

The Role of Government

CHAPTER

4

LEARNING OBJECTIVES

After learning about this chapter, you should know

- LO4-1** The nature and causes of market failure.
- LO4-2** How the public sector has grown.
- LO4-3** Which taxes finance state, local, and federal governments.
- LO4-4** The meaning of government failure.

The Core Issues

The market mechanism produces goods and services and yields jobs, wages, and a distribution of income.

Is this the best possible mix of output? Should government intervene?

1. *Under what circumstances do markets fail?*
2. *How can government intervention help?*
3. *How much government intervention is desirable?*

Market Failure

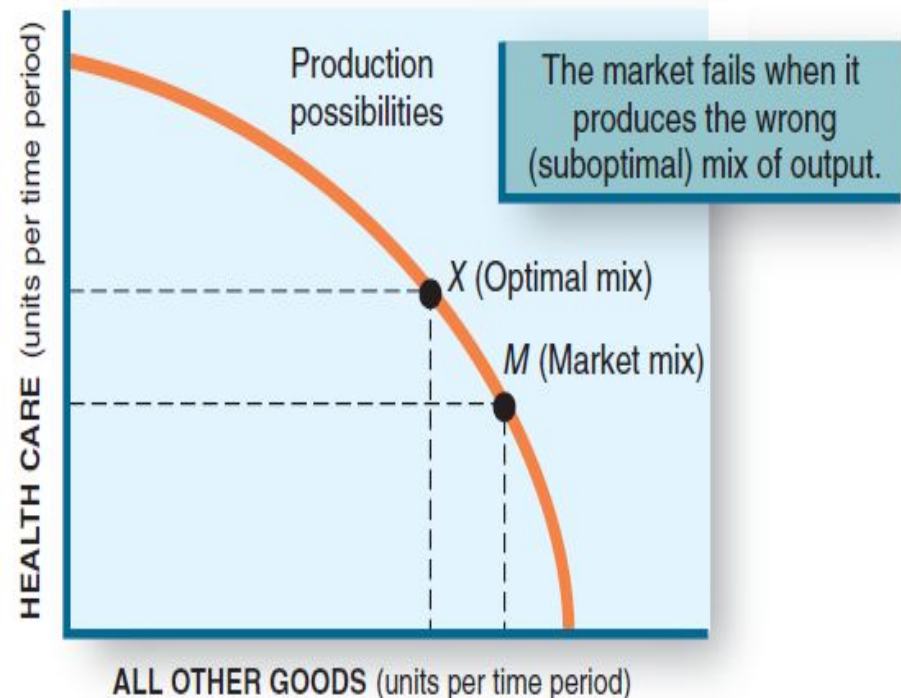
Society wants the combination at point X.

Optimal mix of output:

the most desirable combination of output attainable using existing resources, technology, and social values.

The market mechanism would lead us to point M.

Market failure: an imperfection in the market mechanism that prevents optimal outcomes.



Market Failure II

Market failure: the market mechanism did not lead us to the optimal point on the PPC.

- ✓ Market failure establishes a basis for government intervention.
- ✓ Specific sources of market failure are
 - 1) **Public goods**
 - 2) **Externalities**
 - 3) **Market power**
 - 4) **Inequity**
- ✓ *Additional reason for government intervention:* **Macro Instability**

Public Goods

Private good: a good or service whose consumption by one person excludes consumption by others. *Example: A doughnut.*

Public good: a good or service whose consumption by one person does not exclude consumption by others. *Example: National defense.*

Characteristics of Public Goods

- Nonrival in consumption - One person's enjoyment of the benefits of a public good does not interfere with another's consumption of it.
- Nonexcludable - Once a good is produced, no one can be excluded from enjoying its benefits.

Public Goods II

The free-rider dilemma: the communal nature of public goods may cause some consumers to try for a free ride.

Free rider: *an individual who reaps direct benefits from someone else's purchase (consumption) of a public good.*

The **market** tends to under-produce public goods, if it produces them at all.

Government's role:

1. *Step in and become the buyer.*
2. *The producer then produces the public good.*
3. *Finance the purchase with taxes or user fees.*

Externalities

Externalities

- Costs (or benefits) borne by a third party when a two-party (buyer and seller) transaction occurs.
- The difference between the social and private costs (benefits) of a market activity.

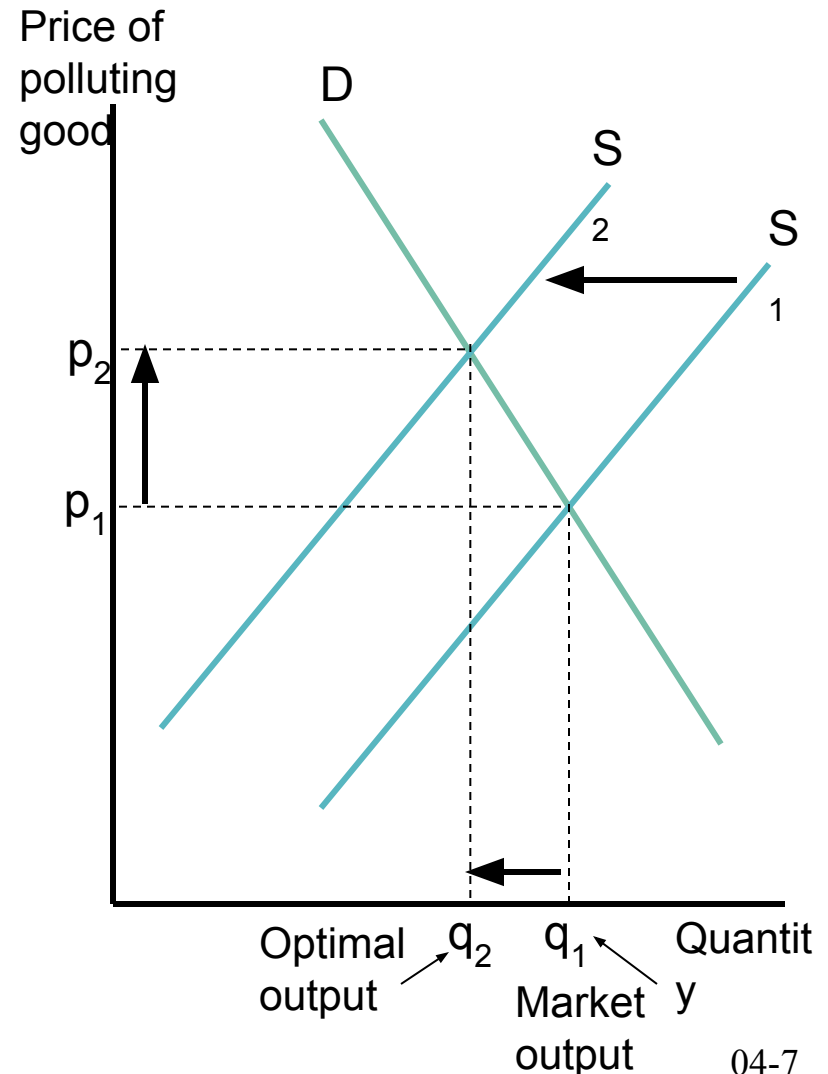
When externalities are present, market prices are not a valid measure of a good's value to society.

Correcting for Externalities

Negative externality (in production)

- Third parties are **hurt (suffer a cost)** because of a market transaction.
- **Too much** is produced and sold at price p_1 because society's costs are **greater than** market costs.
- **Government steps in** to shift costs from society to the producer and the buyer, causing the supply curve to shift left.
- Government action causes **less** to be produced and sold at a higher price
 - *Product is sold at price p_2*

Example: pollution

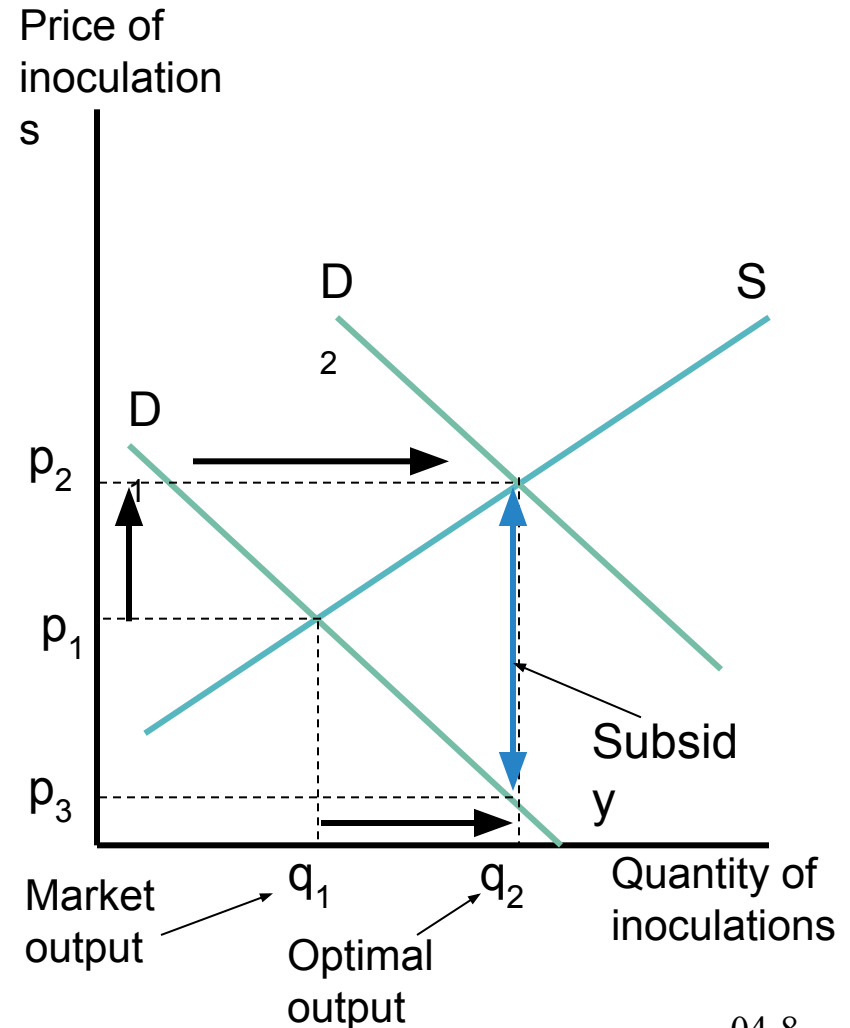


Correcting for Externalities II

Positive externality (in consumption)

- Third parties **benefit** because of a market transaction.
- **Not enough** is produced and sold at price p_1 because society's benefits are **greater than** market benefits.
- **Government steps in** and causes **more** to be produced by subsidizing production or purchase.
 - Product is sold at price p_3

Examples: public education and inoculations



Summary: Externalities

Negative externality

- Society's cost $>$ market cost
- The market overproduces.
- The government restricts production or shifts cost to producer/buyer to shift supply left.

Positive externality

- Society's benefit $>$ market benefit
- The market underproduces.
- The government subsidizes to shift demand right.

Market Power

Market power: the ability of a firm to manipulate the price of a good in the market.

The firm can restrict supply in order to drive up price and maximize profits rather than produce society's desired mix of output.

Government role

- ✓ Restrict market power
- ✓ Promote more competition

Inequity

Income redistribution:

Reduces the inequity in incomes.

Provides a minimum amount of merit goods.

Merit good: *a good society believes everyone is entitled to some minimal quantity of.*

Government redistributes income using:

1) A progressive income tax system.

- *Collect taxes from income earners.*

2) Transfer payments.

- *Provide payments to individuals for which no current goods and services are exchanged.*

Macro Instability

The goal of macro intervention is to foster economic growth.

1. Move out of inefficiency and onto the PPC.
 - *Reduce unemployment.*
2. Avoid inflation.
 - *Promote stable prices.*
3. Increase our capacity to produce.
 - *Economic growth*

Government uses macroeconomic policies in an attempt to meet these goals.

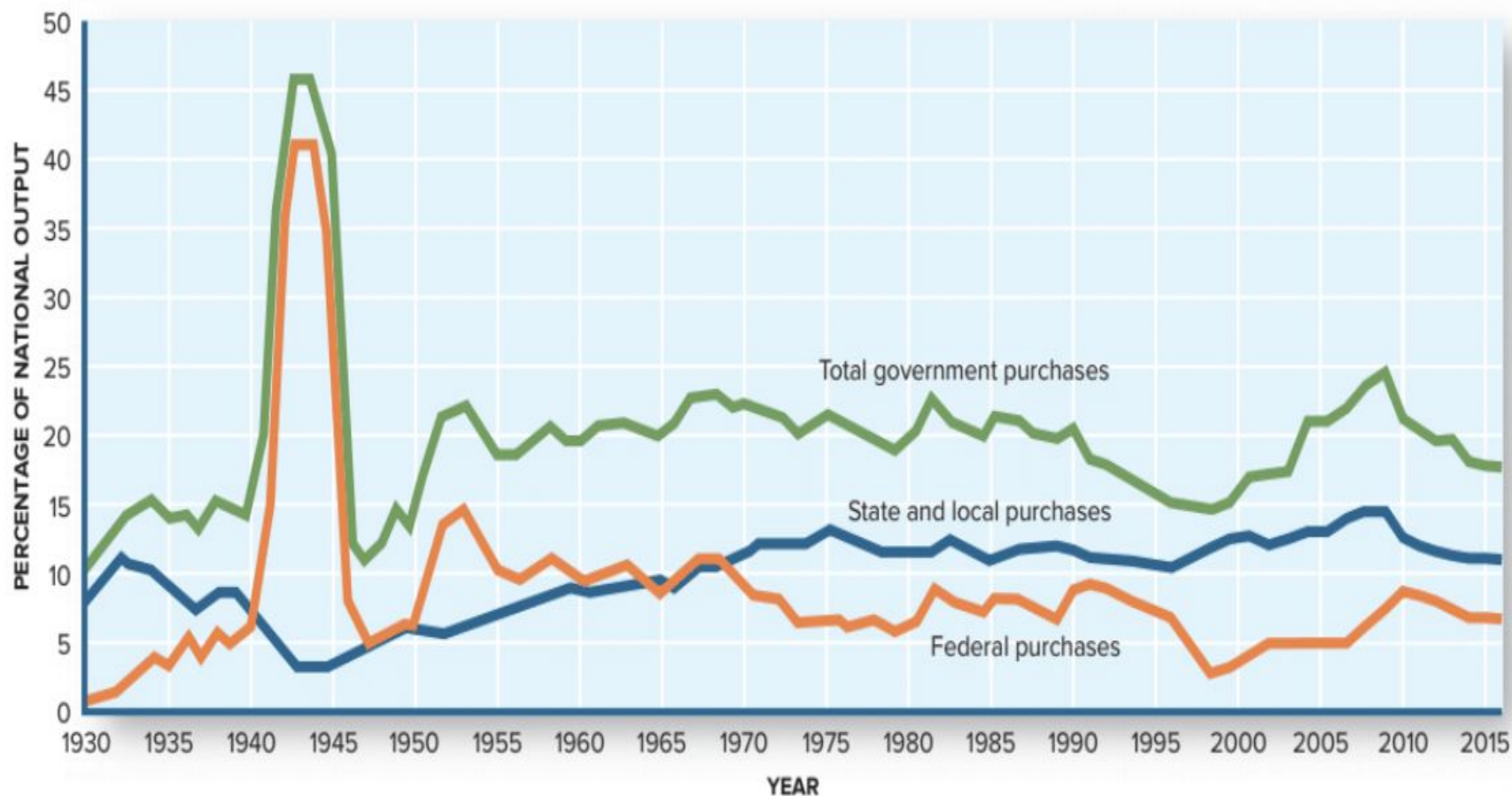
Growth of Government

When society perceives a problem, it looks to government to “fix” the problem, which provides justification for government intervention in the economy.

As a result, government has grown over the last century:

- Over 10 times more employees since 1900.*
- A budget 6,000 times larger since 1900.*

Growth of Government II



Government Finances

Each level of government (federal, state, and local) creates a budget of fund inflows and outflows.

- **Inflows (sources of funds)**
 - *Taxes (and fees/user charges)*
 - *Borrowing*
- **Outflows (uses of funds)**
 - *Purchases of goods and services*
 - *Payments for resources used*
 - *Transfer payments*

Sources of Government Growth

1. Direct government expenditures have grown a bit more slowly than private sector expenditures.
2. Most of the growth in federal spending is from increased transfer payments, which now account for over half of the spending.
3. State and local governments buy much more output than the federal government and employ five times as many people.

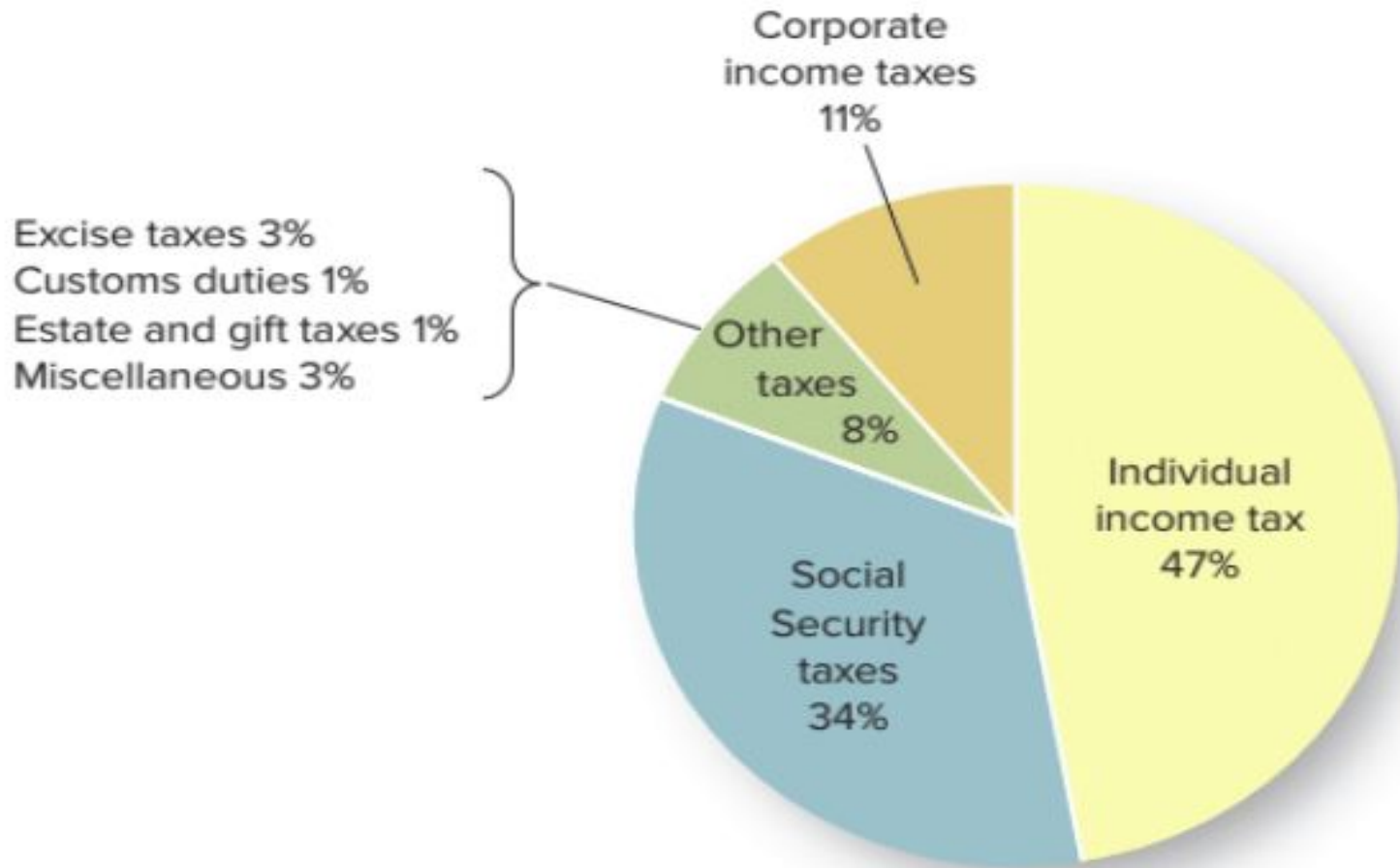
Taxation

- Tax revenue pays for government spending.
- There is a change in the output mix as more government spending absorbs factors of production that could be used to produce consumer goods.
- The **opportunity cost of taxation** is measured by the private-sector output sacrificed when government employs scarce factors of production.
- *The primary function of taxes is to transfer command over resources (purchasing power) from the private sector to the public sector.*

Tax Systems

- **Progressive Tax:** A system in which tax rates rise as incomes rise.
- **Proportional Tax:** A tax that levies the same rate on every dollar of income.
- **Regressive Tax:** A system in which tax rates fall as incomes rise.

Federal Taxes



Taxes

Income Tax

- A progressive tax rate.
- The largest single source of government revenue.
- Compared to those with lower incomes, those with higher incomes:
 - *Pay more taxes.*
 - *Pay a greater fraction of their income in taxes.*

Social Security Tax

- A regressive tax rate.
- Compared to those with lower incomes, those with higher incomes:
 - *Pay more taxes.*
 - *But pay a smaller fraction of their income in taxes.*

Other Taxes

Corporate taxes:

- Usually passed on to the customer in higher prices.
- It is a progressive tax system to the corporation.

Excise taxes:

- Imposed on a specific good or service.
- Some are imposed to discourage production and consumption of these goods.

Property tax:

- A major source of local taxes.
- It is a regressive tax, since poorer people devote a larger portion of their income to housing costs.

Sales tax:

- Another major source of local taxes.
- It is also a regressive tax, since poorer people tend to spend all of their income while richer people do not.

Market Participants

From Chapter 3

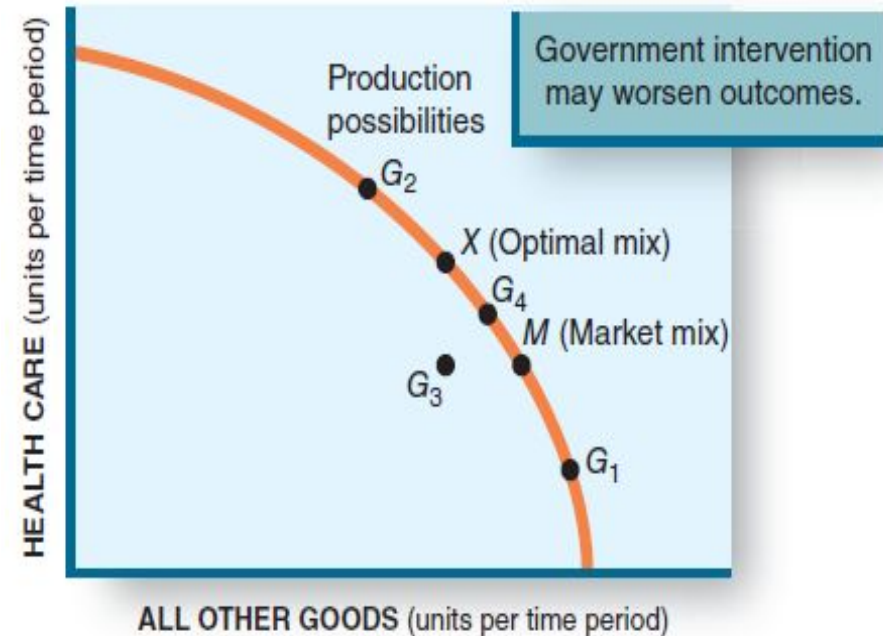
Market participants are trying to obtain the maximum return from the scarce resources they have.

- **Consumers:** maximize the utility (satisfaction of unmet wants) they can get from available incomes.
- **Businesses:** maximize profits by selling goods that satisfy demand while keeping costs low.
- **Government:** maximize the general welfare of society.

Government Failure

The goal of Government intervention is to move the mix of output closer to society's desired mix.

Government failure: occurs when government intervention fails to improve economic outcomes and may worsen outcomes.



Perceptions of Waste

Public perception is that the government isn't producing as many services as it could with the resources at its disposal.

- This inefficiency pushes the economy inside the PPC.

A related question is: Are we giving up too many private-sector goods in order to get those services?

- Is the opportunity cost too high?

Valuation of Costs and Benefits

Additional public-sector activity is desirable only if the **benefits** from that activity exceed its **opportunity costs**.

- *How do we identify the benefits?*
- *How do we enumerate the costs?*
- *Whose values should be used to do this?*

Ballot Box Economics

Voting mechanisms substitute for the market mechanism in allocating resources to the public-sector and deciding how to use them.

- ✓ *The resulting mix may be optimal for the majority but not necessarily for all society.*

Public Choice Theory

Public choice: a theory of public-sector behavior emphasizing rational self-interest of decision-makers and voters.

- ✓ *Government decision-makers are supposed to serve the people.*
- ✓ *Many, however, set their own agenda. Some give higher priority to personal advancement than public welfare.*
- ✓ *Bureaucrats are just as “selfish” (utility maximizing) as everyone else.*

Public Choice: Benefit-Cost Analysis

Private-sector

- Benefits and costs usually accrue to the same person.
- Makes it easy to compare the two and make a decision.

Government

- Benefits and costs usually accrue to different groups.
- Makes it more difficult for the decision maker.
- Politics enter into the decision.
- The decision maker may have no stake in the outcome.

What Does Society Want Produced?

Can either the market based or the state-run system, or a combination of the two, produce the mix of output desired by society in general?

- ✓ *A pure market system will not produce adequate quantities of some goods.*
- ✓ *A pure government system cannot determine the mix of output desired by buyers and sellers.*
- ✓ *By trial and error, a combination of the two systems may arrive at the optimal mix of goods produced.*

Issues to Ponder

“Capitalism has lost some of its luster in the U.S. The percent of Americans aged 18 to 29 who say they support capitalism checks in at only 39 percent.”

From: Bloomberg Opinion, July 12, 2018

Do you think we should move toward more or less government intervention in the U.S. economy? Will your answer change after this course?

Issues to Ponder – Continued

Capitalism *is an economic system based (to a varying degree) on private ownership of the factors of production (capital, land, and labor) employed in generation of profits. It is the oldest and most common of all economic systems and, in general, is synonymous with free market system.*

Socialism *is an economic system in which goods and services are provided through a central system of cooperative and/or government ownership rather than through competition and a free market system.*

Read more: <http://www.businessdictionary.com/definition/socialism.html>