

# THE PUBLIC SECTOR

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## FUNDAMENTAL QUESTIONS

1. How does the government interact with the other sectors of the economy?

Households sell resources to the government—which uses those resources to produce government services—in return for income. Business firms sell the goods and services they produce to the government for revenue. Taxes are the income the government receives from households and firms. In reality, the government may interact directly with foreign consumers and businesses, but most government activity with the international sector occurs when the government uses business firms as intermediaries.

2. What is the economic role of government?

One outcome of the market system is **economic efficiency**—that is, no one can be made better off without making someone else worse off. However, economic efficiency can be limited by **market imperfections, externalities, public goods, monopolies, and business cycles**. The economic role of government is to reduce economic inefficiencies by controlling these factors.

3. Why is the public sector such a large part of a market economy?

There are two explanations for the role of government in the market economy. One view suggests that government intervenes in the economy only to correct market failures. Another argument suggests that government actions result from the rent-seeking behaviors of the individuals who make up the government. That is, voters and politicians use the power of government to transfer benefits to themselves from others.

4. What does the government do?

The economic role of government can be divided into two categories: microeconomic policy and macroeconomic policy. Microeconomic policy deals with providing public goods, correcting externalities, and promoting competition. Macroeconomic policy is divided into two categories: fiscal policy and monetary policy. **Monetary policy** is directed toward control of money and credit, and **fiscal policy** is directed toward government spending and taxation.

5. How do the sizes of public sectors in various countries compare?

The United States and Canada are representative of market systems that rely on the decisions of individuals and in which the public sector is relatively small. Nations like Cuba rely on a planning board or central committee and have large public sectors. The economies of the United Kingdom, Germany, Japan, and Sweden lie in between.

## Key Terms

economic efficiency  
 technical efficiency  
 market imperfection  
 externalities  
 public goods  
 private property right

free ride  
 monopoly  
 business cycles  
 rent seeking  
 public choice  
 monetary policy

Federal Reserve  
 fiscal policy  
 transfer payments  
 budget surplus  
 budget deficit  
 centrally planned economy

## Quick-Check Quiz

### Section 1: The Circular Flow

- The text assumes that the government sector does not interact directly with
  - households.
  - business firms.
  - foreign countries.
  - foreign countries and business firms.
  - households and the international sector.
- Which of the following statements is *false*?
  - The government employs the factors of production to produce government services.
  - Money flows from the government to households.
  - The value of private production equals the value of household income.
  - The total value of output in the economy equals the total income received.
  - In a sense, the household sector purchases goods and services from the government.
- Which of the following statements is *true* for the complete circular flow model?
  - Business firms supply government services and demand tax revenues.
  - Government spending is the same as total output.
  - The flow of imports equals household income.
  - Total output is the sum of household incomes, business revenues, government income, and net exports.
  - Total output is the sum of household incomes, business revenues, government spending, and net imports.

### Section 2: The Role of Government in the Market System

- Economic efficiency* refers to
  - the combination of inputs that results in the lowest cost.
  - a situation in which no one can be made better off without making someone else worse off.
  - the role of central planning boards in determining what goods and services should be produced.
  - the role of government in providing public goods.
  - the role of government in imposing taxes on those goods and services that produce negative externalities.

2. Which of the following is an example of a market externality problem?
  - a. Lana hates her new haircut.
  - b. Stan's new car turns out to be a clunker.
  - c. Jan's neighbor blasts her out of bed with his new stereo at 4:00 A.M.
  - d. Dan's new sweater falls apart the first time he washes it.
  - e. Tim buys expensive basketball shoes that hurt his feet.
  
3. Which of the following does *not* involve negative externalities?
  - a. cigarette smoke in a crowded restaurant
  - b. acid rain
  - c. Amazon rainforests, which help neutralize the effects of air pollution
  - d. a blaring stereo
  - e. the use of a highway by an additional vehicle
  
4. A lighthouse is an example of a
  - a. negative externality.
  - b. positive externality.
  - c. public good.
  - d. commonly owned good.
  - e. private property right.
  
5. If negative externalities are involved in the production or consumption of a good, \_\_\_\_\_ of the good is produced or consumed. The government should \_\_\_\_\_ to encourage producers to produce \_\_\_\_\_ of the good.
  - a. too little; grant subsidies; more
  - b. too little; impose taxes; less
  - c. too much; impose taxes; more
  - d. too much; impose taxes; less
  - e. too much; grant subsidies; less
  
6. Which of the following statements is *false*?
  - a. It is not possible to exclude people from the benefits of public goods.
  - b. Education is an example of a good with positive externalities.
  - c. People have an incentive to try for a free ride when goods are public goods.
  - d. If a good has positive externalities, too little of the good is produced.
  - e. The price system ensures that the appropriate amount of public goods is produced.
  
7. The market system does *not* work efficiently when
  - a. the market price reflects the full costs and benefits of producing and consuming a particular good or service.
  - b. the least-cost combinations of resources are used.
  - c. the benefits derived from consuming a particular good or service are available only to the consumer who buys the good or service.
  - d. private property rights exist.
  - e. market imperfections exist.

8. Public choice economists believe that
  - a. people who do not like a market outcome use the government to change the outcome.
  - b. the government intervenes only to correct market inefficiencies.
  - c. rent-seeking activities increase economic efficiency.
  - d. resources devoted to enacting the transfer of benefits are productive.
  - e. redistributing income increases economic efficiency.
  
9. Which of the following is *not* a public good?
  - a. police protection
  - b. national defense
  - c. streetlights
  - d. cable television
  - e. education
  
10. A market economy reaches an efficient outcome only if the market price of each good and service
  - a. includes the full costs of producing and consuming that good or service.
  - b. includes a substantial profit for the seller of that good or service.
  - c. includes the full costs of producing that good or service.
  - d. includes the costs of the government services used to produce that good or service.
  - e. includes the full costs of consuming that good or service.

### Section 3: Overview of the United States Government

1. Combined government spending on goods and services is larger than \_\_\_\_\_ but smaller than \_\_\_\_\_.
  - a. consumption; net exports
  - b. consumption; investment
  - c. net exports; investment
  - d. investment; net exports
  - e. investment; consumption
  
2. A budget deficit
  - a. exists when federal revenues exceed federal spending.
  - b. last occurred in the United States in 1969.
  - c. occurs when federal spending exceeds federal revenues.
  - d. has no effect on consumption and investment.
  - e. has no effect on economic relationships with other countries.
  
3. Which of the following is *not* a microeconomic function of government?
  - a. provision of public goods
  - b. control of money and credit
  - c. correction of externalities
  - d. promotion of competition
  - e. minimizing the free-rider problem

4. Which of the following is a macroeconomic function of government?
  - a. redistribution of income
  - b. promotion of competition
  - c. determining the level of government spending and taxation
  - d. provision of public goods
  - e. correction of externalities
  
5. The \_\_\_\_\_ is (are) responsible for fiscal policy, and the \_\_\_\_\_ is (are) responsible for monetary policy.
  - a. Federal Reserve; Congress
  - b. Federal Reserve; Congress and the president
  - c. Congress; Federal Reserve
  - d. Congress and the president; Federal Reserve
  - e. Congress; Federal Reserve and the president

#### Section 4: Government in Other Economies

1. Which of the following has an economy that is primarily centrally planned?
  - a. United Kingdom
  - b. Japan
  - c. Cuba
  - d. Germany
  - e. Canada
  
2. In \_\_\_\_\_, government spending (as a percentage of total output) is lower than that of Japan.
  - a. the United States
  - b. Sweden
  - c. France
  - d. Germany

### Practice Questions and Problems

#### Section 1: The Circular Flow

1. Government in the United States exists at the \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_ levels.
2. The household sector obtains government goods and services primarily by \_\_\_\_\_.
3. The \_\_\_\_\_ illustrates how the main sectors of the economy fit together.

**Section 2: The Role of Government in the Market System**

1. \_\_\_\_\_ efficiency is the combination of inputs that results in the lowest cost.
2. \_\_\_\_\_ efficiency is the point at which no one in society can be made better off without making someone else worse off.
3. A small company continues to use an old mimeograph machine even though a new personal copier would cut the company's copying costs by 50 percent. This is an example of \_\_\_\_\_ inefficiency.
4. An African American man is repeatedly passed over for promotion because of race. This is an example of \_\_\_\_\_ inefficiency.
5. Situations in which the least-cost combination of resources is not used or in which a resource is not used where it has its highest value are called \_\_\_\_\_.
6. \_\_\_\_\_ are the costs or benefits of a market activity borne by someone who is not a party to the market transaction.
7. When negative externalities exist, the market price \_\_\_\_\_ (overstates, understates) the full cost of the activity.
8. \_\_\_\_\_ are goods whose consumption benefits more than the person who purchased the good.
9. The limitation of ownership to an individual is called a(n) \_\_\_\_\_.
10. A producer or consumer who enjoys the benefits of a good without having to pay for it is getting a(n) \_\_\_\_\_.
11. Common ownership of a resource results in \_\_\_\_\_ (overutilization, underutilization).
12. Market imperfections may result from \_\_\_\_\_ or inaccurate information.
13. Once streetlights exist, people who have not paid for them cannot be excluded from their benefits. Streetlights are \_\_\_\_\_ goods.
14. A situation in which there is only one producer of a good is called a(n) \_\_\_\_\_.
15. Fluctuations in the economy are called \_\_\_\_\_.
16. The use of resources to transfer income from one sector of the economy to another is called \_\_\_\_\_.
17. Monopolies may produce \_\_\_\_\_ (more, less) of a good in order to be able to charge a higher price.
18. \_\_\_\_\_ theory says that the government may be brought into the market system whenever someone or some group can benefit, even if efficiency is not served.

### Section 3: Overview of the United States Government

1. List three microeconomic functions of government.

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2. The macroeconomic functions of government are \_\_\_\_\_ and \_\_\_\_\_ policies.
3. The \_\_\_\_\_ is the central bank of the United States.
4. Monetary policy is directed toward control of \_\_\_\_\_ and \_\_\_\_\_.
5. Fiscal policy is directed toward \_\_\_\_\_ and \_\_\_\_\_.
6. Monetary policy is the responsibility of the \_\_\_\_\_.
7. Fiscal policy is the responsibility of the \_\_\_\_\_.
8. The \_\_\_\_\_ usually initiates major policy changes.
9. If federal government spending is less than tax revenue, a budget \_\_\_\_\_ exists.
10. If federal government spending is greater than tax revenue, a budget \_\_\_\_\_ exists.

### Section 4: Government in Other Economies

1. A(n) \_\_\_\_\_ is an economy in which the government determines what goods and services are produced and the prices at which they are sold.
2. Match the country with the description of its economy.

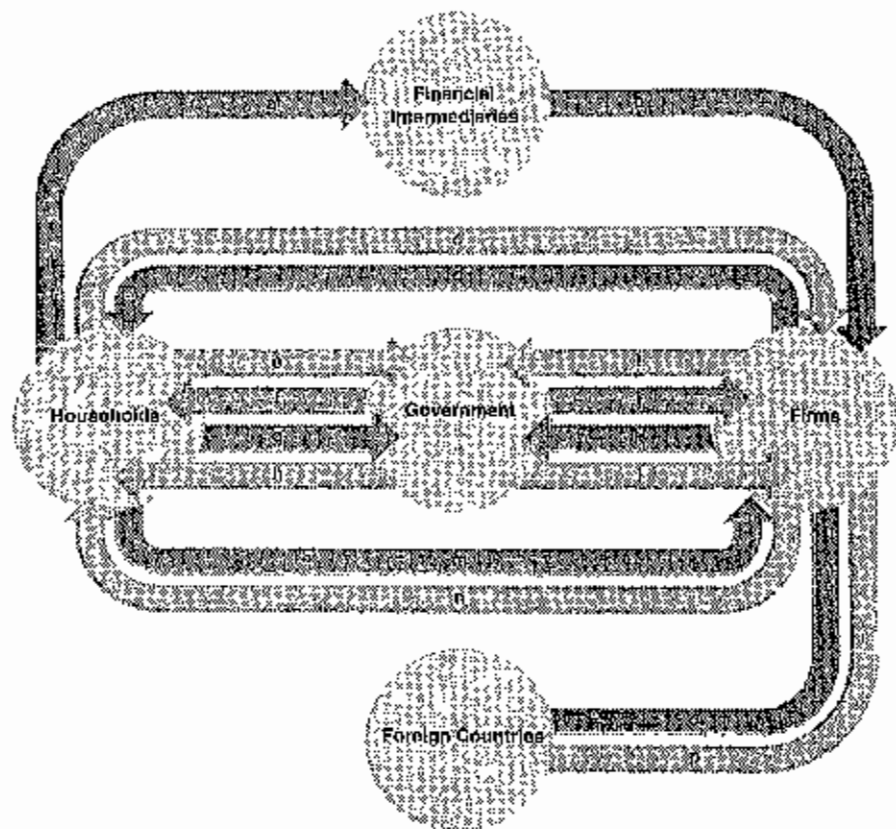
Cuba	Germany
Japan	Sweden
United Kingdom	

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|---|-------|
| a. a capitalist economy in which the government plays an important role through its influence on industrial families                  | _____ |
| b. a market economy in the production of goods and services in which the government accounts for nearly 45 percent of total purchases | _____ |
| c. a country in which the public sector owns few businesses but intervenes a great deal to foster social programs                     | _____ |
| d. a country whose economy is primarily centrally planned   | _____ |
| e. a European country in which public-sector spending was about 40 percent of total output  | _____ |
3. A market economy relies on \_\_\_\_\_ and \_\_\_\_\_ to solve economic problems. In a centrally planned economy, the \_\_\_\_\_ decides what is produced, how it is produced, and who gets what.

## Thinking About and Applying the Public Sector

### I. The Circular Flow Diagram

Use the diagram below to see if you understand how the four sectors of the economy are linked together. In the blanks below, fill in the appropriate labels. Money flows are represented by light gray lines. Flows of physical goods and services are represented by dark gray lines.



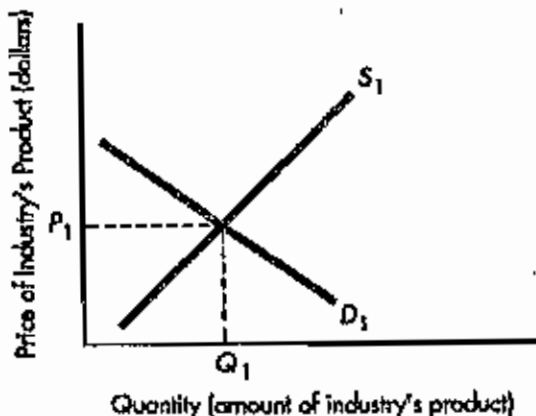
- a. \_\_\_\_\_  
 b. \_\_\_\_\_  
 c. \_\_\_\_\_  
 d. \_\_\_\_\_  
 e. \_\_\_\_\_  
 f. \_\_\_\_\_  
 g. \_\_\_\_\_  
 h. \_\_\_\_\_

- i. \_\_\_\_\_  
 j. \_\_\_\_\_  
 k. \_\_\_\_\_  
 l. \_\_\_\_\_  
 m. \_\_\_\_\_  
 n. \_\_\_\_\_  
 o. \_\_\_\_\_  
 p. \_\_\_\_\_



## II. Government Response to Externalities

1. The graph below shows the demand and supply of an industry's product. This industry currently spews pollution into the air but bears no costs for its actions. If the industry is made responsible for the cleanup, show the effect on the market for this firm's product.



2. How could the government make this cost internal to the firm? What would this do to the price of the firm's output?

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## III. Justifying the Nutrition Labeling and Education Act

The Nutrition Labeling and Education Act requires food manufacturers to disclose what is in their products in a uniform manner. The idea of the act is to allow consumers to compare the nutritional values of dissimilar products.

Consider the role of the public sector as explained in the text, and provide the economic rationale for the Nutrition Labeling and Education Act.

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#### IV. Extending Regulation

A few years ago, the *Wall Street Journal* ran the following headline: "Clinton's Team Moves to Extend Regulation in Variety of Industries." Consider the role of the public sector as explained in the text, and provide the economic rationale for the following actions:

1. "Major airlines have been put on notice that the government is scrutinizing their pricing practices."

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2. "Strict quality-control rules will be imposed on the seafood industry, and more inspectors will be sent into meat and poultry plants to curb a rise in food-borne illness."

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3. "The prescription-drug industry may get slapped with price controls."

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## Chapter 5 Homework Problems

Name \_\_\_\_\_

1. What is included in the U.S. government's microeconomic policy?
2. What is included in macroeconomic fiscal policy? In the United States, who makes decisions regarding fiscal policy?
3. What is included in macroeconomic monetary policy? In the United States, who makes decisions regarding monetary policy?
4. Last year, the government of an island nation spent \$100,000 to build a lighthouse on a dangerous rock 10 miles from the nation's main harbor. Before the lighthouse was built, an average of 25 ships a year ran onto the rock, causing the loss of several millions of dollars every year. During the year the lighthouse has been in operation, no ships have run onto the rock. Why didn't a private company build the lighthouse before, since the benefits are so much more than the costs?

5. The “Global Business Insight” box in this chapter describes the problem of overfishing of halibut around Alaska, and how the U.S. government created ownership rights to fish caught in that area as a way to limit the number of fish caught.

In a market economy, resources that nobody owns, like fish in the ocean or clean air, tend to become overused. Think about the way that halibut fishing permits created ownership rights and an economically efficient market, and describe how a market for air pollution permits could be an economically efficient way to limit the amount of pollution.

If your instructor assigns these problems, write your answers above, then tear out this page and hand it in.

## Answers

### Quick-Check Quiz

#### *Section 1: The Circular Flow*

1. c; 2. c; 3. d

If you missed any of these questions, you should go back and review Section 1 in Chapter 5.

#### *Section 2: The Role of Government in the Market System*

1. b; 2. c; 3. c; 4. c; 5. d; 6. c; 7. e; 8. a; 9. d; 10. a

If you missed any of these questions, you should go back and review Section 2 in Chapter 5.

#### *Section 3: Overview of the United States Government*

1. c; 2. c; 3. b; 4. c; 5. d

If you missed any of these questions, you should go back and review Section 3 in Chapter 5.

#### *Section 4: Government in Other Economies*

1. c; 2. a

If you missed either of these questions, you should go back and review Section 4 in Chapter 5.

### Practice Questions and Problems

#### *Section 1: The Circular Flow*

1. federal; state; local
2. paying taxes
3. circular flow diagram

#### *Section 2: The Role of Government in the Market System*

1. Technical
2. Economic
3. technical
4. economic
5. market imperfections
6. Externalities
7. understates
8. Goods with positive externalities, or public goods
9. private property right
10. free ride
11. overutilization
12. incomplete
13. public
14. monopoly

15. business cycles
16. rent seeking
17. less
18. Public choice

### ***Section 3: Overview of the United States Government***

1. provision of public goods  
correction of externalities  
promotion of competition
2. fiscal; monetary
3. Federal Reserve
4. money; credit
5. government spending; taxation
6. Federal Reserve
7. Congress and the president
8. president
9. surplus
10. deficit

### ***Section 4: Government in Other Economies***

1. centrally planned economy
2. a. Japan  
b. Sweden  
c. Germany  
d. Cuba  
e. United Kingdom
3. individual actions; prices; government

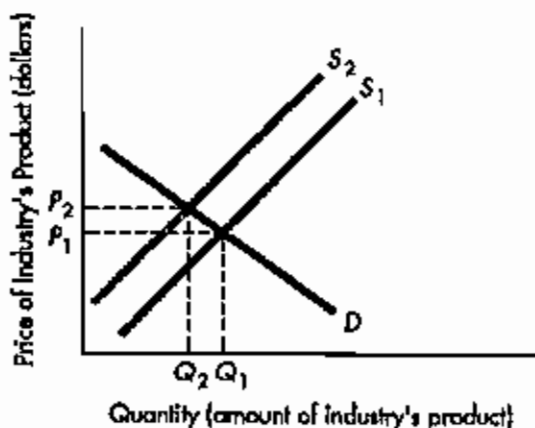
## **Thinking About and Applying the Public Sector**

### ***I. The Circular Flow Diagram***

- a. saving
- b. investment
- c. payments for goods and services
- d. goods and services
- e. taxes
- f. government services
- g. resource services
- h. payments for resource services
- i. taxes
- j. government services
- k. goods and services
- l. payments for goods and services
- m. resource services
- n. payments for resource services
- o. net exports
- p. payments for net exports

## II. Government Response to Externalities

1. If the industry is forced to pay for the cleanup, costs will rise, shifting the supply curve to the left (curve  $S_2$ ). The price of the firm's output will rise, and the quantity produced will fall.



2. The government could achieve this effect by imposing a tax on the industry or by setting quotas on its output. The price would increase.

## III. Justifying the Nutrition Labeling and Education Act

When information is not perfect, market imperfections can result. This means that least-cost combinations of resources may not be used or that resources may not be used where they have the highest value. The Nutrition Labeling and Education Act is an attempt to give consumers accurate and complete information.

## IV. Extending Regulation

1. The government plans to do this to promote competition, which in turn should encourage technical and economic efficiency.
2. Because consumers lack complete information regarding the safety of seafood, meat, and poultry products, firms do not bear the full cost of improper practices.
3. The government is considering price controls to promote competition. Also, lower drug costs have positive externalities.