

# 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?



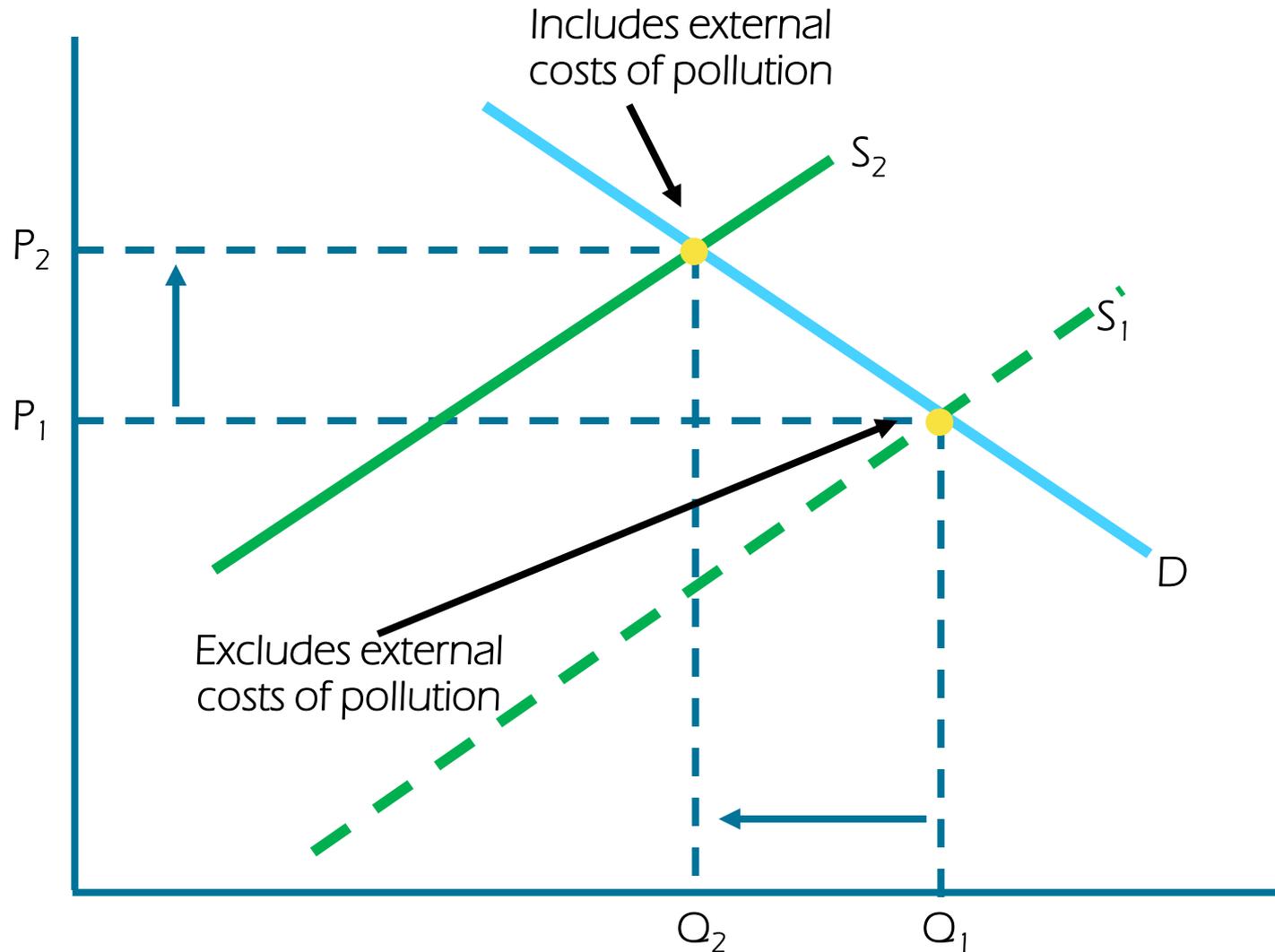
When the supply curve fails to include negative external costs, the equilibrium price is artificially low and the equilibrium quantity is artificially high.

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.

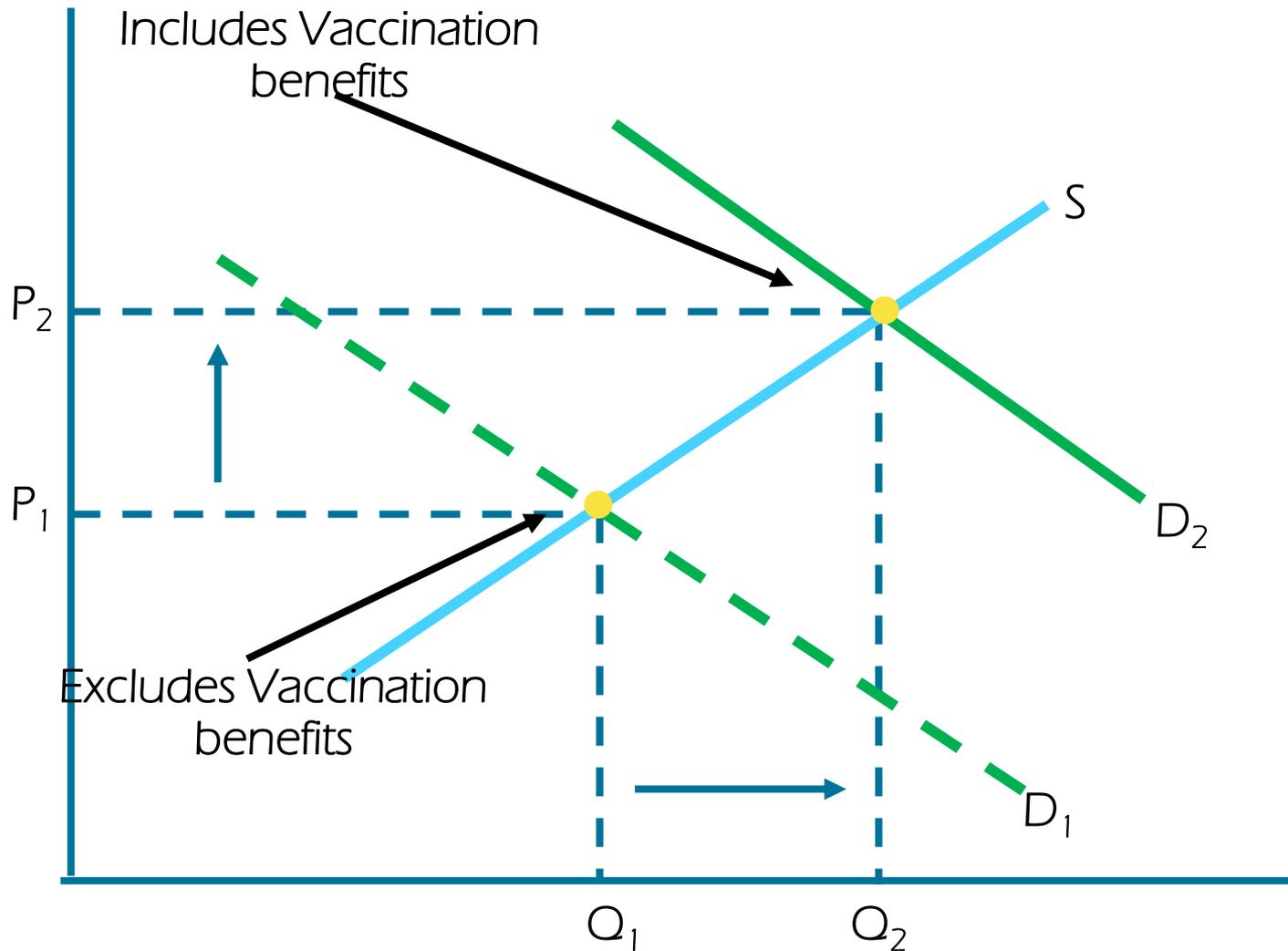


# Chart: External Cost of Pollution





# 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

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