LECTURE 3

Scope of Government

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Key questions

What functions the government assumes upon itself, given private and quasi-private alternatives? What motivates this choice?

How are such functions implemented?

Guidelines

A. Identify and assess government's advantages and disadvantages vis-à-vis practical alternatives in deciding what the government scope should be

B. Be mindful of informational, administrative etc. constraints and look for 2nd best

Case I: Controlling Externalities

A firm imposes external costs on the rest of society (employees, customers, communities etc.)

Possible responses:

- Nationalization
- Regulation
- Law suits
- Private solutions

Comparative (dis)Advantages

Private solutions:
full information; possibly prohibitively high transaction costs

Government regulation:
asymmetric information; stronger enforcement

Courts:
flexibility; weaker deterrence; legal fees

Model (Glaeser, Shleifer, 2003)

D – damage that a firm could cause (to employees, customers, local communities, etc.)
C – cost of preventive measures
Two types of firms:
Type 1 (share α): precautionary measures reduce the probability of damage from p_1 to $p_2 < p_1$
Type 2 (share $1 - \alpha$): probability of damage is unaffected by precautionary measures and equals $p_0 \in (p_2, p_1)$

1st best and Limitations of Public Regulation

Assumption: $(p_1 - p_2)D > C$

1st best: Type 1 firms take precautionary measures, type 2 firms do not.

Regulators don't know firms' types, and can either require that all firms take precautions, or none do so. Neither is 1st best.

Litigation vs. Regulation

Damaged parties can sue the firm that caused the damage, and the latter will be required to pay penalty F ("strict liability").

Court sanctions are economically relevant inasmuch as they affect incentives ex ante. Sanctions force Type 1 firms to take preventive measures if

$$(p_1 - p_2)F > C \text{ or } F > \frac{C}{p_1 - p_2}$$

No impact on Type 2. 1st best?

Cost-efficient Enforcement

A potential offeneder factors in the severety of punishment and the likelihood of its application. The latter is costly to the government as it requires investments into monitoring and investigation, whereas the former appears to be “free”. This explains heavy sanctions for seemingly minor violations. Such approach however has its limits due to court practices and sanction avoidance.

Administrative Capacity

X – cost of evading or offsetting court sanctions.

If $X < \frac{C}{p_1 - p_2}$, courts will not be able to prevent damage.

Explanation: probability of damage (let alone its reduction) is low, and to "bite", penalties ought to be very high, above the enforcement ceiling (exercise: "negligence" rule).

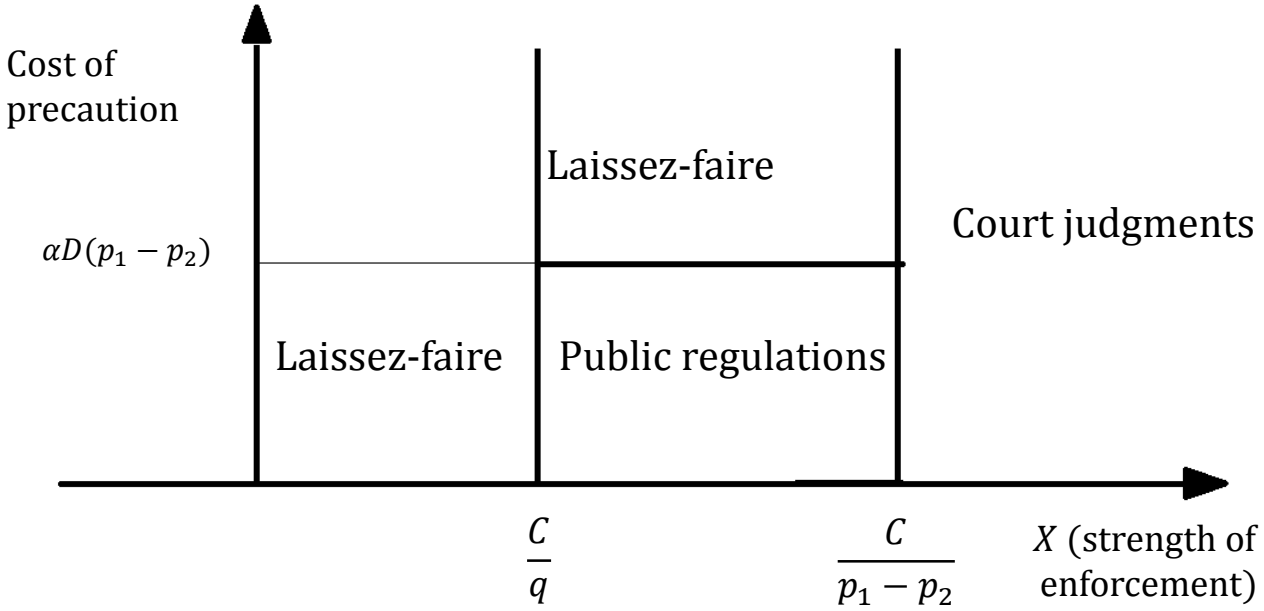
Regulation as 2nd best

Inspections reveal non-compliance with regulation with probability $q > p_1 - p_2$. Required penalties to enforce compliance would be lower: $qF > C \Rightarrow F > \frac{C}{q}$.

If $\frac{C}{q} < X < \frac{C}{p_1 - p_2}$, then court sanctions would be impractical, as opposed to regulations.

If $X < \frac{C}{q}$ (extreme weakness of the enforcement system), then laissez-faire is the only option.

Map of Externalities Control



Coasean Alternatives

Industry could impose on itself standards of conduct by means of self-regulation, to prevent indiscriminate government regulation. Self-prevention of externalities could be an outcome of corporate social responsibility, when companies strive to obtain “a social license to operate” to avert consumer boycotts, protests, law suits etc.

Efficacy of CSR depends on society’s ability to collectively defend its interests

Case II: Public Service Delivery

Two models of provision of public services:
(i) in-house
(ii) outsourcing to private firms

Advantages of outsourcing: stronger performance incentives, higher efficiency, more innovations, lower costs to taxpayers.

Disadvantages of outsourcing: too strong incentives to cut costs (perhaps at the expense of quality)

Public or Private?

Outsourcing can be observed in education, health care, public transit, law and order, public infrastructure maintenance,...and even administration of government programs and prisons.

Public-private partnerships provide for construction and operation by private companies of public infrastructure objects (airports, bridges, public utilities etc.)

Benchmark: Quality of Contracts (Hart, Shleifer, Vishny, 1997)

Powerful incentives of the private sector are a plus, if societal interests are well-protected by high quality contracts with private providers, specifying verifiable performance targets.

Otherwise in-house provision is preferable.

Property Rights and Incomplete Contracts

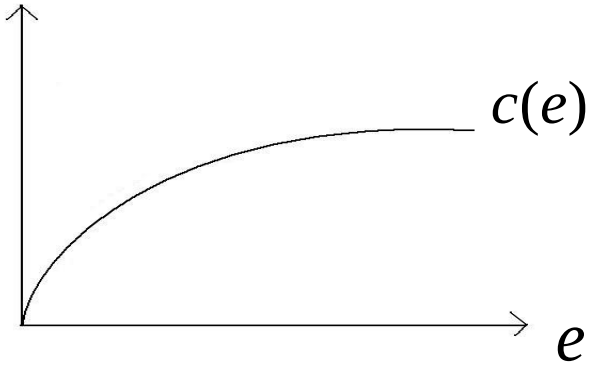
According to Grossman and Hart, property rights include the right to unilaterally make use of the degrees of freedom left unspecified by the contract. Otherwise such changes need owner's approval with proper gain sharing. This weakens the incentives to innovate and cut costs.

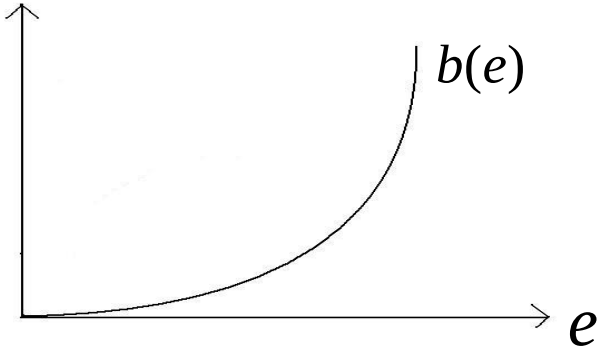
Model

$e > 0$ – intensity of innovations
$c(e)$ – cost of savings
$b(e)$ - quality reduction

1st best: $\max_e c(e) - b(e) - e$

$$c'(e^*) - b'(e^*) = 1$$

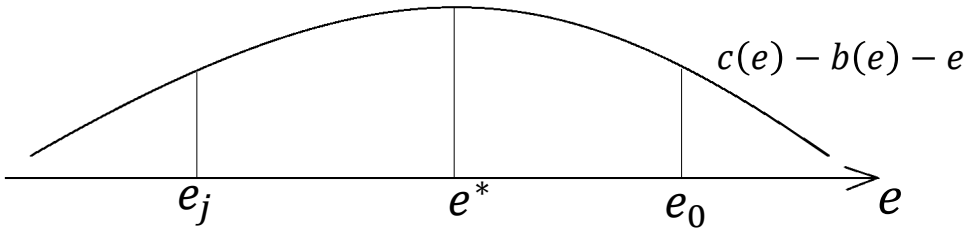




2nd best: Outsourcing or In-house?

Outsourcing: $\max_e c(e) - e; \quad c'(e_o) = 1; \quad e_0 > e^*$

In-house: $\max_e \frac{1}{2}\big(c(e) - b(e)\big) - e; \quad c'\big(e_j\big) - b'\big(e_j\big) = 2; \quad e_j < e^*$



Outsourcing and Quality of Contracts

Strong contracts: $b(e)$ – small.

Outsourcing approximates 1st best and hence is 2nd best.

Weak contracts: $c(e) - b(e)$ – small.

In-house approximates 1st best (in both cases e is small) and hence is 2nd best.

Applications

Weapon manufacturing and garbage removal – good candidates for outsourcing.

Education and health care – mixed bag.

Beware of private prisons...

Case III: Regulatory Capture

Regulations and other public policies and instruments can be captured by narrow interests to serve their needs at the expense of the rest of society. Example: trade restrictions.

Such diversion of regulation defies its purpose and could cause serious harm.

Regulation of Entry and De Soto Effect

Regulatory entry barriers in many countries are excessively high, pushing economic assets and activities into the shadow economy.

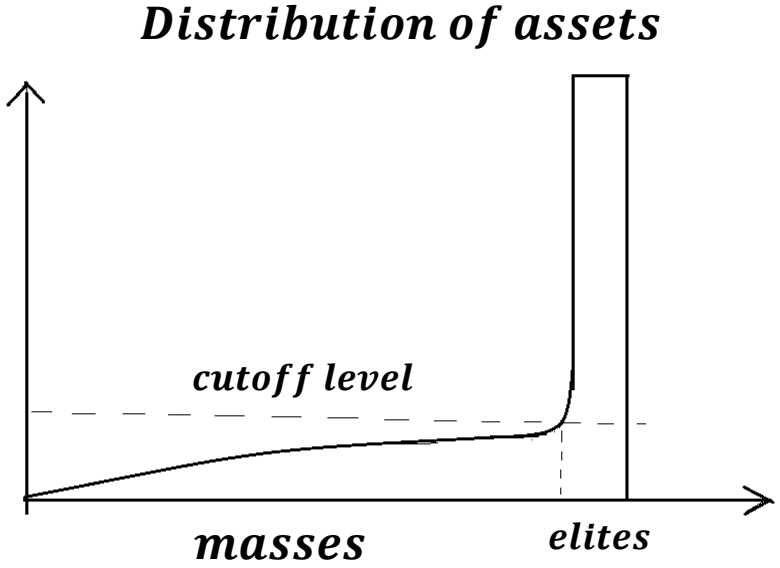
Cutting red tape down to reasonable level increases returns to such assets and advances economic development (access to finance, propensity to invest, etc.)

Evidence of Capture (Djankov et al., 2002)

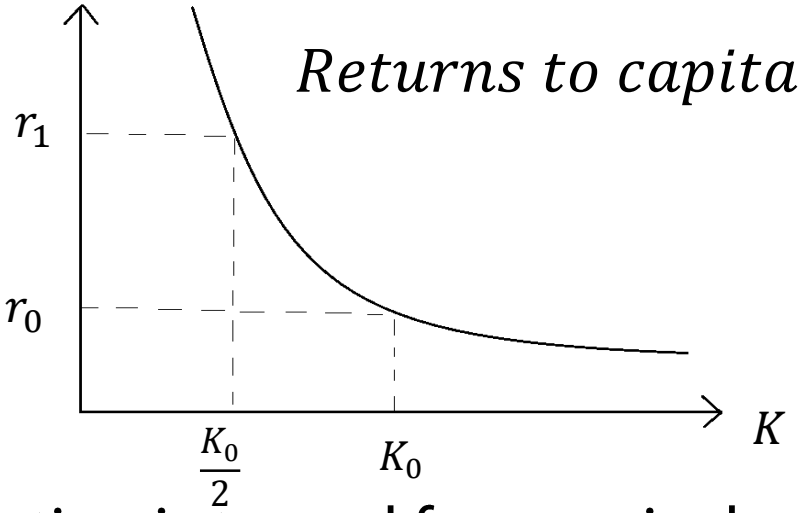
Height of entry barriers is *negatively* correlated with public health, consumer and labor safety, environmental protection and other externality preventions.

It is *positively* correlated with corruption and shadow economy.

Impact of Inequality



Calculus of Capture



Regulation is turned from an inclusive institution into a tool of rent extraction

Public Interest vs. Public Choice

Government's tools and policies can be chosen to serve public interest, in which case they are "inclusive institutions" (Acemoglu, Robinson, 2012)

Alternatively they are outcomes of influence-peddling by powerful elite groups, and turned through "public choice" (Djankov et al., 2002) into tools of rent extraction.

Small Government as a Protection from Capture

Societies uncertain of their ability to prevent government capture and other abuses of public services and programs opt for small government. Higher-trust and more cohesive nations have bigger governments than those where societies are less cohesive and divided among social, economic, cultural etc. “fault lines.”