposes highly restrictive sugar import quotas that result in a domestic price of sugar that has often been two or three times the world price. The quotas benefit sugar growers at the expense of consumers. Given that there are far more sugar consumers than growers, why are the sugar quotas not abolished? Do the quotas improve the living standards of Americans? Why or why not?

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Addendum to Chapter 6

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Economic Organization: *Who Produces, Who Pays, and Why It Matters*

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Production and Payment

		Good is <i>paid for</i> by:	
		Consumer purchaser	Taxpayer or third party
Good is <i>produced</i> by:	Private enterprise	<i>Quadrant 1:</i> Apples, oranges, TV sets, food, housing, & most other goods	<i>Quadrant 2:</i> Health care, food purchased with food stamps
	Government enterprise or contracting	<i>Quadrant 3:</i> Post Office, water & electricity in many cities, toll roads, and many hospitals	<i>Quadrant 4:</i> Public schools, roads, national defense, and law enforcement

- The incentive to economize is influenced by who produces a good and who pays for it.
- Economizing behavior** will be strongest when consumers purchase goods produced by private firms (quadrant 1).
- The incentive to economize is reduced when payment is made by a third party and when production is handled by the government.

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Economic Organization & Incentives

		Good is <i>paid for</i> by:	
		Consumer purchaser	Taxpayer or third party
Good is <i>produced</i> by:	Private enterprise	Quadrant 1: Apples, oranges, TV sets, food, housing, & most other goods	Quadrant 2: Health care, food purchased with food stamps
	Government enterprise or contracting	Quadrant 3: Post Office, water & electricity in many cities, toll roads, and many hospitals	Quadrant 4: Public schools, roads, national defense, and law enforcement

- **Quadrant 1:** good is produced privately and consumers pay for it.
- **Consumers** have a strong incentive to economize because they are spending their own money. **Producers** have a strong incentive to offer consumers value and produce efficiently because failure to do so will mean fewer customers and lower profits.
- This combination leads to **efficient** outcomes.

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Economic Organization & Incentives

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	Government enterprise or contracting	Quadrant 3: Post Office, water & electricity in many cities, toll roads, and many hospitals	Quadrant 4: Public schools, roads, national defense, and law enforcement

- **Quadrant 2:** good produced privately but paid for by someone else.
- **Consumers** have little incentive to economize because someone else is paying the bill. **Producers** have little incentive to provide the good at a low cost because consumers are more interested in obtaining the highest quality, regardless of price.
- This mix leads to high prices & large expenditures on the good.

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Economic Organization & Incentives

		Good is <i>paid for</i> by:	
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	Government enterprise or contracting	Quadrant 3: Post Office, water & electricity in many cities, toll roads, and many hospitals	Quadrant 4: Public schools, roads, national defense, and law enforcement

- **Quadrant 3:** The good is produced by the government and consumers pay for it.
- **Consumers** will search for value because they are spending their own money. Government **producers** are likely to be high-cost suppliers, particularly if they are a monopolist.
- High prices and inefficiency in production are a likely outcome.

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Economic Organization & Incentives

		Good is <i>paid for</i> by:	
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	Government enterprise or contracting	Quadrant 3: Post Office, water & electricity in many cities, toll roads, and many hospitals	Quadrant 4: Public schools, roads, national defense, and law enforcement

- **Quadrant 4:** The good is produced by the government and costs are covered through taxation or by a third party.
- Political process determines what, how, and for whom goods will be **produced**. **Consumers** have few tools to discipline suppliers.
- The outcome is likely to be high production costs and a disconnect between the good produced and the preferences of consumers.

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Economic Organization & Incentives

- Concluding thought:
 - Many major economic problems, including rising health-care costs and dissatisfaction with schools, reflect the structure of economic organization.
 - See Special Topic features on these subjects for additional information.

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End Chapter 6

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