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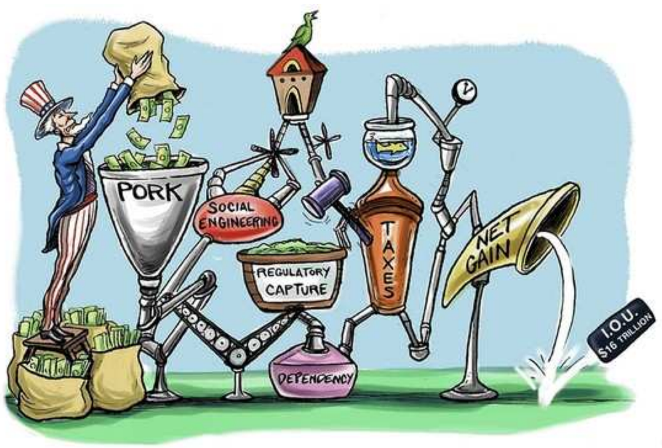
## *The Anatomy of Government Failure*

*Why the cure for an economic or social problem may be worse than the disease it purports to fix.*

By MICHAEL J. BOSKIN

More than any presidential election since 1980, the current campaign is about the proper size and scope of government. With so fundamental an issue at stake, the chronic claims on behalf of government "solutions" for perceived problems need to be subjected to a reality check.

In a market economy, price signals automatically steer society's scarce resources to the uses people value most, and at minimum cost. This is Adam Smith's famous Invisible Hand. But sometimes markets aren't competitive, or they generate effects such as congestion or pollution that are not accounted for in the price system. These "market failures" potentially justify government intervention.

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Potentially—but not necessarily. There may be more effective and less-expensive alternatives to government action such as regulation or antitrust. For example, monopoly profits may attract new entrants, producing the same product or a substitute technology or product—unless the monopolist is protected by government.

More generally, the costs of government regulation may be higher than the benefits—the cure may be worse than the disease. Before undertaking a new government intervention or adopting a new rule, instituting a new program or expanding an old one, the problem of "government failure" has to be considered.

Government failures include the cronyism and pork that arise from spending and subsidy programs. Helping people experiencing hard times to get back on their feet is proper, but if overdone it may induce dependency. Laws are administered by agencies, from the EPA to banking regulators, with their own bureaucratic incentives—and they are prone to capture by the very interests they are supposed to regulate.

Government failures are as pervasive as market failures due to monopoly or externalities, such as pollution, that arise because of ill-defined property rights. The potential for such failures grows as government grows.

More government spending or regulation doesn't necessarily lead to better outcomes. If that were true, Washington, D.C., would have the best public schools in the country and California's prisons would be the envy of the world.

The expansion of agencies or programs, even good ones, is eventually subject to the same law of diminishing returns as everything else. Consider the EPA's ever-tighter pollution standards of dubious benefits causing ever higher additional costs, or government support for energy research and development mutating into industrial-policy failures such as Solyndra. Programs become entrenched, develop powerful constituencies, and are hard to shrink but easy to expand. Think of ethanol mandates and the expansion of Medicare to cover prescription drugs without reforming the program.

To these aspects of government failure, I add five tendencies of governments:

- Wait until forced to act, often too late with great harm. Witness Washington's continued inaction on entitlements, tax reform and debt. Or the lurch from one stopgap measure to another to deal with the crisis in the euro zone. Historically, the Federal Reserve has often waited too long to raise interest rates, making inflation worse than it would have been had the Fed acted earlier.

  Conversely, government inaction can be the best course. President George H.W. Bush refused entreaties in 1990–91 from German Chancellor Helmut Kohl, French President François Mitterrand and British Prime Minister John Major to bail out Mikhail Gorbachev.

- Systematically ignore long-run costs to provide short-run benefits. Exhibit A is President Obama's continued debt-financed spending. For years, in pursuit of increased homeownership, the administrations of Bill Clinton and George W. Bush loosened housing finance to low-income earners. This led to a housing bubble that brought on a financial crisis when it burst.

  Politicians buy votes by spreading coverage far beyond what is necessary to achieve the program's putative goals. FDR's original mission for Social Security was to protect the elderly against poverty. Many wealthy retirees now collect Social Security benefits that are twice the poverty level.

- Try, unsuccessfully, to circumvent the laws of economics. President Carter demanded on national television that the Federal Reserve lower interest rates to combat a roaring inflation, the exact opposite of what basic economics teaches. In response to his demand, the dollar collapsed.

  ObamaCare purports to expand health insurance to 30 million people. This will increase the demand for doctors and hospitals—yet by attempting to keep costs (e.g., payments to providers) down, the bill will likely decrease the supply of doctors and hospitals. Incredibly, proponents of this legislation claim that prices (i.e., program costs) can be reduced without harming the quality of care.

- Ignore the laws of arithmetic, selectively counting some effects while excluding others. President Obama touts the exaggerated number of green jobs his policies have created. Ignored are the larger job losses caused by his anti-fossil-fuel policies.

  Static analyses that ignore incentives will often miss much of the story. Social Security has raised the income of the elderly. But its net contribution is considerably less than Social Security benefit payments, as it encourages earlier retirement and decreases saving for retirement.

- Enact programs or spend money in a crisis or boom whose especially large unintended consequences only become apparent when the economy returns to normal. In a boom, everything

> seems affordable and future projections are invariably too rosy; in a bust, needs are particularly exigent. That is the basic story of budget calamities in states such as California and Illinois.
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> On the federal level, as Nobel laureate James Buchanan observed, politicians hide the true cost of spending from citizens by deficit financing. Recently, deficits have run 30–40 cents of every government dollar spent. But interest will have to be paid on this debt, sooner or later. Right now interest rates are extraordinarily low, and so is the government's cost of servicing the debt. Once they return to more normal levels, the interest costs will explode. There will be no avoiding the taxes to pay for the spending.

We are not short of serious societal problems. Some are even potentially amenable to sensible government solutions. But sensible, let alone cost-conscious and target-effective, government solutions are in much shorter real-world supply than many people suppose. The administration and Congress that convene in January—as well as the American people they represent—must recalibrate government to perform just its necessary functions, affordably and effectively.

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[1] http://online.wsj.com/article/SB10000872396390443995604578003844173281354.html