2. Origins of the State

I. The state and rule enforcement
II. The state and allocation
  a) Externalities
  b) Asymmetrical information
  c) Natural monopolies
III. The state and redistribution

Basic literature is Mueller (2003), pp. 8-63.
I. The State and Rule Enforcement

The state is needed to set rules and take care for enforcement on a just basis. Enforcement needs a strong state:

- Police
- Armed forces
- Independent judiciary
- Checks and balances
  - Opposition
  - Press
  - Academia

→ Normative statement

→ Constitutional Economics (see below)
The view of the state in Economics is that it is the organisational structure of a polity.

The state is not regarded as standing above the human being ➔ Constitutional Economics or citizens vs. (subjects) Untertanen!

Members of society agree unanimously on a social contract or a constitution. As long as actions are made within these rules, the outcome is perceived as being fair.

In this view, there are three types of reasons for the existence of the state. It is necessary:

• to set and enforce rules,
• to take care for allocation, and
• to organise redistributive policy.
Constitutional Economics: Social contracts

1) A just social contract (John Rawls)

Rawls argues with an original position with total equality; each member of the community gives up her knowledge about her position in society and steps behind a *veil of ignorance*.

Equality in the original position leads to unanimity over the social contract. The economic outcome is perceived as being the result of a gamble with random results; therefore it is not acceptable.

Two principles of justice:

- equal rights to most extensive basic liberties;
- equal distribution of social values ➔ Maximin!
2) Constitutional economics (James Buchanan and Gordon Tullock)

Buchanan and Tullock (1962): no normative position, they assume unanimity at the constitutional stage.

Homann and Vanberg have given up this assumption ➔ ficticious consensus is satisfying the conditions.

The veil is a veil of uncertainty, as any individual can be sure about the rules of the game, but not its outcome. This will be accepted as long as there is no betrayal.

Different types of uncertainty:

Identity, numbers and payoffs.
II. The State and Allocation

Allocation theory shows that in general, markets are efficient and generate welfare optimally (without notice of distribution).

However, there are cases of market failure. Three forms can be distinguished:

- externalities,
- asymmetrical information,
- natural monopolies.

For many, these are the main reasons for the state to act economically.

If the markets fail, governmental intervention is necessary to care for efficient allocation.
a) Externalities

aa) Definition:

Economic activity of one person (firm) has an impact on the consumption or production of another person or firm.

Consumption

\[ U_i = U_i(x_i, y_i, Z), \]

the utility function contains arguments not to be influenced by individual \( i \).

Production

\[ \Pi_x = \Pi_x(K_x, L_x, Z), \]

the production function of \( x \) is influenced by an activity of a third person (firm).
In such a case, the government has to try to internalise these external cost.

➔ Pigou tax,

➔ Pigou subsidy,

➔ Property rights

Economic problem: exact measurement of cost.

Political problem: exact definition of property rights.

➔ Market failure versus state failure.

State failure implies inappropriate definition of property rights, economically inefficient internalisation of external cost etc. It has no moral dimension.
bb) Coase Theorem

Ronald Coase has shown that in the absence of transaction cost and with clearly defined property rights external effects do not exist.

In addition, it does not matter for the economic efficiency and ecological effectiveness whether the party responsible for damages or that party suffering from damages has the property rights.

However, transaction cost is rarely negligible and property rights are sometimes difficult to define.

➔ The Coase solution is almost impossible to reach.

Nevertheless, Coase demonstrated the irrelevance of distribution of property rights as well as the relevance of transaction cost.
Digression: Normative and positive aspects of environmental policy

There are several ways to internalise external cost:

- **Ordnungsrecht**
  - emission thresholds
  - technological standards
- Pigou-tax
- Standard-price-approach
- private negotiations (Coase)
  - Emission Banking
  - Bubble Policy
- Emission certificates

Public choice does not analyse the normative properties, i.e. economic cost and ecological effectiveness, but the reason for policymakers to choose a certain environmental policy again market failure versus state failure.
cc) Public goods

Public goods as extreme case of (positive) externalities:

➔ non rivalry (jointness) in consumption and

➔ impossibility of exclusion.

Types of goods:

• private good,
• common pool property,
• club good,
• public good,
• merit goods ➔ Nudging

Free rider problem as the basic problem of collective choice.
Free rider problem

What are individuals willing to pay for the provision of a public good?

Simple but only seemingly precise answer: nothing.

More complicated answer: it depends, on what?

- individual gains from cooperating
- differences in individual gains
- level of state activities already reached
- group size
- social conventions

Prisoners’ dilemma vs. coordination games and chicken games
Figure 2.1: Prisoners‘s dilemma

<table>
<thead>
<tr>
<th></th>
<th>B</th>
<th>Does not Steal</th>
<th>Steals</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Does not steal</td>
<td>1 (10,9)</td>
<td>4 (7,11)</td>
</tr>
<tr>
<td></td>
<td>Steals</td>
<td>2 (12,6)</td>
<td>3 (8,8)</td>
</tr>
</tbody>
</table>

Figure 2.2: A coordination game

<table>
<thead>
<tr>
<th></th>
<th>Strategy A</th>
<th>Strategy B</th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td></td>
<td>(a,a)</td>
<td>(0,0)</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td></td>
<td>(0,0)</td>
<td>(b,b)</td>
</tr>
</tbody>
</table>

Source: Mueller, Dennis C. (2003), …, p.15.
## Figure 2.3: A game of chicken

<table>
<thead>
<tr>
<th></th>
<th>D</th>
<th>Contributes to building fence</th>
<th>Does not contribute</th>
</tr>
</thead>
<tbody>
<tr>
<td>G</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>1 (3,3)</td>
<td>4 (2, 3.5)</td>
</tr>
<tr>
<td></td>
<td>Contributes to building fence</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Does not contribute</td>
<td>2 (3.5, 2)</td>
<td>3 (1,1)</td>
<td></td>
</tr>
</tbody>
</table>

Source: Mueller, Dennis C. (2003), ..., p.16.
The prisoner’s dilemma shows the typical problem related to the provision of public goods, namely free riding.

The coordination game is solved, as both individuals gain most from cooperating ➔ dominating strategy. No one can improve her situation at the expenses of others.

The latter game will at any rate been solved at a maximum when it is repeated, whereas the prisoner’s dilemma can (but not must) evolve again and again.

The game of chickens is the most tricky one, as cell 1 is not the dominant strategy. It may be advantageous to signal credibly not to contribute. In this case, the partner may still choose to contribute.

➔ Application in international affairs
b) Asymmetrical information

Principal-agent-problems (PAP), whether defined as adverse selection (ex-ante) or as moral hazard (ex-post), cause markets to fail.

Ownership and control are separated. Examples are:

- market for insurances,
- labour markets,
- quality aspects (consumer protection).

The regulation of these markets is aiming at healing the market failure; it may, however, lead to state failure:

- insurance: overregulation, capture;
- labour market: employment protection legislation;
- consumer protection: trade protectionism.
c) Natural monopoly

A natural monopoly exists, if (marginal and) average cost decrease in the relevant demand areas under a given technology. Only one firm can serve the demand without welfare losses. Here is a need for regulation, e.g. by:

- price regulation (cost oriented, rentability oriented, ECPR, Price Caps, Ramsey-rule);
- capital return regulation;
- competition for the market;
- prohibition of discrimination;
- structural separation of multi product firms;
- limitation of activities.

→ Problem: regulatory capture*

III. The Redistributive State

A Pareto efficient allocation of resources and goods may not be just.

Society may feel the need to redistribute income and to even out huge income differentials as well as to insure its members against severe risks of life.

These risks include illness, unemployment, wealth losses.

Age cannot be regarded as risk, rather as a chance! Nevertheless, there may be the need for collective action with respect to old age protection:

- externalities, moral hazard.
How can the redistributive state act?

1) Redistribution as insurance/social contract.

2) Redistribution as public good.

3) Redistribution to satisfy fairness norms ➔ inclusive societies

4) Redistribution to increase allocative efficiency.

It may be possible to model these types in a way to reach unanimity about it. Notwithstanding, governments may go too far or exploit certain groups by purpose:

5) Redistribution as taking.

Of course, the organisation of redistribution has impact on economic incentives ➔ shadow economy, corruption.
Redistribution as taking

Table 2.1 Costs and benefits of the EU’s common agricultural policy in comparison with free market outcome, 1980 (mio. of US$)

<table>
<thead>
<tr>
<th>country</th>
<th>producers</th>
<th>consumers</th>
<th>government</th>
<th>net</th>
</tr>
</thead>
<tbody>
<tr>
<td>EC-9</td>
<td>-30,686</td>
<td>34,580</td>
<td>11,494</td>
<td>15,388</td>
</tr>
<tr>
<td>West Germany</td>
<td>-9,045</td>
<td>12,555</td>
<td>3,769</td>
<td>7,279</td>
</tr>
<tr>
<td>France</td>
<td>-7,237</td>
<td>7,482</td>
<td>2,836</td>
<td>3,081</td>
</tr>
<tr>
<td>Italy</td>
<td>-3,539</td>
<td>5,379</td>
<td>1,253</td>
<td>3,093</td>
</tr>
<tr>
<td>Netherlands</td>
<td>-3,081</td>
<td>1,597</td>
<td>697</td>
<td>-787</td>
</tr>
<tr>
<td>Belgium/Luxembourg</td>
<td>-1,24</td>
<td>1,4</td>
<td>544</td>
<td>320</td>
</tr>
<tr>
<td>UK</td>
<td>-3,461</td>
<td>5,174</td>
<td>1,995</td>
<td>3,708</td>
</tr>
<tr>
<td>Ireland</td>
<td>-965</td>
<td>320</td>
<td>99</td>
<td>-546</td>
</tr>
<tr>
<td>Denmark</td>
<td>-1,736</td>
<td>635</td>
<td>302</td>
<td>-799</td>
</tr>
</tbody>
</table>

Distribution problems cannot be judged normatively in a comprehensive way by economists.

- What is a fair distribution?
- Shall the government support certain groups at the expense of others?
- Is the welfare loss of a poor person worse than the welfare loss of a rich person?
- Is a farmer worth more than a worker?

Economists trust a so-called weak value judgement: we prefer the Pareto-superior situation.
However, there are some arguments for a fair distribution and redistribution.

Given that a nation or an economy can be seen as a club, it offers club goods (remember: no rivalry, but exclusion).

A fair distribution is such a club good.

How to achieve fair distribution?

• progressive taxes;
• tax breaks for families or the elderly;
• subsidies for certain groups;
• social help payments;
• free housing, education and health services for poor people;
• Tbc.
Finally: “…distributional coalitions slow down a society’s capacity to adopt new technologies and to reallocate resources in response to changing conditions and thereby reduce the rate of economic growth.” (Mueller 2003, p. 555).

Mancur Olson* not only explained the emergence and persistence of interest groups, but also the reason for economic decline and the role of shocks for nations to rise again.

Examples are the economic rise of Germany, Italy and Japan as well as the decline of the UK, Australia and New Zealand after World War II and India’s long term decline because of rigidities in the caste system. China after 1000 A.D. is also a case.