

CHOICE, MARKETS, AND GOVERNMENT

WHERE YOU'RE GOING

When you have mastered this chapter, you will understand

1. The basic structure of economic theory.
2. Rationality in economics.
3. The meaning of *market performance* and *market failure*.
4. Alternative theories of the economic role of government.

In addition, you will add the following terms to your economic vocabulary:

- | | |
|---------------------------------------|-----------------------------|
| Property Rights | Externalities |
| Ockham's razor | Public goods |
| Self regarding preferences | Other regarding preferences |
| Political rent seeking (rent seeking) | |

WALKING TOUR

After you have read this chapter at least once, you should work step by step through this walking tour. Fill in the blanks and answer the questions as you go along. After you have answered each question, check yourself by uncovering the answer given in the margin. If you do not understand why the answer given is the correct one, refer back to the proper section of the text.

The Structure of Economic Theory

To analyze something means to break it into its component parts. In economic analysis, the component parts of every theory are statements about

- | | |
|---------------|---------------|
| objectives | 1. _____, |
| opportunities | 2. _____, and |
| choices | 3. _____. |

rationally	Economists say that a person who acts purposefully to achieve an objective, given the opportunities that are available, is acting _____.
is not	The assumption of rationality [is/is not] a psychological or philosophical assertion about human nature. It [is/is not] a tool for giving structure to theories about the choices people make.
is	

constraint	If an economist encounters observations that are inconsistent with theories previously thought to be valid, the first reaction is often to see if the original theory failed to take into account some _____ on the opportunities available to people. Failing to find some explanation in terms of opportunities, the next reaction is to see if the previous theory incorrectly characterized people's _____.
objectives	Only as a last resort will an economist conclude that the observed behavior is _____.
rational	Economics

does not outside [does/does not] deny that people sometimes behave irrationally. However, the analysis of irrational behavior lies [within/outside] the scope of economics.

full A theory that assumes that people make full use of all available information in calculating how best to meet their objectives is said to be based on _____ rationality. A theory that assumes that people intend to make choices that best serve their objectives, but have a limited ability to acquire and process information, is said to be based on _____ rationality. Traditionally, neoclassical economic theory assumes _____ rationality. However, there are special situations (such as the tendency of consumers to avoid house-brand products whose price is “too low”) in which a theory based on _____ rationality may better fit observed behavior.

bounded full bounded Another way to think of rationality is in terms of how people evaluate their own preferences. Individuals who are concerned only with their own welfare are said to have _____ preferences. Those who evaluate their well-being in terms of others have _____ preferences.

self-regarding other regarding

Market Performance and Market Failure

market performance The issue of how well markets do their job of providing arrangements for mutually beneficial trade is referred to as the issue of _____. A market in which all possible mutually beneficial trades are carried out efficiently _____ inasmuch as all such trades leave at least one party better off and neither worse off. Economists maintain that for a broad range of goods and services, markets operating according to the principles of supply and demand offer a [high/low] level of performance.

high

market failure A situation in which a market fails to coordinate choices in a way that achieves efficient use of resources is called a _____. There are several sources of market failure. A situation in which producers' or consumers' actions have effects on third parties that are not reflected in prices is called an _____. In such situations, market prices tend to send inaccurate information about opportunity costs. In the case of a harmful externality like air or water pollution, the market price of the good whose production causes the externality tends to be [higher/lower] than opportunity cost.

market failure

externality

lower

public cannot Goods that cannot be provided to one person without also being provided to another person and can be provided to others at no cost (once they are provided to one person) are called _____ goods. They are a source of market failure because private firms [can/cannot] easily produce and sell them at a profit due to the tendency for people to act as free riders.

insufficient monopoly higher

A third source of market failure is _____ competition. For example, when there is only one seller of a good—a _____—the price charged is likely to be [higher/lower] than the opportunity cost.

The Economic Role of Government

hierarchy Government's role in the economy is an example of the use of _____ to make economic decisions. According to one theory of government's role, everything the market can do well should be left to the market; the market failure government should intervene only in case of _____. For example,

market failure

internalize	the government could impose a tax to _____ the effects of
public	pollution. It could take over the task of supplying _____ goods.
antitrust	And in the case of monopoly, it could intervene by using _____ laws
regulation	to preserve competition, or by _____ of a monopoly.
does not	In practice, government [does/does not] confine its role in the economy
	to cases of market failure. Instead, economists find that some government
rent seeking	policies that are not primarily intended to correct market failures can be
	explained in terms of political _____. The term refers to political
economic rents	actions aimed at obtaining payments to factors of production in excess of
	opportunity cost, that is _____. The branch of economics concerned
public choice	with the use of the instruments of government to pursue private ends, and
	with rent seeking in particular, is known as _____ theory.

SELF TEST

These sample test items will help you check how much you have learned. Answers are found at the end of the chapter. Scoring yourself: One or two wrong—on target. Three or four wrong—passing but you haven't mastered the chapter yet. Five or more wrong—not good enough; start over and restudy the chapter.

1. Statements about which of the following are included in every economic theory?
 - a. objectives
 - b. opportunities
 - c. choices
 - d. all of the above

2. A person who acts purposefully to achieve an objective, given the opportunities that are available, is said to be
 - a. objective.
 - b. rational.
 - c. opportunistic.
 - d. presumptive.

3. Which of the following best characterizes economists' view of rationality?
 - a. People rarely act rationally.
 - b. People invariably act rationally.
 - c. To assume that people act rationally often helps in understanding the choices they make.
 - d. People's actions are rational only where money is concerned.

4. If an observation does not fit a previously accepted theory, which of the following is an economist least likely to do?
 - a. Check to see if the previous theory failed to include some key constraint.
 - b. Check to see if the objectives assumed by the previous theory were valid.
 - c. Choose to ignore the observation as probably the result of irrationality.
 - d. Choose to ignore the observation because observations do not matter for the validity of a theory.

5. The term "bounded rationality" refers to people who
 - a. are bound to act rationally regardless of the circumstances.
 - b. intend to act rationally but have limited ability to acquire and process information.
 - c. intend to act irrationally but are led by self-interest to make the rational choice despite their intention.
 - d. make use of all existing information every time they make a choice.

6. A market that makes it possible to carry out all potential mutually beneficial trades can be said to perform
 - a. efficiently.
 - b. rationally.
 - c. opportunistically.
 - d. monopolistically.
7. A situation in which a producer's or a consumer's actions affect a third party, and are not reflected in prices, is called a(n)
 - a. monopoly.
 - b. economic rent.
 - c. constraint.
 - d. externality.
8. Which of the following is a characteristic of public goods?
 - a. If provided to one person, they must be provided to others as well.
 - b. Once provided to one person, they can be provided to others at no additional cost.
 - c. Both a and b are true.
 - d. Neither a nor b are true.
9. Monopoly is viewed as a potential source of market failure because a monopolist may sell the product it produces
 - a. at a price higher than opportunity cost.
 - b. only to other monopolists.
 - c. at a price lower than opportunity cost.
 - d. at a price higher than consumers are willing to pay.
10. According to public choice theory,
 - a. all government policies can be explained in terms of attempts to correct market failures.
 - b. some government programs motivated by rent seeking cause markets to work less efficiently.
 - c. markets never fail to work efficiently.
 - d. the government can do nothing to correct market failures, even if it tries.
11. The fact that wealthy people often take advantage of rent control programs that were originally intended to help low-income renters can best be explained in terms of
 - a. irrationality.
 - b. rent seeking.
 - c. monopoly.
 - d. market failure.
12. According to public choice theory, political rent seeking may influence government policy in which of the following areas?
 - a. Pollution control.
 - b. Regulation of monopoly.
 - c. Production of public goods.
 - d. All of the above.
13. Which of the following is characteristic of traditional neoclassical economics?
 - a. the assumption of full rationality
 - b. an emphasis on the high cost of acquiring information
 - c. models stated in terms of words rather than in graphical or mathematical terms
 - d. careful attention to the internal workings of firms, households, and government agencies

14. In what way have economists extended the reach of traditional neoclassical theory in recent years?
 - a. looking more carefully at the internal workings of firms
 - b. developing models based on bounded rationality
 - c. using economic theory to understand how government agencies make decisions
 - d. all of the above
15. Economists who study entrepreneurship
 - a. must recognize that the process of innovation is nonrational.
 - b. must accept all constraints as givens that cannot be challenged.
 - c. must not limit their attention to equilibrium states of the economy.
 - d. All of the above.

ANSWERS TO CHAPTER 4

Self Test

1. **d.** Economic theories seek to explain choices that people make in pursuit of their objectives, given their opportunities.
2. **b.** The assumption of rationality is central to economics.
3. **c.** Economists recognize that people sometimes do not act rationally, but the study of such actions lies outside the scope of economics.
4. **c.** Answer **a** is the most likely action, **b** the next most likely.
5. **b.** Answer **d** is the assumption of full rationality.
6. **a.** Such a market takes advantage of every opportunity to make one person better off without making another worse off.
7. **d.** Pollution is a common example of an externality.
8. **c.** These properties make it difficult for a private firm to sell the good at a profit because people tend to act as free riders.
9. **a.** In competitive markets, a firm that tries to sell its output at a price above opportunity cost will lose customers to rival firms.
10. **b.** In such cases, there is said to be a “government failure.”
11. **b.** It is perfectly rational for people to use the political process to try to get benefits like rent control for themselves.
12. **d.** Practically any area of government policy is influenced by rent seeking to some degree.
13. **a.** Some modern extensions of neoclassical theory incorporate **b**, **c**, and **d**.
14. **d.** All of these extensions are examined in later chapters.
15. **c.** Entrepreneurship typically involves disruption of previous states of equilibrium.

