

EE401 Political Economy

Chapter 8 Welfare Economics and Government Failure

ii. Government Failure

Ploy Thammapiranon 2/2017
BE, Thammasat University

Welfare economics and government failure

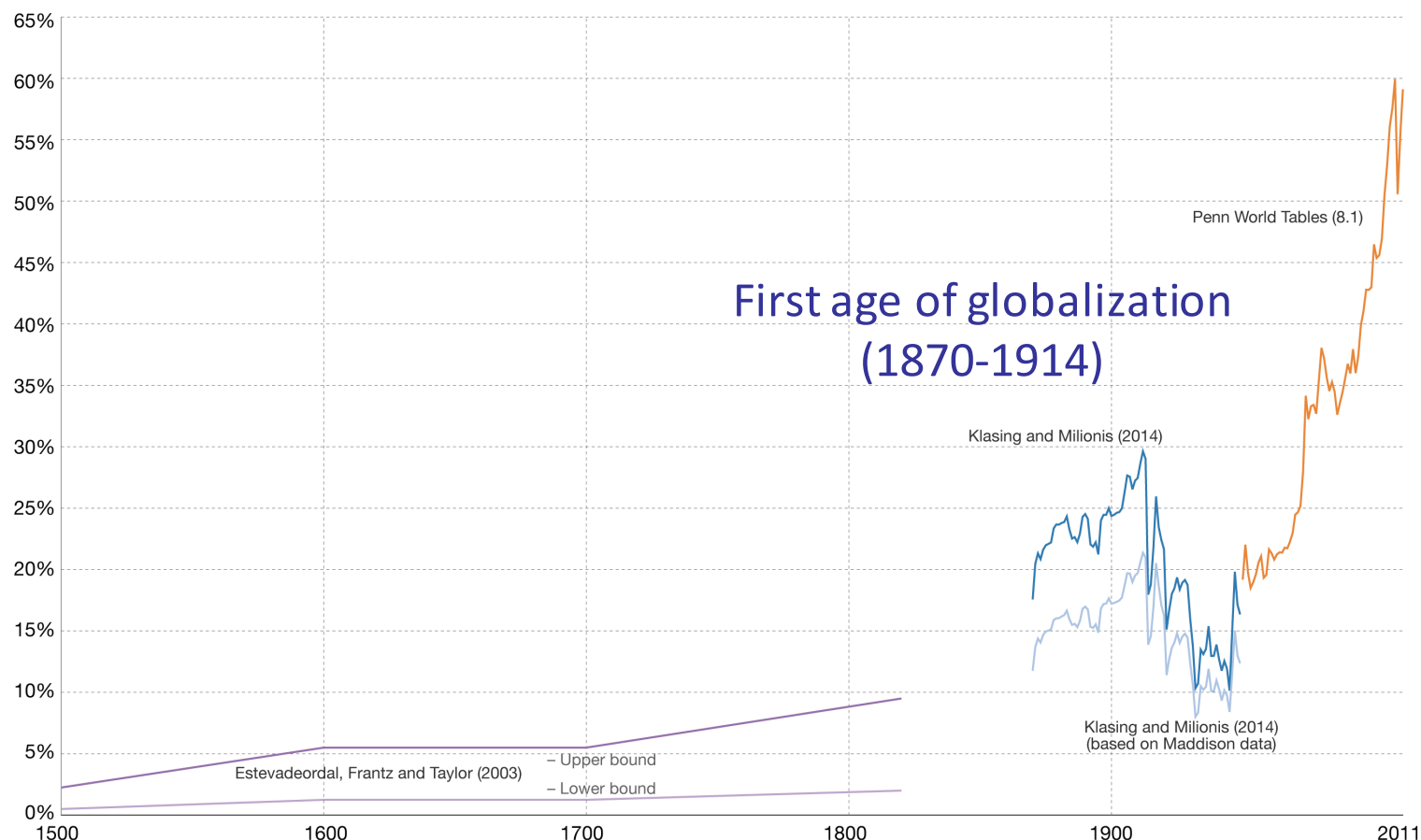
1. The assumptions of welfare economics
2. Potential Pareto improvement or Kaldor-Hicks Efficiency
3. Efficiency vs. Equity
4. Market failure and government wisdom
5. Government failure

5.1 Globalization and collectivism

Globalization over 5 centuries (1500-2011)

Shown is the sum of world exports and imports as a share of world GDP (%)

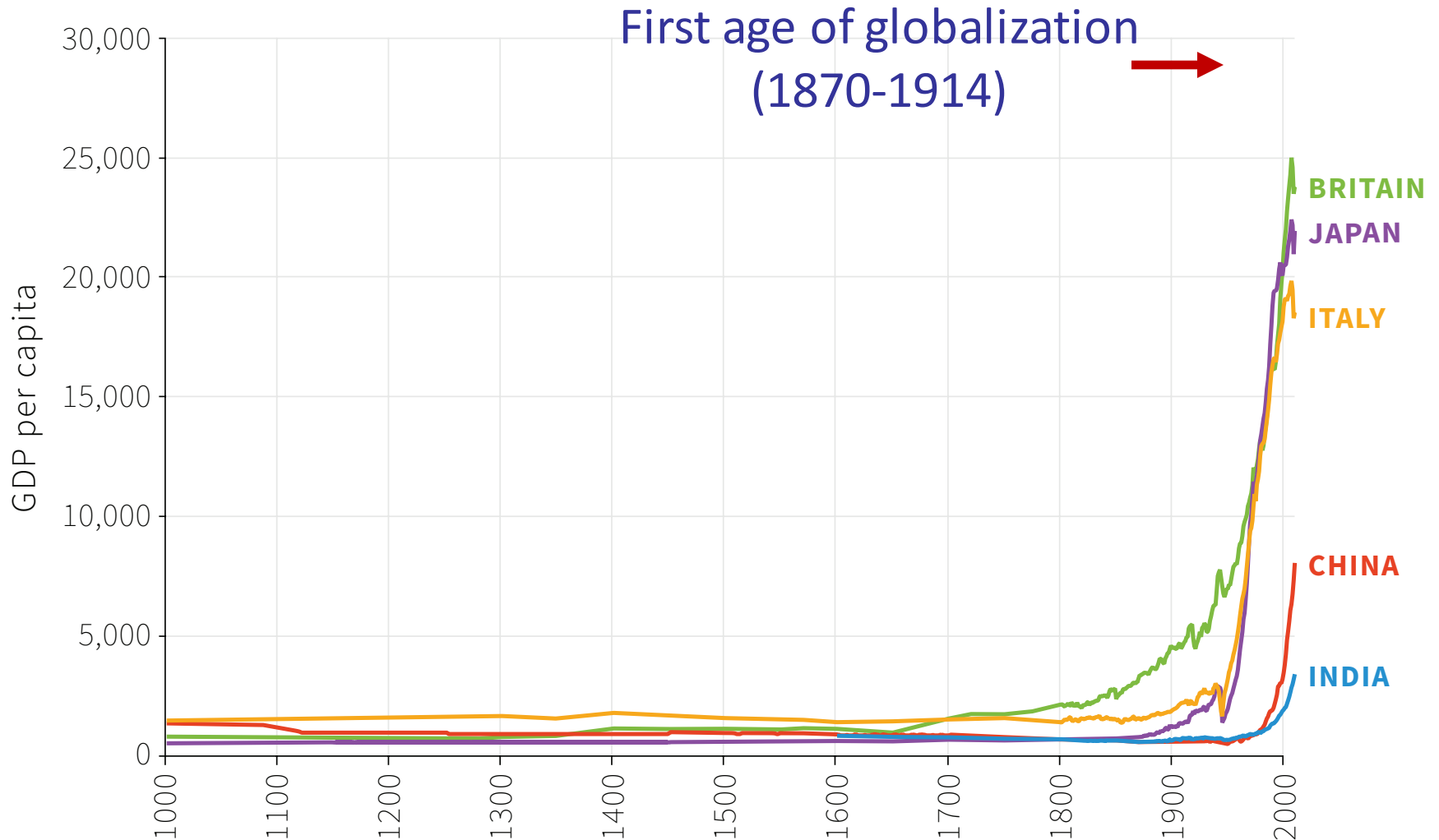
The individual series are labeled with the source of the data



Data sources: Klasing and Milionis (2014), Estevadeordal, Frantz and Taylor (2003) and the Penn World Tables Version 8.1
The interactive data visualization is available at OurWorldinData.org. There you find the raw data and more visualizations on this topic.

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5.1 Globalization and collectivism



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- **Two world wars (1914-1945)**



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- **Two world wars (1914-1945):** collapse of world trade

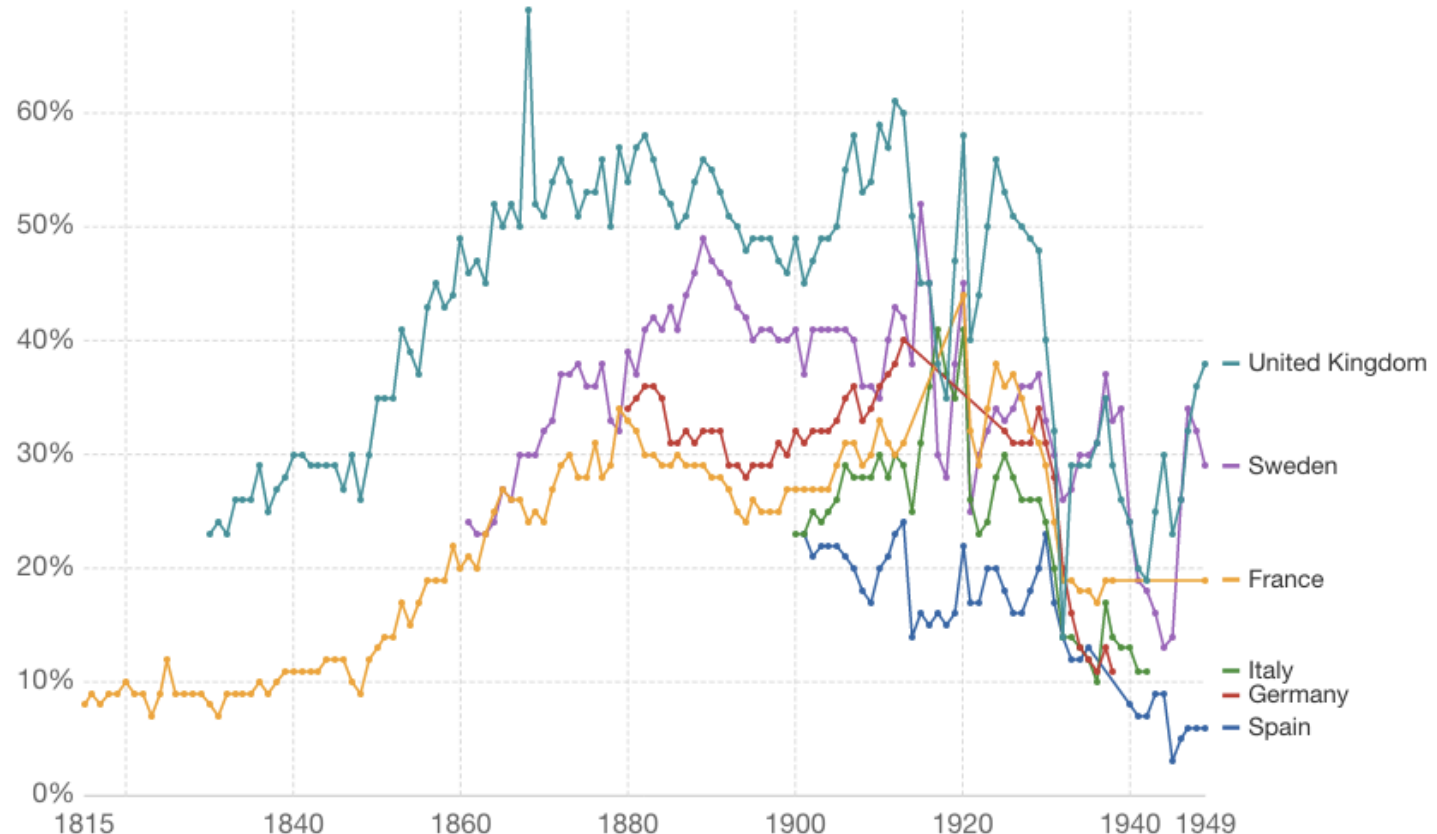


5.1 Globalization and collectivism

- **Two world wars (1914-1945):** collapse of world trade

Trade openness in Europe

Shown is the sum of exports and imports as a share of GDP



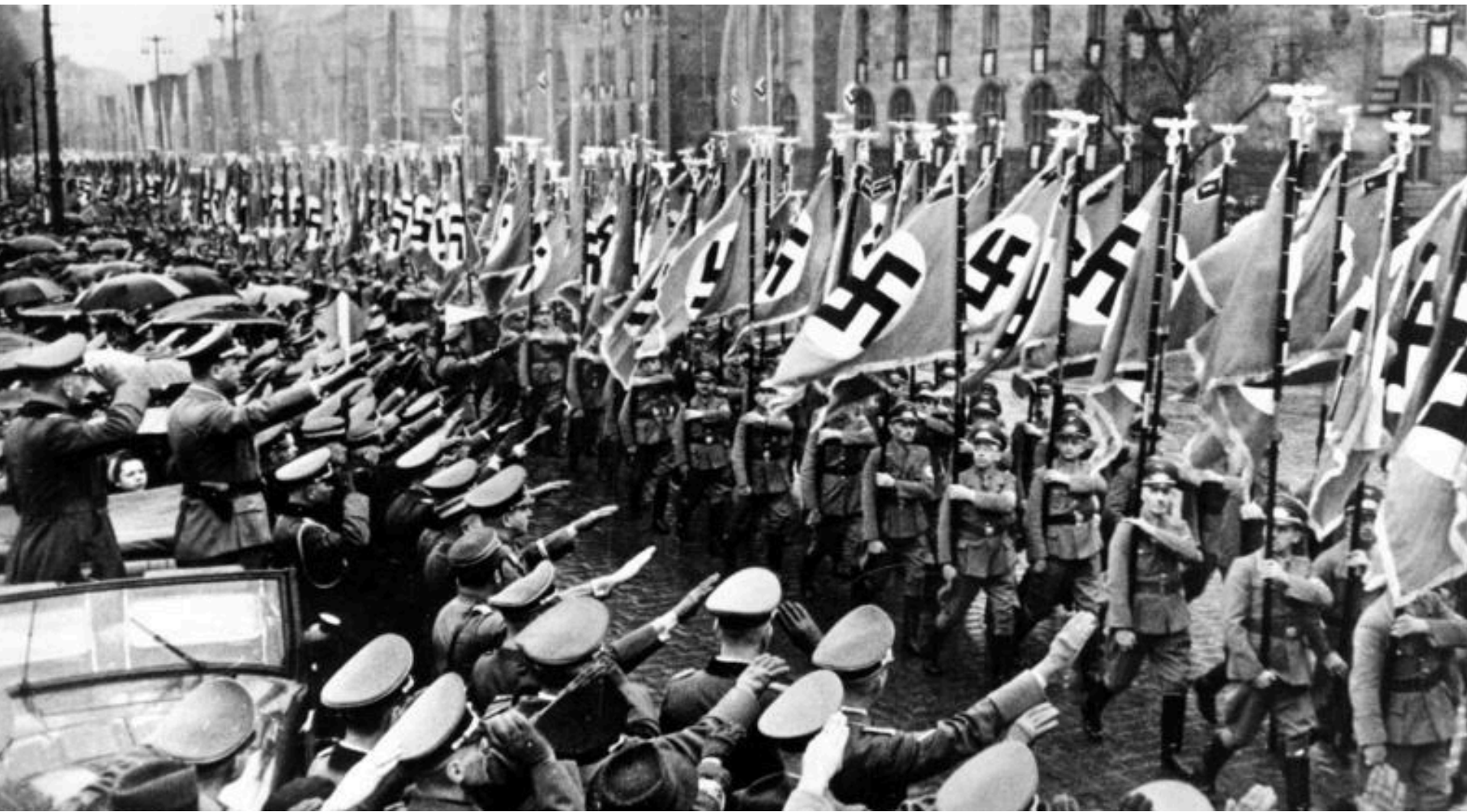
Source: International Historical Statistics - Brian Mitchell (2015)

OurWorldInData.org/international-trade • CC BY-SA

5.1 Globalization and collectivism

- **Two world wars (1914-1945):** political extremism







5.1 Globalization and collectivism

- **Free-market capitalism was discredited.**
 - Market failure and trust in *government wisdom*.
 - Government solution at macro/micro levels.
- **The age of collectivism (1945-1989).**
 - Western Europe: mixed economy.
 - The US: regulatory capitalism.
 - ***Marxist socialism*** in Eastern Europe, Soviet Union and China.

} *Keynesian macro
policy*

5.1 Globalization and collectivism

- **Decolonization** and Third-World development.
 - ✓ Socialism in India and Africa.
 - ✓ **Import substitution** in Latin America and parts of Asia.
- East Asia: **Export-oriented economies** with **strong government** guidance.
- *Authoritarian states* outside the US, Western Europe, and Japan.

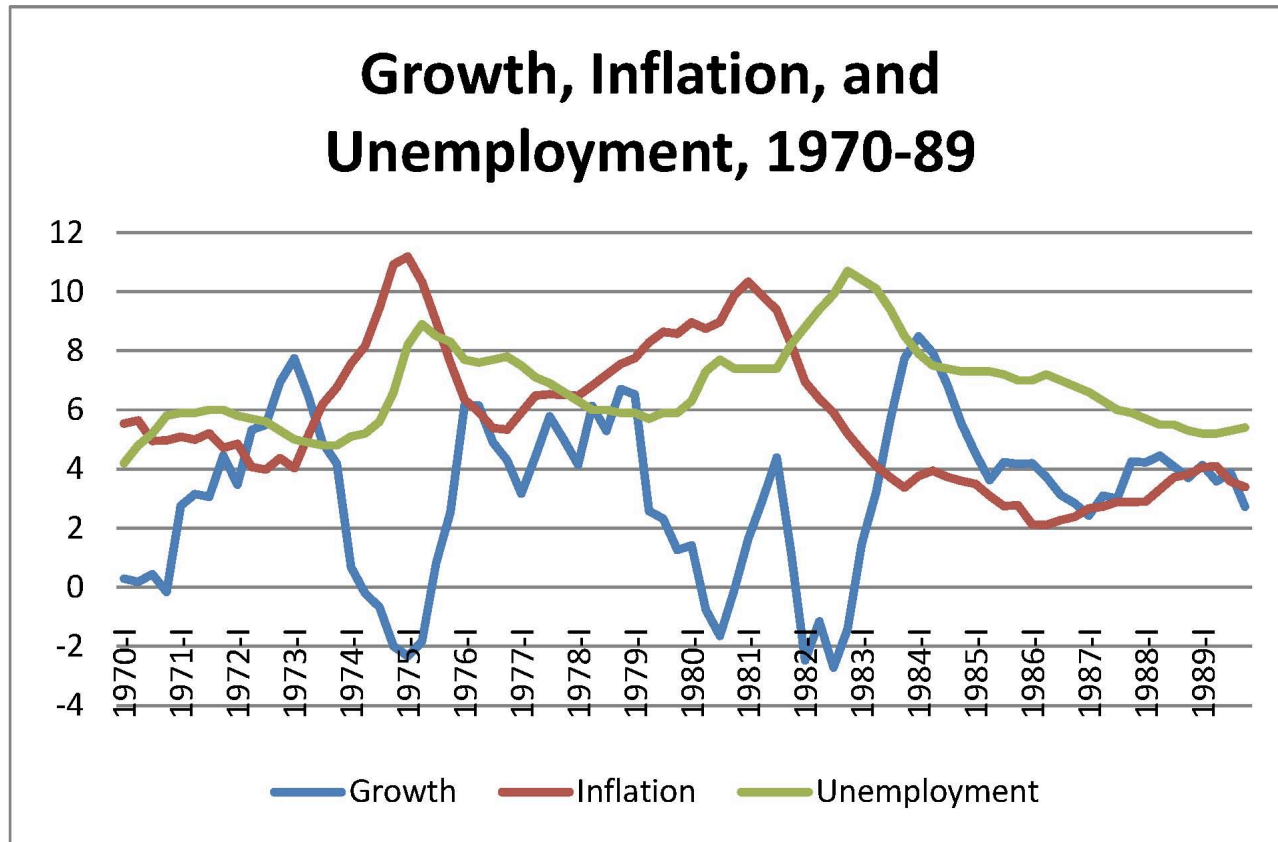
5.2 The crisis of collectivism

- Western capitalism in crisis in late 1970s



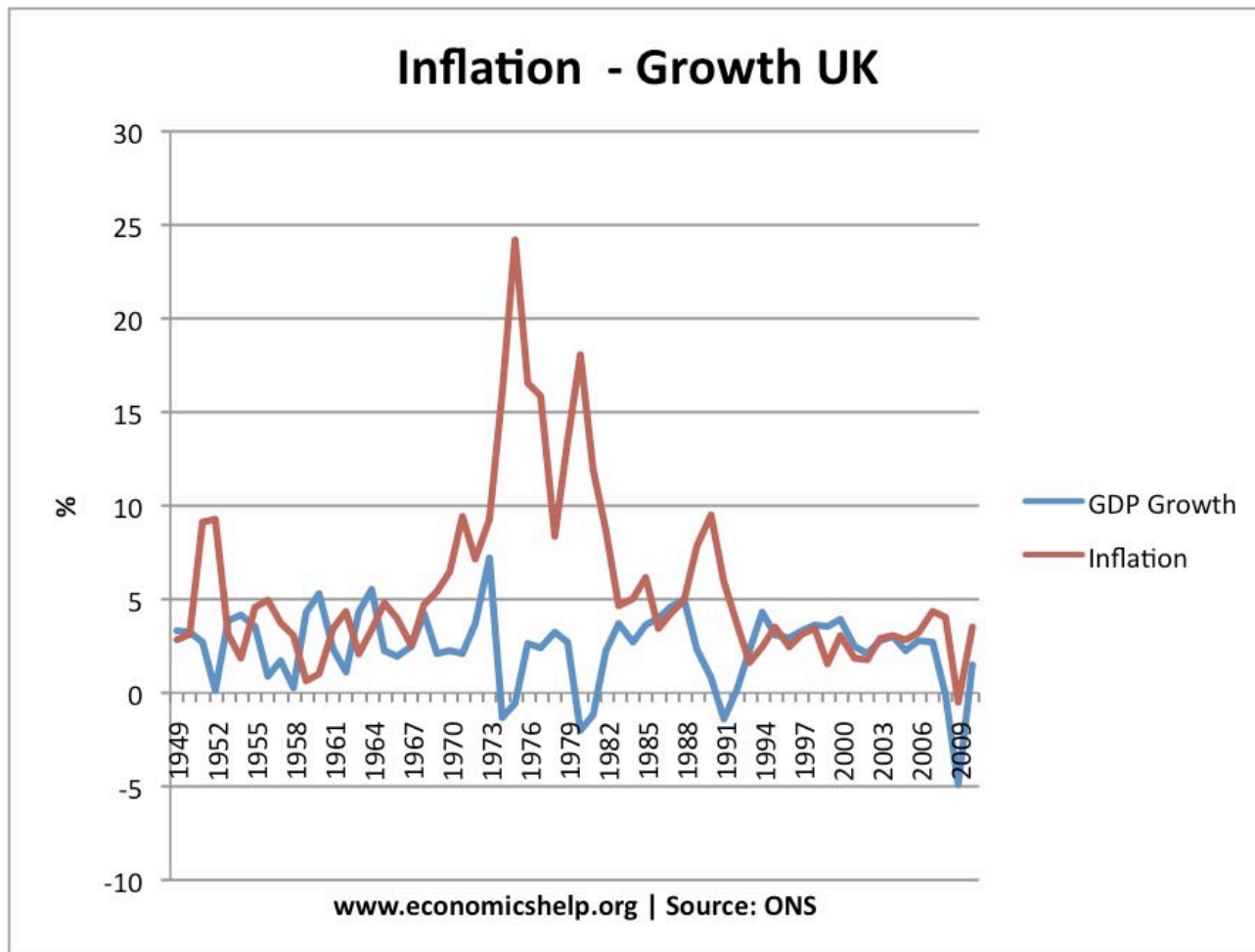
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- Western capitalism in crisis in late 1970s



Keynesian lost credibility.

5.2 The crisis of collectivism

- The debt crisis of Latin America

- State enterprises and fiscal crisis.
- The Mexican debt default of 1982.
- Import substitution policy went bankrupt.

Mexico's change in international reserve



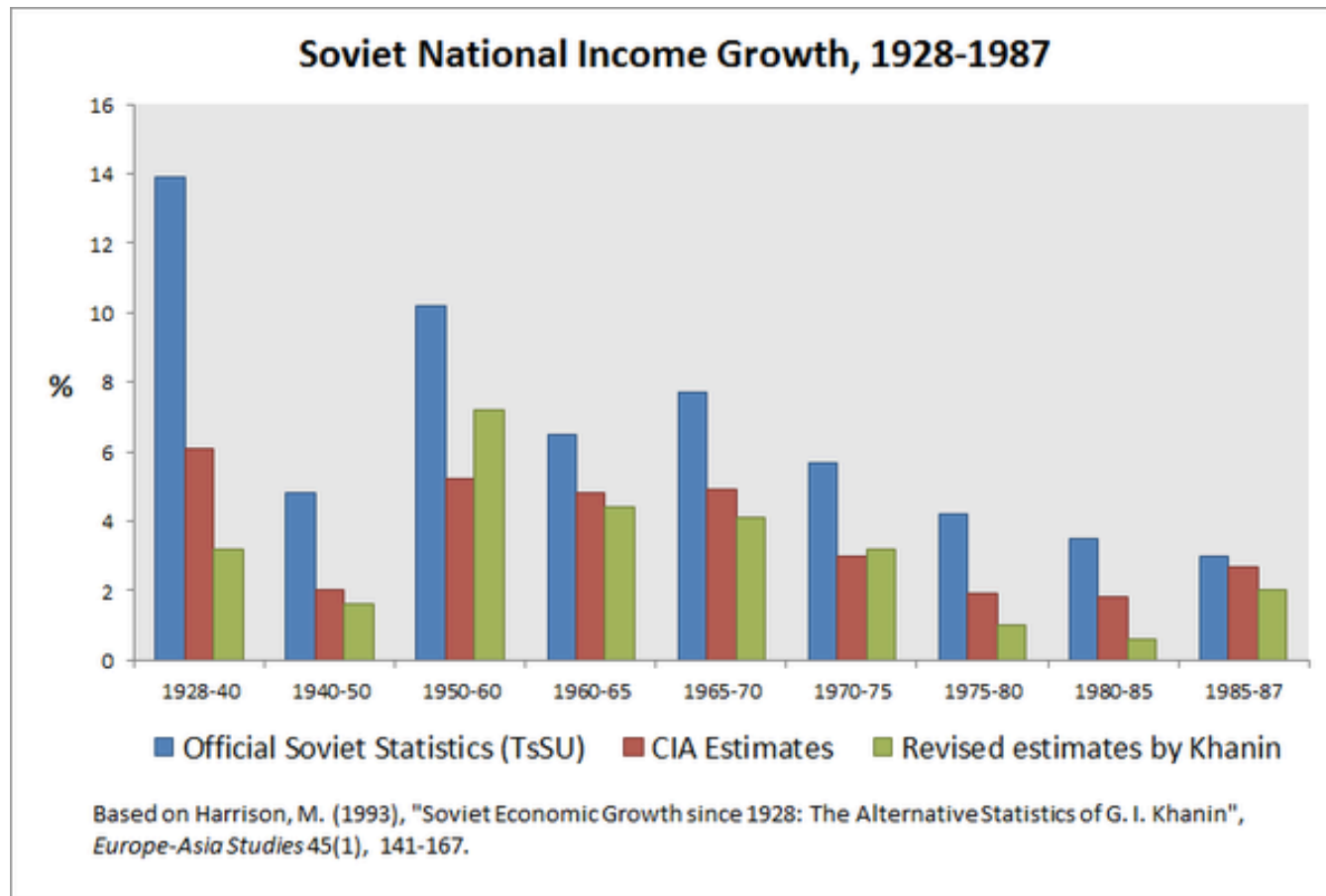
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- Collapse of Marxist socialism.



5.2 The crisis of collectivism

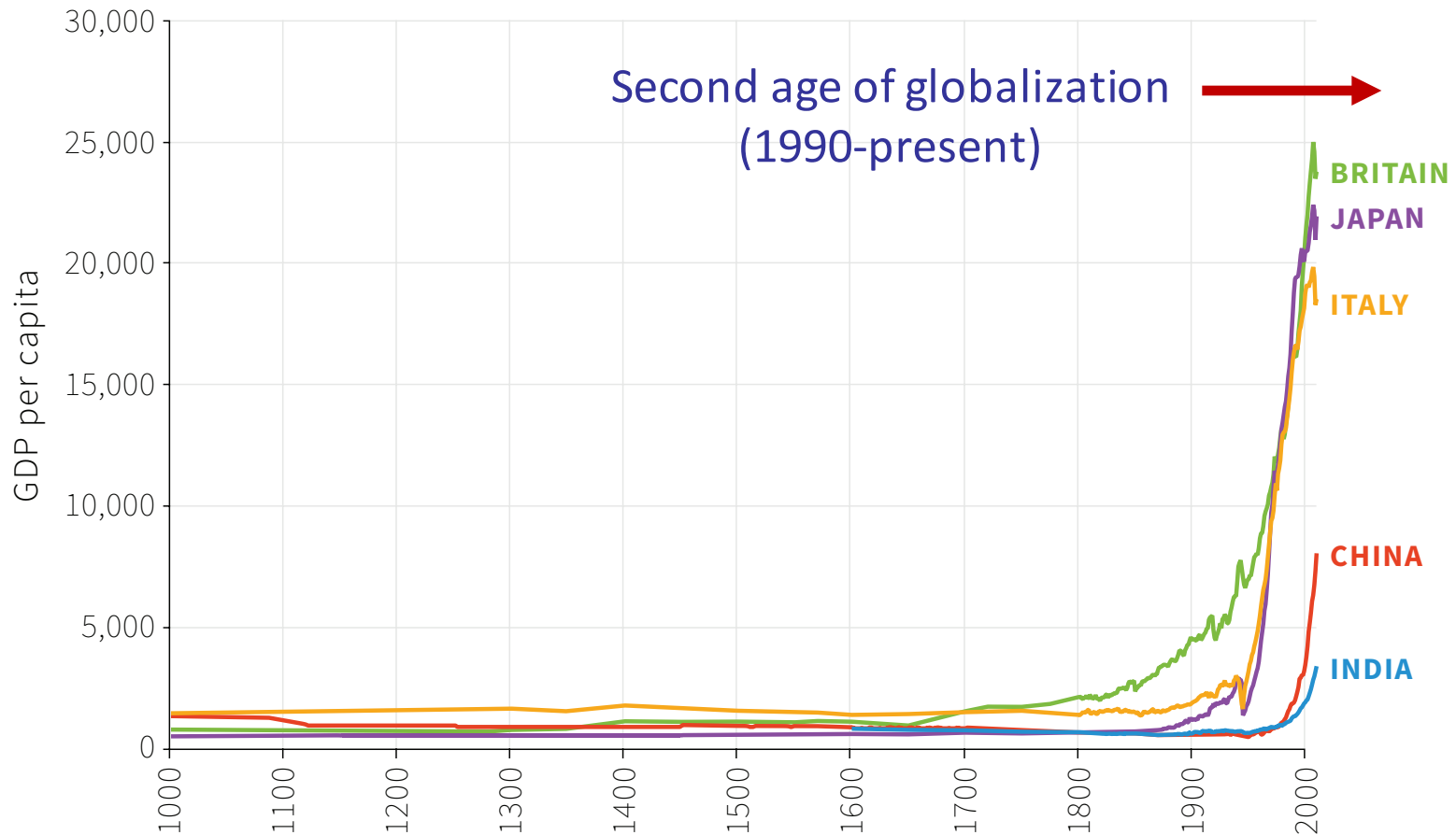
- Collapse of Marxist socialism.





5.2 The crisis of collectivism

- Second age of globalization (1990-present)

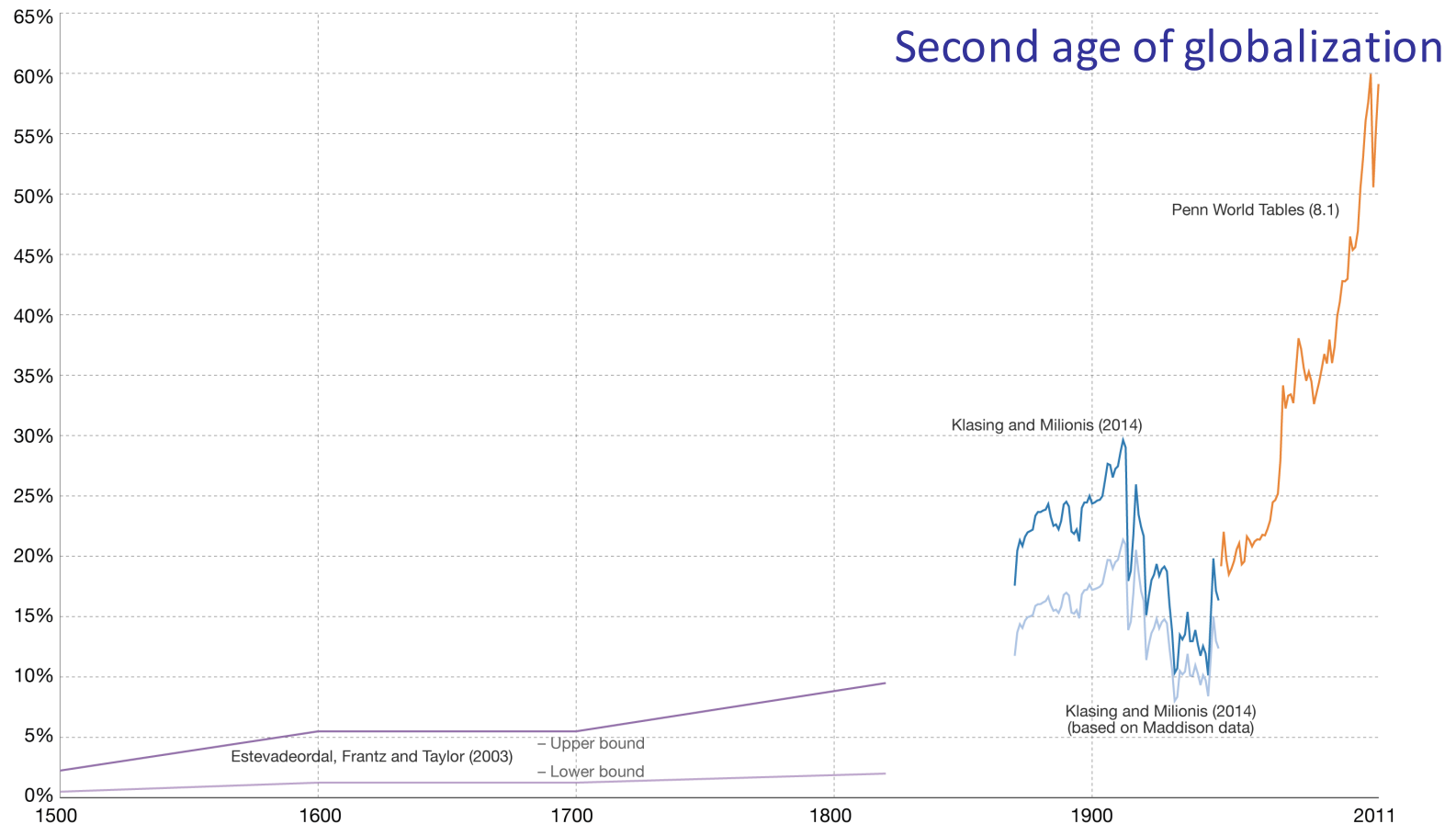


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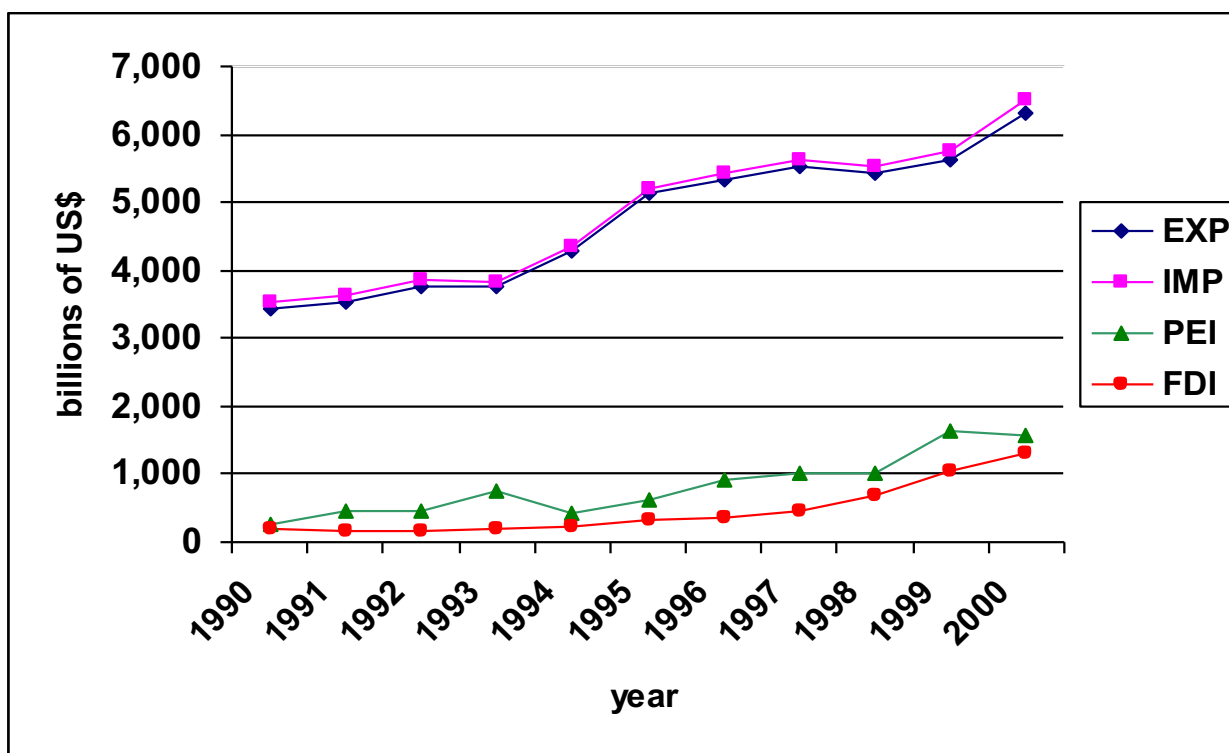


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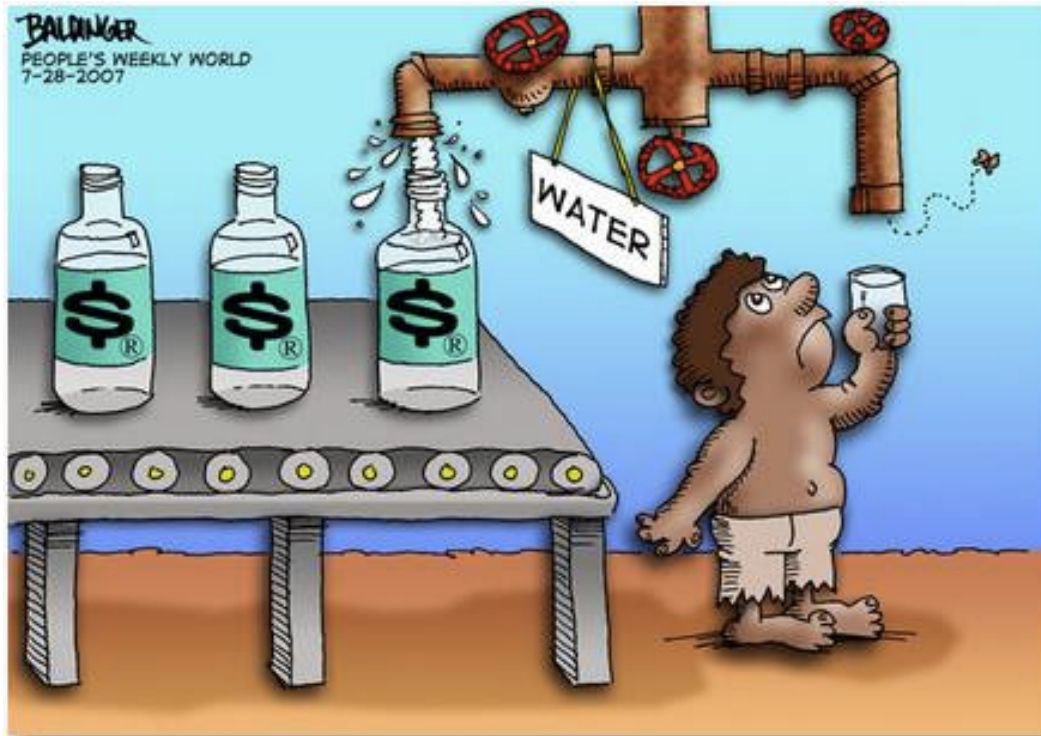
- Second age of globalization (1990-present)
 - Pattern of global capital flows (1990-2000)



Source: IMF, International Financial Statistics Yearbook, 2001 (for export and import data) and IMF, Balance of Payments Statistics Yearbook, 2001 (for PEI and FDI data).

5.2 The crisis of collectivism

- Second age of globalization (1990-present)
 - Free trade and capital movement.
 - Liberalization, privatization and deregulation.



5.3 Government failure

- Experience of the 1950s-1970s puts doubt on **Government Wisdom.**
- **New political economy** from the 1960s.
 - Public choice theory.

James M. Buchanan (1919-2013)
George Mason University,
Nobel Prize 1986.



5.3 Government failure

- What is government failure?
 - The attempt of government to **'improve'** the market but achieving an *even worse outcome*.
 - Welfare reduction and redistribution problems
- Sources of government failure
 - 1) Perverted incentives.
 - 2) Separation of costs and benefits.
 - 3) Institutional myopia.
 - 4) Income redistribution by political means

5.3 Government failure

1) Perverted incentives

- Agents with self-interest act differently under different rules.
- Different systems give different rewards, costs, and encouragement.
 - Market rules:
 - ✓ Competition as a permanent pressure.
 - ✓ Price signal.

5.3 Government failure

1) Perverted incentives

○ Bureaucratic rules:

- ✓ Prohibition of profit-making.
- ✓ Output is offered to all at *near-zero prices* – ‘**non-price signal**’
- ✓ Permanent excess demand
 - Non-price mechanisms: favoritism, relations, political influence
 - Bribes and corruption.
- ✓ ***Inefficient outcomes***: output is handed to persons not with the strongest preference.

5.3 Government failure

2) Separation of costs and benefits

- Cost of public service is borne by all taxpayers.
- Interest groups seek **private benefits at collective expenses**.
- **Near-zero price** for the group encourages more demand (for lobbying) and waste.

5.3 Government failure

2) Separation of costs and benefits

- Government resources are used to **benefit strong, vocal interest groups**.
 - Concentration of benefits to the few at the *dispersal of costs* among many.
 - Gainers become **free-riders**.
- **Misallocation of resources, inefficiency** and waste.
 - Government contracts to favored groups with poor quality work.

5.3 Government failure

3) Institutional myopia

- Markets force producers and consumers to weigh present and future.
- Government is seen as the agent of **'long-term' public interest**.
- Without markets, social welfare functions are **unknown**.
- Decisions are made based on *political power, influences, threats*.

5.3 Government failure

4) Income redistribution by political means

- Political power involves redistribution of wealth and income by **non-market means**.
- In **democracy**, governments make decisions based on popularity, votes, media influences, etc..
 - Interest groups vary.
 - Trend towards *more equal wealth and income distribution*.

5.3 Government failure

4) Income redistribution by political means

- In undemocratic systems, governments are dominated by small, powerful, long-established elites.
 - They use political means to redistribute wealth and income at the expense of the public and the future.
 - *Power concentration creates wealth and income concentration.*