Chapter 1

INTRODUCTION: GOVERNMENT AS SERVANT OF THE PEOPLE

1.1 DEMOCRATIC INSTITUTIONS, "SUBSTANTIVE DEMOCRACY," AND POLICY

Governments affect human welfare in at least four ways. They do so by providing more or less of the goods and services that are complementary to private production and consumption (*production*), or are otherwise not provided or underprovided by the private sector for lack of profitability. They may distort (for better or for worse), obstruct, or burden private sector production and consumption, with taxes and subsidies (*taxation and subsidies*). They may limit the freedom to access the goods and services that are otherwise available in the market, or otherwise regulate all kinds of private sector activities (*prohibition and regulation*). They may redistribute income and wealth (*redistribution*).

Lincoln's 1863 Gettysburg Address referred to the United States as "this nation of the people, by the people, and for the people." The ideal nation is one that belongs to the people, one that is ultimately governed by the people, and one that serves the people.

Governments can of course serve "the public interest." But what is "the public interest"? Typically public policy benefits some and hurts others. How do we decide if the public interest is served?

There is little doubt that governments sometimes hurt the public interest, even with the best of intentions. Some governments actually become "predatory" in nature—that is, they can tax the private sector for the benefit of the powerful people in the government and its associates, as discussed in Young and Marcouiller (1995). This book, however, assumes that the proper role of governments is to serve the people and that public policy should be designed to serve the public interest. Based on this assumption, we demonstrate some principles of public policy design and implementation that should be useful to policy makers as well as all those who are concerned with the quality of public policy.

How will governments serve the people? They serve the people by supplying them with the essential goods and services that the private sector is unlikely to provide or unlikely to provide adequately, such as public hygiene and weather forecasts. They serve the people by arbitrating or resolving conflicts fairly, by reducing risks or helping people cope with risks better—both risks that are macro in nature, affecting the entire economy or society, and risks that are more "micro" in nature, such as accidents and crimes. Governments represent an important aspect of social capital—a capability to mobilize resources and manpower to achieve socially valued goals. Above all, governments should be a friend of each person, so that he or she feels protected and able to pursue happiness as long as doing so does not interfere with others' pursuits.

Proposition 1.1 The Roles of Governments

Governments provide needed infrastructure and other public goods, sets rules and regulations that complement markets so they can function fairly and efficiently, manages macro risks as well as risks that may confront individuals and businesses, mobilizes effort to accomplish socially valued tasks, and generally provides an environment so people can pursue happiness, feeling protected and free to do as they *please as long as they do not harm others.*

While governments are supposed to serve the public interest, government bureaucrats are human beings and are subject to many common weaknesses inherent in human nature. Given the opportunity and the inducements, some individuals within the government will be susceptible to corruption. Here corruption is taken to mean the abuse of the public office for private gains. Politicians as well as bureaucrats need to be prevented from taking advantage of the power that they wield at the expense of the public. Building effective mechanisms to achieve this is the essence of "governance." Institutional arrangements that protect the private sector from harassment by government officials promote economic development. A free press, an independent ombudsman installed with authority, an "independent commission against corruption," etc., are part of an institutional framework that can serve this purpose. Democratic institutions, in particular a representative government formed by general elections, may also serve the purpose. In practice, however, formal democratic institutions *per se*—electoral politics and party politics—do not historically have a better performance record than the other mechanisms mentioned above to combat predatory behaviour by the state. They are neither a necessary nor a sufficient condition for what may be called "substantive democracy"—a government that is truly responsive and that meets the needs of the public.

Proposition 1.2 Public Governance

The essence of public governance lies in setting up effective mechanisms that prevent government officials or anyone in public office from misusing the powers vested in them by virtue of the public office.

Proposition 1.3 Substantive democracy

Substantive democracy is a responsive government, i.e., one that produces services according to the aspirations of the public.

To the extent that there are some basic services that every government must perform because they are commonly and indeed universally regarded crucial to the interests of the public, there is a need to spell out these responsibilities explicitly in the form of a *constitution.* This constitution generally would include, among other things, protection of private property, protection of basic human rights, protection of freedom of the press, an independent legislature and an independent judiciary free from influences of the executive ("separation of powers"), and a bureaucracy accountable to the people. These provisions are even more important than formal democratic institutions such as universal suffrage and general elections.

The main contribution of formal democratic institutions to economic development is to provide smooth transfers of leadership, so that society is not destabilised by a scramble for power, which had been the single most destabilizing force to China's economic development since the inauguration of the Peoples' Republic of China on October 1, 1949. Political upheavals in China have cost tens of millions of lives, had disrupted productive activities, and had driven hundreds of thousands out of the country as illegal emigrants. Only when China found a strong leader, namely Deng Xiao-ping, who put economic development and stability ahead of everything else, was China spared from power struggles from 1979 to 1989. The Tiananmen incident of 1989, however, showed once again the potential horrors of power struggle in the absence of a democratic process for transfer of power.[1] Without doubt, electoral democracy is highly desirable. But proper governance has preventive functions, while the ballot box essentially provides only remedial functions—allowing corrupt or ineffective officials to be voted out of office *after* they have done the damage.

One may argue that the ballot box by threatening with voting out the present administration may motivate good behaviour. Yet history tells us that the ballot box is neither a necessary nor a sufficient condition to protect property rights, to enforce contracts, to provide adequate infrastructure, to provide a stable macroeconomic environment, or to provide adequate social safety nets. All of these functions are necessary regardless of who is in power, if the economy is to flourish. There is no room for a government, popularly elected or otherwise, to alter this basic mission. On the other hand, any government that is effective in delivering these public goods is like a producer that responds to consumers' needs and abides by "the consumers' sovereignty," which is a characteristic of the market economy and refers to the fact that producers follow the demands of the consumers to supply what they want. We can describe such a responsive, sensitive, and effective government as "substantively democratic" even though it may not be "formally democratic."

Proposition 1.4 Substantive versus Formal Democracy

A constitution and other governance mechanisms that effectively prevent the misuse and the abuse of power are more important than the ballot box. The ballot box can at best allow corrupt or otherwise ineffective officials to be voted out of office—a remedial function, but proper governance mechanisms serve a preventive function and help prevent the abuse of power regardless of who is in power.

Unfortunately, the modern day democratic process is often used by various sectarian or partisan interests for their private gains to the detriment of others' interests. The democratic process has been the avenue through which various business, labor, and social groups further their narrow interests. Such “rent-seeking” behaviour is often disruptive to economic development and social harmony. Such disruptions should be minimized and restrained. Again, *effective governance*, which is NOT a political process, is the key.[2] Regrettably, however, in practice not many governments, particularly authoritarian ones, have been able to set up such governance mechanisms that are credible and truly free from political pressures.

While an effective, “economically friendly” constitution (written or implicit) and a bureaucracy disciplined to support such a constitution are a boon to economic development, they are generally not considered to be the substance of democracy. Hong Kong is a case in point. As is well known, Hong Kong had been cited by Milton Friedman to be the perfect model of capitalism, and has topped the world in the ranking of economic freedom by the Heritage Foundation for many consecutive years. During the colonial days, and since 1972, Hong Kong had an Independent Commission Against Corruption and a Commissioner for Administrative Complaints (now called Ombudsman). A Public Accounts Committee of the Legislative Council was charged with the responsibility of examining reports prepared by the Director of Audit. But colonial Hong Kong was certainly not a democracy in the formal sense. In China, steps have been taken to make the bureaucracy more accountable to the people, but the Chinese Communist Party in the People’s Republic of China (PRC) does not tolerate an effective political opposition. None of its leaders derives his mandate from the popular vote. To most observers, China is clearly undemocratic. In Korea when the military took over the government in 1961 it revamped the bureaucracy to support President Park Chung Hee’s economic program (“the economically friendly constitution”) that sought to provide the institutional and physical infrastructure for development. Despite the dictatorial style of Park before his assassination in 1979, and despite the one party rule of the PRC, the economic development that unfolded, both in China and in Korea, is testimony that the lack of formal democratic institutions does not in itself inhibit economic progress. It must be noted, though, that rapid economic growth notwithstanding, one does have legitimate misgivings about the lack of proper governance in these regimes. China's lack of press freedom and the apparent influence of the executive on the judiciary are cases in point.[3]

India has practised democracy for quite some time, but for years its market institutions had been underdeveloped. Only from the early 1990s did it begin to adopt a more liberal policy for foreign investment and to embark on bold economic reforms. But it is still not even clear that democracy or neoliberalism has worked well for India in the sense of serving the country's best interest. Rajinder Sahota wrote in 2007: "There exist two India's. Neo-liberal market reforms beginning in the early 1990s have [created] nine new billionaires last year alone. Following a neoliberal agenda, the Indian government scaled back provision of basic services such as water, seed and credit, driving subsistence farmers to gamble on export crops such as genetically modified cotton. Without protection in hard years, about 1 million farmers have committed suicide since 1995 and several million more have been driven off their land and into destitution in urban mega-slums." (*Financial Times*, April 18, 2007)

Political scientists are also well aware of the danger posed by "the tyranny of the majority" and seek to protect minority interest with a constitution. As demonstrated in the Appendix, if the majority gains slightly while the minority suffers a lot, it may not make sense to go ahead with the policy, even though the majority would vote for it.

Economists are also well aware of the possibility of "*the tyranny of the minority*." It is recognized that disperse interest groups are often under-represented in the democratic process, because costs are concentrated among the politically active few while benefits are dispersed among the inactive many. In contrast, narrow interest groups stand to capture most of the gains achieved by their political activities. Consequently the silent majority often suffer. Indeed, the US tax code is testimony to the fact that over the years, the interest of the majority has been eroded by various tax concessions granted at different times to pacify various narrow interest groups. Another glaring example is the political popularity of protectionist measures that benefit a few even though large numbers of consumers suffer.

These sentiments are shared by Robert Barro. Barro found the US insistence on promoting democracy—sometimes ignoring the sacrifice in terms of the rule of law—dubious. "China was continually attacked for its lack of democracy, although it had made major strides in enhancing the rule of law,[4] whereas Russia was applauded for its free elections despite its difficulties in maintaining law and order." (Barro, 2000, p.8) Commenting on US efforts to promote democracy among developing countries, Barro concluded: "If there is a limited amount of energy that can be used to accomplish institutional reforms, then it is much better spent in a poor country by attempting to implement the rule of law—or more generally, property rights and free markets. These institutional features are the ones that matter most for economic growth, and these features are not the same thing as (formal) democracy." (p.9)

Amy Chua (2003) and Laura D'Andrea Tyson (2003) are even more pessimistic about how democracy may fail to deliver in practice. Chua argues that when various interest groups scramble for power and for their own interest in an electoral environment without the protection of an effective constitution that ensures law and order, the result may be corruption and violence. Tyson referred to the historical "recall" of California governor Gray Davis in 2003 and argued that the main complaint against him, namely that his out-of-control spending led to a fiscal crisis, was invalid as "state per capita spending grew at an average annual rate of only 1 per cent from fiscal 1989-90 to fiscal 2002-03, a much slower pace than during previous decades." Moreover, "as a result of several voter initiatives, about 70 per cent of state spending is earmarked in advance, limiting the discretion necessary to make trade-offs in a crisis."

The economic success of the four little dragons or "tigers": Korea, Taiwan, Hong Kong, and Singapore in the past thirty years, has not been predicated on the existence of democracy. The spectacular take-off of the Chinese economy since 1979 is, likewise, not based on the existence of a democratic government. Yet common to all of these success stories are the prevalence or the emergence of the market system, the existence or the emergence of the rule of law so that contracts are enforceable and property rights are respected or are increasingly respected, a government that is intent to supply adequate infrastructure and to educate and train its labor force, and relative social and political stability.

Concomitantly, if we cast our eyes on the economic stagnant economies such as those found in Africa, we find that they often lack basic market institutions, are marred by social and political instability, poor infrastructure, and the absence of the rule of law caused by rampant corruption. Some of these countries are formal democracies. The mere existence of formal democratic processes, it now appears clear enough, is insufficient to guarantee an effective government that can provide the crucial government services that are complementary to private sector activity.

Proposition 1.5 Formal Democracy Not a Panacea

Experience in Asia and elsewhere suggest that electoral or formal democracy is neither a necessary nor a sufficient condition for economic prosperity or a happy society. Democracies may be subject to the tyranny of the majority and the tyranny of the minority which need to be contained by proper governance mechanisms, particularly the constitution.

In typical democratic states, various factions in society try to use the political process to gain an edge over others. This happened in the United States, Germany, France, among others in the league of industrial nations, and in India and various African states among the less developed countries. Depending on the extent of strife, these political manoeuvring can have potentially damaging economic consequences. Higher taxes may be needed to fund expenditures that benefit special groups. Protectionist regulations and special tax favors benefit one industry at the expense of others. Barriers to trade damage economic efficiency.

Elected or otherwise, governments have to do two kinds of things: first to promote the common good and second to balance the interests of diverse groups. The former is its proper function, while the latter is often necessary for it to remain in power. Before the advent of modern day economics people may not know what constitute the ingredients of good government, and they may either place their bets on a dictator or on the arbitrary outcome of the democratic process. Nowadays we know the ingredients of good government: provision of adequate infrastructure, upholding the rule of law and fair play in the market place, ensuring public order and social stability, providing an effective social safety net, maintaining a stable macroeconomic environment, protecting basic human rights. No matter which party takes power, it has to work in these areas, and the bureaucracy—not political parties—should be relied upon to deliver these needed governmental services. In countries where political parties vie for power, different parties may balance the interests of diverse groups in somewhat different ways, but minor balancing acts should not have a material effect on economic and social development as long as the common good is put on the top of the agenda ahead of the minor balancing. In countries where there is just one dominant party and little competition among political parties, proper and effective governance becomes even more important. The public should be educated to hold their governments responsible for the delivery of the key government services.

Proposition 1.6 Role of Public Governance

Effective public governance is not only needed to prevent public officials from abusing or mis-using their powers, but also needed to prevent interest groups from mis-using the political process to further their private ends, and to protect the interests of minorities.

2. DEFINING THE PUBLIC INTEREST

We have mentioned the common good a few times, but what exactly is the common good or the "public interest"? This book argues that the public interest has to be defined using an *ex ante* perspective. This means we need to consider policy options and choose that which appealed to us the most when we had no vested interests to defend—as if we were "behind a veil of ignorance" and could be anyone within the society. This impartiality test using the "Rawlsian perspective"(after John Rawls who is renowned for his *Theory of Justice*[5]) is central to the definition of public interest. It often allows us to tell what constitutes a better policy choice when traditional theoretical constructs lead us to nowhere. The *ex ante* approach to interpreting the public interest can be traced to John Stuart Mill, who stated, in a letter to George Grote:[6]

> "human happiness, even one's own, is in general more successfully pursued by acting on *general rules*, than by measuring the consequences of each act; and this is still more the case with the *general happiness,* since any other plan would not only leave everybody uncertain what to expect, but would involve perpetual quarrelling…."

Very often, choices about public policy reflect political compromises as politicians try to "balance the interests of different parties." Such balancing acts may tell politicians what is feasible and what is politically most expedient. But it does not tell us which option is the most socially desirable. We need to re-invent public choice mechanisms so that we can arrive at choices that enhance our common, *ex ante*, welfare.

Proposition 1.7 The Public Interest

The public interest is the interest of "the representative individual"—an imaginary person who forgot his identity and who imagined that he had equal chance of being anyone in society. By pondering policy options using this ex ante perspective impartially, the most preferred option is the one that is deemed to maximize the public interest. With *the public interest defined this way, policy decisions should be made on the basis of comparing benefits in terms of enhancement of the public interest on the one hand, and costs on the other hand.*

3. POLICY MAKERS HAVE TO UNDERSTAND HUMAN NATURE AND SYSTEM EFFECTS

Having defined public interest this way, this book has two important messages to convey: first is that misguided policies, those that bring misfortune to many people, are usually a result of inadequate understanding about or inadequate consideration of human nature as it is. Human nature has to be considered a constraint that policy makers must confront squarely.

Another important message of this book is the need to understand the interactions and dynamics of the socio-economic-psychological system that often hangs in a delicate balance much like an ecological system. An apparently small policy error can cause a huge damage. We have three chapters, in Part IV, that draw on the historical cases studies of the Great Depression in the 1930s, a severe recession in Hong Kong in 1998, and the Global Financial Tsunami of 2008-2009 to illustrate this important point.

Proposition 1.8 Human Nature and the Public Policy

Public policy that fails to take account of human nature as it is will fail, and may lead to serious consequences.

Proposition 1.9 The Socio-psychological-economic System as an Ecological System

The socio-psychological-economic system hangs in delicate balance so that policies that tips the balance may lead to domino effects that spread throughout the system.

4. POLICY EVALUTATION CRITERIA

The Hicks and the Kaldor Criteria

Traditional welfare economics texts describe an approach to policy evaluation based on comparing the size of the gains to gainers to the size of the losses to losers, which include the "Hicks test" and the "Kaldor test." The Hicks criterion, proposed by J.R. Hicks, says that a change is desirable as long as the losers cannot bribe the gainers into forfeiting the change. The Kaldor criterion, proposed by Nicholas Kaldor, says that a change is desirable if the gainers can compensate the losers. In their original versions, any "bribes" or "compensations" need not take place in reality. As long as gains are bigger than losses, a change is taken to be a social improvement, otherwise it is not.

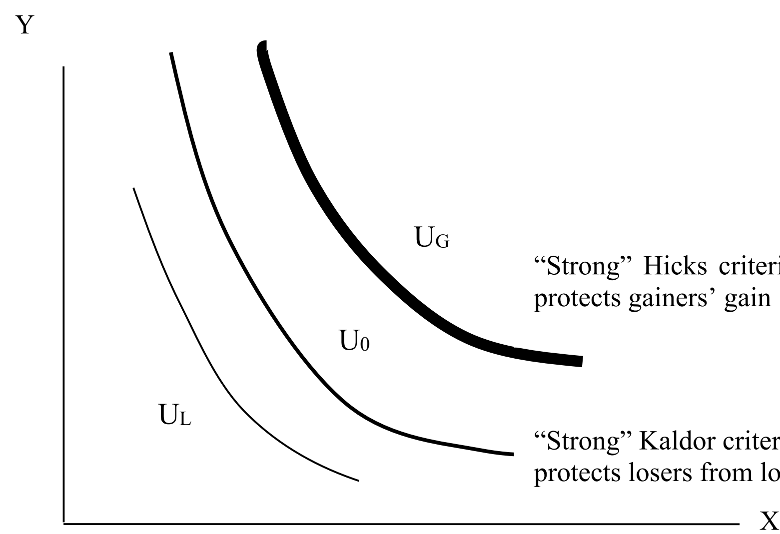

Figure 1.1. Initial utility at U_0 for both A and B. Change produces a gainer with utility at U_G and a loser with utility at U_L. Change is desirable under Hicks criterion if losers cannot bribe gainers to give up the change. Change is desirable under Kaldor criterion if gainers could compensate losers for the loss. "Strong" means any "bribes" and compensations are actually paid.

In Figure 1.1, utility for two groups of people, A and B, are initially assumed to be identical, at U_0. Each of the curved lines is an "indifference curve" indicating equal utility achieved through different consumption bundles of good X and good Y. Suppose a policy makes A better off and B worse off. A's utility goes up to U_G while that of B goes down to U_L. According to Hicks, if A's gain is bigger than B's loss, B would rather suffer the loss than to pay A to forgo the change. This would indicate that the change is socially desirable.

If compensation is indeed paid, we can validate the Kaldor criterion. Since losers can be fully compensated, they will not lose anything. If no one loses but someone gains, we can say there is a social gain. If compensation is not paid, then someone will gain and someone will lose. We cannot conclude if "social welfare" will rise with the change since we may not have consensus about how different individuals' welfares are counted in social welfare. For the same reason we cannot conclusively decide how social welfare changes under the Hicks criterion.

Indeed, we can demonstrate that the Hicks criterion is highly misleading. If B cannot bribe A to forgo the change, we can say that A's gain is greater than B's loss in money terms. But we cannot say that A's gain in utils is greater than B's loss in utils. Moreover, imagine that you live in a world in which the Hicks criterion rules. Every morning you face the possibility of suffering an unpredictable loss because someone could do something that hurts you and justify that by saying that his gain is bigger than your loss. This constant threat would reduce your "*ex ante*" utility. Because even the gainer under the Hicks criterion today faces such a threat over the longer term, he may not prefer upholding the Hicks criterion.

From this perspective, if the Kaldorian compensation were actually made, the Kaldor criterion is superior. Under the Kaldor criterion, *provided that gainers actually have to compensate losers for any losses endured*, losers need not worry about those threats. Without their approval no one can implement a change that hurt them, and if they should get hurt, they can demand full compensation. *Provided that compensations are actually implemented*, the Kaldor criterion is an acceptable standard to determine if a change is socially desirable. But this is really no different from the Pareto criterion, which says that a change is socially desirable if some people benefit but no one suffers, and if compensations are not feasible or not paid, passing the Kaldor criterion does not really give us any assurance that "social welfare" gains under the policy in consideration.

Proposition 1.9 Limited Usefulness of the Hicks Criterion and the Kaldor Criterion

The Hicks criterion generally offers no convincing guide as to whether the public interest is served. The Kaldor criterion does provide a clearer guide, but only if compensation to losers is actually paid. Dropping the Hicks/Kaldor criteria would imply dropping cost benefit analysis based on aggregate net benefits regardless of distributional consequences.

The Representative Individual Criterion

It is argued that the public choice problem should rather be seen as one of trying to find out what will maximize *ex ante* welfare for *everybody*, by taking a thought experiment and momentarily forgetting one's own identity and interests. This is the Rawlsian thought experiment: momentarily forgetting one's identity, as if one were behind a "veil of ignorance," and assuming equal probability to step into the shoes of anyone in society. *Ex ante welfare is defined as an evaluation of welfare by the representative individual as he faces an equal probability to be anyone in the community. Only when vested interests are totally ignored can one be fair-minded in evaluating policies.* As different *ex ante* welfare follows different institutional arrangements, the challenge is to find the set of institutional arrangements that maximizes *ex ante* welfare.

In general, if there are two prospects associated with two different institutional arrangements, and they involve identical expected utilities but different dispersions of *ex post* utilities the individual will have an *ex ante* preference for one over another. We postulate that the perceived dispersion of *ex post* utilities is a "mental bad" that reduces *ex ante* utility. Thus utility functions are defined not only with respect to tangible, physical, qualities like taste, smell, sound, nutrition, etc., but also with respect to mental, but no less real, qualities such as a sense of security or insecurity. Thus the value of *ex ante* utility depends on *both* the expected utility EU *and* the probability distribution of the *ex post* utilities:

$$U^a = U^a(\text{ EU, Probability Distribution of U})$$

U^a obviously rises with the expected utility due to physical qualities. We assume that, in addition, it declines with an increase in perceived risk as posed by the probability distribution of U, which will bring about a negative mental quality. [7]

This approach appears to parallel that of Kahneman *et.al.*(1997), who considered decision making under uncertainty and introduced the concept of "decision utility." However, Kahneman *et. al*.(1997) attached no normative meanings to "decision utility" and considered that concept only as an instrument to explain behavior, assuming that decision makers somehow maximize "decision utility" in the face of uncertainty. In contrast, our *ex ante* utility is a measure of the wellbeing of the individual in question as he faces a risky prospect. We hypothesize that while other things being equal the person feels better off anticipating a higher EU, he will also feel more secure and better off when he perceives lower risk.

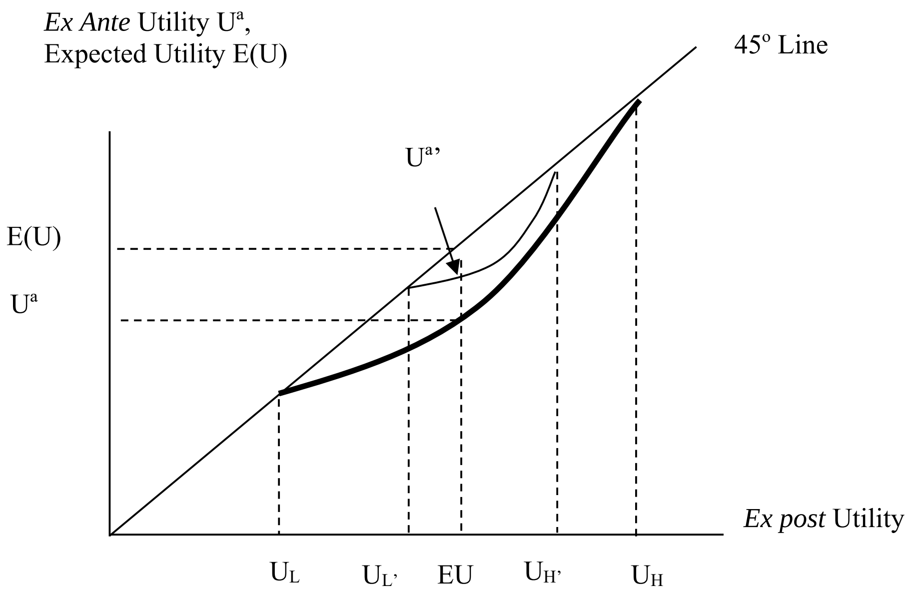

Figure 1.2 Prospective or *Ex Ante* Utility

Figure 1.2 shows how *ex ante* utility is related to expected utility. Focusing on the bold curved line first, suppose a prospect involves a probability P of utility at a high level U_H and a probability (1-P) of utility at a low level U_L. Depending on the probability combinations, expected utility may lie closer to U_H or to U_L but always on the 45 degree line. It is equal to the probability-weighted average of *ex post* utilities in the two possible states of the world. In the event of 100 per cent certainty that U= U_H("fortunate") expected utility = *ex ante* utility = U_H. In the event of 99 per cent probability of being "fortunate" and 1 per cent of being "unfortunate," *ex ante* utility will dip slightly below expected utility because of a discount related to the *ex ante realized fear or anxiety*. Thus the curved lines traces the *ex ante* utilities for different probability mixes. The thin curved line shows that the *ex ante* utilities tend to be higher for the same expected utility if the dispersion of utilities is smaller. The vertical distance between the 45 degree line and the *ex ante* utility line represents the disutility of the fear or anxiety due to the dispersion.

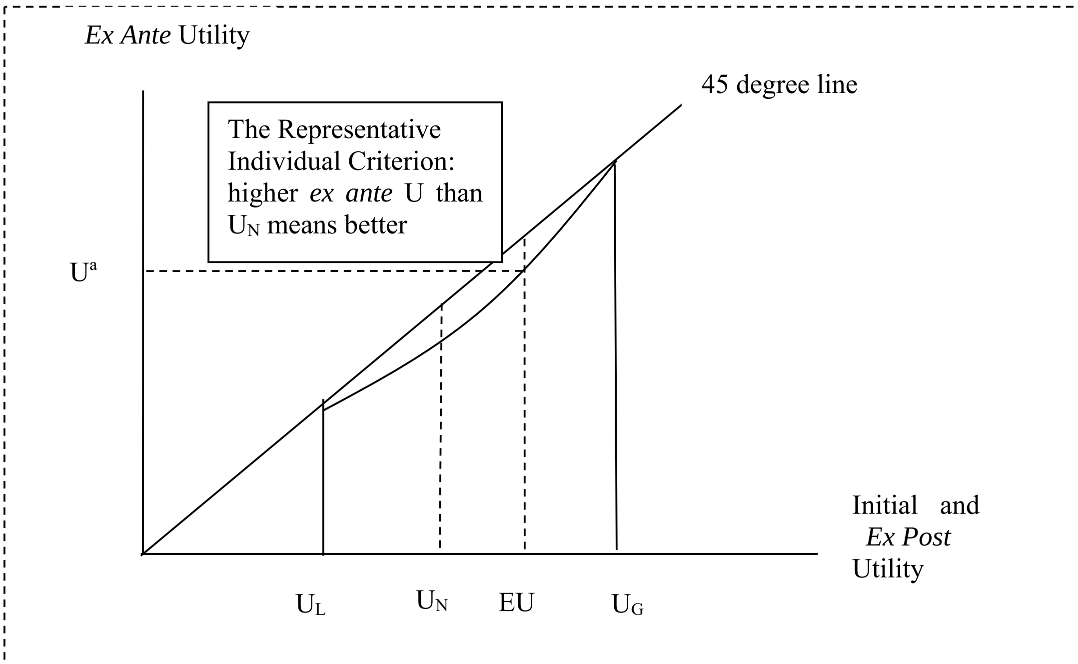

Figure 1.3 Representative Individual *Ex Ante* Welfare criterion (RI): Change is desirable if and only if the *ex ante* utility (U^a) with the change is higher than "Utility Now" (U_N). An example of such a change is a competition that both the potential loser and the potential gainer, both initially at U_N, agree to play out.

The RI criterion posits that the policy is socially desirable if and only if *ex ante* utility is higher than the utility under the status quo U_N. This is illustrated by the height of the horizontal dotted line. Consider the market mechanism versus central planning. Presumably some people will become better off and some other people will *eventually* become worse off under the market mechanism than under central planning. *Ex post*, those benefiting under central planning probably would have preferred central planning. *Ex ante*, however, everybody other than the central planners themselves (who can decide others' fate as well their own) probably prefer the market mechanism. The concept of *ex ante* welfare asks us to evaluate the benefits of the market mechanism versus those of central planning impartially through the eyes of the representative individual. Thus, if we did not assume that we were the planners and made decisions deciding others' fate, if we think *impartially* and consider the risks of having powerful planners making horrible decisions, wouldn't we all decide against central planning?

Consider an institutional arrangement that condones slavery versus one that condemns slavery. Rather than saying A should be a slave to serve B because A's loss is smaller than B's gain (or vice versa), we will argue it is far better not to make anyone a slave, because the *ex ante* welfare of a system without slavery is higher. Both A and B will feel better off if they feel assured that none of them will ever be made a slave.

Proposition 1.10 Representative Individual Criterion

The representative individual criterion is based on an impartial assessment of the predicaments of every member in society and calls a policy an improvement if acting under a veil of ignorance about one's identity, one still opts for that policy.

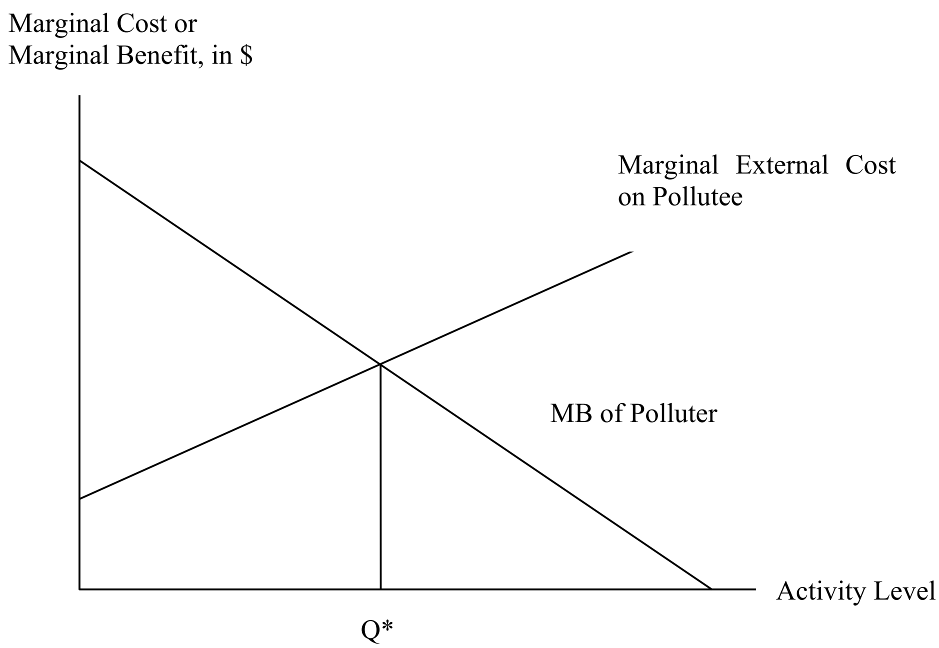

Figure 1.4 The Coase Theorem: Apparent Symmetry in Defining Property Rights

5. INADEQUACY OF THE THE COASE THEOREM

We may also note that this perspective shows up an important fallacy with the traditional interpretation of the Coase Theorem. Ronald Coase, the Nobel Laureate in Economic Science well known for his analysis of the problem of social cost, argues that in the face of externality, say, with a polluter emitting pollution that hurts a pollutee, provided that transaction costs are negligible, the efficient outcome will obtain regardless of whether property right is defined in favor of the polluter or the pollutee. The fallacy lies not with the conclusion over which level of polluting activity is socially optimal but with the presumption that society's welfare will improve equally regardless of how property rights are defined, so long as they are well defined. Suppose property rights are defined in favor of the polluter. Anyone, including the polluter who benefits today, stands to face the possibility that another polluter could come into the picture one day and could claim that the benefits due to his polluting activities are so great and that he has to tolerate them or "bribe" him to cut back his pollution. With this possibility hanging in the air, everyone may become worse off. The *ex ante* loss of welfare resulting from the threat can be quite substantial. On the other hand, if property rights are defined in favor of the pollutee, people feel secure, because a new polluter will have to have their consent through compensation before engaging in the polluting activities. So we can safely conclude that defining property right in favor of the pollutee serves the public interest better.

Proposition 1.11 The Inadequacy of the Coase Theorem

The alleged symmetry of the outcome regardless of in whose favor property rights are defined as long as property rights are clearly defined, which is due to Chicago economist Ronald Coase, ignores the fact that defining rights in favor of the polluter actually leads to an ongoing uncertainty that waking up tomorrow one could face the possibility of yet another polluter emerging in the neighbourhood who might reduce his welfare to an unknown degree.

6. STRUCTURE OF THE BOOK

This book is intended to be of practical value to policy makers and to citizens interested in shaping the course of public policy making. Plenty of real life examples will be used, and we will cover many subjects including labor market policy, health policy, housing, social security, crime and punishment, legal aid, education, and banking and finance. While the areas look diverse, readers should find the arguments intelligible and should find that the same themes about policy design and decision making mechanisms recur again and again.

The following diagram shows an outline of the coverage of this book. We need to first define the meaning of public interest and then the criteria to evaluate if public interest is served. With “public interest” well defined, it will then be possible to consider the constraints faced by policy makers. When all the constraints are fully recognized, particularly the constraint of human nature, but also the constraints posed by the existing institutional framework, culture and values, technology, and the dynamics of change, it will then be possible to conduct a reasonable assessment of alternative policy options. Each policy option must then be evaluated against specific criteria. It is a basic principle that any policy decision must be evaluated for its costs and benefits. Only when benefits outweigh costs for the representative individual should a policy be adopted. It is also a basic principle that benefits and costs cannot be properly assessed without using a systems perspective and considering all the effects that will work out, and without taking full cognizance of the concerns and propensities inherent in human nature. We hope we can demonstrate to readers that, armed with these perspectives, we will be able to assess the efficacy of both micro level and macro level policies.

Appendix I: Organization of “Public Policy and the Public Interest”

Public Policy and the Public Interest

Meaning of Public Interest	Hierarchy of Policy Goals	Economic Efficiency & Policy Efficiency	Distributive Equity	Meaning of Justice	Constraints to be Reckoned

Kaldor, Hicks, or Representative Individual Criterion? Policy Priorities: What makes good government and good public policy The Importance of Governance. Chapters 1 and 2	Human Nature: Incentives, Concerns, & the Behavior-perception Law Does the Policy work with or go against human nature? Does the policy address people’s greatest worries and concerns? Chapter 3	Institutional Constraints: Rigid or Adaptive; Closed or Open? Just or unjust? What are good institutions. Chapter 4	Physical Laws of Nature: Technology and Laws of Demographic Changes. Chapter 8. Chapter 14	Culture and Value Constraints; Mental Goods and Mental Bads. Is the policy compatible with existing culture and values? Ch. 10	Systems Effects & Dynamics of Key Variables: Does the policy recognize the ecological or systematic Effects? Ch. 12-13	Information Cost & Administrative Cost: Is the policy feasible given the information and administrative costs? Ch. 2

Is the policy proposed or the institutional change proposed desirable? Is it feasible? If not feasible now, will it be feasible in the future? Is it worth striving for?

Basic Question: Are benefits of a policy decision or a policy strategy decision greater or smaller than costs?

Applications and Examples

Health Policy Chapter 5	The Rule of Law, Tart Law Reform, and Legal Aid, Ch. 6	Bank Runs and Deposit Insurance Ch. 7	A Sustainable pension plan Chapter 8	Optimal Government Chapter 9	Education and Cultural Policy, Chapter 10	Taxes, Social Safety Net and Redistribution Chapter 11
Examples of systems effects: Ch. 12, Ch. 13, Ch.14	Globalization and Millennium Development Goals, Ch. 15					

Appendix II:

Ex ante utility of the representative individual

We take "public interest" to mean the *ex ante* utility of the representative individual. Traditionally, economists define the social welfare function as a function of the *ex post* welfare of each individual comprising society. We argue that this approach will not lead us anywhere. Kenneth Arrow has demonstrated in his "(im)possibility theorem" that this is not going to work. So we are departing from this concept, and instead adopt the *ex ante* approach pioneered by John Stuart Mill.

Suppose in a community, the distribution of utility under status quo and under a proposed policy is as follows (distribution in brackets):

Utils (status quo)	50 utils (100% of the population all enjoy 50 utils each)			
Utils (Policy A)	40 utils (25%)	50 utils (25%)	60 utils (25%)	70 utils (25%)

Clearly the gainers outnumber the losers, while 25 per cent of people are indifferent. By majority rule, the policy will be adopted.

If people do not know whether they will gain or lose, and after everybody has taken a look at the odds and then asked to vote, it is not clear that Policy A will be adopted, even though expected utility is higher under Policy A than under the status quo.

Note that we are talking about utils, and we are assuming trading is not feasible. If in the absence of knowledge as to who will gain and who will lose, they decide against

Policy A, then we can infer that *ex ante* utility under A is lower than *ex ante* utility under the status quo.

Status Quo	50 utils (100% of the population)			
Policy A	40 utils (25%)	50 utils (25%)	60 utils (25%)	70 utils (25%)
Policy B	40 + Δ utils (25%)	50 utils (25%)	60 utils (25%)	70 utils (25%)

Now suppose that the community votes against A in the absence of the knowledge as to who will gain and who will lose. Now further suppose that Policy B is available which promises to add Δ to the number of the utils for the losers. Let Δ be raised by greater and greater amounts, there will come a point when Δ =Δ* such that *ex ante* utility under Policy B turns out higher than that under the status quo.

Let us now consider the case of introducing anti-smoking law that bans smoking in public places.

Suppose the util pay-off matrix is as follows:

Status Quo(No Ban)	20 utils (10%)	60 utils (45%)	70 utils (45%)
Smoking Banned in Public Places	18 utils (5%)	58 utils (45%)	72 utils (50%)

We assume that with no anti-smoking law, 10 per cent of people suffer from poor health so that their utility is 20. With anti-smoking law in place, only 5 per cent suffer poor health. Because they are not allowed to smoke and they suffer from poor health anyway, their utility is lowered. Under the status quo, healthy smokers have utility at 70, while healthy non-smokers have utility at 60. Under the anti-smoking law, healthy non-smokers have utility at 72(raised from 60), unhealthy smokers have utility at 18(down 2 utils), while healthy smokers disallowed smoking have utility at 58, and there are more healthy people.

Presented with such data, *ex ante* utility will certainly be higher under the anti-smoking law. *Under the assumption that people are risk averse toward great suffering*, the increase in the probability of suffering poor health weighs heavily against the status quo of no ban.

It is interesting to note that even if we are given with such data, traditional social welfare function based on *ex post* utilities will not inform us clearly whether the law represents an improvement over the status quo. Additional and very specific assumptions about the weighting of utilities for smokers and for non-smokers will be needed before any conclusion can be drawn.

Finally, let us consider a hypothetical situation as follows:

Status Quo	50 utils (100%)	
Policy A	45 utils (20%)	51 utils (80%)

Here under a simple majority rule, and assuming those who stand to gain as well as those who stand to lose from Policy A know the consequences of the policy, the policy will be adopted. However, expected utility as well as *ex ante* utility is lower under Policy A than under the status quo. The representative individual criterion unambiguously yields the result that Policy A will reduce social welfare.

Review Problems:

1. Party politics is often considered an important element in democracy. What are the benefits and costs of multi-party politics?

2. Go to the list of "failed states." http://en.wikipedia.org/wiki/Failed_state Pick examples from among these failing states. What is the nature of the failure? Why do these states fail?

3. Go to the World Database of Happiness webpage. What account for the high scores of the happiest nations?
http://worlddatabaseofhappiness.eur.nl/hap_nat/nat_fp.php?mode=1

4. What is the nature of governance? What are the mechanisms of public governance? What are the mechanisms of corporate governance? Why is governance important?

5. To what extent should we respect the privacy of individuals? What is the social cost of privacy? Should surveillance cameras be set up in public places? Should the police be allowed to tap phones and check private emails?

6. What should and what should not be transparent? Why?

7. From the representative individual's perspective, should there be limits to freedom of speech?

8. In Figure 1.1, suppose losers have to actually bribe gainers to stop a policy that hurts them. Draw an indifference curve depicting losers' utility (i) assuming that the change takes place; (ii) assuming that they succeeded in bribing gainers to give up the change.

9. In Figure 1.1, suppose gainers have to actually pay losers to have them approve a policy that otherwise would hurt them. Draw an indifference curve depicting gainers' utility, assuming that they succeeded in compensating losers and the policy went ahead.

Note:

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[1] This interpretation is admittedly debatable. But the result is that the Secretary General of the Party Zhao Ziyang was ousted, and not through an accepted due process. See his memoir: *Prisoner of the State: The Secret Journal of Premier Zhao Ziyang* (Simon and Schuster, 2009) for a personal account.

[2] It does normally take a political process, however, to achieve the institutions that guarantee proper governance.

[3] The cases of Zhao Lianhai—who was prosecuted and jailed for causing social unrest for his role in defending the rights of victims of the melamine-contaminated milk powder incident in 2008, as well as that of Liu Xiaobo, the 2010 Nobel peace prize winner, are cases in point. The former was eventually released on "clinical" grounds while the latter was still held in jail as of January 2011.

[4] This positive assessment about China notwithstanding, China still has a long way to go before its rule of law is sufficiently well established to attract the trust and confidence of both its people and the international community.

[5] Harsanyi(1956) actually introduced this thought experiment much earlier than did Rawls.

[6] Mill, in Mineka and Lindley (eds) Published 1972, Vol. XV, p.762, 1862. The rest of the quotation follows: "….and hence general rules must be laid down for people's conduct to one another, or in other words, rights and obligations must, as you say, be recognized; and people must, on the one hand, not be required to sacrifice even their own less good to another's greater, where no general rule has given the other a right to the sacrifice; while, when a right *has* been recognized, they must, in most cases, yield to

that right even at the sacrifice, in the particular case, of their own greater good to another's less. These rights and obligations are (it is of course implied) reciprocal" (italics added by this author)

[7] Yew-kwang Ng (1984a) argued that under reasonable assumptions, the expected utility framework already captures risk aversion over incomes or other objective variables and that additional risk aversion over the dispersion of *ex post* utilities would be irrational. Given the specification of the utility function that he considered, where *ex ante* risk considerations do not enter the utility function, he is entirely correct. Our discussion herein considers the case where the utility function is DEFINED to depend ALSO on the *ex ante* consideration of risk, just as equation [23] indicates. This specification assuming the existence of negative mental goods or "mental bads" seems justified by the observation that people actually show symptoms of anxiety over unlikely events such as contracting SARS suggesting that utility is affected by the prospect of risk. Moreover, this should not be regarded irrational just as we should not regard a particular form of the utility function irrational.