

CHAPTER
2

Principles for Analyzing Government

Chapter at a Glance

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Chapter Overview and Topics for Discussion

This chapter looks at several ways in which we might analyze what public policies would be in the public interest. Ultimately, this is a normative question, and toward the end of the chapter the distinction between positive and normative analysis is discussed. This distinction could be discussed first, although I have a preference for waiting until I have discussed the efficiency of markets, and ways that similar tools might be used to judge government resource allocation.

The Market Economy

Students seem to respond to a discussion about how they take for granted the many goods and services they are able to consume in the market economy. This is a good place to reinforce the benefits we all reap from comparative advantage and gains from trade. I like to ask my students how much they think they would have to consume if they had to produce everything they consumed. How much food would they have to eat if they had to grow their own food? What kind of car would they be driving if they had to build their own car? How much gasoline would they be putting in the car if they had to refine their own gasoline?

Showing how markets efficiently allocate resources in a supply and demand diagram is a good lesson, and it helps to reinforce the model's use down the road when the welfare losses from externalities, excise taxation, and so forth are illustrated using the same framework.

The Role of Government

If markets are so great, why have a government? One reason is that governments can protect the rights of individuals. National defense, police protection, and courts fulfill this role. Indeed, the operation of the market presupposes that rights are protected.

The chapter notes, however, that a government powerful enough to protect the rights of individuals also has the potential to violate individuals' rights. Thus, government power needs to be constrained to prevent it from working against the public interest.

The government might pursue other activities besides protecting rights. Most students would agree that the government should pursue activities that are in the public interest. This opens the question of what is in the public interest.

The Public Interest

Utilitarianism is one way of determining the public interest. One might ask whether a public policy produces gains to the gainers greater than the losses to the losers. The problems are that interpersonal utility comparisons are hard to make, and that even if the gainers gain more than the losers lose, this might be unfair to the losers.

The Pareto Criteria

The Pareto criteria are more generally acceptable, but the biggest problem is that taken literally, because almost any public policy will have at least some net losers, they are almost never applicable to collective decisions. Market exchanges are Pareto superior moves, however, so the Pareto criteria may be useful as a benchmark.

The analysis in this chapter does show that any efficiency-enhancing changes could be made in such a way as to be a Pareto improvement. This suggests looking for ways in which losers can

be compensated, both for fairness and in order to reach political agreement. If the costs cannot be structured such that a change is a Pareto superior move, then the change is not efficient.

The issue of agreement is a significant one that is often overlooked when analyzing the Pareto criterion. If public policies can be structured to be Pareto improvements, then everyone can agree and the policies are more likely to be implemented. Even “efficient” policies will run into problems gaining political approval if there are groups that are made worse-off by the policies, and therefore they will oppose them.

Other Measures of the Public Interest

The chapter looks at the Hicks-Kaldor criterion of potential compensation, the social welfare function (as a form of utilitarianism), and as a less theoretical measure, cost-benefit analysis. There is a more extensive discussion of cost-benefit analysis in Chapter 17.

Positive and Normative Economics

The distinction between positive and normative economics is more important in public finance than in other areas of economic inquiry because government is the result of human design. Because collectively we decide what type of government we will have, we need criteria for determining what makes a good government.

Equity and Efficiency: The Goals of Public Policy

Efficiency goals are easy to agree on because everyone can be made better off. Sometimes, equity and efficiency goals might conflict, and it is worth discussing the normative issues involved in resolving such conflicts. How many of our equity goals would we be willing to compromise to gain economic efficiency?

Efficiency is a positive concept because either we move toward the Pareto frontier or we do not. But as a goal of public policy it is normative, and we must decide how much we value efficiency relative to other public policy goals.

Answers to the Review and Discussion Questions

1. Using a graph, explain why in a competitive market economy each individual, in pursuing his own self-interest, is led as if by an invisible hand to pursue the best interest of the entire society. Is your explanation positive or normative?

The supply and demand diagram in Figure 2.1, page 26, can be used to answer the question. If the demand curve shows the value of output to those who consume it and the supply curve shows the opportunity cost to the producers of producing output, then the intersection of the supply and demand curves show the optimal level of output. To the left, demand is greater than supply, so the value of output is greater than its opportunity cost, so we would want to produce more. To the right, supply is greater than demand, so it costs more to produce output than it is worth to consumers. Thus, the intersection of supply and demand is optimal. Because this is the level produced by competitive markets, each individual in a competitive market economy, in pursuing his or her own self-interest, is led as if by an invisible hand to pursue the best interest of the entire society. This explanation is normative because it argues that the competitive level of output is desirable.

2. Why does the operation of a market system presuppose that individual rights are protected? Describe an economy in which individual rights are not protected. What institutions of government protect individual rights, and how do they work?

If rights are not protected, people could steal the output of others and voluntary exchange would be undermined. Such an economy would be bad for everybody (even the tough guys who steal from everybody else) because nobody would produce very much if they believed it would just be stolen from them. Thus, there wouldn't even be very much to steal! The government protects rights through police protection, national defense, and courts.

3. What is utilitarianism? What are the advantages and disadvantages of using utilitarianism to determine the public interest? Is some form of utilitarianism currently being used to measure the public interest? Explain. Should some form of utilitarianism be used?

Utilitarianism tries to maximize the total amount of social utility in a society. To do so, there must be some way to compare the gains to the gainers against the losses to the losers. This is difficult because utility cannot actually be measured (but the dollar value might be approximated through cost-benefit analysis). Also, it may be unfair to have some people gain at the expense of others. Ultimately, however, almost every public policy imposes at least some costs on some people, so making the judgment that the gains to the gainers outweigh the losses to the losers is almost unavoidable if the government is to do anything at all. Because of this, we could say that some form of utilitarianism is used to measure the public interest.

4. Explain the concepts of Pareto optimality and Pareto superiority. How do the concepts differ? Would the Pareto criteria or utilitarianism provide a more effective measure of the public interest?

Pareto optimality is the situation where nobody can be made better off without making someone else worse off. A situation is Pareto superior to another if at least one person is better off and nobody is worse off. Pareto optimality applies to individual situations. They either are or are not optimal. Pareto superiority is used to compare two situations. The Pareto criteria provide a more effective measure of the public interest than utilitarianism because there is no need to make interpersonal utility comparisons. (Unfortunately, when there are gainers and losers from a policy, the concept of Pareto superiority cannot be applied, but a situation still could be evaluated to see whether it is Pareto optimal.)

5. Relate the notion of potential compensation to the concept of Pareto superiority. If the beneficiaries of a change could potentially compensate the losers, is the change in the public interest? Are there some conditions under which potential compensation would suffice as a measure of the public interest and others under which actual compensation should be demanded?

A change would be Pareto superior if compensation was made. Whether this would be in the public interest without compensation is a normative issue. If losses were small, or if over a large number of policies everyone could expect to be net gainers, then potential compensation might be judged a satisfactory measure of the public interest.

6. What is a cost-benefit analysis? What problems might arise in trying to carry out such an analysis? Is a cost-benefit analysis more closely related to utilitarianism or to the Pareto criteria? Given the necessity of determining what is in the public interest, is a cost-benefit analysis a reasonable method of making the determination? What additional criteria could be used to supplement a cost-benefit analysis?

Cost-benefit analysis tries to convert all gains and losses from a project into dollar amounts so that the gains and losses can be compared directly. It is an extension of utilitarianism. It may be reasonable to look at the costs and benefits in this way, but ultimately other criteria must be used to decide whether the project would be in the public interest. If compensation were paid, any project with net benefits could be a Pareto superior move. Otherwise, interpersonal utility comparisons would have to be made to judge a program to be in the public interest.

7. What is the distinction between positive and normative economics? Why is this distinction especially relevant to the study of public finance?

Positive economics analyzes the facts of the world. Normative economics makes value judgments to determine what is desirable or undesirable. Facts are either right or wrong, but there is no scientific way to determine whether one person's values are any more valid than another's. This distinction is especially relevant to the study of public finance because we design our governments, so we need to develop criteria to decide when government activity would be desirable or undesirable.

8. Is there a trade-off between equity and efficiency in public policy, or can the two goals be reached simultaneously? Explain how policies might be designed that are both equitable and efficient.

There may be trade-offs between equity and efficiency. Programs can be made more equitable if policy makers are cognizant of the distribution of costs and benefits. Programs might be

designed to approximate Pareto superior moves, for example. Inevitably, trade-offs will sometimes remain, however.