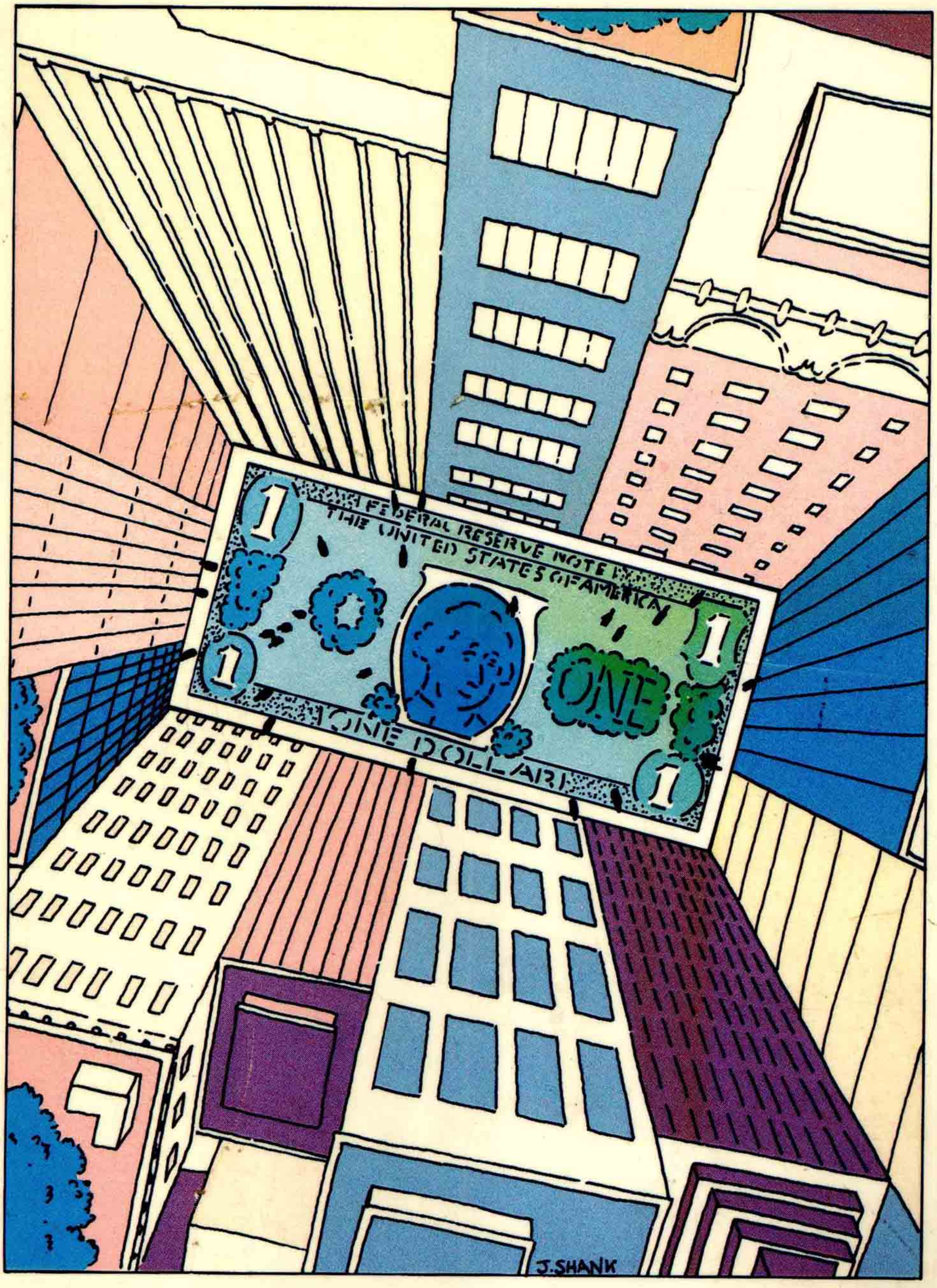
ECONOMICS OF PUBLIC POLICY

THIRD EDITION



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ECONOMICS OF PUBLIC POLICY: The Micro View

3rd Edition

Preface to the Third Edition

We have all met people who tell us that economics was the most boring subject they took in college. "Economics?" they react, "that's a course in definitions, graphs and dull theoretical abstractions." For many of them, that is the way it was. But not today.

Economic theory *is* abstract. And that is the way it should be. All of those abstract concepts you are about to encounter make up the meat and potatoes of any course in economics. They have to be mastered in order to think logically about the world around us. They are as important to economics as the rules of the English language are to speaking and writing, as the rules of mathematics are to adding and subtracting.

In the past, a typical course in economics was confined to the learning trinity: instructor, textbook, and student. The text book presented the abstract principles. The student struggled to learn them. The instructor stood in the middle. His job was to help shift the principles off the pages of the text and into the student's head.

So far, so good. But an important ingredient was often missing—the *relationship of economic theory to the real world.* This did not happen by design. At the end of important lectures, most instructors would try to squeeze in some practical applications of the principles being discussed. Textbooks would do the same thing at the end of important chapters. But this practice often did more harm than good.

Discussions of real-world events were necessarily brief. After all, the class had to move on. There were more definitions, graphs, and theoretical abstractions to master. So time in the classroom and space in the textbook permitted only scant references to the relationship of economics to the outside world. Even then, students were all too often left to wonder if they were getting only the "economic side" of the question.

Today things are different. Trial and error have convinced us that a fourth cornerstone must be added to the learning of economics. That's where this book comes in.

Its primary purpose is to help students understand how economic theory applies to the real world. It does this by showing how some of our most important (and often controversial) public policies reflect economic principles in action.

The book is organized to complement practically all major textbooks in use today. As the textbook presents a key economic concept, this book shows what that concept means when applied to an important public issue or policy. The concepts discussed here arise in the same order as they arise in most introductory courses in microeconomics.

We have not simply presented the "economic side" of public policies, however. Each chapter furnishes the historical and institutional background of the policies analyzed. We look briefly at where our current policies came from, and how they differ from policies adopted in the past.

Why do we have the policies we have, rather than some other policies? Each chapter addresses this question too. We look at a number of the political forces at work and some of the reasons why some interest groups are more successful than others.

Naturally, different people have different values. Ethical views about what policies we ought to have vary a lot from person to person—even among professional economists. In the first chapter we look at some of the most popular standards used to evaluate public policies. In each succeeding chapter we show what these standards mean when applied to specific policies.

This book, then, not only shows how economics relates to the real world. It also shows how economics relates to other disciplines as well—history, sociology, political science, and even ethics.

In preparing the third edition of this book, we were struck by the truth of the old saying, "The more things change, the more they stay the same." In the world of public policy economics, things do change but the same issues continue to arise in new forms. We have responded to change in three ways.

First, there are issues that, while not really new, have achieved a new level of prominence. An example is equal pay for work of comparable worth—the women's issue of the 1980s, as it has been called. Specialized books on personnel management and compensation policy have discussed this issue for years, but it has only recently become an issue on the national political stage. We have added an entirely new chapter on comparable worth.

Second, there are issues that provide new illustrations of old principles. The ethical and economic problems raised by technically possible but extremely expensive organ transplants are an example. We lead off our chapter on rationing of medical care with an organ transplant example. Similarly, our chapter on the environment now highlights the problem of acid rain. Again, familiar principles are applied to new headlines.

Third, there are changes in policies themselves. These are the basis for the greatest number of changes in this edition. Accordingly, we discuss the Reagan administration's unsuccessful PIK experiment in our farm policy chapter; we discuss policy changes introduced by FTC Chairman James Miller in our consumer fraud chapter; we discuss the effects of impending deregulation in our natural gas chapter; and we discuss the controversy over the Simpson-Mazzoli immigration reform bill in our chapter on supply and demand divided by the Rio Grande. Every chapter is thoroughly updated to take recent policy changes into account.

We are grateful for all the help we have received in preparing this and previous editions. Our own students and colleagues at the University of Dallas and George Mason University have been especially helpful. Users of the book at colleges and universities across the country have passed along their suggestions, many of which we have used. Finally, we want to thank the very able staff at West Publishing Company for bringing out such an attractively designed and produced book.

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Thinking about Public Issues and Policies

Every day we hear about public issues. Some of these issues are called crises: we hear there is an energy crisis, a teenage unemployment crisis, or an environmental crisis. Others are problems that could become crises: we hear about the worsening problems of illegal aliens, of Social Security, and of the volunteer army. Other issues are simply constant irritations: food prices rise or postal delivery seems to get worse.

So what should we do? Should we keep the volunteer army? Should we raise the minimum wage? Do we need more consumer protection? Should we deregulate the price of natural gas? The list of possible solutions is even longer than the list of issues, and the longer both lists get, the more people turn to economists for help. But what kind of help can economists give?

Economists can, of course, suggest policies and offer opinions. They can say, "Keep the volunteer army" or "I personally don't think we should raise minimum wages." Offering opinions like these is as much the right of economists as it is the right of other citizens, but it is not really economists' professional specialty. Their real specialty is providing a certain *way of thinking* about public issues and policies.

That is where this book comes in. We haven't written it just to give you our opinions—we could have done that in a newspaper editorial. Instead, we have written it to help you understand the economic way of thinking by showing that way of thinking in action, applied to some of the major issues of contemporary public policy.

Tracing the economic effects of public policy

Learning what questions to ask is a large part of understanding the way economists think about issues and policies. Probably the most important question, and often the most difficult to answer, is What are the effects of a certain policy? This question is difficult to answer because public policies usually have a whole network of indirect effects in addition to their direct effects. These indirect effects are often unexpected and unintended, and they are often partly or wholly hidden from view. The first step in analyzing a public issue, then, must be to trace the direct and indirect effects of the policies that are being used or suggested to deal with that issue.

When economists set out to trace the economic effects of public policies, they use certain well-established tools of their trade. Learning how to use these tools is an important part of every introductory economics course. As you read through this book, you will be introduced to practical applications of these tools one by one. First, we will examine such concepts as scarcity, opportunity cost, and the production-possibility frontier. Next, we will show how supply and demand analysis can be put to work. From there, we will explore theories of consumer choice, monopoly and competition, factor markets, and more. Taken together, these tools constitute what we call *positive economics*—the scientific study of economic institutions, policies, and actions.

Evaluating economic policy

After we have examined the effects of a policy, we are in a position to ask a second important question: Is the policy *good* or *bad?* Should we institute the policy, or, if it is already in force, should we keep it? Should we instead reject the policy, or should we abolish it if it is now in force?

Whether a policy is good or bad is not a question of positive economics. The evaluation of public policies is often called *normative economics*, but this term is misleading in an important sense. What we call "normative economics" is not really a branch of economics at all: it would be more accurately described as the application of ethics or philosophy to economic issues. The economist's special tools of the trade, so useful in tracing the effects of a policy, cannot tell us whether that policy is good or bad.

But this fact does not mean that we have to grapple with these questions bare-handed. To determine whether a policy is good or bad, we need not rely on whims, hunches, or reflexes. Instead, we can use clearly defined normative standards. It is true, as we will see, that not everyone agrees on which normative standards are valid or on which ethical principles are more important than others. Yet such disagreements are no excuse for failure to think and express ourselves clearly in the realm of normative economics.

We wish to keep all of this in mind whenever we evaluate economic policies in this book. It is not our aim, however, to ask you, the reader, to agree with our own ethical viewpoint. Instead, we will look at the issues from the point of view of three different kinds of normative standards: efficiency, equality, and liberty. We will describe these briefly here, and their meaning will become clearer as they are applied in a number of cases throughout the book.

Efficiency

Our first standard is one that occupies a prominent place in the thinking of many economists: the standard of economic efficiency. In the most general sense, the word *efficiency* means the property of producing or acting with a minimum of expense, waste, and effort. Whether you are repairing a car, baking a cake, or producing something for someone else, there are usually a number of ways to perform the task. The efficient way is the one that minimizes the time, effort, and money required. The concept of efficiency also applies to the choice of how to spend your income. Efficiency in this case means buying those items that give you the most satisfaction or happiness, given your limited budget.

Efficiency also applies to choices about the courses you take in college, the way you spend your leisure time, and the choice of a career. In fact, just about every choice you make can be judged by the standard of efficiency. In each case, the efficient choice is the one that results in the largest benefit given the cost or the one that results in the smallest cost given the benefit we seek.

Most of us, then, have some idea of what efficiency means when applied to our personal lives. We may even have some idea of what it means for a business firm to be efficient. But economists go beyond this: they not only apply the concept of efficiency to individuals and to business firms—they also ask about the efficiency of markets and even of entire economic systems.

That's where economic theory comes in. In many ways the study of economics *is* the study of efficiency, so the more you learn about economics, the more you will learn about efficiency. As a starting point, however, we will simply note that notions of *cost* and *benefit* can be applied to the economic system as a whole. In a general sense, an efficient economy is one that maximizes the value of its resources or one that minimizes the costs of producing the goods and services consumed.

The concept of efficiency can also be applied to public policy. For example, one of our most important public policies is the policy of enforcing contracts. If a person fails to keep a promise agreed to in a contract, courts of law stand ready to enforce the contract or to award damages to the injured party. Imagine what would happen if there were no contract law or no system of enforcement. You would spend an enormous amount of time and energy investigating the character and reputation of people with whom you wanted to make agreements. Most sellers would insist on cash, rather than credit, purchases. There would be a lot less lending, a lot fewer long-term agreements. And a great many goods and services we now enjoy would not be produced at all. So, at least in principle, the policy of contract enforcement makes our economy much more efficient than it would be otherwise.

Almost every public policy involves a cost. Whether we are paving a road, building a bridge, constructing a dam, or even enforcing contracts, the benefits do not come free. By the standard of efficiency, a policy or a change in policy is judged to be good if the benefits exceed the costs. It is judged to be bad if the costs exceed the benefits. But *the standard of efficiency does not require that the people who benefit be the same people who bear the costs*. Typically, some individuals will be better off because of a policy; others will be worse off. Efficiency only requires that we look at the *sum* of the benefits and the *sum* of the costs.

In comparing the costs and benefits of a policy to see if it is efficient, economists often find it useful to ask this question: Can the people who like a policy potentially *compensate* the people who do not like it and still be better off than they would have been without the policy? If compensation is possible, the benefits of the policy are said to be greater than the costs of the policy.

Consider, for example, a policy of prohibiting all smoking in restaurants. Let's say that Ed, a typical nonsmoker, would be willing to pay $10 more than the cost of his meal to enjoy his food in a smoke-free environment. John, a typical smoker, would be willing to pay up to $8 for the pleasure of enhancing the taste of fine food and drink with that of fine tobacco. Given these preferences, Ed could pay John $9 in return for a promise not to smoke during dinner and both would be better off than if John smoked. If Ed and John were really typical of smokers and nonsmokers, a nonsmoking policy for restaurants would be efficient in the sense that it contains the potential for making everyone better off. Most economists do not insist that compensation payments actually be made. A policy is declared efficient as long as it generates a "fund" of benefits potentially large enough to cover, or more than cover, all costs.

Of course, many of our public policies are not very efficient. As we will see, a lot of government policies raise costs for producers, reduce benefits for consumers, and create other forms of waste. In fact, if we were only concerned with efficiency, we should be prepared to make some pretty radical changes in the way we do things.

But efficiency isn't the only standard that people care about. Let's look briefly at two other criteria.

Equality

Our second standard focuses on the distribution of income and wealth. By this standard, a policy that causes income and wealth to be more equally divided would be judged to be a good policy, even if by our first standard it were judged to be inefficient. For example, whenever we tax the rich and distribute the proceeds to the poor, administrative costs are incurred. The dollar value of the burden on taxpayers exceeds the dollar value of benefits received at the other end. Nonetheless, such transfers are judged to be good because they promote equality.

On the other hand, it might be very efficient to spend tax dollars to build a particular bridge or dam. But suppose the project would mainly benefit the wealthy and leave most of the poor worse off than before. The project would then be a bad one by the standard of equality.

Just as they have discovered ways of measuring costs and benefits, economists have also developed ways of measuring the degree of inequality. This allows them, in principle, to say whether a policy creates more equality even if it affects millions of different people in different ways. There are some sticky problems, however. Suppose one family has two children. Another has no children. In order to achieve equality, should the first family have twice the income of the second? Or suppose that one person works 80 hours a week while another works only 40. Does equality mean that both workers should receive the same monetary income? Or should the extra leisure time enjoyed by the second worker count as a form of income in kind?

These questions are not trivial. What to do about the value of leisure time and the problem of comparing people in different generations is very important in some issues, such as Social Security. In fact, in Chapter 15 we will see that according to one set of answers Social Security appears to create more equality; according to another set of answers, the system appears to create more inequality.

Our analysis of illegal aliens in Chapter 13 reveals another problem. Does the standard of equality apply only to U.S. citizens, or do illegal aliens count too? Our discussion will demonstrate that the flow of illegal aliens probably creates more inequality among our own citizens, but if the citizens of other countries are included, the flow of aliens undoubtedly leads to more overall equality of income and wealth.

When they think about creating more equality, most people are typically thinking about raising the incomes of those in poverty. And, true enough, most policies that help the poor tend to create more equality and most policies that hurt the poor tend to create more inequality. But not always. Consider a policy that takes a little bit of income from the poor, a lot of income from the rich, and transfers all of this income to middle-class citizens. Such a policy could actually increase overall equality while harming those at the bottom of the income ladder.

What all of this means is that while we can often talk about equality in a rigorous way, the concept is not quite so simple as it first might seem.

Liberty

Our third standard—that of liberty—comes from a long tradition in Western political thought. This standard is based on a view of liberty that was formally developed in England by John Locke and that later influenced many of our founding fathers, including Thomas Jefferson. In its strictest form, the standard holds that each individual has a right to act in accordance with private choice, free from force, threat, or coercion by others.

Most of us are familiar with such fundamental civil liberties as freedom of speech, freedom of the press, and freedom of religion. But economic liberties are included here too: the right to own property, the right to produce goods and services, and the right to engage in voluntary exchange with others. As applied to the evaluation of public policy, this standard says that any policy is bad if it violates the individual's civil and economic liberties. For example, forcing the rich to give to the poor would violate this standard even though it might result in more equality. On the other hand, a policy of enforcing contracts is judged to be good by the standard of liberty because it protects property rights and facilitates voluntary exchange.

So what about taxes and government-provided goods like streets and highways? Some advocates of liberty take the extreme position that all taxes are coercive and that all goods and services (even the police and courts!) should be provided through the private marketplace. This is not the traditional view, however, nor is it the interpretation we will be concerned with here.

For our purposes we will consider government taxes and spending policies to be consistent with the standard of liberty so long as, on balance, each individual is left no worse off than before. That means that it is all right for government to impose a tax on a person so long as the tax creates benefits for that person that are greater than or equal to the value of the taxes collected. Thus, taxing the citizens of Idaho to build a dam in Idaho might be consistent with the standard of liberty. But taxing the citizens of New York to build a dam in Idaho would be inconsistent with that standard. Unlike the standard of efficiency, therefore, the standard of liberty, at minimum, requires that *those who bear the costs of a policy be the same people who receive the benefits.*

These three are not the only standards that can be used to evaluate public policy. Many other standards exist. In fact, the list of all possible standards is probably infinite. We have selected these three for three reasons. First, all three of these standards are frequently used in debates over public issues. Second, each of these three standards has fairly clear-cut implications, and each can be used to judge a wide variety of policies. Third, all three standards require some knowledge of economics. In each case, we need to discover the economic effects of a policy before we can say whether it promotes efficiency or equality, or whether it is consistent with the standard of liberty.

We suspect many of our readers will not fully agree or disagree with any one of the standards we have discussed. That creates no problem when a policy is judged to be good by all three standards. Enforcement of contracts, for example, promotes economic efficiency, is consistent with the standard of liberty, and probably contributes to a little more equality as well. Surprising as it may seem, a lot of other policies and policy changes are also consistent with all three standards.

But many policies are not. That's where *value trade-offs* come in. For example, most economists believe that achieving complete equality of income for all citizens would have disastrous effects for economic efficiency. If each person were guaranteed an equal share of the income pie, regardless of contribution, there should be very little incentive for the individual to produce much. As a result, few people favor total equality of income. On the other hand, staying strictly with the efficiency standard might lead to widely different incomes for different individuals, and very few people are indifferent to extreme inequality. Most people prefer something in between. They are willing to trade off some efficiency for more equality. The exact trade-off, of course, can differ a lot from one person to another.

Similarly, most of us do not particularly like the idea of government restrictions on our behavior. We may even dislike the idea of restricting the behavior of others. But suppose that by giving some people a little less liberty we could have more efficiency or more equality. Many people would be willing to make such a trade-off.

You may want to consider other standards not discussed here. In fact, we encourage you to develop your own value trade-offs and apply them to the issues as you read this book. But, to be honest with yourself, don't decide which policies you like and then search for a way to defend them. First decide what fundamental values you accept, and then see what these imply about public policy. You may be surprised.

Explaining public policy

In addition to tracing the effects of public policies and evaluating those policies, this book will tackle a third job: the job of trying to explain why we have the particular policies we do have. For example, in a later chapter we will argue that our current policy on pricing electric power causes waste and inefficiency, gives few benefits to the economically disadvantaged, and violates the rights of consumers and potential competitors. Evaluation raises a question: If the policy is so bad, why don't we change it?

Answering questions like this is the job of a relatively young branch of economics called *public-choice theory*. Public-choice theory analyzes policy choices made through our political system, using the same kinds of tools economists routinely use to analyze the private choices made in the marketplace. For example, an important principle of public-choice theory is that all political actions and decisions—and the bits of information on which those actions and decisions are based—are *costly*. This principle helps explain why some public policies are not in the best interest of the majority of voters even though our system of government is democratic.

It is well known that small special-interest groups can often get favors from the government at the expense of the general taxpayer. The explanation of why such favors are granted is often that it is much less costly for a small special-interest group to organize and promote its interests than it is for a large group, such as taxpayers in general, to organize and defend itself.

As it progresses, this book will closely examine some of these costs and will introduce a number of other applications of public-choice theory. Now let's look at some selected policies one by one, trace their consequences, evaluate them, and attempt to explain their origins.

Questions for thought and discussion

1. Which of the three standards of evaluation discussed in this chapter seems the most reasonable to you? Is your choice a matter of emotional preference or can you defend it logically?

2. Can you think of any ethical standard for evaluating public policy that would require no knowledge of economics?

3. Three other standards are not discussed in this book:
   a. A policy is good if it benefits society as a whole;
   b. A policy is good if a majority of people prefer it;
   c. A policy is good if it forces people to do what they ought to.

Can you discover any problems with these standards? (Can their terms be rigorously defined? Can logical implications for public policy be derived from them?)

Selected references

At the conclusion of each chapter additional readings on the issue or issues discussed will be listed. Most are written for the nonspecialist; the suggested readings differ considerably in level of difficulty, however. Hence, some additional comments are warranted.

The concept of economic efficiency as it is normally used to evaluate public policy is lucidly presented by Mishan—some knowledge of basic economics is required, however. Rawls favors a certain type of equality and believes that public policy should be designed to maximize the well-being of the least well-off citizens. The relationship of equality, efficiency, and liberty is discussed; but his book, while important, is not easy reading. Some knowledge of basic ethical philosophy is suggested. Nozick argues for liberty but discusses its relationship to equality and efficiency as well. Most writers do not fully accept any of these three standards, and they search for some kind of trade-off. Friedman's work primarily focuses on the trade-off between liberty and efficiency; Okun focuses instead on the trade-off between efficiency and equality. Again, some knowledge of basic economics is helpful in reading both books.

Friedman, Milton. *Capitalism and Freedom.* Chicago: University of Chicago Press, 1962.

Mishan, E. J. *Economics for Social Decisions: Elements of Cost-Benefit Analysis.* New York: Praeger Publishers, 1973.

Nozick, Robert. *Anarchy, State, and Utopia.* New York: Basic Books, 1974.

Okun, Arthur. *Equality and Efficiency.* Washington, D.C.: Brookings Institution, 1975.

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