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would have been in the absence of government transfers (Haveman 1988; Danziger 1988). Federal taxes are also progressive, though only mildly so (Pechman and Mazur 1984; Haveman 1988). In a historical context, the period 1960–80 saw the US government transformed from a traditional defense–transportation–natural resources enterprise to a major engine for poverty reduction. Social policies that are redistributional by nature grew from about a quarter to nearly half of federal activities over this period (Haveman 1988). Nevertheless, as he also points out, in spite of the massive increase in taxes and spending, inequality was no lower in 1988 (and is probably higher now) than it was in 1950, because of rising inequality in market incomes.

Secondly, as argued by Alesina and Angeletos (2003), redistribution from rich to poor is more limited in the USA than in continental Europe at least in part because of differences in public attitudes towards the source of income inequality. In a society like the USA, people are much more likely to believe that individual efforts determine income and that poverty is due to lack of effort rather than bad luck or social injustice. Americans accept a larger measure of inequality and choose less redistribution, because they believe that the distribution of incomes produced by the market is closer to what they consider to be a fair outcome. Schwabish, Smeeding, and Osberg (2003) offer a different perspective on the relationship between income inequality and social spending. They argue that cross-national differences in social expenditure are associated with and according to their theory, may be driven by the degree of inequality in the top half of the income distribution, because political influence is concentrated among the rich who stand to benefit less (or lose more) from social and welfare programs the more unequal the society.

Thirdly, and related to the previous point, many defenders of American economic and political institutions argue that inequality plays a crucial role in creating incentives for people to improve their situations through saving, hard work, and investment in education and training. According to this line of argument, wide income disparities may be in the best long-term interest of the poor themselves as the benefits of higher economic growth "trickle down" to the poor. However, Smeeding, Rainwater, and Burtless (2000) conclude that the supposed efficiency advantages of high inequality do not appear to have accrued to low-income residents of the USA, at least so far, but rather to those further up the income scale. Kenworthy (1998) assesses the relationship between the "extensiveness" of social welfare policies and overall poverty rates in fifteen developed countries over the period 1960–91, allowing for the possible impact on long-run economic growth. The results of his multivariate analysis, though not conclusive, suggest that social welfare policies do significantly help to reduce absolute and relative poverty, even when possible indirect, dynamic effects on long-term economic growth are taken into account.

Finally, there are various ways in which the methodology used in comparative studies may exaggerate the differences between countries, making simple comparisons of pre- and post-transfer poverty or inequality potentially misleading. This relates to the problem with establishing incidence discussed at the start. For example, in countries with generous earnings-related social insurance schemes, older people

will have had less need to make private provision for their retirement, so they are more likely to have relatively low pre-transfer incomes. A simple comparison of pre- and post-transfer poverty rates will show that government transfers are lifting many older people out of poverty. But, this implicitly assumes that people would not alter their behavior in the absence of social insurance or other government transfer schemes. In practice, many of these older people would have made alternative arrangements and would not in fact have been poor in the absence of government transfers. Similarly, by deducting taxes and national insurance contributions, but not private pension contributions, the "standard approach" to the analysis of income data will exaggerate the disposable incomes of middle- and higher-income groups in countries where pensions are more private than public (Whiteford and Kennedy 1995).

Studies based solely on cash incomes may also give a distorted picture of the impact of social and welfare policies, because governments may seek to achieve their redistributive goals through programs which provide non-cash benefits rather than just through tax-transfer mechanisms. Smeeding et al. (1993) find, however, that the ranking of countries according to levels of cash and non-cash transfers is similar (with the exception of Canada whose non-cash ranking is well above its cash transfer ranking), suggesting that governments have not used cash transfer and non-cash benefit programs as substitutable methods of achieving their social objectives. Non-cash incomes appear to reinforce the distributional impact of conventional tax-transfer mechanisms, rather than acting to offset them in any major way.

5.4 Analysis of Individual Programs

Twenty years ago, in his book *The Strategy of Equality*, Julian Le Grand (1982) reached the striking conclusion that "almost all public expenditure on the social services [in the UK] benefits the better off to a greater extent than the poor." Goodin and Le Grand (1987*a*) extended this analysis to other countries and to include examples of cash payments, as well as in-kind services. Their conclusion has been widely, though not universally accepted. Esping-Andersen (1996), for example, states that "it is now well-established that huge areas of welfare state activity, especially in education and the other in-kind services, are probably of greatest benefit to the middle classes."

If this is so, a large part of social policy would have failed in what many would see as one of its main aims. As we shall see below, this conclusion depends critically on a series of assumptions about how to analyze the distributive impact of social welfare programs, and more fundamentally, on the meaning attached to their redistributive role.

Le Grand (1987) examined the use of various social services in the UK in the 1970s and found that people from lower social classes used fewer health services per ill

person, benefited less from subsidies to owner-occupiers and transport-related subsidies, and that their children were less likely to stay on in post-compulsory state education. Of the services he looked at, only subsidies to council tenants and rent rebates were directed primarily at the poor (though his analysis did not cover social care or cash transfers, both of which are also pro-poor). Goodin and Le Grand (1987*b*) used the example of the Australian social security system to argue that even programs that are tightly targeted on the poor at their inception may, over time, be "infiltrated" by the non-poor, defeating or at least defusing their redistributive aims—what they term "creeping universalism." At the same time, those services targeted at the poor have a tendency to be cut first when budgets are under pressure. Hanson (1987) argued that state-funded programs in the USA are particularly vulnerable to these kinds of pressures because "footloose" businesses lobby them to keep taxes low. The neglect of social assistance is easily carried out simply by not adjusting benefit levels for inflation—as a result, the entry point for social assistance (i.e. the maximum permissible income to qualify for AFDC payments) fell from 80 per cent of the official US poverty line in 1968 to 57 per cent in 1981. Thus, governments appear to favor public services that are extensively used by the middle classes and to neglect spending areas that are targeted at the poor.

The authors offered several possible explanations for "middle-class capture." The better off, being generally better educated and more articulate, are more able to manipulate the system to their advantage: to ensure, for example, that their doctor refers them to a specialist or that their children go to the right schools. They are also likely to face lower costs in using services and have greater political influence.

To some extent at least, therefore, inequality in health care and other services reflects inequality in society more generally. On this basis, they argue that governments should intervene directly in the market to ensure it produces the "right" income distribution in the first place, rather than relying on fiscal transfers or in-kind provision of social services to "patch up" the secondary income distribution.

These conclusions have been challenged on at least two grounds. First, some have argued that universal programs are a good thing per se, because they foster social cohesion, whereas targeted programs can be socially divisive. This view seems to be consistent with the founding principles of the British welfare state. According to Marshall, "universal benefits symbolise the fact of social equality by conferring on everyone a badge ... of citizenship." If equality is seen in terms of a common system of provision for all, then equality of entitlement is more important than equality of use or equal use for equal need (Powell 1995). Taking measures to reduce the participation of the middle classes would involve lowering the quality of services to deter middle-class users and/or tightening the conditions for access and risking stigmatizing low-income users, neither of which would seem to be of benefit to the poor.

Secondly, subsequent analyses of the distributional effects of welfare programs—both cash and in-kind—have found that they involve substantial redistribution from low- to high-income groups. It is important to be careful in specifying the precise distributional question being asked. For instance, poorer groups may receive fewer

(or lower-quality) services *relative to their* needs than higher-income groups, but may still receive the largest aggregate amounts, simply because their needs are so much greater. Sefton (2002) examines the UK distribution of what he calls the "social wage" (benefits in kind from health care, education, social housing, and social care) between income groups between 1979 and 2000. The results show that the poorest fifth of households receive, on average, around twice the value of services that the richest fifth of households receive. Part of this pro-poor bias is accounted for by the demographic composition of income groups: older people and children, who are the most intensive users of welfare services, are disproportionately represented among lower-income groups. But, a significant pro-poor bias remains even after controlling for demographic factors, because certain services are targeted at poorer households, some services are strongly needs related (which skews them towards lower-income groups), and higher-income groups are much more likely to use private education and health care. Calero (2002) comes to very similar conclusion using Spanish data for 1994. He finds that age determines a considerable part of the distribution of spending on cash benefits and benefits in kind, but that social spending also leads to significant reductions in inequalities between social classes.

Furthermore, neither of these studies takes into account the distributional effects of taxation. Most social spending is financed from general taxation so it is difficult to say definitively which taxes are used to pay for which services. However, on plausible assumptions, allowing for taxation will substantially strengthen the redistributive impact of welfare policies. This is because most forms of taxation are proportional to incomes or progressive. Thus, even if spending on welfare programs were equal across income groups, those on lower incomes would still be net gainers, simply because they pay less tax into the system.

Having said this, some studies of individual policies or programs have shown these are less redistributive than they may appear at first. Gustman and Steinmeier (2000), for example, show that the US social security benefit system is not nearly as progressive as a point-in-time examination of the benefit formula would suggest. Replacement rates are considerably lower for those with relatively high average annual earnings over their lifetime than for those with low average earnings (ranging from 15 up to 90 per cent in 2000), implying substantial redistribution from high to low earners—and indeed this is the case at the level of the individual. However, about half of this redistribution is *within* families—from men to their spouses, especially those who have spent large amounts of time out of the labor market. There is much less redistribution from high- to low-income families. Similarly, Liebman (2002) finds that the extent of income-based redistribution is fairly modest compared to the benefits paid out by the social security system—only between 5 and 9 per cent of the total. Much of the intra-cohort redistribution is related to factors other than income, including from people with low to people with high life expectancies and from single workers and two-earner couples to one-earner couples. Since high-income families tend to have higher life expectancies and receive larger spouse benefits, a substantial part of the progressivity implicit in the basic benefit formula is offset.

6. Conclusions

Whilst nearly all acts of government have redistributive effects, most are not primarily about "traditional" redistribution from rich to poor. Even redistributive policies are often concerned with different forms of redistribution and have other objectives besides redistribution. Nonetheless, government tax and transfer policies substantially reduce inequality and poverty in all rich OECD countries, though with varying degrees of success. The outcomes in different countries are shaped by differences in political and economic values, including judgements about the trade-offs between equity and efficiency and the merits of targeted versus universal support, as well as considerations of political economy.

In a broader context, the politics of important areas of public policy may depend as much on who gains from government's activities and their financing as on their success against other, often primary objectives. This is not only true of cash transfer or taxation policies, but applies across most areas of government. When reform is proposed, debate often focuses on who are the losers from any transition from the status quo, rather than on assessing any new structure in its entirety. However, determining who the losers and gainers are usually depends on particular and contestable assumptions about how the world would be in the absence of policy change, as well as the time period over which comparisons are made. Empirical studies in the last twenty or so years have helped to shed light not only on what the redistributive impact of government is, but also on the most appropriate ways of framing the questions.

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CHAPTER 31

MARKET AND NON-MARKET FAILURES

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1. Introduction

All government action involves coercion, if only the coercive use of the taxing power. Liberal principles therefore dictate that the state should intervene only where voluntary action produces suboptimal results. Such situations are sometimes identified with the "market failures" of the economics textbooks. But not every case where the results of individual choice and voluntary coordination fall short of some ideal involves a market failure as economists use the term: there are also failures of other voluntary institutions, and of the mechanisms of individual choice. These might be called "failures of private choice" or "failures of voluntary action." Simply finding a market (or other private) failure does not, without further analysis, justify government intervention. The costs and risks of coercion are often serious enough to justify tolerating the imperfect voluntary outcomes of private choices.

This chapter explores the implications of these three ideas: deference to voluntary action as a "default option," recognition of the scope of departures from the optimal in private choice, and acknowledgement of the pervasiveness of government failure. Combined, they provide the template for responsible policy analysis, taking account of all consequences foreseeably arising from a recommended course of action.

2. Departures from Optimality under Voluntary Action and State Intervention

Markets mediate cooperation for mutual benefit. Under certain highly restrictive assumptions, the market equilibrium can be shown to be a Pareto optimum, a state in which the well-being of any individual cannot be enhanced without worsening the position of at least one other individual (Bator 1959). Where those assumptions do not hold markets are said to "fail:" fail, that is, to produce Pareto-optimal results.

One doctrine of public decision making holds that the state's coercive power should be brought to bear only against such "market failures," and to create the conditions, such as enforceable contracts and property rights, that allow markets to function. (An exception is usually made for "distributional" questions.) But this doctrine is surely too narrow. Markets do indeed mediate cooperation, but so do the non-market institutions sometimes lumped together as "civil society:" families, neighborhoods, professional societies, not-for-profit enterprises, churches, voluntary associations, and less easily pictured phenomena such as norms, practices, and values. These, too, can fail to secure optimal cooperation. It would be perverse, though possible, to use the language of market failure to analyze a litter-strewn neighborhood, a neglected child, dangerously aggressive driving, an ethos hostile to learning, or a culture wanting in altruism or inclined to violence. It would be equally perverse to insist on such an analysis as a prerequisite for treating those conditions as possible targets of public intervention.

The economic analysis underlying the doctrine of market failure assumes an individual capable of maximizing expected subjective utility, subject to constraint: a good steward of his own well-being. That assumption is obviously false for children and the insane. But it is also false for many decisions made by ordinarily competent people about, for example, time management, saving, financial risk taking, diet, exercise, and the use of psychoactive chemicals. And it is not obviously true of the processes by which individuals change their own preferences, by investing in their capacities to appreciate or contribute to music, literature, or painting, or by attempting to increase their self-command or altruism. Nor is it fully consistent with the observed relationships between expenditure and well-being studied by the developing discipline of hedonics (Easterlin 2002; Layard 2005). Thus the scope of suboptimal performance in voluntary individual choice and spontaneous organization is substantially larger than orthodox welfare-economics approaches suggest.

Yet if the scope of potentially justifiable state actions should be broadened to take account of failures of civil society institutions and of individual rationality as well as market failures, it remains true that the scope of actually justified state actions will turn out to be a good deal narrower. Government is not, after all, a frictionless device

for correcting for market or other failures. No one claims that it is. But applying this insight demands a step most policy analysts shy away from: comparing the efficiency of the institutions of voluntary choice, left to their own devices, with the efficiency of state action, or with the efficiency of private action as modified by regulation.

We understand government effectiveness to be a function of institutional incentives, material resources, and the sophistication of personnel, mediated by the transaction costs imposed by the institutional and cultural context (in particular the citizenry's willingness to cooperate with government objectives without extensive surveillance or threat). Understanding these constraints on government effectiveness is essential to policy analysis, since analysts have a professional obligation to hold themselves responsible for all of the predictable consequences of their recommendations, and these include both the way that other actors will respond to actual or possible government intervention and the way that governments will, over time, respond to the demand for intervention.

In essence, we accept the basic formulation of the problem of public choice proposed by James Buchanan: "Under what circumstances will collective-governmental supply be more efficient than private or non-collective supply?" This question, Buchanan adds, "the economist must answer on the basis of some comparative analysis of alternative institutions. The results that may be predicted to emerge from publicly organized supply must, in each case, be compared with those that may be predicted to emerge from non-collective, voluntarily organized, market supply" (Buchanan 1999).[1] So finding a hypothetical failure of private action is not sufficient to show that some choice ought to be made publicly rather than privately: the effects of individual choice and voluntary cooperation must be compared with those of government intervention before concluding that identified imperfections need something other than the policy Burke called "salutary neglect" (Burke 1974).

To accept Buchanan's formulation does not dictate accepting his rubric, shared with most other public choice theorists (notably William Riker), for the analysis of the quality of public intervention. The claim that actors in the public arena invariably act entirely for private benefit—that political man is simply economic man acting under different incentives—is neither empirically well supported nor theoretically demonstrable without making untenably restrictive assumptions.

Relaxing the assumption that officials are invariably predatory makes it conceivable that intervention by admittedly flawed government institutions will sometimes yield better results than letting things be. Once we take seriously both sides of the problem—the failures of markets, other means of voluntary cooperation and individual choice on the one hand and, on the other hand, government failures—the optimal scope of government action comes to depend crucially on government competence. The greater the prevalence and degree of suboptimal decision making in administration, the higher ought to be the threshold beyond which the powers of the state are mobilized against market and other private failure. The more competent the government, the greater the scope of interventions with which it can be trusted.

[1] But see O'Hare 1989 for an argument that "supply" is only one category of governmental action.

Those who would advise policy makers must take seriously the institutional context of their recommendations. A policy might be desirable in the context of efficient government, low corruption, and informed decision making but disastrous in the absence of these conditions. If the quality of intervention suffers as its scale increases, due to competing demands for the attention of decision makers, the diminished performance on other tasks that would result from adding a new program to the governmental repertoire (Rose and Peters 1975; Douglas 1976; Crozier, Huntington, and Watanuki 1975) may prove as important as the budgetary cost of the new program. In many situations the most pressing agenda for policy analysts will be to alter the context of decision making and administration to expand the scope for efficient government correction of private failures. The likely effect of a given policy choice on the quality of future public decision making and implementation may be among its most important consequences.

3. The Classical Market Failures

Markets can be said to "fail" whenever an exchange that would be a Pareto improvement—one that would improve the well-being (as the participants understand it) of all those affected—will not be made by self-interested agents (Bator 1958). A monopolist, for example, sets his price where marginal revenue equals marginal cost, rather than where price equals marginal cost, as a competitive market would require. The profit gain to the monopolist from the higher price is less than the sum of the consumers' surpluses lost due to the combination of higher price and smaller volume: the potential consumers' surpluses from the units not sold at the monopoly price, but which would have been sold at the competitive marginal-cost price, are a deadweight loss. The consumers, if they could costlessly organize without free-rider problems to buy the monopoly from the monopolist, could pay the monopolist a sum greater than the monopoly profit and still increase the welfare of each consumer. But they cannot, and therefore the monopoly price remains in place. The market thus fails to maximize consumers'-plus-producers' surpluses. Here regulation can, in principle, help matters, either by fixing a price for the monopoly good nearer the marginal-cost price or by forcing competition.[2]

However, a good with increasing returns to scale in production—whose marginal cost is falling throughout the relevant range—cannot be efficiently produced by more than one producer. Such a good is therefore a "natural monopoly," and thus a candidate for price regulation or public provision.

The extreme of "natural monopoly" is a situation in which the marginal cost is zero. Zero marginal cost is characteristic of goods that are non-rival in consumption

[2] As William Baumol (2002) has argued, actual competition may not be necessary as long as the market remains "contestable," that is, the possibility of new entry is maintained.