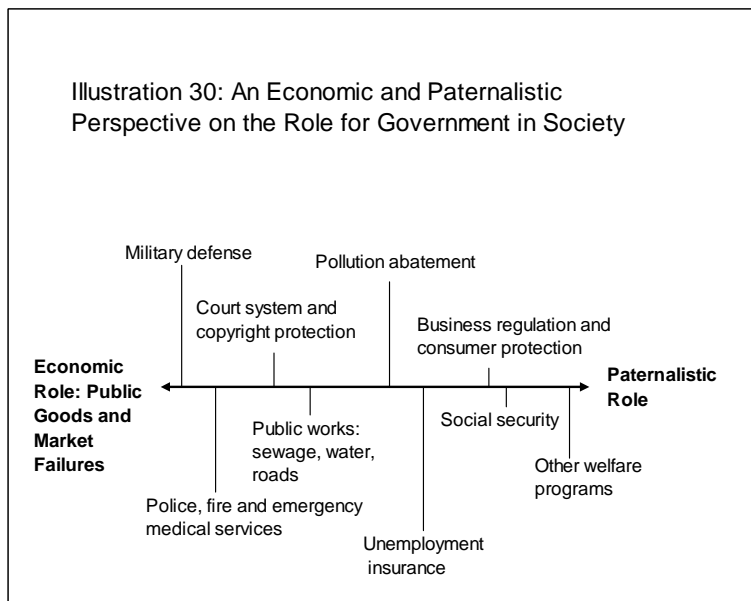


Economic and Paternalistic Roles for Government

Notes for *Hardfire* Television Show

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Many but not all the ideas in these Notes are based on my book *Economics for Everyone* (Bloomington: Unlimited Publishing 2006), Chapter V. The Economic Role for Government. The Notes have been prepared for the Brooklyn Cable Access Television show *Hardfire*, which is libertarian in nature. In my book I try to make it clear which ideas most economists agree on and I try to make it clear when a concept discussed in the book is still under debate by economists. These Notes are much more polemical and contain many more of my own personal opinions. In other words, this is not to be read as dispassionately scholarly.



You will see from the above Illustration that I have classified government interventions in the economy on a continuum from left to right, with the left-hand side being labeled “economic” and the right hand side being “paternalistic”. In the book I define paternalism “people using government to protect them from their own actions or as a substitute for acting in their own self-interest”. The idea behind these Notes is to clarify in more depth the ideas in the book.

Most (but not all) economists agree that government should play a role in the economy; the main economic rationale for a government role in the economy is for what are known as “market failures” and “public goods”.

Market Failures

- 1) When not enough of a good or too much of a good is provided in the market this is known as a “market failure”, e.g. when not all the gains and losses to a market transaction are captured by the private parties engaged in a private market transaction and therefore too much or too little of a good is produced in the free market;
 - a) The most obvious example of a market failure is pollution emitted by a factory that affects the people nearby in the water supply or airborne pollution affecting those nearby the production facility. These external costs which are not captured in the selling price between buyers and sellers are known in economic jargon as “market externalities”.

Many economists believe that these costs can indeed be captured in the market exchange process by putting a direct tax on the polluters equal to the ‘external’ costs and then reimbursement is made to those harmed by the pollution for which the taxes collected. This means too that the extra taxes paid for the pollution drives up producer costs so less of the goods made with pollution-producing processes are sold in the market because the prices are higher. The producer then has the incentive to reduce pollution and thus reduce the tax costs of production.

Another way to price pollution into the production costs, absent forced government intervention through taxes, which can oftentimes be difficult to price accurately (and which can also be out-of-date due to bureaucratic lags and asymmetric information) is to include directly the costs of those harmed by the pollution directly into the pricing of the good through voluntary negotiation with the effected parties, or absent free negotiation, through alternative arbitration or the court system. Those harmed (be they individuals or local or state governments) then receive a portion of the revenues of all goods sold by the polluter if and until the pollution is abated.

Increasingly we are witnessing producers with incentives to reduce pollution voluntarily, and not only through the price mechanism¹. We are seeing this now through companies certifying their production processes as “green” or “carbon neutral” or even ‘carbon negative.’ This gives the consumer and society (the market) the choice as to whether or not they prioritize clean, non-polluting productive techniques.

- b) “Commons” can also be deemed another type of market failure. Public lands and international waterways can be over used to the benefit of the individual farmer or fisherman, to the detriment of all others using these common spaces (which is known in economic jargon as “the tragedy of the commons”) and many economists see a role for government regulating the use of these common spaces. Or this can be negotiated voluntarily keeping in mind the free-rider effect of those using the commons without paying for it. (See the next section for more information on the “free-rider” concept.
- c) The most common example used of something that the market does not produce enough of is basic research, like advanced

¹ In fact it might be argued that unused manufacturing by-products could be more efficient if captured back into the manufacturing process as in many cases it is energy that is being released into the environment and not being used as effectively as it could be in the production process. This release of this energy into the environment can often be the result of inadequately-enforced property rights.

materials and technologies that don't lead immediately to products which can be commercialized but with further development could lead to more efficient materials or manufacturing processes that would not be profitable for any one company in the short-term but could lead to technological breakthroughs economy-wide (the internet is an example here). (We are ignoring the assignment of property rights to these government-developed goods as beyond the scope of this discussion).

Public Goods

- 2) The last example above of market failure might also be known as a 'public good'; where the market wouldn't produce something that is good for the whole society because no one company would make a profit selling it because it is not ready to be "commercialized". A public good is something that is developed for the common good but there is no way for the market to price the good and there is no way to exclude someone from using the good once it is provided.
 - a) The most common example of a common good is common defense, or military defense. This introduces the notion of the 'free-rider'. Some people could be forced to pay for military defense but no one can be excluded from benefiting from the defense. Everyone benefits from defense, just like everyone benefits from public parks, but no-one can be excluded from using the park or benefiting from the defense of the nation from external aggression.

There is no way to put a price on national defense or a park because everyone has the incentive to say that the benefit to them personally is less than it actually is. Therefore the body politic has deemed parks and defense public goods and taxes are charged and used to pay for these common goods. (Publicly-funded education is another idea of a public good, however this can be debated because the decision to have children is a private one.) Another notion behind public goods is that no one can be excluded from benefiting from the public good whether they pay for them or not. That is why most

economists agree that public goods should be provided by the government. (It should be noted that one way to pay for parks would be to have a nominal amount coming from general taxes with those actually using the parks paying a use fee, but this user fee might be considered an overly regressive tax structure).

- b) International treaties governing the use of international waters are another example of a “public good” in an international context. However, regulation of these public goods is obviously more difficult to enforce than in a sovereign context.

Other Government Interventions

I have included Police, Fire, and Emergency Medical Services next on the continuum. This may be controversial to some economists of the libertarian-bent because theoretically these could be provided privately, however, due to the non-exclusionary factor these could very easily be considered a public good, with strong repercussions if private provision was to fail. These services could be privately-provided, but I believe they should be funded through local government.

Most economists would agree that the rule of law and a sound, dependable court system is one of the main fundamentals underpinning a free and open society. The ability to enforce contracts and property rights underpins all economic contracts and without this rule of law there would be too much uncertainty in day-to-day business dealings and uncertainty would undermine economic efficiency and undermine long-term growth and prosperity; with long-term growth needed most of all by society's poor. Of course alternative dispute resolution performs a very vibrant and cost-effective substitute in many contracts and is used effectively quite often, but when this fails, the rule of law as codified and in common law provides the arbiter of last resort.

The same can be said for Public Works (sewage, water, roads, mass transportation). This can be funded by government, through the local tax-base, but it can be, and often is, provided privately through competitive bidding. And, competition can provide better value for the taxpayer than can local government bureaucracy.

Pollution abatement is next on the continuum. As mentioned above, private market participants are increasingly having the incentive in developed societies where rule of law – and instantaneous information thanks to the internet - can provide recourse to those wronged by polluters. However, where private recourse fails there is a role for the government court system to step in and provide redress to those wronged.

Further along the continuum is where we begin to see less of an economic rationale for government in the economy. Next on the continuum is unemployment insurance. This is perhaps where the economic becomes the paternalistic. Incentives matter. When someone is paid not to work, they have an incentive not to work. We are seeing this now in recent legislative proposals to give unemployment insurance to those that lose their jobs to outsourcing. This can be seen as political paternalism. Who is to say, who is to decide whether or not that job was indeed lost to outsourcing? And why would someone who lost their job to outsourcing have priority for funding over someone who lost their job to not maintaining their skill set for a domestic position? Who is to make this decision? Or why should this person have priority over someone who lost their job to an unforeseen demand change in the domestic market? Or why should this person have funding priority over someone who tried to start their own business and failed? Or should not the sole bread-winner have priority over a multi-income family? And who is to decide this and how is to be proved and at what cost?

In a larger sense, government paternalism “crowds-out” true civil society, if the government steps in to lessen the risk one takes in their job and life choices what does this do to us as people? How do we learn from our mistakes? Where are the roles for our family, for our friends, for our colleagues, for our neighbors, for our local charities when it is to be expected that government will step in to provide for us? Government paternalism takes away what it means to be human, to live in a freely-organized community. We become a political society dependent on the state, not a society dependent on our loved ones and those for whom we care directly and for those who care directly for us.

I will group together the next set of paternalisms: Business Regulation, Consumer Protection, and Corporate Subsidies for Preferred Industries. We are free peoples making our free choices; by government making these choices for us we are no longer free. There is no economic rationale for

these interventions, there may be political, idealistic or paternalistic reasons for these interventions, but these interventions certainly aren't prescribed by any economic principles. The cynical would say that these interventions are special interest hand-outs. Economically we would argue that government picking winners and losers subsidizes the less efficient at the expense of the greater productivity of society. Subsidizing an industry gives that industry less of incentive to be efficient, which has unintended consequences throughout the economy.

Historically, the Democrat political party gets funding from labor unions which are now greatly public employee unions. This removes the public policy incentives for more efficient provision of public services, this includes of course public education, which is notoriously in need of reform in the United States. In addition, Democrats receive funding from trial lawyers, this prevents legal reform, such as "loser-pays" for frivolous lawsuits. This has an estimated cost of 1% to 2% of the Gross Domestic Product (GDP) of the American economy.

The Republican political party on the other hand receives political donations from large corporations, which in return creates special-interest based perverse economic incentives. These incentives include interest-rate tax write-offs for home mortgages which favors the rich over the poor. Other Republican economically-distorting policies include subsidizing exports (through the Export-Import Bank) which prioritizes foreign consumers over domestic consumers, oil and gas exploration subsidies, which favors the use of fossil fuels over the development of alternative fuels, the subsidy of ethanol-based fuels which misdirects use of farmland, the protection of the domestic sugar industry from imports which makes domestic industries using sugar as an input to production less cost-effective than foreign producers of sugar-based products, which harms employment and entrepreneurial activity in domestic sugar-based manufacturing sectors. These are all examples "economic paternalism" based on special-interest politics which are harmful to all but the few receiving the subsidies in return for their political contributions.

The last two, most egregiously paternalistic, roles for government in the economy are social security and welfare programs. Again, incentives matter. Welfare programs may destroy the fabric of community-based help, of helping your neighbor when they are temporarily in need. One need look no further than the Hurricane Katrina disaster in New Orleans for an

example of the state crowding-out, or actually preventing through force, community-based aid.

On unemployment insurance; some people work long enough to gain enough workdays to collect unemployment, quit working, collect unemployment, and then start working again. And then begin the cycle over again. When “welfare as we know it” was reformed many poor neighborhoods became revitalized, people were able to earn their own way, fix-up their homes, build self-respect. Our unemployment level has hovered around the natural rate (5%) for several years so there is not a lack of demand for labor in today’s economy. Welfare is soul-destroying, government-dependency building, paternalism, nothing more.

The Social Security program tells us that we are no longer productive useful citizens when we reach the age of 62 ½. What does this do to our self-esteem? What does this do to our ability and need to take care of ourselves as we grow older? We do not need to plan ahead for ourselves or our loved ones because the government will do so for us. Social Security may have lessened the care and respect with which many societies treat their elderly.

Many people are just reaching their peak in intellectual capacity at around age 60. What kind of signals does the US Government send to potential employers that that their potential employee has an incentive to quit or to work less? We are destroying a half a generation or more of American productivity.

Alexis de Tocqueville wrote of America in the 1840s, in Volume II of *Democracy in America*. He wrote that the United States of America was headed towards a “soft despotism manifested in military adventurism, which allows subjects to do anything but take responsibility for themselves.”

Hopefully it is not too late to prove incorrect de Tocqueville’s surprisingly prescient and early prediction.

Here are some random facts taken from this week's (November 26, 2007) popular news to support de Tocqueville's thesis:

- 1) Every American family is in debt to the tune of \$440,000 due to Social Security and Medicare/Medicaid IOUs (see gao.gov for more information).
- 2) There is proposed legislation to nationalize "the remaining American machine tool industries" to protect us from Chinese and Indian competitors.
- 3) There is a legislative proposal to nationalize all ethanol production for 'national security'.
- 4) More than one Presidential candidate wants to nationalize health care
- 5) The mayor of New York wants restaurants to list the calories and fat content of all menu items.
- 6) There is a legislative proposal to give every family a per child \$1500 tax credit to encourage having more children (who is to pay for 1) above after all?).
- 7) There is a legislative proposal to outlaw 'pop-up' ads on the internet. Even if this could be regulated, what would be the cost to privacy and consumer freedom of choice?

Creeping state paternalism abounds, just open your eyes or perhaps it is so prevalent and expected that one fails to take notice or, even worse, to care.