Microeconomics with Ethics

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Chapter 21
Government Policies: Price Supports / Political Economy

In the previous Chapter we considered a price floor set in a competitive labor market designed to force the wages of low-skilled workers up to a level deemed more acceptable. One of the unfortunate effects was the excess supply of labor, or, worker unemployment. Unemployment was the outcome because while the minimum wage law mandates a higher wage, it does not simultaneously require firms to hire more workers.

In this Chapter we'll consider a price floor implemented in a product market. This policy is commonly used for agricultural products to assure adequate supply of important food products and to support the incomes of farmers. As we demonstrate below, a guaranteed price higher than the free market price will also cause excess supply, just as in the labor market. However, in this case the excess supply is a product rather than a service and a government price mandate is meaningless if the product cannot be sold. The result is that government must step in and purchase any excess supply resulting from the price floor. This is fundamentally what makes a price support different from a wage price floor.

In this Chapter we'll derive first derive the welfare impacts of a price support in a product market. As is becoming typical, we'll show how income is redistributed because of the policy and that overall market efficiency is reduced. We'll then openly question why it is that government policies are often chosen that our models suggest will make market outcomes worse.

One possible answer arises due to political economy issues. Political economy is a term used to refer to the interaction between the political system and the economic system. In other words, political economy considers the political motivations that affect economic policymaking. The price support result in this Chapter offers an excellent entry point to show why it is often true that business interests tend to be favored over consumer interests, taxpayer interests and the interests of the general public as reflected in market welfare.

21.1 Welfare Effects of a Price Support in a Perfectly Competitive Market

Learning Objectives

1. Learn the market welfare effects of a price support in a perfectly competitive market.

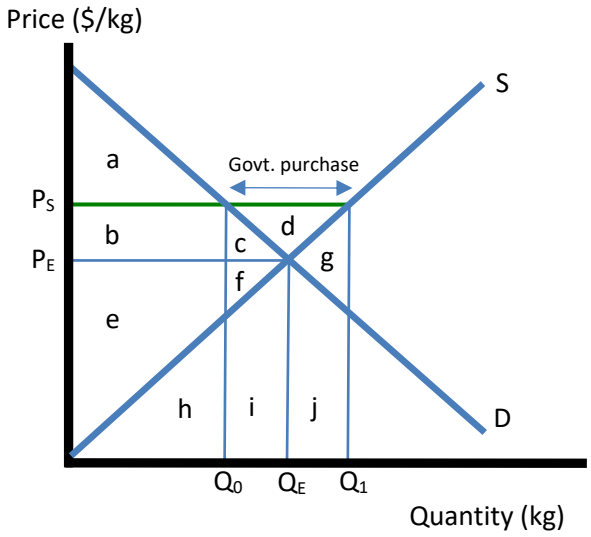
Consider a perfectly competitive market for, let's say, soybeans depicted in Figure 21.1. The domestic market demand and supply curves are labeled D and S respectively and would generate a free market price, P_E, and quantity traded of Q_E. Next suppose the government implements a binding price support, P_S, at a price in excess of P_E, as shown. The higher price

will cause market demand to fall to Q_0, but will encourage greater market supply to Q_1. This creates excess supply of $(Q_1 - Q_0)$, which the government will have to purchase itself if it is to be good on its word to guarantee that soybean farmers can sell their product at the higher price P_S. If the government did not purchase the excess, the soybean farmers would have to store that excess in the hope they could sell it at a future date and would even suffer a reduction in revenues earned, despite the higher price, if soybean demand were inelastic. This would not be a policy good for the farmers.

Thus in a price support system the government purchases all excess soybeans supplied to the market and must therefore store the product itself. Government storage takes the burden away from the farmer but creates a two-fold burden for the taxpayer. First is the expense of storing the commodity until it can be sold at a later date and the second is the expense of purchasing the soybeans.

The first problem limits what types of products the government for which they will use a price support policy. The commodity must be storable for a reasonable period of time. In the US, price supports have been applied to grains like corn, soybeans and wheat, and dairy products which can be stored in powdered form or after being processed into cheese. Price supports are not as amenable for fruits and vegetables which are much more perishable.

Figure 21.1 Effects of a Price Support in a Perfectly Competitive Market



Next consider the welfare effects of a price support. The changes in surplus and the government revenue effects are summarized in Table 21.1. The increase in the price to P_S reduces soybean consumer surplus by area (b + c). Soybean consumers lose because of the price support. The higher price received by the soybean producers, together with their increase in supply, raises producer surplus by area (b + c + d). We can see that one source of the higher profit accruing to firms comes directly from the higher prices paid by consumers. The price support redistributes

income from soybean consumers (area b + c) to soybean producers. Soybean producers gain because of the price support.

The government purchases, financed by taxpayers, is equal to the product price times the excess supply the government must purchase, or, $P_S (Q_1 - Q_0)$. This is given by area - (c + d + f + g + i + j). This has a negative sign because the row is labeled, change in government revenues, and expenditures can be represented as negative revenue. More intuitively, the negative sign captures the cost, or burden, on taxpayers who must cover this expense. Taxpayers lose because of the price support.

Table 21.1 Welfare Effects of a Price Support in a Perfectly Competitive Market
$\Delta CS = -(b + c)$
$\Delta PS = (b + c + d)$
$\Delta GR = -(c + d + f + g + i + j)$
$\Delta MW = -(c + f + g + i + j)$

The net change in overall market welfare is unambiguously negative. Market efficiency is reduced by area (c + f + g + i + j). Overall there is less total happiness accruing in the market because of the price support.

The net market welfare effect can be decomposed into two distinct areas. The area (c + f) represents the deadweight losses that occur because trade is directed away from the free market price and quantity, causing a reduction in private trades and a loss in surplus on both sides. For the producers that loss is made up for, and then some, by the government purchase of the surplus production. This area is also the same deadweight losses that arose with the price floor in the labor market in Chapter 20.

However, with a price support there is an additional loss. The remaining net loss is area (g + i + j). This is the area under the supply curve for the government support purchases. Recall from Chapter 15 that the area below the supply curve represents the total variable costs in production. That means area (g + i + j) in essence is the money paid by taxpayers to covers the costs of producing the excess soybeans. The additional money paid by taxpayers (c + d + f) represents increases in soybean producer profits because of the price support.

Notice that the net welfare loss is much larger with a price support than it was with the price floor in the labor market, area (c + f + g + i + j) > (c + f), suggesting that this is a much more expensive government policy. However, there is some exaggeration in this result. These much higher costs implicitly assume that the surplus purchases are thrown away and never produced any future economic value.

However, the typical practice with a price support is that government purchases will be stored for some period of time and then resold on the market later, hopefully when the market price exceeds the price support price. In that case, the revenues earned later by selling the stored

soybeans would recover the losses to taxpayers from the previous period. Although a higher price earned might make it possible for the taxpayer to come out ahead, we must remember that there are storage costs to consider. Note that in the welfare analysis above we assumed there were no storage costs. This was done to keep the analysis simple, but to be more accurate and complete we should recognize they are there.

Some of those costs are the storage facility expenses and some are the costs of spoilage which will increase the longer the product is stored. These extra expenses make it less likely the taxpayer losses will be fully recovered. If, by chance, the stored soybeans can be sold for at least their total variable cost to produce, namely area (g + i + j), then the net effect of the price support would be equivalent to a pure price floor.

In a perfect world, the price support policy could act as a price stabilizer in the soybean market. Suppose soybean production fluctuates significantly from year to year because of weather as commodity prices often do. In some years production is high and farmers have trouble covering expenses at harvest time because of the resulting low prices. In this case a fixed support price set above the known average costs would provide insurance by guaranteeing that farmers could sell all of their crop at a profitable price with any surplus being purchased by the government. If in the following year if bad weather reduces harvests and raises prices above the support price, then the government could release their storage stocks. The higher supply would reduce the market price back near the support price. In this way variable supplies are smooth over the years and prices are much less volatile.

However, weather fluctuations are unlikely to be so regular and it is often the case that government stockpiles of price-supported commodities rise to levels that make it too costly to continue. In these cases, government often resorts to other policies to reduce the oversupply caused by the price support. One method the US government has used is direct payments to farmers to not grow specific crops. Oddly, this can be a sensible policy if the costs of the direct payments is smaller than the costly government purchases and storage costs. Another method to rid itself of excess stored supplies is to donate the commodity as foreign aid to other countries in need. A third method to dispense with excess supply is to sell the product in foreign markets at much reduced prices. Although this outcome may be welcomed by foreign consumers who can buy the commodity more cheaply, it typically angers foreign commodity produces who lose profits because of the foreign dumping. The final method to reduce the surplus is to apply an export subsidy and pay farmers to export their product abroad. This policy will raise the domestic price and reduce the need for government to buy the surplus itself. It will also benefit foreign consumers while angering foreign producers.

If we formally analyzed the welfare impacts of each of these responses we would mostly discover additional net welfare losses. Some groups would surely benefit from these policies and others would lose, but economic efficiency would be reduced even further. This then offers an example

of how government interventions can cause unintended consequences which in turn inspire policy responses that have additional negative consequences.

Key Takeaways

1. In a perfectly competitive market, a price support will raise the product price, decrease market demand, and increase supply of the product. The excess supply is purchased by the government.
2. In a perfectly competitive market, a price support will decrease consumer surplus,

increase producer surplus, and require expenditures by government financed by taxpayers. The net effect is a reduction in overall market welfare.
3. The net market loss is mitigated, but still negative, if the government can sell the surplus commodity afterwards.
4. The government surplus can also be disbursed later as foreign aid, or sold as reduced prices abroad.
5. Additional inefficient government policies sometimes arise to avoid surplus purchases under the price support including export subsidies and payments to farmers not to grow certain crops.

21.2 Why Do Governments Implement Welfare Reducing Policies?

Learning Objectives

1. Learn three reasons governments may choose to implement inefficient economic policies.

In this and previous chapters, we have considered a series of government policies including taxes, subsidies, opening to international trade, import tariffs, a price ceiling, a price floor and a price support. All of these are policies that are commonly applied by many governments around the world. The key result in all of these policies, with the exception of opening to international trade, is that government intervention reduces economic efficiency. All of these policies, save one, reduces overall happiness in the economy and lowers the average well-being of the citizens. An important question to address then, is why do governments so often implement policies that are destructive to net economic welfare. Here are three possible answers to that question.

1) Nobody ever listens to economists

When economists are asked to provide input into public policy discussions they typically arrive equipped with complex models and statistical studies. To many outside observers, these abstract arguments often seem a bit detached from reality. Although economic advice is solicited and considered, it is possible that their suggestions are too complicated to be effectively communicated to the general public. This may be why only the simplest economic arguments make it into general public discussions, leaving more nuanced and contradictory conclusions festering by the wayside.

Another common feature of economic advice are warnings that certain results will only follow under certain circumstances. While economists will argue that these caveats are necessary to understand the complexity of situations, others may be annoyed by the apparent waffling. US president Harry Truman's famous plea for a one-handed economist is a clear indication of the difficulty of grasping economic advice even at the highest levels.

Of course, this suggestion is meant to be a bit facetious since economic advisors in government abound especially in agencies like the Central Bank, Treasury, Budget and Commerce. In the US, there is also the Council of Economic Advisors available to give direct consultation to the President and others branches of government. However, anyone who has taught economics to

large numbers of university students, will recognize that eyes-glazed-over look of many students learning economics. That look often persists among non-economics majors who make their way into government agencies and into the newsrooms who communicate about economic and political issues.

I have taught a generation of students in Washington DC, many of whom have gone onto careers in the Federal government. Based on these personal observations, I fear that there may still be a bit of truth to this possible cause.

2) There is something important missing from the model

This second point is much more serious and relevant. All of the policy analyses completed in the previous chapters have been conducted under the assumptions of perfect competition. What we learn in these policy exercises is that there is no way to improve upon the free market outcome with any sort of government intervention when the market is perfectly competitive. The one result in which market efficiency rises with a policy intervention is the opening to international trade. However, opening to trade actually increases competition to a global scale, in essence, making the market even more perfectly competitive.

Thus, if markets in the country and the world were truly perfectly competitive, there would never be any need for government intervention. But, what if the markets are not perfectly competitive? What if the assumptions in these models are not always satisfied? If that is true, it doesn't automatically negate the conclusions we've reached. Instead, it means that we need to reconstruct the models to see if the conclusions remain valid. This is something we have done already and will do more of in later chapters.

For example, in chapter 4, we considered what would happen if there were unethical behavior by market participants in the form of theft or deception. In terms of the model, this involves relaxing the perfect competition assumptions of mutually voluntary exchange and perfect information. We showed how this behavior would inhibit trade as participants protect themselves by staying away from the market. As a result increases in surplus value would not occur and the typical results of gains in surplus value from trade would have to be adjusted. To correct this problem, suppose a government raises taxes and uses the revenues to finance a judicial system that hold thieves and deceivers responsible for their actions. In this case, the deadweight losses from the taxes would have to be weighed against the positive benefits of laws under the judicial system. This implies that in the absence of perfect competition, that is with changed assumptions, taxes might not be welfare reducing.

Later, in Chapters 22-25, we will introduce many more, so-called, market imperfections into an otherwise perfectly competitive model and demonstrate when government policies can cause improvements in market efficiency.

Thus, if markets are not completely perfectly competitive, then governments might not be implementing welfare reducing policies when they set a tax or implement a price floor. Instead,

they may be recognizing that the world is not perfectly competitive and are implementing policies to correct for those imperfections.

3) The government may not be trying to maximize national welfare

The economic models we have developed enable us to measure all of the costs and benefits expected to accrue to all of the participants in a market including consumers, producers and, when there is government intervention, taxpayers. Because the effects are all measured in currency units, such as dollars, we can compare the magnitudes of the group costs and benefits against each other. We also propose an obvious way to make judgments about ideal, or optimal, economic arrangements and policies, namely to maximize the sum total welfare accruing to all market participants. In other words we imagine the goal of an economy, or of a government acting as a steward for that economy, to be the maximization of market welfare.

Economists often describe a government acting in this way as a social planner, or sometimes a benevolent dictator. These labels signify that the government is not subject to any political process, such as a representative democracy which could be thought of as a process that transmits information about people's preferences to legislators who implement policies in line with those preferences. Instead, in the economics exercises, we implicitly imagine that government can implement whichever policy it deems is suitable, perhaps based on wise economic advice. (nah, probably not, … see point #1 above!). Alternatively, we can avoid this issue if we assume that however the political process works in a country, its design achieves the same outcome as if it were chosen by a benevolent dictator.

But what if the political process itself, perhaps by unintentional design, makes it difficult to implement the policies that maximize the national welfare. If this is true, then policy choices might not be the same as a benevolent dictator would choose. Another way to say this is that the government does not attempt to maximize national welfare.

But if maximizing the national welfare is not the goal, or the outcome of the political process, then what is the goal? In the next section, we will address this issue by considering not only the gains and losses that occur because of various policies, but the distribution of those gains and losses and the ways in which the distribution can affect economic policy through the political process. We will not delve too deeply into this issue, but only go far enough to introduce a few crucial features about the way a representative democracy translates citizen interests into economic policies. We'll offer some evidence to suggest that governments, as they actually operate, may not strive to maximize the national welfare. Instead they are drawn via the political process to implement those policies that cater to certain influential special interests.

Next, we use a numerical version of a price support policy to illustrate a political economy reason why national welfare reducing price supports may be implemented and examine the general implications of economic decisions made via this process.

Key Takeaways

1. Three reasons governments may choose welfare reducing policies include:
    a. Governments don't listen to economists
    b. Governments take into account issues that are missing from the standard economic models
    c. Governments are not trying to maximize market welfare.

21.3 The Political Economy of Price Supports

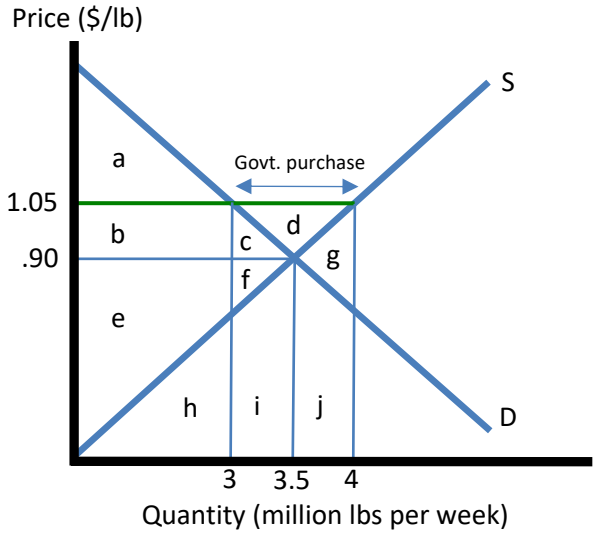
Learning Objectives

1. Learn how the magnitudes and distribution of the costs and benefits of a price support can affect policy choices.

In this section we will repeat the welfare analysis of a price support but will do so numerically rather than conceptually. Recall that a conceptual analysis is one that marks the prices and quantities generally (e.g., P_1, Q_1) and records surplus and revenue changes using labeled areas (a, b, c, etc) on a diagram. In a numerical analysis, we merely assign values to the prices and quantities so that all the welfare measurements have numerical values.

Let Figure 21.2 loosely represent the weekly market for butter in the US. By loosely, I mean that the values given are similar to values in the actual US butter market in an earlier period. Precise recent values are not necessary because these calculations will only be used to illustrate political economy implications, not to predict anything about the real butter market.

Figure 21.2 Measuring the Welfare Effects of a Price Support



Note that at the free market equilibrium the wholesale price of butter is $0.90 per pound and the quantity traded is 3.5 million pounds per week. Suppose the US agriculture department has a price support policy in place with the guaranteed price set at $1.05 per pound. Since the price support is higher than the free market equilibrium price, the support is binding.

At the price $1.05 the quantity supplied rises to 4 million pounds and the quantity demanded falls to 3 million pounds per week. That implies that the government would have to purchase and store 1 million pounds of butter per week.

Table 21.2 summarizes the changes in welfare that would arise from this price support policy, relative to the free market outcome. We report the changes in surplus weekly and annually. The annual outcome, of course, assumes that there are no adjustments to market supply or demand

for the entire year and that the free market price remains constant. This is not wholly realistic but is intended to demonstrate how seemingly small policy changes can have significant impacts when implemented over a long period of time.

Table 21.2

Welfare Effects of a Price Support in the Butter Market

Weekly	**Annually**
$\Delta CS = -(1.05 - .90)(3M) - (½)(1.05 - .90)(0.5M)$ $= - 450{,}000 - 37{,}500$ $= - \$487{,}500$	$\Delta CS = - \$25{,}350{,}000$
$\Delta PS = (0.15)(3.5M) + (½)(4M - 3.5M)(0.15)$ $= + 525{,}000 + 37{,}500$ $= + \$562{,}500$	$\Delta PS = + \$29{,}250{,}000$
$\Delta GR = - \{(1.05)(1M) - (½)(0.15)(1M)$ $= - (1{,}050{,}000 - 75{,}000)$ $= - \$975{,}000$	$\Delta GR = - \$50{,}700{,}000$
$\Delta MW = - 487{,}500 + 562{,}500 - 975{,}000$ $= - \$900{,}000$	$\Delta MW = - \$46{,}800{,}000$

Notice that the price support policy is a mere 15 cents higher than the market price of butter. To many consumers, who may pay $1.50 or $2.00 per pound of butter at the retail level, this price support seems fairly minute and inconsequential, Nevertheless, when this small price support is implemented in a large market it results in annual changes measured in the tens of millions of dollars.

However, whether ones notices or does not notice the effects of the seemingly small price support program will depend on what one's role is in the butter market. In Table 21.3 we present a breakdown of the effects by noting the sizes of the different units that are affected.

For example, given that the US population is 320 million people, the total number of butter consumers will surely number in the millions. Although many people do not explicitly purchase butter for their households, butter is widely used in baked goods such as bread, cookies and cakes as well as in many other products. Some people do avoid dairy products completely so surely some citizens may consume no butter at all. The exact number of butter consumers is not necessary for this example, so let's assume that about 60% of Americans consume butter each year, or about 200 million consumers.

Next, although we use a model that assumes the butter market is perfectly competitive, the actual butter market is somewhat concentrated. The American Butter Institute, a trade

association representing the interests of butter industry in Washington DC, lists 27 members on its website and claims that these members make up 90% of sales in the US butter market. Let's assume then that total butter producers number just 27.

Table 21.3

Welfare Effects of a Price Support per Unit

Unit	# in Unit	Per Unit Annual Effect
Consumers	200 million	- $0.13
Producers	27	+ $1,080,000.
Taxpayers	300 million	- $0.17

Finally, the number of people who pay taxes to the Federal government, which runs the price support program, may be measured in many different ways but surely numbers in the millions. If we cast the net widely and include both direct and indirect tax payments, we could include almost the entire population. For example, the US government collects a tax on gasoline nationwide. This, anyone who drives a vehicle, or buys products that were delivered by a gas-powered vehicle, or who lives in a household (e.g., children) who benefited from the goods that were transported to them in a gas-powered vehicle, can be said to have contributed to total federal revenues. Thus, using this, perhaps exaggerated approach, let's assume the total number of people contributing to Federal tax revenues is 300 million.

In the final column in Table 21.3 we show the per unit cost or benefit that accrues due to the price support. Note the stark differences in magnitude between the per consumer and per taxpayer costs compared to the per firm benefits. Each individual consumer and taxpayers loses less than 20 cents per year as a result of the policy while each butter firm stands to gain more than a million dollars.

Next let's consider is how these stark differences might affect behavior in the political arena, especially in a representative democracy.

Key Takeaways

1. A simulated butter support price of $1.05, 15 cents higher than the free market price, generates annual gains and losses measured in tens of millions of dollars
2. Because of the small number of major butter firms, the annual gain from the price supports measures over $1 million per firm.
3. Because of the very large numbers of consumers and taxpayers, the per individual loss from the price support measures less than 20 cents annually.
4. The small losses to consumer and taxpayers, when multiplied by the large numbers of individuals affected, exceeds the large benefit multiplied over the small number of butter producers.

21.4 The Logic of Collective Action

Learning Objectives

1. Learn some important factors affecting the effectiveness of groups lobbying for favorable policy outcomes in a representative democracy.
2. Learn why democratic governments may naturally implement policies that favor a wealthy minority of business interests over a much larger majority of consumer and taxpayer interests.
3. Learn how the democratic system can cause *government failure* to implement efficient economic policies.

The title of this section is drawn from the title of a well-known book from 1965 written by the economist Mancur Olson. The book focuses on the question of how special interest groups form to petition their government for favorable policies and what determines whether an interest group will be successful.

To apply Olson's theory we should imagine the country is a representative democracy that elects representatives to implement laws that are desired by the people. This describes many, but not all, countries in the world today. The role of the representative, no matter whether a congressman, senator, President or Prime Minister, is not to implement policies that they want personally, but to implement the policies that are demanded by the people they directly represent. To achieve this goal countries must enable free speech among its citizens, and, as stated in the First amendment of the US Bill of Rights, the "right to petition the government for a redress of grievances." A more modern description of this right might be to say that all citizens have the right to lobby the government for the policies he or she prefers.

In a representative democracy there is power in numbers and one of the fundamental problems framers of democratic constitutions must consider is how to prevent the so-called, "tyranny of the majority." In other words how does one prevent a small majority, for example 51% of the people, from implementing policies that exploit the remaining 49% of the people. The most common solution is the creation of a Bill of Rights, designed to prevent a majority from discriminating and exploiting any minority group. We'll leave discussion of this complex issue for another course, but we introduce it here merely to suggest that the natural concern people have about the operation of a democracy is the concern about majorities. Mancur Olson's work is interesting and provocative largely because it shows that we might also need to worry about minorities exploiting the majority. Let's see why by using the price support exercise above as an example.

Suppose government representatives are petitioned by representatives in the butter industry to consider implementing a price support policy. Butter representatives seeking this policy may argue that because butter prices fluctuate wildly, there are some years in which overproduction leads to extremely low prices, and butter firms must sell their products at a loss. This forces them to lay off workers and suffer excessive losses in profits. They argue that a price support policy of $1.05 would in the worst of times only result in an increase in price of 15 cents. In return the policy assures job stability in the butter industry.

The problem with this proposal is that the butter manufacturers who will benefit from this policy are clearly in the minority. Butter creamery employment in the US came to just over

3000 workers across a total of 56 firms. Recall that 27 of those firms produce about 90% of all US butter so the remaining 29 firms are very small.

If we consider the aggregate losses that will accrue to consumers and taxpayers, these losses are clearly much larger than the benefits that accrue to the butter manufacturers and their workers. In addition, the losses affect the vast majority of the population. Our estimate was 200 million consumers and 300 million taxpayers would be negatively affected by the price support. If we put this policy to a vote and assume voters will vote based on their self-interest, then the majority of consumers and producers would assure the price support is not implemented.

However, Mancur Olson's argument suggests that the outcome is likely to come out differently. First, one might ask the simple question of which sized-group, large or small, is more likely to be influential in a representative democracy? Intuition suggests that the large group could supply more votes and would therefore always be more influential.

However, Olson approached the question in a different way and asked instead, which size group, large or small, has the greater ability to organize its members to act in a unified way? To this his answer was a small group. There are several reasons. First small groups are more likely to have clear objectives that are easily understood and communicated. Large groups may share some interests, but have many other overlapping interests that can obscure the objective of the group.

Second, in order to communicate a collective interest to one's representatives, it is necessary to create an organizational structure with people dedicated to this task. As a trade association, the purpose of The American Butter Institute is monitor proposed legislation and to promote the butter manufacturer interests in Washington DC. This could include talking with representatives about a price support policy, among other things. To finance this group of lobbyists the Institute relies on voluntary contributions from its members, the 27 large butter firms in the industry. With such a small total number of firms, it is easy to communicate with every butter firm and for everyone participating to know who has contributed and who has not.

On the other hand, a large organization would have more difficulty contacting everyone and soliciting their support. Even though an association could finance its activities with a smaller per member contribution, the anonymity afforded by being a small fish in a big pond, would inspires many to skirt their participation hoping that the many other members would contribute instead. This type of avoidance is known as free riding and will be discussed again in Chapter 22 when we discuss public goods. Thus, large groups have an organizational disadvantage relative to smaller groups.

In the case of the price support, there is an additional complication that tends to favor the effectiveness of the small group. Because in this example the small group is very small, the benefits that accrue to it from the price support are extremely large per firm. Note that this would not be the case if the butter industry were truly perfectly competitive and had, say 50,000 firms. With only 27 firms in the industry, the extra profit from the price support exceeds a $1 million per firm. If firms decide to contribute, say 5% of their expected profit from the price support to their trade association, the association would have almost $1.5 million to promote the policy to government officials. That gives the association a lot to work with and greatly increases it chances of success.

But what about the interest of the majority? Shouldn't that overwhelm anything the firms could do? Well, imagine yourself, after learning the lessons in this chapter, putting together an anti-

butter-price support association designed to thwart the butter industry's promotion of this policy. Luckily you have the internet and can send an email to millions of individuals, that is, if you can get access to millions of email addresses. For the sake of simplicity, assume you can find these emails quickly and costlessly. Next you write to the millions of households and inform them how much they might lose because of the proposed price support on butter. You explain that for a household average butter consumers (with 4 people) they might have to pay upwards of 52 cents more per year for butter if the price support policy is implemented. If their butter consumption is higher than average, perhaps consuming five times the average, that extra expense could rise to $2.50 per year. But that's not all. As taxpayers, as well as consumers, their tax bill would likely rise as much as 68 cents per year, which when added to their the higher expenses for butter could add up to over $3 extra per year per family. Suppose you ask for a contribution of just 5% of their expected loss, only 15 cents per year.

You can see where this is going. Can you imagine any email recipient taking your claim seriously and sending you 15 cents? To raise the equivalent of the $1.5 million we imagined the Butter Institute was receiving, you would have to get 10 million positive responses. Your efforts would face the obvious difficulty of finding 10 million email addresses, a problem we assumed away earlier. It would also face a problem of convincing the recipient that your calculation is correct. Would they automatically accept your math. Of course, you are welcome to include the price support supply and demand curve diagram above, but I'd doubt if that analysis would convince anyone … remember, no one listens to economists! And finally, even if you could find millions of households and even if they accept the data as 100% factual, there is the added hurdle that saving at most a few dollars per year is just not worth anyone's individual time and attention. Thus, despite knowing that the vast majority of citizens will lose from this policy, the large numbers of losers do not offer advantages in the political process.

Next, imagine yourself as a legislator, newly elected to office, willing to open your office door to any of your constituents who care to "petition their government." If you have butter firms in your district you are sure to hear directly from them or from their trade association arguing in favor of the price support policy. These groups may also offer to contribute to your future reelection campaign or to political action committees that aligned with your political interests. These are perfectly legal actions that lobbying groups may take. You would also likely be happy to hear how this policy will help preserve jobs for specific individuals, some of whom you may know personally. And you will know that support for this policy can be used in your future campaign as another item of how you have directly helped your constituents.

As for the opposition consumer and taxpayer interest groups, you are unlikely to hear anything from that side. No one will visit your office to complain and even if you have an economist friend or remember lessons from your earlier economics class, those lessons will seem too abstract and uncertain compared to the real life stories you will hear from the butter supporters.

All of this doesn't guarantee success for the butter interests. There remain many hurdles to overcome. Convincing one legislator isn't enough, you will need to convince a majority to support the action. Also, adding $50 million in subsidy payments to the budget per year will have to be weighed and contested against other spending priorities. The process is much more complicated than described here.

Also, it is important to recognize that this process occurs not just in one sector but in many sectors simultaneously. The butter industry may not succeed in its legislative endeavor, but other industries attempting to achieve similar government interventions will succeed. And it not just price supports, it's also attempts to change environmental policies and trade policies,

and energy policies and tax policies, and so on. Each government policy or rule change by itself is almost inconsequential to the typical consumer and taxpayer. But, if you multiply each one of these inconsequential actions, hundreds or thousands of times over, for many years, then the impact on consumers and taxpayers will be substantial. And yet, it would still be almost impossible to attribute the subsequent decline in average living standards to any one source.

Nevertheless, the basic principle highlighted by Mancur Olson is that when the benefits from an action are *concentrated* in the hands of a small group while the costs are *dispersed* widely across a large group, then the small group is more likely win the political contest. Small groups, who have a lot to gain, can organize and affect the political process more effectively than large groups who experience small individual losses.

General Application

I should emphasize that this is not a corrupt process. Instead it is a feature of a representative democratic system that all should be aware of. If it seems corrupt, that's because it is a process in which a small group of individuals gain at the expense of a much larger group. Also, it involves a small special interest group currying favor with legislators to enable this transfer to take place.

In contrast, this process would be corrupt if the trade association transferred money directly into the personal bank accounts of legislators to secure their vote for the price support policy. But that's not what happens. Those who will suffer losses have equal access to the legislators by virtue of free speech and could convince them to pursue policies in their favor instead. Sometimes this does happen.

Consumer and taxpayer groups sometimes do secure legislation that works in their interests. For example, we showed in Chapter 18 that opening to free trade in a market is likely to benefit consumers more than it hurts the import-competing industries. Political economy pressures may give industries an advantage in obtaining protective tariffs, but sometimes countries do choose to implement free trade agreements and the consumer interests win.

In part, this may be because economic lessons have had some influence in the formation of public policies. Many politicians have studied economics and have learned the lessons about how to promote economic efficiency. The free market ideology that some politicians subscribe to is based in part on a belief that government intervention often makes things worse for people overall. This means that lobbying efforts for special interests have to overcome the hurdle that some politicians will be unconvinced by their arguments. The logic of collective action only describes one tendency in the choice process, but it is one that matches reality to a degree.

As a general rule, the results from the price support model generalizes in many other situations. Normally it is business interests that can expect to receive concentrated benefits from government policy decisions. As was highlighted in Chapter 16, business have an incentive to restrict competition in their industry in order to maximize their own profitability. This inspires support for government production subsidies in agriculture and energy, intellectual property protections, and professional licensing restrictions, and opposition to antitrust laws, environmental policies, labor unions, and much more. Any ability on the part of firms in an industry to concentrate production and make monopoly profit also enables them to fund lobbying efforts to support their interests. As a result there is always considerable pressure upon legislators in democracies to implement policies that are favorable to business. In the

public press you will regularly hear about the importance of promoting business in order to sustain and create new jobs.

For example, in the US in 2022 it was estimated by opensecrets.org that over $1 billion was spent in the US on lobbying activity. The vast majority of this money was spent by associations representing industry or professional interests. For example, the top 5 US associations in terms of lobbying expenditures in 2021 are shown in Table 21.4.

Table 21.4 Top 5 US Lobbying Expenditures (million $)	
US Chamber of Commerce	66.4
National Assn of Realtors	44.0
Pharmaceutical Research & Manufacturers of America	30.4
US Business Roundtable	29.1
Blue Cross/Blue Shield	25.2

The top lobbying group is the USCC which represents general business interests, as does the US business roundtable. Also in the top 5 are representatives of the real estate industry, the pharmaceutical industry and the health insurance industry. The list of industry lobbying organizations in the US is quite extensive. Wikipedia maintains this list of industry trade groups in the US numbering in the hundreds.

Naturally, what these industry groups will rarely communicate is how government support for business interests may also result in harm to consumers and taxpayers. They may be forgiven for that oversight firstly because it is not in their interests to do so, and secondly, because in a democracy all interest groups have the ability to petition their government and that includes consumer and taxpayer interest groups.

However, because the negative effects that business-friendly policies are likely to have on both consumers and taxpayers are widely dispersed, these groups find it much more difficult to organize and express their interests to government policy makers. It is not impossible though, and some consumer and taxpayer advocacy associations do exist. Wikipedia maintains this page listing prominent consumer organizations in the US. Notice that the US list of associations numbers only about a dozen, many fewer than the business/industry side.

It has long been obvious that large businesses who have acquired large monopoly profits, or in some cases have profited from corrupt or illegal activities, have used some of those profits to influence political decisions. The policies chosen often sustain or advance the monopoly positions, or protect corrupt activities, usually to the disadvantage of the average consumer and taxpayer. Crony capitalism is a term often used to describe this process when it gets out of control. Fascism is another term sometimes used in this context especially when the large business interests controlling political decisions are promoting militarization and foreign

hostilities. Needless to say, this is an ongoing problem with democratic institutions that demands attention and new solutions.

In the US, there is a long legislative history with attempts to minimize the ability of special interest groups having an outsized influence in determining who is elected and ultimately which policies the government implements. But sometimes these laws have conflicted with the fundamental principles of free speech and the right to petition the government. See especially the 2010 Citizens United vs the FEC supreme court decision for a recent example of this.

This issue remains one of the continuing challenges for democracies. Individuals who favor a stronger role for government often see it as solution needed to implement the policies that will reduce the influence of powerful special interest groups. However, others may be opposed to a larger government role because they recognize that because of the way democratic institutions work, more government may mean even more influence granted to large powerful business interests. The best solution is not contained in a simple solution like "more government" or "less government." Instead, any solution must recognize not only what government can do but how economic and political agents influence what government actually chooses to do.

In the next Chapter we will introduce models that include deviations from the standard assumptions of perfect competition. Economists call these deviations either market imperfections or sometimes, market failures. We will see that in the presence of these failures, government intervention can sometimes be applied to improve the economic outcome. However, the political economy problem described here is sometimes referred to as *government failure* because government is not inclined to choose the economic policies that are best for the people overall. This occurs because of the way information about citizens' desires is imperfectly transmitted to representatives who implement policies. Thus, the objective of democratic governments may not be to maximize overall market welfare, but instead to maximize the welfare of influential special interest groups, which, in more cases than not, tend to be business interests.

Key Takeaways

1. In the Logic of Collective Action, small interest groups can organize more effectively than large groups because they can avoid the free rider problem.
2. For many economic policies, such as price supports, concentrated benefits accrue to businesses, whereas dispersed losses accrue to consumers and taxpayers. This pattern increases the effectiveness of business lobbying relative to consumers and taxpayers and can explain why democratic governments often choose policies that do not improve economic efficiency.
3. Democracy requires free speech to enable constituents to communicate their policy desires to their representatives. However, the Logic of Collective Action suggests why the loudest voices will often represent the minority interests of wealthier businesses
4. Government failure occurs when democratic governments choose economic policies that favor wealthier interests over others, and that reduces overall economic efficiency