



Lesson 8 – Setting the Rules: Costs and Benefits of Government Action

Introduction

This lesson gives students the opportunity to apply the economic way of thinking to the political arena. After exploring differences between private and public choice they will apply public choice theory to understand why “bad economics” often makes for “good politics.”

Objectives

At the end of this lesson, students will be able to:

- Differentiate between rule of law, rule of man and rule of force.
- Use marginal analysis to evaluate government action.
- Describe the characteristics of public goods
- Use public choice theory to explain why government action may result even if the marginal cost is greater than the marginal benefit.

Economic Concepts

Externalities

Opportunity cost

Special Interest Groups

Incentives

Public choice

Taxation

Lobbying

Public goods

Voluntary Exchange

Voluntary National Content Standards in Economics

<https://www.fte.org/teachers/teacher-resources/voluntary-national-content-standards-in-economics/>



STANDARD 10: INSTITUTIONS: Institutions evolve in market economies to help individuals and groups accomplish their goals. Banks, labor unions, corporation, legal systems, and not-for-profit organizations are examples of important institutions. A different kind of institution, clearly defined and well enforced property rights, is essential to a market economy.

STANDARD 16: ROLE OF GOVERNMENT: There is an economic role for government in a market economy whenever the benefits of a government policy outweigh its costs. Governments often provide for national defense, address environmental concerns, define and protect property rights, and attempt to make markets more competitive. Most government policies also redistribute income.

STANDARD 17: COSTS AND BENEFITS OF GOVERNMENT PROGRAMS: Costs of government policies sometimes exceed benefits. This may occur because of incentives facing voters, government officials, and government employees, because of actions by special interest groups that can impose costs on the general public, or because social goals other than economic efficiency are being pursued.

Presentation Guidelines and Suggestions

1. Voluntary trade creates wealth.

- Conduct the review with reference to students' experiences in the "Magic of Markets" activity. Ask them to list the conditions that were made wealth-generating trade between individuals possible. *(See slide of ERP #4.)*
 - both parties expect to gain;
 - both parties are willing to trade at the terms (prices) presented; their participation in the exchange is voluntary; and
 - both parties have the authority to transfer the rights to the goods, services or resources involved in the trade; their property rights are clearly defined and secure.
- Establish that while the willingness to trade and the perception of gain were individual functions in the market, the rules of the game that secured property rights are established by government.

2. The rule of law provides an institutional foundation that encourages voluntary trade. Nations where the rule of law is firmly established reap greater benefits from voluntary trade than those without the rule of law.

- Discuss the essential role of government in establishing the rules of the game in which markets and trade take place. *(See slides.)*
 - Defining and enforcing laws is an important role of government; however the mere existence of laws is not sufficient to establish the rule of law.



- Define the Rule of Law, Rule of Man, and Rule of Force and clearly distinguish between the three.
 - The rule of law exists when the rules that govern behavior and interactions among individuals and groups of individuals apply to both the governed and the governing.
 - The rule of man exists when laws are applied at the discretion of the governing.
 - Under the rule of force, people own what they can defend. The allocation of goods is in accord with individuals' ability to manage violence, rather than in accord with the highest-valued uses of those goods.
 - Resources are consumed in the process of managing violence and the wealth of society is lower than under the rule of law.
 - Examples of the rule of force are found in the illegal drug trade today, for example, in the United States and Mexico. The rule of force is also observed in Zimbabwe, where lawless bands of marauders take land from the farmers who have cultivated it for many years, and in Russia, where force is often used to settle commercial disputes.
 - By establishing secure property rights, the rule of law promotes voluntary exchange. When the rule of law does not exist, the resulting uncertainties reduce willingness to trade.
 - People living in nations without the rule of law experience lower standards of living and are more likely to be extremely poor.
3. Government provision of goods and services is subject to the same guidelines as private production: it should take place only when marginal benefit exceeds marginal cost.
- The opportunity cost of government spending *at the margin* is private spending.
 - The opportunity cost of government spending on a particular program is the foregone benefit of increased spending on another program.
 - For *public goods*, the marginal benefit of government provision can exceed marginal cost. Marginal benefit does *not* exceed marginal cost for all goods and services provided publicly. Some goods and services provided for the public by government are *not public goods* in an economic sense.
 - Public goods are “non-rivalrous” in consumption and “non-exclusive” in production.
 - Non-rivalrous, non-exclusive goods and services are unlikely to be provided privately because it is not profitable to do so when there are incentives for people to be free-riders.
 - The “free-rider” problem exists when consumers cannot be excluded and therefore have no incentive to pay for the good or service.
 - Because private businesses are unlikely to produce them, public goods the government is the economically efficient provider.



- Publicly-provided goods are paid for by taxes. The opportunity cost of using tax revenue to provide goods and services is the foregone benefits of the next best use (either government or private) of that money.
 - Because taxation is involuntary, taxpayers undertake actions to minimize the burden they bear. This is costly and it implies that for government programs to be efficient, they must generate more than one dollar of benefits for each dollar of taxes, because the marginal benefit must also cover the social cost that arises when people try to minimize the burden of the taxes they must pay.
 - Technology may change the argument for government production of specific public goods over time.
 - The benefits of government provision of goods or services exceed the costs when government is the *least cost provider*. However, government engages in many activities that do not meet this criterion.
 - Government actions *may* improve the functioning of markets. Government may enact laws against monopolies and cartels to protect open markets and maximize the gains from trade.
 - Politicians and government officials respond to incentives. Thus, government actions *may also* work against the efficient allocation of resources in open markets though regulations and other restrictions (e.g., ban on advertising).

TEACHING TIPS:

- Note that this is not an all-or-nothing distinction in terms of providing the requisite conditions for trade. The Rule of Man *may* provide some of the security necessary to generate wealth-creating trade, but will not be as effective in this regard as the Rule of Law. Use Chinese market reforms since 1978 as an example. The Rule of Force is about the use of violent methods to allocate resources. Uganda under dictator General Idi Amin is one such example.
- Show video example: Rule of Man in Cuba
 - <http://www.youtube.com/watch?v=hPyrELYSXGo> (*This is a more engaging video, with news coverage of events and conditions in Cuba, and “dangerous” people being punished for “anti-social” behavior. Also covers activities of the Ladies in White, only people given permission to protest against the regime. 2006 film. Start at about 2:30 and run through 10:30*)
- Discuss relationship between rule of law and standard of living in countries throughout the world. (*See slide of Freedom House map, ranking based on rule of law. Compare to World Bank map of standard of living.*)
- Discuss other “roles” or “jobs” for government and provide examples. Relate back to benefits vs. costs.



- Establish that taxes are not voluntary payments and that taxes can be imposed in many forms, some of them indirect.
 - Ask what types of “goods or services” require government to compel people to pay for them with taxes. Alternatively, ask what goods or services will the private sector find difficult to profitably produce – that is, goods that consumers value, but are still not provided by private markets?
 - Define and give examples of public goods and of publicly provided goods that are not public goods.
 - Illustrate the “free rider” problem. Tie back to earlier lessons on incentives.
 - Provide examples in which technological advance changes the case for government production of goods: lighthouses and EZ pass toll roads, for example. *(See powerpoint slide.)*
 - Governments offer many more goods and services than just a “Rule of Law” system and public goods. Ask students to list some of the other things that local, state and the federal governments do. What explains these “other” activities of government?
 - Provide examples of externalities that are addressed through government action. *(See powerpoint slides.)*
 - What if we removed all the street signs in your town or city? What cost would that impose on drivers?
 - Discuss the “mix” of government services. Even with externalities included, governments engage in many activities that appear to be beyond their comparative advantage. *(See powerpoint slide.)*
4. Public Choice theory explains that the incentives facing officials and citizens encourage an active role for government in the economy even in the absence of government comparative advantage and make government especially responsive to special interest groups.
- The benefits and costs of specific government activities are not evenly distributed.
 - Special Interest Groups and Lobbyists: The benefits of political actions are concentrated and the costs are diffuse.
 - Ordinary Citizens: The costs of political actions are concentrated and the benefits are diffuse.
 - Elected officials have an incentive to be most attentive to those groups that help to keep them in office – special interest groups, groups of people (such as senior citizens) who are more likely than other to vote, and organizations willing to fund campaigns and political advertising.
 - Because the lawful use of force is a role of government, use of that force to reallocate wealth may be inevitable—and costly to society, reducing overall wealth.



- Rules may be necessary to keep government activities limited in the presence of the imbalance between special interest groups and ordinary citizens.
 - “Government is the great fiction through which everybody endeavors to live at the expense of everybody else.” Frédéric Bastiat (1801 – 1850)

TEACHING TIPS

Introduce public choice theory by reminding students of earlier discussion of rational choice – that people choose the alternatives they perceive to have the greatest excess of benefits over costs.

- Questions for discussion: Do people act this way only as producers and consumers or in all roles of their lives? Do people in government act this way? Do we expect them to? Why or why not? Does making rational choices mean that people are always selfish?
 - Provide examples of public choice analysis including rational ignorance, special interest politics, concentrated benefits and diffuse costs, immediate benefits and deferred costs, etc.
 - Lobbying videos:
 - events leading to movie restrictions in Canadian theatres: <http://www.youtube.com/watch?v=K3lpXAbi5Dw>
 - Integrated lobbying on illegal immigration: <http://video.aol.com/video-detail/new-powerful-form-of-lobbying/2390825653>
5. Discuss Bastiat quote: “Government is the great fiction through which everybody endeavors to live at the expense of everybody else.” Frédéric Bastiat (1801 – 1850).
- Ask students to discuss whether local governments expand into as many areas as the federal government. Ask them to use Public Choice theory to explain their answers.
 - Ask students to think of whether there are any unintended consequences for government activities. Does the government always get the results it is seeking?
 - If you did not use the corruption video in Lesson 4, it is also appropriate here:
 - <http://www.youtube.com/watch?v=7SFx2R9JwHE> 3 min video. Play from beginning to about 1:20 (“You can’t make this stuff up!”) or 1:55 (“Would you buy a used car from this man?”) (*The Barroso Commission is the current European Commission, or executive branch of the EU, responsible for carrying out the policies and regulations of the EU by overseeing departments employing about 25,000 civil servants. The commission president, Jose Manuel Barroso, took office in 2004 and will serve through 2009. Barroso was at first seen as the lowest common denominator by outside commentators. Criticism of his proposed team of*



commissioners by members of the European Parliament forced him to appoint new members. This film is a speech by one of the British members of the European Parliament, commenting on Mr. Barroso's proposed appointees.)

Conclusion

- Government facilitates wealth-producing voluntary exchange by establishing and enforcing the rule of law that secures property rights.
- At the margin, the opportunity cost of government spending is private spending.
- Government is the efficient provider of “public goods.”
- The marginal benefits of government taxation and subsidies may outweigh the marginal costs when significant externalities exist.
- The incentive to expand government activities beyond those for which the benefits exceed the costs is explained by Public Choice theory.