**The Efficiency Role of Government:**

* When a well-functioning, perfectly competitive market is permitted to reach its \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_, the outcome is efficient
	+ No opportunities for mutual gain remain unexploited
	+ Any government intervention that changes the market quantity (say, a price ceiling or a price floor) will create inefficiency—a welfare loss
* But government can—and does—contribute to the economic efficiency of markets
	+ Provides infrastructure that permits markets to function
		- Physical infrastructure—bridges, airports, waterways, and buildings
		- Institutional infrastructure—laws, courts, and regulatory agencies
	+ Stepping in when markets are not working properly
		- When they leave Pareto improvements unexploited and therefore fail to achieve economic efficiency

**The Institutional Infrastructure of a Market Economy:**

* Americans take their institutional infrastructure almost completely for granted
* In some countries
	+ Police are more likely to steal from citizens than to protect them from thievery
	+ People have no effective rights to their own property
	+ If a person is injured by a drunk driver, there may be no system for compensating her or punishing the drive
* In nations with highly developed and stable legal infrastructures, such incidents are the exception
* When countries are divided into three groups, according to the quality of their institutional infrastructure
	+ There is a \_\_\_\_\_\_\_\_\_\_\_\_ relation between infrastructure and output per worker

**The Legal System: Criminal Law:**

* The backbone of a market economy’s institutional infrastructure is the legal system
* Criminal law
	+ While criminal law has important moral and ethical dimensions
		- Central economic function is to limit exchanges to \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ ones
	+ By making most involuntary exchanges illegal, criminal law helps to channel our energies into exchanges and productive activities that benefit all parties involved—Pareto improvements
		- In this way, criminal law contributes to economic efficiency

**Property Law:**

* Property law gives people precisely defined, enforceable rights over things they own
* When property rights are poorly defined
	+ Much time and energy are wasted in disputes about ownership
		- People spend time trying to capture resources from others
			* Time that could have been spent producing valuable goods and services
* Property law contributes to economic efficiency by increasing total \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
	+ Raising total benefits that markets can provide by reducing disputes about property
	+ Channeling resources into production

**Contract Law:**

* In countries in which contract law is less well defined or less strictly enforced, investors would worry that they would not be able to collect their share
* A contract is a mutual promise
	+ Often one party does something first and the other party \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ to do something later
* Contracts play a special role in a market economy
	+ Without them, only Pareto improvements involving simultaneous exchange could take place
		- You get a bag of apples from a farmer and simultaneously hand over some money
* Contracts enable us to make exchanges that take place over time and in which one person must act first
	+ In this way, contracts help society enjoy the full benefits of specialization and exchange
* Legal enforcement of contacts is not the only force that makes people keep promises
	+ Parents, religious organizations, and schools teach people that keeping promises is a moral obligation
	+ A reputation for failing to keep promises would be harmful to a business or a person
* While socialization and concern over reputation are important, contracts and the infrastructure for enforcing them play vital role in making economy more efficient
* Because of contract law, people are more willing to take a chance with a new business
	+ Since they know that they have a law behind them if new business reneges on a deal

**Tort Law:**

* Deals with interactions among strangers or people not linked by contracts
* Specifically, a tort is a wrongful act—such as manufacturing an unsafe product—that causes \_\_\_\_\_\_\_\_\_\_\_\_\_ to someone, and for which the injured person can seek remedy in court
	+ Tort law defines types of harm for which someone can seek legal remedy
		- And what sorts of compensation the injured person can expect
* When people and business are held responsible for injuries they cause, they act more carefully
* Also protects against fraud
	+ In which a seller of something—a product, a business, shares of stock—lies to the buyer in order to make the sale

**Antitrust Law:**

* Designed to prevent business from making agreements or engaging in other behavior that limits competition and harms consumers
	+ Operates in three areas
		- Agreements among competitors
			* U.S. antitrust law—expressed in Section 1 of Sherman Act—prohibits “contracts, combinations, or conspiracies” among competing firms that would harm consumers by \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ prices
		- Monopolization
			* Section 2 of Sherman Act Makes it illegal to monopolize or attempt to monopolize a market
		- Mergers
			* In a merger, two firms combine to form one new firm
				+ The result is to increase the danger of higher prices from oligopoly or monopoly
				+ Mergers of this type are often blocked by U.S. government based on Section 7 of Clayton Act

**Regulation:**

* Important part of the institutional infrastructure that supports a market economy
	+ Under regulation, a government agency—such as the Food and Drug Administration (FDA), the Environmental Protection Agency (EPA), or a state public utilities commission—has power to direct business to take specific actions
* In addition to protecting public safety and health
	+ Regulation is also used to help markets function more \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
* Regulation differs from use of legal procedures in a fundamental way
	+ Regulators reach deep into the operations of business to tell them what to do
		- While legal procedures typically result in fines or other penalties if businesses do something wrong

**Law and Regulation in Perspective:**

* Invisible hand of market system \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ operate on its own
	+ Legal system, along with regulatory agencies, creates an environment in which invisible hand can do its job
	+ Almost every Pareto improvement that we can think of relies on legal and regulatory infrastructure
		- But what about cases where law and regulation don’t seem to be working perfectly?
			* Does this mean that our institutional infrastructure is failing us?
* Yes…and no
	+ While instances like these are never welcome, society has chosen not to eliminate them entirely
	+ Must balance benefits—safer products, reduced crime—against costs
* A legal and regulatory system that ensured the complete elimination of crime, unsafe products, and other unwelcome activities would be less efficient than a system that tolerated some amount of these activities
	+ An efficient infrastructure must consider the costs, as well as the benefits, of achieving our legal and regulatory goals

**Market Failures:**

* Another vitally important role for government
	+ To intervene in situations of market failure
		- When a market equilibrium—even with the proper institutional support—is economically \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
* General types of market failures to which economists have devoted a lot of attention
	+ Monopoly power
	+ Externalities
	+ Public goods
* While economists and policy-makers agree in theory on what causes a market failure
	+ Dealing with real-world market failures remains one of the most controversial aspects of government policy

**Monopoly and Monopoly Power:**

* A firm has monopoly power when it can influence the price that it charges for its product
	+ A market with just one seller, or a few oligopolists who cooperate and behave as a monopoly, is a more serious market failure
* Monopoly and imperfectly competitive markets—in which firms charge a single price greater than marginal cost—are generally inefficient
	+ Price is too high, and output is too low, to maximize net benefits in market
* What can government do to make this monopoly market more efficient?

**The Special Case of Natural Monopoly:**

* A natural monopoly exists when, due to economies of scale, one firm can produce for the entire market at a lower cost per unit than can two or more firms
	+ If government steps aside, such a market will naturally evolve toward \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_
* If breaking up a natural monopoly is not advisable, what can government do to bring us closer to economic efficiency?
	+ One option is public ownership and operation
		- Public takeover of private business is rare, except when certain conditions are present
	+ That leaves one other option
		- Regulation

**Regulation of Natural Monopoly:**

* Under regulation, a government agency digs deep into the operations of a business and takes some of the firm’s decisions under its own control
	+ In the case of a natural monopoly, regulators are interested in achieving economic efficiency, which they do by telling the firm what price it can charge
* At first glance, you might think that natural monopoly regulators have an easy job
* Unfortunately, it’s not that easy
	+ There is the matter of information
		- \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ must be able to trace out firm’s MC curve as well as market demand curve
* Even with perfect information about monopolist’s cost and demand curves, regulators have a serious problem
* If they set the efficient price of $15 so that buyers demand efficient quantity of 100,000, firm’s cost per unit is greater than $15
	+ Firm will suffer a loss
	+ In long-run, it will go out of business