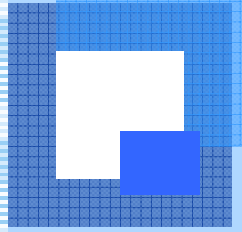


# *Chapter 15*

## *Government and Industry: Challenges and Opportunities for Today's Managers*

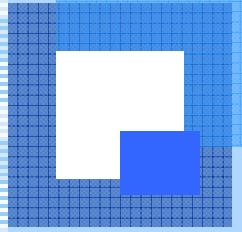
*Managerial Economics: Economic  
Tools for Today's Decision Makers, 4/e  
By Paul Keat and Philip Young*



# Government and Industry

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- The Rationale for Government Involvement in a Market Economy
- Doing Business with the U.S. Government
- Government Deregulation, Mergers, and Acquisitions

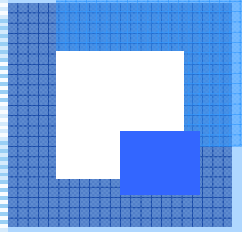


# Government Involvement in a Market Economy

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## Functions of Government in a Market Economy

- Provide legal and social framework
- Redistribution of income and wealth
- Regulation of natural monopolies

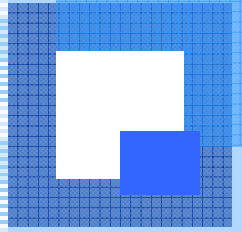


# Government Involvement in a Market Economy

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## Functions of Government in a Market Economy

- Provide for a competitive framework
- Reallocation of resources in the presence of externalities
- Stabilization of the aggregate economy



# Government Involvement in a Market Economy

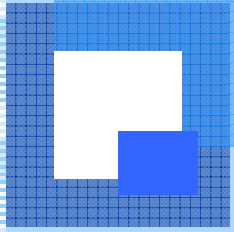
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Competitive Framework: Antitrust  
Laws

Sherman Anti-Trust Act

Clayton Act

Federal Trade Commission Act



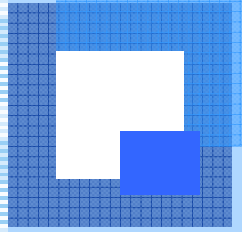
# Government Involvement in a Market Economy

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The purpose of antitrust laws

Two schools of thought

1. Economic efficiency
2. Protection of small independent firms



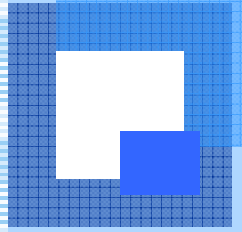
# Government Involvement in a Market Economy

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## Dealing with market externalities

Under perfect competition:

- resources are efficiently allocated
- social welfare is maximized

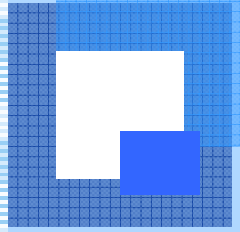


# Government Involvement in a Market Economy

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## Dealing with market externalities

However, if all costs are not included in the price or all costs are not compensated, **market failure** results.

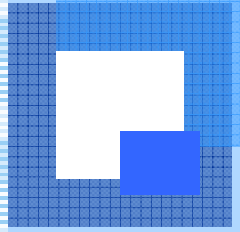


# Government Involvement in a Market Economy

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A **benefit externality** (positive externality) arises if certain benefits of the production or consumption of a good or service accrue to third parties.

Producers cannot appropriate all the revenue so **too little** may be produced.

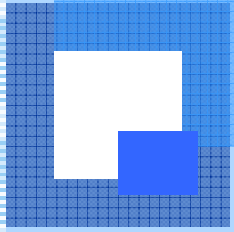


# Government Involvement in a Market Economy

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A **cost externality** (negative externality) arises if some of the costs of production or consumption of a good or service are borne by third parties.

The product's price will be lower than if it had been fully costed and **too much** of the product will be produced.



# Government Involvement in a Market Economy

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## Examples

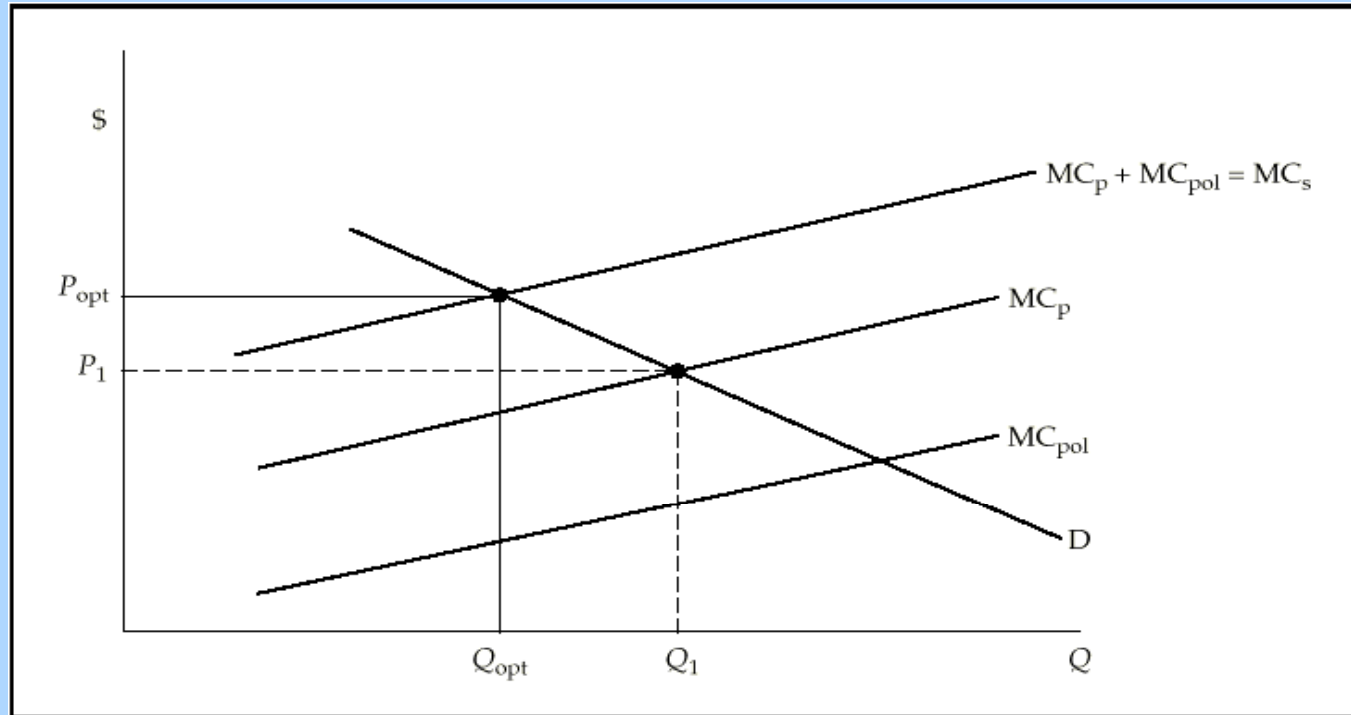
### Benefit externality

- Private garden
- Information
- Innovations

### Cost externality

- Pollution

# Government Involvement in a Market Economy

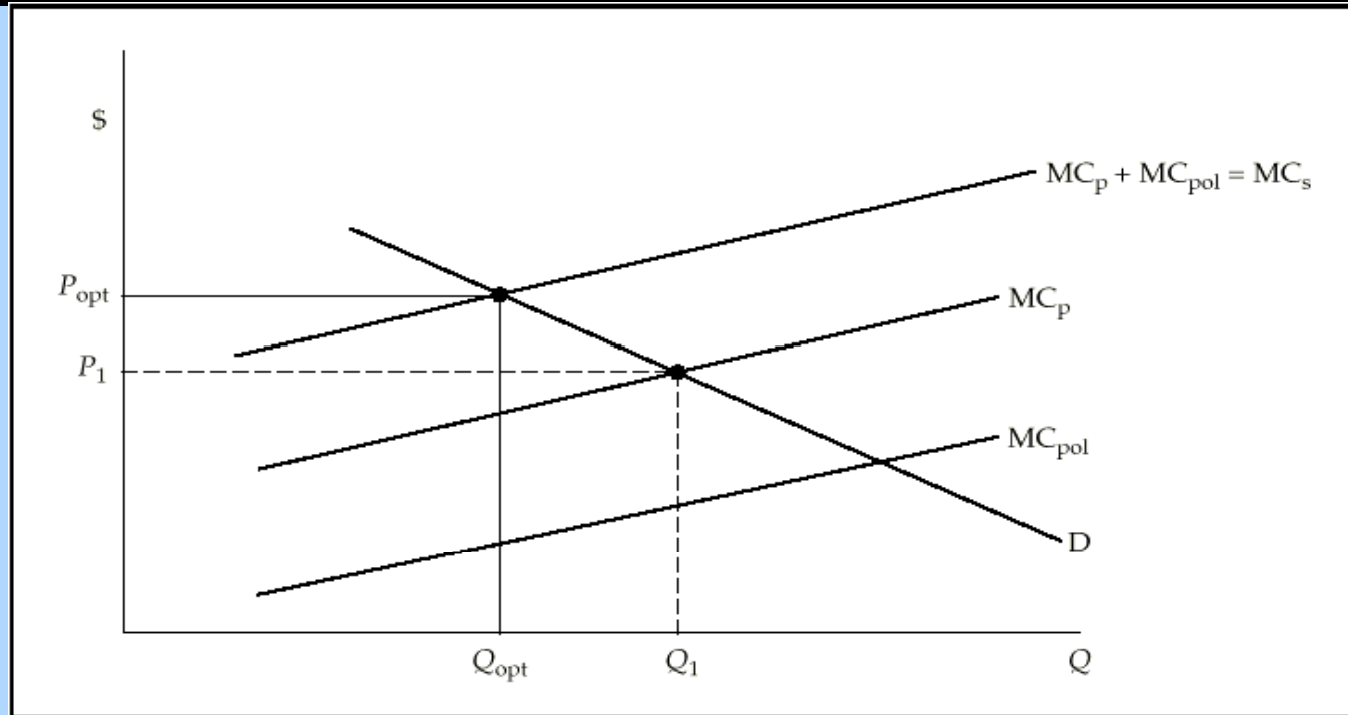


$MC_p$  = marginal production cost

$MC_{pol}$  = marginal pollution cost

$MC_s$  = marginal social cost

# Government Involvement in a Market Economy

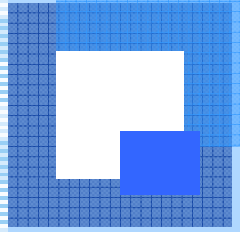


$P_1$  = market price

$P_{opt}$  = socially optimal price

$Q_1$  = market clearing quantity

$Q_{opt}$  = socially optimal quantity

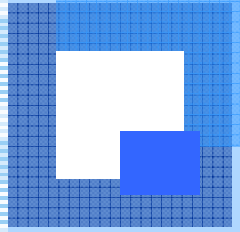


# Government Involvement in a Market Economy

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**Socially optimal price** occurs where the price of the product equals the marginal social cost.

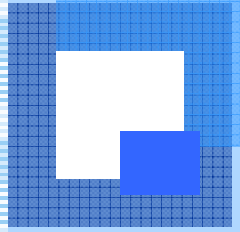
At this point, less pollution will be produced than under competitive conditions. ( $Q_{\text{opt}} < Q_1$ )



# Government Involvement in a Market Economy

How can the optimal equilibrium be attained?

- Government can restrict production to  $Q_{opt}$ .
- Government can impose a pollution tax equal to  $MC_{pol}$ .
- Government can set maximum pollution levels for the industry then sell (tradable) pollution licenses.

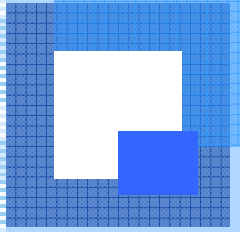


# Government Involvement in a Market Economy

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**Coase Theorem**: The idea that government intervention to eliminate the effect of externalities is not necessary if property rights are correctly and clearly defined.

If property rights (i.e. pollution permits) are assigned, bargaining between the parties involved would result in an optimal solution.

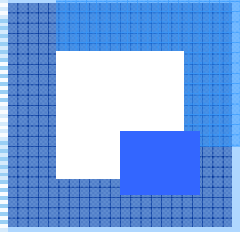


# Government Involvement in a Market Economy

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## Problems with Coasian bargaining

- Normative issues
- Transaction costs
- Unfair bargaining
- Incomplete information

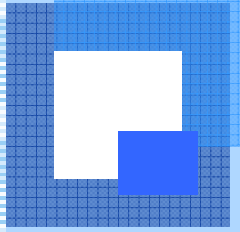


# Government Involvement in a Market Economy

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## Stabilization of the Aggregate Economy

- **Monetary Policy**: the use of the money supply and interest rates by the Federal Reserve System to influence the macroeconomy
- **Fiscal Policy**: the use of taxes and government spending to influence the macroeconomy



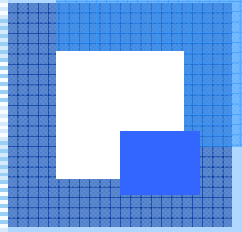
# Government Involvement in a Market Economy

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## Monetary Policy

The primary goals of monetary policy are to achieve a certain level of economic activity and price level.

Recently monetary policy has involved influencing the **Federal Funds rate**.



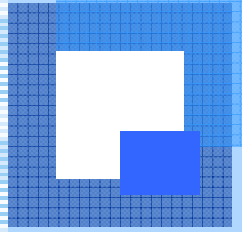
# Government Involvement in a Market Economy

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## Monetary Policy

The **Federal Funds rate** is the interest rate at which banks are able to borrow funds from other banks.

The Federal Open Market Committee determines whether the Federal Funds rate target should be changed.

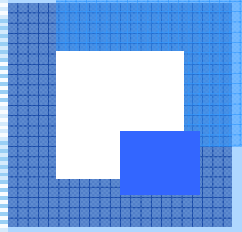


# Government Involvement in a Market Economy

## Monetary Policy

The Fed may have to engage in open market operations to bring the rate to its desired (target) level.

**Open market operations** involves buying and selling government securities in the market in order to increase or decrease the money supply, thus influencing interest rates.



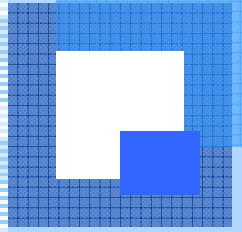
# Government Involvement in a Market Economy

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## Fiscal Policy

Fiscal Policy is designed to achieve macroeconomic goals relating to output and employment.

By manipulating receipts and expenditures, a surplus or deficit is created.



# Government Involvement in a Market Economy

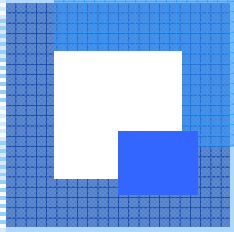
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## Fiscal Policy

To stimulate the economy, the government will:

- decrease taxes
- increase expenditures,

which shifts the federal budget toward deficit.

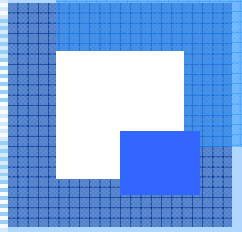


# Government Involvement in a Market Economy

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## Policy Lags

- Recognition
- Implementation
- Operational

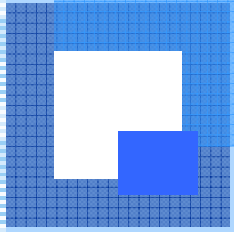


# Doing Business with the U.S. Government

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Monopsony: A market in which there is only one buyer.

The government procurement office is often cited as a good example of a monopsony.

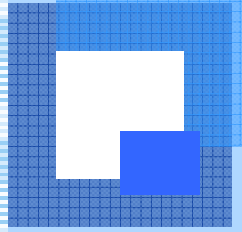


# Doing Business with the U.S. Government

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What the U.S. government buys is influenced by:

- Government strategic plans
- Budget and program input from federal departments
- Priorities set by the President
- Availability of appropriated funds
- Congressionally mandated requirements
- Surplus/deficit conditions
- Politics

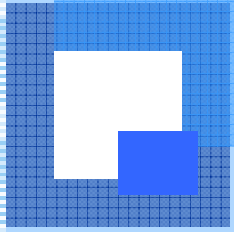


# Doing Business with the U.S. Government

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Government acquisition is controlled  
by:

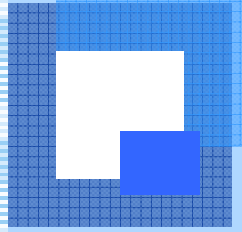
- Armed Services Procurement Act
- Federal Property and Administrative Act



# Doing Business with the U.S. Government

Companies doing business with the government must comply with:

- Competition requirements
- Profit restrictions
- Audits
- Bid protest rules
- Accounting requirements
- Socioeconomic Programs

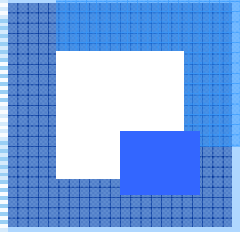


# Government Deregulation, Mergers, and Acquisitions

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From the late 1970's through the 1990's the government eliminated most regulatory control in the following industries:

- Telecommunications
- Electric and gas utilities
- Airlines
- Commercial banks

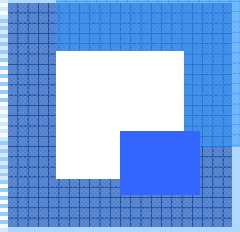


# Government Deregulation, Mergers, and Acquisitions

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Deregulation has resulted in more competitive environment.

Many companies have sought to merge with or acquire other companies in order to survive and grow.



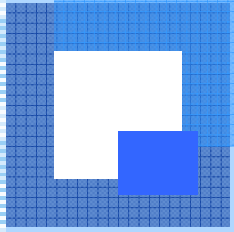
# Government Deregulation, Mergers, and Acquisitions

The basic motivation for mergers is to increase the value of the combined firms.

$$V_{A+B} > (V_A + V_B)$$

V = total market value

A & B = companies involved

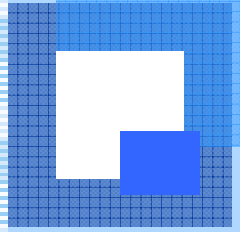


# Government Deregulation, Mergers, and Acquisitions

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## Incentives to Merge

1. Synergies in production
  - Revenue enhancements
  - Operating economies
  - Financial economies



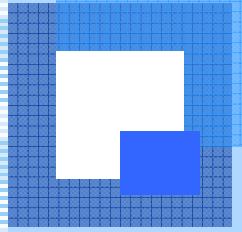
# Government Deregulation, Mergers, and Acquisitions

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## Incentives to Merge

### 2. Improved management

The merger may create an opportunity for improving the overall management level by eliminating poor managers.



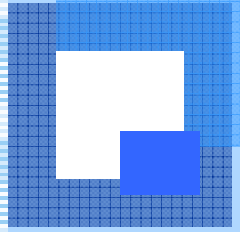
# Government Deregulation, Mergers, and Acquisitions

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## Incentives to Merge

### 3. Tax consequences

The merger may reduce the tax bill of the two combined companies.



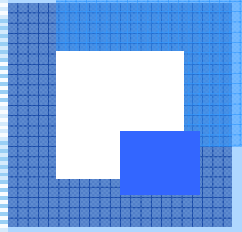
# Government Deregulation, Mergers, and Acquisitions

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## Incentives to Merge

### 4. Managerial power

A merger may occur when the acquiring company's managers are seeking to increase their span of authority.



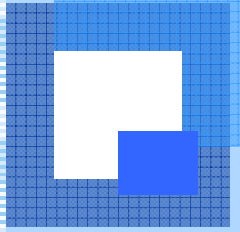
# Government Deregulation, Mergers, and Acquisitions

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## Incentives to Merge

### 5. Diversification

Mergers among unrelated firms was said to decrease the variability of sales and earnings and thus benefit stockholders.



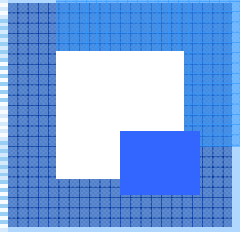
# Government Deregulation, Mergers, and Acquisitions

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## Incentives to Merge

### 6. Market power

Mergers may decrease competition in an industry, thus leading to higher profits for the remaining firms.



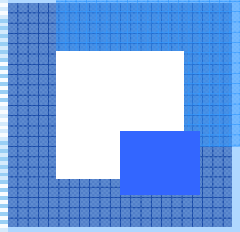
# Government Deregulation, Mergers, and Acquisitions

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Stockholders of the target firm gain substantially.

Stockholders of the acquiring firm gain very little.

Overall increase in value of combined firms.



# Government Deregulation, Mergers, and Acquisitions

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Evidence regarding profitability of merged firms is mixed.

Merger activity does not appear to have increased the level of industry concentration.

There appears to be no decrease in research and development of merged firms.