Foundations of Public Policy

- Primacy or sovereignty of the individual
- Individual rights, freedoms and well-being

- Private enterprise relies on:
  - Economic Freedom
    "Freedom to enter in voluntary exchanges"
  - Consumer sovereignty
    "Each consumer has a right to his or her own preferences"

- Exceptions?

- Limited role of the government

Economic Organizations

- Market-based economic systems
  - Primacy of the individual
- Feudal Europe (Hierarchical)
  - Divine right or will of good directly
- Central planned socialism
  - Class over the individual
- Others

Role of Government

"An individual generally neither intends to promote the public interest nor knows by how much he is promoting it… By directing industry in such a manner as its product may be of greatest value, he intends only his own personal gain, and he is in this aim… led as if by an "invisible hand" to promote an end which was no part of his intention"

"By pursuing his own self-interest, the entrepreneur frequently promotes that of society more effectually than when he means to promote it"

"It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest"

Adam Smith, "Wealth of Nations" (1776)

Arguments for Competition

- First Welfare Theorem:
  - **Competitive** markets achieve Pareto efficiency
    (“There is no arrangement of resources such that someone can be made better off without making someone else worse off”)
- Second Welfare Theorem:
  - Every Pareto-efficient allocation can be attained by a **competitive** economy provided with the correct distribution of resources
- Political arguments:
  - Dispersion and decentralization of political and economic power

(Perfectly) Competitive Market

1. Consumers are perfectly informed about all goods, all of which are private goods.
2. Producers have production functions that rule out increasing returns to scale and technological change.
3. Consumer maximize their preferences given budget constraints; producers maximize their profits given their production functions.
4. All agents are price takers, and externalities among agents are ruled out.
5. A competitive equilibrium, a set of prices such that all markets clear is determined

Market Failure

- First welfare theorem rarely applies
- However, it tells us when markets fail to work effectively
- Example: monopoly power

- Definition: A market failure is a situation in which private markets fail to achieve allocative or Pareto efficiency

Sources of Market Failure

- Imperfect competition
- Public goods
- Externalities
- Informational problems

In this course, we will ask…

- What particular market failures provide a rationale for government intervention?
- How can economic theory illuminate the character of market operation, and the role for government action and the appropriate action?
- What do empirical analyses of economic behaviour and the effects of government intervention indicate about the direction that this intervention should take?