PAI 897
Lecture 10
Correcting Market and Government Failure – Generic Policies

Of course, each situation has specific characteristics, so that a generic policy may not be appropriate.

However, these are the fundamental tools we have to use in policy, so we should be familiar with how they work.

We should reach for them first, and make sure they fit the context of the policy question we confront.

Some we have seen before, so we are gathering them up while presenting variations on them as well.

1) Freeing, facilitating, and simulating markets.
   Freeing (getting out of the way and allowing)
   Facilitating (supporting or creating)
   Simulating (creating by stepping back one level)

- Freeing by deregulation. Removal of barriers to entry, putting in place regulatory oversight.
  - A common story is that the technology has changed since the original regulation has passed.
    - Land line phone systems giving way to cell phones.

        - Broadcast networks giving way to cable television giving way to satellite TV.
        - In the US, experience with trucking, banking, railroads, airlines…

  Note deregulation is not necessarily moving from regulation to no regulation, it is often a reduction in regulation.

- Freeing by Legalization.
    - Removing criminal sanctions.
    - Decriminalization, removing criminal penalties and replacing with civil penalties such as fines.

  Why should we legalize marijuana? Why should we not?
  Why should we legalize gambling? Why should we not?
  Why should we legalize prostitution? Why should we not?

- Privatization as a way of freeing markets.
  1) Switching from subsidized provision by an agency to provision through user fees.
  2) Contracting out provision previously produced by a government agency
  3) Denationalization, selling state owned enterprises to the private sector
  4) Demonopolization (or monopsonization) that allows private firms to compete in a market that was filled by a government entity.

- Facilitating markets.
  - Creating a market by establishing property rights (remember Coase example) or creating new marketable goods.
    - Allocate rights to existing goods. Use power of the state to create rights to resources. Fishing areas, grazing permits, water use permits….
    - Create market for the right to use existing goods. A common example is tradable permits for use of the good, like emissions.
      - This creates a market so that the firms have an incentive to reduce use when the cost of abatement is less than the cost of the permit to use.

- Simulate markets. If it is not feasible to have competition within a market, use an auction to create competition for the market.
    - Right to provide a monopoly good is allocated by an auction procedure. Right to drill, right to mine,…
        - Does government have people who can accurately assess the value of the resources?
        - Do we know the extent and value of the externalities?
        - Are the bidders really competitive?
        - Is the decision making based on the best bid for society?
        - Is it clear ex ante by what elements is the competition being judged?
        - Is government 'powerful' in relation to bidders?

Chart 10.1 Freeing, Facilitating, Simulating Markets

<table>
<tr><th>Generic Policies</th><th>Perceived Market Failure (MF), Government Failure (GF), Distributional Issue (DI), Limitation of the Competitive Framework (LCF)</th><th>Typical Limitations and Collateral Consequences</th></tr>
<tr><td colspan="3">Freeing Markets</td></tr>
<tr><td>Deregulate</td><td>GF: Allocative inefficiency from rent seeking
LCF: Technological changes</td><td rowspan="3">Distributional effects: windfall losses and gains, bankruptcies

Transitional instability</td></tr>
<tr><td>Legalize</td><td>LCF: Preference changes</td></tr>
<tr><td>Privatize</td><td>GF: Bureaucratic supply</td></tr>
<tr><td colspan="3">Facilitating Markets</td></tr>
<tr><td>Allocate through Property Rights</td><td rowspan="2">MF Negative Externalities
MF: Public Goods
MF Open Access Goods</td><td rowspan="2">Distributional effects: windfall gains and losses

Thin Markets</td></tr>
<tr><td>Create New Marketable Goods</td></tr>
<tr><td colspan="3">Simulating Markets</td></tr>
<tr><td>Auctions</td><td>MF: Natural Monopoly
MF: Public Goods
DI: Transfer of scarcity rents</td><td>Collusion by bidders, opportunistic behavior by winning bidder, political pressure to change rules ex post</td></tr>
</table>

Taxes and Subsidies.

Review of tax and subsidy graphs.

- Specific on producer.
- Specific on consumer.
- Ad valorem on consumer.
- Per unit subsidy producer
- Per unit subsidy consumer
- Matching subsidy.
- Constrained subsidy.

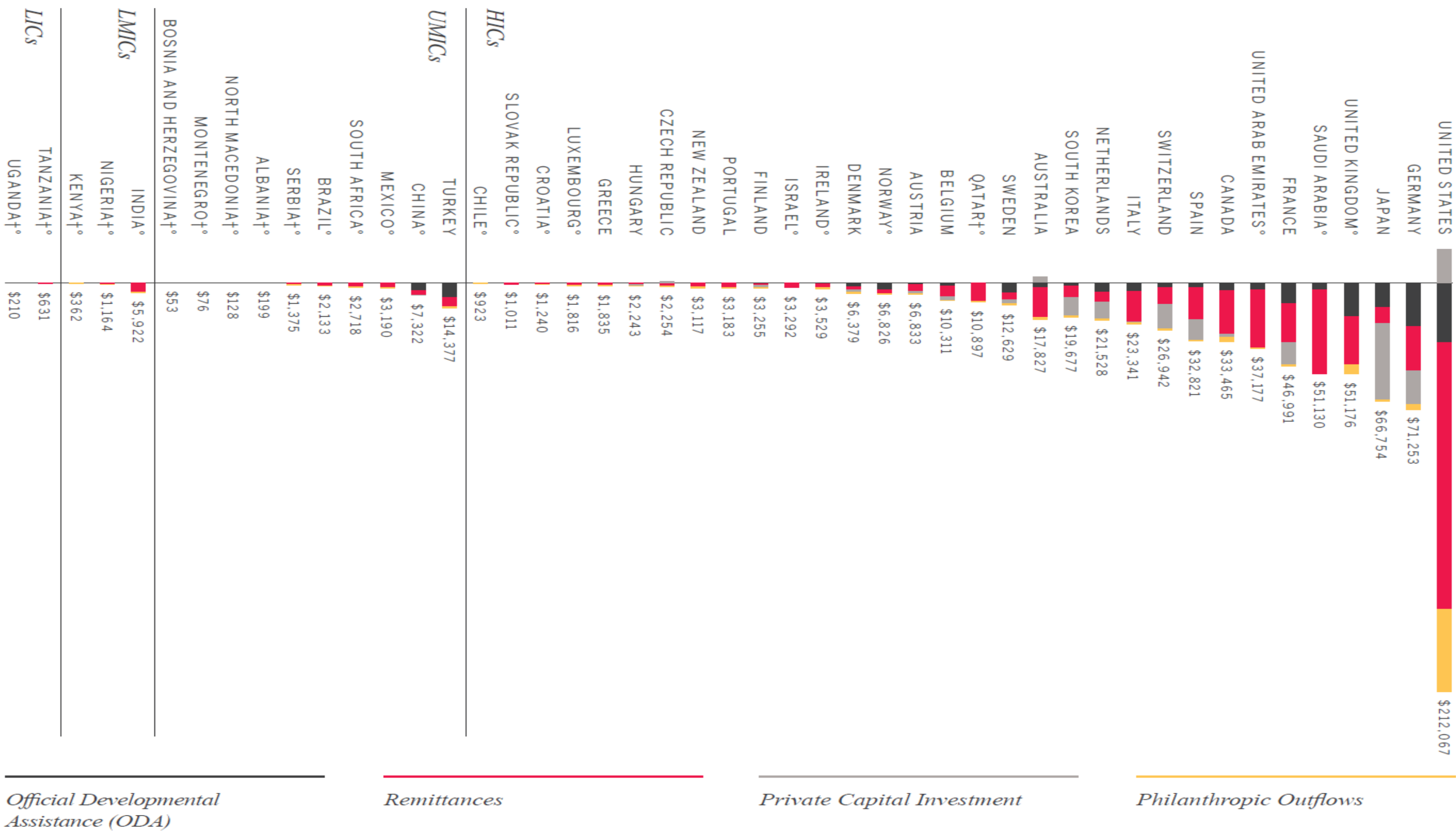
Tax expenditure as a way to subsidize behavior.

Forgone tax income by government as a way to change the incentives facing consumers.

Effectively lowering the price of the targeted good.

Why are charitable contributions deductible?

FIGURE 4: TOTAL CROSS-BORDER RESOURCES BY FLOW AND BY ECONOMY, 2018 *(in millions of inflation-adjusted 2018 US dollars)*



Source: Indiana University Lilly Family School of Philanthropy, 2020 *Global Philanthropy Tracker*

Data: ODA and private capital investment from the OECD; Remittances from World Bank; Philanthropic outflows from various sources researched by the Indiana University Lilly Family School of Philanthropy and shared by partner organizations for some economies. See Appendixes for specific data sources for each economy included.

Notes: HICs: High-income countries; UMICs: Upper-middle income countries; LMICs: Lower-middle income countries; LICs: Low-income countries
† Countries that did not have ODA estimates / ° Countries that did not have estimates on private capital investment

Why is mortgage interest deductible?

Why is wealth in the form in increased equity in a home not taxed?

What are some distributional issues here?

https://sgp.fas.org/crs/misc/R46429.pdf

Overall review of supply side subsidies.
Take the basic argument that the supply of the good leads to positive externalities.

There is a public interest in having the commodity supplied at a lower price and have more of it.

Note that subsidies are different than taxes at some basic level as taxes generate revenue, subsidies require the use of revenue.

Table 10.2: Using Subsidies and Taxes to Alter Incentives

Generic Policies	Perceived Market Failure (MF), Government Failure (GF), Distributional Issue (DI), Limitation of the Competitive Framework (LCF)	Typical Limitations and Collateral Consequences
Supply-side taxes		
Output taxes	MF: Negative externalities DI: Transfer of scarcity rent	Frequent adjustment of tax levels required
Import tariffs	LCF: Market power of foreign exporters	Deadweight loss for consumers, rent seeking by domestic producers
Supply-side subsidies		
Matching grants	MF: Positive externalities MF: Public goods DI: Increase equity	Diversion of resources to non-targeted items.
Tax expenditures (business deductions and credits)	MF: Positive externalities MF: Public goods	Misallocation of resources across industries, horizontal tax inequity
Demand-side taxes		
Commodity taxes User fees	MF: Negative externalities MF: Information asymmetries MF: Public goods MF: Open access	Deadweight losses and black markets
Demand-side subsidies		
In-kind subsidies	MF: Positive externalities LCF: Utility interdependence DI: Floors on consumption	Restricts consumer choice, bureaucratic supply failure, lumpiness leads to inequitable distribution.
Vouchers	MF: Positive externalities DI: Increased equity GF: Bureaucratic supply failure	Informational asymmetries, short-run supply inelasticities, institutional resistance.
Tax expenditures (personal deductions and credits)	MF: Positive externalities DI: Increase equity	Poor targeting of subsidies, vertical and horizontal tax inequities

Establishing Rules and Regulations.

Not using incentives to influence choices, but the coercive power of the state. Can be civil or criminal sanctions that punish behavior.

Frameworks that govern behavior.

Can markets exist without rules in the background?

What rules do we need to make markets function?

What set of rules do we need to allow government to make rules that influence markets?

Regulations.

Command and control. Directive is given, compliance is monitored, noncompliance is punished.

Price regulation.

Review examples of price floors and price ceilings.

Review example of regulating a monopoly.

Allocative inefficiency – resources used in a non-Pareto optimal way due to market power / trade restrictions.

X-inefficiency – resources used in a non-Pareto optimal way due to lack of competitive pressure. Management efficiency that leads to production not at the frontier of technological efficiency.

Regulations allowing Price Discrimination:

10 wealthier households each WTP $10 for a cubic meter of water

20 poorer households each WTP $5 for a cubic meter of water

	10 wealthy	20 poorer	Total Revenue	Water
Uniform $5	$5*10=$50	$5*20=$100	$150	30
Uniform $10	$10*10=$100	0	$100	10
Price Discrimination	$10*10=$100	$5*20=$100	$200	30

Based on Perloff, Microeconomics, page 397

Quantity regulation.

Control amount of externality generating product that is supplied.

Control amount of the good that produces a negative externality

Control the number of livestock put on the commons.

Outright ban. Why is it illegal to buy or sell human organs in the US?

Control of externality directly.

Marginal cost of abatement, marginal benefit of abatement.

Marginal cost of permit comparison.

Standards in production.

Labor laws, occupational health and safety oversight.

Food and Drug administration.

Lead testing.

Direct information provision. Ad campaigns, putting warning labels on products, calorie counts in restaurants, cereal boxes…Country of origin labels, efficiency ratings, all trying to deal with information asymmetry issues.

Public school report cards, provision of information, graduation rates, spending per student,…

https://data.nysed.gov/

Syracuse City School District Report from the State

https://data.nysed.gov/profile.php?instid=800000040902

Report from a NGO Great Schools. org

https://www.greatschools.org/new-york/fayetteville/690-Jamesville-Dewitt-High-School/

Indirect information provision.

Licensure – you have to have official authorization to provide a good or service.

http://www.op.nysed.gov/prof/

Organization report cards

Maxwell and US News and World Report

Less stringent, you have to meet certain standards to be in an association and they signal you have standards that meet the group's expectations.

https://www.appam.org/membership/institutional-membership/

10.3 Establishing Rules

Generic Policies	Perceived Market Failure (MF), Government Failure (GF), Distributional Issue (DI), Limitation of the Competitive Framework (LCF)	Typical Limitations and Collateral Consequences
Frameworks		
Civil laws (especially liability rules)	MF: Negative externalities MF: Information asymmetries MF: Public goods DI: Equal opportunity LCF: Thin markets	Bureaucratic supply failure Opportunistic behavior Imbalance between compensation and appropriate deterrence
Criminal laws	MF: Negative externalities MF: Public goods LCF: Illegitimate preferences	Costly and imperfect enforcement.
Regulations		
Price regulation	MF: Natural monopolies DI: Equity in distribution of scarcity rent DI: Equity in good distribution	Allocative inefficiency X-inefficiency
Quantity regulation	MF: Negative externality MF: Public goods MF: Open access	Rent seeking Distorted investment Black markets
Direct information provision (disclosure and labeling)	MF: Information asymmetries MF: Negative externalities	Cognitive limitations of consumers
Indirect information provision (registration, certification, and licensing)	MF: Information asymmetries MF: Negative externalities GF: Bureaucratic supply failure	Rent seeking Cartelization
Regulation of the circumstances of choice	LCF: Cognitive limitations to rationality	Few applications discovered so far beyond opt-out versus opt-in

If there is a market failure, there is a case for policy intervention. Government could step in using policy measures considered so far.

What is the case or direct government provision of goods and services?

Consider national defense for example. Public provision of this public good could be justified to minimize moral hazard / opportunistic behavior.

Note Blackwater / Wagner kinds of counterexamples.

Collection of taxes, printing money, administration of justice; agency problems if supplied by private firms.

'Double market failure', when we identify market failure has occurred but also that policies generated in the context of market operation will not work.

Direct supply, see the list from Leman on 245-6.

- Facilitating commerce
- Managing public lands
- Constructing public works and managing real property
- Research and testing
- Technical assistance
- Laws and justice
- Health care, social services, direct cash assistance
- Education and training
- Marketing
- Internal administration

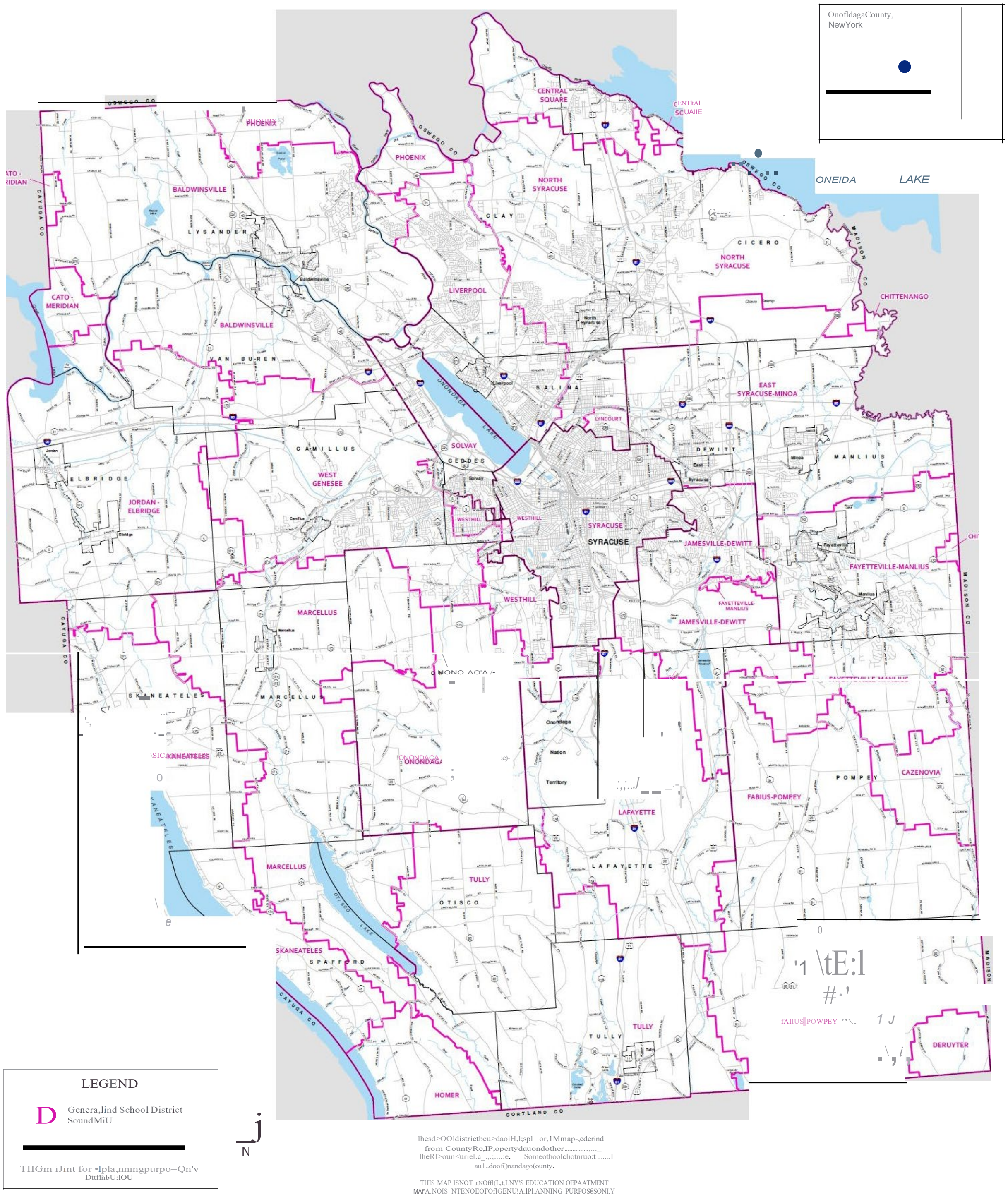
Independent agencies:

Government corporations (TVA, Port Authority of NY-NJ, Postal Service, FDIC, Corporation for Public Broadcasting)

Special districts (watershed management, primary and secondary school districts,…)

http://www.ocswcd.org/maps.html

Generalized School District Boundaries in Onondaga County



Contracting out.

Trash collection.
Road building.
Correctional facilities.
Work for USAID
Work for Department of State

10.4 Supply by non-market mechanisms.

Generic Policies	Perceived Market Failure (MF), Government Failure (GF), Distributional Issue (DI), Limitation of the Competitive Framework (LCF)	Typical Limitations and Collateral Consequences
Direct Supply		
Bureaus	MF: Public goods MF: Positive externalities MF: Natural monopolies DI: Equity in distribution	Rigidity; dynamic inefficiency; X-inefficiency
Independent Agencies		
Government corporations	MF: Natural monopolies MF: Positive externalities DI: Equity in distribution GF: Bureaucratic supply failure	Agency loss
Special districts	MF: Natural monopolies MF: Local public goods MF: Negative externalities DI: Universal provision	Agency loss; insensitivity to minorities with intense preferences
Contracting Out		
Direct contracting	MF: Public goods, especially local public goods. GF: Bureaucratic supply failures	Opportunistic behavior by suppliers; lock-in and low-balling.
Indirect contracting (nonprofits)	MF: Positive externalities GF: Bureaucratic supply failures DI: Diversity of preferences LCF: Endogenous preferences (behavior modification)	Weak coordination of services

Insurance and cushions.

Insurance can fact problems of adverse selection, moral hazard, and incomplete information. Purchasers of insurance may have incomplete understanding of the probabilities of different risk that are covered by insurance.

Insurance is ex ante risk management.

Mandatory insurance is a way to have complete risk pooling.

Public provision of insurance can be a way to pool risk and address these problems.

Social Security's Old Age, Survivors, Disability Insurance (OASDI)

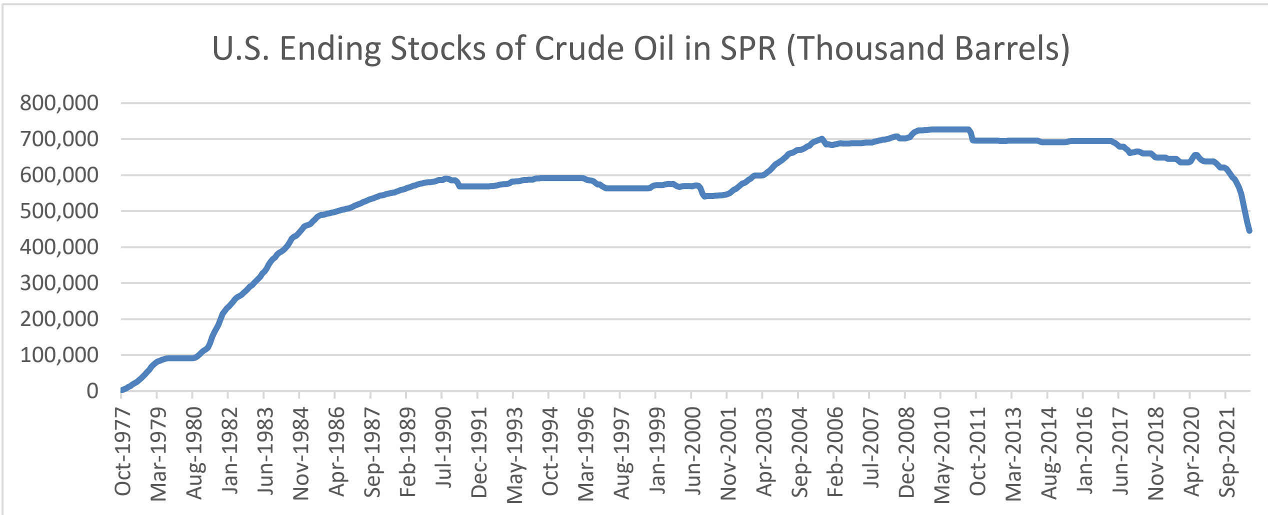
Will people on their own have enough resources to cover expenses in retirement, loss of a parent, injury?

Are the costs to society if they don't high enough to justify a public response?

Requiring and subsidizing insurance is another policy option. FEMA and building in floodplains.

Cushions are ex post risk management.

Stockpiles: chromium, platinum, vanadium, manganese, US Strategic Petroleum Reserve.



China’s strategic pork reserve.

https://www.reuters.com/article/china-hogs-reserves/update-4-china-to-use-pork-reserves-to-stabilise-market-idUSL2N2NR05C

US Commodity Credit Corporation

Transitional Assistance.

Buy outs. Conklin NY with Susquehanna floods, highway construction, costal zones, fire prone areas,…

Grandfather clauses, going forward the policy will apply but will not be applied to existing structures / practices.

Cash grants.

Negative income tax.

Hunger Safety Net Program.

Cash during the pandemic.

Potential incentive effects on motivation to seek employment.

Table 10.5 Insurance and cushions.

Generic Policies	Perceived Market Failure (MF), Government Failure (GF), Distributional Issue (DI), Limitation of the Competitive Framework (LCF)	Typical Limitations and Collateral Consequences
Insurance		
Mandatory insurance	LCF: Adverse selection	Moral hazard
Subsidized insurance	MF: Information asymmetries DI: Equity in access LCF: Myopia LCF: Misperception of risk	
Cushions		
Stockpiling	LCF: Adjustment costs GF: Price controls	Rent seeking by suppliers and consumers
Transitional assistance (buy-outs, grandfathering)	LCF: Adjustment costs GF: Macroeconomic dynamics	Inequity in availability
Cash grants	DI: Equality of outcome LCF: Utility interdependence	Reduction in work effort; dependency

10.6 Primary (P) or Secondary (S) Sources for Solutions

	Market Mechanisms	Incentives	Rules	Nonmarket Supply	Insurance and Cushions
Traditional Market Failures					
Public Goods	S	S	S	P	
Externalities	S	P	P	S	
Natural monopolies	S	S	P	P	
Information Asymmetries			P	S	S
Other Limitations of the Competitive Framework					
Thin markets			P		
Preference-related problems	S	S	P		
Uncertainty problems			P		S
Intertemporal problems			S		P
Adjustment costs					P
Macroeconomic dynamics		P			S
Distributional Concerns					
Equity of opportunity		S	P		S
Equality of outcomes			S	S	P
Government Failures					
Direct democracy			P		
Representative government	P		S		
Bureaucratic supply	P	S	S	S	
Decentralization	S	P		S	