Laugher Curve

Q. How many economists does it take to screw in a light bulb?
A. Eight. One to screw it in and seven to hold everything else constant.

Introduction

Economists use the invisible hand framework to determine whether the government should intervene in the market.

- **Invisible hand framework** – perfectly competitive markets lead individuals to make voluntary choices that are in society’s interest.

Market Failures

- **Market failure** – the invisible hand pushes in such a way that individual decisions do not lead to socially desirable outcomes.
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<th>Market Failures</th>
<th>Externalities</th>
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<td>□ When a market failure exists, government</td>
<td>□ <em>Externalities</em> are the effect of a decision on a</td>
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<td>intervention into markets to improve the outcome is</td>
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<td>justified.</td>
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<td>□ <em>Government failure</em> occurs when government</td>
<td>□ Externalities can be either positive or negative.</td>
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<td>intervention does not improve the situation.</td>
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<td>□ <em>Negative externalities</em> occur when the effects</td>
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<td>of a decision not taken into account by the</td>
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<td>decision-maker are detrimental to others.</td>
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A Negative Externality Example

- When there is a negative externality, marginal social cost is greater than marginal private cost.
  - A steel plant benefits the owner of the plant and the buyers of steel.
  - The plant’s neighbors are made worse off by the pollution caused by the plant.

A Negative Externality Example

- **Marginal social cost** includes all the marginal costs borne by society.
  - It is the marginal private costs of production plus the cost of the negative externalities associated with that production.

A Negative Externality Example

- When there are negative externalities, the competitive price is too low and equilibrium quantity too high to maximize social welfare.
A Positive Externality Example

- Private trades can benefit third parties not involved in the trade.
  - A person who is working and taking night classes benefits himself directly, and his co-workers indirectly.

**Marginal social benefit** equals the marginal private benefit of consuming a good plus the positive externalities resulting from consuming that good.

A Positive Externality Example

Alternative Methods of Dealing with Externalities

- Externalities can be dealt with via:
  - Direct regulation.
  - Incentive policies.
  - Voluntary solutions.
Direct Regulation

- **Direct regulation** – the amount of a good people are allowed to use is directly limited by the government.

Incentive Policies

- Incentive policies are more efficient than direct regulatory policies.
- The two types of incentive policies are either taxes or market incentives.

Direct Regulation

- Direct regulation is inefficient, not efficient.
  - **Inefficient** – achieving a goal in a more costly manner than necessary.
  - **Efficient** achieving a goal at the lowest cost in total resources without consideration as to who pays those costs.

Tax Incentive Policies*

- A **tax incentive program** uses a tax to create incentives for individuals to structure their activities in a way that is consistent with the desired ends.
- The tax often yields the desired end more efficiently than straight regulation.
Tax Incentive Policies

- This solution embodies a measure of fairness about it – the person who conserves the most pays the least tax.

- A way to handle pollution is through a tax called an effluent fee.

- Effluent fees – charges imposed by government on the level of pollution created.

Market Incentive Policies

- Market incentive program – market participants certify they have reduced total consumption – their own and/or other’s – by a specified amount.
Market Incentive Policies

- A market incentive program is similar to the regulatory solution.
- The amount of the good consumed is reduced.

Market Incentive Policies

- A market incentive program differs from a regulatory solution.
- Individuals who reduce consumption by more than the required amount receive marketable certificates that can be sold to others.

Voluntary Reductions

- Voluntary reductions allow individuals to choose whether to follow what is socially optimal or what is privately optimal.
- Economists are dubious of voluntary solutions.

Voluntary Reductions

- A person’s willingness to do things for the good of society generally depends on the belief that others will also be helping.
Voluntary Reductions

- The socially conscious will often lose their social conscience when they believe a large number of other people are not contributing.

  - This is example of a free rider problem – individuals’ unwillingness to share in the cost of a public good.

The Optimal Policy

- An optimal policy is one in which the marginal cost of undertaking the policy equals the marginal benefit of that policy.

The Optimal Policy

- Resources are being wasted if a policy isn’t optimal.

  - What is saved by reducing the program is worth more than what is lost from the reducing the program.

The Optimal Policy

- Some environmentalists want to totally eliminate pollution.

- Economists want to reduce pollution to the point where marginal costs of reducing pollution equals the marginal benefits.
The Optimal Policy

- **Optimal level of pollution** – the amount of pollution at which the marginal benefit of reducing pollution equals the marginal cost.

Public Goods*

- A **public good** is nonexclusive and nonrival.
  - **Nonexclusive** – no one can be excluded from its benefits.
  - **Nonrival** – consumption by one does not preclude consumption by others.

Public Goods

- There are no pure examples of a public good.
  - The closest example is national defense.
  - Technology can change the public nature of goods.
  - Roads are an example.

Public Goods

- Once a pure public good is supplied to one individual, it is simultaneously supplied to all.
- A private good is only supplied to the individual who bought it.
Public Goods

- With public goods, the focus is on groups.
- With private goods, the focus is on the individual.

Public Goods

- In the case of a public good, the social benefit of a public good is the sum of the individual benefits.

The Market Value of a Public Good

- Adding demand curves vertically is easy to do in textbooks, but not in practice.
- This is because individuals do not buy public goods directly so that their demand is not revealed in their actions.
Government Failures and Market Failures

- Government failure occurs when the government intervention in the market to improve the market failure actually makes the situation worse.

Reasons for Government Failures

- Governments do not have an incentive to correct the problem.
- Governments do not have the information to deal with the problem.
- Intervention in the markets is almost always more complicated than it initially looks.

Reasons for Government Failures

- The bureaucratic nature of government intervention does not allow fine tuning.
- Government intervention leads to more government intervention.