

Test Yourself: Government Functions in the Economy



If all economists were laid end to end, they
would still not reach a conclusion.

GB Shaw



What is an externality?



An externality is a cost or benefit imposed on people other than the consumers and producers of a good or service.

A **negative externality** is one that is detrimental to third parties, such as pollution.

A **positive externality** is one that is beneficial to third parties, such as vaccinations or public goods.



What is the effect of externalities?



When the supply curve fails to include negative external costs, the equilibrium price is artificially low and the equilibrium quantity is artificially high.

External costs cause the market to over allocate resources, and external benefits cause the market to under allocate resources.

When externalities are present, market failure gives incorrect price and quantity signals, and resources are misallocated.



Chart: External Cost of Pollution

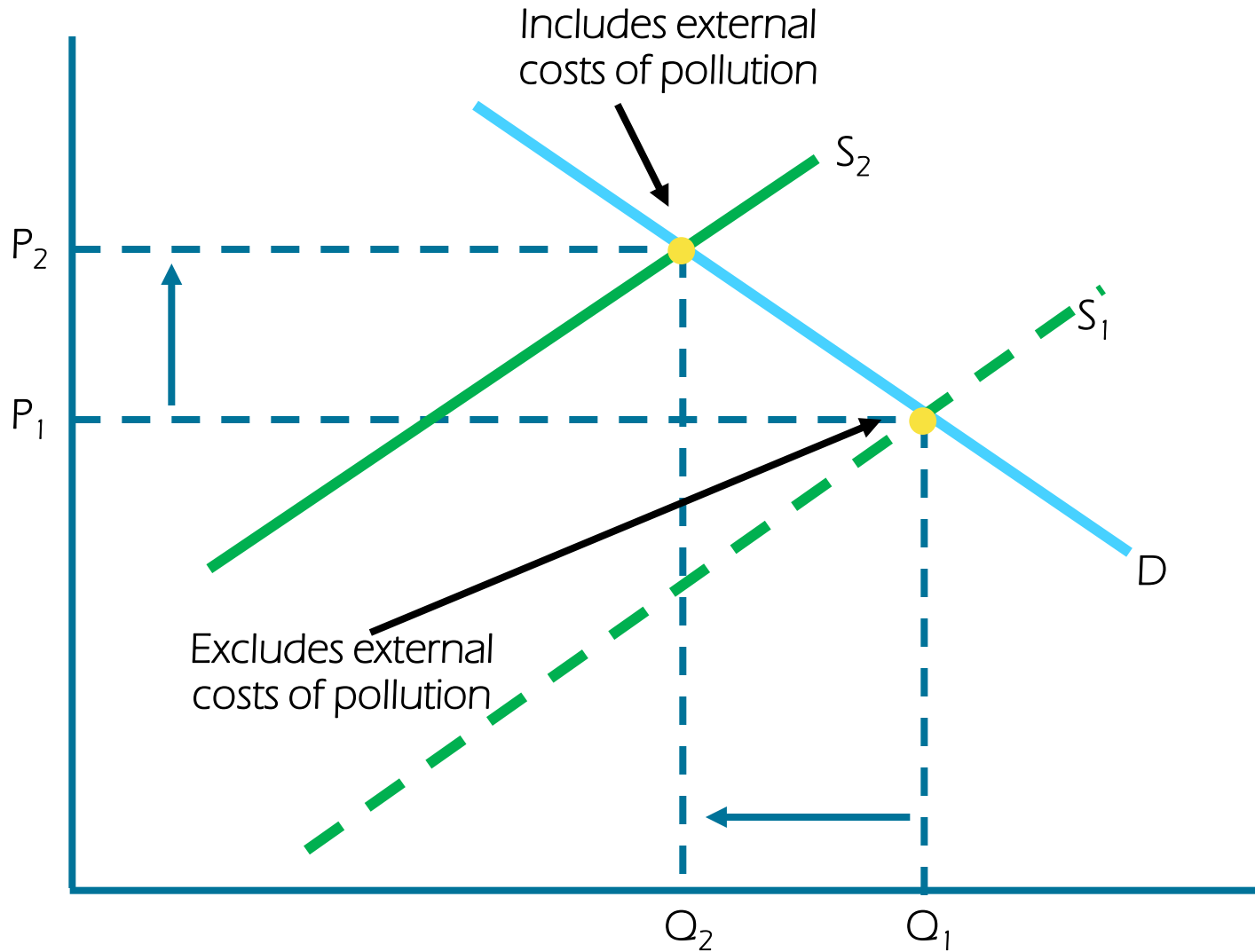
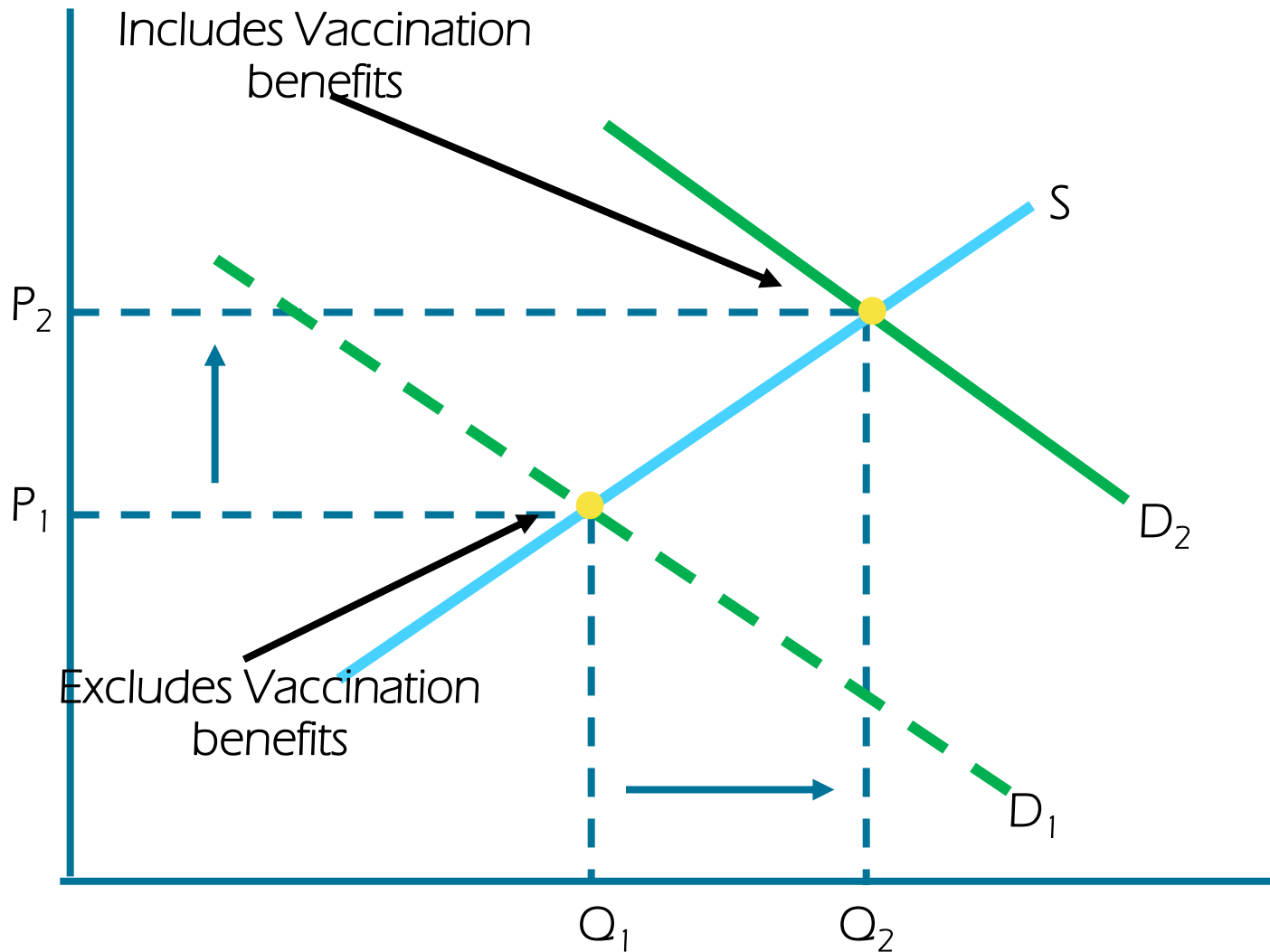




Chart: External Benefit of AIDS Vaccinations





What is a public good?



A public good is a good that, once produced, has two properties: (1) users collectively consume benefits and (2) no one can be excluded.

National defense, public education and roads are examples of public goods.

If public goods are available only in the marketplace, people wait for someone else to pay. The result is an underproduction or zero production of public goods.



In addition to correcting for externalities and providing public goods, what are the government's other functions in the economy?



In addition to correcting for externalities and providing public goods, the government's other functions in the economy are:

- providing a **legal system**
- promoting **competition**
- ensuring economy-wide **stability**
- promoting **merit goods** and discouraging **demerit goods**
- **income redistribution**



In case
you're
interested...

Economists to Watch

When a number of senior economists were asked which young, untenured economists were doing impressive work on real-world problems, these were the 13 young researchers whose names came up most often.

RESEARCH AREAS INCLUDE

Raj Chetty, <i>Berkeley</i>	Unemployment benefits and tax credits
Stefano DellaVigna, <i>Berkeley</i>	The decline in crime during the weekend a violent movie is released
Amy Finkelstein, <i>M.I.T.</i>	Medicare's role in increasing health spending
Roland Fryer, <i>Harvard</i>	The causes of racial inequality
Xavier Gabaix, <i>M.I.T.</i>	A rationale for chief executive pay
Matthew Gentzkow, <i>Chicago</i>	How newspapers cater to readers' political views
Dean Karlan, <i>Yale</i>	Microfinance in poor countries
Ulrike Malmendier, <i>Berkeley</i>	Irrational behavior, among everyone from chief executives to eBay customers
Benjamin Olken, <i>Harvard</i>	Corruption in Indonesia
Emily Oster, <i>Chicago</i>	Health in developing countries
Jesse Rothstein, <i>Princeton</i>	What school choice doesn't accomplish
Jesse Shapiro, <i>Chicago</i>	How television can benefit disadvantaged toddlers
Justin Wolfers, <i>Penn</i>	Online bettors' success in predicting elections

▲ Lines indicate married couples



How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



**CONTINUED IN
TEST YOURSELF: THE CIRCULAR FLOW**