Public Sector Notes

- All points on the production possibilities curve are productively efficient, but only one is allocatively efficient.
  - The book refers to the allocatively efficient point as the “optimal mix of output.”
  - At the allocatively efficient point for society, every good will be produced such that the marginal cost to society equals the marginal benefit to society (MC=MB).
- The market fails when the market mechanism fails to achieve allocative efficiency (i.e. fails to produce what society wants).

- When the market fails to achieve allocative efficiency, they are not producing what society wants. Three potential causes are:
  1. **Public goods.**
     - The thing that distinguishes public goods from private goods is that people can be excluded from consuming private goods.
     - Public goods are subject to the free-rider problem. Individuals can take a “free ride” off of the purchase of others.
       - As such, public goods are underproduced. (See Figure 4.2)
       - These are goods for which the MB to society exceeds the MC, but the difficulty in excluding nonpayers makes everyone wait for someone else to pay – they want to take a free ride.
     - Note that just because the government pays for something does not make it a public good. Only the lack of excludability makes a public good public.
     - Examples of public goods include:
       b. Basic research – addressed in part by the government’s patent system.
       The government also funds a great deal of research.
       c. Fighting poverty? If lower poverty is preferred by all, it is subject to the free-rider problem and nonexclusion.
  2. **Externalities.**
     - These occur when some of the costs (or benefits) of an activity are borne by third parties (i.e. individuals who are neither buyers nor sellers in the market).
       - This means that the good’s value is not measured correctly.
     - Social demand is used to take into consideration the demand of both participants and nonparticipants in the market.
       - Social demand = market demand + externalities.
       - Market demand is from participants.
       - Externalities if from nonparticipants. Negative externalities are negative and positive externalities are positive.
     - Negative externalities are situations where some costs are imposed upon third parties. In these cases, not all costs are borne by those participating in the market.
       - So the social demand for a good that involves a negative externality is lower than that reflected in the market and the good is overproduced. (See Figure 4.3)
• Examples of negative externalities include pollution, cigarettes, neon clothing.
• Positive externalities are situations where some benefits are passed onto third parties. In these cases, those participating in the market do not receive all benefits.
• So the social demand for a good that involves a positive externality is higher than that reflected in the market and the good is underproduced.

Examples of positive externalities include immunizations, education, and flower production (beekeepers benefit and vice versa).

In some cases, externalities can be addressed by private means, but often government intervention in the form of regulations and/or taxation may be necessary.

3. Market power.
• Either a buyer or a seller can have market power, although for product markets we are generally concerned with sellers who have market power.
• **Market power** means the ability to alter market price.
• In the extreme, a firm can have a monopoly by controlling all market supply of a given good or service.
• A firm with market power controls price by controlling quantity. As we saw with the market demand curve, the price buyers are willing to pay is higher when the quantity available is lower.
• This means that where market power exists, there will be a tendency to supply less than would be supplied were the market completely competitive (i.e. less than what society wants).
• The government uses antitrust law and regulation to address this type of market failure.
• **Antitrust laws** seek to control market structure and the competitive behavior of firms.

• Prices are one method of allocation. Others are possible as well, however (such as first-come, first-served).
  • Inequity is one reason why alternative measures may be utilized.
• When the market fails to produce for the “right” people, it can be said that the market has failed as well. This is a case of:
  1. Inequity.
  • The government can transfer wealth from the “haves” to the “have-nots” by using a system of taxes and transfers.
  • **Transfer payments** are payments made where no goods or services are exchanged.
  • Rather than giving money, the government can instead make in-kind transfers (i.e. provide the desired goods directly). This is frequently the method followed for goods that society feels citizens are entitled to (such as food, housing, and medical care). The book calls these types of goods **merit goods**.

• When the government intervenes and fails to improve the situation, this is called **government failure**.
  • It is possible that the government will actually do worse than the market.
• Potential sources of government failure:
  1. Waste.
  • **Pork** – government provided goods that government officials secure for their constituents.
  2. Government may be productively inefficient.
  • In this case, the government uses too many resources to produce a given amount of output. The result is that society is at a point inside the production possibilities curve.
  3. Government may be allocatively inefficient.
  • The government may not produce what society wants (i.e. may incorrectly value certain goods and services).
  • We have to consider the opportunity cost of allowing the government to provide a given good or service in order to determine the appropriate level of production and/or service.
  • This question (as with all “how much” questions) is best answered using cost-benefit analysis.
  • Only want to provide a good or service if the benefit is greater than or equal to the cost of supplying it. (MB=MC)
  • Note that it is particularly difficult to measure benefits, many of which can not be put in quantitative terms.

• **Public choice** is the economic analysis of collective and government decision-making, politics, and the democratic process.
• It assumes that, as with market theory, actors are rational, utility ("happiness")
  maximizing individuals.
• Areas of analysis include voting theory, political platforms, constitutional
  structure, bureaucracy, logrolling, legislatures, executive departments, and
  lobbyists, among others.