Chapter 5-2
Role of Government in the Market System

Adam Smith and Efficiency
• Everyone—consumers, firms, resource suppliers—attempts to get the most benefits for the least cost.
• As Adam Smith noted in 1776, self-interested individuals, wholly unaware of the effects of their actions, act as if driven by an invisible hand to produce the greatest social good.

Government as the Guardian
• An efficient use of resources implies a maximum value of output from a resource base. This is called technical efficiency.
• When one person cannot be made better off without making someone else worse off is called economic efficiency.

The Government’s Role
Markets may fail to achieve efficiency and create a role for government as a result of:

- Imperfect Information
- Externalities
- Public Goods
- Lack of Competition
- Business Cycles

Market Imperfections
• When information is not perfect, market imperfections may result, leading to inefficiency
• Brand names, franchises, and product warranties are helpful ways of dealing with information problems.
• Government may require full and correct disclosure (food labels, stock prospectuses, etc…).

Protecting the Food Supply
The FDA has issued a rule on the maintenance of records to ensure the Security of the U.S. Food Supply against Bioterrorism. It requires persons who manufacture, process, pack, transport, distribute, receive, hold, or import food to maintain records identifying the source of all food received, and the subsequent recipient of all food released.
Externalities

- **Externalities** are the costs or benefits of a transaction that are borne by someone not directly involved in the transaction.
- Suppliers maximize profits and consumers maximize net benefit **ONLY** when the market process fully incorporates all the costs and benefits into decisions.

Public Goods

- Public Goods are goods whose consumption by one person does not diminish the quantity or quality available to other consumers. Specifically, they:
  - **Can be jointly consumed**
    Individuals can simultaneously enjoy consumption of the same product or service.
  - **Are non-excludable**
    Consumption of the good cannot be restricted to the customers who pay for it.

Characteristics of a Public Good

- No one enjoys a **private property right** to a public good.
- As a result, people have an incentive to try and enjoy the benefits of the goods without helping to pay for them. That is, everybody has an incentive to become a **free rider**.
- But to the extent that people do become free riders, too little will be produced.

Examples of Public Goods

- Examples of **public goods**:
  - National defense
  - Public radio and television stations
  - Clean air
  - Unpolluted ground water
- Note that markets may develop ways of providing public goods (e.g. use of advertising to support radio and television).

Lack of Competition

- **Monopoly**: a market with only one producer.
- If one firm controls production economic efficiency can suffer. Governments often regulate monopolies to ensure economic efficiency.

Business Cycles

- Fluctuations in the economy impact employment rates and income.
- People call on the government to protect them against the periods of economic ill health and to minimize the damaging effects of business cycles.
Public Choice

- **Public Choice** is the study of how government actions result from the self-interested behaviors of voters and politicians.

- Self-interested behavior is present in both the public and private sectors, it only differs in the way it plays out.

Public Choice Analysis

- The government may be brought in to benefit specific individuals or groups who do not favor the market outcome.

- This is referred to as **rent-seeking**—the use of resources to transfer wealth from one individual to another without increasing production or total wealth.

- Thus government intervention may not seek efficiency gains.

Public Choice Conclusions

- Self-interest directs public sector activity, just as it directs market activity.

- Government actions (like price ceilings or floors) are often enacted for political gain, not as a remedy for economic inefficiency.