



THE PUBLIC SECTOR PART I

There are people in the public sector with a range of experiences that have no equivalent in business, but are essential to governing ... The value of those skills can't easily be measured against a bottom line.

Dee Dee Myers



MARKET FAILURE

☞ Our goal is to produce the optimal mix of output.

... An optimal mix of output is the most desirable combination of output attainable with existing resources, technology and social values.



MARKET FAILURE

☞ Ideally, the market mechanism leads to an optimal mix of output.

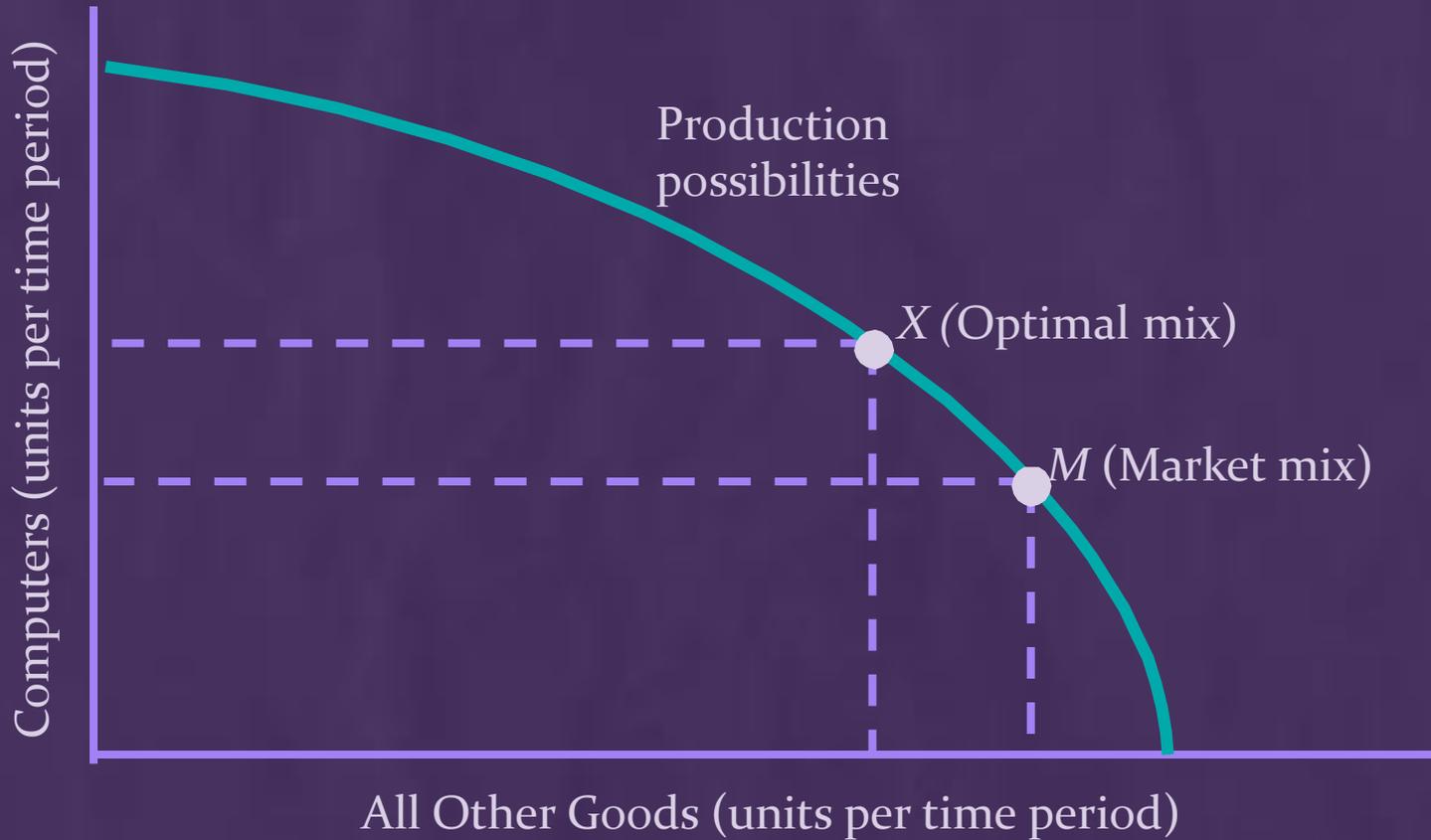
... The market mechanism uses market prices and sales to signal desired outputs (or resource allocations).

MARKET FAILURE

Market failure occurs when an imperfection in the market mechanism prevents optimal outcomes.



CHART: MARKET FAILURE





CAUSES OF MARKET FAILURE

∞ The four specific sources of market failure are:

... public goods

... externalities

... market power

... equity



PUBLIC GOODS

- ⌘ A private good is a good or service whose consumption by one person excludes consumption by others.
- ⌘ A public good is a good or service whose consumption by one person does not exclude consumption by others (parks, roads, public schools, etc).



THE FREE-RIDER DILEMMA

∞ The communal nature of public goods may cause consumers to try for a free ride.

... A free rider is an individual who reaps direct benefits from someone else's purchase (consumption) of a public good.



UNDERPRODUCTION OF PUBLIC GOODS

- ⌘ Markets tend to under-produce public goods and over-produce private goods.
- ⌘ If we want more public goods, we need a non-market force — government intervention — to get them.



EXTERNALITIES

∞ Externalities are the costs (or benefits) of a market activity borne (or enjoyed) by a third party.

... The difference between the social and private costs (or benefits) of a market activity.



EXTERNALITIES

- ⌘ Whenever externalities are present, market prices aren't a valid measure of a good's value to society.
- ⌘ The market will under-produce goods that yield external benefits and over-produce those that generate external costs.

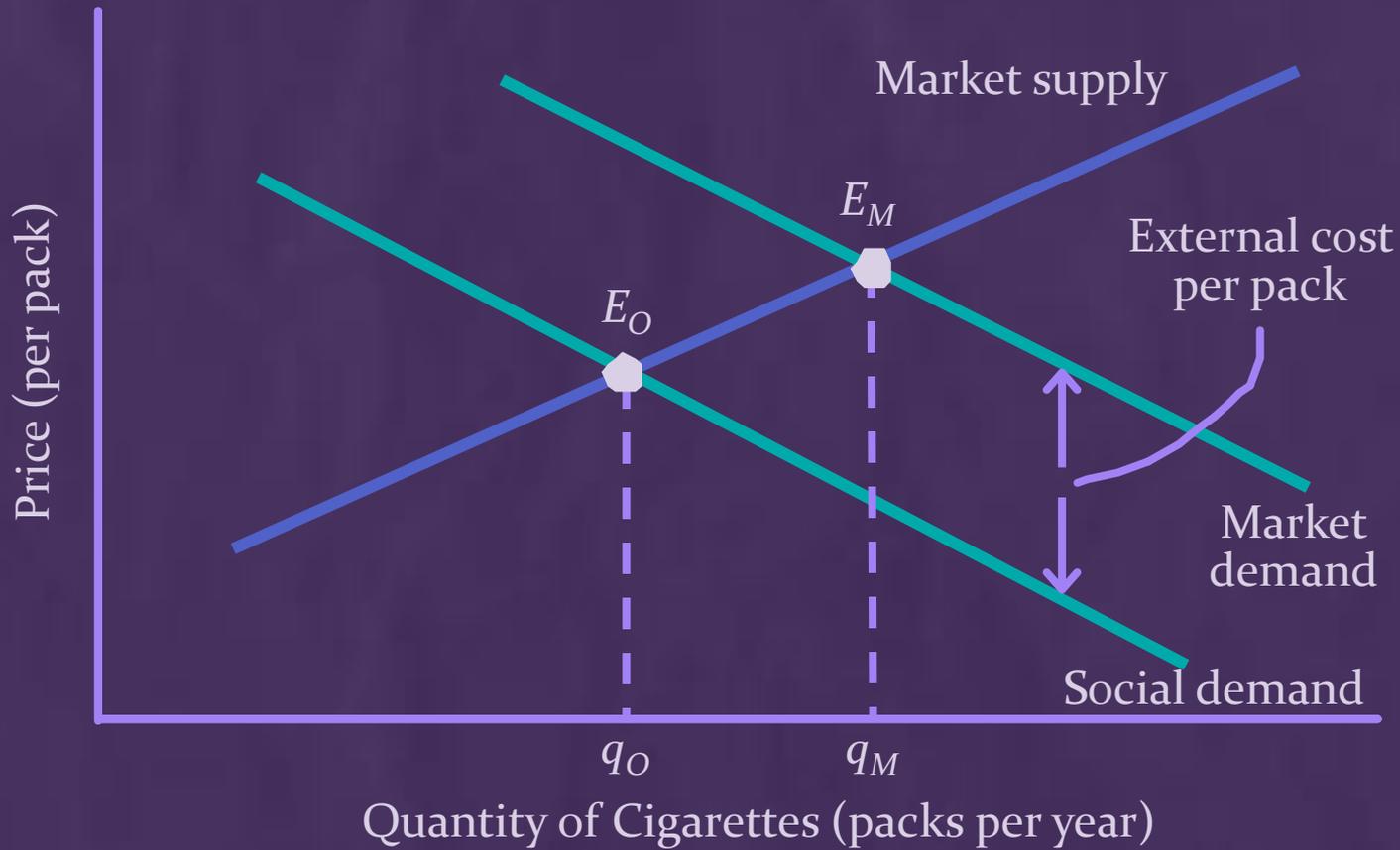


EXTERNAL COSTS

- ⌘ Social demand equals market demand plus externalities — the externality is subtracted if it is an external cost.
- ⌘ The optimal production mix is where the social demand curve intersects the supply curve.



CHART: EXTERNALITIES





EXTERNAL BENEFITS

- ∞ Externalities can also be beneficial.
- ∞ If a product yields external benefits, the social demand is greater than the market demand.



EXTERNAL BENEFITS AND COSTS

☞ The market fails by:

... over-producing goods that have external costs.

... under-producing goods that have external benefits.

☞ To get that optimal mix, we need government intervention.

MARKET POWER

The market may fail when the *response* to price signals is flawed, rather than the signals themselves.



RESTRICTED SUPPLY

- ⌘ When a firm has market power it has the ability to alter the market price of a good or service.
- ⌘ Market power gives a producer the ability to maximize profits rather than produce the optimal mix of output.

RESTRICTED SUPPLY

A monopoly is a firm that produces the entire market supply of a particular good or service.

ANTITRUST POLICY

Government follows an antitrust policy when it intervenes to alter market structure or prevent abuse of market power.

NATURAL MONOPOLY

A natural monopoly is an industry in which one firm can achieve economies of scale over the entire range of market supply.

NATURAL MONOPOLY

The government may have to regulate the *behavior* of a natural monopoly to ensure that consumers get the benefits of its cost efficiency.

INEQUITY

The distribution of goods and services generated by the marketplace is not necessarily “fair.”

TAXES AND TRANSFERS

Transfer payments are made to individuals for which no current goods or services are exchanged, such as Social Security, welfare, unemployment benefits, etc.



MERIT GOODS

- ⌘ The government is called upon to distribute merit goods when the market does not provide enough.
- ⌘ A merit good is a good or service society deems everyone is entitled to some minimal quantity of.

MACRO INSTABILITY

The micro failures of the marketplace imply that we are at the wrong point on the production-possibilities curve or inequitably distributing the output produced.



MACRO INSTABILITY

∞ The goal of macro intervention is to foster economic growth.

...Get us on the production possibilities curve (full employment).

...Avoid inflation (price stability).

...Increase our capacity to produce (growth).



MACRO INSTABILITY

- ⌘ Unemployment is the inability of labor-force participants to find jobs.
- ⌘ Inflation is an increase in the average level of prices of goods and services.

GROWTH OF GOVERNMENT

The potential micro and macro failures of the marketplace provide specific justifications for government intervention.



CONTINUED IN
THE PUBLIC SECTOR PART II