

## Reading 1 The Subject of Political Economy

### I. The Relation of Economics to Politics

In general, the fields of economics and politics are different subjects. Yes, they both study the behavior of groups of people. But, I suspect most economists would agree that politics steps in when the self-organizing and regulating mechanism of the free economy fails to perform adequately. Politics becomes necessary when there is substantial market failure. That is, when people can group together and get along living and making contracts with each other satisfactorily, there is no need for a government. Governments are created precisely because there is some need for it to exist – a need that cannot be satisfied by a laissez-faire economy. It is reasonable that we need government to provide some order to society, since free markets are always vulnerable to power, intimidation, injustices, and fraud. While we don't need government to tell us what to do in every aspect of our life, we nevertheless find it useful to create governments when free interaction becomes too costly or noncompetitive.

What this means is that there is a political calculation to be made for every economic plan, every economic transaction, and every economic institution we experience. We must do this to evaluate whether we should act politically. If the cost of acting freely and economically becomes too high, then some political compromise must be made. Economics and politics are therefore closely related, at least for this reason.

However, politics and economics are also related in another way. There are many choices we have about our political institutions and the type of government that we want to utilize. There is also the issue of how we go about creating this government and how we act to maintain it. To make these judgments, we can employ economics to help us evaluate different types of governments, different types of political choices, and different types of policies chosen by government. Surely, this type interaction cannot be denied.

Thus, while it is true that the two fields of economics and politics are nominally separated and have different vocabularies, they are very much related in practice and influence each other greatly. Modern political economy goes even further by attempting to integrate all of social science into the study of politics and economics (including such things as sociology, social psychology, statistics, rational decision-making, etc.). Modern political economy sees a political dimension in virtually everything in life and it recognizes that other subjects have much to contribute to our understanding and evaluation of the political system we live under.

### II. Some Specific Areas of Study in Political Economy

Political economy has been usefully subdivided into three fields. These are

(1) the role of government and/or power relationships in resource allocation for each type of economic system (command, market, and mixed),

(2) international political economy, which studies the economic impacts of international relations, and

(3) economic models of political processes and public choice theory.

These three subdivisions above cover such topics as:

--- government failure, economic regulation, monopoly, rent-seeking, market protection, institutional corruption, and distributional politics, economic sanctions, inter-generational equity.

There is also an empirical aspect to this subject covering things like

--- the influence of elections on the choice of economic policy, determinants and forecasting models of electoral outcomes, the political business cycles, central-bank independence, and the politics of excessive deficits, and the economics of war.

Political economy is now a vast and very heterogeneous subject. It has become so intellectually amorphous that it is quite difficult to circumscribe its scope of study. We will limit ourselves to only a part of this vast and rich subject. Because students at TKU take a required course in international political economy in their third year, we will focus entirely on domestic political economy during the second year.

### III. The Economic Role of Government

We have seen that the best government is one that supplies only what the private market inadequately supplies. There are really five basic roles for the government in the economy. Let's consider each of these reasons.

First, governments exist because the private market often cannot provide a sufficient amount of goods and services which we need. We call this phenomenon market failure. A good example of market failure is traffic control. Can you imagine a private company which would operate the traffic lights and stop signs in Taipei? How would they be able to force people to pay for the use of these lights and signs? Also, if the traffic light failed and some people were hurt in an accident, would they be able to sue the company for damages? Although it may be possible to have a private market for traffic control in a small village, it is not possible in a large modern city such as Taipei. The private market fails, and so there is a need for the government to supply the service.

Second, governments are needed to provide a system of justice and enforcement of contracts. Can you imagine a private company which would create laws for us to live by? Also, how could a private company provide the service which a court in Taipei provides. When one company breaks a contract with another company, what recourse does the second company have? How can it get

restitution in a private market for justice? Sometimes private arbitrators can be used. What this means is that both companies agree to a neutral party listening to the evidence and making a final decision on who is wrong. The companies are then bound to accept the decision of the arbitrator. This is a common practice in labor/management disputes, and is called binding arbitration. But, it is impossible for all legal decisions in a modern economy to be handled by such arbitration.

Third, governments are needed to control externalities or third party effects which arise in private market transactions. An externality can be easily seen by taking the example of smoking. When I buy cigarettes from a company selling them, this is a private market transaction. However, when I smoke the cigarettes, other people must endure the bad smell of the smoke. We call this a third party effect, or an externality. Another example involves pollution from a factory. Suppose a factory produces steel and pollutes the air near your house. Each day you find that smoke from the factory ruins your clothes which you have hung up to dry. How can you get the factory to stop polluting the air? In general most transactions have third party effects and the government can be used to control these externalities.

Fourth, the economy sometimes goes into recession and sometimes experiences inflation. We say that the economy is unstable. One important role for government is to see that these recessions and inflations are not too severe, since they may create social unrest. The government can use fiscal and monetary policy to help stabilize the economy. We refer to these as stabilization policies.

Finally, the government is needed to ensure that there is a reasonable distribution of income and wealth. History has shown that if either income or wealth becomes too unequal, then violent groups will arise to threaten the social order. Taiwan has an excellent distribution of income and wealth compared to the United States. One of the main reasons for this was the land reform which occurred in the 1950's. However, the distribution of income has been getting worse in recent years, and some people have called on the government to do something about this problem.

#### IV. WHAT ARE PUBLIC GOODS?

We often say that the government's main role is to provide goods and services which the private market undersupplies. These types of goods and services are called public goods. Let's take a closer look at public goods.

A public good or service is one which, once it is provided for a group of consumers, cannot be excluded from other consumers. Public goods occur because the private market sometimes allows "free riders" to exist. A good example of this is national defense. Suppose that I contract a private firm to protect me, here on the island of Taiwan, from any foreign army. If I pay this firm to protect me, it will also protect you, since my protection will keep you safe also. Note that you did not pay for the protection, but the firm cannot exclude you from enjoying the safety

provided me. You have become a "free rider". In such a case, I would be very stupid to pay the firm to protect me. I should act as you do and become a "free rider" also. But, if everyone acts this way, then the market will not exist. We will have market failure. Therefore, national defense is a pure public good.

There are other examples of public goods, such as the building of lighthouses, and the construction of dams for flood control. However, we should emphasize that most goods provided by the government are not pure public goods. Let's consider the case of the Taipei Bridge. This bridge could be constructed and owned by a private company. They would operate it for a profit. Anyone who wanted to cross the bridge would have to pay a toll. If the bridge collapsed, then the company would be held liable. Also, the company would reasonably price the toll in order to make a competitive profit. Therefore, we should say that not all goods and services provided by the government are pure public goods.

## V. HOW CAN EXTERNALITIES BE CONTROLLED?

As we have said, private markets often cause externalities to arise. The government can be used to control these third party effects. There are two basic ways to do this: (1) direct controls, and (2) indirect controls. Direct controls means that the government sets a limit on the amount of externality produced. A factory is forced by law to limit the amount of pollution it discharges. With indirect controls the government uses taxes to control the amount of the externality. A good example of this is a pollution tax. Usually, this tax is levied on the output -- which is the source of the pollution. Environmental taxes have recently become very popular in the US. These taxes are sometimes called "green taxes", because they make the environment cleaner.

### Discussion Questions:

1. What is the difference between a liberal and a conservative?
2. What is meant by "market failure" and give an example.
3. What is binding arbitration and when is it used?
4. What is an externality and give an example.
5. What does it mean for the government to stabilize the economy?
6. What is the definition of a public good?
7. Who uses public goods? Who pays for public goods?
8. Why is flood control a public good?
9. Explain the meaning of the term "free rider" and give an example.
10. When society has a problem, should government be used to solve the problem?