

3.5 — Intro to Political Economy

ECON 306 · Microeconomic Analysis · Fall 2020

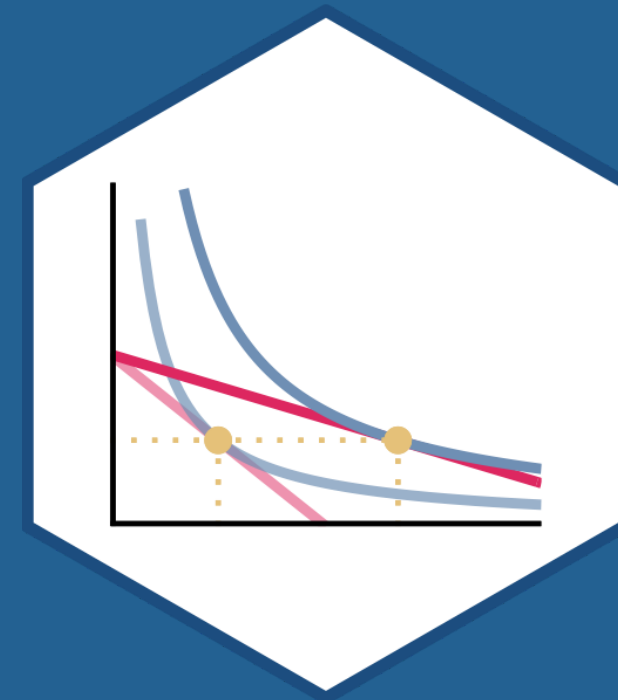
Ryan Safner

Assistant Professor of Economics

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🌐 microF20.classes.ryansafner.com



Outline



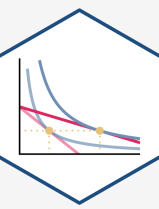
Policies That Raise Transaction Costs & Prevent Equilibrium

An Example: *Some* Economic Impacts of Covid

Making Fair Comparison

Public Choice: The Economic Analysis of Politics

Welfare Economics, Reminder

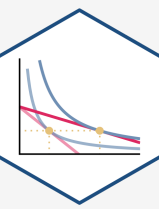


- **Markets are great when:**
 1. They are **Competitive**: many buyers and many sellers
 2. They each **equilibrium (prices are free to adjust)**: absence of transactions costs or policies *preventing prices from adjusting* to meet supply and demand
 3. **There are no externalities** are present: costs and benefits are fully internalized by the parties to transactions
- If any of these conditions are not met, we have **market failure**
 - May be a role for governments, other institutions, or entrepreneurs to fix
- Let's first talk about #2

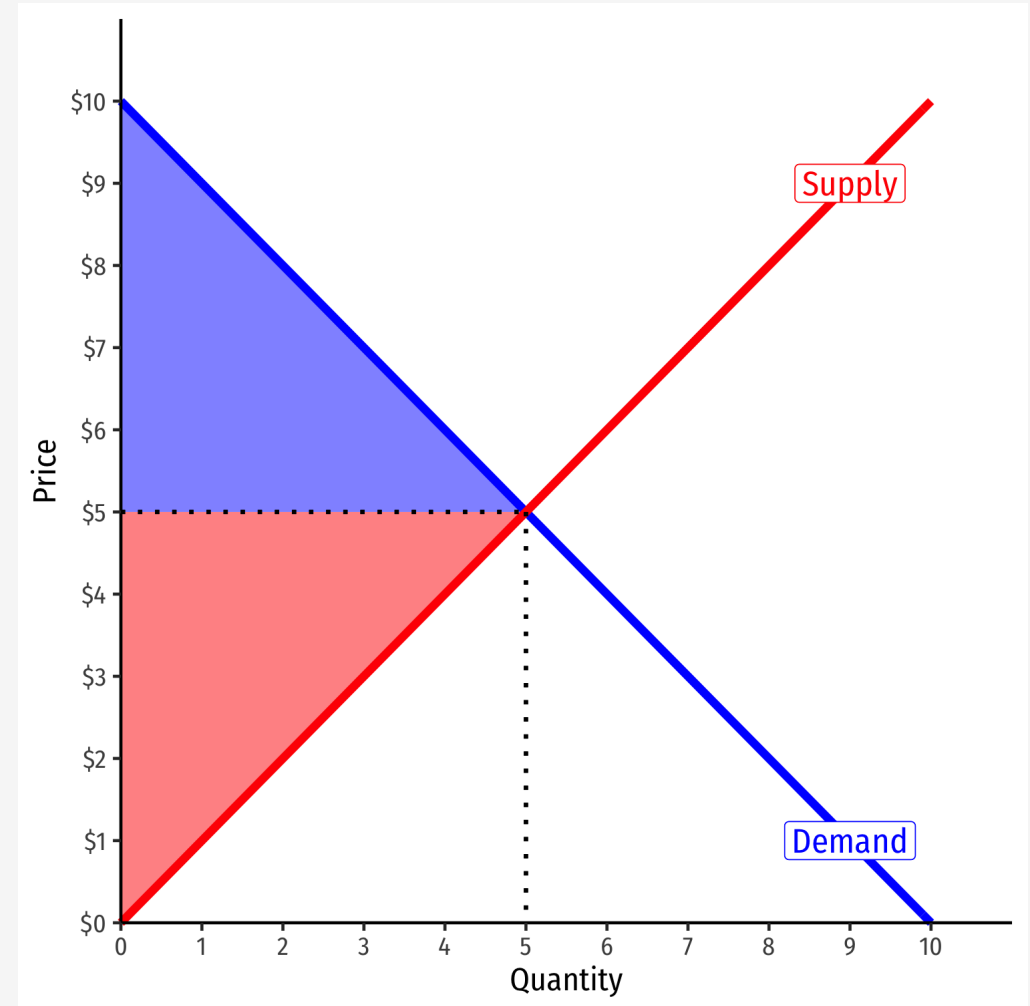


Policies That Raise Transaction Costs & Prevent Equilibrium

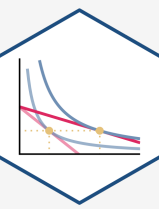
Dis-equilibrated Markets



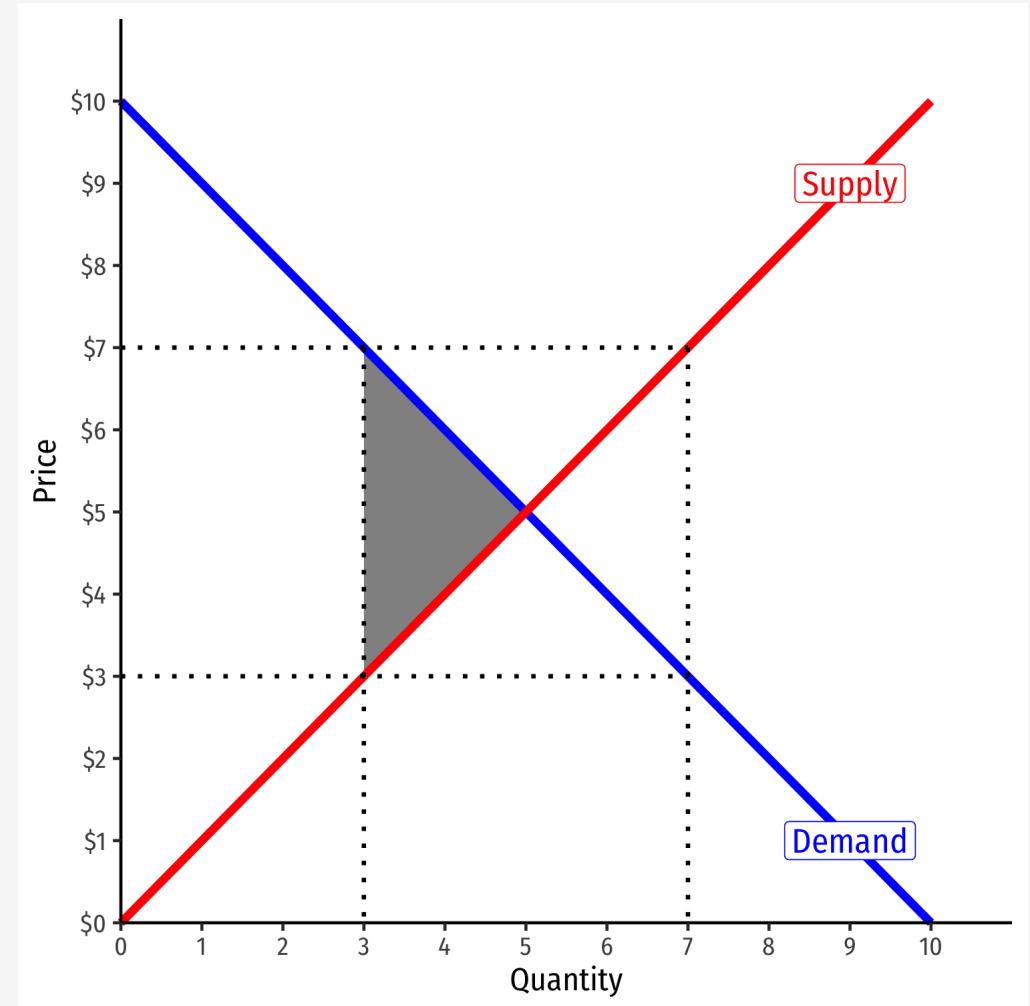
- The static benefits of markets all come from markets *being in equilibrium*:
 - allocative efficiency (CS+PS)
 - Pareto efficiency
 - productive efficiency
- But don't forget the *dynamic benefits* of markets as a discovery process! ([class 3.3](#))
 - *discovery* of better allocations of resources
 - creation & elimination of profit opportunities
 - entrepreneurship & innovation



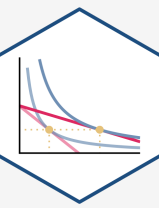
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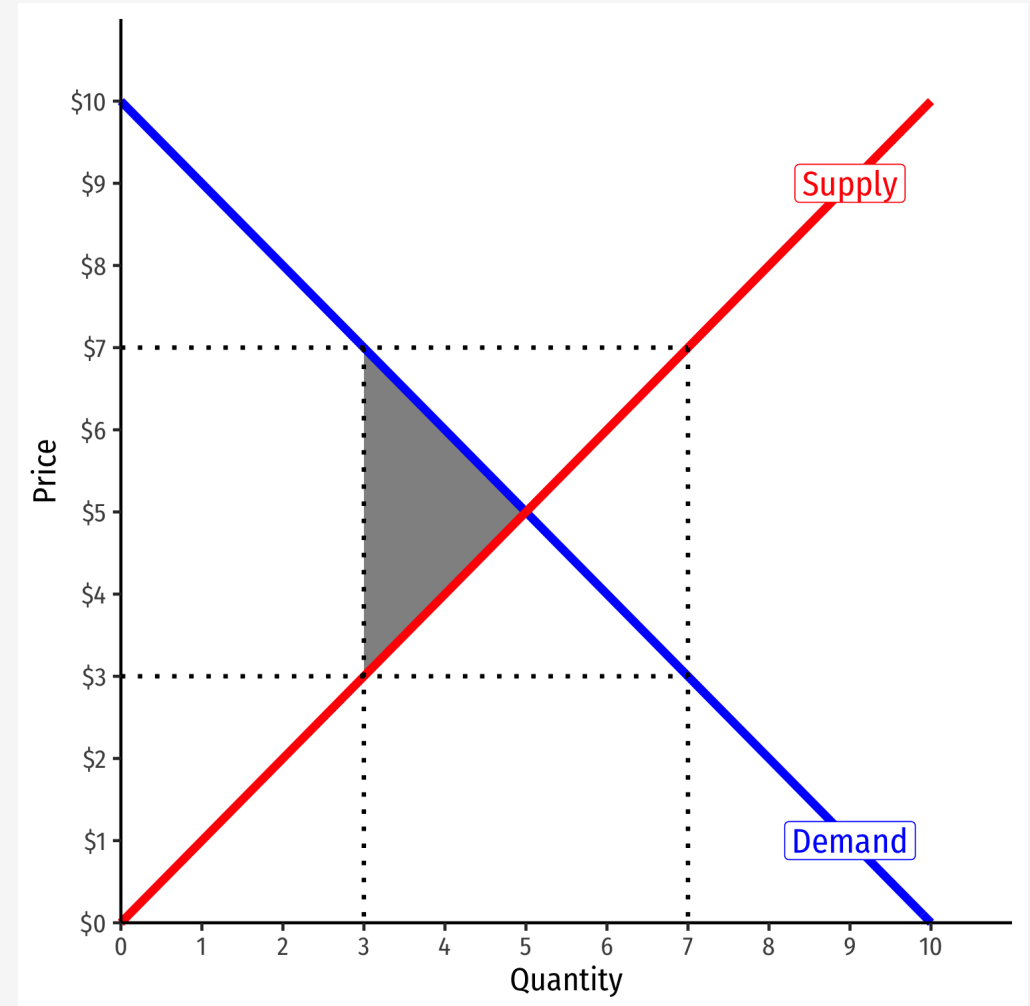
- To *reach* equilibrium, market prices need to be able to adjust
 - Shortage: price needs to rise
 - Surplus: price needs to fall
- There are ***unrealized gains from trade*** that exist in disequilibrium (shaded)
 - Buyers & sellers both can be made better off if they can adjust the price

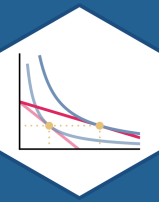


Dis-equilibrated Markets



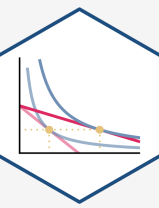
- If market prices are *prevented* from adjusting, shortage/surplus becomes *permanent*
- Lost **CS** and/or **PS**: **Deadweight loss (DWL)**
 - **inefficiency** created by (permanent) diseq.
- Various government policies can prevent markets from equilibrating & create DWL:
 - **Price regulations** (price ceiling like rent control, price floor like minimum wage)
 - **Taxes, subsidies, tariffs, quotas**[†]
 - These should have been covered in Principles





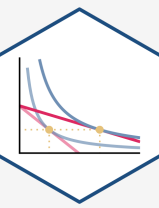
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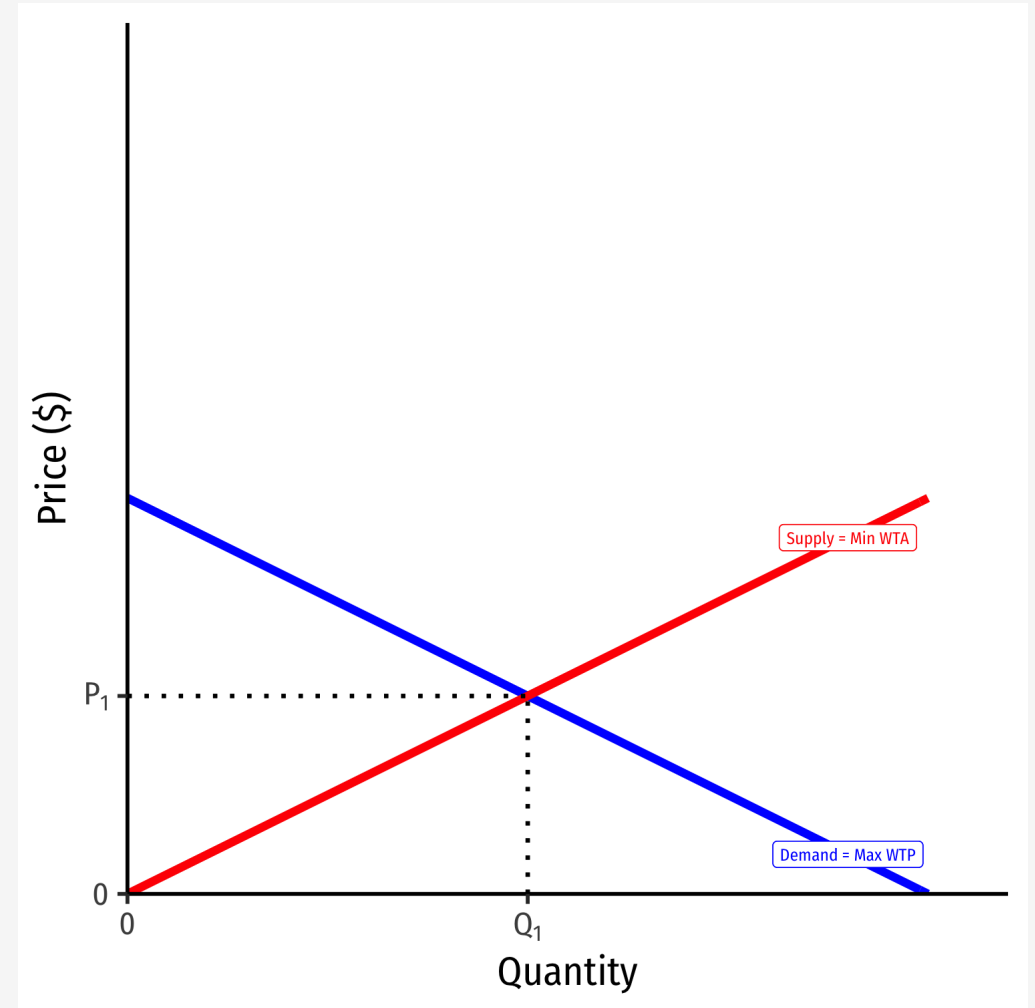


- Where did all of the ... go?
 - Toilet paper
 - Hand sanitizer
 - Masks
 - PPE
 - Ventilators
- Three major issues:
 - price elasticity of supply
 - price gouging laws
 - restrictions & regulations on supply

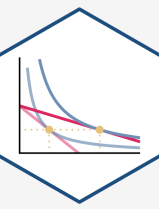
Increase in Demand



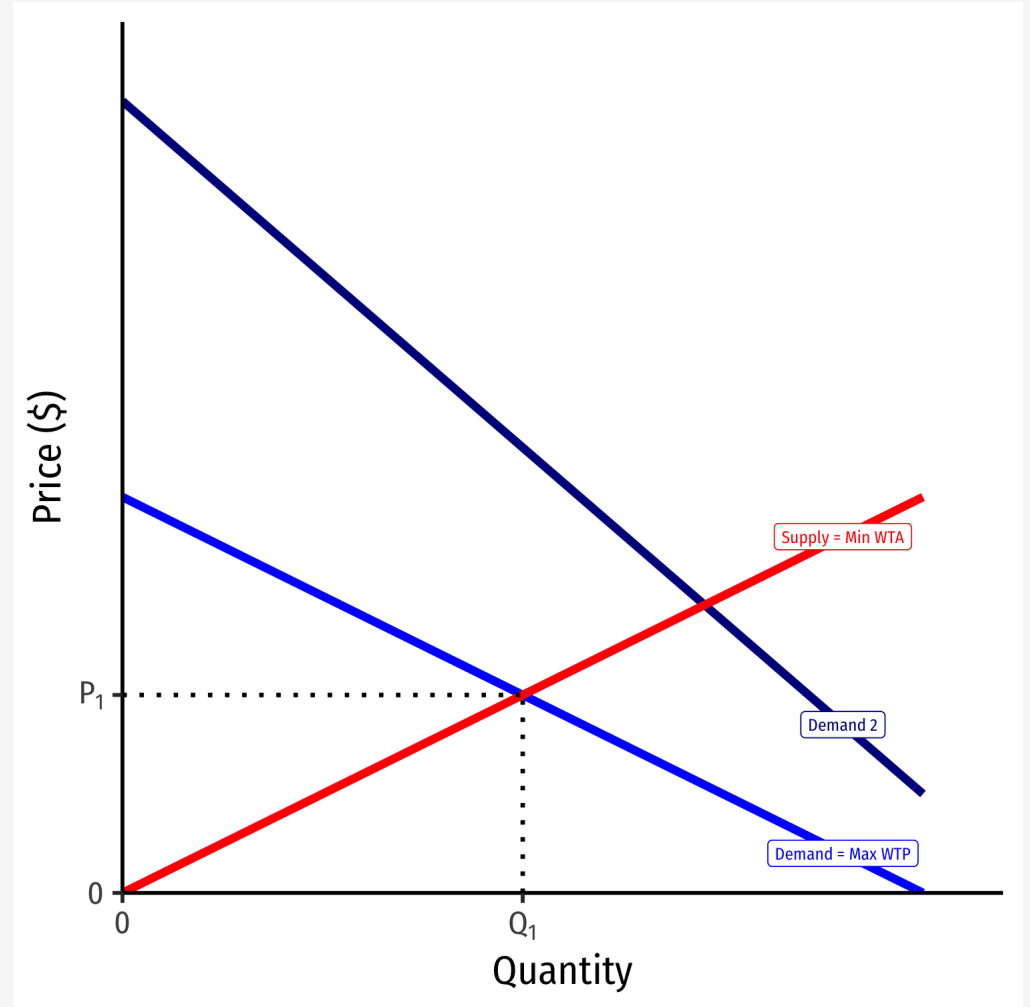
- Consider a market for a good in equilibrium, P_1



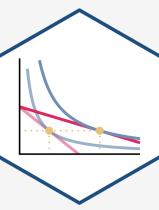
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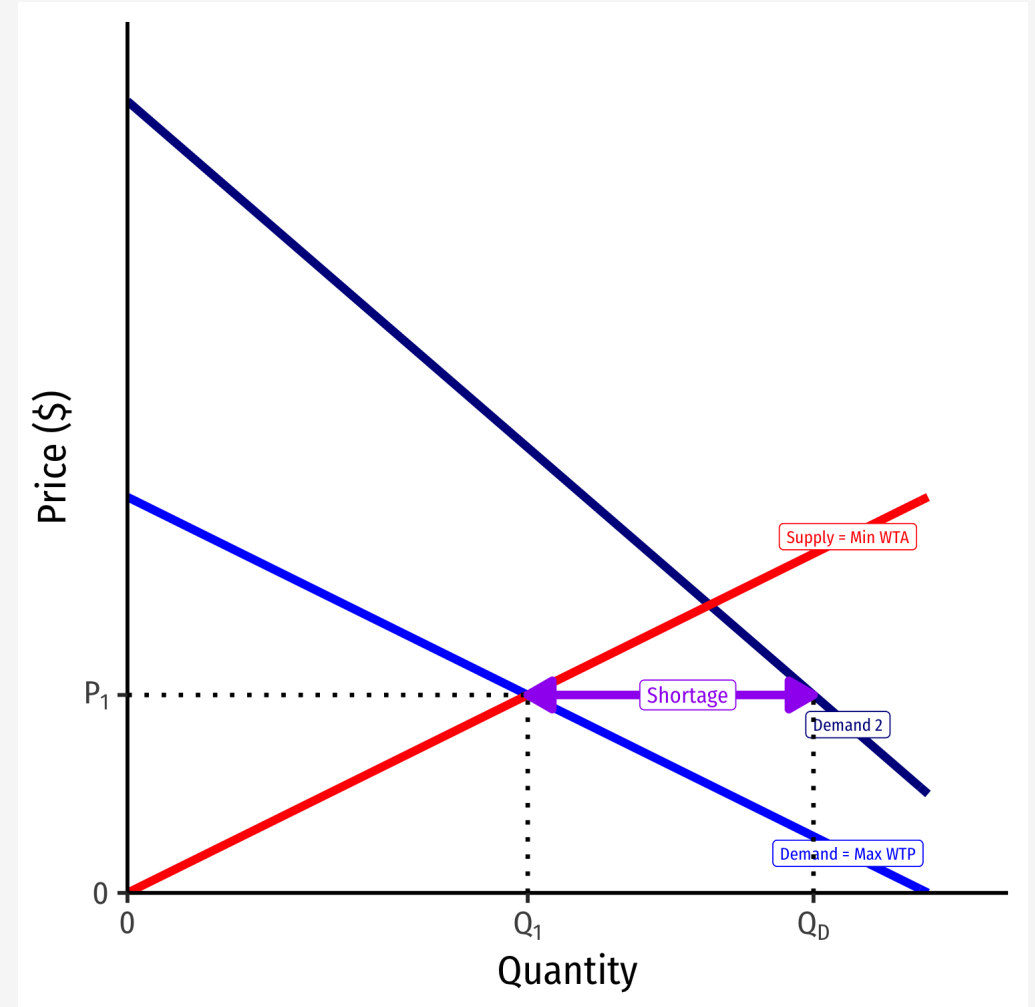
- More individuals want to buy more of the good at *every* price
- Demand *increases*, becomes *less elastic*



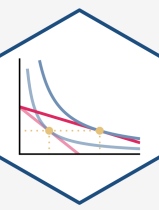
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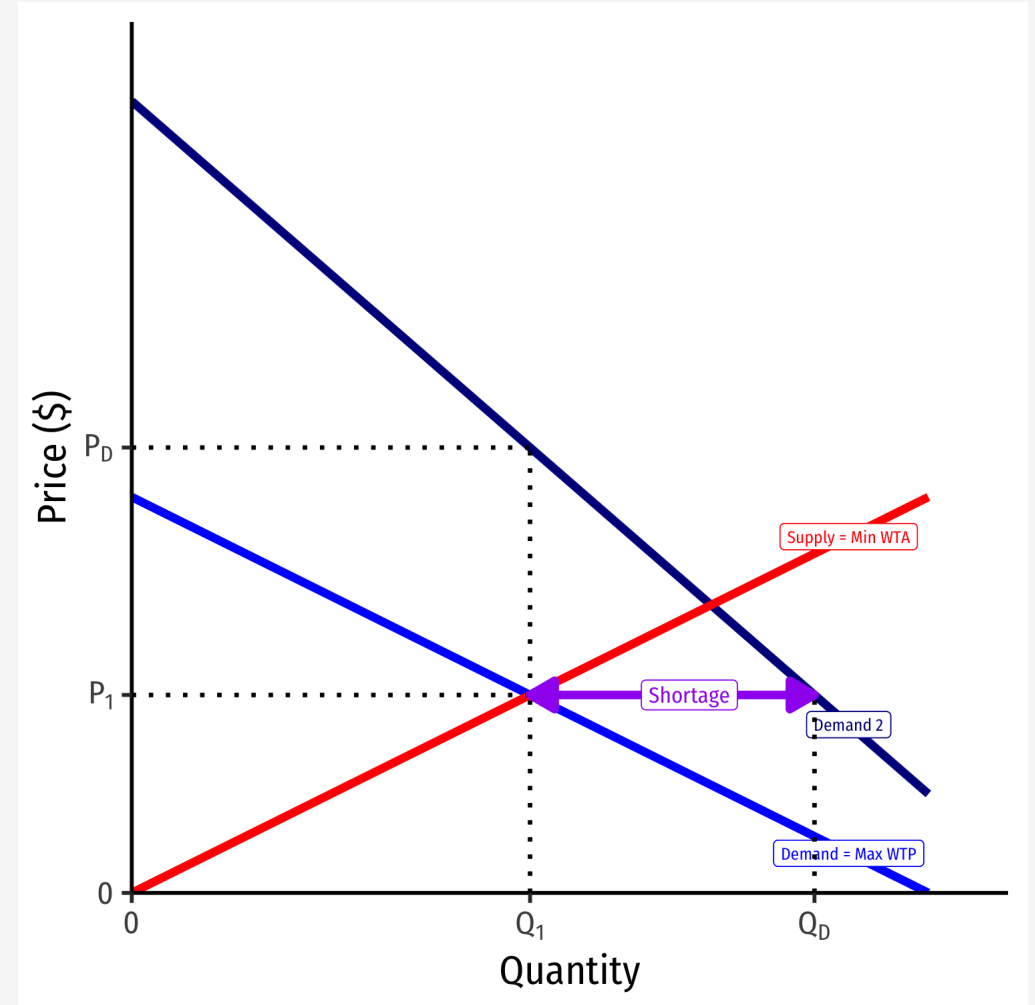
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- At the original market price, a **shortage!**
($q_D > q_S$)



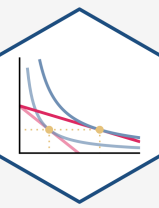
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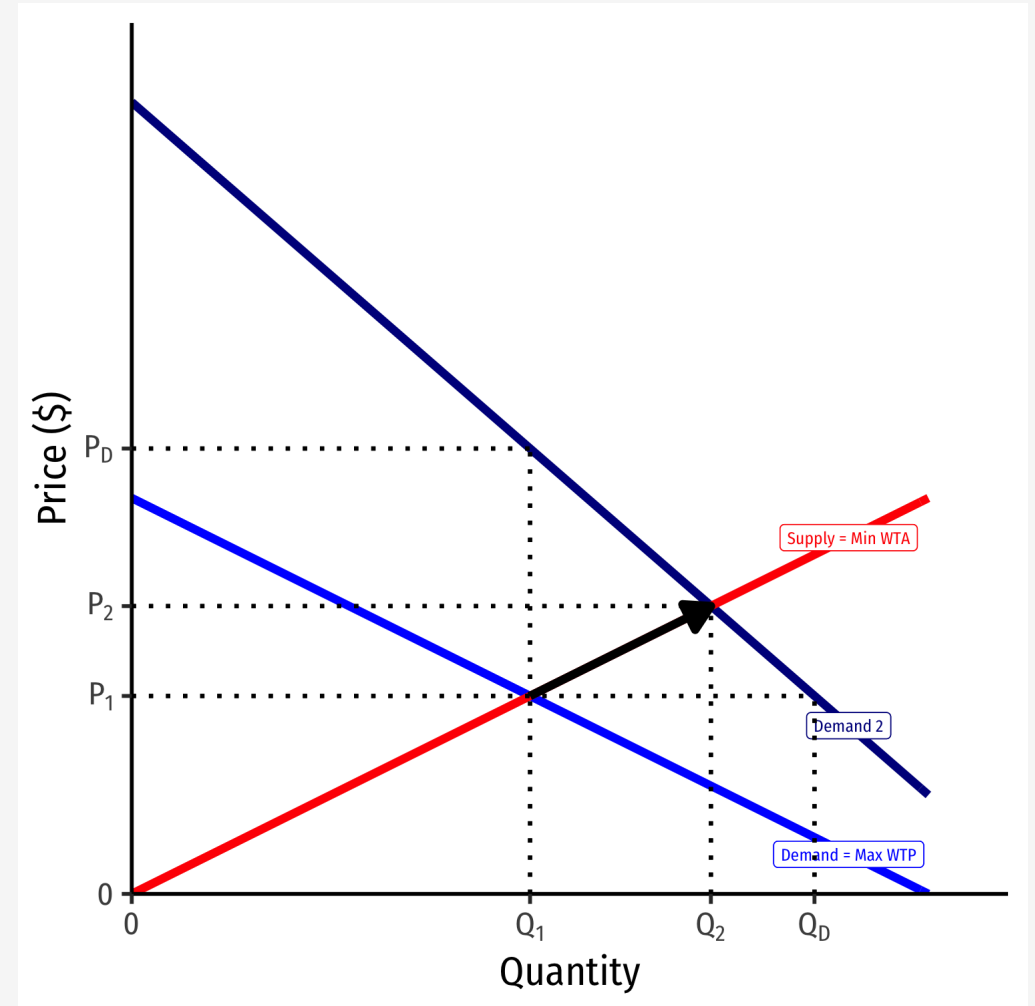
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- **Sellers** are supplying Q_1 , but some **buyers** willing to pay more for Q_1



Increase in Demand



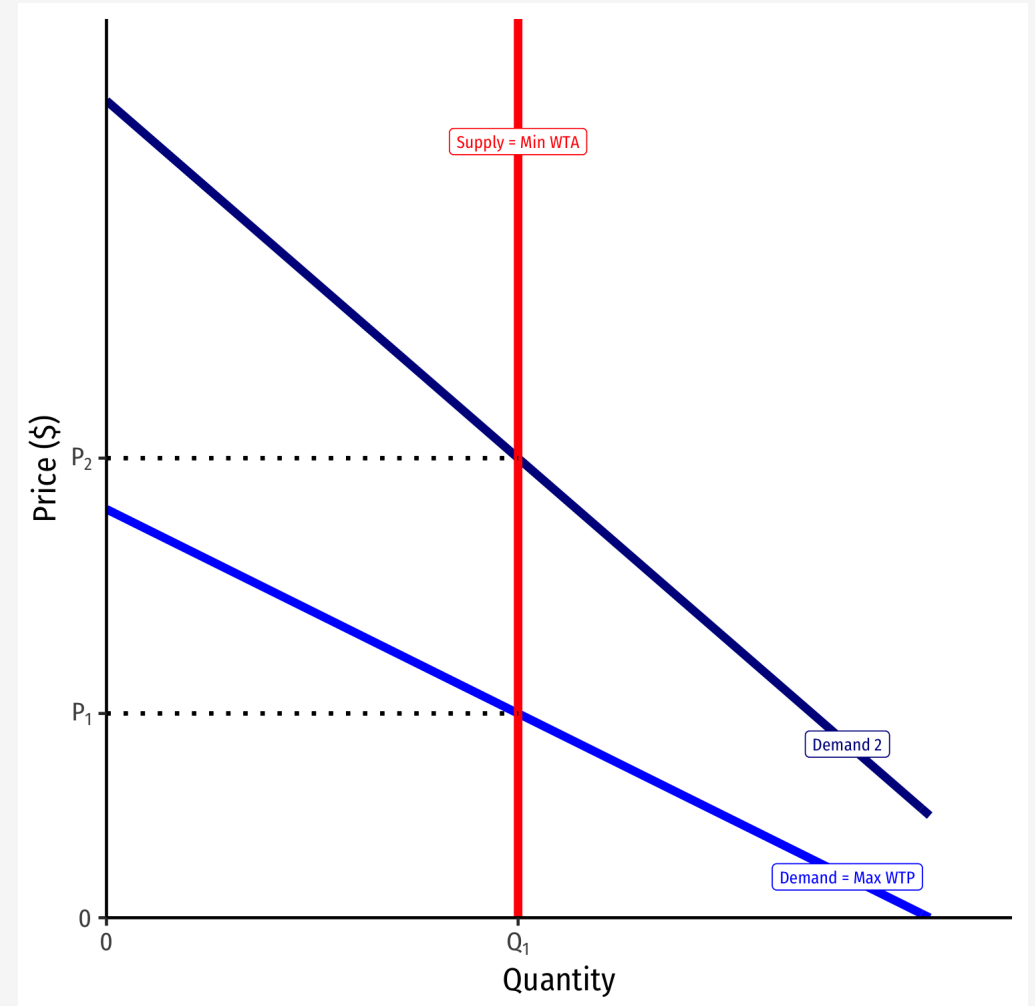
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- Demand *increases*, becomes *less elastic*
- At the original market price, a **shortage!** ($q_D > q_S$)
- **Sellers** are supplying Q_1 , but some **buyers** willing to pay more for Q_1
- **Buyers** raise bids, inducing **sellers** to sell more
- Reach new equilibrium with:
 - **higher market-clearing price (P_2)**



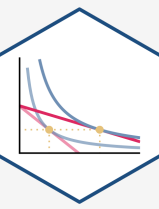
One Possibility: Inelastic Supply



- It might that **supply** is very *inelastic*
 - Here: *perfectly* inelastic (for convenience)
- Suppliers can't produce and sell more units even if they want to at very high price demanded
 - sudden shock to inventories (short run)
 - rising production costs
 - government regulations & restrictions
- Thus, the new high price is an equilibrium that will persist for a while
 - no “inefficiency,” just a fixed supply of goods we cannot easily change



One Possibility: Inelastic Supply



A screenshot of a web browser displaying a blog post from flexport.com. The browser's address bar shows 'flexport.com'. The page header includes the Flexport logo, a search icon, and a 'Get Started' button. The main content area features a photograph of a person in a white protective suit and mask, holding a clipboard. The article title is 'Why There Aren't Enough Masks, and How to Get More', dated 'APR. 14, 2020'. The author is identified as 'Ryan Petersen, Flexport Founder and CEO'. The article text discusses the shortage of masks and PPE in American hospitals, noting that demand is expected to increase significantly (20x) and that the current supply chain cannot handle this demand shock. It also lists five components contributing to the shortage: insufficient inventory stockpiles, manufacturing capacity and quality control, international trade compliance, air uplift capacity, and working capital financing.

flexport.

Get Started

Back to Blog

APR. 14, 2020

Why There Aren't Enough Masks, and How to Get More

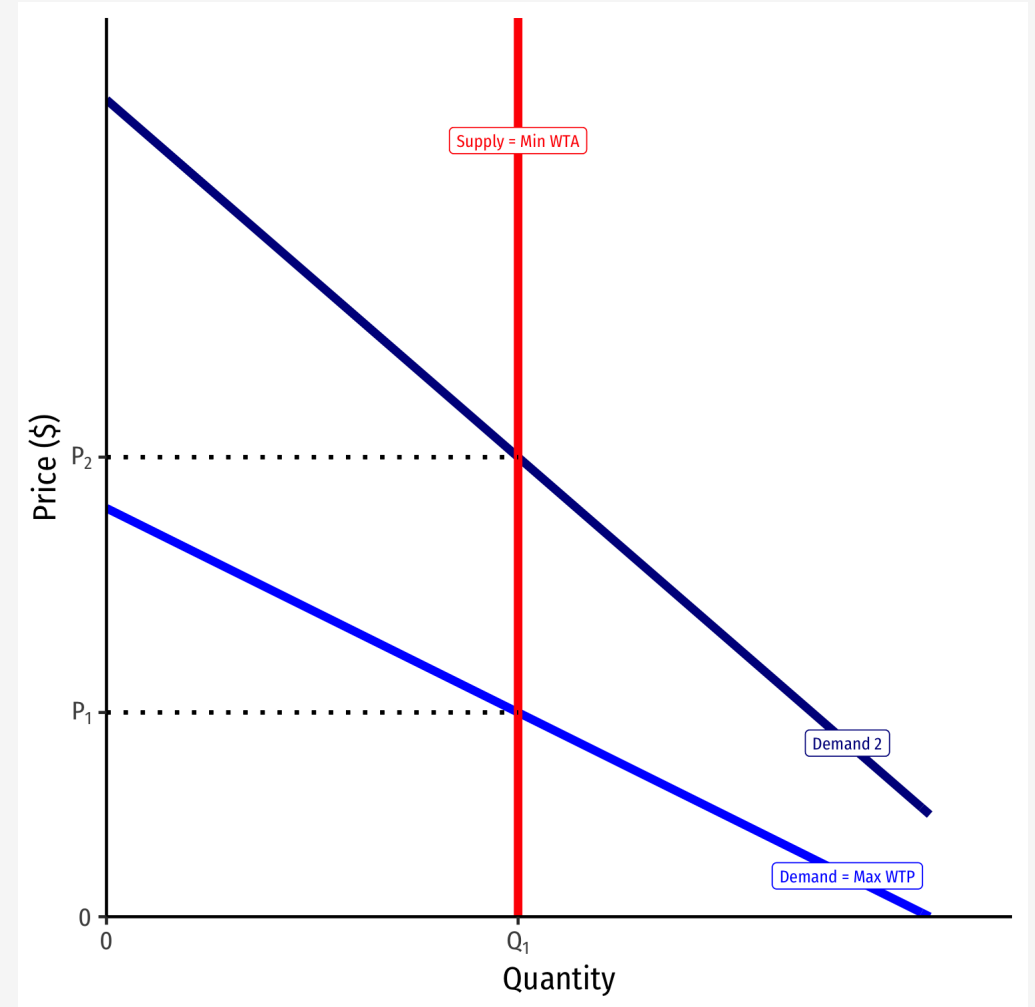
Tags: Coronavirus, Freight Forwarding

Ryan Petersen, Flexport Founder and CEO
Flexport CEO

American hospitals are disastrously short of masks and other personal protective equipment (PPE), and demand will only increase. They estimate they will need 20x their ordinary supply over the next few months. In its current form, our supply chain cannot handle this demand shock.

In this blog post, I'll share my view of how this problem happened, and explore some ideas for how we can better serve our healthcare workers.

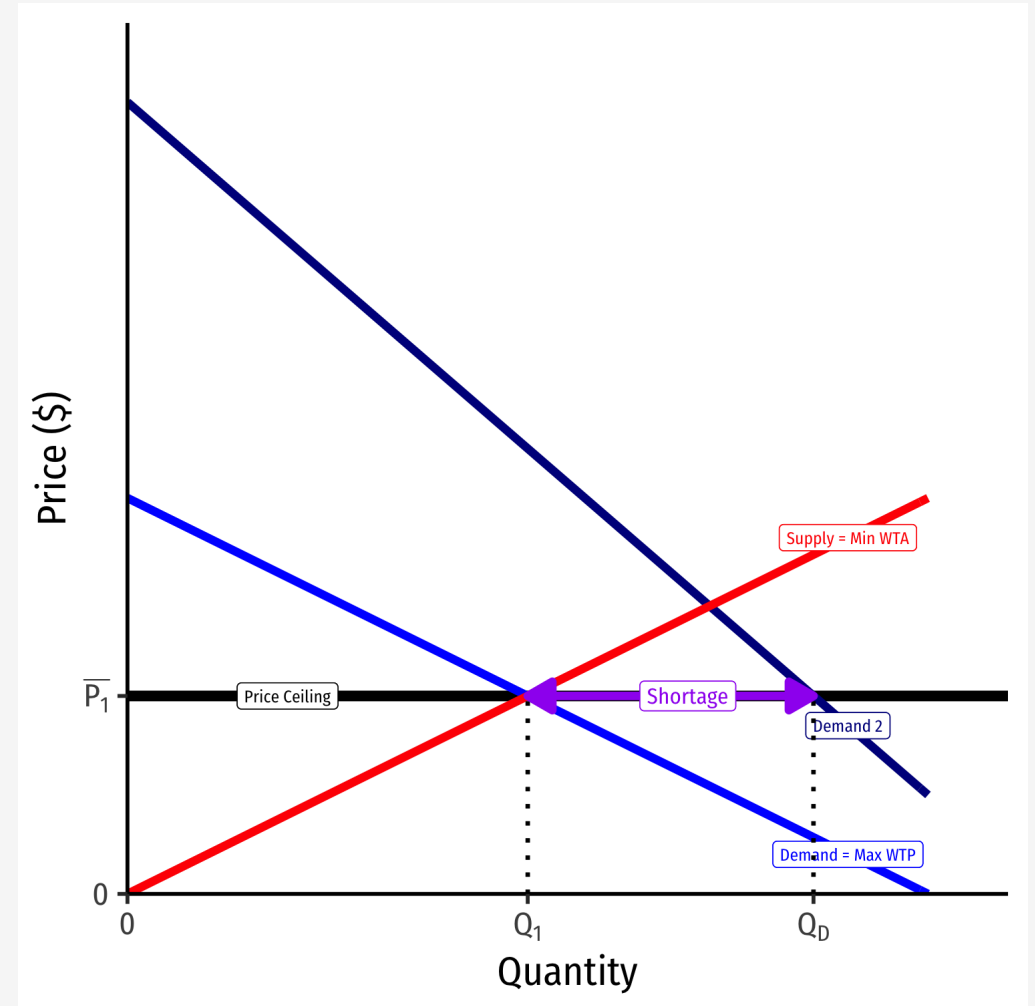
The current shortage of PPE is not due to a single cause. It has at least five components: insufficient inventory stockpiles, manufacturing capacity and quality control, international trade compliance, air uplift capacity, and working capital financing. And if we don't plan ahead, we'll have a sixth



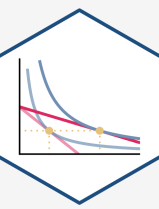
Price Gouging Laws



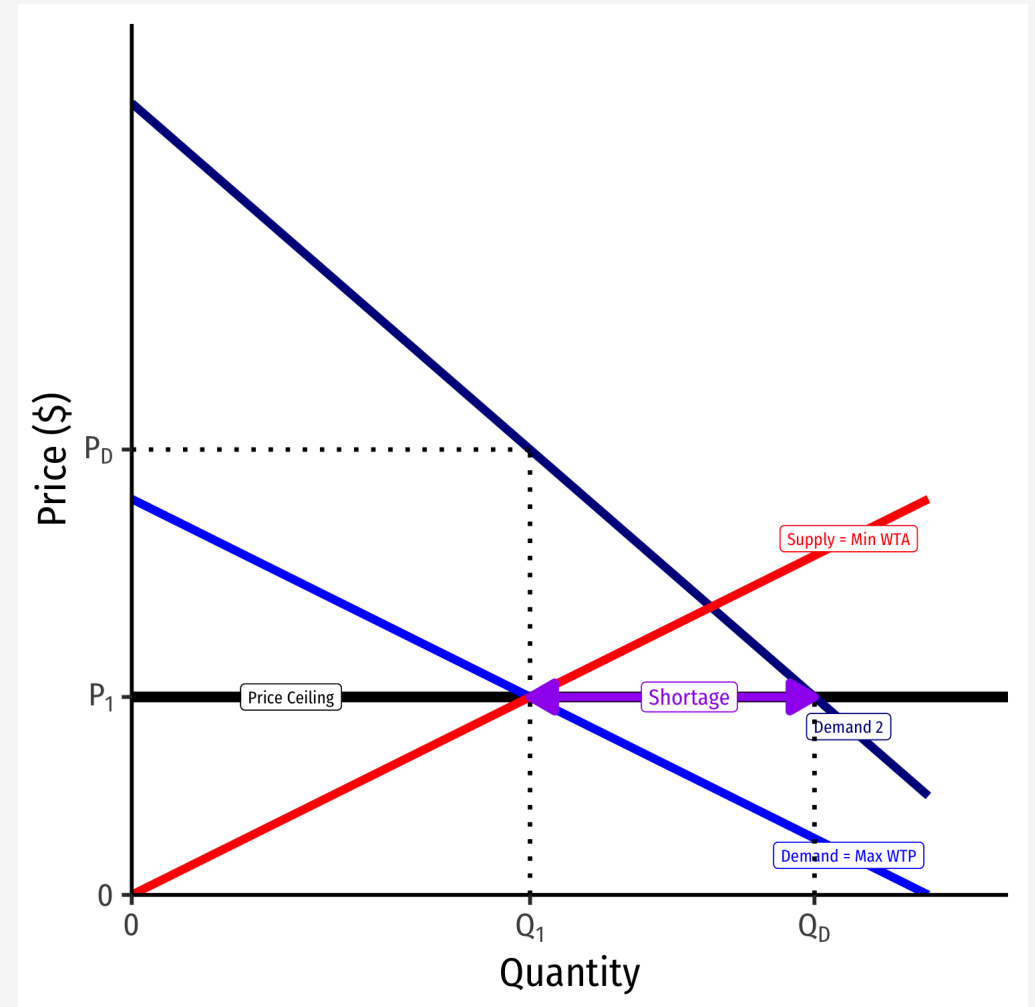
- Additionally, government has **anti-price-gouging laws**, a **price ceiling** at the original price, P_1
- $Q_d > Q_s$: **excess demand**, a **shortage**!
- Sellers will not supply more than Q_1 at price \bar{P}_1



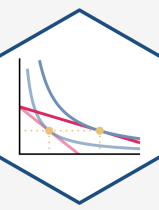
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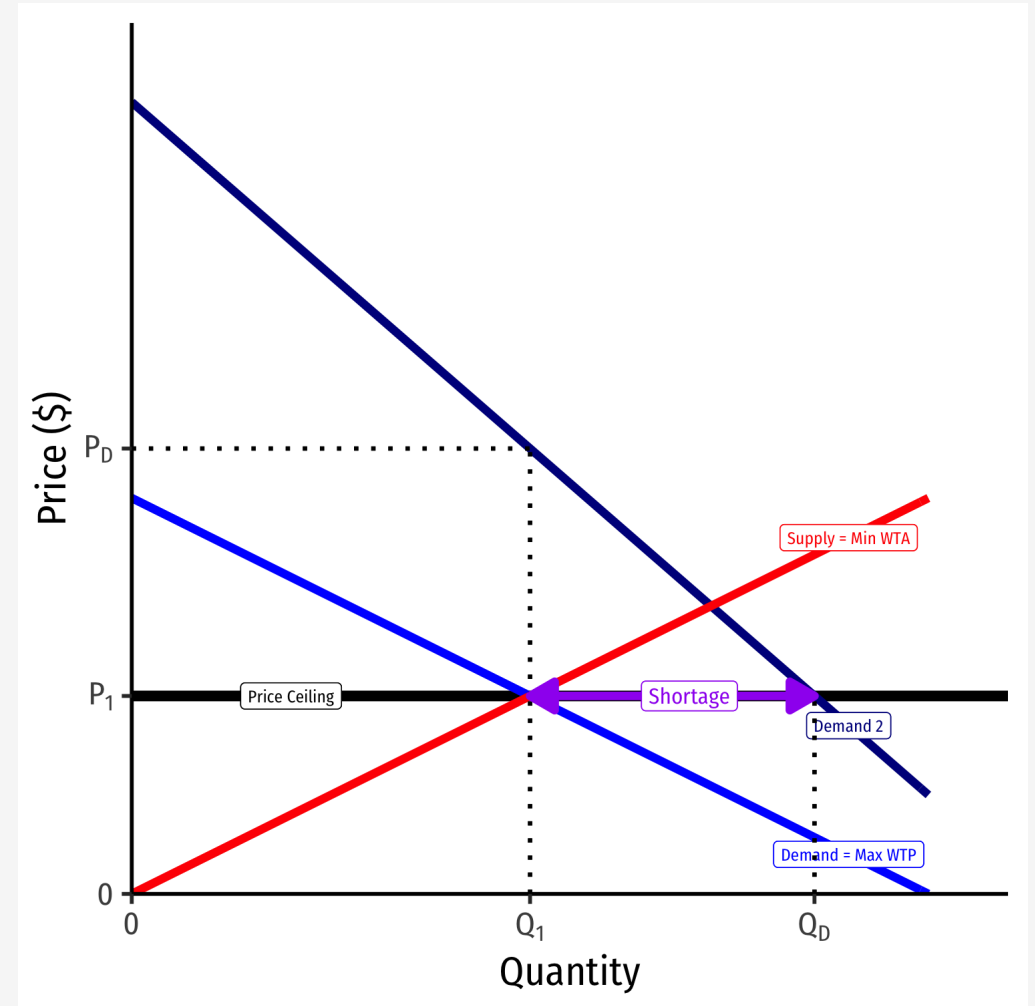
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- $Q_d > Q_s$: **excess demand**, a **shortage**!
- Sellers will not supply more than Q_1 at price \bar{P}_1
- For Q_1 units, buyers are willing to pay P_D !



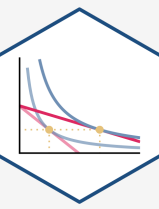
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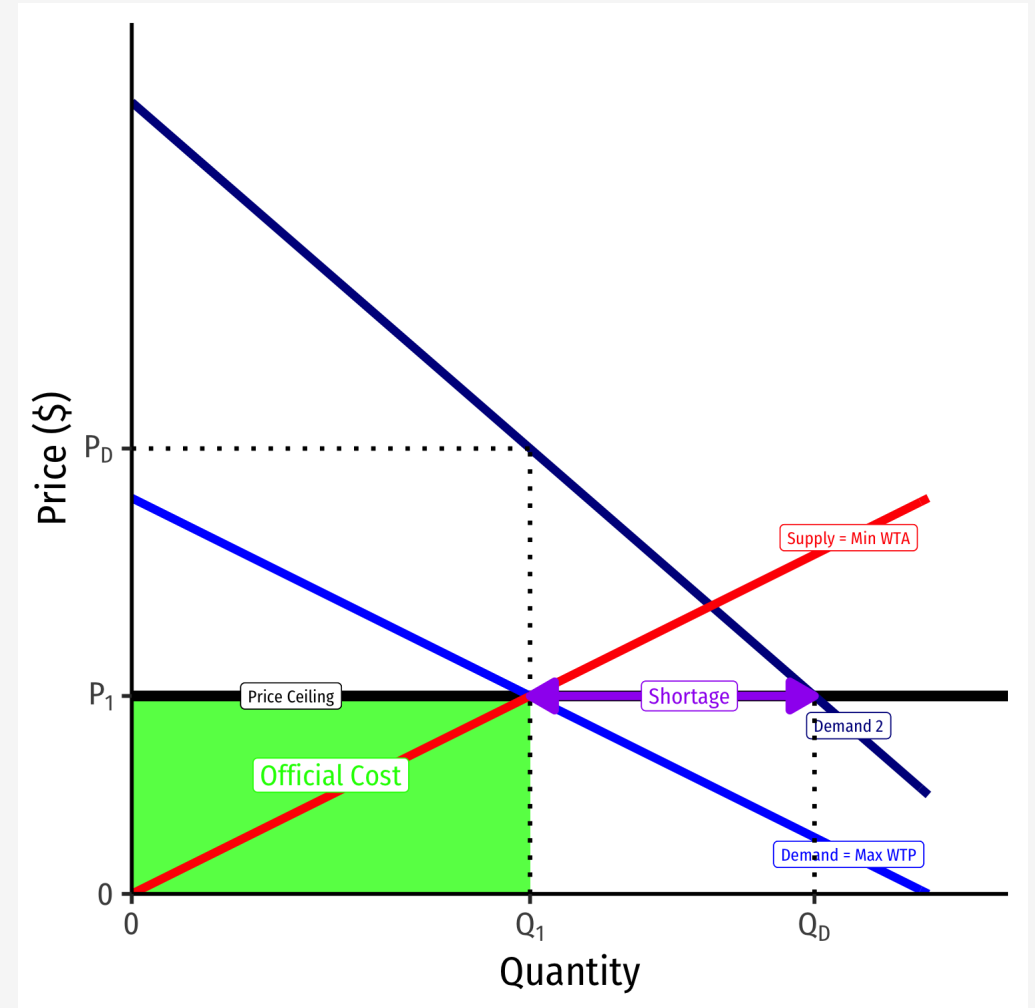
- **If prices were allowed to adjust:** buyers would bid higher prices to get the scarce Q_s goods
- Sellers would respond to rising willingness to pay, and produce and sell more
- **But the price is not allowed to rise above \bar{P}_1 !**



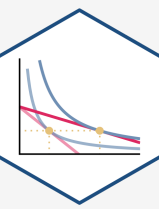
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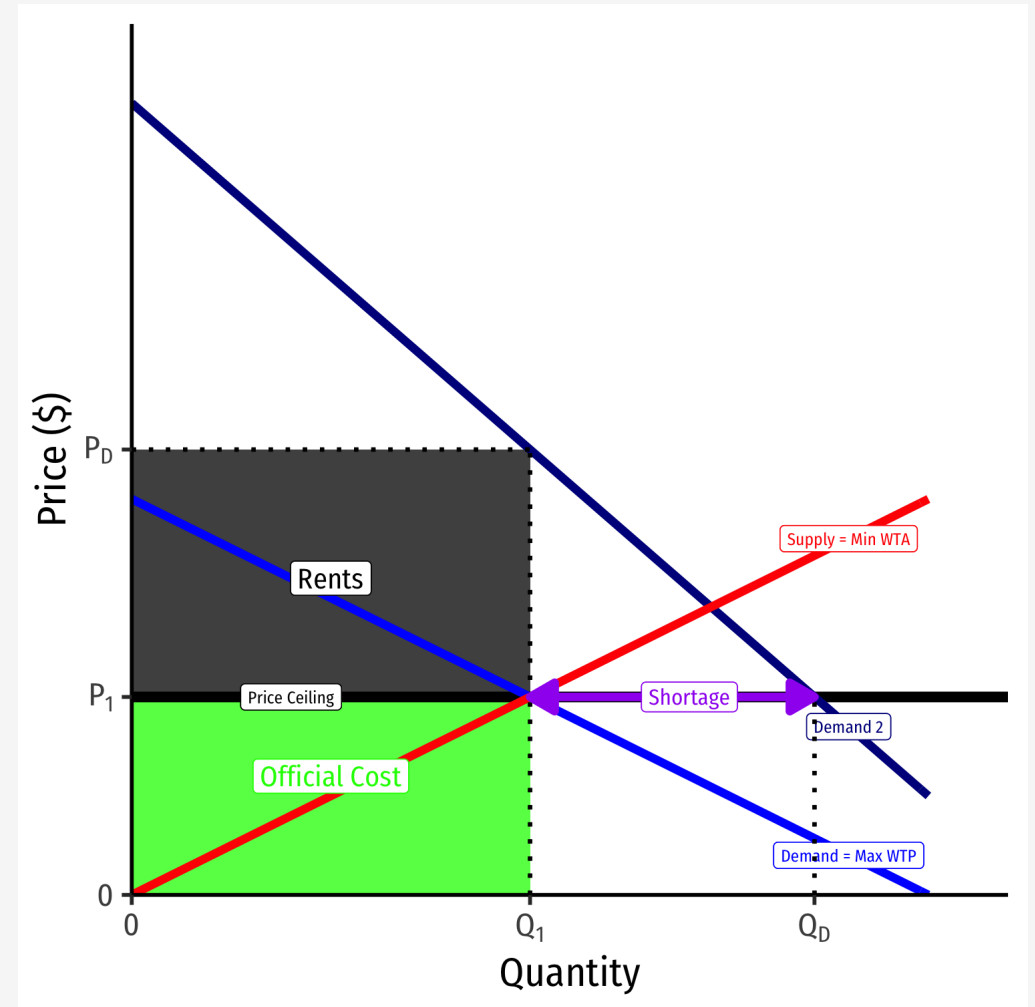
- Official price is \bar{P}_1 , sellers gain **monetary revenues**



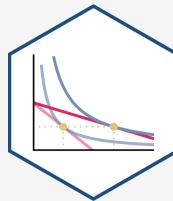
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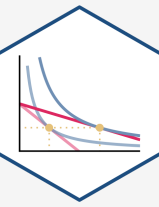
- Official price is \bar{P} , sellers gain **monetary revenues**
- Competition exists between buyers to obtain scarce Q_s goods
 - Buyers willing to pay P_D *unofficially*
- Goods are distributed by non-market means:
 - Queuing
 - Black markets
 - Political connections, favors, corruption
- **Economic rents:** excess returns (above cost) go to those who own & distribute the scarce goods



Forms of Rents



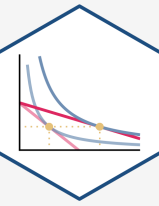
(Temporarily) Raising Prices Can Solve the Shortage



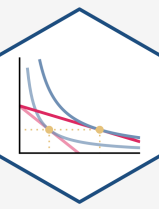
A relatively high price:

- **Conveys information:** good is relatively scarce
- **Creates incentives for:**
 - **Buyers:** conserve use of this good, seek substitutes
 - **Sellers:** produce more of this good
 - **Entrepreneurs:** find substitutes and innovations to satisfy this unmet need

(Temporarily) Raising Prices Can Solve the Shortage



(Temporarily) Raising Prices Can Solve the Shortage



BIRGΣЯ
@Birger_s



A supermarket in Denmark got tired of people hoarding hand sanitizer, so came up with their own way of stopping it.

1 bottle kr40 (€5.50)

2 bottles kr1000 (€134.00) each bottle.

Hoarding stopped!

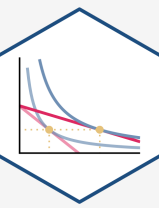
[#COVID19](#) [#Hoarding](#) pic.twitter.com/eKTabEjScc (via [@_schuermann](#)) cc [@svenseele](#)

2:28 AM · Mar 18, 2020



♡ 4.2K ⚡ See the latest COVID-19 information on Twitter

Forcing Low Prices Doesn't Solve the Shortage



Russell Roberts ✓
@EconTalker



Shopper: Your chicken is too expensive. The butcher across the street is only \$1/lb.

Butcher: So buy from the butcher across the street.

Shopper: But he's out of chicken.

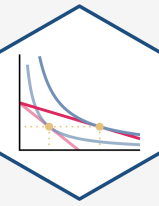
Butcher: Yeah, when I'm out I charge \$1/lb, too.

10:15 AM · Apr 13, 2020

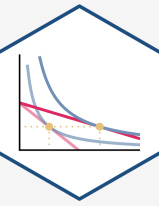


♥ 1.5K 💬 233 people are Tweeting about this

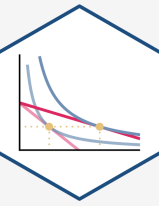
Supply-Side Restrictions & Regulatory Burden



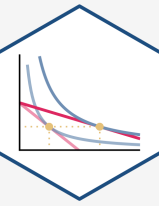
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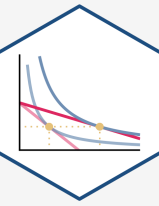
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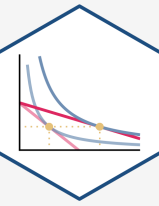
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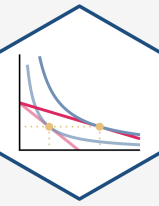
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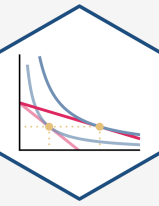
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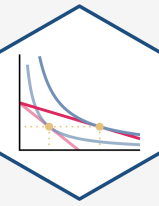
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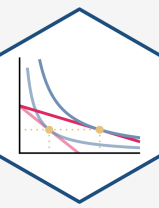
Supply-Side Restrictions & Regulatory Burden





Making Fair Comparisons

Two Fundamental Problems of Political Economy

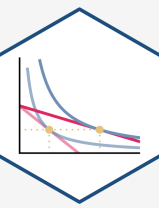


- All societies face two fundamental problems, which institutions emerge (or are created) to address:

The Knowledge Problem: How to coordinate the *tacit, fragmented* knowledge of opportunities and conditions *dispersed* across millions of individuals (and accessible to none in total) in order to maximize the ability of individuals to achieve their goals

The Incentives Problem: How to structure incentives that individuals face in a way that maximizes cooperative behavior (voluntary exchange and association) and minimizes non-cooperative behavior (cheating, opportunism, exploitation, violence, rent-seeking)

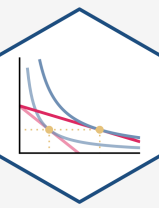
Robust Political Economy



- **No system is perfect**
- We need to find arrangements that are **robust** to knowledge & incentive problems
- **Easy (unpersuasive) case:** perfect information & pure benevolence
 - every system works *in theory!*
- **Hard (persuasive) case:** uncertainty & selfish behavior
 - what works best *in practice?*
- Treat people as they are: sometimes good, bad, smart, stupid, opportunistic, altruistic,



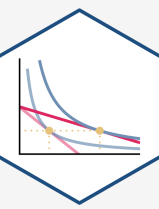
Robust Political Economy



I THINK YOU SHOULD BE MORE SPECIFIC HERE IN STEP TWO



Robust Political Economy



- People often recommend optimal policies as if they could be installed by a **benevolent dictator**
 - A dispassionate ruler with **total control**, **perfect information**, and **selfless incentives** to implement optimal policy
 - A “1st-best solution”
- In reality, 1st-best policies are distorted by the knowledge problem, the incentives problem, and politics
 - Real world: 2nd-to- n^{th} -best outcomes



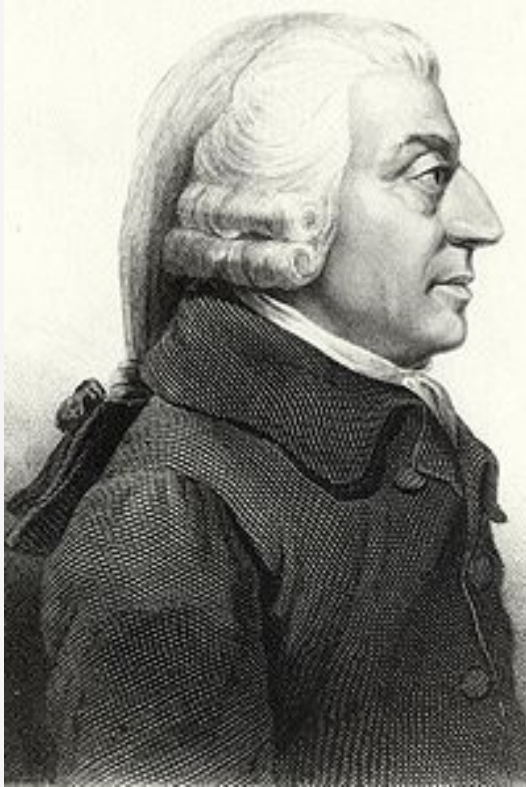
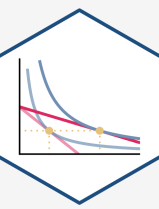
Comparative Institutional Analysis



- Compare imperfections of *feasible* and *relevant alternative* systems
 - **The “Nirvana Fallacy”**: comparing an imperfect system in reality with an ideal system in theory
- Economics: *think on the margin!*
 - One system's “failure” does not automatically imply another will be “successful”!
 - Real world requires **tradeoffs**
 - “economics puts parameters on people's utopias”
 - “compared to what?”



Institutions: Operationalizing Adam Smith



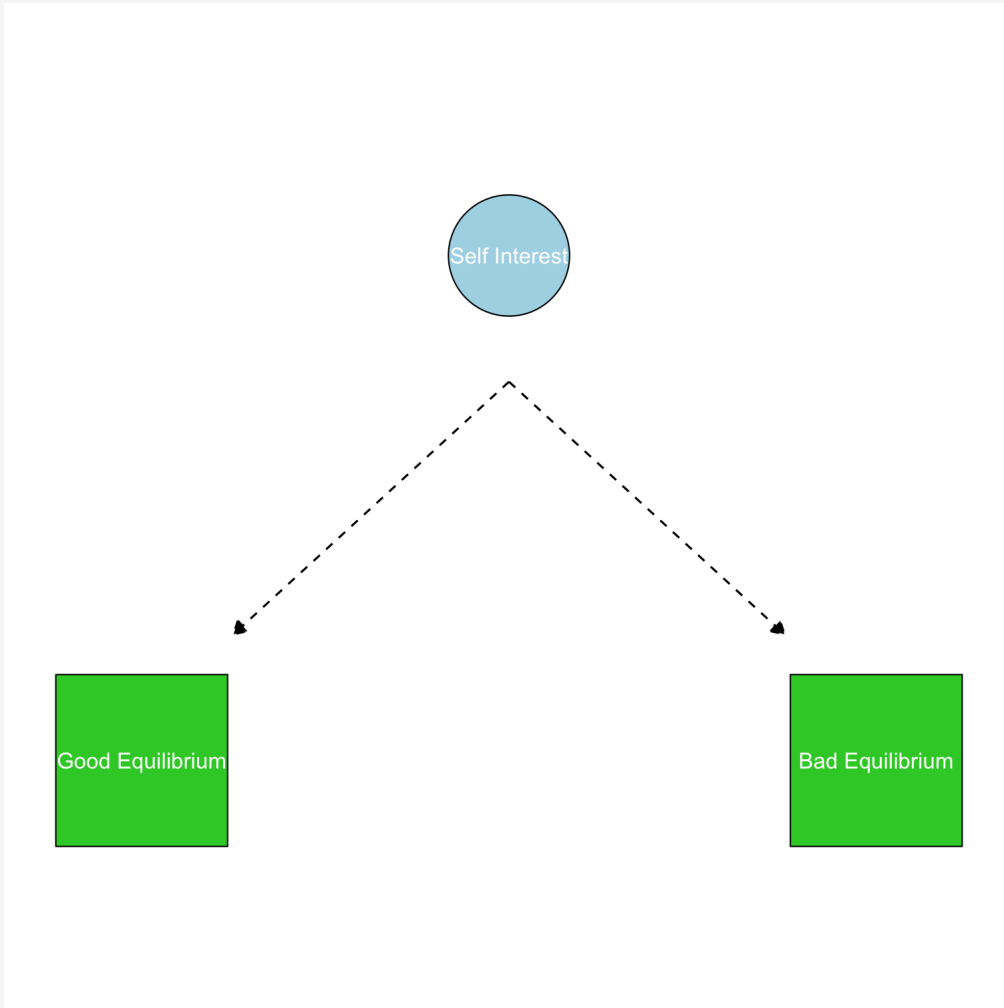
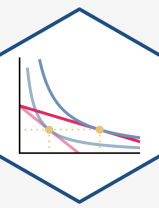
“[Though] he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention...By pursuing his own interest he frequently promotes that of the society more effectually than when he really intends to promote it,” (Book IV, Chapter 2.9).

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*

Adam Smith

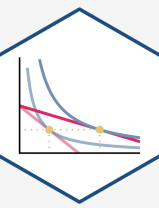
1723-1790

Institutions: Operationalizing Adam Smith

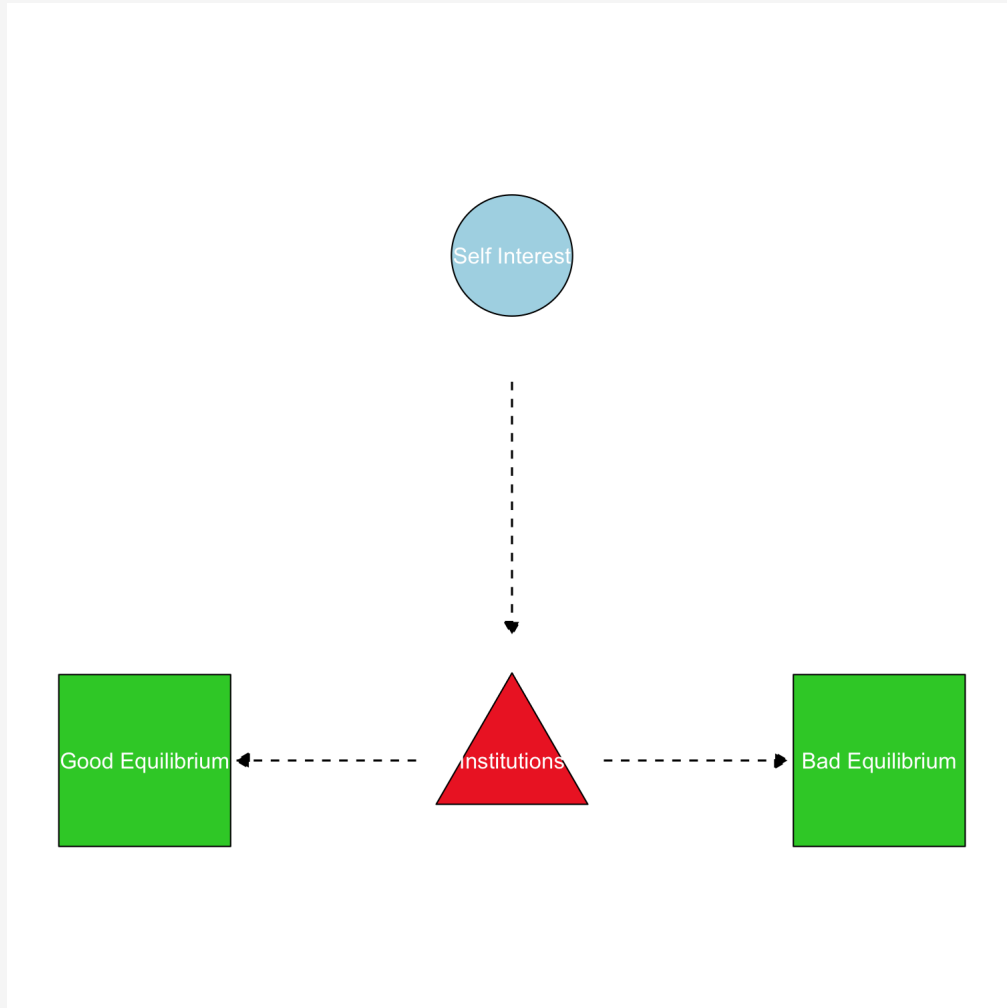


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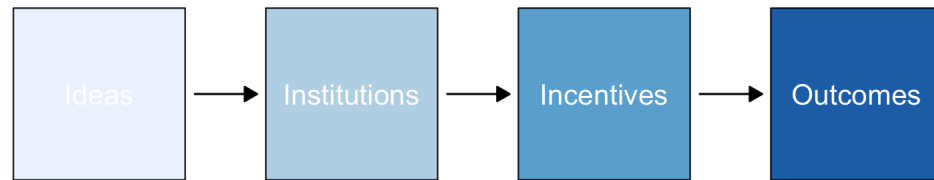
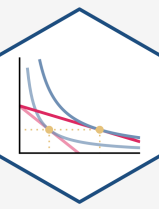
Institutions: Operationalizing Adam Smith



"[Though] **he intends only his own gain**, and he is in this, as in many other cases, **led by an invisible hand** to promote an end which was no part of his intention...By pursuing his own interest he frequently **promotes that of the society** more effectually than when he really intends to promote it," (Book IV, Chapter 2.9).



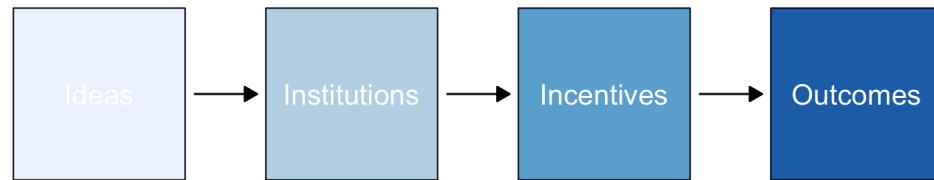
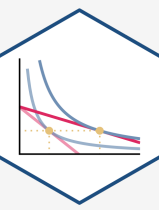
A Logical Framework for Political Economy



- **Outcomes:**

- relative level of wealth or poverty
- relative level of equality or inequality
- stability of politics, finance, macroeconomy

A Logical Framework for Political Economy



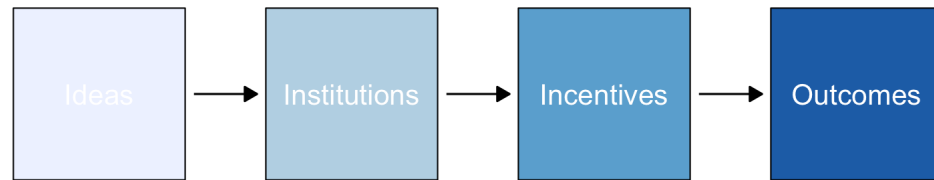
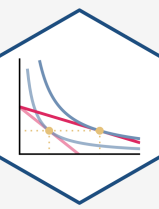
- **Outcomes:**

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- ...are determined by **Incentives:**

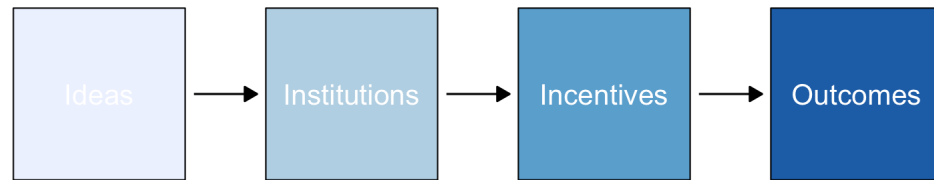
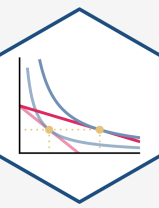
- relative prices or costs of various choices
- profits and losses
- information

A Logical Framework for Political Economy



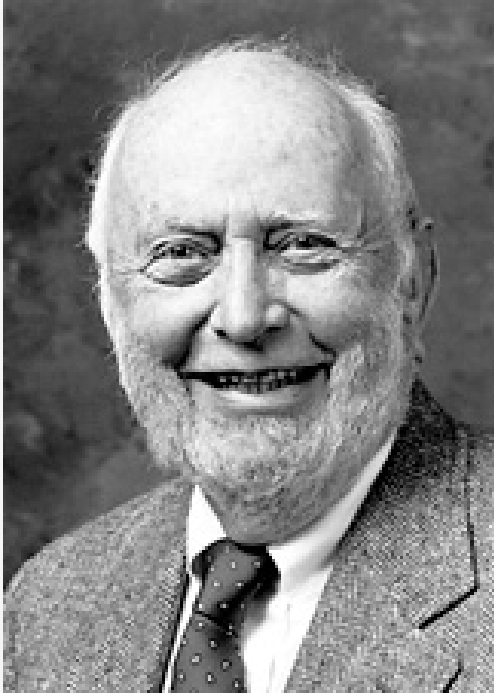
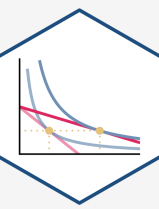
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 - (in)equality before the law or corruption
 - constraints on politics and economics

A Logical Framework for Political Economy



- **Outcomes:**
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- ...are determined by **Institutions:**
 - allocation of rights, property, & power
 - (in)equality before the law or corruption
 - constraints on politics and economics
- ...are determined by **Ideas:**
 - political and social worldview -"isms"
 - which groups (should) have status

What are Institutions?



Douglass C. North

1920-2015

Economics Nobel 1993

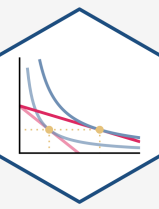
“Institutions are the humanly devised constraints that structure political economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights),”
(p.10)

“Institutions are the rules of the game in a society,”
(p.1).

North, Douglass C, (1991), "Institutions," *Journal of Economic Perspectives* 5(1): 97-112.

North, Douglass C, (1990), *Institutions, Institutional Change, and Economic Performance*

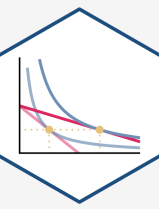
Incentives are Structured by Institutions



“Who needs this nail?”

“Don't worry about it! The main thing is that we immediately fulfilled the plan for nails!”

Incentives are Structured by Institutions



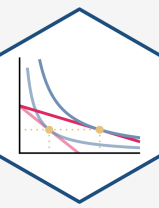
“Dear customer, in the leather goods department of our store, a shipment of 500 imported womens' purses has been recieved. Four hundred and fifty of them have been bought by employees of the store. Forty-nine are under the counter and have been ordered in advance for friends. One purse is in the display window. We invite you to visit the leather department to buy this purse!” (p.38).

White, Lawrence H, 2012, *The Clash of Economic Ideas*, pp.38-9



Public Choice: The Economic Analysis of Politics

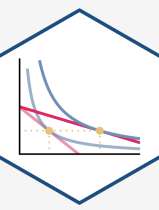
Groups Don't Choose



- **“Society”** is not a choosing-agent or an optimization problem
- Individuals have **different interests** in their different social capacities
 - Consumers, producers
 - Voters
 - Interest groups
 - Elected officials
 - Bureaucrats
- Learn more in my [Public Economics course](#)



Major Actors in a Liberal Democracy



- **Voters** express preferences through elections
- **Special interest groups** provide additional information and advocacy for lawmaking
- **Politicians** create laws reflecting voter and interest group preferences
- **Bureaucrats** implement laws according to goals set by politicians



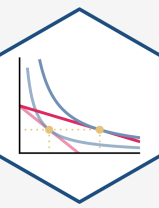
Voters in a Liberal Democracy



- **Voters** express preferences through elections
- Voters as economic agents:
 1. **Choose:** < a candidate >
 2. **In order to maximize:** < utility >
 3. **Subject to:** < constraints? >

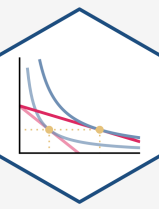


The Collective Action Problem of Democracy



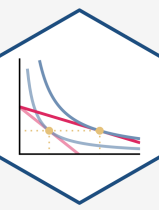
- Citizens vote in politicians to enact various laws that citizens prefer -- and vote politicians out of office if they fail to deliver
- A **collective action problem**: citizens need to monitor the performance of politicians and bureaucrats to ensure government serves voters' interests

The Collective Action Problem of Democracy



- Voting is **instrumental** in enacting voters' preferences into policy
- Good governance is a **public good**: an individual citizen enjoys **small fraction of benefit** created
- Additionally, policies & elections depend on many millions of people
- Individual bears a **private cost** of informing self and participating
- Hence, a **free-rider problem**

The Rational Calculus of Voting

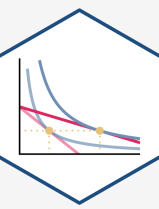


- A rational individual will vote iff:

$$p(B) + W > C$$

- B : perceived net benefits of candidate X over Y
- p : probability individual vote will affect the outcome of the election
- W : individual's utility derived from voting regardless of the outcome (e.g. civic duty, "warm glow," etc)
- C : marginal cost of voting

The Rational Calculus of Voting

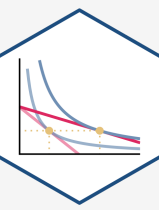


- A rational individual will vote iff:

$$p(B) + W > C$$

- $p \approx 0$
 - Outcome requires many votes
- B is a public good
 - Get small fraction of total benefit
- $C > 0$
 - Cost of informing oneself and voting informed

The Rational Calculus of Voting

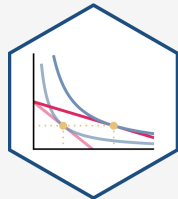


- A rational individual will vote iff:

$$p(B) + W > C$$

- If citizens are *purely* rational, $W = 0$
- Citizens then vote if $p(B) > C$
- Prediction: **rational citizen does not vote**

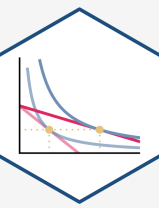
Voter Turnout: Presidential Elections



Year	Turnout of Eligible Voters
2016	55.7%
2012	54.9%
2008	58.2%
2004	55.7%
2000	50.3%
1996	49.0%
1992	55.2%

Sources: [Wikipedia](#), U.S. Census Bureau, Bipartisan Policy Center

The Rational Calculus of Voting

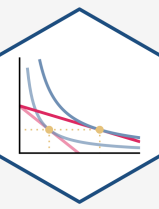


- A rational individual will vote iff:

$$p(B) + W > C$$

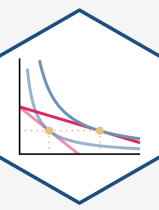
- Now suppose, $D > 0$
- Citizens then vote if $D > C$
- More importantly, the voter votes *regardless* of the positions of the candidates!
- Vote for *non-rational* reasons: "more presidential looking," "taller," "a better

The Rational Calculus of Voting



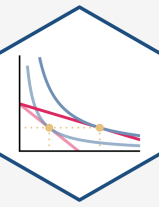
- Many *do* vote, even at significant personal cost!
- "**Expressive voting**": people vote to express identity, solidarity, tribalism, preferences, etc
- Voting as a **pure consumption good**, not an instrumental investment to achieve policy preferences

Rational Ignorance



- Model predicts **rational ignorance**
- Not necessarily *no* voting, but
 - Less than maximum turnout
 - Voting **not for instrumental, "rational" reasons**, but for non-rational reasons

Rational Ignorance



Winston Churchill

1874-1965

"The best argument against democracy is a five minute conversation with the average voter."

Rational Ignorance

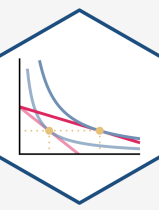


TABLE 1.1 Political ignorance and the 2010 election

Question (date of survey)	% Correct Answer	% Wrong Answer	% Admit Don't Know
Knew that the deficit in 2010 was larger than in the 1990s (Nov. 11–14, 2010)	77	12	11
Knew that Congress had passed a health care reform bill in 2010 (July 1–5, 2010)	73	14	13
Knew that the unemployment rate was 10 percent (rather than 5, 15, or 20) (Nov. 11–14, 2010)	53	30	17
Knew that Republicans won control of the House of Representatives, but not the Senate in the 2010 election (Nov. 11–14, 2010)	46	27	27
Knew that U.S. forces suffered more combat deaths in Afghanistan than in Iraq in 2009 (Jan. 14–17, 2010)	43	32	25
Knew that the Obama stimulus bill included at least “some” tax cuts (Nov. 6–15, 2010)*	43	54	3

Somin, Ilya, 2014, *Democracy and Political Ignorance*

Rational Ignorance

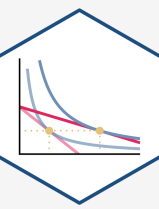
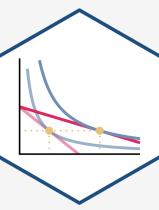


TABLE 1.1 *Political ignorance and the 2010 election*

Question (date of survey)	% Correct Answer	% Wrong Answer	% Admit Don't Know
Knew that defense is the largest category of spending in the federal budget (Nov. 11–14, 2010) ^b	39	42	19
Knew that Harry Reid is the majority leader of the Senate (Jan. 14–17, 2010)	38	18	44
Knew that John Boehner would be the new speaker of the House of Representatives (Nov. 11–14, 2010)	38	24	38
Knew the TARP bailout bill was enacted under Bush rather than Obama (July 1–5, 2010)	34	47	19
Knew that the economy grew during 2010 (October 24–26, 2010) ^c	33	61	6
Knew that John Roberts is the chief justice of the Supreme Court (July 1–5, 2010)	28	18	53
Knew that David Cameron is the prime minister of Great Britain (Nov. 11–14, 2010)	15	25	60

Somin, Ilya, 2014, *Democracy and Political Ignorance*

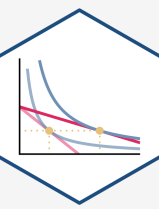
Special Interest Groups in a Liberal Democracy



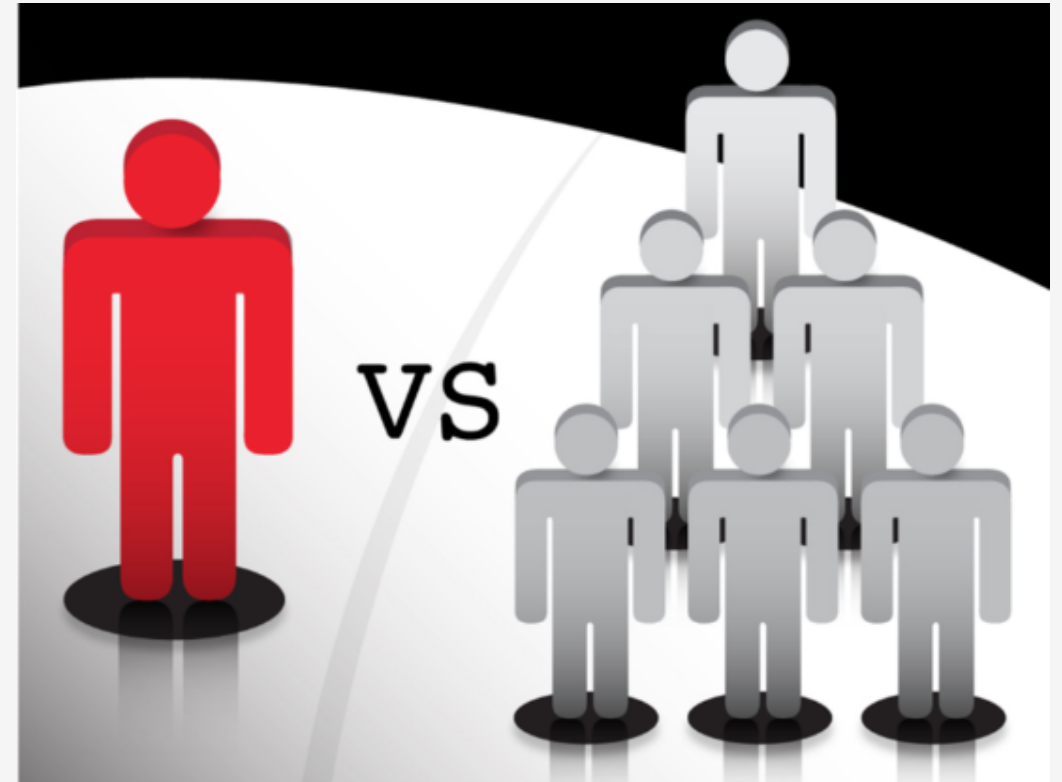
- **Special interest groups:** any group of individuals that value a common cause
- SIGs as economic agents:
 1. **Choose:** < a candidate to support >
 2. **In order to maximize:** < utility >
 3. **Subject to:** < budget >



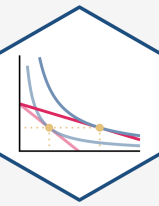
The Logic of Collective Action



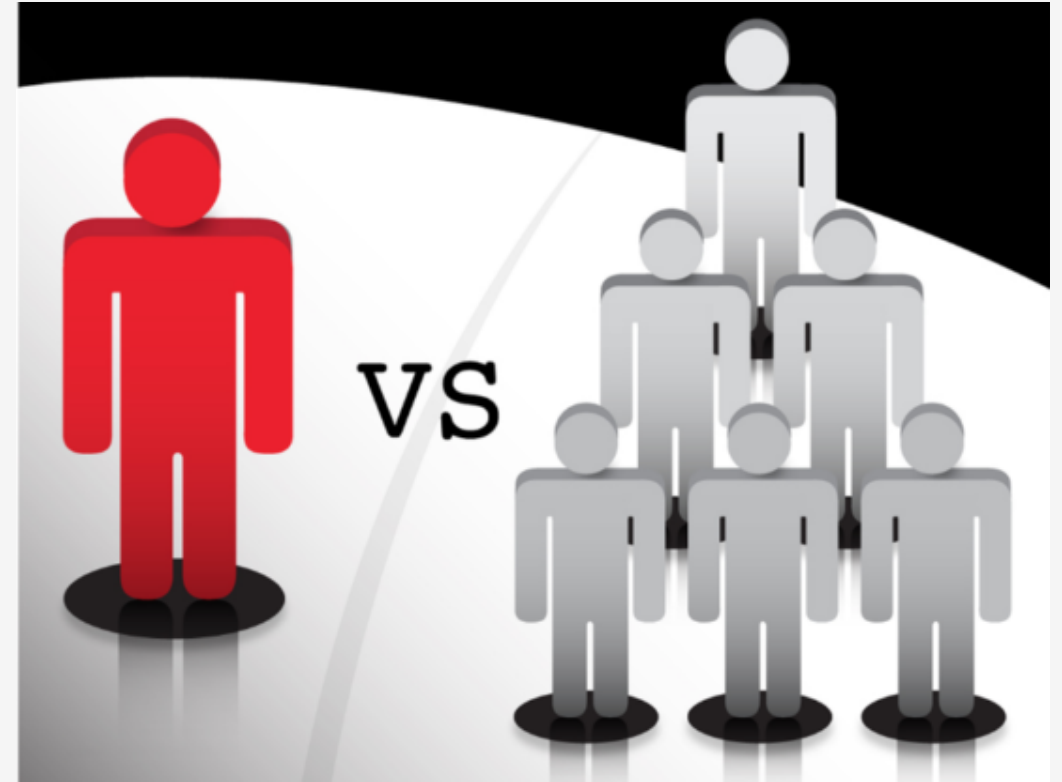
- But power and influence is not evenly distributed across interest groups
- Logic of collective action: **Smaller** and more **homogenous** groups face **lower** collective action costs of organizing than **larger** and more **heterogeneous** groups
- Smaller groups to whom benefit (cost) of a policy is more concentrated can outmobilize larger groups where benefit (cost) is more dispersed



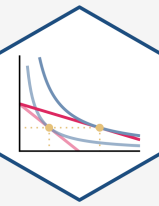
The Logic of Collective Action



- Policies in representative democracies tend to feature **concentrated benefits** and **dispersed costs**



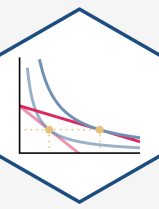
Politicians in a Liberal Democracy



- **Politicians** create laws reflecting voter and interest group preferences
- The politician's problem:
 1. **Choose:** < a platform >
 2. **In order to maximize:** < votes >
 3. **Subject to:** < being re/elected >

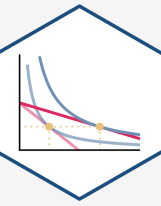


Politician's Incentives: Who's Interests To Represent?

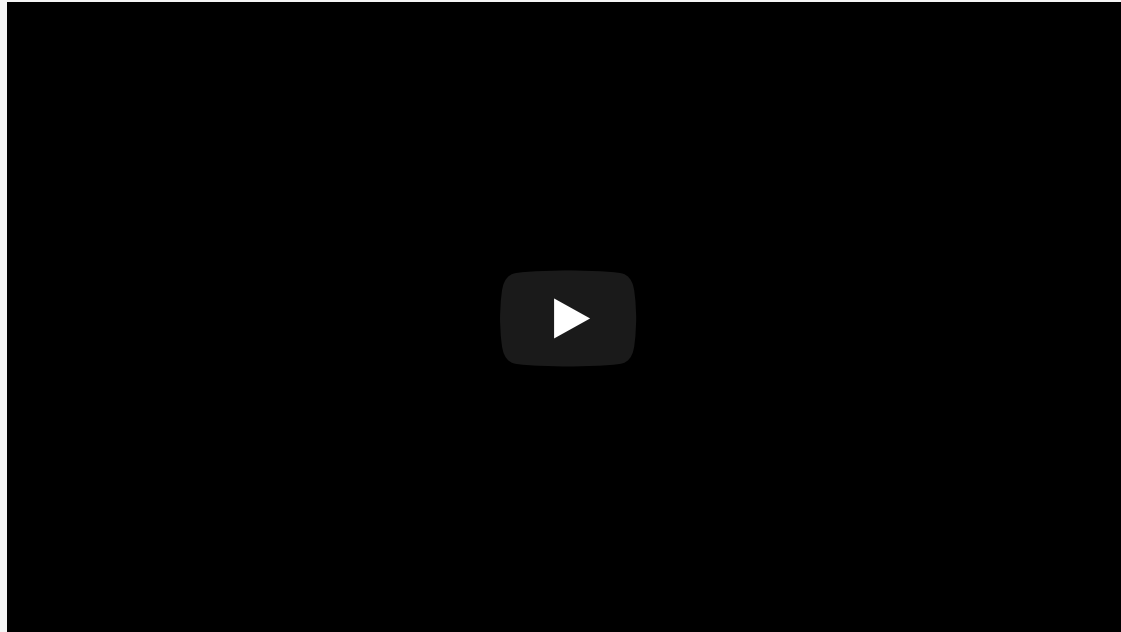
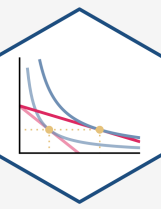


- Rationally ignorant voters pay little attention to actual substance or policy-making; more to TV-friendly spectacles
- Big speeches, ribbon cutting ceremonies, attack ads on rivals, etc
- Platforms more about broad platitudes than substance "family values," "tough on crime," "change," "drain the swamp" etc.

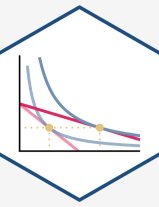
Politician's Incentives: Who's Interests To Represent?



Politician's Incentives



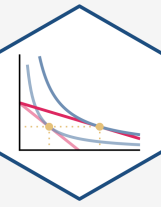
An Example



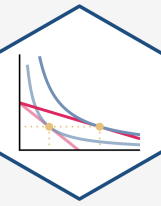
"In fiscal year (FY) 2013, Americans consumed 12 million tons of refined sugar, with the average price for raw sugar 6 cents per pound higher than the average world price. That means, based on 24 billion pounds of refined sugar use at a 6-cents-per-pound U.S. premium, Americans paid an unnecessary \$1.4 billion extra for sugar. That is equivalent to more than \$310,000 per sugar farm in the United States"

Source: [Heritage Foundation](#)

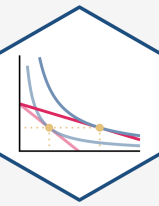
An Example



An Example



An Example



- And yet, each individual pays maybe \$1-2 a year in higher prices for sugar
- Difficult to mobilize voters to petition to end the sugar subsidy to save \$1
- Sugar producers stand to lose a billion dollars
- Sugar PACs that contribute thousands to key lawmakers



“The Government Should Do..”



- People often commit the nirvana fallacy and view the government as a unicorn
- **“The Munger test”**: replace “the government should do [X]” with:

“Politicians elected by rationally ignorant voters and capturable by lobbying by special interests should suggest to autonomous bureaucrats, to [do X]”

- If it’s still worth doing, then great, the government should do it!

