Market Failure and Government

Efficiency and Intervention

Efficiency? So what?

Like equality, fairness, equity, justice, honor, etc., **efficiency** is a **normative value**—an end, a goal.

It is sometimes **consistent** with these other values, and sometimes it is **in conflict** with those other values.

Economics, normatively, emphasizes efficiency. Economics, positively, analyzes efficiency.

Markets and Efficiency

Pareto Efficient — cannot improve anyone's situation without making another person worse off

Marshallian efficiency — maximizing total surplus according to willingness to pay (demand) or to sell (supply) criterion

- **Consumer surplus** — Total willingness to pay net of price
- **Producer surplus** — Price net of opportunity cost

Market Failure Defined

Laissez-faire market equilibria are generally **efficient**; they're **Pareto** efficient **and** they **maximize joint surplus**.

Sometimes, however, market forces **fail** to produce a situation that is **Pareto efficient** and/or **maximizes joint surplus**.

Economists call this outcome a **market failure**.

Market Failure Clarified

Pareto is **messy**. What do **“better off”** and **“worse off”** mean? Utility/psychological? “No likey!”

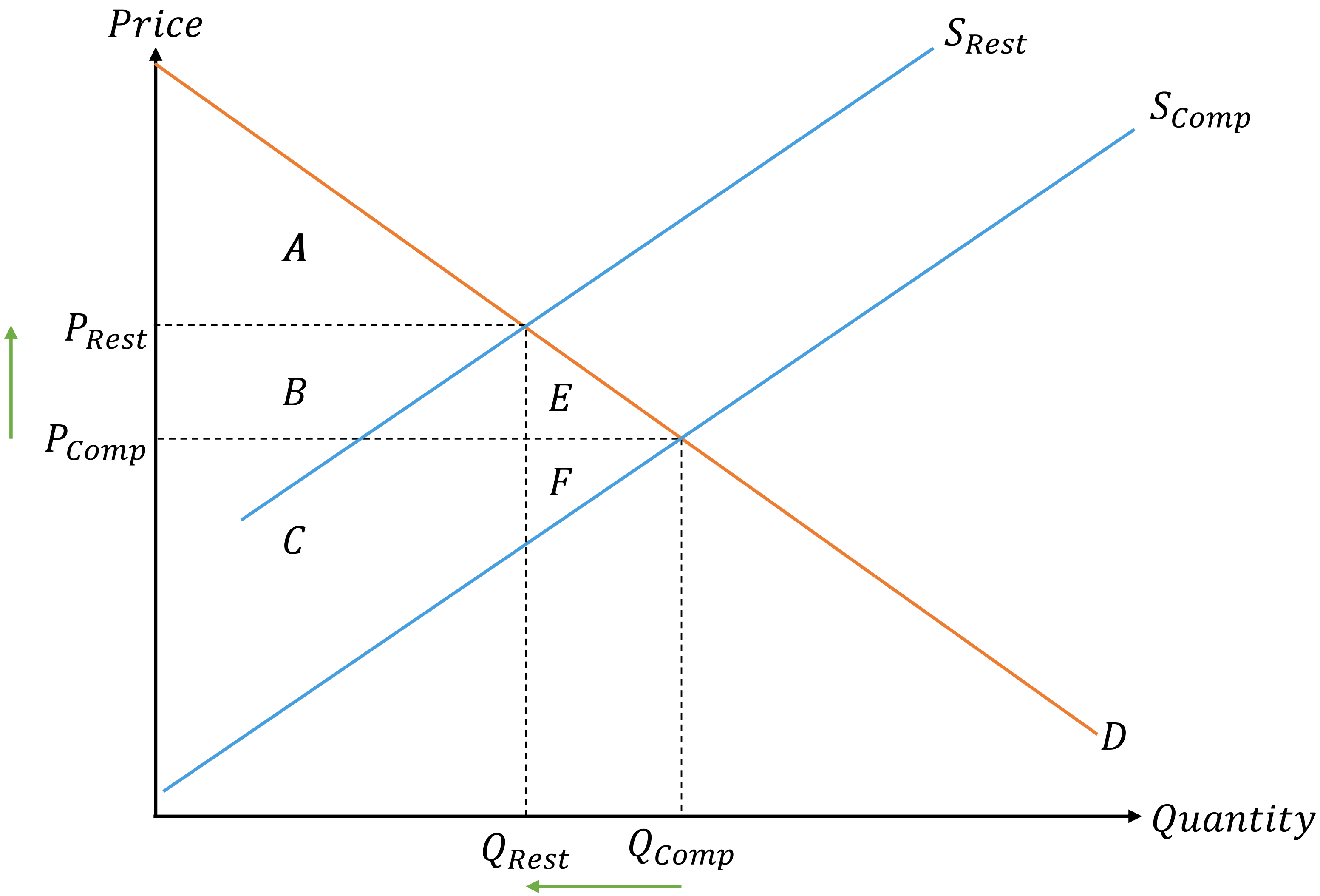
What about wealth/property? We use **willingness to pay**. **Maximizing joint surplus**.

Inefficient outcomes—in w.t.p.—can still be Pareto efficient.

Major Categories of Market Failure

1. Insufficient competition
2. Information problems
3. Externalities
4. Public Goods
5. Inequity

Insufficient Competition, Graphically



When competition (S_{Comp}) is restricted (S_{Rest}), there is less of the good available than could be under a different institutional setting. This raises price and reduces quantity.

E and F are deadweight loss. B is a transfer of wealth from consumer to producers.

Issues with Insufficient Competition

Why is there **too little competition**? Property rights, comparative costs, or legal barriers?

Rent-seeking behavior

“Compared to what?” and Anti-Trust

Information Problems

Imperfect information is the state of the world. Asymmetric information, while OK (even necessary) in small doses, can be a problem:

Adverse Selection – unobserved **quality**

“market for lemons,” online dating

Moral Hazard – unobserved **behavior**

insurance and risky behavior

Externalities and Public Goods

Professor Christian Vossler has prepared some wonderful materials to help with this topic. Find them in the Canvas course under the Chapter 12 module!

Inequity?

Let me remind you: Like equality, fairness, equity, justice, honor, etc., **efficiency** is a **normative value**—an end, a goal.

It is sometimes **consistent** with these other values, and sometimes it is **in conflict** with those other values.

Market failures are when markets fail to achieve **efficiency**—not **other values**!

Government Failure

Governments, ideally, **could** remedy some market failures.

The **Nirvana fallacy**: it’s foolish to compare actual things with imagined, idealized, fictional things.

Mike Munger and the Unicorns

The Unicorn Argument

1. Go ahead, make your argument for what you want the State to do, and what you want the State to be in charge of.
2. Then, go back and look at your statement. Everywhere you said "the State," delete that phrase and replace it with "politicians I actually know, running in electoral systems with voters and interest groups that actually exist."
3. If you still believe your statement, then we have something to talk about.

The Problem

	Good Incentives	Poor Incentives
Good Knowledge	High school civics and Unicorns “The West Wing”	‘Conflicting perspectives and goals’ “House of Cards”
Poor Knowledge	‘Imperfect information’ Planning fiascos	This vale of tears