The Government’s Role in Dealing with Externalities

Externalities are spillover effects resulting from production or consumption. They are costs or benefits that affect someone other than the producer or consumer of a good or service. Externalities can be negative or positive. Air pollution and secondhand smoke, for example, are negative externalities associated with driving and smoking. Without government intervention, such negative externalities can cause great, even if unintended, harm. Governments can be equally helpful in promoting activities that have positive externalities. Immunizations, for example, prevent individuals from getting harmful diseases. They also prevent individuals from spreading those diseases to others—a positive externality. To encourage immunization, state governments require children to receive vaccinations against common diseases before enrolling in public school.

Supporting Positive Externalities: Subsidies and Public Provision
Goods and services that generate positive externalities tend to be underproduced relative to their benefits. Higher education is a prime example. People who graduate from college gain the benefit of greater earnings. However, education also benefits society by creating a more productive workforce. To support this positive externality, federal and state governments allocate resources to education.

Limiting Negative Externalities: Command-and-Control versus Market-Based Policies
One of the most widespread and troubling side effects of both production and consumption is environmental pollution. Governments can seek to limit this externality in two ways—through command-and-control policies and through market-based policies.

Command-and-control policies. The term command and control comes from the military and refers to the use of authority by a commanding officer to accomplish a mission. The commander exercises authority by issuing orders that others are expected to obey. As one writer puts it, “the idea is that people do what you tell them to do, and if they don’t, you yell at them until they do, and if they still don’t, you throw them in the brig for a while.” Regulatory agencies that adopt command-and-control policies follow a similar approach, issuing rules that others are expected to follow.

There are problems with this approach, however. As economist Robert W. Crandall observed, the EPA’s goal for urban smog reduction could cost more than $13 billion per year, but result in less than $3.5 billion in improved health, agricultural, and amenity benefits.

Market-based policies. Economists generally prefer the use of market-based policies to deal with negative externalities. Such policies use incentives, rather than rules and enforcement, to change producers’ behaviors. One market-based policy is a corrective tax, which the government levies on producers of pollution. Corrective taxes give producers an incentive to reduce their harmful waste products. These taxes also have the benefit of raising revenue.
Government’s Role in Providing Public Goods

The government plays another widely accepted role in the economy as a provider of public goods. Abraham Lincoln encouraged this form of government engagement when he wrote, *The legitimate object of government, is to do for a community of people, whatever they need to have done, but can not do, at all, or can not, so well do, for themselves—in their separate, and individual capacities.*

—Abraham Lincoln, 1854

Consider a good that could be produced by a private firm, such as a dam to control the flooding of a river. Some people in the river’s floodplain might be willing to pay for the protection the dam provides, but the firm would not be able to provide that protection only to those people and withhold it from others. Anyone living in the floodplain would be able to enjoy that protection free of charge.

No profit-seeking firm can be expected to provide a good that consumers do not have to pay for. A government, by contrast, does not seek to make a profit. Rather, it can pay for public goods with tax dollars, thus ensuring that all taxpayers contribute to the cost.

Analyzing the Costs and Benefits of Providing Public Goods

Most people want government to provide public goods, such as national defense and streetlights. But as the scarcity-forces-tradeoffs principle reminds us, no government has the resources to provide everything that people might want. It has to make choices, but how? One way is to analyze the costs and benefits of producing that good.

Consider a proposal before a city council to widen a road in order to relieve congestion. City planners provide the council with detailed estimates of the costs of buying the needed land and hiring a construction company. Estimating the benefits is more challenging. If the road is widened, commuters are likely to spend less time and use less gas stalled in heavy traffic. How much less is uncertain. Nonetheless, estimates of these benefits are made and assigned a dollar value.

At this point, political considerations may also play a part in the council’s decisions. If enough voters want a wider road, the council members might decide to approve the project even if the costs seem likely to out-weigh the benefits. The result would be an inefficient use of the city’s scarce resources. The funds used to widen the road might well have provided more benefits to more people had they been used differently.

Economists describe situations in which government intervention leads to an inefficient use of resources as *government failures*. Such failures arise for several reasons. Politicians who want to stay in office may support legislation that pleases voters but is not cost effective. Or they may engage in *logrolling*—agreeing to vote for another lawmaker’s legislation if that lawmaker agrees to vote for their own legislation. Such compromises often lead to wasteful spending and economic inefficiency.
Government’s Role in Promoting Economic Stability

Americans clearly benefit from economic stability. In a stable economy, jobs are secure, goods and services are readily available, and prices are predictable. Producers, consumers, and investors can plan for the future without having to worry about sudden upheavals in the nation’s economy.

The government promotes economic stability in part by creating a widely accepted currency—the dollar—that maintains its value. The government also promotes stability by stimulating business activity during economic slowdowns. It does this through tax incentives, which encourage businesses to invest in new capital equipment, and through tax rebates, which encourage consumers to spend more money.

In 2008, for example, difficulties in the housing market sent the economy into a tailspin. Reacting to the uncertainty, consumers cut back on spending. To generate more spending, Congress enacted an economic stimulus package—legislation specifically designed to stimulate business activity. The package called on the Internal Revenue Service to mail checks of $600 or more, depending on family size, to 130 million households. The nation’s leaders encouraged Americans to spend their stimulus checks on consumer goods and services.

Income Distribution and Poverty in the United States

Markets allocate resources efficiently, as Adam Smith noted when he described the invisible hand of the marketplace. But Smith did not conclude that markets allocate resources fairly. Some people, for example, end up with vastly higher incomes than others.

Every year, the U.S. Census Bureau charts the distribution of income in the United States. It starts by ranking households on the basis of their incomes. Then it divides the entire list of households into five equal parts, called quintiles. The bottom quintile contains the lowest incomes, and the top quintile contains the highest incomes.

The Census Bureau also calculates the percent of total income each quintile received. In 2012, for example, the bottom fifth received 3.2 percent of all income, while the top fifth received 51.0 percent. Clearly, income is not distributed equally in the United States.

Another tool for measuring the distribution of income is the poverty rate. This rate is the percentage of households whose incomes fall below a certain dollar amount determined by the Census Bureau. That dollar amount, called the poverty threshold, is the estimated minimum income needed to support a family.

Poverty rates vary depending on such factors as age, race, ethnicity, and family composition. It is also worth noting that the Census Bureau’s rankings vary from year to year. Just because a family is in the bottom fifth this year does not mean it will stay there. A hallmark of American society is economic mobility. People who work hard are usually able to move up the economic ladder. As a result, relatively few families remain in poverty for the long term.
Government’s Role in Redistributing Income

For much of our nation’s history, the poor relied mainly on friends, family, and private charities to provide for their basic needs. Local communities sometimes established poor houses and poor farms to house the very poor. Otherwise, the poor were left to fend for themselves as best they could.

Then came the Great Depression. With it came an expanded role for government in the economy. New Deal programs aided millions of Americans. The Social Security Act, for example, did much to reduce poverty among disabled and older Americans. However, these programs did not lift every family out of poverty.

During the 1960s, the federal government launched a War on Poverty to help the nation’s neediest families. Congress devised dozens of antipoverty programs that together created an economic safety net. Those programs had some success. The poverty rate for families dropped from 18.1 percent in 1960 to 10.1 percent in 1970.

Since the 1960s, most antipoverty programs have involved some form of income redistribution, a policy designed to reduce the gap between the rich and the poor. This policy works by taxing wealthier members of a society and then distributing that money to the poor to achieve greater income equality. Redistribution takes a number of forms, including those described here.

Welfare. When most people talk about welfare, they are referring to Temporary Assistance for Needy Families. The TANF program, funded largely by the federal government but run by the states, provides benefits, services, and work opportunities to needy families. In some states, TANF benefits come in the form of cash transfers, or direct payments of cash from the government to individuals.

Other TANF benefits are distributed in the form of goods or vouchers, rather than cash. These in-kind transfers include food stamps, public housing, school lunches, and Medicaid. For example, when a person receives health services through the Medicaid program, the government pays the health care provider. No cash goes to the Medicaid recipient.

Earned income tax credit. The government also helps the working poor through the Earned Income Tax Credit. Low-wage workers can claim this credit when they file their federal income tax forms. The credit is applied against whatever taxes are due. Depending on a worker’s family size and income, the credit can exceed those taxes. If it does, the worker receives a tax refund.

Unemployment insurance. Employers, through federal and state taxes, contribute to a fund that provides unemployment insurance for workers. If workers are laid off from their jobs, the state sends them payments—unemployment compensation—for a certain period of time or until they find another job. Each state administers its own unemployment insurance program, based on federal standards.