



Economics of the Public Sector

lecture No.3

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In most Western economies, primary reliance for the production and distribution of goods lies in the private rather than the public sector.

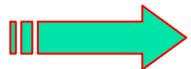
Why?

Those who believe in the private enterprise system believe that this form of economic organization has certain desirable characteristics; in particular, that it leads to an efficient allocation of resources.

This belief is, in fact, one of the oldest tenets of economics!

Is it true?

If this is true, then why is government needed?



This chapter, we will examine the successes and failures of private markets



Ch. 2, The Economic Rationale for Government

- Sect.1, The efficiency of competitive markets: the invisible hand.
- Sect.2, Market failures as a rationale for government activity.
- Sect.3, Redistribution and merit goods: two further rationales for government activity.
- Sect.4, Two perspectives on the role of the government.



Sect.1, The efficiency of competitive markets: the invisible hand.

- Part 1: Invisible hand
 - ---Competition and profit motive would lead individuals serve the public interest when they pursue their own interest.
- Part 2: The two fundamental theorems of welfare economics.
 - --- In what sense, then under what conditions, do competitive markets lead to economic efficiency?
- Part 3: The Pareto efficiency of the competitive economy
 - ---Why does competition under ideal conditions lead to efficiency?

Sect.1, The efficiency of competitive markets

Adam Smith, “invisible hand”

Competition and profit motive would lead individuals serve the public interest when they pursue their own interest.



Sect.1, The efficiency of competitive markets

- **The intuition behind Smith's insight:**
- 1, If there is some commodity or service that individuals value but that is not currently being produced, then they will be willing to pay something for it.
- 2, Entrepreneurs, in their search for profits, are always looking for such opportunities.

Price > Cost produce

⇒ For new commodities

New cost < Current cost
produce

⇒ For more efficient
ways of production

} Better serve
the needs of
consumers



Sect.1, The efficiency of competitive markets

In other words:

3, If the value of a certain commodity to a consumer exceeds the cost of production, there is a potential profit for an entrepreneur, and he will produce the commodity.

4, Similarly, if there is a cheaper way of producing a commodity than that which is presently employed, an entrepreneur who discovers this cheaper method will be able to undercut competing firms and make a profit.

The search for profits on the part of firms is thus a search for more efficient ways of production and for new commodities that better serve the needs of consumers.

No government committee needs to decide whether a commodity should or should not be produced.

It depends the margin between the price which the buyer would pay and the cost which the producer would spend.



Sect.1, The efficiency of competitive markets

- On the one side, there is a widespread consensus among economists that competitive forces do lead to a high degree of efficiency, and that competition does provide an important incentive to innovation.
- On the other side, however, during the past two hundred years economists have come to recognize that there are some important instances where the market does not work as perfectly as the more ardent supporters of the free market suggest.



Sect.1, The efficiency of competitive markets

In what sense
Under what conditions } do competitive markets lead
to economic efficiency?

The answer is summarized by the two
fundamental theorems of welfare economics!



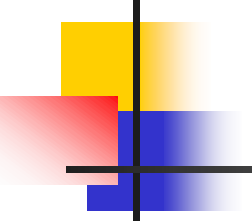
Part.1, The two fundamental theorems of welfare economics

- **First fundamental theorem:**
- Under certain conditions, competitive markets lead to an allocation of resources with a very special property: there is no rearrangement of resources (no possible change in production and consumption) such that someone can be made better off without, at the same time, making someone else worse off.

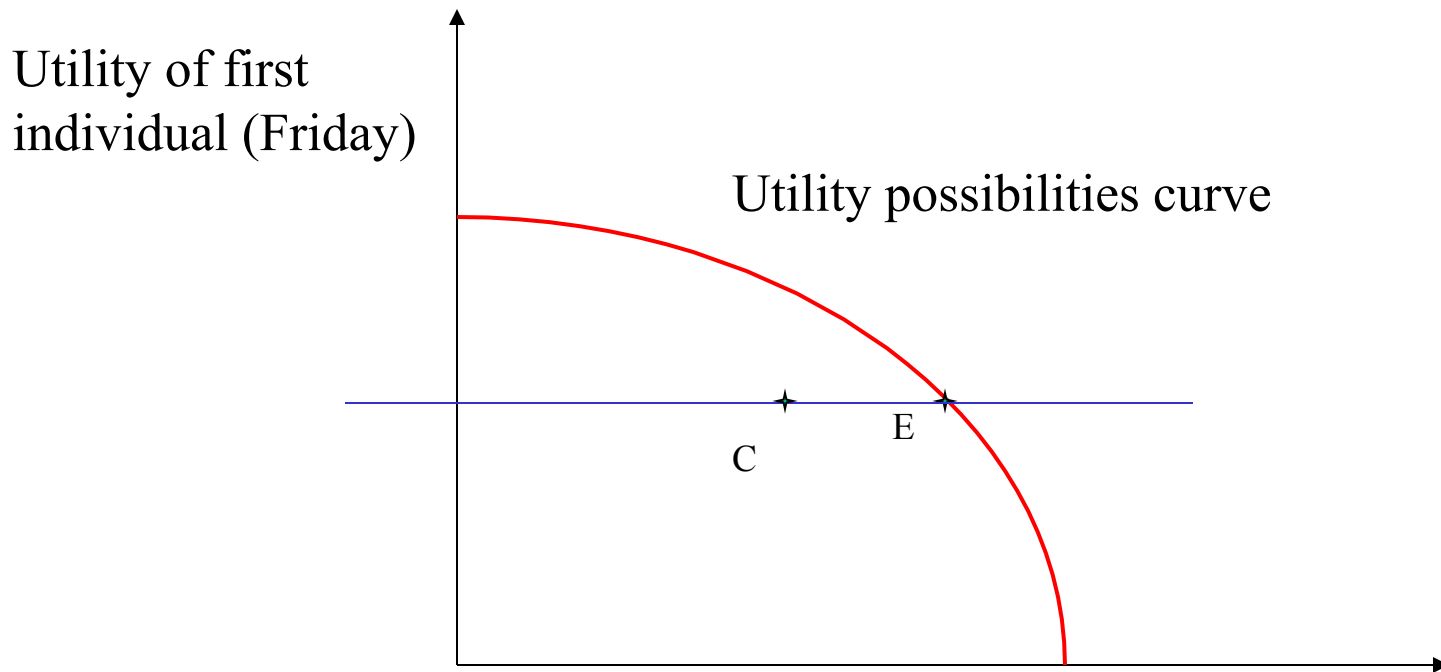


Part.1, The two fundamental theorems of welfare economics

- Resource allocations that have the property that no one can be made better off without someone else being made worse off are called **Pareto efficient (or Pareto-optimal) allocations.**

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- 按照帕累托的说法，如果社会资源的配置已经达到这样一种状态，即任何重新调整都不可能在不使其他任何人境况变坏的情况下，而使任何一人的境况更好，那么，这种资源配置的状况就是最佳的，也就是具有效率的（王传纶、高培勇《当代西方财政经济理论》，pp.10），这样的状态就是帕累托最优状态。
 - 只要经济活动的结果是“得者的所得多于失者的所失”，那么这种经济活动带来的是“卡尔多改善”（高培勇等《公共经济学》，pp.12）

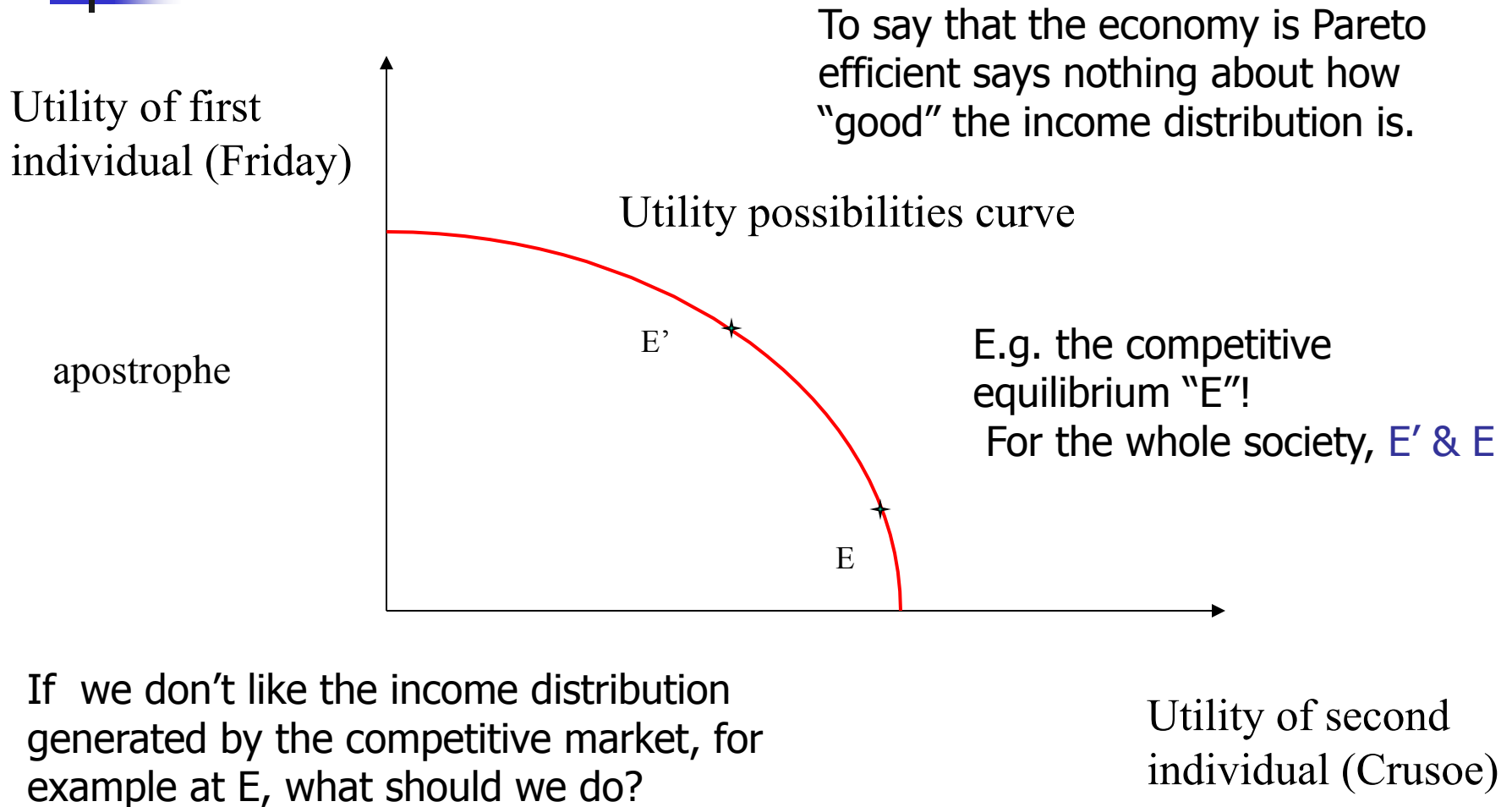
Diagrammatic way of representing the Pareto efficiency of the economy



1st theorem: under certain conditions, a competitive economy will attain some point along the UPC.

Utility of second individual (Crusoe)

Part.1, The two fundamental theorems of welfare economics





Part.1, The two fundamental theorems of welfare economics

- **Second fundamental theorem!!!**

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