

Introduction to Special Topics in Business Economics

THE RELATIONSHIP BETWEEN GOVERNMENT AND BUSINESS

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Structure

- 1 Reasons for Government Intervention in the Market
 - Markets and the Role of Government
 - Types of Market Failure
 - Government Intervention in the Market
 - Firms and Social Responsibility
- 2 Government and the Firm
 - Competition Policy
 - Policies towards R&D and training
- 3 Government and the Market
 - Environmental Policy

Main objectives of government intervention:

- 1 Social Efficiency (e.g. motorways)
 - $MSB > MSC \rightarrow$ produce more
 - $MSC > MSB \rightarrow$ produce less
 - $MSB = MSC \rightarrow$ keep production at its current level
- 2 Equity (e.g. living)
 - Fair distribution of resources?
 - Policies of government?

1) Externalities

Externalities: When the actions of producers or consumers affect people other themselves

- External Benefits
- External Costs

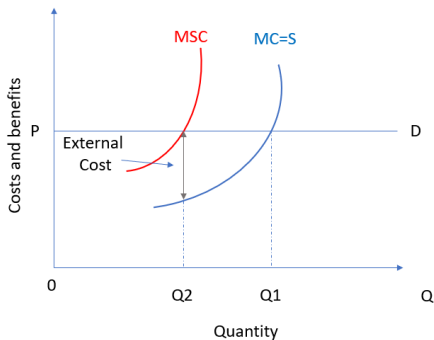
Therefore,

Social Benefit = Private consumption of consumers + externalities

Social Cost = Private production of firms + externalities

- There are *four* types of externalities

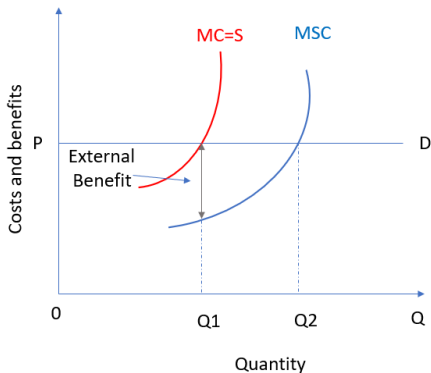
External costs of production ($MSC > MC$)



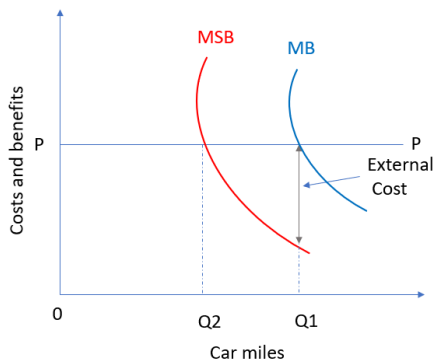
In a Perfect market:

- $MC=P(=MB)$ (max profit at Q_1)
- Assuming no externalities from consumption, $MB=MSB$
- Socially optimum output at Q_2 , where $P=MSC$
- **However**, $Q_1 > Q_2 \implies$ **overproduction** from society's point
- Why do they arise? Other examples?

External benefits of production ($MSC < MC$)

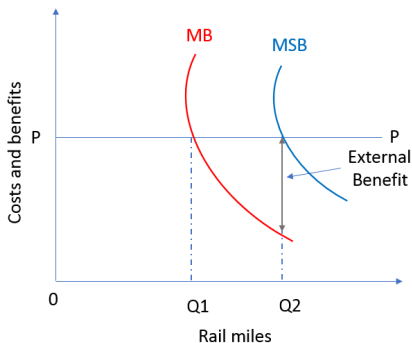


- $MC=P$ (max profit at Q_1)
- Socially optimum output at Q_2 , where $P=MSC$
- $Q_1 < Q_2$

External costs of consumption ($MSB < MB$)

- Consumer's utility: Q_1 miles ($MU=P$)
- Socially optimum Q_2 , where $MSB=P, Q_2 < Q_1$

External benefits of consumption ($MSB > MB$)



- $Q_1 < Q_2$

To sum up:

External **costs** → too little produced or consumed

External **benefits** → too much produced or consumed

2) Market Power

Whenever **markets** are **imperfect**, the market will fail to equate MSB and MSC, even if there are no externalities

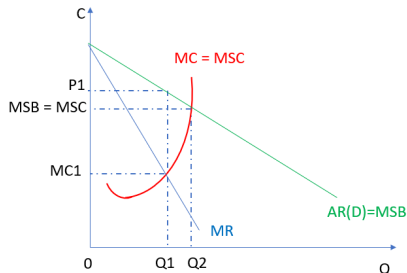


Figure 1: Monopoly

- $MR < AR = P = MSB$
- $MR = MC \Rightarrow$ maximization of profit at Q_1
- If there are no externalities, $MSB = MSC$ at $Q_2 > Q_1$

3) Ignorance and Uncertainty

- Perfect competition assumes that consumers, firms and factor suppliers have perfect knowledge of costs and benefits
- However, many economic decisions are based on expected future conditions (e.g. buying a car, productivity of a worker)
- **Asymmetric information:** When the different sides in an economic relationship have different amounts of info (e.g. banks-firms)
- Other examples of asymmetric information?

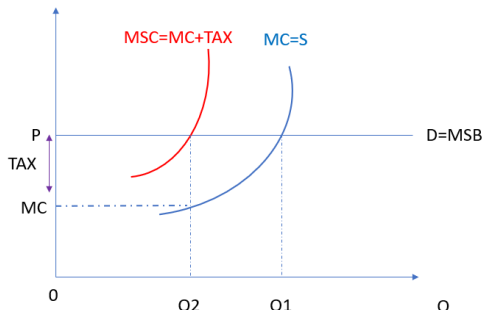
4) Immobility of factors, time - lags in response and protecting people's interest

- Even under conditions of perfect competition, factors may be very slow to respond to changes in demand or supply.
- The economy is in a constant state of disequilibrium and the long run never comes.
- As firms and consumers respond to market signals and move towards equilibrium, so the equilibrium position moves and the social optimum is never achieved.
- When monopoly power exists, the problem is made even worse as firms put barriers to entry
- **Merit goods:** Goods which government feels that people will underconsume and which therefore ought to be subsidised or provided free. (e.g. health, education)

Taxes and Subsidies

Government Interventions can be used to achieve various economic objectives which may not be best achieved by the market.

- **Tax** goods or activities where market produces too much (e.g. chemical emissions)
where tax = external cost = marginal pollution cost
- **Subsidise** those where the market produces too little
- *Disadvantage* of taxes and subsidies?



Changes in Property Rights and Legal Restrictions

- **Property rights** define who owns property, to what uses it can be put, the rights other people have over it and how it may be transferred. By extending these rights, individuals may be able to prevent other people imposing costs on them, or charge them for doing so.(e.g. chemical company - river)
- **Laws** can be of 3 types:
 - ① Those that prohibit or regulate behaviour that imposes external costs
 - ② Those that prevent firms providing false or misleading information
 - ③ Those that prevent or regulate monopolies and oligopolies

Examples: Polluting activities, toxic chemicals, selling unsafe goods

Price controls and provision of information

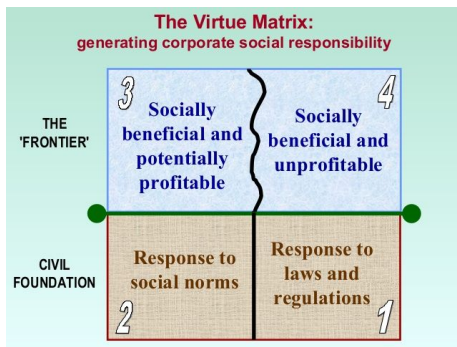
- Prices could be **raised** above the market equilibrium to support the incomes of certain suppliers (e.g. high prices for food → increase on farmer's income)
- Prices could be **lowered** in order to protect consumers' interests. (e.g. prevent monopoly or oligopoly from charging excessive prices)
- **Provision** of consumer information, for example, on the effects of smoking or job information

Views of Corporate Social Responsibility

- *The classical view:* Business managers are responsible only to their shareholders, and as such should be concerned solely with profit maximization. If they take into account social responsibilities, they will undermine the market mechanism.
- *The socioeconomic view:* Modern business has changes and society expects business to adhere to certain moral and social responsibilities. As such, all businesses are responsible not only to their shareholders, but to all stakeholders (e.g. workers, customers, suppliers)

Environmental scanning involves the business surveying changing political, economic, social, technological, environmental in order to remain in tune with consumer concerns. (e.g. environmentally friendly firm)

Generating CSR



Civil foundation: It refers to socially responsible actions that society expects firms to take and firms will normally do so.

The frontier: It refers to activities that are not directly in the interests of shareholders, but have a moral or social motivation.

Examples?

Economic Performance and CSR

Pressure from various stakeholders are likely to increase CSR over time.

CSR can lead to:

- Improved economic performance
- Enhanced brand and firm's reputation
- Attract and retain employees
- Better Access to capital

Examples?

Is **market power** necessarily a bad thing?

- Firms may not exploit their position of power- for fear that very high profits will lead to other firms overcoming barriers to entry
- Even if they do make supernormal profits, they may still charge a lowest price because of their economies of scale.
- Use profits for R&D and capital investment

There are 3 possible targets of **competitive policy**:

- *Monopoly* policy: The abuse of the existing power of monopolies and oligopolies (Article 102)
- *Merger* policy: The growth of power through mergers and acquisitions (Article 102)
- *Restrictive practices* policy: oligopolistic collusion (Article 101)

The Internet is just one example of how technology and technological change are shaping the whole structure and organization of business, its productivity and hence the competitive performance of national economies. The rate of technological advance can have dramatic effects on a country's living standards.

Technological policy refers to a series of government initiatives to affect the process of technological change and its rate of adoption. Three stages can be identified:

- Invention
- Innovation
- Diffusion

Market failure on technological change:

- R&D free riders
- Monopolistic and oligopolistic market structures
- Greater possibility of duplication
- Risk and uncertainty

Forms of *intervention*:

- Patent system
- Public Provision
- R&D Subsidies
- Cooperative R&D
- Diffusion policies

Training and economic performance are linked in three main ways:

- 1 Labour productivity
- 2 Innovation and change
- 3 Costs of production

The environment and production

- **Environmental Policy:** Initiatives by government to ensure a specified minimum level of environmental quality.
- The policy should ensure that all externalities are fully "internalized". This means that firms and consumers are forced to pay the full costs of production and consumption. e.g. their marginal private costs plus any external cost
- Difficulty of government to estimate the costs of the pollution.

Policies:

- 1 *Market-based environmental policy:* taxation (rate of tax = external MC). Taxes have the advantage of relating the size of the penalty to the amount of the pollution.
- 2 *Non-market-based environmental policy:* Command and Control (CAC) systems: The use of laws or regulations backed up by inspections and penalties (such as fines) for non-compliance with the maximum permitted levels of emissions
- 3 *Trading Permits:* A combination of the above mentioned