Ch.5
The government

The opportunity cost of government

There are three opportunity costs of government

1. The opportunity cost of the resources used to produce goods supplied through the public sector. If these resources were not used by the government, then they could be used by people and firms in the private sector.
2. The second opportunity cost is the cost of resources used to collect taxes and to enforce government rules.
3. The third opportunity cost of government is the deadweight loss of taxation. People's incentives tend to change with a change in taxation. (Don't worry about this point for the first test as Dr. Fabricant has not covered the taxation section of chapter 4.)

Economic efficiency

Two rules of economic efficiency
1. An economic action is efficient if it produces more benefits than costs for the individuals of the economy.
2. An economic action is inefficient if the costs outweigh the benefits to individuals.

Economic inefficiency results when we do not undertake an efficient action and when we do undertake an inefficient action.

Two main functions of the government

1. Protective function
    a. The fundamental importance of the government is to provide a system where people rights and property rights are protected in a structured and secure environment.
    b. Economically, the protective function allows people the freedom to produce goods and services and then enjoy the benefits of their output without having to worry about someone coming and taking it away. (If someone does come and take it away there is a system for

repayment (the court). The efficiency of that system will be left up to the individual to judge.

2. The productive function of the government
    a. Some goods are difficult to produce in the private sector because it is difficult to see the link between payment of a good and receipt of that same good
    b. The most important productive function of the government is providing a stable monetary framework for society

The role of government and the flaws in the market system

1. Lack of competition
    a. If sellers of a similar product collude (Ford, Chrysler, GM for example) to set prices, a government may step and force the collusive actors to disband
    b. The government has set up antitrust laws to deal with monopoly powers (Sherman Antitrust Act and the Clayton Act) when they believe that society is being harmed by the actions of a firm (Microsoft for example)

2. Externalities
    a. Externalities are the side effects that occur when pursuing an action. For example, a manufacturing plant sends smoke into the air causing air pollution.
    b. Externalities arise because of poorly defined property rights. In the above example, the property rights of the air are not well defined (who owns the air?).
    c. Positive externalities provide benefit to people from undertaking an action. Positive externalities are usually not seen in society because people want to enjoy all the benefits of their work. (Why would I produce a good that benefits you if you are not paying for it? I would want to receive some form of compensation from you.)
    d. Negative externalities impose costs upon the rest of society. These are the most frequent types of externalities talked about because everybody wants to reduce their costs. (Why should I bear the cost of producing a good when I can get you to bear that cost? That would increase my return to producing and you cannot take action against me.)

e. The government's role may be to impose some sort of restriction or tax on those actions which produce negative externalities (the actions which produce negative side effects) and to provide subsidies for those actions which produce positive externalities

3. Public goods
   a. Goods that can be jointly consumed so that they are not diminished when one person consumes them (the usual examples are national defense and knowledge)
   b. Free riders are people who enjoy public goods but do not pay for them (think about those people who show up to your keg party but do not give you any money for the beer – they are enjoying a good but not paying for it – they are free-riding)
   c. The problem with public goods is that they allow people to free-ride. The market will not produce the good if they cannot get people to pay for it. National defense is the best example of a public good. National defense carries a high value to society, yet individual contributions would have little impact on the total supply of defense available. (How much impact would a contribution of $1 million have? How much does one stealth bomber or aircraft carrier cost?) People would see that their contributions did not matter, even if they contributed a lot of money, and would count on everyone else to pay for it. Meanwhile, everyone else is thinking in the exact same manner.