


Difficult Cases for the Market and the Role of Government

Full Length Text — Part: 2 Chapter: 5
Micro Only Text — Part: 2 Chapter: 5
Macro Only Text — Part: 2 Chapter: 5


To Accompany "Economics: Private and Public Choice 12th ed."
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A Closer Look at Economic Efficiency

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What is Economic Efficiency?

- Economists use the concept of *efficiency* to judge actions because efficient use of resources implies the maximum value of output from the resource base.
- 2 conditions necessary for *ideal efficiency*:
 - All activities that provide individuals with more benefits than costs must be undertaken.
 - No activities that provide benefits less than costs should be undertaken.
- In order for economic efficiency to be achieved, both conditions must be present.

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Economic Efficiency

- As more resources are used to expand the level of an activity, the **marginal benefits (MB)** of the activity generally decline and **marginal costs (MC)** rise.
- From the viewpoint of efficiency, the activity should be expanded as long as the **$MB > MC$** .
- Q_1 is inefficient as there are some units for which the **MB** exceeds the **MC** which are not undertaken.
- Q_3 is inefficient as there are units produced where the **MC** exceeds the **MB**.
- Q_2 is the economically efficient level of output. At Q_2 the **MB** stemming from the consumption of that unit just equals the **MC** of producing it.

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If It is Worth Doing, It is Worth Doing Imperfectly


- There is an old saying, "If it's worth doing, it's worth doing to the best of your ability." Is this really true?
- Economics indicates that at some point the gains from doing something better will not be worth the cost.
 - It makes sense to stop short of perfection.
- Economics is about trade-offs: even worthy activities can be pursued beyond the level consistent with economic efficiency.

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If It is Worth Doing, It is Worth Doing Imperfectly

- When making personal decisions, people seem to be more aware that perfection is almost never worth the cost.
- The principle also applies to government.
- Regardless of the sector, achievement of perfection is generally not worth the cost.


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The Economic Role of Government

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Two Major Functions of Government

- There is substantial agreement among scholars that at least two functions of government are legitimate:
 - **Protective function:** protection of individuals and their property against invasions by others.
 - **Productive function:** the production of goods and services that cannot easily be provided through private markets.

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Protective Function of Government

- The most fundamental function of government is the **protection** of individuals and their property against acts of aggression.
- Involves the maintenance of a legal structure (**rules**) for the enforcement of contracts and a mechanism for the settlement of disputes.

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Productive Function of Government

- Involves the provision of a limited set of goods difficult to supply through the market.
 - A stable monetary and financial environment is vital.

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Questions for Thought:

1. Which of the following make sense:
 - a. Make the highest possible grade in your economics class.
 - b. Eliminate all air and water pollution.
 - c. Make airplanes fully secure against terrorist attacks.
 - d. Make automobiles so safe that there will never be another traffic fatality.
2. What is the distinction between the "protective" and "productive" functions of government?
3. "If it's worth doing, it's worth doing to the best of your ability." What is the economic explanation for why this statement is often said but rarely done?

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Potential Shortcomings of the Market

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Four Reasons Why the Invisible Hand May Fail

- Lack of Competition
- Externalities
- Public Goods
- Poor Information

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Why the Invisible Hand May Fail

(1) *Lack of Competition*

- Sellers may gain by restricting output and raising price.
- Too few units will be produced.

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Lack of Competition

Sellers may gain by restricting output and raising price.

Price

P_2

P_1

Q_2

Q_1

Quantity/time

S_2 (restricted supply)

S_1 (competitive supply)

D

- In this market, under competitive conditions, *supply* and *demand* result in an output of Q_1 and price P_1 .
- But, if producers in the market are able to restrict *supply* and/or limit entry into the market ... the restricted *supply* S_2 will result in an output of $Q_2 < Q_1$ and price of $P_2 > P_1$.
- Lack of competition results in too few units produced and a price above the competitive market level.

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Why the Invisible Hand May Fail

(2) Externalities

- **Externalities** exist when the market fails to register fully costs and benefits.
- **External costs:**
 - Present when the actions of an individual or group harm the property of others without their consent.
 - The problem arises because property rights are imperfectly defined and/or enforced.
- **External benefits:**
 - Present when the actions of an individual or group generate benefits for nonparticipating parties.

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Problems that Arise When External Costs are Present

- Because some of the costs of production, are not fully registered, the supply curve understates the true cost of production.
- Units may be produced that are valued less than their cost.
- From the viewpoint of efficiency, too many units are produced.
- Pollution problems are often a side effect.

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External Costs

Failure to register fully external costs.

- In this market, under initial **supply** and **demand** conditions, output Q_1 and price P_1 exist.
- If all costs were measured and included ... the **supply** curve S_2 would result in output $Q_2 < Q_1$ and price $P_2 > P_1$.
- With external costs (a **negative externality**) too many units are produced and price is below that which would prevail if all costs were identified and factored into the market process.

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Problems that Arise when External Benefits are Present

- The demand curve understates the total value of the output.
- Units that are more highly valued than their costs may not be produced.
- From the viewpoint of efficiency, too few units may be produced.

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External Benefits

Failure to register external benefits.

- In this market, under present *supply* and *demand* conditions, output Q_1 and price P_1 exist.
- If all benefits were measured and included... the new *demand* curve D_2 would result in output $Q_2 > Q_1$ and price $P_2 > P_1$.
- With external benefits (a *positive externality*) too few units are produced and price is below that which would prevail if all benefits were identified and reflected in the market process.

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Why the Invisible Hand May Fail

(3) Public Goods

- **Public goods** are:
 - *jointly consumed*
 - Individuals can simultaneously enjoy consumption of the same product or service.
 - *non-excludable*
 - it is not possible to restrict consumption of the good to those who pay for it.

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Problems that Arise With a Public Good

- If a public good is made available to one, it is simultaneously made available to others.
- Because those who do not pay can not be excluded, no one has much of an incentive to pay for such goods; each has an incentive to become a **free rider**.
 - **Free rider:**
 - a person who receives the benefits of the good without helping to pay for its cost.
- When a lot of people become free riders, too little of the good is produced.


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Characteristics of a Public Good

- It is the good's characteristics, not the sector in which it is produced, that distinguishes it as a public good.
- Examples of **public goods**:
 - national defense
 - broadcast radio and television signals
 - clean air
- Markets often develop ways of providing public goods (like the use of advertising to support provision of radio and television). Nonetheless, public goods often cause a breakdown in the harmony between self-interest and the public interest.

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Why the Invisible Hand May Fail

(4) Poor Information

- The consumer's information problem is minimal if the item is purchased regularly.
- Problems of conflicting interests and unhappy customers can arise if goods are:
 - difficult to evaluate on inspection and seldom repeatedly purchased from the same producer, or,
 - potentially capable of serious and lasting harmful side effects that cannot be predicted by a lay-person.

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Why the Invisible Hand May Fail (4) *Poor Information*

- Market responses to poor information:
 - Consumer information publications
 - Provide expert evaluation and unbiased information
 - Brand names and franchises
 - Provide standardized quality and dependability
 - Warranties
 - Supplier promises to repair possible problems

◀ [Jump to first page](#) ▶

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Shortcomings of the Market and the Role of Government

- When markets allocate goods inefficiently, the problem can generally be traced to one of four sources: absence of competition, externalities, public goods, or poor information.
- Market shortcomings due to these factors raise the possibility that government intervention beyond the protective function might improve things.
- But before jumping to that conclusion, we need a better knowledge about how the political process works.
 - That is the topic of the next chapter.

◀ [Jump to first page](#) ▶

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Questions for Thought:

1. When external costs are present, how will the equilibrium price and output in a competitive market compare with the price and output consistent with ideal economic efficiency? Is the level of output too large or too small? Explain.
2. When the production and sale of a product generates external benefits will competitive markets sometimes produce too little of the product? Why or why not?

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Questions for Thought:

3. (a) Explain why the following *are* public goods: an anti-missile system around Chicago, a radio broadcast signal, and the stability of the currency provided by a central bank such as the Federal Reserve System.

(b) Explain why the following are *not* public goods: a college education at a state university, Yellowstone National Park, and the services of your local fire department.

4. Why are public goods sometimes difficult for markets to allocate efficiently?

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Questions for Thought:

5. Which of the following is true of public goods?

a. Public goods can only be supplied by the government.

b. From the standpoint of economic efficiency, markets will tend to supply too large a quantity of a public good.

6. Why do golf course developers generally purchase a large tract of land, much larger than will be used for the course, prior to its construction?

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**End
Chapter 5**

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