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Principles of Economics

Government Intervention in a Free Market Economy

Introduction:

We have seen that perfectly competitive markets can provide an efficient (socially and technically) level of goods and services to an economy's citizens, without any government involvement in the markets. Does this mean that government is not necessary in an economy? No! In theory, government can do stuff that a free market economy will not do. Let's explore this topic.

Government can, in theory:

- a) Enhance economic efficiency
- b) Enhance fairness

Government and Efficiency

Government enforcing contracts:

An agreement between a buyer and seller is worthless if one of them reneges on the deal. For example, suppose a wheat buyer signs a contract with a wheat seller to buy a certain amount of wheat in the August. But when August comes, the buyer reneges on the deal, leaving the wheat farmer with a bunch of unsold wheat. This situation is quite inefficient, even if the wheat market is perfectly competitive.

Government, therefore, can enhance efficiency by enforcing contracts between buyers and sellers, and by preventing theft.

Government and *Imperfect Competition*:

Sure—perfect competition is efficient. But we know that most markets in the real world aren't even close to being perfectly competitive. Instead, they are monopolies, oligopolies, and monopolistically competitive. Combined, these three types of markets are known as *imperfect competition*. We know that imperfectly competitive markets are inefficient.

Government can therefore, in theory, enhance efficiency by:

- a) Promoting competition through antitrust laws and other laws prohibiting collusion or anti-competitive practices.
- b) Regulating natural monopoly with price ceilings.

Government and Externalities

An *externality* is a cost or benefit of an activity borne by people not directly involved in the activity. For example, if I smoke in a room where you are located, forcing you to breathe in the smoke, then you are bearing a negative externality caused by my smoking. For another example, if I get a flu shot then I not only protect myself from the flu but I also will not be contagious and therefore protect others as well; this is a positive externality.

Negative Externalities:

Pollution is a consequence of most types of production; this is a negative externality. If firms are allowed to pollute without having to bear the costs of it, then they will provide an inefficiently large amount of the product. Let's look at this more formally:

We know that social efficiency occurs where price = marginal cost, right? Well this marginal cost must include ALL costs of production, including *external costs*—the cost of externalities:

$$\text{True marginal cost} = \text{marginal cost of production} + \text{marginal external cost}$$

The firm doesn't have to "pay" for the external costs in a free market, so it won't consider them when deciding how much stuff to produce. Hence the firm's costs will be artificially low, prompting them to produce too much stuff to be efficient.

Government, therefore, can in theory enhance efficiency by reducing the level of production of things whose production involves negative external costs.

Government can do this, in theory, by any of these means:

- 1) Forcing firms to bear the costs of their pollution.
- 2) Taxing the product, where the amount of the tax per unit produced should equal the amount of the marginal external cost.
- 3) Limiting the amount of product produced.
- 4) Limiting the amount of pollution that a firm is allowed to produce.

Note! The most efficient level of pollution is NOT zero!

Production involves pollution. With zero pollution we would have zero production. This is definitely not efficient. (Indeed, in this extreme case, none of us would be alive.)

Positive Externalities:

Some production comes with positive externalities; a company who produces a cure for the common cold, for example, will help not only those who buy the cure but also those who won't get the cold from the cured people. If firms produce goods that benefit people who don't even buy their product, then they will provide an inefficiently small amount of the product. Let's look at this more formally:

We know that social efficiency occurs where price = marginal cost, right? Well this marginal cost should be reduced if the product provides benefits to people who don't buy the product—the benefits of positive externalities:

$$\text{True marginal cost} = \text{marginal cost of production} - \text{marginal external benefit}$$

The firm doesn't receive any revenue for the external benefits in a free market, so it won't consider them when deciding how much stuff to produce. Hence the firm's revenues will be artificially low, prompting them to produce too little stuff to be efficient.

Government, therefore, can in theory enhance efficiency by increasing the level of production of things whose production involves an external benefit.

Government can do this, in theory, by any of these means:

- 1) Subsidizing the product, where the amount of the subsidy per unit produced should equal the amount of the marginal external benefit.
- 2) Increasing the amount of product produced.
- 3) Subsidizing the development of products with positive externalities.

Government and Public Goods

A *public good* is defined as a non-rival and non-excludable good.

Non-rival means that one person's consumption of the good does not reduce the amount of the good available to be consumed by others.

Non-excludable means that it is very, very expensive for producers of the good to prevent people who don't pay from consuming the good.

Examples:

- Sunlight is a public good.
- A library is NOT a public good.
- A missile defense system is a public good.
- Police protection is NOT a public good.
- Mosquito control in a city is a public good.
- "Public" school is NOT a public good.
- The light from a lighthouse is a public good.
- A bridge is NOT a public good.

Note! Most things provided by government are NOT public goods!

Because public goods are non-excludable, it is difficult or impossible for a firm to generate revenue from providing the good, since those who don't pay for it can easily consume it for free. So private firms are not likely to provide these goods on their own. Yet these goods benefit members of society!

Government can enhance efficiency by providing (or paying firms to provide) public goods in the socially efficient amount.

Government and Fairness

Another word meaning fairness is *equity*.

An efficient outcome isn't necessarily fair. Consider a child, abandoned by her parents, with no money. This child cannot purchase anything—food, clothing, medical care. This is an efficient outcome in a free market system. But is it fair?

What is fair?

I cannot tell you what is fair, nor can anyone else. You must decide for yourself what you deem to be fair.

Here are some relatively famous views of fairness (all simplified):

Laissez-faire:

The efficient outcome is fair. People get what they deserve. People are poor because they are lazy and rich because they work hard.

Marxist: “From each according to his ability, to each according to his need.”

People should contribute to society whatever their abilities enable them to contribute, and they should receive back from society what they need.

Maximin (Rawls):

A society should consistently strive to maximize the utility of the worst off person in the society.

Utilitarian (Bentham)

The fairest society is one in which government acts to maximize the sum of all citizens' combined utilities.

Welfare State

Citizens who have fallen on hard times through no fault of their own should be helped by the rest of us

Government can improve society by making it fairer.

Warning! Attempts to redistribute income from Rich to Poor can make the economy less efficient by reducing the incentive to work, save, and produce. Hence we sometimes hear of the *equity-efficiency tradeoff*.

Warning! In theory, government can do all kinds of neat stuff to make our economy fairer and more efficient. But in practice, if they do the wrong things, then they can actually make our economy less efficient and less fair!