

**29th Class**

**4/11/11**

Now starting the policy-focused part of the course

The goals are to show how economic theory leads to the proposing of governmental intervention, either into individual markets or into the economy as a whole, and how economic theory also provides a framework within which to evaluate governmental intervention

We'll lead off with three lectures about micro-intervention, i.e., intervention into specific markets, and then switch to macro-intervention

--today go over general principles for when micro policy can be good because it attempts to redress market failure

--Wed. discuss two important sources of market failure related to the nature of certain types of goods

--Fri. consider government's role in combating monopoly power

In general government intervention can either be justified on economic efficiency grounds (i.e. that it will increase efficiency) or on equity grounds (e.g., worry that freely operating markets do not lead to equitable outcomes)

In the earliest part of the course I often focused on cases where government intervention made markets less efficient. For instance, adding a tax or subsidy onto a market moved us away from the point chosen by the freely operating market and led to DWL. Similarly, quotas, price ceilings, and price floors led to DWL. Thus we were even able to measure the cost of government intervention as the DWL.

However, this assumed that the freely-operating market was at the optimal point to begin with. When are cases when this would not happen?

certain types of goods and markets do not fit the criteria we have set up for markets to work well

-some goods generate externalities; both negative and positive externalities call for market intervention in order to increase efficiency in cases where private markets are not able to coordinate their production appropriately (discuss appropriate intervention; in particular consider taxing negative externalities and subsidizing for positive externalities)

-some goods are underprovided by a private market; calls for direct provision by government in order to increase efficiency

-for some goods, it is inefficient to have more than one or two firms in an industry (natural monopoly cases); for other goods, anticompetitive practices have led to a small number of firms

--in case of natural monopoly, regulate pricing (need to have government run it? think of examples of former government monopolies that are now privatized)

--in case of lack of competition, regulate firm behavior so as to lead to lower prices, and in some cases, to encourage entry or potential entry by additional firms

-some additional more complex problems that I will mention but not analyze thoroughly in this course, related to imperfect or asymmetric information (thus violating the fundamental assumption of full information about everything, including all characteristics of the good and the buyers and sellers of the good)

--adverse selection (e.g. insurance markets, used car markets)

--moral hazard (e.g. car insurance, air bags)

-in addition, existence of transactions costs may cause certain markets to not exist or be much smaller than if there were no transactions costs; not really a market failure, just a fact; however sometimes the government (or a nonprofit) may be able to reduce transactions costs by for example serving as a creator of and clearing house for information (information is a public good) e.g. consumer product safety information

again this is really a failure of coordination; firms might also band together and tax themselves in order to create a way of paying for things of common interest (e.g., paying for a lobbyist)

note this is all different from the question of why markets for some goods exist in the first place since we assume that consumers are rational and buy things that they want

for an alternative view, see a recent Onion post:

<http://www.theonion.com/articles/continued-existence-of-edible-arrangements-disprov,19856/>

discussion of policy brings us back to dichotomies from the beginning of the course

--positive vs. normative (describing what is vs. prescribing what should be)

even if the prescription is based on an efficiency-increasing argument, it is still normative

efficiency vs. equity

sometimes the government may choose to intervene even if it reduces efficiency

though economists generally argue that the government should refrain from intervening in individual markets if the fundamental problem is that some people do not have enough income to participate fully in such markets; instead provide income transfers paid for out of general taxation revenue

--then prices in individual markets will not be distorted

e.g. if people can't afford housing, providing housing subsidies or instilling rent control is less efficient than simply giving them more income

e.g. if people can't afford food, same thing (providing food stamps or instilling price controls on food less efficient than simply giving them more income)

show the way these programs work in the US at the federal level

[http://en.wikipedia.org/wiki/Supplemental\\_Nutrition\\_Assistance\\_Program](http://en.wikipedia.org/wiki/Supplemental_Nutrition_Assistance_Program)

[http://en.wikipedia.org/wiki/Section\\_8\\_housing](http://en.wikipedia.org/wiki/Section_8_housing)

on the other hand, if we tie cash transfers to particular good behaviors we may be able to internalize externalities and provide income without distorting prices  
--note apparent success of Brazil's and Mexico's cash transfer systems to families in exchange for their increasing inputs into children (assuring school attendance, getting immunizations)—

Bolsa Familia and Oportunidades

<http://www.pri.org/business/global-development/mexico-anti-poverty-program.html>

[http://en.wikipedia.org/wiki/Bolsa\\_Fam%C3%ADlia](http://en.wikipedia.org/wiki/Bolsa_Fam%C3%ADlia)

<http://en.wikipedia.org/wiki/Oportunidades>

compare to problems occurring in Middle East over unsustainable food subsidies

Answers to Practice Problems from 4/8/11

I. 1) 0

2)  $Y = 800$ ;  $r = 10$

II. 1)  $Y = 800$ ;  $e = 1$

2)  $NX = 0$ , so no surplus or deficit

III. 1)  $Y = 800$ ;  $r = 10$ ;  $e = 1$ ,  $NX = 0$

2)  $Y = 675$ ,  $r = 8.75$ ,  $e = 1.75$ ,  $NX = -37.5$