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Chapter 1 : Public goods: real-world examples (article) | Khan Academy

Public Goods and Externalities, by Tyler Cowen, from the Concise Encyclopedia of Economics Most economic arguments for government intervention are based on the idea that the marketplace cannot provide public goods or handle externalities.

Individual life, liberty, and the pursuit of happiness are commonly cited. Health is a fundamental private good. Some minimal level of material well-being is part of the "good life" envisioned by the founders of the country, but it is important to note that in the Classical tradition on which the founders drew, the good life, or "happiness," included more than material well-being. In this tradition participation in the life of society is commonly considered part of the "good life. What is a "private good"? Two related ethical questions in a democratic society are "Should everyone have at least an adequate opportunity to succeed in their efforts in the pursuit of happiness? Some individuals have inspiring stories about how they overcame adversity to achieve success. These stories, while they may be true, function as cultural myths, telling us about our aspirations as a society. But are these inspiring stories representative ones, or are they striking because they are exceptional? We never read the stories of those who suffered initial disadvantages, worked hard, played by the rules, and yet did not succeed. Among the many reasons to explain failure in these stories we do not hear, one that is difficult to exclude is that the barriers to success were too great. These stories are either mundane or depressing. They do not tell us what we want to believe about our society. We would prefer to think that those individuals who did not succeed were responsible for the outcome, that they failed as a result of some personal deficiency, that in this respect they are fundamentally unlike the rest of us. For centuries this kind of thinking has been applied as a way of explaining misfortune, whether sickness or economic: The converse of this logic is that success serves as verification of deservedness. But do particular people who suffer sickness or who are economically struggling deserve their situation? And if they do not, should anyone else care? If they do not deserve their situation, is there any collective responsibility to right the injustice they experience? Even if they were thought to deserve their situation, is there any obligation to help our fellow citizens? These are ethical questions. We can and do argue about how well we can sort out causes for the adverse circumstances experienced by grown adults. But for children, one simply cannot argue coherently that they have deserved their situation, whether it be a favorable or unfavorable one. They are simply lucky or unlucky as to birth. So on the basis of justice it would seem beyond reproach that children should have some minimally adequate opportunity to succeed. It is a fundamental question of justice that children be provided with opportunity to accomplish an education. The same can be argued with respect to food and shelter for children: They have a right to a certain level of private goods. What is the proper role of government concerning the well-being of its citizens? Minimally it is to provide those necessary goods that cannot be achieved by individuals acting as discrete entities. The common defense is certainly a necessary and perhaps the primary "public good" according to this definition. Provision of clean air is a public good. Minimization of contagious disease is a public good. Construction and maintenance of roads is a public good. Provision of safe drinking water and electricity are recognized in law as public goods, in that these services are provided by public utilities. Maintaining social and economic order through a legal system and enforcing the laws are also public goods. Laws to ensure provision of public goods typically constrain private goods, even with respect to life, liberty, and the pursuit of happiness. All these public goods require resources to accomplish, and these resources include individual acknowledgment of legitimate constraints on their private goods, including payment of taxes levied groupwise. There is a tight relationship between the various public goods and the resources required to accomplish them. Before determining the proper relationship, one ought to have an understanding of the value of public goods, as well as of the rationale for their publicness. Thus the question of whether education should be considered an important "public good" should first be framed independently of the question of what level of taxes is acceptable. Once this question and others about other public goods are

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answered, all the "public goods" and their costs should be then be prioritized and considered against the cost to individuals in the form of taxes. It may well be that all the desirable public goods envisioned will be deemed to be too expensive to accomplish, and careful deliberation will be required to resolve the matter of which are important enough to fund with public money. Taking a position about what is an unacceptable level of taxes without first being clear about the full nature and scope of the public goods in question is simply narrow-minded and short-sighted. It is to be rejected on pragmatic grounds. Education is an important public good. But education of children is more than a public good with respect to the right to social justice for the individual children. It is also a public good because an educated populace is in the interest of all to ensure mutual economic well-being and to ensure a strong and viable democracy. Public education has a long history in the U. This country led the world in providing public access to education in the early s. Public education, funded by taxes, has been a long-standing collective statement that education of children is a public good. Children participating in public education embody by their participation the development of this public good. Providing access to public education has come to be considered a responsibility or duty of government, not a right that must be demanded. The history of public education in the U. The Morrill Act of was a striking statement by the U. Congress that higher education is also a public good. By virtue of this Act, the U. Congress declared that higher education for those not part of the economic and social elite was a public good. This Act made a strong contribution to the economic well-being of a large part of the U. This Act established a route by which many of the less privileged could work hard and achieve success. It was in the spirit of the American dream, an opportunity for hard work to pay off, for upward economic mobility not to be limited to the inspiring stories of the few who manage to overcome great disadvantages. If we are solely responsible for our successes in the pursuit of happiness, perhaps we could even defend keeping all our resources for personal use. But if we are not solely responsible, then to the extent that we are not, it is as if we were given the happiness we have. Our collective sense of justice, as well a specifically Christian ethic both say that much is rightly expected of those to whom much is given. Those who have done well in their pursuit of happiness have some obligation to help those who have not done well. Those earning more should pay a disproportionately greater share of the taxes to support public goods. Taxes to support the public good should not fall disproportionately on those less well off. Public education is important in this country for two reasons, both of which speak to "public goods. The second public good is the collective economic good. Reduction of public investment in public education is a reduction in the public good in both senses. The extent of the role of government in our lives should be considered pragmatically, not ideologically. A pragmatic view judges the value of government actions by the outcomes. One outcome of a minimal role of government is a minimal ability to accomplish public goods of many types. A decreased prioritization of public goods is in effect a diminished sense of social responsibility among citizens. Considered solely from the perspective of the individual in the short term, it is hard for an individual not to see an appeal in this outcome. But the proper role of government, determined by a resolution of the tension between level of taxation and level of public goods, should not be determined without a full consideration of the role of government with respect to the public goods to be valued. Resolving this tension is a matter for careful pragmatic consideration. I suspect that many in this country have taken for granted the ready availability of public goods of many types, losing the ability to perceive these public goods for what they are. Without a clear consideration of the value of public goods it is easy to reduce the level of contributions we ask of ourselves collectively to produce these public goods. I hope we will consider the entire scope of our collective democratic project, and "measure twice" before cutting. Because what would be cut is not limited to taxes and not limited to particular public goods; it involves our individual relationships to our collective society. We run a serious risk of diminishing our collective selves as a people, which may be the most important public good of all. This broad form of public good may be invisible from a myopic view focusing on private goods. I predict that if dramatic reduction of the role of government is accomplished without careful consideration of public goods that are in fact important to all of us, the reduction of public goods will eventually be apparent, visible once again even to those citizens

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who think that this reduction is a good idea today. Yet even presuming the accuracy of this prediction, I worry about the time it will take to realize what will have been lost and the additional time for remedies to be instituted and accomplished. Of course, my prediction may be wrong. Our diminished sense of the public good may diminish us as a people so thoroughly that we cannot recover the public-spiritedness that has contributed to the greatness of this country.

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Chapter 2 : Public good - Wikipedia

education occurs if there are positive externalities. The simple reason for this is that the price of the "good" in the case of education and the price of the "bad" in the case of pollution do not reflect the true social costs of production (for pollution).

Externalities, Public Goods, and Social Choice market failure Occurs when resources are misallocated or allocated inefficiently. Externalities externality A cost or benefit imposed on, or enjoyed by an individual or a group that is outside, or external to, the transaction. MSC is equal to the sum of the marginal costs of producing the product and measures the true cost " internal and external " of the process of production. The case of acid rain highlights the fact that efficiency analysis ignores the distribution of gains and losses. To establish efficiency, we need only demonstrate that the total value of the gains exceeds the total value of the losses. But when UK acid rain lands on Sweden, the Swedish bear the cost. The costs are borne unequally. When people drive their cars into the city at rush hour, they contribute to the congestion and impose costs in the form of lost time and poisonous emissions on others. The most significant and hotly debated issue of externalities is global warming. When other people or firms engage in an activity, there are benefits from that activity enjoyed by people outside of the immediate activity. From an economics perspective, there are problems with positive externalities as well. The problem with positive externalities is that the individuals in charge have too little incentive to engage in the activity because someone is providing it for nothing. Externalities and Environmental Economics Private Choices and External Effects Externalities in a Village The marginal benefits to Harry exceed the marginal costs he must bear to play his stereo system for a period of up to 8 hours. When the stereo is playing, a cost is being imposed on his next door neighbour, Jake. When we add the costs borne by Harry to the damage costs imposed on Jake, we get the full cost of the stereo to the two-person village made up of Harry and Jake. Playing the stereo more than 5 hours is inefficient because the benefits to Harry are less than the social cost for every hour above 5. Externalities and Environmental Economics Private Choices and External Effects marginal private cost MPC The amount that a consumer pays to consume an additional unit of a particular good. If a pesticide pollutes the water in a river, MDC is the additional cost imposed by the added pollution that results from increasing output by 1 unit of pesticide per period. Externalities and Environmental Economics Internalising Externalities Five approaches have been taken to solving the problem of externalities: While each is best suited for a different set of circumstances, all five provide decision makers with an incentive to weigh the external effects of their decisions. An example of 4 is carbon permit trading. Externalities and Environmental Economics Internalising Externalities " Taxes and Subsidies Tax Imposed on a Firm Equal to Marginal Damage Cost If a per-unit tax exactly equal to marginal damage costs is imposed on a firm, the firm will weigh the tax, and thus the damage costs, in its decisions. At the new equilibrium price, P_1 , consumers will be paying an amount sufficient to cover full resource costs as well as the cost of damage imposed. The efficient level of output for the firm is q_1 . The biggest problem with using taxes and subsidies is that damages must be estimated in financial terms. Taxes also provide firms with an incentive to use the most efficient technology for dealing with damage. Externalities and Environmental Economics Internalising Externalities Bargaining and Negotiation Coase theorem Under certain conditions, when externalities are present, private parties can arrive at the efficient solution without government involvement. Legal Rules and Procedures injunction A court order forbidding the continuation of behavior that leads to damages. The Kyoto Protocol is an international treaty on global warming negotiated by the United Nations in the It came into force after it was ratified by Russia in February A total of countries have ratified the agreement, which commits them to reduce their emissions of carbon dioxide and five other greenhouse gases or to engage in emissions trading. The United States refused to ratify the treaty. Note that some economists have argued for redistribution of income on grounds that it generates public benefits. If we accept the idea that redistributing income generates a public good, private endeavours

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may fail to do what we want them to do, and government involvement may be called for. Public Social Goods

Public Provision of Public Goods All societies, past and present, have had to face the problem of providing public goods. When members of society get together to form a government, they do so to provide themselves with goods and services that will not be provided if they act separately. Public Social Goods

Optimal Provision of Public Goods Economist Paul Samuelson demonstrated that there exists an optimal, or a most efficient, level of output for every public good. Private producers, whether perfect competitors or monopolists, are constrained by the market demand for their products. If they cannot sell their products for more than it costs to produce them, they will be out of business. Because private goods permit exclusion, firms can withhold their products until households pay. We all buy the quantity of each private good that we want. Market demand is the horizontal sum of all individual demand curves. This means adding demand curves vertically. The Problems of Optimal Provision

One major problem exists. Social Choice Government Inefficiency: Theory of Public Choice Looking at the public sector from the standpoint of the behaviour of public officials and the potential for inefficient choices and bureaucratic waste rather than in terms of its potential for improving the allocation of resources has become quite popular. This is the viewpoint of what is called the public choice field in economics that builds heavily on the work of Nobel laureate James Buchanan.

Social Choice Rent-Seeking Revisited A monopolist would be willing to pay to prevent competition from eroding its economic profits. Many "if not all" industries lobby for favourable treatment, softer regulation, or antitrust exemption. This we call rent-seeking. Theory may suggest that unregulated markets fail to produce an efficient allocation of resources. This should not lead you to the conclusion that government involvement necessarily leads to efficiency. There are reasons to believe that government attempts to produce the right goods and services in the right quantities efficiently may fail. Government and the Market There is no question that government must be involved in both the provision of public goods and the control of externalities. The question is not whether we need government involvement. The question is how much and what kind of government involvement we should have.

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Chapter 3 : Market failure - Wikipedia

Chapter Public Goods, Externalities, and Government Behavior All levels of government participate in the economy in a variety of ways. For example, they produce goods and services, purchase goods and services, mandate that people buy certain products, and mandate that firms use certain methods of production.

Public goods free-to-air television, air, national defense Elinor Ostrom proposed additional modifications to the classification of goods to identify fundamental differences that affect the incentives facing individuals [8] 1 Replacing the term "rivalry of consumption" with "subtractability of use". Forests, water systems, fisheries, and the global atmosphere are all common-pool resources of immense importance for the survival of humans on this earth. Challenges in identifying public goods[edit] The definition of non-excludability states that it is impossible to exclude individuals from consumption. Technology now allows radio or TV broadcasts to be encrypted such that persons without a special decoder are excluded from the broadcast. Many forms of information goods have characteristics of public goods. For example, a poem can be read by many people without reducing the consumption of that good by others; in this sense, it is non-rivalrous. Similarly, the information in most patents can be used by any party without reducing consumption of that good by others. Official statistics provide a clear example of information goods that are public goods, since they are created to be non-excludable. Creative works may be excludable in some circumstances, however: Copyrights and patents both encourage the creation of such non-rival goods by providing temporary monopolies, or, in the terminology of public goods, providing a legal mechanism to enforce excludability for a limited period of time. For public goods, the "lost revenue" of the producer of the good is not part of the definition: Steven Shavell has suggested the following: Although it is often the case that government is involved in producing public goods, this is not necessarily the case. Public goods may be naturally available. They may be produced by private individuals and firms, by non-state collective action, or they may not be produced at all. However, some theorists such as Inge Kaul use the term " global public good " for public goods which is non-rival and non-excludable throughout the whole world, as opposed to a public good which exists in just one national area. Knowledge has been held to be an example of a global public good, [12] but also as a commons, the knowledge commons. This is in contrast to the procedure for deriving the aggregate demand for a private good, where individual demands are summed horizontally. Social goods[edit] Social goods are defined[by whom? Note that some writers have used the term "public good" to refer only to non-excludable "pure public goods" and refer to excludable public goods as " club goods ". Some goods, like orphan drugs, require special governmental incentives to be produced, but cannot be classified as public goods since they do not fulfill the above requirements non-excludable and non-rivalrous. Law enforcement, streets, libraries, museums, and education are commonly misclassified as public goods, but they are technically classified in economic terms as quasi-public goods because excludability is possible, but they do still fit some of the characteristics of public goods. This has been sufficient to fund actual lighthouses. Technological progress can create new public goods. The most simple examples are street lights, which are relatively recent inventions by historical standards. Official statistics are another example. Technological progress can significantly impact excludability of traditional public goods: The costs for electronic road pricing have fallen dramatically, paving the way for detailed billing based on actual use. Some question whether defense is a public good. It consists of specific resources committed in certain definite and concrete waysâ€”and these resources are necessarily scarce. A ring of defense bases around New York, for example, cuts down the amount possibly available around San Francisco. Free rider problem Public goods provide a very important example of market failure, in which market-like behavior of individual gain-seeking does not produce efficient results. The production of public goods results in positive externalities which are not remunerated. If private organizations do not reap all the benefits of a public good which they have produced, their incentives to produce it voluntarily might be insufficient. Consumers can take advantage of public goods without contributing sufficiently to their creation.

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If too many consumers decide to "free-ride", private costs exceed private benefits and the incentive to provide the good or service through the market disappears. The market thus fails to provide a good or service for which there is a need. Public goods give such a person an incentive to be a free rider. For example, consider national defense, a standard example of a pure public good. Suppose homo economicus thinks about exerting some extra effort to defend the nation. The benefits to the individual of this effort would be very low, since the benefits would be distributed among all of the millions of other people in the country. There is also a very high possibility that he or she could get injured or killed during the course of his or her military service. On the other hand, the free rider knows that he or she cannot be excluded from the benefits of national defense, regardless of whether he or she contributes to it. There is also no way that these benefits can be split up and distributed as individual parcels to people. The free rider would not voluntarily exert any extra effort, unless there is some inherent pleasure or material reward for doing so for example, money paid by the government, as with an all-volunteer army or mercenaries. The free-riding problem is even more complicated than it was thought to be until recently. Any time non-excludability results in failure to pay the true marginal value often called the "demand revelation problem", it will also result in failure to generate proper income levels, since households will not give up valuable leisure if they cannot individually increment a good. In the case of information goods, an inventor of a new product may benefit all of society, but hardly anyone is willing to pay for the invention if they can benefit from it for free. In the case of an information good, however, because of its characteristics of non-excludability and also because of almost zero reproduction costs, commoditization is difficult and not always efficient even from a neoclassical economic point of view.

Assurance contract An assurance contract is a contract in which participants make a binding pledge to contribute to building a public good, contingent on a quorum of a predetermined size being reached. Otherwise the good is not provided and any monetary contributions are refunded. A dominant assurance contract is a variation in which an entrepreneur creates the contract and refunds the initial pledge plus an additional sum of money if the quorum is not reached. The entrepreneur profits by collecting a fee if the quorum is reached and the good is provided. In game-theoretic terms this makes pledging to build the public good a dominant strategy: My aim in doing so was not to describe what life would be like in such a world but to provide a simple setting in which to develop the analysis and, what was even more important, to make clear the fundamental role which transaction costs do, and should, play in the fashioning of the institutions which make up the economic system. The world of zero transaction costs has often been described as a Coasian world. Nothing could be further from the truth. It is the world of modern economic theory, one which I was hoping to persuade economists to leave. I argued in such a world the allocation of resources would be independent of the legal position, a result which Stigler dubbed the "Coase theorem. A minor alternative, especially for information goods, is for the producer to refuse to release a good to the public until payment to cover costs is met. Author Stephen King, for instance, authored chapters of a new novel downloadable for free on his website while stating that he would not release subsequent chapters unless a certain amount of money was raised. Sometimes dubbed holding for ransom, this method of public goods production is a modern application of the street performer protocol for public goods production. Unlike assurance contracts, its success relies largely on social norms to ensure to some extent that the threshold is reached and partial contributions are not wasted. One of the purest Coasian solutions today is the new phenomenon of Internet crowdfunding. Here rules are enforced by computer algorithms and legal contracts as well as social pressure. For example, on the Kickstarter site, each funder authorizes a credit card purchase to buy a new product or receive other promised benefits, but no money changes hands until the funding goal is met.

Government provision[edit] If voluntary provision of public goods will not work, then the solution is making their provision involuntary. This saves each of us from our own tendency to be a free rider, while also assuring us that no one else will be allowed to free ride. One frequently proposed solution to the problem is for governments or states to impose taxation to fund the production of public goods. This does not actually solve the theoretical problem because good government is itself a public good. Thus it is difficult to ensure the government has an incentive to provide the optimum amount even if it were possible for the

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government to determine precisely what amount would be optimum. These issues are studied by public choice theory and public finance. Sometimes the government provides public goods using "unfunded mandates". An example is the requirement that every car be fit with a catalytic converter. This may be executed in the private sector, but the end result is predetermined by the state: Unfunded mandates have also been imposed by the U.S. Regardless, the role of the government is to provide vital goods to all individuals, some of which they cannot obtain on themselves. However, this is not possible with all goods such as pure public goods that are inseparable and inclusive, thus require "provision by public means". Unlike government provision, subsidies may result in some form of a competitive market. The potential for cronyism for example, an alliance between political insiders and the businesses receiving subsidies can be limited with secret bidding for the subsidies or application of the subsidies following clear general principles. Depending on the nature of a public good and a related subsidy, principal-agent problems can arise between the citizens and the government or between the government and the subsidized producers; this effect and counter-measures taken to address it can diminish the benefits of the subsidy. Subsidies can also be used in areas with a potential for non-individualism: For instance, a state may subsidize devices to reduce air pollution and appeal to citizens to cover the remaining costs. Similarly, a joint-product model analyzes the collaborative effect of joining a private good to a public good. For example, a tax deduction private good can be tied to a donation to a charity public good. It can be shown that the provision of the public good increases when tied to the private good, as long as the private good is provided by a monopoly otherwise the private good would be provided by competitors without the link to the public good.

Privileged group[edit] The study of collective action shows that public goods are still produced when one individual benefits more from the public good than it costs him to produce it; examples include benefits from individual use, intrinsic motivation to produce, and business models based on selling complement goods. A group that contains such individuals is called a privileged group. A historical example could be a downtown entrepreneur who erects a street light in front of his shop to attract customers; even though there are positive external benefits to neighboring nonpaying businesses, the added customers to the paying shop provide enough revenue to cover the costs of the street light. The existence of privileged groups may not be a complete solution to the free rider problem, however, as underproduction of the public good may still result. An example of the privileged group solution could be the Linux community, assuming that users derive more benefit from contributing than it costs them to do it. Another example is those musicians and writers who create music and writings for their own personal enjoyment, and publish because they enjoy having an audience. Financial incentives are not necessary to ensure the creation of these public goods. Whether this creates the correct production level of writings and music is an open question.

Merging free riders[edit] Another method of overcoming the free rider problem is to simply eliminate the profit incentive for free riding by buying out all the potential free riders. A property developer that owned an entire city street, for instance, would not need to worry about free riders when erecting street lights since he owns every business that could benefit from the street light without paying. Implicitly, then, the property developer would erect street lights until the marginal social benefit met the marginal social cost. In this case, they are equivalent to the private marginal benefits and costs. While the purchase of all potential free riders may solve the problem of underproduction due to free riders in smaller markets, it may simultaneously introduce the problem of underproduction due to monopoly.

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Chapter 4 : Market Failure vs. Government Failure | Goodman Institute for Public Policy Research

may undersupply good that generates positive externalities or benefits, and it may oversupply good that generates negative externalities or costs. Okay, enough with the abstractions.

The existence of market failure is often taken as an excuse for government intervention to do whatever markets fail to do. As a first approximation, I am going to define the market as the sphere of activity where everything is voluntary. All trade is voluntary. All transfers of income and wealth among people are voluntary. I am going to define government as the sphere of activity where everything is coercive. Government puts limits on private behavior and enforces those limits by fines, taxes, imprisonment and even death. Also government may force private citizens to do what they otherwise would not have done – again, under threat of force. So everything that is voluntary is a market activity. Everything that is coercive is a government activity. In the economic realm, that idea is very well defined. An ideal economic arrangement is one in which people have exhausted all opportunities for mutually beneficial exchange. Once they have done that, there is no way to make one person better off without making someone else worse off. Such a condition is called Pareto Optimality. Market failure is also well defined. It means failure to achieve Pareto Optimality. Why would that occur? According to Hernando de Soto, if you live in the slums on the outskirts of Lima, Peru and you accumulate any assets, you have to invest resources in protecting your assets, since the Lima police are unlikely to be of much help. Put another way, when government protects people from acts of force and fraud it is insuring that all behavior really is voluntary. In these roles, government is enabling and expanding the range of potential voluntary behavior and creating new opportunities for everyone to become better off. Are there any other reasons why markets might fail to achieve the Pareto Optimal ideal? One is the existence of public goods – defined as a good whose benefits accrue to everyone, regardless of whether or not the consumer contributes to its production. A dam that prevents periodic flooding is an example. A lighthouse that prevents ship wrecks is another. In both cases I benefit even if I contribute nothing. So my economic incentive is to be a free rider and hope that others chip in and create the public good without my help. Because of this incentive, economics predicts that in a world of purely voluntary behavior public goods will be under produced and private goods will be over produced – relative to the ideal. Another reason why markets may fail is the existence of externalities – by which we mean important effects that are external to the market. For example, if you and I are ship owners and I build a lighthouse to protect my ships from a dangerous reef, you are able to get an external benefit for which you never paid a price. As the previous paragraph shows, the problem of public goods is a subset of the more general problem of externalities. There are also negative externalities. Pollution is an example. In a Pareto Optimal world, we will produce things until the marginal social benefit equals the marginal social cost. But in the presence of these market failures, economics has a clear prediction: If we all care about the suffering of the poor and I give money to relieve that suffering, I am not just helping the poor; I am also helping you, the early Friedman reasoned. Without coercion, you and others like you will be tempted to be a free rider on my charity. Thus, purely private, voluntary charity results in too little help for the poor. The Nobel Prize winning economist Ronald Coase had a way of summarizing all of this that is helpful. Coase said the only reason why there is market failure at all is because of transaction costs. As long as there are well defined property rights, the only thing that can prevent mutual beneficial arrangements is the costs of reaching agreement, including information costs, communication costs, bargaining costs, etc. Imagine five people stranded on an island and suppose they deal with each other in a completely voluntary way. Is there any reason for them to form a government? None that I can think of. If there is a public good that needs to be produced digging a well, for example, there is nothing to prevent them from agreeing to produce it and agreeing on how to share the cost. Ideal Government Until recently, almost all economics textbooks treated government as though it always acted ideally. If there are public goods, we need government to produce them. If there are negative externalities, like pollution, we need government to curtail them. If there are positive

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externalities, like symphonies and art museums, again we need government to subsidize them. The idea that government might systematically do the wrong thing was not seriously considered. That attitude is strange, when you stop to think about it. Fail to build a dam or a lighthouse? You might point to an unsafe drug or two or an unsafe automobile and in these cases there may have been a few thousand preventable deaths. The most urgent need in the world right now is not the need to regulate private economic activity. It is the need to restrain bad government. What would ideal government look like? It looks just like the ideal economic system. Why do governments fail at this task? They fail for the same reasons markets fail. Imagine everyone in the United States "all million of us" gathering together in a big political convention to sort out what to do about all the public goods and externality problems. That would be impossibly unwieldy. Or to use the language of economics, the transactions costs of getting agreement at such a convention would be almost infinitely high. In that case we would have to convince million people to agree on something. They just become less visible. That means everyone on the same side has an incentive to be a free rider. We all benefit if our favorite candidate wins regardless of our contribution to the effort. So in general, we are less likely to vote, to contribute money, to engage in get-out-the vote activities, or even to learn much about what the candidates stand for than if the goal were to secure a private good of equal value. The same principles apply to legislation. Imagine a bill to change government policy in a way that would be optimal. Such a change is like a public good. Each of us has an incentive to be a free rider, since we benefit from the change whether or not we help get it passed. However, on the other side there are likely to be special interests who will oppose the bill. Although these people also face problems of collective action, for them the defeat of the bill is more like a private good. Their individual stake in the issue is very large, whereas the stake for you and me is very small. Thus the economic prediction: People can make an effort to influence public policy in many ways. They can vote, contribute money, time and labor. Whatever they do, optimal public policy will result if 1 people have perfect knowledge about how various public policies will personally affect them, 2 candidates have perfect knowledge about what voters want and the level of support they are willing to offer, 3 the various forms of effort voting, money, labor, etc. That last condition was not a misprint. The effort each of us makes as a percent of any benefit we expect to receive must be equal across all citizens. And if they are not equal, say, because some people are members of organized trade associations that bundle votes and campaign contributions in order to increase their influence while others do not, large welfare losses will result. Since the conditions for optimality are not even remotely likely to ever be met, that leads to: Optimal public policy will never occur. Now consider the following problem. Since we know that government decision making is inherently faulty, the strong presumption is that things should be left to the market. Entrepreneurship is the discovery of previously unexploited opportunities to make people better off. If you like, you can regard every one of those previously unexploited opportunities as a case of market failure. They exist because of imperfect information, imperfect communication etc. Every case of market failure is a potential opportunity for an entrepreneur to get rich. No one gets rich by copying what everyone else is doing. Innovators get rich if they can figure out how to solve previously unsolved problems. And entrepreneurship is a natural force in a dynamic, capitalist economy. There is no countervailing force in the public sector, however. There can be political entrepreneurs, of course. But there is no natural tendency for them to move us in the direction of a Pareto Optimal world. They gain by increasing their vote total. Thus, market failure must be large and enduring before it is wise to supplant it with government decision-making. Global warming is one example. National defense is another. But for ordinary markets, we are almost always going to be better off to keep government at bay. The Failure to Understand Government Failure For some reason a lot of people have blinders on when it comes to thinking about government.

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Chapter 5 : Lesson Plan: Externalities and Public Goods - ppt Summary - Economic Investigations

Externalities. Private markets, such as the cell phone industry, offer an efficient way to put buyers and sellers together and determine what goods are produced, how they are produced, and who gets them.

Economics of governance 6. Endogenous policy theory F. Main alternative to public choice: Social Benefits and Costs A. Background to public choice: A thief clearly enjoys private benefits of stealing. The thief making himself better off by making others worse off. How to measure "social benefits"? The same way we always do: If some people benefit and some people suffer from a policy, the net social benefits are the SUM of the private benefits positive and negative. Issues frequently become political when private and social costs differ. Moreover, once a decision is political, it almost inevitably implies costs and benefits for people who opposed the decision, not just its supporters. The Tragedy of the Commons A. Economists usually focus on how ownership gives people incentives to use resources in a sensible way. But it is possible for something to be unowned. This has frequently happened. For example, a pasture may be "common property. Frequently, however, common ownership gives rise to what economists call the "tragedy of the commons. This can "snowball" into an awful outcome that benefits no one. If one person owned the fisheries, or a forest, or a pasture, they would have the incentive to maintain it, improve it, and take a long-term perspective. That is the benefit of property rights that is absent in the commons - a benefit not just for owners, but for users as well. In sum, the basic idea of the tragedy of the commons is that when no one owns a resource, it gets over-used. But what exactly does "over-use" mean in economic terms? Economists call these costly side effects "negative externalities. How do you diagram negative externalities? In addition to the demand curve, draw a "social benefits curve. Social optimum is at the intersection of the social benefits curve and the supply curve, but market equilibrium is at the intersection of the demand curve and the supply curve. Economists call this a market failure, since self-interested behavior leads to inefficient results. Negative externalities are also often called "public bads," especially when the externalities are large relative to demand so the socially optimal quantity is close to zero. People value better air, but polluters normally have no incentive to care. There is no feasible way to exclude non-payers from the cleaner air. Since you do not have to pay to use it, selfish people will not pay to use it. And if no one will pay for it, why would selfish producers provide it? Positive externalities are the other side of the coin. Draw a social benefits curve above the demand curve. Positive externalities are also often called "public goods," especially when the externalities are large relative to demand so the equilibrium quantity is close to zero. Non-excludability is once again the key attribute. People value defense, but how can suppliers be paid to provide it? Must distinguish benefits from external benefits. Must include both positive and negative externalities in your calculations. Some popular and plausible examples: Some popular but dubious examples: Some unpopular but plausible examples depending on the society: Further insight from Friedman: The problem with public goods is not that one person pays for what someone else gets but that nobody pays and nobody gets, even though the good is worth more than it would cost to produce. Correcting for Negative Externalities A. A common initial reaction people have to negative externalities is: The cure is worse than the disease. Many valuable activities like driving and even many activities essential to life like breathing! A particularly crazy variant: Perverse effects of technological mandates: Since they raise the price of new cars, they encourage people to keep driving old cars that pollute a lot more. These approaches are highly inefficient. Quantitative limits and technological mandates ignore heterogeneity: Some firms can reduce pollution more cheaply than others; some people may value polluting more than others; some technologies may cost more than they are worth. More efficient regulatory solutions that take heterogeneity into account exist: This gets you the same pollution level at a lower price. Firms that can easily switch to less polluting technologies sell their permits to firms where reducing pollution is expensive. Getting the margin right. A tax on cars reduces the number of cars produced, but does nothing to discourage people who own cars from polluting. Correcting for Positive Externalities A. A common initial

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reaction people have to positive externalities is: There is no need for government to take over the whole industry just because of some positive externalities. A much less intrusive option is for government to subsidize activities with positive externalities. Getting the margin right: Suppose there are positive externalities of voter education, but not math. If you subsidize ALL education, adjusting for the externalities of voter education leads to an inefficiently high level of mathematical education. The economist Ronald Coase pointed out that government action to correct externalities is often premature. Another solution to the externality problem is to define property rights, then allowing parties to bargain. Common sense ethics tells us to distinguish e. But from an economic point of view it can be equally efficient to make polluters pay pollutees for the right to pollute, or have pollutees pay the polluters to pollute less. Externalities as a Rationale for Government Intervention A. When economists see negative externalities, their usual reaction is to say "Government should tax or ban that. When economists see positive externalities, their usual reaction is to say "Government should subsidize or produce that. If government has the power to tax negative externalities, political forces may lead it to tax all sorts of things with no negative externalities to speak of. Similarly, if government has the power to subsidize positive externalities, political forces may lead it to subsidize all sorts of things with no positive externalities to speak of. In other words, externalities may affect government behavior as well as market behavior. If so, we face a choice between market failure and government failure. Voter acquisition of information XI. The tale of the Roman emperor and the two minstrels. The sensible approach is comparative. What are the main public goods problems markets face? The main public goods problems governments face? How can markets and governments solve public goods problems? The unanimous contract condo association 3. The privileged minority mowing your lawn 4. Bundling commercials on radio and TV 5. Merger orchard owner marries beekeeper F. Constitutional reform is a popular answer, but there is every reason to think that constitutional politics works just like regular politics. If the government is unable to solve the public goods problems of government, then there is no reason to think that government will want to solve the public goods problems of markets that it can solve! Perhaps this explains why most of what actual governments do has nothing to do with public goods: Social Security, Medicare, education