CHAPTER 2

Government and the Economy

POLITICAL FREEDOM AND ECONOMIC FREEDOM are closely related. Any comparison among contemporary nations or examination of the historical record demonstrates two important relationships between the nature of the political system and the nature of the economic system:

- All nations which have broad-based representative government and civil liberties have most of their economic activity organized by the market.

- Economic conditions in market economies are generally superior to those in nations (with a comparable culture and a comparable resource base) in which the government has the dominant economic role.

The evidence is striking. No nation in which the government has the dominant economic role (as measured by the proportion of gross national product originating in the government sector) has maintained broad political freedom; economic conditions in such countries are generally inferior to those in comparable nations with a predominantly market economy. Voluntary migration, sometimes at high personal cost, is uniformly to nations with both more political freedom and more economic freedom.

The reasons for these two relationships between political and economic systems are simple but not widely understood. Everyone would prefer higher prices for goods sold and lower prices for goods bought. Since the farmer's wheat is the consumer's bread, however, both parties cannot achieve all they want. The most fundamental difference among economic systems is how these conflicting preferences are resolved.

A market system resolves these conflicts by allowing the seller to get the highest price at which others will buy and the buyer to get the lowest price at which others will sell, by consensual exchanges that are expected to benefit both parties. Any attempt by one party to improve his outcome relative to the market outcome requires a coercive activity at the expense of some other party. The politicization of price decisions—whether of wages, commodities, or interest rates—tends to reduce both the breadth of popular support for the government and the efficiency of the economy. A rich nation can tolerate a good bit of such mischief, but not an unlimited amount. One should not be surprised that all nations in which the government has dominant control of the economy are run by a narrow oligarchy and in most economic conditions are relatively poor. In the absence of limits on the economic role of government, the erosion of economic freedom destroys both political freedom and economic performance.

Only a few dozen nations now guarantee their citizens both political and economic freedom. The economic role of government in these nations differs widely, without serious jeopardy to political freedom. Within the range of experience of the United States and the other free nations, the relation between the political system and the government's economic role is more subtle. Expansion of the economic role of the government tends to reduce both the level of agreement on government policies and the inclination to engage in political dissent. The link between political and economic freedom is important. Increasing economic freedom will also provide greater assurance of our political freedom.

A major objective of this Administration's economic program is to reduce the Federal Government's role in economic decisionmaking while strengthening the economic role of individuals, private organizations, and State and local governments. This shift will entail substantial reductions in the size and number of Federal spending programs, significant reductions in both personal and business Federal tax rates, major reforms of Federal regulatory activities, and a reduced rate of money growth. While an important element in this redefinition of the Federal Government's economic role is a political judgment about the appropriate relationship among individuals, the States, and the Federal Government, this redefinition also is supported by an extensive body of economic analysis.

This chapter discusses the extent to which government intervention in economic matters is appropriate, why concern over "too much government" appears to have emerged so strongly in recent decades, and why the Administration's program is an appropriate response.

In probing the role of government in the economy, economists usually start by analyzing the effects of a competitive economy on economic efficiency. In a rough sense, economic efficiency refers to the ability of an economy to satisfy each person as much as possible, consistent with the preferences of others. For such a competitive economy to be completely efficient, however, certain assumptions would have to be satisfied that are never fully satisfied in the real world. Therefore, it is often argued that government intervention is justified in order to correct the inefficiencies which occur when the desired conditions are not achieved.

However, failure to satisfy certain assumptions is not sufficient to justify government intervention. To show that a perfectly functioning government can correct some problem in a free economy is not enough, for government itself does not function perfectly. Moreover, many current interventions cannot be explained easily by arguments based on the alleged failure of the operation of free markets. Many current interventions, in other words, cannot be justified by any efficiency criterion.

The following section of this chapter discusses situations in which some types of government intervention in the economy may be justified. The section on The Division of Roles in a Federal System discusses the considerations involved in determining the appropriate level of government at which such intervention should take place. The section on Limits on the Exercise of the Federal Role discusses the political process and argues that government intervention will not always be consistent with the principles developed in the prior sections; that is, this section focuses on the possibility of "government failure" in intervening in the economy. The last section, Principles Guiding the President's Economic Program, discusses the Administration's economic program in light of the preceding analysis.

THE LIMITED CASE FOR GOVERNMENT INTERVENTION

Under certain assumptions discussed below, a competitive economy can be shown to lead to general economic efficiency. In standard economics, an economy is said to be "efficient" if it is impossible to make anyone better off without making someone else worse off. That is, there is no possible rearrangement of resources, in either production or consumption, which could improve anyone's position without simultaneously harming some other person. If there is a possibility of such a rearrangement occurring, then this means that someone could be made better off without harming anyone else. If such a possibility does exist, then the economy is not efficient.

Each person in such an economy is considered to be concerned primarily with his or her own welfare. Since there is no central authority directing the course of this economy, whatever results occur are the unintended consequences of millions of individual actions. Nonetheless, the outcome of this undirected but self-interested behavior is efficient in the sense mentioned above. Despite the absence of any central direction, it can be shown that an economic order is generated which has the desirable characteristic of being economically efficient. Moreover, an efficient economic system is responsive to individual wants; that is, efficiency is defined in terms of each person achieving his or her own goals.

Such a system relies on the ability of people to trade freely with each other, for a bargain entered into voluntarily by two individuals is expected by both of them to make both of them better off. Two conditions must be fulfilled for such trades to occur. First, individuals must have the right to enter freely into whatever bargains they wish; that is, there must be freedom of contract. Second, property rights must be well defined in all cases except those where the cost of enforcing the right would be greater than the value of the right.

Certain additional characteristics must be present if the economy is to be efficient. The most important of these characteristics are: the absence of externalities, the absence of significant monopolies, and the appropriate provision of public goods. Though such an economy is efficient, "efficiency" says nothing about the distribution of income which results from the process. By some criteria the market-generated distribution of income in an efficient economy may be unacceptable. Thus, government intervention may be justified to correct market failures or to change the resulting distribution of income. It is also possible that an efficient economy may be less stable than is generally considered desirable.

EXTERNALITIES

An externality is said to exist where an economic agent (be it producer or consumer) either does not bear the full marginal costs of an economic action or does not gain its full marginal benefits. Therefore, these agents may not undertake the activity at its optimal economic level. If there are external costs, the agent may undertake too high a level of the activity. If there are external benefits, the agent may not undertake enough of the activity.

An example of an activity with external benefits is education. Because some of the benefits of living in a nation of people with a common language and culture are external, individuals considering only their own benefit from education will most likely buy too little. The standard example of an activity that imposes external costs is manufacturing that results in pollution. Consider a factory which pollutes the air. Those who live near the factory will suffer the costs of the pollution, but the factory owner will probably not consider these costs in deciding how much to produce. Since the factory owner does not bear these costs, the product made in the factory will be underpriced in relation to its true economic cost. Hence, too much of the good, and too much pollution, will probably be produced. Government intervention may therefore be justified where either marginal costs or benefits are external.

Private transactions between parties may sometimes be adequate to solve externality problems, but this requires that transaction costs be low. This requirement will not in general be satisfied when many parties are involved.

Since externality problems occur because decisionmakers either do not pay all the costs of their actions or do not reap all of the benefits, the most efficient way to correct the problem is to change the marginal costs and benefits. With respect to education the conventional solution has been to establish systems of public education paid for by taxes and offered below cost to students. This solution itself creates problems, since the creation of a tax-subsidized producer of education may lead to the producer having a monopoly over education. But monopoly is inefficient, whether it is public or private. An alternative would be to grant a "voucher," with the amount of this voucher equal to the difference between private benefit (the benefit to the student) and total benefit (the benefit which accrues to other members of society as well as to the student). This would avoid the problem of monopoly and might generate pressures for more efficient schools.

To deal with the external costs of pollution, the conventional solution has been regulation of pollution control technology by government agencies. Since this form of regulation often does not take account of differences in abatement costs for different polluters, it is often inefficient in that the public pays more than is necessary for a given amount of pollution reduction (or a smaller reduction in pollution is achieved for a given expenditure than would be possible with a more efficient scheme).

Two ways of reducing pollution more efficiently have been identified. One is to charge those who pollute a fee based on the cost imposed on others by the pollution. This method has been used in West German waterways and has been quite effective. Another alternative is for the government to create property rights in air or water. These rights would then be purchased by those who valued them most—that is, by those who would pay the highest cost to reduce their pollution. These two methods, if implemented correctly, would probably lead to the same outcome.

MONOPOLY

One of the conditions of market efficiency is that there must be enough buyers and sellers of a good so that each of them has little influence on its price. This condition is not always satisfied, however. Sometimes technical and cost conditions in an industry are such that there will be room for only one or a few firms. Two approaches have been taken in the United States to this problem. In cases of natural monopoly, direct government regulation or ownership is common. In industries where only a few firms exist, the antitrust laws are more commonly used to avoid the costs of monopoly.

Most of the natural monopolies arise from the need to provide public utility services, such as electricity and water. Regulation of most of these natural monopolies occurs primarily at the State and local level and is not covered in this *Report*, but there are some monopolies regulated at the Federal level. In some cases of natural monopoly, however, newer technology may so change technical and cost considerations that additional firms would enter the market if permitted to do so by regulatory authorities.

In an industry with few firms it may be possible for the firms to act in collusion and thus behave as a monopoly. When this occurs, the profits of the firms are increased, but efficiency losses are imposed on the economy. Even though such collusions are unstable, losses of efficiency occur during their existence. The antitrust laws make such behavior illegal.

The effects of mergers on economic efficiency are more difficult to discern than the effects of illegal monopoly. Two firms in the same industry may merge for any of at least three reasons. First, a merger may be an attempt to obtain monopoly power. When this occurs the merger will be inefficient and should be stopped. But, firms may also decide to merge to take advantage of economies of scale or because one is better managed and can therefore increase efficiency in resource use. In these latter two cases a merger is likely to improve efficiency and should be allowed. The difficulty, of course, is that it is not always obvious whether monopoly or an increase in efficiency will be the dominant effect of any given merger.

Though there are difficult cases, this Administration has already made some changes in policy in the administration of Federal antitrust laws, changes based on economic analysis. First, a merger between two firms which have a relatively small share of the market should be allowed, for there is little danger of monopoly. Second, no significant economic problems are likely to arise from a merger of firms in unrelated industries (a conglomerate merger); such a merger will not create any significant monopoly power. Third, there is little danger of monopoly and therefore no reason for Federal intervention when a firm merges with another firm that is a customer or a supplier of the first (a vertical merger). Finally, a firm that obtains a large share of a market by being a more efficient competitor is acting in a desirable fashion and should not be punished by antitrust action on the part of the Federal Government. In recent years, those in charge of administering Federal antitrust laws sometimes have behaved as if they viewed their function as protecting existing firms from competition. From an economic viewpoint the purpose of the antitrust laws is to maintain competition, even if competition leads to the decline of firms which are less efficient.

PUBLIC GOODS

A public good has two distinctive characteristics. The first is that consumption of the good by one party does not reduce consumption of the good by others, and the second is that there is no effective way to restrict the benefits of such goods to those who directly pay for them. The standard example of a public good is national defense. If national defense deters a foreign aggressor, everyone in the country benefits. This means that no individual will have sufficient incentive to spend his own resources on national defense, since he will benefit from his neighbor's spending. Hence, such public goods as national defense are usually provided by some action of the national government. Government action is usually necessary for the optimal provision of many public goods, and this point does not arouse controversy among economists. Sometimes there are debates, however, about whether a particular good is sufficiently public in nature to justify its being provided by the government.

Another public good is information. If one person learns some valuable fact and tells someone else, the use of the information by one does not reduce the use of the same information by the other. If a consumer organization spends resources to find out which products are best and sells a publication that provides this information to subscribers, these subscribers may then pass the information on to others who did not pay for it. This can be shown as a market failure, in the sense that the private market did not generate enough information; if the organization could capture all of the returns, it would provide additional information. Patents and copyrights are designed to reduce this problem by giving inventors and writers property rights in their product, thus providing incentives for production, but there are still cases where the private market does not generate sufficient information. This provides the rationale for government financing of certain kinds of research.

INCOME REDISTRIBUTION

In a market economy, individual income depends upon what one has to sell and on the amount which others are willing to pay for it. What most people sell on the market is their labor. About 75 percent of national income is in the form of wages and salaries and other forms of labor remuneration. Others have capital or land to rent, and their return is interest and dividends, or rent income. Most people earn income from both capital and labor over their lifetimes. But some persons may have few or no valuable things to sell, and these persons will have low incomes. A decision may then be made to transfer income to such people directly through government. Two justifications can be presented for such transfers of income, one based on the social value of providing certain forms of income insurance, the other based on benevolence. We consider each.

Anyone may lose his ability to earn income. A worker may become physically disabled or find that technological progress has made his or her skills obsolete. Or an investor may find that changing market conditions have eroded the return on capital. Since individuals generally do not like the risk of losing their ability to earn income, they often seek to insure themselves against such a possibility.

But there are difficulties in providing insurance against falling incomes by way of private-market mechanisms. A major difficulty is what is called "adverse selection." Assume that some insurance company offered actuarily fair insurance against this risk and charged all persons the same premium. (That is, the amount of the premium equals the expected cost of having a low income.) Since most persons are averse to risk, they might buy this insurance even though the premium would be somewhat greater than the expected cost because of the expense of writing the insurance. Some persons would be better risks than average, and new insurance companies would compete with the first company for these better risks. This would leave the original company insuring only the bad risks, which the company would then find financially intolerable. Ultimately, one class of persons would be unable to obtain any insurance.

This would be an example of market failure and an argument for government provision of insurance, since the government can force everyone to join the same insurance pool. The appropriate form of insurance to those who experience a temporary loss of income is a cash grant. Welfare payments and unemployment compensation may be viewed as just this sort of insurance.

The second argument for government transfers to the poor is an argument based on benevolence. Many people prefer not to live in a society where there is poverty and thus have an incentive to transfer some of their resources to the poor voluntarily. When one individual performs such a transfer, all individuals who dislike poverty benefit. Thus, most people will have an incentive to reduce their contributions to the poor and rely on the contributions of others. In all likelihood, such voluntary transfers would be too low to keep people out of poverty; it may become necessary for the government to do it.

In cases where transfers of income are desirable, economic theory can indicate the most efficient form of transfer. One goal should be to minimize interference in private markets. Price controls on gasoline and laws decreeing minimum wages, for example, are considered by many economists to be inefficient ways of helping the poor.

The way in which resources should be transferred to the poor depends on the goal of the donors. If the goal is simply to improve the welfare of the poor, the most efficient solution probably would be a system of cash transfers, since it can be assumed that recipients are best able to determine the pattern of spending that maximizes their welfare. But if the donor is more concerned with the specific goods which the recipient consumes, a direct transfer of goods may be preferable. In this case the argument can be made for using some form of voucher. A voucher is essentially a coupon usable only for the purchase of a specific type of good. Food stamps are one example. Use of vouchers instead of a direct transfer of goods allows recipients to determine their own consumption but restricts the type of goods which the recipient may purchase.

Regardless of the form of transfer, there is still an efficiency cost. Transfers reduce the incentive of recipients to work, and the taxes imposed on the rest of society to finance these transfers also cause losses in efficiency. There are also costs of administering the program. Economists are able to give advice on ways of transferring income which may serve to minimize these effects, but the decision as to the amount of the transfers is a political decision, not an economic one.

MACROECONOMIC STABILITY

A market system may sometimes be subject to unacceptably large fluctuations in income. When this occurs, it has implications for the general welfare. First, average income levels may be smaller with fluctuations than if the level of activity is more stable. Second, even if the average level of incomes is unaffected by such fluctuations, people are generally risk-averse. That is, most people prefer a steady stream of income to a fluctuating stream, even if their total income is the same over a period of time. For these reasons, government may have a role in helping to provide stability.

An alternative view is that a market economy is inherently quite stable. According to this view, government actions are the primary destabilizing factors in the economy. That is, many fluctuations in income which seem to be caused by private sector actions are actually caused by attempts to outguess the government. (This issue is discussed in more detail in Chapter 3.)

Macroeconomic stability also involves the question of what to do about money. Money performs several functions in an economy. Its use economizes on transaction costs and on information costs, since all persons accept the same money and are aware of its value. However, the government must be careful in its money creating function not to exacerbate cyclical fluctuations. Excess creation of money leads to inflation, which reduces money's value.

Although the Federal Government is the appropriate agent for stabilizing the economy, the limits of such action must be understood. This Administration believes that "fine tuning" of the economy—attempting to offset every fluctuation—is not possible. The information needed to do so is often simply not available, and when it becomes available it is quite likely that underlying conditions will already have changed. As a result, a policy of fine tuning the economy is as likely to be counterproductive as it is to be helpful. Though it is necessary for the government to have macroeconomic policies, including both monetary and fiscal policies designed to achieve some desired growth of income, such policies are not suitable for correcting small fluctuations in economic activity.

THE DIVISION OF ROLES IN A FEDERAL SYSTEM

The preceding sections have discussed situations where government intervention in private economic activities may be appropriate. An equally important concern is determining the level of government at which intervention, when desirable, should take place.

Our system of government is a Federal system, one in which certain powers have been granted to the Federal Government while other powers have been granted to the States. In recent decades, however, there has been a substantial centralization of power at the national level.

One constraint on the power of any government to impose costs on its citizens is the ability of those citizens to move elsewhere. Thus, one argument for reliance on State government is essentially the argument that it restricts the power of government, since any State which passed laws which were sufficiently inefficient would probably find itself losing residents. The long-term increase in the power of the Federal Government at the expense of the State governments has probably weakened this constraint on governmental power.

Another argument for federalism is that State and local governments are more likely to choose the amount and quality of governmental services preferred by their voters, whose preferences and resources vary greatly. This argument has important implications for both the types of services that should be provided at the different levels of government and the structure of the tax system. Decisions on government services that benefit people throughout the Nation, such as national defense and the protection of basic constitutional rights, are appropriately made by the Federal Government, and such services should be financed by Federal taxes. But, government services that provide benefits only or predominantly to residents of a specific region, such as urban transit and sewer systems, can probably be provided more efficiently by State or local governments and financed by State and local taxes or user charges on those persons directly benefited.

In this view, Federal grants-in-aid to State and local governments should be restricted to services provided by these governments that have significant benefits for residents in other regions of the country. Over the last several decades, however, Federal grants-in-aid have not been directed at assisting such services. Instead, these grants have in many cases reduced the State or local "tax price" of a wide range of other services and therefore have increased their utilization beyond that which most local residents would prefer. Consequently, the relative growth of Federal financing of State and local services has probably increased the total size of government in the United States while reducing its efficiency and responsiveness. The case for a return to a more balanced federalism is a case for both efficiency in the provision of public services and for greater individual freedom and choice in the Federal system.

LIMITS ON THE EXERCISE OF THE FEDERAL ROLE

So far, this chapter has summarized the theoretical reasons for a limited role of the Federal Government in the economy. Even when the government justifiably undertakes certain activities, however, there are reasons for believing that it is unlikely to do a perfect job. Just as there sometimes are reasons for expecting "market failure," sometimes there also are reasons for expecting "government failure." In this section we discuss some of these reasons.

THE POLITICAL PROCESS

For several reasons the political process is overly responsive to special interest groups. One cause of this is the high cost of information. Consider, for example, an import quota program that will give rather large benefits to firms and workers in the industry to be protected by the quota. Although such a program will impose only small costs on everyone else in the economy, it will be inefficient because the sum of the losses will be greater than the sum of the gains. However, each of the losers will lose so little that it will often not pay to spend the resources necessary to learn about the losses. The average voter would have to make a detailed study of law and economics, for example, to determine how much government-induced cartelization of the trucking industry costs him. It is quite rational for the average voter not to bother to learn about this cost, for the resources spent in doing so would probably be greater than the per capita cost of the government activity that led to cartelization. (Economists refer to this as "rational ignorance.") On the other hand, the beneficiaries of government policies gain substantial amounts, and it pays for them to spend resources in learning about government activities. Thus, trade associations hire lobbyists whose job includes informing members of an industry about political decisions which may affect their operations.

Moreover, even if the average voter had the information required to make a rational decision on how to vote in the next election, it is not clear what effect this would have. Assume that a citizen knows that his or her legislative representative voted for an import quota that will cost the voter $50 but also voted for some other bill which will benefit the voter's own special interest group and give him or her a benefit worth $500. The rational behavior of the voter will therefore be to vote for the reelection of the representative. That is, there are good reasons for expecting the political process to be responsive to special interests. It is possible for a representative to be elected by favoring a set of special interest policies, each of which appeals only to a minority of the electorate. Moreover, achieving a victory with such a "coalition of minorities" would be possible even if all the voters had all the information they needed to make a reasoned choice. That is because the gains from such special interest policies will be concentrated among the majority, while the costs will be borne by members of both the majority and the minority. Therefore, it is possible for a majority coalition made up of several special interest groups to gain benefits for themselves, even if the sum of the costs to all affected parties is greater than the sum of the benefits.

The same arguments also apply to other political activities. It will pay for concentrated special interests (including both business and unions) to make campaign contributions to those who vote for benefits for people in the industry, but it will not, in general, pay for citizens to make contributions to representatives who vote against such bills. This is because the losses suffered by each voter are small and because overturning inefficient legislation is a public good. It does not generally pay to contribute voluntarily to the provision of a public good that affects a large number of people.

The fact that the political process is likely to be overly responsive to interest groups constitutes an argument for limiting the power of government to intervene in the economy. Each citizen would like to use government to transfer resources to himself but is often skeptical or hostile when the government transfers resources to others. Moreover, the net result of all such transfers is an efficiency loss. One of the ways by which particular special interest programs can be constrained is to limit the power of government to provide any such programs.

For a long period the Federal Government behaved as if constraints on such legislation were binding. More recently, its power to intervene in many areas has been greatly expanded, and the amount of transfers, and of resources spent on obtaining transfers, has increased to a marked degree.

The essence of the problem is that each individual has an incentive to take actions which, considered in their entirety, have a net negative impact on society, even though they are generally rationalized as being in the public interest. Intervention begets intervention. Only by changing the general principles which encourage intervention in many areas can we resist the multiple appeals for special interest laws which, taken as a whole, reduce the general welfare.

SUPPLY BY GOVERNMENT AGENCIES

When government directly provides some service, the service is ordinarily performed by government employees. Government employees are sometimes criticized for being inefficient and sometimes praised for being dedicated to the public interest. Most theories of bureaucratic behavior make neither of these assumptions. Rather, it is assumed that government employees behave like everyone else and are concerned primarily with promoting their own interests. Thus, to study the effects of government provision of goods and services, it is important to study the incentives that motivate government employees.

There are several incentives for government managers to increase the size and power of their agency. First, the salary and promotion prospects of a manager depend in good measure on the size and influence of the agency, as does the manager's power. Second, even when government employees are motivated by their perceptions of the public interest, this often leads to the same desire to enlarge their agency's size and influence. Once a person goes to work for an agency which fulfills his vision of the public interest, he will then be likely to want to expand the power of the agency, independent of his own self-interest, because he believes such expansion will benefit the public. This is a partial explanation of the relatively long life of agencies and the difficulty in terminating them—those who work for the agency become a special interest group. It is also a partial explanation for overspending by government.

It can be argued that the risk structure arising from government regulation also creates perverse incentives for agency managers. Two errors can occur, for example, when a government official must decide whether to approve a new drug. If the official approves a drug which is unsafe, some persons who use it will suffer harmful side effects. Alternatively, the official may fail to approve some safe drug, in which case some persons will suffer needlessly from a disease.

These types of errors will always be possible, no matter what decisionmaking process is used. Nonetheless, the official faces an asymmetric situation. If the drug is approved and someone dies from having used it, the official will be blamed for approving an unsafe drug. Conversely, if the drug is not approved, those who would benefit from using it are not likely to know that the drug has been disapproved. Thus, in circumstances like these, agency managers can be expected to be overly risk-averse—not because of the nature of the manager but because of the incentive structure in which the official must operate.

Since these types of responses by agency managers are predictable, they must be considered in designing programs. We must begin with the realization that government will not function perfectly and then attempt to determine if a predictably imperfect government program will achieve better results than those of an unregulated market.

DIVERSITY OF CONDITIONS AND PREFERENCES

One advantage of a market economy, mentioned earlier, is that such an economy is responsive to varying consumer demands. Individuals have different preferences and desire different goods and services. Tastes differ. If these desires are matched by a willingness to pay for them, then firms will find satisfying them worthwhile. The market will produce diverse products in response to diverse demands.

If a good is a public good, however, this diversity will probably not be found. We are all provided the same amount of national defense, whether we are pacifists or hawks. That is the nature of public goods, and for true public goods there is no alternative. However, government sometimes treats goods which could be private as if they were public goods only. Thus, students from families that are not willing to pay the full cost of private school tuition have no choice but to attend the same public school system. Voucher plans are attempts to get around this problem, as are proposals for refundable tuition tax credits.

Detailed government regulation of technology also works to reduce the responsiveness of the economy to changed conditions. Such regulation, by not allowing entrepreneurs to take advantage of new technologies, retards economic progress.

LIMITS ON INFORMATION

If government policies are to achieve their goals, they must be based on correct information, a condition which is not always satisfied. Examples of problems in obtaining the information needed to formulate and implement macroeconomic policy were discussed above.

Sometimes the problem is that policymakers cannot predict the extent to which individuals will respond to changes in policy. The imposition of credit controls in 1980 had surprisingly rapid and perverse effects on the economy. Policymakers also underestimated the extent to which the cost of medical care would rise as a result of the medicare and medicaid programs. As a result, there were substantial unanticipated budgetary consequences.

In general, it can be predicted that people will respond to new rules or regulations by trying to minimize the adverse impact of such regulations on themselves. However, it is generally difficult or impossible to predict the exact nature of this response, since there may be millions of individuals affected by a given regulation and some of them will think of alternatives which did not occur to the policymakers. The myriad of ways in which individuals subvert price controls is illustrative. One solution is to attempt to devise policies which make use of incentives. Too often, regulation takes the form of specific rules which ignore the possibility of unexpected responses.

One critical advantage of a market economy is that it is "informationally efficient." That is, a market will function well even if each individual knows only his own preferences and opportunities. When government controls an activity, on the other hand, much more information must be collected. This is an expensive process, and sometimes the necessary information is simply not available. This places another restriction on the ability of the government to achieve its goals.

TIME HORIZON

Elected officials are generally interested in reelection. Thus, it is often argued that a program which imposes costs today in return for future benefits will be overly discounted by elected representatives, even if the program has a positive net present value. ("Net present value" refers to the sum of benefits less costs, adjusted for the time value of money.) Conversely, elected officials are likely to prefer programs with near-term benefits and deferred costs. In such cases, costs may not be appropriately discounted and net benefits may be overstated. In the private market, on the other hand, projects with a positive value over an extended time period are more likely to be undertaken because the benefits of such projects can be capitalized and the property rights sold. Although government does undertake some such projects, it is more often preoccupied with short-term effects.

Recently, for example, some analysts have detected a "political business cycle" in which government spending projects or programs initiated just before an election lead to higher taxes or inflation which do not occur until after the election. This is a predictable result of the political process. Wage and price controls, which produce short-run moderation in the rate of inflation, lead to longer term losses because they reduce the responsiveness and flexibility of the economy. Since some of these ill effects occur long after controls are imposed, there sometimes are incentives to impose such controls just before an election. The short time horizon inherent in a political process with nontransferable property rights is another obstacle to the development of truly effective programs.

PRINCIPLES GUIDING THE PRESIDENT'S ECONOMIC PROGRAM

The problems discussed in this chapter have prompted the new economic policies of the Administration. In this section the Administration's Program for Economic Recovery is related to general principles concerning the proper role of government in the economy and to the necessary constaints on government action discussed above.

EMPHASIS ON PERSONAL RESPONSIBILITY

Many government programs, such as detailed safety regulations or the provision of specific goods (rather than money) to the poor, are best described as paternalistic. Paternalism occurs when the government is reluctant to let individuals make decisions for themselves and seeks to protect them from the possible bad effects of their own decisions by outlawing certain actions. Paternalism has the effect of disallowing certain preferences or actions. This Administration rejects paternalism as a basis for policy. There is no reason to think that commands from government can do a better job of increasing an individual's economic welfare than the individual can by making choices himself. Moreover, the long-term cost of paternalism may be to destroy an individual's ability to make decisions for himself.

As discussed above, there are economic arguments for transferring resources to the poor. However, if the primary concern is the welfare of the poor, the most efficient form of transfer is probably cash rather than benefits in kind. (Examples of benefits in kind are public housing, food stamps, and medical care.) Poor people given money can best determine for themselves what goods to buy. If they are given goods or services instead, their ability to learn to make their own choices is limited.

REFORM OF REGULATION

As discussed above, many current regulations cannot be based on allegations of market failure, and many regulations which do have such justification are administered inefficiently. Efforts are being made by the Administration to cut back the scope of the first kind of regulation and to improve the workings of the second. One area where there has been a major effort at reducing the scale of government intervention is energy, which is discussed in Chapter 6.

The Administration is also involved in a careful review of Federal enforcement of the antitrust laws. The purpose of these laws is to maximize consumer satisfaction by reducing monopoly power. In the past, however, the laws often have served both to protect smaller businesses and to penalize larger ones, even when greater size was due to increased efficiency. Efforts are being made at both the Federal Trade Commission and the Department of Justice to reform the enforcement of the antitrust laws to make them more consistent with the promotion of economic efficiency.

Because property rights in air and water have not been sufficiently extensive there are grounds for government intervention to alleviate pollution. However, the form of much prior intervention was inefficient. Most of this regulation has been carried out by specifying the allowable pollution control technology rather than by defining property rights or by charging fees for polluting.

This Administration is also making a major effort to emphasize the use of benefit-cost analysis in regulation. Regulation which imposes more costs than benefits is inefficient. For example, regulations that limit entry to a potentially competitive industry, such as interstate trucking, generate high transportation costs which are ultimately borne by consumers. The most elementary benefit-cost analysis would demonstrate the inefficiency of such regulation.

Even if used as well as possible, however, benefit-cost analysis is only the second best solution. The best solution is to respect the judgment of the private market whenever it is available. In many areas of safety regulation, for example, the best solution would probably be to rely on market judgments about the value of safety. Where this may not be possible, benefit-cost analysis can improve the information on which regulation is based.

In areas such as environmental regulation, where the market will not work unaided, benefit-cost analysis may be necessary to identify the optimal degree and form of pollution control. Even if a system of effluent charges were used, for example, an analysis of costs and benefits would be necessary to determine the optimal charge. If a system of pollution rights were used, the amount of rights to be created would have to be determined in some similar way.

FEDERALISM

One important principle of this Administration is an increased reliance on State and local governments to carry out necessary governmental activities. The replacement of many categorical grant programs by large block grants is one example of this policy change. A longer term policy of the Administration is to shift a substantial number of programs—and a portion of the Federal tax base—to the States.

As indicated earlier, there are economic reasons for this increased reliance on State governments. States are generally more responsive to voters in their jurisdiction than is the Federal Government and can make better judgments about local conditions.

LONG-RUN FOCUS

As discussed above, the political process has placed its major emphasis on the achievement of short-term goals. This Administration intends to place emphasis on long-run policies. For example, the Economic Recovery Tax Act of 1981 cuts tax rates over a 3-year period, after which the personal income tax structure will be indexed so that inflation will not increase marginal tax rates on real income. The Administration is also seeking a long-term solution to the financial problems facing the social security system.

However, there is a more fundamental sense in which emphasis is being placed on long-term goals. Many of the Administration's policies have reduced government expenditures for various groups or provided less of an increase in such outlays than has been expected. The fundamental premise behind these reductions is that they ultimately will lead to substantial and sustainable economic growth. This has particular relevance for the poor, most of whom probably have historically benefited more from sustained economic growth than from government transfer programs.

INCREASED RELIANCE ON THE MARKET

Another principle mentioned several times in this chapter is an increased reliance on market-like devices when appropriate government interventions are undertaken. Since this is an important principle, an indication of how such a principle will be translated into action will demonstrate some relationships between seemingly disparate changes in the forms of intervention.

First, consider the reason for reliance on devices which simulate market operations where intervention is the desired policy. The only alternative is direct regulation, which puts the government in an adversarial position to the party being regulated. Such adversary relationships create ill will between the government and business or other regulated parties. Ill will is also created when, for example, government employees monitor and control the spending of welfare recipients. Besides creating ill will, monitoring of behavior is expensive. Yet monitoring allows regulators to achieve their goals only imperfectly, since there are millions of regulated individuals, businesses, and other private institutions, and regulators will be able to monitor only a small fraction of these agents.

The advantage of market-like devices is that they can create incentives to behave in the desired way. That is, if we can simulate an effective market, we can rely on self-interest to achieve the desired goals. This will reduce the cost of achieving the regulatory goal and also increase the extent to which the goal will be achieved.

A good example is provided by comparing government safety regulation of firms with private market insurance against risks. In the case of government regulations, violators are punished, commonly with a fine, which may create incentives for the regulated firms to conceal possible violations and to avoid cooperation with safety inspectors. If, on the other hand, a firm which is insured can make its operations safer, it will usually benefit by having its insurance premium reduced. Thus, such firms have an incentive to cooperate with insurance company inspectors and adopt any recommendations which are made. This is but one example of how a market device, by eliciting cooperation, is more efficient in achieving desired goals than is regulation, which elicits conflict.

EMPHASIS ON THE GENERAL WELFARE

As stressed throughout this chapter, many current programs provide benefits to special interest groups. These programs are inefficient in that the gains to the beneficiaries are generally less than the cost to the public as a whole. Nonetheless, the political process, if unconstrained, would continue to establish such programs. In recent years effective constraints have been reduced. But if these special interest programs could be eliminated, almost everyone would benefit because of the losses in economic efficiency caused by these programs. However, it is extremely difficult politically to reduce such programs one at a time, since the beneficiaries would then perceive their losses clearly and seek to regain them.

The alternative, which this Administration adopted in both its spending and tax cuts, is to reduce a large number of programs simultaneously. If enough cuts in both spending and tax rates can be made simultaneously, most individuals may recognize that, while they may lose from cuts in a specific program, they gain enough from cuts in other programs and in lower taxes to compensate for their losses. Thus, the principles of optimal government intervention explain why the Administration insisted on very broad cuts in spending. Congressional approval of much of this plan indicates that this strategy was appropriate. A general reduction in special interest programs is a necessary step to meet the constitutional charge to "promote the general Welfare. . . ."