

WHY ECONOMICS?



CONCEPT #4 – THE ROLE OF GOVERNMENT

What students should know about economics and why: 6 Key Ideas

#4 How Should the Government be Involved in the Economy?

Most people would agree that markets do a pretty good job of providing incentives for producers to produce and minimizing the costs of exchanging goods and services. But there are certain services (e.g. education for all, national defense) and certain societal goals (e.g. assisting the poor, minimizing pollution, preserving endangered species) that are unlikely to be accomplished if left strictly to markets. An ongoing question is what markets can and should do and what, if anything, is the role of government in markets.

It is generally accepted that an important role for government is to define, establish and enforce property rights. . A property right to a good or service includes the right to exclude others from using it and the right to transfer the ownership or use of the resource to others. People will preserve and improve resources if they gain the rewards from doing so; if they don't gain the rewards, they are more likely to use them up. For example in 15th century Europe, freed serfs overused the timber in nearby forests to the point that the forests nearly disappeared. This phenomenon is called the *Tragedy of the Commons*. When a resource is owned by everyone, it is owned by no one and will be overused. So governments can prevent this problem by assigning property rights to those resources and a system for enforcing them.

It is also generally recognized that government should provide goods and services when it appears the benefits to society of doing so outweigh the costs to society. Though many will disagree on what particular services government should provide, it is important to understand some of the questions to consider in weighing the costs and benefits. Is the service one that will be provided if not provided by the government? If there isn't a way to charge for the service and limit its use to those who pay, probably not. For example, it is impractical to charge people to "use" a street light since it is difficult to prohibit people from using the service (the service is not excludable) and one person using it does not reduce the amount available to others (the service is non-rival). National defense is another common example. It does not make sense for every individual to buy or build their own missile defense system or to hire their own army. If a person did develop their own missile defense system, there would be no way to

prevent a neighbor from enjoying the benefits of the system. The neighbor could simply sit back and enjoy being defended. This is called the *Free Rider Problem*. So, it is expected that the government will provide certain goods and services and tax all citizens to pay for them. Some also argue that there are industries that involve such high startup costs so the government should allow a firm to act as a monopoly and attempt to regulate it so that it ACTS as a competitive firm.

There are also situations where one person's actions have a positive or negative effect on others. Vaccinations protect not only the vaccinated, but also the people around them. To have your children's schoolmates vaccinated against communicable diseases protects your children. So it is often thought that government should provide these types of services. Where negative effects of others actions occur, some believe that government should step in to reduce those actions.

Society must decide how much and what kind of services it wishes government to provide and then pay for those services through taxes and fees. The question of how big the government should be depends upon the amount of goods and services society wants government to provide.

A more controversial role of government is income redistribution. A progressive tax system in the form of income redistribution imposes higher marginal taxes on richer individuals. While most would agree that it is not ethical to take money from the poor and give it to the rich, it is much less clear whether a society should take from the rich and give to the poor.

In terms of monetary and fiscal policy, most economists would agree that the government has some role to play in stabilizing the economy and promoting economic growth with full employment. How far the government should go in this area, and what tools should be used are matters of much debate. A basic understanding of these policies will help one better evaluate the arguments of the various views and influence the direction as a more informed voter. There can be a problem, however, in "leaving it to the government." Just as markets fail to perform their jobs effectively when the conditions for efficient markets do not exist, so can governments fail to perform their jobs effectively when the conditions for efficient governments exist...Students who understand the possible shortcomings of government intervention to market failures will become more discerning voters.

Ideally, economic educators will be able to bring students to the point that they address individual issues by asking, "Which of the two imperfect solutions (market or government) is better?" and vote on the basis of that conclusion.

This document was created by a CEE/NAEE Task Force

Jim Charkins (CA), Mary Lynn Reiser (NE), Joanne Dempsey, (IL) and Sarah Finley (VA)