



ECONOMICS

PRIVATE AND PUBLIC CHOICE

16TH EDITION

GWARTNEY – STROUP – SOBEL – MACPHERSON

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, 16th ed.***”

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Slides prepared by Joseph Connors with the assistance of Charles Skipton & James Gwartney

A Closer Look at Economic Efficiency

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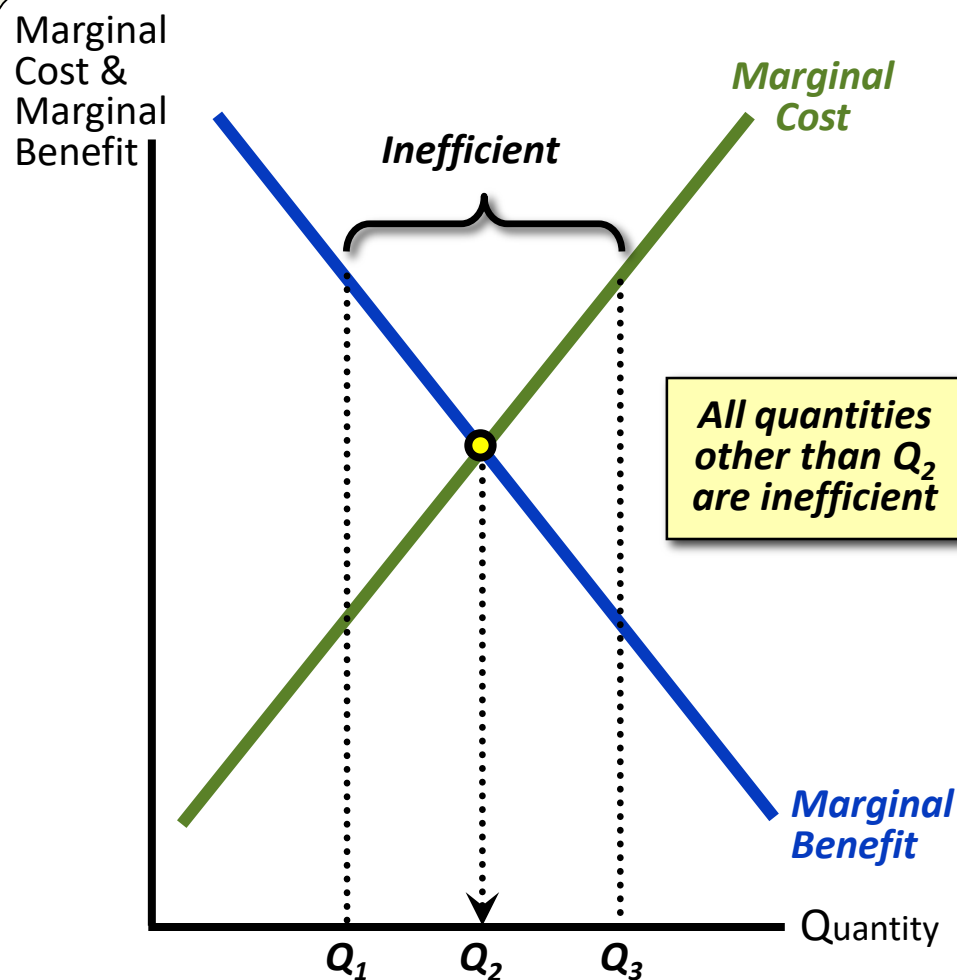
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What is Economic Efficiency?

- Economists use the concept of ***efficiency*** to judge actions because efficient use of resources implies the maximum value of output from the resource base.
- Two 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.

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 also 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.



If It's Worth Doing, It's Worth Doing Imperfectly



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If It's Worth Doing, It's Worth Doing Imperfectly

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- 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.

If It's Worth Doing, It's Worth Doing Imperfectly

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- 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.

Thinking About 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.

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.

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.

Potential Shortcomings of the Market



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Four Reasons the Invisible Hand May Fail

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

“The principal justification for public policy intervention lies in the frequent and numerous shortcomings of market outcomes.”

—Charles Wolf, Jr. senior economic advisor
at the RAND Corporation

Why the Invisible Hand May Fail:

(1) Lack of Competition

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- When competition is absent:
 - Sellers may gain by restricting output and raising price.
 - Too few units will be produced.

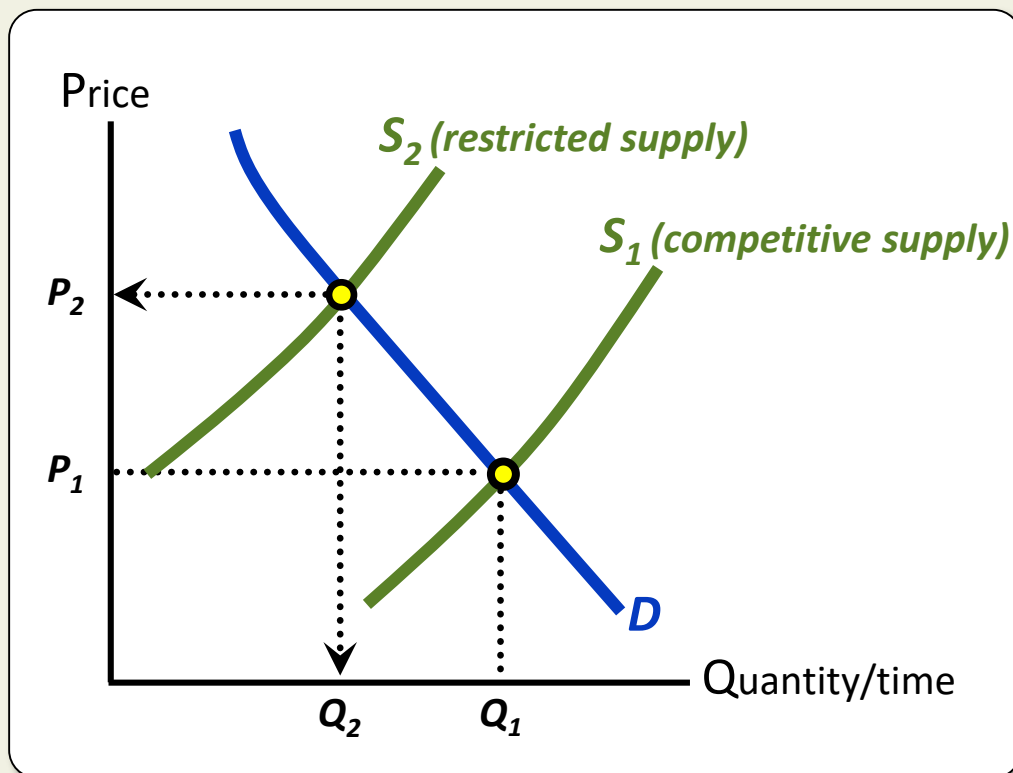
Lack of Competition

Sellers may gain by restricting output and raising price.

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



Why the Invisible Hand May Fail:

(2) Externalities

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- **Externalities** exist when the market fails to register fully costs and benefits.
 - **External costs:**
 - Present when the actions of individuals, group, or firms 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 individuals, groups, or firms generate benefits for nonparticipating parties.

Problems that Arise when ***External Costs*** are Present

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- Because some of the costs of production are not fully registered when external costs are present, the supply curve understates the true cost of production.
 - This is inefficient because units will be produced that are valued less than their full cost.
- Can you explain the link between external costs and pollution?



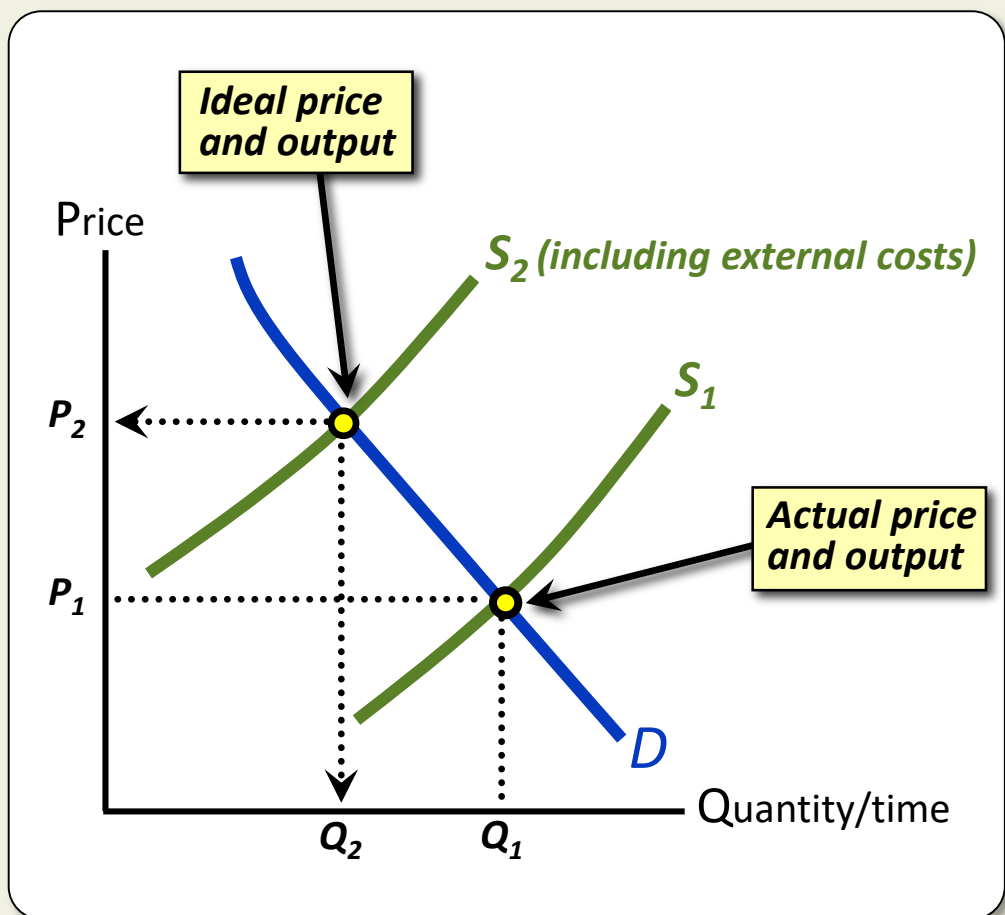
External Costs

Failure to fully register external costs

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- In this market, under initial **supply** and **demand** conditions, output Q_1 and price P_1 exist.
- If all economic 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.



Problems that Arise when ***External Benefits*** are Present

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- 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 will often be produced.

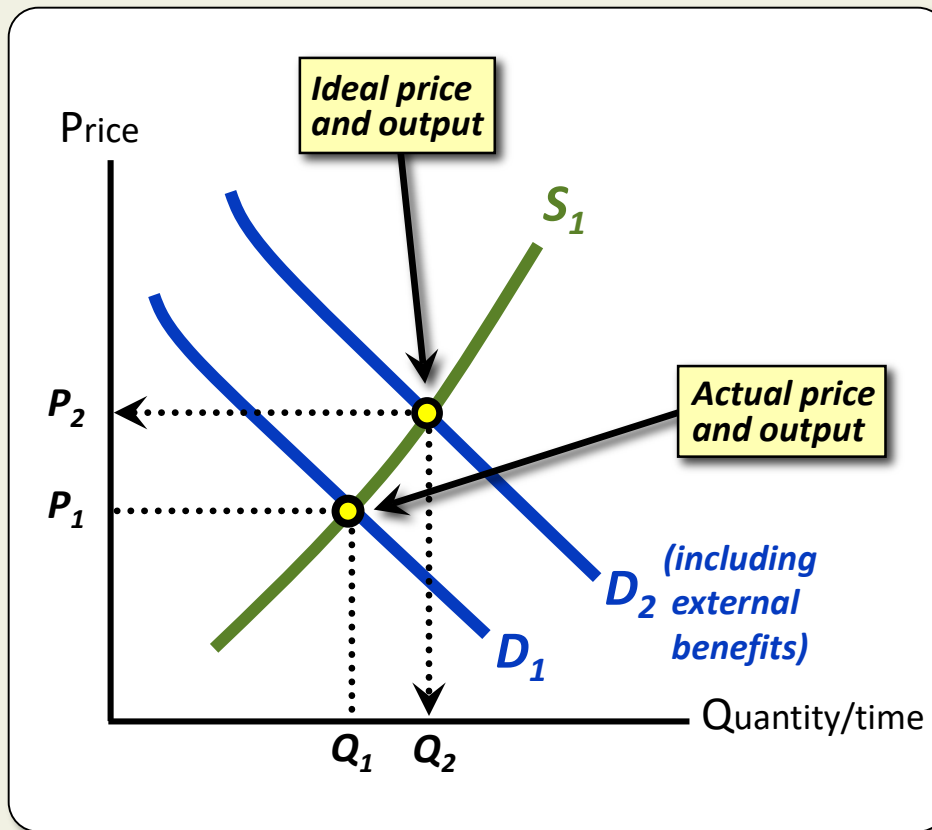
External Benefits

Failure to fully register external benefits

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- 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 $P_2 > P_1$.
- When external benefits (a **positive externality**) are present, *too few* units will often be produced and price will be less than that which would prevail if all the benefits were identified and reflected in the market process.



Market Efforts to Capture External Benefits

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- Entrepreneurs have a strong incentive to figure out ways to capture external benefits.
- Sometimes, they are able to capture what would otherwise be external benefits by extending the scope of the firm.
- Can you explain why the Disney corporation purchased far more land than needed for its amusement parks when it developed Disney World in Florida?



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Why the Invisible Hand May Fail:

(3) Public Goods

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- **Public goods** are:
 - *jointly consumed*
 - Individuals can simultaneously enjoy consumption of the same product or service.
 - *non-excludable*
 - it is costly, and in some cases, impossible to restrict the availability of the good to only those who pay for it.

Problems that Arise With a Public Good

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- If a **public good** is made available to one, it is simultaneously made available to others.
- Because suppliers are unable to establish a one-to-one link between payment for and receipt of the good, it will be difficult to provide public goods through markets.
- 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.

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.
 - For example: the use of advertising to support the provision of broadcast radio and television.
- Nonetheless, public goods often cause a breakdown in the harmony between self-interest and the efficient use of resources.

Why the Invisible Hand May Fail:

(4) Poor Information

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- 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.

Why the Invisible Hand May Fail:

(4) Poor Information

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- Market responses to poor information include:
 - Consumer information publications
 - Provide expert evaluation and unbiased information, examples include *Consumer Reports* and the Better Business Bureau.
 - Brand names and franchises
 - Provide standardized quality and dependability
 - Warranties
 - Supplier promises to repair possible problems

Market and Government Failure



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Market Failure

- ***Market failure*** is the term used to describe the failure of markets to achieve the ideal conditions of economic efficiency.
- When markets allocate goods inefficiently, the problem can generally be traced back to the *absence of competition, externalities, public goods, or poor information*.

Government Failure

- ***Government failure*** is the term used to describe the situation when there is reason to anticipate that political decision-making will fail to achieve the ideal conditions of economic efficiency.
- Government action directed by political decision-making is merely an alternative form of economic organization. It is not a corrective device that can be counted on to provide a remedy for the shortcomings of markets.
- When market failure is present, it does not follow that political action will necessarily lead to a more efficient allocation of resources.

Markets Versus Government

- *Economic analysis is comparative.* It involves comparison of expected outcomes under market and political organization.
- The following chapter will analyze the operation of the democratic political process so it will be possible to compare it with the market process.