

ROLE OF GOVERNMENT IN A MARKET ECONOMY

Discussion

With a partner, brainstorm ideas about what the government should do or what functions the government should perform in our economy

(create a written list)

Role of Government in a Market Economy

- Govt has a LIMITED role**
- In market economies, most decisions are made by individual consumers and producers/privately owned businesses**
- LAISSEZ-FAIRE (leave to do)**

Role of Government in a Market Economy

There ARE some roles the government plays in market economies...

Role of Government in a Market Economy

- 1) **Provide a legal system** to make and enforce laws and to protect private property rights
- 2) **Provide public goods** that individuals or private businesses would not provide

Role of Government in a Market Economy

- 3) **Correct market failures** such as external costs and external benefits
- 4) **Maintain competition** by regulating competition

Role of Government in a Market Economy

- 5) Redistribute income** by taxing those with larger incomes and helping those in need
- 6) Stabilize the economy** by reducing unemployment and inflation, and promoting economic growth

SURPRISE QUIZ TODAY!

Copies of the questions AND answers are available for \$1 each. IOUs are also acceptable.

HOW MANY WANT TO BUY A COPY OF THE QUIZ?

ECONOMIC QUIZ

WITH ANSWERS

1) Who wrote, “In this world nothing is certain but death and taxes”?

Benjamin Franklin

2) Who was the author of *The Wealth of Nations*?

Adam Smith

3) Who wrote *The General Theory of Employment, Interest, and Money*?

John Maynard Keynes

4) What does TNSTAAFL stand for?

There's no such thing as a free lunch

PUBLIC GOODS

WHY WERE MORE STUDENTS WILLING TO BUY THE QUIZ THE FIRST TIME THAN THE SECOND TIME?

MOST GOODS AND SERVICES PRODUCED IN MARKET ECONOMIES ARE *PRIVATE GOODS AND SERVICES*.

THE CONSUMERS WHO PURCHASE THESE GOODS CONSUME THESE GOODS; FOR EXAMPLE, A HAMBURGER IS A PRIVATE GOOD.

NATIONAL DEFENSE IS AN EXAMPLE OF A **PUBLIC GOOD**.

PUBLIC GOODS

PUBLIC GOODS DIFFER FROM PRIVATE GOODS BECAUSE THEY HAVE THESE CHARACTERISTICS:

SHARED CONSUMPTION:

WHEN ONE PERSON CONSUMES A PUBLIC GOOD, IT DOES NOT PREVENT OTHERS FROM ALSO CONSUMING THE GOOD

NONEXCLUSION:

ONCE A PUBLIC GOOD IS PRODUCED, IT IS DIFFICULT OR IMPOSSIBLE TO EXCLUDE OTHERS FROM CONSUMING THE GOOD, EVEN IF THEY DID NOT PAY FOR IT.

PUBLIC GOODS

BECAUSE PEOPLE CAN CONSUME PUBLIC GOODS WITHOUT PAYING FOR THEM (CALLED THE **FREE-RIDER PROBLEM**), PRIVATE BUSINESSES DO NOT HAVE INCENTIVES TO PRODUCE ENOUGH PUBLIC GOODS.

THEREFORE, THE GOVERNMENT OFTEN PROVIDES THEM, THROUGH TAX DOLLARS, IF PEOPLE WANT THEM.

EXTERNALITIES

MARKET PRICES USUALLY REFLECT THE COSTS PRODUCERS PAY TO PRODUCE GOODS AND THE BENEFITS CONSUMERS RECEIVE FROM THE GOOD.

A KIND OF **MARKET FAILURE** OCCURS WHEN MARKET PRICES FAIL TO REFLECT ALL THE COSTS AND ALL THE BENEFITS INVOLVED.

THIS KIND OF MARKET FAILURE IS CALLED AN ***EXTERNALITY PROBLEM.***

EXTERNALITIES

EXTERNALITIES EXIST WHEN SOME OF THE COSTS OR BENEFITS ASSOCIATED WITH THE PRODUCTION OR CONSUMPTION OF A PRODUCT SPILL OVER TO THIRD PARTIES, WHO DO NOT PRODUCE OR PAY TO CONSUME THE PRODUCT.

EXTERNALITIES

POSITIVE EXTERNALITIES ARE BENEFITS ENJOYED BY SOMEONE WHO DOES NOT PRODUCE OR PAY TO CONSUME A PRODUCT.

AN EXAMPLE OF A POSITIVE EXTERNALITY IS ELEMENTARY EDUCATION, BECAUSE SOCIETY AS A WHOLE BENEFITS WHEN OTHERS CAN READ AND WRITE. THE GOVERNMENT PROVIDES FREE PUBLIC EDUCATION TO ENCOURAGE EVERYONE TO BE EDUCATED.

POSITIVE EXTERNALITIES OFTEN CALL FOR GOVERNMENT SUBSIDIES OR GOVERNMENT PROVISION.

EXTERNALITIES

NEGATIVE EXTERNALITIES ARE COSTS PAID BY SOMEONE WHO DOES NOT PRODUCE OR PAY TO CONSUME A PRODUCT.

AN EXAMPLE OF A NEGATIVE EXTERNALITY IS AIR POLLUTION CAUSED BY CIGARETTE SMOKING:

BECAUSE OTHERS SUFFER FROM THE SMOKE, THE GOVERNMENT MAY PASS LAWS PREVENTING SMOKING IN CERTAIN PLACES.

NEGATIVE EXTERNALITIES OFTEN CALL FOR THE GOVERNMENT TO CLEARLY DEFINE PROPERTY RIGHTS, OR FOR CORRECTIVE GOVERNMENT MEASURES SUCH AS TAXATION OR FINES.

LIFE ON DISMAL LAKE

MAMA SMITH

PAPA SMITH

TEENAGE CHILD #1

TEENAGE CHILD #2

SNIVLEY WHIPLASH

15 FAMILIES

LIFE ON DISMAL LAKE

ACT I

THE SMITH FAMILY OWNS ALL THE LAND AROUND 100-ACRE DISMAL LAKE AND BUILDS ITS HOME ON THE EASTERN EDGE OF THE LAKE. LIFE IS VERY PLEASANT FOR THE FIRST YEAR. THEN, UNKNOWN TO MAMA AND PAPA, THE SMITH CHILDREN BEGIN THROWING THE FAMILY GARBAGE IN THE LAKE WHEN THEY TAKE IT OUT ONCE A WEEK, BECAUSE THIS IS EASIER THAN CARRYING THE BAGS ALL THE WAY TO THE ROAD FOR THE COUNTY TRASH TRUCKS TO PICK UP. AFTER A FEW MONTHS THE LAKE BEGINS TO STINK, AND MAMA AND PAPA SMITH DISCOVER WHERE THE GARBAGE HAS BEEN GOING. THE SMITH CHILDREN ARE NOW DISMAL BECAUSE THEY MUST CLEAN UP THE LAKE INSTEAD OF GOING OUT WITH THEIR FRIENDS FOR THE NEXT FOUR WEEKENDS.

LIFE ON DISMAL LAKE

DISCUSSION QUESTION:

ONLY THE SMITH FAMILY LIVES ON THE LAKE. IS THERE AN EXTERNALITY PROBLEM (ARE ANY COSTS IMPOSED ON OTHERS OUTSIDE THE FAMILY) WHEN THE CHILDREN THROW THE TRASH IN THE LAKE?

HOW SHOULD THIS PROBLEM BE SOLVED?

LIFE ON DISMAL LAKE

ACT II:

- SNIVLEY WHIPLASH

WHEN THE SMITH CHILDREN GO TO COLLEGE, MAMA AND PAPA SMITH SELL ALL THE LAND AROUND THE DISMAL LAKE EXCEPT THEIR ONE-ACRE HOMESTEAD TO A MAN NAMED SNIVELY WHIPLASH. WHIPLASH BUILDS A HOME ON THE WESTERN EDGE OF THE LAKE AND IMMEDIATELY STARTS THROWING GARBAGE INTO THE LAKE INSTEAD OF TAKING IT OUT TO THE ROAD FOR THE COUNTY TRASH SERVICE.

LIFE ON DISMAL LAKE

QUESTIONS FOR DISCUSSION:

NOW BOTH THE SMITHS AND WHIPLASH LIVE ON THE LAKE. IS THERE AN EXTERNALITY PROBLEM WHEN WHIPLASH THROWS GARBAGE INTO THE LAKE?

HOW SHOULD THIS PROBLEM BE SOLVED?

LIFE ON DISMAL LAKE

ACT III:

- 15 FAMILIES

ONE YEAR LATER WHIPLASH, WHO TURNS OUT TO BE AN UNSCRUPULOUS LAND DEVELOPER, STOPS THROWING TRASH IN DISMAL LAKE AND CLEANS IT UP. THEN HE SUBDIVIDES THE LAND, SELLS HOMESTEAD PLOTS TO 15 FAMILIES FOR \$100,000 EACH AND MOVES AWAY. THE 15 NEW OWNERS BUILD LARGE HOUSES ON THEIR LOTS. AFTER A FEW MONTHS, GARBAGE SHOWS UP ON AND AROUND DISMAL LAKE AGAIN – THIS TIME FROM TWO OR MORE UNIDENTIFIED FAMILIES.

LIFE ON DISMAL LAKE

ACT III, CONTINUED:

THE SMITHS CALL A NEIGHBORHOOD MEETING TO DISCUSS THE PROBLEM. AT THE MEETING, FOUR FAMILIES ACCUSE FIVE OTHER FAMILIES OF THROWING GARBAGE INTO THE LAKE. THE ACCUSED FAMILIES DENY THE CHARGES AND ACCUSE OTHER FAMILIES. THE MEETING BREAKS UP WITH EVERYONE SHOUTING AT EACH OTHER. DISMAL LAKE CONTINUES TO BE A SMELLY, DISMAL PLACE.

LIFE ON DISMAL LAKE

QUESTIONS FOR DISCUSSION:

NOW 16 FAMILIES LIVE ON THE LAKE. IS THERE AN EXTERNALITY PROBLEM WHEN SOME UNIDENTIFIED FAMILIES THROW GARBAGE INTO THE LAKE?

HOW CAN THIS PROBLEM BE SOLVED?

THE ROLE OF GOVERNMENT IN A MARKET ECONOMY

- 1) PROVIDE A LEGAL SYSTEM**
- 2) PROVIDE PUBLIC GOODS**
- 3) CORRECT MARKET FAILURES**
- 4) MAINTAIN COMPETITION**
- 5) REDISTRIBUTE INCOME**
- 6) STABILIZE THE ECONOMY**