Sources of government failure - when government doesn’t act in the interests of its population.

Size-maximizing bureaucracy. Bureaucracies might be more interested in their own preservation and growth than in efficiently doing what they are assigned. Define inefficiency of a company by being able to get more output with less inputs. Thus a company is efficient if it can’t get more output with the same quantity of inputs. In publicly owned companies there is not much pressure to make profits - if they make losses they will be subsidized.

Niskanen (1971) developed a model of the budget-maximizing bureaucrat. The bureaucrat runs an agency which has a monopoly on government provision of a good (e.g. Department of Public Works collects trash, maintains sewers).

Bureaucrat’s salary is usually not connected to how efficiently the job is conducted. Instead, bureaucrat’s compensation, in the form of wages, benefits, status and quality of support staff is based on measurable output of the bureaucracy. The compensation of the director of the Department of Public Works depends on how many problems in the town the department fixes. So the Department of Public Works director wants to maximize the budget of the agency. The goal is not to choose an efficiency-maximizing level of service. It is difficult for the town government to enforce efficient production in the Public Works Department because the director knows more about the cost of service provision than the town government.

Are goods provided more efficiently in private or public sector? For purely private goods (steel, telecommunications, banking), private production is more efficient. In a list of 71 studies comparing state-owned public companies to private companies, public companies did better than private in only 5; in 56 studies the private companies were more efficient and 10 studies showed similar performance.

Majumdar (1998) rated the efficiency of Indian industrial companies, rating a perfectly efficient company by 1.0. Results were that state-owned companies scored 0.65, partly private/partly public owned companies scored 0.91 and privately owned companies scored 0.975.

When state-owned companies are privatized (sold to private, profit-maximizing owners) efficiency increases; a smaller company is required to produce the same level of output.

Limitations on the benefits to privatization. Natural monopolies - due to decreasing average costs over a large range of output, it is more efficient to have the good provided by a single producer. There are high fixed costs and low marginal costs after the fixed costs have been paid. In natural monopoly markets, there
will tend to be only one firm in the private market equilibrium. Thus, competitive pressure will not act on a firm in a natural monopoly. Prices will be set above marginal cost and there will be inefficiency. Having the government provide the good or service can lead to lower prices for consumers.

Kemper and Quigley (1976) found, using data from municipalities in Connecticut, that private garbage collection was less expensive than public collection because the private collectors used monopoly power to charge high prices.

A middle option is contracting out. The government keeps the responsibility of providing the good but doesn’t actually do the work itself. Instead the government gives the job to a private firm (workers are not government employees). There can be competition in the form of competitive bidding, where private firms compete for who can provide the good at the lowest price. Kemper and Quigley found that this option was the most efficient for garbage collection.

But in practice, contracting out can be non-competitive. Government bureaucrats can give the contract to the bidder who gives them the highest personal kickback or who adds most to their bureaucratic power. In this case either private provision or public provision could be better than contracting out.

While privatization of private goods markets seems to improve efficiency, it is not clear that private provision of social services like health insurance, cash welfare and public safety is more efficient than public provision. Markets for social services often have externalities or other market failures that limit the ability of the private market to provide them efficiently. Hart, Shleifer and Vishny (1997) compared private to public prisons. The private prisons (contracted out to companies like Corrections Corporation of America, which runs a prison for undocumented immigrants, and Wackenhut - or now GEO - Correction Corporation) cost 10% less per prisoner, but this saving was made by paying the prison guards less. The result was lower quality guards, leading to more violence in the prisons.

Contracting out with non-competitive bidding

Contracting out is more likely to result in a gain in efficiency if potential contractors are in competition with each other to cut costs or improve quality. But competitive bidding for contracting seems to be the exception rather than the rule.

Examples: Science Applications International Corporation (SAIC), one of largest government contractors, was hired to conduct environmental testing and cleanup jobs at Kelly Air Force Base in Texas in the late 90’s. Contracts were awarded without competitive bidding and government paid $24 million. In 2002 government filed a fraud suit against SAIC, accusing SAIC of listing higher-paid employee categories on job descriptions but using lower-paid employees to do the work, and of describing to the Air Force profits of 10% when its actual profits were 23%.
Wackenhut Corporation has been main security contractor at weapons plants in the US since early 2000s. In running drills to test security at the weapons plants, Wackenhut attackers told defenders which buildings would be attacked. So the drills found the defense system to be very secure, but they were cheating.

In 2003 and 2004 DHB Industries got contracts of hundreds of millions of dollars to supply body armor to troops in Iraq. Already in 2002 NYPD had returned 6400 vests to DHB for replacement after they were found to be defective. Workers also accused the company of sloppy quality control. The Marines got the vests despite warnings from the Army, but 23,000 DHB vests were eventually recalled.

After Hurricane Katrina, more than 80% of the $1.5 million in contracts signed by FEMA were awarded without bidding or with limited competition.

Leviathan Theory

Niskanen sees the larger government and the bureaucratic agencies as two separate entities; the larger government tries to control the bureaucrats for the benefit of the population. Brennan and Buchanan (1980) view the government and the bureaucracies as one entity, called ”Leviathan”. They think that this entity tries to increase the size of the public sector as much as possible using the ignorance of the electorate. This theory concludes that taxpayers can’t trust the government to spend their money efficiently and should try to limit government spending.

This view of government can explain rules that limit government tax raising or spending. If the government were assumed to be completely benevolent, such rules would not be needed.

Another way to prevent inefficient amounts of government growth is by ensuring that politicians have pressure from voters to spend tax money efficiently, otherwise they will get voted out.

Corruption - government officials try to maximize their or their friends’ personal wealth through their power. Why does corruption exist? Or, why doesn’t it exist everywhere? For example, why doesn’t the clerk at the DMV ask for extra money to speed up your driver’s license application? Maybe because if there was a lot of corruption at the DMV, people would get upset and elect someone who would clean it up.

Electoral accountability seems to keep corruption in check. This is supported by Persson and Tabellini (2000). They used surveys of business leaders to measure government corruption, as businesspeople are some of the most direct victims of corruption. Comparing systems of proportional voting like in the UK (where voters vote for a party, which chooses the leader) to systems where voters choose individual candidates, like in the US. They found that there is more corruption with proportional voting. They reasoned that in such systems individual politicians are less accountable to the voters since they could still
be chosen by the party even if voters don’t want them (This seems somewhat questionable).

A study by Djankov et al. (2002) found that countries where entrepreneurs have to go through a larger number of bureaucratic procedures to start a business tend to have more corruption. The procedures range from 2 days in Canada and Australia to 152 days in Madagascar. Costs of these procedures range from less than 0.5% of per capita GDP in the US to more than 460% of per capital GDP in the Dominican Republic.

Also, paying government employees higher wages tends to make them less willing to risk their job through corruption.

Empirical Evidence

Effects of government failure on economic growth. Mauro (1995) finds that nations with higher levels of corruption and bureaucratic red tape have lower levels of growth. The model predicts that if Zaire (the most bureaucratically inefficient nation in the sample) increased its efficiency to that of Switzerland, New Zealand, the Netherlands or Singapore (the most efficient in the sample), then its growth rate would be 4.9% higher each year.

A problem with such a study is that the estimates could be biased. Nations with low-quality governments differ from those with high-quality governments for other reasons as well, which can lead to the differences in growth. Suppose the efficiency of a government increases with wages of government workers. Then it would be low growth that is causing inefficiency, not the other way around. Or it could be that they both cause each other.

A historical paper by Acemoglu, Johnson and Robinson (2001) looks at two sets of nations colonized by the same European powers. Treatment were countries in the Caribbean, Central America and Africa. In colonial times these were governed from a distance. Colonizers tried to extract as much raw materials as possible. Did not care about setting up institutions like property rights or other bureaucracies that create economic success. Control were USA, Canada, New Zealand, Australia and other countries (e.g. Chile) that were governed from within. European colonizers moved there and set up institutions to foster economic success. The treatment countries have grown much more slowly post colonization. They appear to be harmed by inefficient government institutions. Authors calculate that if Nigeria could improve its government institutions to the level of Chile’s its per capita income would increase by a factor of 7.

A similar comparison can be made with North and South Korea. They were similar before WWII. Maddison (2001) showed that they had both incomes of around $770 per capita in 1950. In 2000 North Korea had per capita income of $1200 and South Korea had per capita income of $12,200.

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Chapter 10 - State and local government expenditure.
Optimal fiscal federalism is the question of what should be under the control of the federal government and what should be under the jurisdiction of the states. The No Child Left Behind Act generated a debate over optimal fiscal federalism because it was a federal act that imposed more federal control over public education, which was historically run by state and local governments. One advantage of having local governments control service provision is that it can allow communities to choose the services that best match their tastes. But sometimes matching local interests may not be in the national interest.

Fiscal federalism in the United States and abroad.

In 1902 the federal government’s fiscal role was limited to spending on national defense, foreign relations, judicial functions and the postal service. State and local governments provided education, police, roads, sanitation, welfare, health and hospitals. State and local governments funded spending mostly on their own; less than 1% of state and local government revenues came from federal grants. Federal government spending was 34% of total government spending; local was 58% and state was 8%.

By 1952 federal government spending was 69% of all spending, local and state were 20% and 11%. 10% of state and local revenue came from government grants.

Due to: 16th Amendment to Constitution, enacted 1913, allowed federal government to tax individuals (before that it was forbidden by the Constitution). Also, the New Deal programs, the federal government’s responses to the Great Depression. Social Security was started in 1935.

Now federal grants are 30% of state and local revenues.

Optimal fiscal federalism

What programs are best administered locally, state, or federally?

The Tiebout model.

It is difficult to design democratic institutions that induce people to honestly reveal their preferences. It is also difficult to aggregate individual preferences into a social decision. Governments are often unable to provide the optimal level of public goods.

Tiebout (1956) thought that the factors missing from the public goods market that guarantee efficient provision in the private goods market are shopping and competition. Shopping is deciding to buy from one firm over another because the first firm’s product is of better quality, or cheaper. Due to the possibility of shopping firms in private goods markets have to compete with each other. This leads them to produce efficiently.

In many public goods markets there is no shopping. In general people don’t decide whether to live in the US or Canada based on whether an additional
missile is produced by the government. Voters can shop across political parties based on how much of a public good they promise to provide, but there are few political parties, and there are many choices to base one’s decision on. There is little competition facing the federal government when it chooses how much of a public good to provide; thus inefficient amounts may be provided.

But when public goods are provided by local and state governments, it is much easier for people to move to the next town or the next state if they are not happy with the level of public good in their town or state.

Suppose you found out that the local high school was paying $75 each for the metal covers on electric sockets, which cost $0.80 each (happened in Chicago in 1992). You might want to move to the next town, as this waste raises your property taxes for no good reason. With local public goods, there is a preference revelation device - mobility.

Tiebout thought that the threat of moving away can cause efficiency in local public good provision, and that under certain conditions, public goods provision is fully efficient at the local level.

Formal model

Many people are divided across towns that provide different levels of public goods. Town $i$ has $N_i$ residents, finances public goods spending $G_i$ with a uniform tax of $G_i/N_i$ on all residents.

Tiebout showed that individuals will divide up in such a way that each resident in any town has the same taste for public goods and demands the same level of public goods spending $G_i$.

With a uniform tax to finance the public goods, there is no incentive for people to lie about how much public goods they want. To lie, a person would actually have to carry out their lie by moving to a town with a different level of public provision, which they wouldn’t want to do. There is no possibility of free-riding when all individuals in a town must pay the same amount in tax and all have the same preference. The problem of preference aggregation is also solved - everyone in the town wants the same amount of public good, so the government divides that amount by the population to get the tax each person pays.