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Market Failure and Government Failure

LEARNING OBJECTIVES

1. Identify the sources of market failure
2. Explain possible remedies for market failure
3. Describe the causes and effects of government failure
4. Discuss the remedies for government failure

MARKET FAILURE: SOURCES AND REMEDIES

Under the right conditions, markets provide incentives for consumers and firms to allocate resources efficiently. The conditions are right for efficiency when:

- firms are perfectly competitive.
- consumers and firms have all the information that is relevant to their decisions in the marketplace.
- consumers can't use any goods or services without paying for them.
- there are no **externalities**, which are side effects felt by people other than those causing the effects.

MARKET FAILURE: SOURCES AND REMEDIES PART II

- **Market failure**—when markets do not allocate resources efficiently.



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- The reasons for market failure include spillover effects called externalities. For example, the decision to drive causes the externalities of road congestion and pollution.

POSITIVE EXTERNALITIES

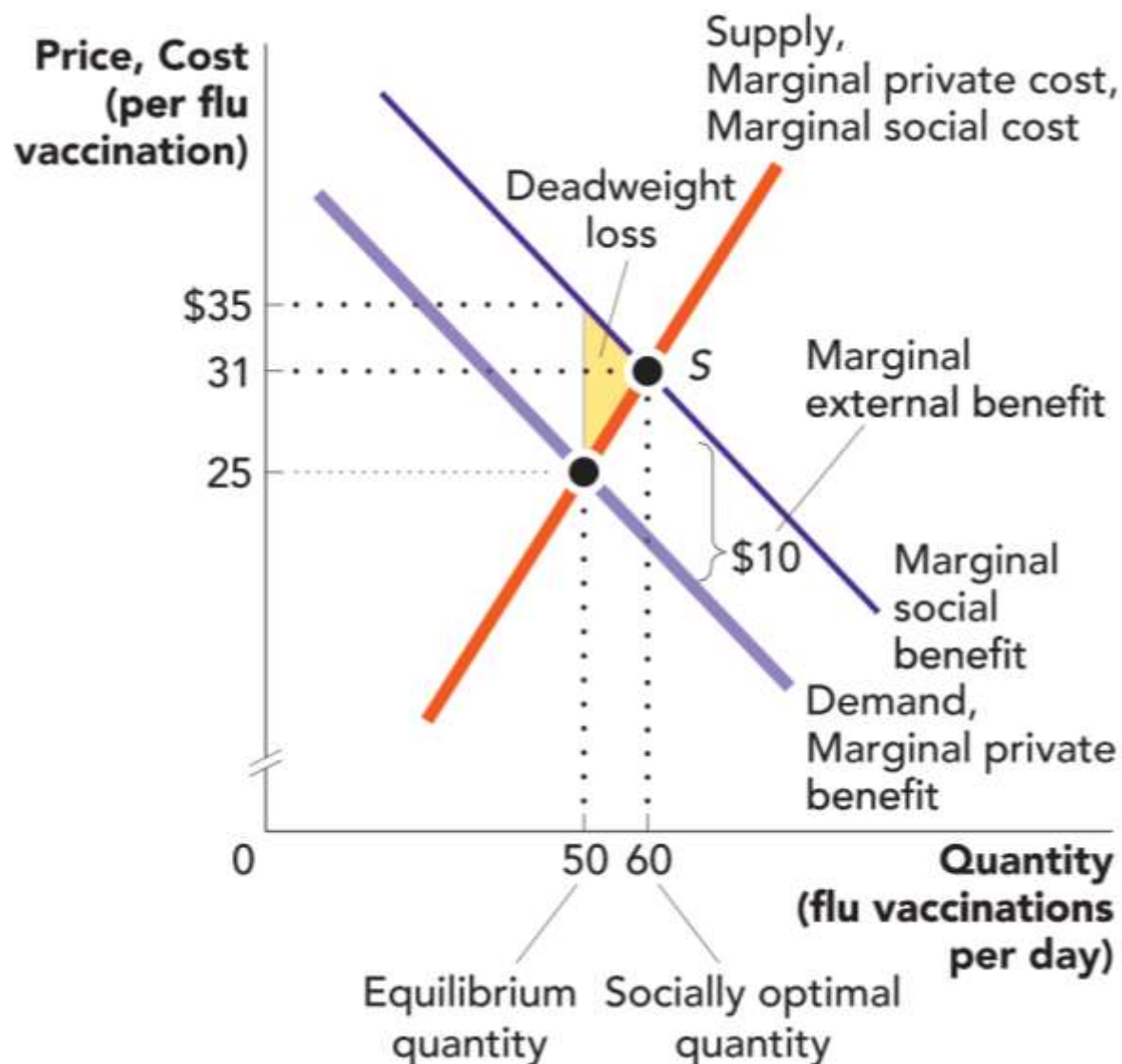
- **Positive externalities**—desirable effects felt by people who were not involved in the decisions that created those effects.
- **Marginal external benefit**—the increase in the external benefit created by the purchase of one more unit of a good.
- **Marginal private benefit**—the purchaser's benefit from one more unit of a good.
- **Marginal social benefit**—the additional benefit for everyone affected by the purchase of one more unit:

marginal social benefit = marginal private benefit + marginal external benefit

- **Marginal private cost**—a firm's cost of providing one more unit.

A POSITIVE EXTERNALITY RESULTS IN DEADWEIGHT LOSS

- When a good, such as flu vaccinations, creates positive externalities, each unit of the good provides a benefit to society that isn't received by the buyers or sellers of the good.
- Consequently, the quantity purchased is less than the best quantity for society, and the result is deadweight loss.



REMEDIES FOR POSITIVE EXTERNALITIES

- **Subsidies**—payments to buyers or sellers encouraging them to create positive externalities.
- Subsidies help buyers internalize, or feel personally, the full benefit of their decision to do what's best for society.



Andy Katz/Pacific Press/LightRocket via Getty Images

- Because trees create positive externalities, some governments subsidize tree purchases.

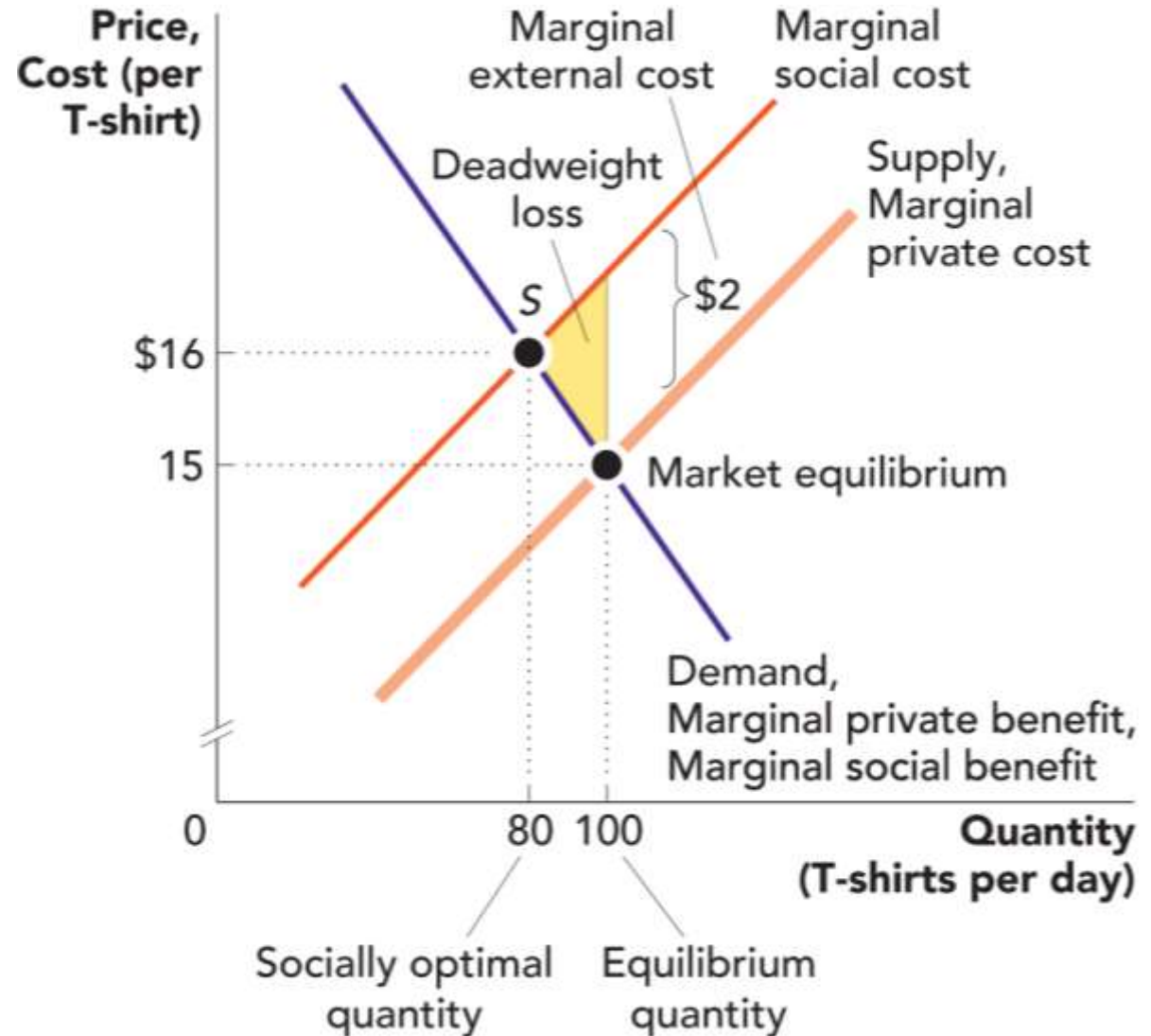
NEGATIVE EXTERNALITIES

- **Negative externalities**—undesirable effects felt by people who were not involved in the decisions that created those effects.
- **Marginal extra cost**—the amount by which one more unit increases the external cost.
- **Marginal social cost**—the sum of the marginal private cost and the marginal external cost:

$$\text{marginal social cost} = \text{marginal private cost} + \text{marginal external cost}$$

A NEGATIVE EXTERNALITY RESULTS IN DEADWEIGHT LOSS

- When there are negative externalities, each unit of a good imposes a marginal external cost on society that isn't paid by either the buyers or the sellers of a good. As a result, too much of a good is consumed.



REMEDIES FOR NEGATIVE EXTERNALITIES

- **Excise tax**—a tax used to make sure firms pay the full cost of what they produce, including the marginal external cost.
- Regulation is another solution to negative externalities. Many times, governments estimate the socially optimal quantity and limit outputs to that quantity.



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- Due to factors such as sentimental value, some goods may be worth more to an individual than their cost to society.

LEARN BY DOING: PRACTICE QUESTION 1

While sitting on a restaurant's outdoor patio, a smoker sits down next to you. Getting secondhand smoke from this other patron is an example of what? Why?

- a) a positive externality because you helped supply the smoker by giving them an opportunity to smoke
- b) a subsidy because the restaurant helped pay for the smoker's cigarettes
- c) a nonrival good because you and the smoker could share the cigarette
- d) a negative externality because you were not involved in the smoker's decision to buy and smoke cigarettes

LEARN BY DOING: PRACTICE QUESTION 1

(Answer)

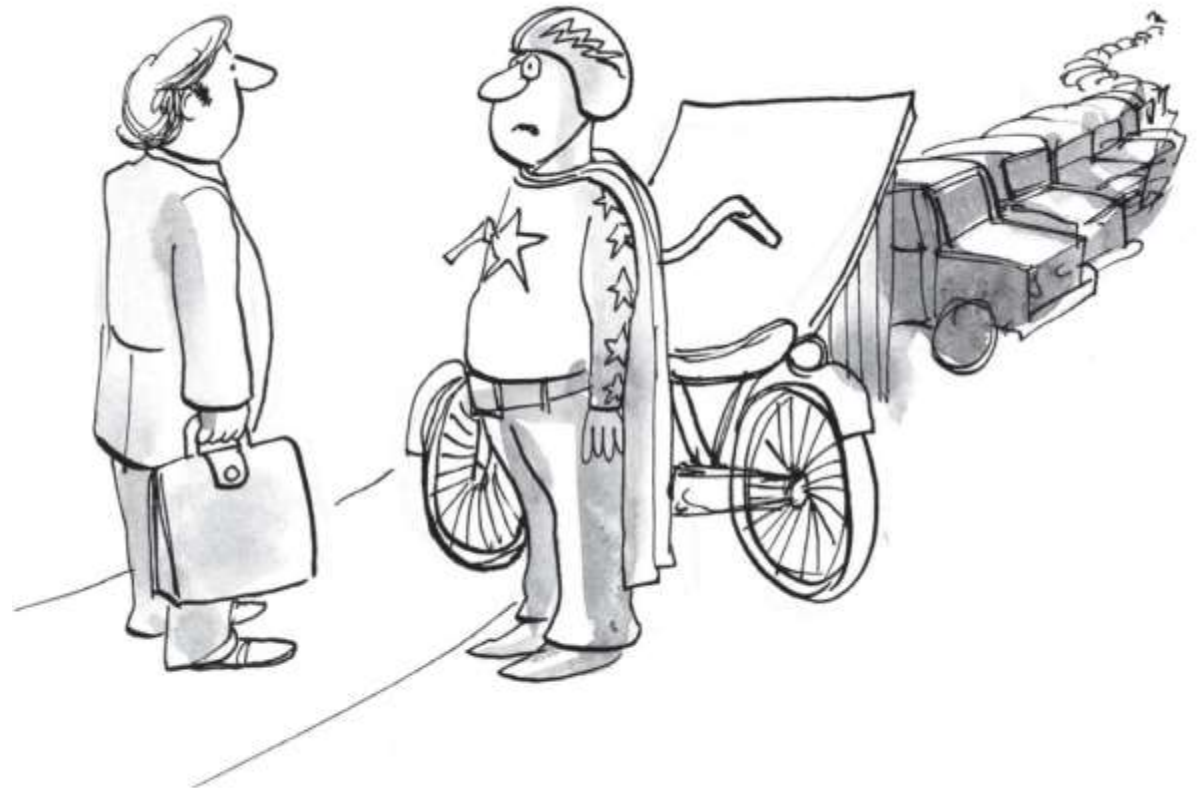
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IMPERFECT INFORMATION

Even if everything else about a market is ideal, there can still be market failure.

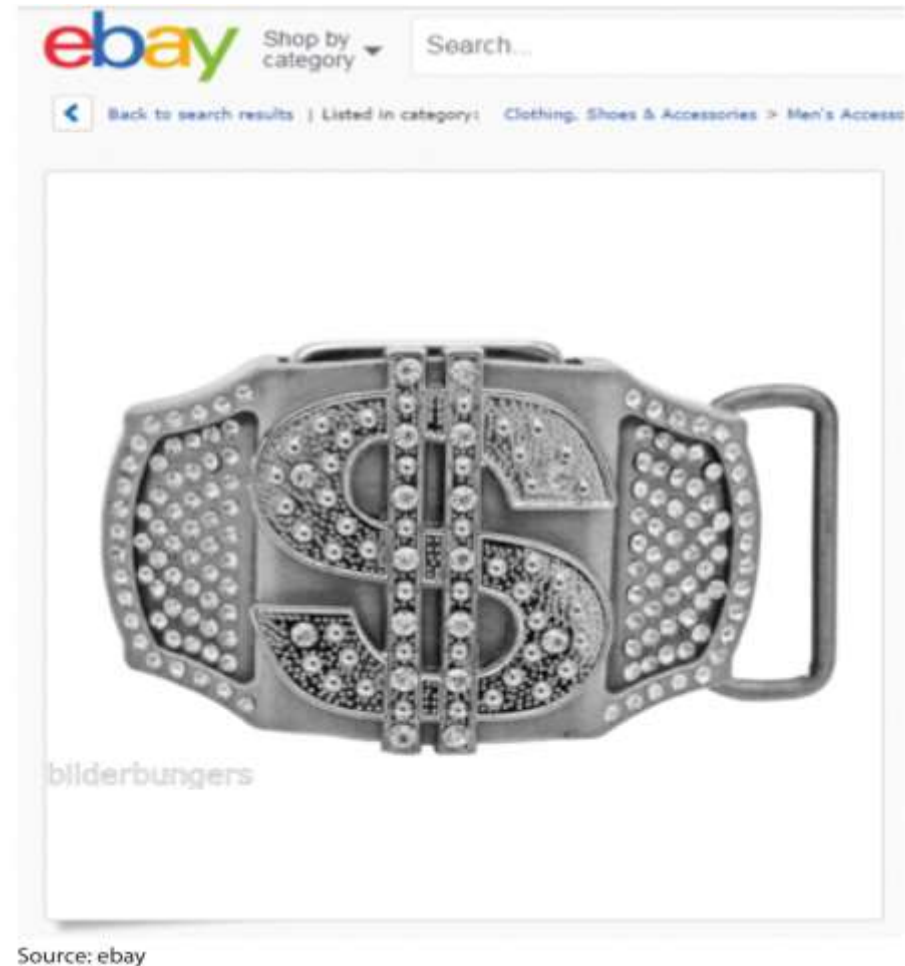
- **Asymmetric information**—when either the buyer or the seller has more information than the other party.
- **Adverse selection**—when one party takes advantage of information the other party lacks when the second party is deciding what to buy or sell.
- **Moral hazard**—the problem of people taking more risks when they are insured against the consequences.



"I'm looking to dramatically increase my insurance coverage."

REMEDIES FOR IMPERFECT INFORMATION

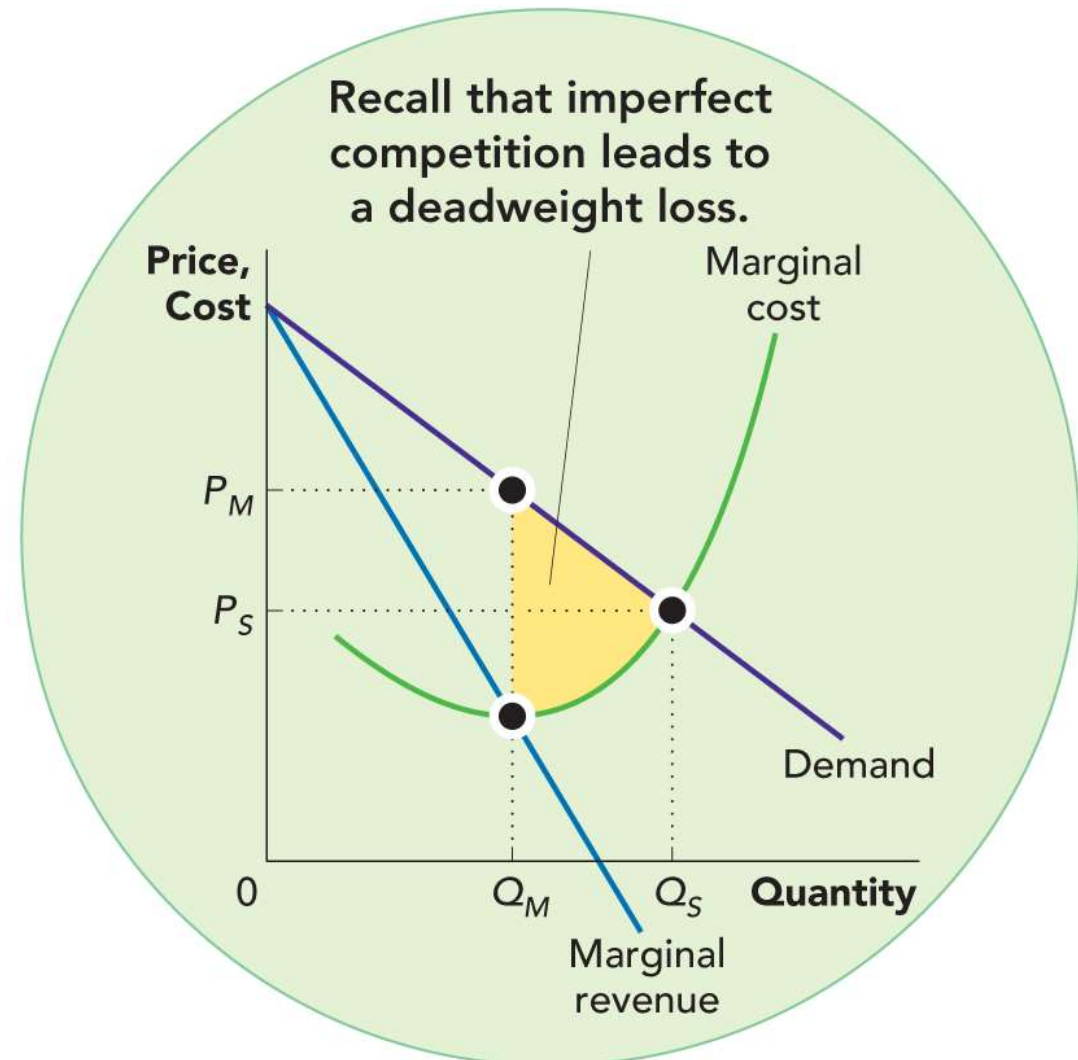
- **Copayment**—a fixed amount of money that someone with insurance must pay each time an individual incurs a cost covered by the insurance.
- **Coinsurance**—when the insured pay some percentage of the cost incurred.
- **Deductible**—the amount that insurance customers must pay before their insurance starts covering costs.



- Modern technology also provides some remedies for information problems. Websites such as eBay bring together buyers and sellers who wouldn't otherwise find each other.

IMPERFECT COMPETITION

- With imperfect competition, firms charge a price above the marginal cost and produce less than the socially optimal quantity. This results in deadweight loss.



REMEDIES FOR IMPERFECT COMPETITION

- **Sherman Antitrust Act**—legislation that restricts anticompetitive behavior by firms, such as the consolidation of several companies under the control of one business enterprise known as a trust.
- **Clayton Antitrust Act**—legislation that prohibits anticompetitive actions, such as price discrimination, mergers, and exclusive trade agreements, between firms when such actions would substantially decrease competition in the market.
- **Exclusive dealing agreement**—an agreement that prevents a buyer from making purchases from the competitors of a seller.
- **Tying agreement**—an agreement that requires the buyer to purchase a second product from the seller.

PUBLIC GOODS AND FREE RIDERS

- **Nonrival good**—a good the same unit of which can be used by more than one person at the same time.
- **Nonexcludable good**—a good others can't be excluded from using.
- **Public good**—a good that is both nonrival and nonexcludable.
- **Private goods**—goods that are rival and excludable.
- **Free-ride**—to enjoy the benefits of a good without paying for it.



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INEQUITY AND ITS REMEDIES

- Sometimes markets distribute income and goods in ways that are unfair.
- Governments typically address equity goals by collecting taxes disproportionately from rich citizens and using the tax revenue to fund programs for underprivileged citizens.
- Conflicts between equity and efficiency complicate policy decisions.

GOVERNMENT FAILURE

- **Government failure**—when governments implement policies that allocate resources inefficiently.
- **Transaction costs**—the costs of completing a transaction, such as negotiating a policy or purchasing a good, not including the price of a good itself.
- Sources of government failure include:
 - imperfect information.
 - conflicting perspectives and goals.
 - bureaucratic inefficiencies.

REMEDIES FOR GOVERNMENT FAILURE

- Unbiased cost-benefit analysis and a focus on efficiency are steps in the right direction.
- The government should invest more in information gathering, pursue more goals, and cut bureaucratic hurdles.



LEARN BY DOING: PRACTICE QUESTION 2

On a sunny day, you decide to go by the park and enjoy the weather. When you get to the park, you find that many other people had the same idea as you, and you can do nothing about it. What is the park an example of?

- a) a private good
- b) a subsidy
- c) a public good
- d) a tying agreement

LEARN BY DOING: PRACTICE QUESTION 2

(Answer)

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- c) a public good (correct answer)**
- d) a tying agreement