

# THE ECONOMICS OF GOVERNMENTS AND MARKETS

NEW DIRECTIONS IN EUROPEAN PUBLIC POLICY

Lois Duff



# The Economics of Governments and Markets: New Directions in European Public Policy

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## Foreword

It is easy for students of economics to get the impression that the subject has little practical relevance. Economics is often presented as a body of abstract theories, with carefully chosen, highly unrealistic examples used to illustrate them. Too often students are left with the notion that economics is not geared to solving real-world problems, and provides little by way of a guide to policy-makers.

In this highly original book, Lois Duff shows how relatively simple economic concepts can be very powerful in helping to analyse social issues and in providing solutions to a wide range of contemporary problems. The judicious mix of theory, examples and case studies will provide the student of micro-economic policy with a sound foundation for assessing the relative roles of government and the market in dealing with issues such as pollution and waste disposal; the operation of public utilities such as postal services and electricity; and the provision of health care, housing, higher education, roads and railways.

After an introductory part (chapters 1–3), which presents the core theory necessary for understanding the subsequent applications, the book then examines the issues one by one, with a separate chapter devoted to each. Every chapter follows a common pattern: The problem is identified and the current system of allocating resources is described, along with its various strengths and weaknesses; then various options for reforming the system of allocation are considered; there then follow two case studies drawn from around Europe that illustrate different approaches to tackling the problems; finally, there is a discussion section which draws lessons from the case studies.

Students will welcome this book in helping to bring alive a field of economics that can make a powerful contribution to tackling some of the most pressing problems faced by people in all countries as we move into the new millennium. The examples and case studies are all relevant to the student's direct experience of living in a modern industrial society. The uniform structure for each of the chapters in Parts 2–4 will help students navigate their way through the book and show how common themes can be identified in many apparently quite different problem areas.

Tutors will welcome the way that they can tailor the use of the book for their specific courses. The style is straightforward and direct, with theory only used to the extent that it is directly relevant to analysing the issues. This makes the book accessible not only to students of economics but also to those studying sociology, social policy, politics, public administration and business studies, who have had only a basic grounding in economics.

*John Sloman*

# Preface

This book looks at the changing role of government in regulating certain sectors of the economy, emphasizing different approaches adopted in Europe. There has been a change in the way governments see their role in the market economy: many are looking to the market to take an increased role, but under government supervision. This book charts the new approaches being taken by selected western European nations, in their efforts to improve both the efficiency and equity outcomes of their public services, national industries and care of the environment.

This book is written for students who will have, at least, an introductory background in economics, and some of the analysis and economic concepts used go up to intermediate level. It is written for the needs of students of public sector economics, social economics and applied microeconomics. Diagrams have been kept to the absolute minimum because many of the issues discussed can be dealt with adequately without them. Although the book has been written for economics students, it will be of interest to readers in related academic areas, such as social policy, public policy, social administration and political economy, and perhaps to professionals in the fields of education, health and housing.

The book is intended to introduce students to specific key economic concepts, through a framework of analysis, with a strong unifying theme, on a wide range of contemporary economic problems. The aim is to avoid too abstract an approach, but to introduce the relevant theory at the beginning and then apply it in the case studies. As the concepts and theories are explained at the beginning, the book can be used as a textbook; alternatively, it may be used as a supplementary text to provide an understanding of the various approaches adopted by different countries. Each chapter is self-contained and can be read independently of the other chapters. Each chapter contains the relevant economic concepts, questions, and further reading.

The book is by no means comprehensive on the role of the public sector, but rather it focuses on a wide range of sectors where governments have principally adopted market-orientated approaches. This enables students to extract from the morass of detail the essentials of policy decisions and the economic and political considerations at stake. Students often study economics along with other subjects and so an effort has been made to take a multidisciplinary approach. Many textbooks often focus on the theory and offer only brief examination of the policy aspects, whereas this book provides a balance between the two. In addition, the new directions in public policy are set in the context of developments at the EU level, in recognition that the European dimension is becoming increasingly important.

The original contribution of this book is the use of case studies. This has been adopted for a number of reasons. There is a strong argument in favour of teaching economics by the case study method on the grounds that cases can convey information about relationships which principles cannot. Case studies are more than examples: they allow an application of a principle and they can illustrate the complexity of economic decisions which involve trade-offs. In the case of public policy, implementation problems and strengths can be highlighted in a realistic setting. Students can find themselves involved in the middle of a real problem. Realism adds to the setting.

The approach adopted in this book is to use two case studies side by side. This reinforces the learning principles and offers scope for comparing different approaches adopted. More is conveyed in the whole than in the two halves. Also, case studies can motivate: they make us want to learn more about particular nations and the different approaches they have adopted. Finally, the emergence of modularization in higher education presents specific challenges and problems for teachers of economics, in that they often have to teach students with varying backgrounds in economics. One way to overcome this problem is to present the concepts through case studies, thereby creating an unfamiliar environment for those students familiar with the concepts. To this extent the book has some claim to originality. My hope is that other writers will thereby be encouraged to develop the case study approach. If the book achieves this objective, we will all gain.

The early theoretical chapters assume a knowledge up to intermediate microeconomic level. Chapter 1 explains how a market works and sets out the efficiency arguments for allowing a perfectly competitive market to operate. Chapter 2 provides the efficiency rationale for intervention and explains the inequalities which emerge as a result of markets. Chapter 3 introduces the government objectives and various approaches adopted to ensure an efficient allocation of resources. Chapters 4 to 12 introduce the policy analysis. These are divided into three broad themes: social welfare, national industries and environmental themes. All chapters have a common structure. They begin by discussing the factors for change, both within the market and within the current level of government involvement. The economic rationale for government intervention in each particular area is discussed, and this is followed by a description of the possible and actual types of intervention. Alongside discussion of ongoing and possible options for reform, the section ends with a separate reference to developments at EU level. The case studies are then presented back-to-back. Each follows a common set of headings and presents the relevant background and objectives being pursued. Selected approaches are then analysed from the viewpoint of efficiency and, where relevant, equity. The chapters close with a discussion in terms of the costs and benefits of each approach and a comparison between the approaches adopted. The final chapter analyses the new directions of public policy under each theme.

This text is a product of twelve years' teaching, researching and consulting for governments. There is a debt of gratitude to former students, supervisors and

colleagues, from whom much has been learned. I would like to thank personally all my present colleagues at the School of Economics, University of the West of England, Bristol, and everyone else who gave assistance and feedback. Thanks to the Centre for Social and Economic Research (CESER) which kindly funded part of the time it took to write this book. I wish to express thanks to Chris Harrison from Longman for the support and encouragement he gave me. Finally, I owe my greatest debt to my family and all my long-suffering friends.

*Lois Duff*

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# Part 1

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## Theory



## Chapter 1

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# The economics of the market

Key words used: equilibrium, quantity demanded, quantity supplied, efficiency, opportunity costs

Society needs to find a way of deciding what, how and for whom to produce. This chapter explains how markets and prices allocate resources between competing uses. Any discussion on the role of markets and governments involves theories of how the market and government potentially operate. A starting point is to describe the market from the point of view of the perfectly competitive model. In reality, all economies are mixed and the divisions between governments and markets are not always clear. Nevertheless, it is still useful to present the material in this way, as it provides a conceptual framework from which it is possible to understand how the free market pricing system should work and how it should allocate resources.

## The market mechanism

We are constantly trying to understand the world we live in, and when we provide explanations, we are, in effect, theorizing about it. Scientists try to explain how matter changes, sociologists try to explain how people behave, and economists try to explain how resources are allocated. These people explain the world by constructing simple models about reality. The aim is to try and bring out the important features and to abstract away from the little things. Models can add to our understanding only if they stand detached from the world. A theory helps us to define relationships. Models should be logical, moving from one step to another. They should contain a set of variables and a set of assumptions which link them together. Finally, there should be a deduction or prediction element about what we would actually expect to find in the real world.

Economists have used the model of perfect competition to explain the workings of the capitalist economy. It addresses issues such as demand, supply, resource allocation, price determination and welfare. The perfect competition model is a useful starting point for any discussion of public policy reforms, as many of the reforms rely on the notion of the market when they come to consider



issues such as privatization. The market mechanism will be described under a number of key headings:

- Scarcity necessitates rationing.
- Consumer choice and the Law of Demand.
- Producer choice and the Law of Supply.
- Shortages and surpluses.
- Shifts in the demand and supply curves.

### ***Scarcity necessitates rationing***

We live in a world where goods and resources are limited in their supply compared to our wants and needs. When goods are scarce there must be a way of rationing them. Rationing in the real world could take many forms. It could be done on the basis of beauty, the most attractive people receiving what they want, or on the basis of the strongest, or on a first come, first served basis, or using a waiting list. Competition is therefore only one way to ration, and it works by rationing goods on the basis of how willing and able people are to pay for the good. Western economies rely heavily on markets and prices to allocate resources among competing uses.

The perfect competition model is based on a number of assumptions:

- The economy consists of many independent producers and consumers: no one is sufficiently powerful to influence market outcomes by their own action and everyone is a price taker.
- Individuals and companies are assumed to be self-interested and rational, and they seek to maximize their levels of satisfaction (utility) or profits. It is assumed that people cannot suffer for others and that their levels of utility are independent of others'.
- Companies are profit maximizing and will always strive to produce at the least cost.
- In each and every market there is a market-clearing price which is determined where quantity demanded equals the quantity supplied.
- There is no government intervention.
- Finally, it is assumed that there is perfect knowledge.

As we shall see throughout this book, in reality, markets are not perfect, consumers are not always rational in their decision making and companies have other goals besides maximizing profits. Moreover, for some goods there is no market demand because it is impossible to state a preference or a willingness to pay.

### ***Consumer choice and the Law of Demand***

A market is a set of arrangements by which buyers and sellers are in contact for the exchange of goods or services. With some markets the buyers and sellers