



Incentives: Markets vs. Government

Concepts, Terms and Topics:

Protective and Productive Roles of Government; Market Failure, Monopoly, Externalities and Public Goods; Government Failure, Special-Interest Policy, Political Incentives, and Economic Inefficiency

DAY 1—CLASS DAY



LOOKING BACK—WEEK 10

Review Homework
Take Quiz 9



LOOKING AHEAD—WEEK 11

Let's Discuss—*What Do You Think?*

*Let's Do—Stimulus Spending and Crony Capitalism

*Let's Discuss—Final Project: DECISION TIME!

DAY 2

- READ** CSE Part 3 Introduction
Element 1—Government promotes economic progress...
- WATCH** *Videos* *Property Rights and Eminent Domain (4:17)*
Is Government Too Big? (4:53)
- DO** **Workbook** Questions 1-6

DAY 3

- READ** CSE Part 3 Element 2—When monopoly is present...
Element 3—Public goods and externalities...
- WATCH** *Video* *Learn Liberty—Externalities Potato Chip (4:46)*
- DO** **Workbook** Questions 7-13

DAY 4

- READ** CSE Part 3 Element 4—Allocation through political voting...
- WATCH** *Video* *Political vs. Market Choices (1:33)*
- DO** **Workbook** Questions 14-18

DAY 5

- READ** CSE Part 3 Element 5—Unless restrained by constitutional rules...
- WATCH** *Videos* *Stimulus and Crony Capitalism (4:23)*
Pork Barrel Spending (4:26)
- READ** **Article** Politics and Foreign Trade by Dwight Lee
- WATCH** *Video* *Trade Restrictions and Crony Capitalism (2:05)*
- DO** **Workbook** Questions 19-24



Once politics becomes a tug-of-war for shares in the income pie, decent government is impossible.

—Friedrich Hayek

Everyone wants to live at the expense of the State. They forget that the State lives at the expense of everyone.

—Frédéric Bastiat



LOOKING BACK—WEEK 10

Review Homework

Take Quiz 9



LOOKING AHEAD—WEEK 11

*Discuss upcoming: Optional Final Project Preparation—DECISION TIME!

Let's Discuss—*What Do You Think*

According to Thomas Jefferson, “A wise and frugal government, (is one) which shall restrain men from injuring one another, which shall leave them otherwise free to regulate their own pursuits of industry and improvements, and shall not take from the mouth of labor the bread it has earned.” What characterizes a “wise and frugal” government?

When government restricts itself to providing the even-handed enforcement of private property rights, and taxes property accordingly, individuals will build wealth and help others prosper as they respond to the incentives created by the rules of private property and voluntary exchange.

Would people be better off if voting was more widely used to determine what goods should be produced and consumed? Why or why not?

When choices are made by majority voting rather than through markets, the majority or their elected representatives will decide for everyone. With democratic voting, the majority imposes its preferences on the minority. Many individuals in both the majority and minority are forced to pay for many items that they would not have purchased.

*Let's Do—Optional Group Activity: Stimulus Spending and Crony Capitalism

The Functions of "A Wise and Frugal Government"

Protecting Rights and Providing Public Goods



Week 11
Day 2



CSE Part 3: Ten Elements of Clear Thinking about Economic Progress and the Role of Government

INTRODUCTION—

1. What is economic efficiency?

"Economic Efficiency means getting the most value from the available resources."

2. Public choice is a term that in the last 50 years has become an integral part of economics. To what area of study does the term *public choice* refer?

The term public choice refers to the study of how political allocation works. Given that government expenditures now constitute 40 percent or more of our national income, understanding how political allocation works is vitally important.

ELEMENT 1—GOVERNMENT PROMOTES ECONOMIC PROGRESS BY PROTECTING THE RIGHTS OF INDIVIDUALS AND SUPPLYING A FEW GOODS THAT ARE DIFFICULT TO PROVIDE THROUGH MARKETS.

3. In what two ways can government promote social cooperation and enhance its citizens' economic welfare?

- *by providing "people with protection for their lives, liberties, and properties"*
- *and by supplying "a few select goods that have unusual characteristics that make them difficult to provide through markets."*

4. What is the result of government performing its protective function well? Explain why.



"When this function [protective function] is performed well, citizens can have confidence that they will not be cheated and that the wealth they create will not be taken from them—by either selfish intruders or by the government itself [through high taxes and excessive regulations, or the ravages of inflation]. This protection provides citizens with assurance that if they sow, they will be permitted to reap. When this is true, people will sow and reap abundantly, and economic progress will result."

5. Why is the provision of a stable monetary and price environment, one of the most important productive functions of government?

"...when governments perform this function well, people will invest more, cooperate more fully through trade, and achieve higher income levels."

6. Why are government projects financed through taxes or through borrowing, difficult to measure in both their costs and their benefits?

 *There are no buyers spending their own money and thereby revealing information about their benefits. Moreover, the revenues paid to the suppliers were extracted through compulsory taxation and therefore they provide no assurance that the project is valued more than its cost.*



Property Rights and Eminent Domain (4:17)

Market activity is based on mutual agreement and voluntary exchange. Government, however, has the sole authority to use force to accomplish its goals. As John Stossel explains, when elected city leaders don't approve of certain buildings in an area, they can deem that area blighted, then use their power of eminent domain to destroy the area and replace it with something else as long as the alternative is in the public interest. Think about how this incentive structure will influence economic and political activity.



Is Government Too Big? (4:53)

Government plays a vital role in the economy. John Stossel explains government's protective function which includes maintaining rule of law, preventing people from attacking each other, and protecting private property. Philosopher Tibur Machan explains how governments substitute their judgment in place of citizen's judgment, and how the founders believed government should be limited to protecting liberty. However, government has grown under every recent president.



CSE Part 3: Ten Elements of Clear Thinking about Economic Progress and the Role of Government

ELEMENT 2—WHEN MONOPOLY IS PRESENT AND BARRIERS TO ENTRY HIGH, MARKETS WILL FAIL TO ACHIEVE IDEAL EFFICIENCY.

7. When does a monopoly exist?

"A monopoly exists when there is a firm that is the only producer of a good or service for which there are no good substitutes."

8. What are two major sources of monopoly and when do they occur?

- *Economies of scale—"economies of scale and grants of privilege. Economies of scale occur when large firms have lower per-unit costs than their smaller rivals. If economies of scale persist as a firm obtains a larger and larger share of the market, a single firm will dominate and become a monopoly. The production of electricity provides an example. As power plants for the generation of electricity become larger, the per-unit cost of generating electricity generally declines. As a result, there is a tendency for a single, large firm to dominate this market."*
- *Grants of privilege—"government itself is sometimes the source of monopoly. Licensing, taxes that favor one group over another, tariffs, quotas, and other grants of privilege reduce the competitiveness of markets. While some of these policies may be well-intentioned, they protect existing firms and make it more difficult for potential rivals to enter the market, thereby encouraging monopolies and dominant firms."*

9. What should the government do to ensure markets are, and remain, competitive?



Governments "should refrain from making things worse through licensing requirements and discriminatory taxes."

And "governments may also prohibit anti-competitive actions such as collusion, the merger of dominant firms in an industry, and interlocking ownership of firms."

ELEMENT 3—PUBLIC GOODS AND EXTERNALITIES RESULT IN INCENTIVES THAT MAY ENCOURAGE SELF-INTERESTED INDIVIDUALS TO UNDERTAKE ACTIVITIES THAT ARE INCONSISTENT WITH IDEAL ECONOMIC EFFICIENCY.

10. What are two distinguishing characteristics of "public goods" provided by the "productive" function of government?

"Public goods have two distinguishing characteristics: 1) jointness in consumption—provision of the good to one party simultaneously makes it available to others, and 2) nonexcludability—it is difficult or virtually impossible to exclude non-paying customers."

11. What are some examples of “public goods” and why are they difficult for markets to provide?

Some examples of public goods are: national defense, flood-control projects, and mosquito-abatement programs. These programs all meet the criteria because once they are provided everyone in the region benefits even though not everyone in the region may not have paid for the particular service. "Thus, because potential suppliers are unable to establish a one-to-one relationship between payment for and receipt of the good, it will be difficult to provide public goods through markets."

12. Are all goods provided by the government *public goods*? Why or why not?



"Many of the goods provided by governments clearly do not have the characteristics of public goods. Medical services, education, mail delivery, trash collection, and electricity come to mind. Although these goods are often supplied by governments, nonpaying customers could be easily excluded and providing them to one party does not make them available to others. Thus, even though they are often provided by governments, they are not public goods."

13. Define externalities and give an example of one you have personally experienced.



Externalities are basically "spillover effects." Sometimes the actions of an individual or group will "spill over" and exert an impact on others, affecting their well-being without their consent."

Examples will vary.

For example, if you are trying to study and others in your home or apartment complex are distracting you with loud music, they are imposing an externality on you. You are an external party—not directly involved in the transaction, activity, or exchange—but you have been affected by it."



Learn Liberty—Externalities Potato Chip (4:46)

When is a potato chip more than a potato chip? What causes externalities and how can they be "fixed"? This clip explains and answers those questions. It also cautions against potential solutions.



CSE Part 3: Ten Elements of Clear Thinking about Economic Progress and the Role of Government

ELEMENT 4—ALLOCATION THROUGH POLITICAL VOTING IS FUNDAMENTALLY DIFFERENT THAN MARKET ALLOCATION.

14. What are four reasons market allocation leads to greater economic progress than democratic political allocation?



"First, in a democracy, the basis for government action is majority rule. In contrast, market activity is based on mutual agreement and voluntary exchange. In a democratic setting, when a majority—either directly or through their elected representatives—adopts a policy, the minority is forced to pay for its support even if they strongly disagree."

"Second, there is little incentive for voters to be well informed about either candidates or issues. An individual voter will virtually never decide the outcome of an election...Recognizing this point, most voters spend little, if any, time and energy studying issues and candidates in order to cast a well-informed vote."

"Third, the political process generally imposes the same outcome on everyone, while markets allow for diverse representation. Put another way, government allocation results in a 'one size fits all' outcome, while markets allow different individuals and groups to "vote" for and receive desired options."

"Fourth, market and political decision-makers face different incentives...the profit-and-loss mechanism of a market economy tends to direct resources toward productive projects and away from counterproductive ones. But, the political process does not have a similar mechanism that can be counted on to direct resources toward productive activities...when unconstrained by constitutional limits, elected officials will tend to gain votes by providing favors to some at the expense of others."

15. What is the "rational ignorance effect"?

The rational ignorance effect is a term economists use to describe how voters can both be poorly informed and rational at the same time. Knowing that their single vote will virtually never decide the outcome of an election, voters will spend very little time studying the issues and the candidates in order to make an informed choice. Thus voters are poorly informed yet, "their lack of information is rational because an individual's vote is so rarely decisive."

16. Due to the “rational ignorance effect,” how do decisions made by consumers in the marketplace compare to those made about voting?



“The weak incentive of voters to make informed choices is in sharp contrast to that of consumers in the marketplace. Market consumers individually decide how to spend their money, and if they make bad choices, they personally bear the consequences. That fact gives them the motivation to spend their money wisely. When consumers consider the purchase of an automobile, personal computer, gym membership, or thousands of similar items, they have a strong incentive to acquire information and make informed choices.”

17. How is government failure similar to market failure?

“Government failure is present when the incentives confronted by political participants encourage counterproductive rather than productive use of resources. Like market failure, government failure reflects the situation where there is a conflict between what is best for individual decision-makers and getting the most value out of resources.”

18. What did the framers of the Constitution include in order to place restraints on the government’s economic role and how have these restraints eroded over time?



“They enumerated the permissible taxing and spending powers of the central government (Article I, Section 8) and allocated all other powers to the states and the people (Tenth Amendment). They also prohibited states from adopting legislation “impairing the obligation of contracts” (Article I, Section 10). Furthermore, the Fifth Amendment specifies that private property shall not be “taken for public use without just compensation.” Over time, however, Supreme Court decisions eroded these restraints and government control over both individuals and businesses expanded, as did federal control over the states.”



Political vs. Market Choices (1:33)

Allocation of resources through the political process is fundamentally different from allocation through markets. John Stossel illustrates how voting only allows people to choose among limited options, while markets allow people to choose from many alternatives, selecting only the things they value more than cost (price). How will voting influence the value of the goods and services selected compared to the combination chosen through markets?



CSE Part 3: Ten Elements of Clear Thinking about Economic Progress and the Role of Government

ELEMENT 5—UNLESS RESTRAINED BY CONSTITUTIONAL RULES, SPECIAL-INTEREST GROUPS WILL USE THE DEMOCRATIC POLITICAL PROCESS TO OBTAIN GOVERNMENT FAVORS AT THE EXPENSE OF OTHERS.

19. What is “the special interest effect”?

Special-interest effect: “The bias of the political process toward adoption of programs that provide substantial individual benefits to well-organized interest groups at the expense of small individual cost imposed on the bulk of voters. There is a tendency for such issues to be adopted even when they are inefficient.”

20. What are “logrolling” and “pork-barrel” legislation and how are both used?

“Logrolling is the practice of trading votes between politicians to get the necessary support to pass desired legislation.”

“Pork-barrel legislation is the bundling of unrelated projects benefiting many interests into a single bill. Both logrolling and pork-barrel legislation often make it possible for counterproductive projects benefiting concentrated interests to gain legislative approval.”

21. Explain why special interest programs can retard or create a drag on the economy.



Each special interest program by itself produces a small drag (because products are more expensive than they otherwise would be) but all of them together create an enormous drag and bust the federal budget. They cost the federal budget billions, which are of course collected from the taxpayers; they waste resources by encouraging Americans to produce what we are ill-suited to produce usually resulting in higher costs and prices, lowering our standard of living.

22. Unlike market exchanges, which are win-win activities, “political exchange” activities can be a win-lose activity. List three examples where the business of modern politics has been used to extract resources from the general public in order to provide favors to well-organized voting blocs.



Answers may vary, but in addition to the sugar program, grain, cotton, tobacco, peanut, wool, and dairy programs are all programs which bring to light the political power of special interest.



Stimulus and Crony Capitalism (4:23)

Economics indicates that special interest groups have an incentive to use the democratic political process to gain advantage for themselves while imposing hidden costs on others. John Stossel illustrates how Serious Materials, a window manufacturer, derived subsidies and tax credits that were not provided to other window producers. Given the incentive structure generated by special interest issues, such favoritism is an expected outcome.



Pork Barrel Spending (4:26)

By using the example of a proposed \$200 million bridge in Ketchikan, Alaska, this segment illustrates the ability of special interests to obtain government funding for projects that benefit a small number of people. The irony of the situation is that most of the local residents seem to be opposed to the bridge. Even so, the Alaskan congressman is pursuing the funding. It provides an excellent illustration of the economics of collective decision-making in action.



Politics and Foreign Trade by Dwight Lee

23. Why would even the workers employed by industries that benefit from trade protections be better off living in an economy with completely free trade?

Even workers employed by industries that benefit from trade protections would be better off living in an economy with completely free trade because “even though individuals may benefit from their industry’s protection, they would lose far more as consumers from the protections of everyone else.”

24. Typically, why don’t people realize the costs that are imposed on them through trade restrictions?

“A trade restriction concentrates benefits on the few in the protected industry at costs that are thinly dispersed over the entire consuming public. With the cost of a trade restriction spread over millions of consumers, few if any will be aware of the little extra they are paying for the protected product. Even if a consumer is aware of the extra cost, she will seldom know that it is caused by a trade restriction.”



Trade Restrictions and Crony Capitalism (2:05)

Democratically elected officials often benefit from the support of special interest groups. Using the case of the steel industry, John Stossel explains the origins of rent-seeking and “crony capitalism.” Well organized groups that lobby Congress for favors are often able to benefit at the expense of those that are less well organized. In turn, this bias encourages rent-seeking and adoption of inefficient policies.