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GOVERNMENT POLICY TOWARDS BUSINESS

Lecture Notes
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Chapter 3 The Normative Analysis of Government

- Types of societies
 - 1) Feudal - Rights to govern are the result of inheritance, which also allows the sovereign to determine the rights and responsibilities of citizens. Kings, princes, lords are seen as having traditional rights.
 - 2) Theocracy - The rights to govern are derived from some religious basis. The teachings of the religion determine the rights and responsibilities of citizens. In general, there is no separation of church and state, the religious leaders determine the rights and responsibilities of citizens appealing to religious doctrine.

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Normative Basis of Government

- 3) Constitutional Democracy - The rights and responsibilities of citizens and the state are outlined in a constitution. The governing party is elected to for a limited period of time. The legislative branch enacts laws, which the executive branch is to uphold the laws, while the judicial branch decides on the legality and constitutionality of the laws.
- 4) Political Dictatorship - the rights and responsibilities of citizens are determined by the state. No separation of legislative and executive branch. Voting is one man (or woman), one vote, once.

Western democratic tradition emphasizes

- 1) Individual freedom (economic and political)
- 2) Private property rights (the right to the use, the right to partition rights to the property, and the right to transfer the ownership rights to other individuals.)

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In Western Societies there are two dominant political views - Liberal and Conservative

- Definition – A liberal political position has a number of definitions.
- **Classical Liberal** - as evidenced by John Stuart Mill, assumes that society is best served by respecting individual rights to free speech, free expression and free enterprise.
- The government's role is to ensure that one person's rights does not interfere with the rights of other individuals.
- A Classical Liberal thinks society should focus on equality of opportunities for individual members.
- Respect for property rights is a key concern of a classical liberal.

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Liberal versus Conservative Political Views

- **Modern Liberal (or progressive)** - is concerned with equality of outcomes
 - a key role for government is to further social justice which is measured largely in economic and social standing.
 - in pursuing social justice, a modern liberal feels all existing institutions are up for discussion.
 - A modern liberal believes that all societies are in need of reform.
 - Believes that inequality of outcomes is either due to lack of education or faulty institutions.
 - Places great faith in the ability of reformers to successfully change existing institutions to achieve social justice.

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Liberal versus Conservative Political Views

- **Conservatives** place more emphasis on equality of opportunities.
- For a conservative, the role of government is to enforce laws and maintain property rights and institutions.
- Conservatives feel that institutions that have existed for a long time must have merit.
- Conservatives are wary of major changes to society and worry about unintended consequences.
- Feel that even with equality of opportunity, that there will be some inequality of outcome and the goal of equality of outcome would give governments too much power.
- Conservatives feel the size of government needs to be limited, because larger governments erode individual liberties.

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Normative Basis of Government

- Principle Methods of Allocating, Producing and Distributing resources in an economy.
- 1) Central Planning - Plans are drawn up for the allocations of inputs (capital and labour) to the production of goods and services, which are then distributed in some fashion to citizens.
Ex. Former Soviet Union, China
- 2) Decentralized System - Based on consumer demands (consumer sovereignty), private firms produce goods and services by hiring capital and labour. Payments to capital and labour are made according to the availability of capital and labour.

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Normative Basis of Government

- The Great Depression and the Intellectual Debate between Central Planning and Decentralized Markets
- The Great Depression was the catalyst of a great debate between the relative merits of central planning and decentralized markets for organizing economic activity in an economy.
- The **Great Depression** was a severe worldwide economic **depression** in the decade preceding World War II. The timing of the **Great Depression** varied across nations, but in most countries it started in 1930 and lasted until the late 1930s or middle 1940s.

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Normative Basis of Government

A) Central Planning

- In ***Capital: Critique of Political Economy (1867)*** Karl Marx proposes that the motivating force of capitalism is the exploitation of labour, whose unpaid work is the ultimate source of surplus value and then profit.
- The employer is able to claim the right to profits because he or she owns the productive capital assets (means of production), which are legally protected by the capitalist state through property rights (In a historical section of ***Capital*** Marx argues that property in many cases was first achieved through plunder and conquest and the activity of the merchant and 'middle-man').

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Normative Basis of Government

- Marx's theories about society, economics and politics – the collective understanding of which is known as Marxism – hold that human societies progress through class struggle : a conflict between an ownership class that controls production and a dispossessed labouring class that provides the labour for production.
- States, Marx believed, were run on behalf of the ruling class and in their interest while representing it as the common interest of all; and he predicted that, like previous socioeconomic systems, capitalism produced internal tensions which would lead to its self-destruction and replacement by a new system: socialism.

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Normative Basis of Government

A) Central Planning

- He argued that class antagonisms under capitalism between the bourgeoisie and proletariat would lead to working class eventually gaining political power and eventually to the establishment of a classless society, communism, a society governed by a free association of producers.
- Marx actively fought for its implementation, arguing that the working class should carry out organized revolutionary action to topple capitalism and bring about socio-economic change.
- According to Marx, the capitalist system is unsustainable, since it is built on increasing exploitation of labour and would initially be replaced by socialism, before a transition to communism.

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Normative Basis of Government

• A) Central Planning

- The only solution to the upcoming capitalist crisis was to replace private ownership of the means of production. Rather than goods be distributed to labour by capitalist firms, goods would be distributed "From each according to his ability, to each according to his need."
- With the elimination of private ownership all means of production would be under the control of the state, which would decide on the allocation of capital and labour, the types of goods and services produced, and how goods and services would be distributed.

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Normative Basis of Government

- A) Central Planning
- The **five-year plans for the development of the national economy of the Soviet Union (USSR)** were a series of nation-wide centralized economic plans in the Soviet Union.
- The plans were developed by a state planning committee based on a theory of productive forces that was part of the general guidelines of the Communist Party for economic development.
- Fulfilling the plan became the watchword of Soviet bureaucracy (for more details see an Overview of the Soviet economic planning process in Wikipedia).

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Normative Basis of Government

- A) Central Planning: Five Year Plans under Stalin
- Each five-year plan dealt with all aspects of development: capital goods (those used to produce other goods, like factories and machinery), consumer goods (e.g. chairs, carpets, and irons), agriculture, transportation, communications, health, education, and welfare.
- However, the emphasis varied from plan to plan, although generally the emphasis was on power (electricity), capital goods, and agriculture. There were base and optimum targets.

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Normative Basis of Government

- A) Central Planning
- Because meeting the goals of the five-year plans had top priority as a measure of progress toward a communist utopia, official lying about productivity became part of the economic system.
- The attempt to turn an illiterate peasant society into an advanced industrial economy in a single decade brought intense suffering, but hardship was tolerated because, as one worker put it, Soviet workers believed in the need for "constant struggle, struggle, and struggle" to achieve a Communist society.
- These five-year plans outlined programs for huge increases in the output of industrial goods. Stalin warned that without an end to economic backwardness "the advanced countries...will crush us."

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Normative Basis of Government

- A) Central Planning
 - The same method of planning was also adopted by most other communist states, including the People's Republic of China.
 - In addition, several capitalist states have emulated the concept of central planning, though in the context of a market economy, by setting integrated economic goals for a finite period of time.
 - Nazi German emulated the practice in its four-year plan designed to bring Germany to war-readiness.

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Normative Basis of Government

B) Decentralized Markets

- Adam Smith (The Wealth of Nations, 1776))
- Adam Smith was a keen observer of the emerging industrial revolution in Europe.
- He was interested in trying to understand what was taking place, what was the reason for the great increase in production that was taking place.

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Adam Smith

- I. Division of Labour
- The *Wealth of Nations* introduced a number of concepts
- I) Division of Labour
 - can be defined as the process of subdividing the production of one good into a set of intermediate steps
- Construction of a Chair
 - 1) one person cuts down the tree
 - 2) second person planes the wood
 - 3) third person makes the legs etc.

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Adam Smith

- Benefits of Division of Labour
- 3 Benefits from the Division of Labour (Smith)
 - 1) leads to an increase in dexterity of every particular worker
 - 2) saves time moving from one stage of work to another
 - 3) leads to the invention of labour saving machines by the workers

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Adam Smith

- II. Propensity in Human Nature to Trade
- Division of Labour leads to a surplus of products produced.
- Smith argued that it was human nature for individuals to trade their respective surpluses.

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Adam Smith

III. Division of Labour Limited by the Extent of the Market

- Smith argued that the process of division of labour was limited by the extent (or size) of the market.
- “When the market is very small, no person can have any encouragement to dedicate himself entirely to one employment...” Book One, Chapter III

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Adam Smith

- Smith pointed that self interest on the part of producers may have unintended consequences which are beneficial to society.
- “An individual generally neither intends to promote the public interest nor knows how much he is promoting it .. By directing industry in such a manner as its product may be of greatest value, he intends only his own personal gain, and he is in this aim ... led as if by an “indivisible hand” to promote an end which was no part of his intention.”
- “It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard from their own self-interest.”

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Adam Smith

- Smith pointed out that in many cases we can rely on decentralized decisions to produce goods and services which are desired by individuals.
- As an example, Smith pointed out the example of his breakfast, tea came from India, eggs from England, jam from perhaps Scotland, silverware from another part of England, etc.
- Smith argued that in getting these goods to market, there was no central planner. Each of these sellers, based on the profit motive, would acquire all of these goods from merchants who would acquire them from farmers and other producers.

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Adam Smith

- Smith recognized that the opportunity to make money by serving the needs of citizens lead to an outcome where in general, the supplies of needed goods were made available.
- Smith recognized a limited role for governments, to ensure that market exchanges were not conducted subject to monopolistic conditions, that public goods, like roads and national defence were provided, as well as the enforcement of private contracts and the protection of private property and personal safety.

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Adam Smith

- Subsequent writers like Hayek recognized that decentralized markets economize on the use of information. Unlike central planning, no single individual or organization needs a knowledge of the demand and supplies in the entire economy.
- Adam Smith was actually describing a decentralized system of competition, in that sellers were producing goods to satisfy the needs of buyers, and buyers were seeking to satisfy their demands for goods and products.
- Subsequent economic analysis has been devoted to specifying the precise conditions needed for this decentralized system to produce an efficient allocation of resources in an economy.

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Adam Smith

- Smith emphasized the importance of preserving competition. He famously stated,
- “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.”
(The Wealth of Nations)

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The Meaning of Competition

- The idea of competition in terms of markets is well defined in economics and business.
- Competition is not between buyers and sellers, rather there is competition between sellers (for the patronage of buyers) and between buyers (for the goods offered by sellers).
- Note that with free entry, market economies allow firm firms (if they are more efficient or provide a better product) to take business and sales away from existing firms. Existing business owners may suffer a loss in income.
- Contrast this with illegal or criminal “firms”. How do they respond to entry of competing firms?

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Perfect Competition

- Economists define perfect competition as a market with the following characteristics.
- 1) No buyer or seller acting alone can influence the market price.
- 2) The product is homogeneous – that is, each seller sells the identical product.
- 3) Buyers and sellers have identical information about the nature of the good being offered for sale.
- 4) Entry and exit from the market is costless in the long run

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Normative Reasons for Government Intervention

- Brander argues there are 4 major reasons for why governments should intervene in the economy.
- 1) Efficiency and Market Failure
- 2) Macroeconomic Stabilization
- 3) Fairness
- 4) Non-Economic Reasons

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Normative Reasons for Government Intervention

- In what follows, a number of potential areas for government intervention are discussed.
- That is, the following provide possible justifications for government intervention; however, a key issue is whether “actual” government intervention is always needed or whether “actual” government intervention may make things better or worse than no government intervention.

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Normative Reasons for Government Intervention

- 1) Efficiency and Market Failure

Definition: A market failure is a situation in which private markets fail to achieve Pareto efficiency.

There are 4 major sources of market failure

1. Imperfect Competition
2. Asymmetric Information
3. Incomplete Property rights (externalities and public goods.
4. Poorly designed government policies (government failure.)

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Efficiency and Market Failure

- 1) Imperfect Competition

Definition: Imperfect competition is said to exist when goods are not sold according to the condition $P=MC$.

MC = marginal cost and P =Price per unit

- When this occurs, the goods and services are not yielding the maximum possible benefit to consumers.
- Types of Imperfect Competition include
 - a) Natural monopoly markets - Single firm production is the most efficient.
 - b) Legal Monopolies - single firm sheltered from competition.
 - c) Oligopolies - small number of firms
- These cases will be considered in more detail in later chapters.

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Efficiency and Market Failure

- 2) Asymmetric Information
 - In some cases, sellers of goods or services know more about the product than buyers.
ex. a used automobile
 - In some case, buyers of goods or services know more about their situation and how their demands will affect the costs incurred by sellers)
ex. buyer of health insurance which undisclosed illness
- Definition: Asymmetric Information Market is a market where one party to the transaction has more information about the nature of the good or service being traded than the other party.

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Efficiency and Market Failure

- Government intervention may take the form of
 - i) mandatory disclosure of information.
 - ii) fines for misleading information.
- Market responses may take the form of
 - i) sellers of products may allow buyers to evaluate the product before purchasing (take the car to an independent mechanic). In the case of health insurance, a comprehensive physical examination may be required.
 - ii) third party sources of information may be available, magazines like *Consumer Reports*, websites that collect customer comments.

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Incomplete Property rights (public goods and externalities)

- 3) Public Goods

Definition: A pure public good is a good or service that is non-rivalrous, that is one person's use or enjoyment of the good or service does not diminish another person's use or enjoyment.

Ex. A park, a television show, a you tube video.

Definition: A private good is good or service that is rivalrous, that is one person's use or enjoyment of the good or service means that it is not available to other individuals.

Ex. Food, bicycle, service from a doctor.

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Efficiency and Market Failure

- As an example, consider three individuals, Alpha, Beta and Gamma. Suppose the value they place on additional visits to the zoo (or park) per month are as follows.

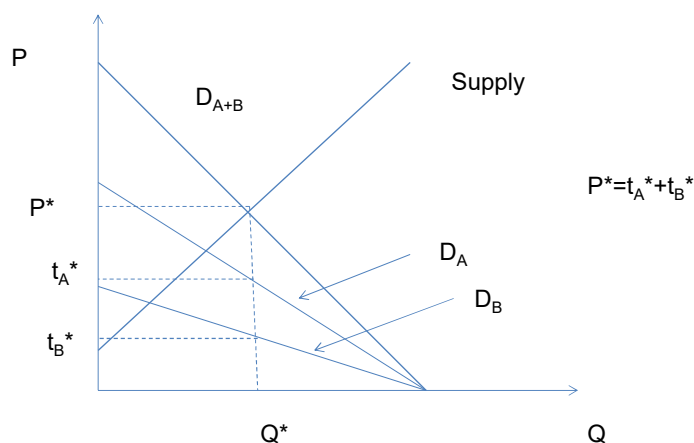
• Visits	Alpha	Beta	Gamma	Total Marginal Valuation
• 1	10	10	7	27
• 2	7	5	6	18
• 3	4	2	5	11
• 4	2	0	3	5
• 5	1	0	2	3

For example, the table states that Alpha places a value of \$10 on the first visit, and \$7 on the second visit, \$4 on the third visit, etc.

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Public Goods

- Suppose we have two individuals who have different demands for a public good.



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Public Goods

- For public goods, we sum the demand curves vertically, because both individuals A and B both benefit from the amount of the public good, Q provided.
- The optimal quantity of the public good occurs where
 - $D_{A+B} = S$
- This yields the optimal output level Q^* .
- The total cost of supplying the public good is then
 - $TC = P^* \times Q^*$
- One method of paying for the good is to charge A a tax price t_A^* and charge B a tax price t_B^* .
- Questions: (i) Is this possible? (ii) Is it fair?

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Efficiency and Market Failure

- 3) Public Goods

Question 1. Suppose it costs \$11 a day to keep the zoo open, how many days should the zoo be open, assuming they are available to go to the zoo on the same days?

Question 2: How might the zoo cover its operating cost?

Question 3: What information would be required if the zoo was to be operated privately, and the zoo would be opened the optimal number of days?

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Efficiency and Market Failures

- 4) Externalities

Definition: An externality is an effect borne by a party who is not part of the contract between a buyer and seller of a good or service.

- For example, an airline sells a ticket to a passenger for a flight that leaves the airport at 4:00 am. The airport is in the middle of a residential area.
- What is the externality? The externality is the loss in utility to the residents who are disturbed by the noise of the aircraft. For example, the residents might feel the damage imposed on them in dollar terms is \$d.

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Externalities and Market Failure

- Externalities can be both negative and positive.
- ex. Negative externalities – noise, pollution, congestion
- ex. Positive externalities - neighbours who keep a tidy yard, immunization, buskers (those that are good musicians), people who walk to work or take public transit (less congestion)

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Externalities and Market Failure

- In general, for goods and services which yield negative externalities too much will be produced by private firms, for goods and services which yield positive externalities too little will be produced.
- For negative externalities, governments may tax or restrict the level of the activity.
- For positive externalities, government may subsidize or promote the level of the activity.

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Efficiency and Market Failure

• 5) Government Failure

Definition: Government Failure is a market failure that results from governments intervening in markets where there is no obvious private market failure.

- The issue is not that governments should not intervene in markets for reasons other than private market failure, but the approach taken results in a market failure.

Ex. Rent control, price supports for agriculture.

- Intervention for redistribution purposes often leads to a misallocation of resources.
- Particularly when the government decides to provide private goods publicly using the tax system. This will be examined in detail under the fairness category.

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Macroeconomic Stabilization and Economic Growth

- Most countries have governments involved in macroeconomic stabilization policies.
- In Canada
 - The Bank of Canada is responsible for monetary policy, which requires the monitoring of interest rates and the exchange rate and the price level. The objective is to stabilize the economy and promote economic growth.
 - The Finance Department of the Federal Government is responsible for federal fiscal policy, the collection of taxes, federal government spending, and the maintenance of fiscal transfers to the Provinces.

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Fairness and Other Rationales for Policy Intervention

- Many countries include Canada have policies in place for reasons of equity or fairness.
- Equity largely comes in two forms.
- Horizontal equity – means individuals in the same economic or social situation should be treated equally.
- Vertical equity - means individuals in different economic or social situations should not be treated equally.
- Often issues of fairness lead to what is called the redistribution of income or benefits. The redistribution can be at the individual level, the municipal level, or the provincial level.
- Governments can transfer income directly through the tax and transfer system, or by publicly providing private goods.

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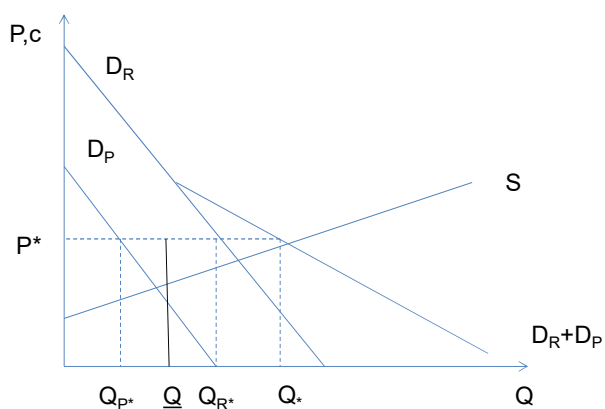
Publicly Provided Private Goods

- A number of goods like health care and education which are private goods are publicly provided.
- These goods are provided with zero cost to the citizen and are financed by income or other taxes on all citizens.
- Why is this done?
- Consider two groups P and R, who have collective demands for the good, as illustrated in the following diagram.

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Publicly Provided Private Goods

Two groups D_R and D_P



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Publicly Provided Private Goods

- If the good was privately purchased by the two groups, group P, would purchase Q_{R^*} and group R would purchase Q_{P^*} the total amount provided would be Q^* which would cost a total of $C=cQ^*$, where c is the cost per unit.
- The P group would pay $C=cQ_{P^*}$ and the R group would pay $C=cQ_{R^*}$. If a price P^* were charged per unit, the total costs would be covered.
- Now suppose the government decides to provide Q to both groups. And furthermore, to pay for the total amount suppose the government levies an income tax on both groups which is related to the amount they would have purchased if they could have purchased it privately.

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Publicly Provided Private Good

- In this case, the total cost can be $C=cQ^*$ can be covered by a tax of $T=tQ_R^*$ levied on the R group and a tax $T=tQ_P^*$.
- What is the ultimate effect of this policy of providing this private good using public provision?
- First, the R group consumes less than their preferred amount, and the P group consumes more than the amount if would purchase if the good was privately provided.
- The effect has been a redistribution in kind of the good from the R group to the P group.
- Is there another way to achieve this redistribution?

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Other Reasons for Government Involvement

- Some governments advance additional reasons for government involvement in the economy.
- 1) Promote Arts and Culture - this argument is that the government needs to assist in promoting a country's art and culture.
- 2) Paternalism reasons - paternalism means that government intervention in some markets is needed because individuals cannot be guaranteed to make the right decisions.
- 3) To promote societal values - government institutions may be seen as necessary to promote certain societal values that would be undersupplied without government, bilingualism, multiculturalism.

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3.11 Cost Benefit Analysis

- In evaluating the merits of a project or policy governments have needed some method of aggregating benefits and costs.
- Cost Benefit Analysis is the branch of applied economics that is designed to assess the desirability of projects.
- Features of a Cost Benefit Analysis
 - 1) All costs and benefits are defined in terms of monetary values. In general, this is based on the aggregate willingness to pay of citizens.
 - 2) Since the costs and benefits of the project are long lived, the benefits and costs must be converted into a single measure, which is the net present value of the project.

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Cost Benefit Analysis

- 3) In determining the net present value of the project a discount rate is needed to convert future values (either benefits or costs) into present values.

Note: Discounting is the opposite of compounding.

A Compounding Question: How much will \$100 be worth in two years, if the interest rate at which the money can be invested is 5% and the interest is compounded annually.

We use the formula

$$\begin{aligned} FV_2 &= PV(1+r)(1+r) = PV(1+r)^2 \\ &= 100(1.05)^2 = 110.25 \end{aligned}$$

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Cost Benefit Analysis

- Discounting answers the opposite question.
- A Discounting Question: What would be the equivalent value in today's dollars of \$110.25 received in two years, if the expected interest over the two year period is assumed to be 5% and the interest is compounded annually.
- $FV_2 = PV(1+r)^2$ or solving for PV, we get
- $PV = FV_2 / (1+r)^2$ substituting $FV_2 = 110.25$, $r = .05$, we get
- $PV = 110.25 / (1.05)^2 = \100.00

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Cost Benefit Analysis

- $PV(\text{Benefits}) = B_0 + B_1/(1+r) + B_2/(1+r)^2 + B_3/(1+r)^3 + \dots \quad (1)$
- and
- $PV(\text{Costs}) = C_0 + C_1/(1+r) + C_2/(1+r)^2 + C_3/(1+r)^3 + \dots \quad (2)$
- Where the subscript refers to the year in which the benefit or cost is to be received. Subtracting (2) from (1) yields the Net Present Value or (NPV) of the project.
- $NPV = (B_0 - C_0) + (B_1 - C_1)/(1+r) + (B_2 - C_2)/(1+r)^2 + (B_3 - C_3)/(1+r)^3 + \dots \quad (3)$
- If $NPV > 0$, the project yields a positive net present value to society.
- If $NPV < 0$, the project yields a negative net present value to society.

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Cost Benefit Analysis and Net Present Value (Profitability)

- It is important to distinguish cost benefit analysis that is used by governments to evaluate the desirability of a project versus the net present value (or net profitability) used by a private firm.
- Consider the Keystone XL pipeline that has been proposed.
- A Private firm will in general only be interested in the private benefits (which are profits) and the private costs (which are the expenditures required to build the pipeline).

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Cost Benefit Analysis and Net Present Value (Profitability)

- A Government department or regulatory authority will be interested in not only the private benefit and costs but also benefits and costs that are received and borne by other members of society.
- These costs can include additional consumer benefits as well as environmental costs.

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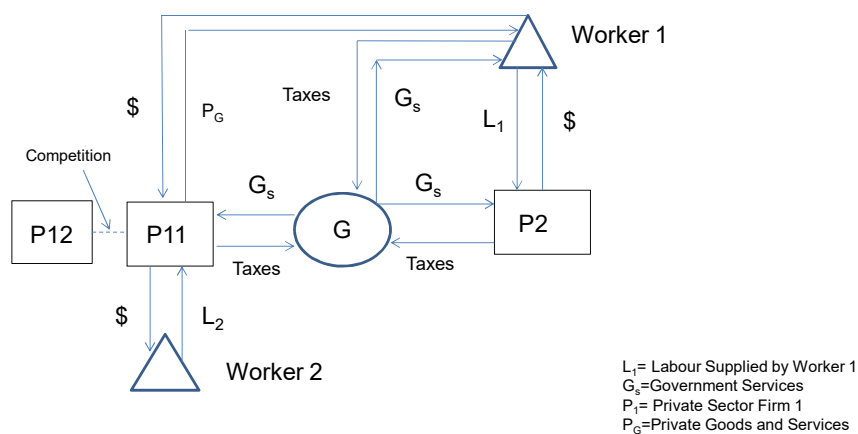
Appendix

- Private Sector Based Economy - Versus Government Based Economy

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Private Sector Based Economy

- Circular Flow Diagram



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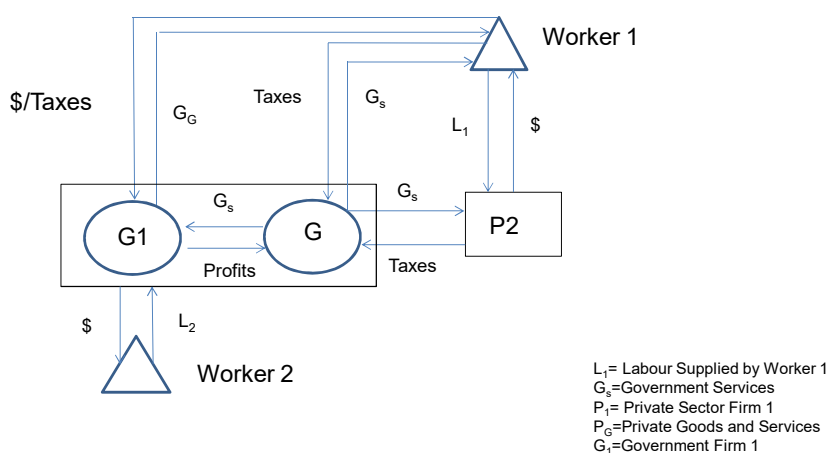
PRIVATE SECTOR BASED ECONOMY

- In the diagram we can see that worker 1 supplies his/her labour to Private sector firm 2 (P2), in exchange for a salary \$. The worker and firm (P2) also pay taxes to the government in exchange for services.
- The worker buys goods and services from other private firms (P11) in exchange for private goods.
- Also in the diagram is a firm (P12) that competes with P11.

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Government Sector Based Economy

- Circular Flow Diagram



GOVERNMENT SECTOR BASED ECONOMY

- In this diagram, suppose now that P11 and P12 are taken over by the government, they are now a state owned enterprise G1.
- So instead of the taxes paid by the P11 (and P12) going to the government, the profits of the state owned enterprise go to the government.
- Worker 1 now pays a combination of taxes or user fees (\$) to the government enterprise G1 rather than only (\$) that was paid to the former Private firm P11 in exchange for government provided goods and services (G_G).
- Now Worker 2 is a government employee rather than an employee of P11.