

**Day 2 Hour 4**  
**THE ECONOMIC ROLE OF GOVERNMENT**

I. Why Do We Need a Government?

Perhaps the most fundamental question that we can ask about public finance is why we need a government. This question is important because many people believe that government is too large and needs to be reduced. We often call these people conservatives, as opposed to liberals, who believe that government is essential in solving the many problems which society faces. There are really five basic reasons why that government must exist. Let's consider each of these reasons.

First, governments exist because the private market often cannot always provide a sufficient amount of goods and services which we need. We call this phenomenon market failure. A good example of market failure is traffic control. Can you imagine a private company which would operate the traffic lights and stop signs in Taipei? How would they be able to force people to pay for the use of these lights and signs? Also, if the traffic light failed and some people were hurt in an accident, would they be able to sue the company for damages? Although it may be possible to have a private market for traffic control in a small village, it is not possible in a large modern city such as Taipei. The private market fails, and so there is a need for the government to supply the service.

Second, governments are needed to provide a system of justice and enforcement of contracts. Can you imagine a private company which would create laws for us to live by? Also, how could a private company provide the service which a court in Taipei provides. When one company breaks a contract with another company, what recourse does the second company have? How can it get restitution in a private market for justice? Sometimes private arbitrators can be used. What this means is that both companies agree to a neutral party listening to the evidence and making a final decision on who is wrong. The companies are then bound to accept the decision of the arbitrator. This is a common practice in labor/management disputes and is called binding arbitration. But, it is impossible for all legal decisions in a modern economy to be handled by such arbitration.

Third, governments are needed to control externalities or third-party effects which arise in private market transactions. An externality can be easily seen by

taking the example of smoking. When someone buys cigarettes from a company selling them, this is a private market transaction. However, when he smokes the cigarettes, other people must endure the bad smell of the smoke, not to mention the unhealthy aspects of ambient smoke. We call this a third-party effect, or an externality. Another example involves pollution from a factory. Suppose a factory located nearby manufactures a product and pollutes the air near your house. Each day you find that smoke from the factory ruins your clothes that you have hung up to dry. How can you get the factory to stop polluting the air? In general, most transactions have third party effects and the government can be used to control these externalities.

Fourth, the economy sometimes goes into recession and sometimes experiences inflation. We say that the economy is unstable in the short run. One important role for government is to see that these recessions and inflations are not too severe, since they may create social unrest. The government can use fiscal and monetary policy to help stabilize the economy. We refer to these as stabilization policies. As an aside, it is very understandable that some people do not believe this is a legitimate role of government, unless the recession is very deep and long lasting. In addition, inflations are almost always caused by government.

Finally, the government is needed to ensure that there is a reasonable distribution of income and wealth. History has shown that if either income or wealth becomes too unequal, then violent groups will arise to threaten the social order. Taiwan has an excellent distribution of income and wealth compared to the United States. One of the main reasons for this was the land reform which occurred in the 1950's. However, the distribution of income has been getting worse in recent years, and some people have called on the government to do something about this problem. Once again, it is reasonable that some people may believe that government has no role in deciding the distribution of income and wealth. Markets should decide this, not the government.

## II. What are Public Goods?

We often say that the government's main role is to provide goods and services which the private market undersupplies. These types of goods and services are called public goods. Let's take a closer look at public goods.

A public good or service is one that once it is provided to a group of consumers cannot be excluded from other consumers. Public goods occur because the private market sometimes allows "free riders" to exist. A good example of this is national defense. Suppose that I contract a private firm to protect me, here on the island of Taiwan, from any foreign army. If I pay this firm to protect me, it will also protect you, since my protection will keep you safe also. Note that you did not pay for the protection, but the firm cannot exclude you from enjoying the safety provided me. You have become a "free rider". In such a case, I would be very stupid to pay the firm to protect me. I should act as you do and become a "free rider" also. But, if everyone acts this way, then the market will not exist. We will have market failure. Therefore, national defense is a pure public good.

There are other examples of public goods, such as the building of lighthouses, and the construction of dams for flood control. However, we should emphasize that most goods provided by the government are not *pure* public goods. Let's consider the case of the Taipei Bridge. Although difficult, this bridge could be constructed and owned by a private company. They would operate it for a profit. Anyone who wanted to cross the bridge would have to pay a toll. If the bridge collapsed, then the company would be held liable. Also, the company would reasonably price the toll in order to make a competitive profit (since other bridges could be built). In America, The National Bridge Inventory lists roughly 2,200 privately owned highway bridges in 41 states and Puerto Rico. Therefore, we should say that not all goods and services provided by the government are pure public goods.

### III. How can Externalities be Controlled?

As we have said, private markets often cause externalities to arise. The government can be used to control these third-party effects. There are two basic ways to do this: (1) direct controls, and (2) indirect controls. The term "direct controls" means that the government sets a limit on the amount of externality produced. A factory is forced by law to limit the amount of pollution it discharges. With indirect controls the government uses taxes to control the amount of the externality. A good example of this is a pollution tax. Usually, this tax is levied on the output -- which is the source of the pollution. Environmental taxes have recently become very popular in the US. These taxes are sometimes called "green taxes", because they make the environment cleaner.