Chapter 9

Government Intervention
• The goal of this chapter is to define appropriate government intervention in the marketplace. Specifically:
  – Under what circumstances do markets fail?
  – How can government intervention help?
  – How much government intervention is desirable?
After completing this chapter, you should know:

1. What market failure means.
2. Why the market under produces public goods.
3. How externalities distort market outcomes.
Learning Objectives

After completing this chapter, you should know:

4. How market power prevents optimal outcomes.

5. What government failure is.
Laissez Faire

• Adam Smith coined the phrase *laissez faire* in the late 1700s as a doctrine of “leave it alone,” or nonintervention by government in the market mechanism.

• Adam Smith wanted to establish the presumption of market efficiency.
• The market mechanism may fail to provide the optimal mix of output:
  – The *optimal mix of output* is the most desirable combination of output attainable with existing resources, technology, and social values.
The Nature of Market Failure

- Market failure is an imperfection in the market mechanism that prevents optimal outcomes:
  
  - *Market mechanism:* the use of market prices and sales to signal desired outputs (or resource allocations).
Market failure implies that the forces of supply and demand have *not* led to the best point on the production possibilities curve.

It also establishes a basis for government intervention.
There are four specific sources of microeconomic market failure:

– Public goods.
– Externalities.
– Market power.
– Inequity.
Market Failure I: Public Good

• A public good is a good or service whose consumption by one person does not preclude consumption by others.
  – Examples include national defense and flood-control dams.
Private Good

• In contrast to a public good, a *private good* is a good or service whose consumption by one person excludes consumption by others.

  – Examples include donuts and soda.
The Free-Rider Dilemma

- A **free rider** is an individual who reaps direct benefits from someone else’s purchases (consumption) of a public good.
The distinction between public goods and private goods is based on the nature of the goods, not who produces them.

Free riders of public goods upset the customary practice of paying for what you get.
Government Role in Public Goods

• Everyone would wait for someone else to pay.
• Thus, the market would underproduce public goods.
• Government steps in and causes public goods to be produced.
• Then collects taxes to pay for them.
• *Externalities* are costs (or benefits) of a market activity borne by a third party, not the buyer or the seller.
  
  – The difference between the social and private costs (benefits) of a market activity.
External Benefits

• The market will underproduce goods that yield external benefits.
  – Others benefit from a two-part transaction.
  – Social benefit exceeds private benefits.
  – Government’s role is to increase production.

• Example: public education.
External Costs

• The market will overproduce goods that generate external costs.
  – Others suffer a cost from a two-party transaction.
  – Social costs exceeds private costs.
  – Government’s role is to decrease production.

• Example: pollution
Social Demand

• Social demand includes not only private benefits but also accounts for any externalities:

$$Social\ demand = Market\ demand + Externalities$$
• If the externality is a negative one, the activity imposes external costs.
• Whenever external costs exist, market demand *overstates* social demand.
External Benefits

• An external benefit augments private demand.
• Whenever external benefits exist, the social demand exceeds the market demand.
• When external costs exist, firms will produce *more* of the good than is socially desirable.
A producer has an incentive to continue polluting using cheaper technology as long as doing so is more profitable.
External Cost

• People tend to maximize their personal welfare, balancing private benefits against private costs.

• When external costs exist, a private firm will not allocate its resources and operate its plant in such a way as to maximize social welfare.
Social versus Private Costs

- **Social costs** are the full resource costs of an economic activity, including externalities.
- **Private costs** are the costs of an economic activity directly borne by the immediate producer or consumer (excluding externalities).
• External costs are equal to the difference between social and private costs:

\[ \text{External costs} = \text{Social costs} - \text{Private costs} \]

• If pollution costs are external, firms will produce too much of a polluting good.
Policy Options

• The goal is to discourage production and consumption activities that impose external costs on society.

• We can do this in one of two ways:
  – Alter market incentives.
  – Bypass market incentives.
Emission Fees

• Market incentives can be altered via emission charges:
  – An **emission charge** is a fee imposed on polluters, based on the quantity of pollution.

• An emission fee increases private marginal cost and thus encourages lower output.
• Market incentives can be bypassed through direct regulation.
• Government specifies the required outcome and the *process* by which it is to be achieved.
• The Clean Air Act of 1970 mandated fewer auto emissions and the processes to reduce those emissions.
Overregulation

• Excessive process regulation may *raise* the costs of environmental protection and discourage cost-saving innovation.
• The market price reflects all the benefits and costs of participants in the market, but not necessarily the social costs.

• Market power is the ability to alter the market price of a good or service, which may cause the *response* to price signals to be flawed.
 Restricted Supply

• Market power results from restricted supply due to:
  – Copyrights.
  – Patents.
  – Control of resources.
  – Restrictive production agreements.
  – Efficiencies of large-scale production.
The direct consequence of market power is that one or more producers attain discretionary power over the market’s response to price signals.

- To reduce competition.
- To enhance profits.
- To limit consumer choice.
Antitrust Policy

• The goal of government intervention is to prevent or dismantle concentrations of market power.

• *Antitrust policy:* government intervention to alter market structure or prevent abuse of market power.
The Sherman Act (1890)

- Prohibits “conspiracies in restraint of trade,” including mergers, contracts, or acquisitions that threaten to monopolize an industry.
The Clayton Act (1914)

• Outlaws specific antitrust behavior not covered by the Sherman Act.
• Principal aim of the act was to prevent the development of monopolies.
The Federal Trade Commission Act (1914)

• Created an agency to study industry structures and behavior so as to identify anticompetitive practices.
Antitrust Decisions

• Antitrust legislation has been used to break up:
  – The steel monopoly in the early 1900s.
  – The tobacco monopoly in the early 1900s.
  – The AT&T monopoly in the 1980s.

• Also, to get Microsoft to change its exclusionary licensing practices.
Market Failure IV: Inequity

- Is the distribution of goods and services fair? If not, government intervention can redistribute income.
- The government alters the distribution of income with taxes and transfers.
Figure 9.7

Poor people’s share of total income

Before government intervention: 1.1%

After taxes and transfers: 4.4%
Income Transfers

• Examples of income transfers include
  – Social Security.
  – Welfare programs.
  – Unemployment benefits.
The goals of macro intervention:

• To foster economic growth.
• To get us on the production – possibilities curve (full employment).
• To maintain a stable price level (price stability).
• To increase our capacity to produce (growth).
• The potential micro and macro failures of the marketplace can be used to justify government intervention.

• Can we trust the government to fix the shortcomings of the market?
• Government intervention typically entails a lot of groping in the dark for better, if not optimal, outcomes.

• Vested interests often try to steer the government away from the social optimum.

• Government officials may act on their own political agenda that does not reflect society’s interest.
Government Failure

• Government intervention might worsen, rather than improve market outcomes:
  – Government failure: government intervention that fails to improve economic outcomes.
• The challenge for public policy is to decide when *any* government intervention is justified, then intervene in a way that improves outcomes in the least costly way.
• There is no guarantee that the visible hand of government will be any better at reaching a societally optimal outcome than the invisible hand of government.
What We Learned

1. Market failure occurs when the market outcome is suboptimal, as in public goods, externalities, market power and inequity.

2. Everyone gets to use public goods “for free” once they exist, so nobody is willing to pay for them. The market, therefore, under produces these goods.
What We Learned

3. Externalities – third-party costs or benefits of a market transaction – are not included in the decision-making process. The market overproduces goods with external costs and underproduces goods with external benefits.
4. Market power enables a producer to ignore market price signals and produce a suboptimal mix of output.

5. Government failure occurs when intervention fails to improve, or maybe even worsens, economic outcomes.