

Week 13 & 14

Market Success and Market Failures

The Source of Market Failures

- ***Market failure*** occurs when resources are misallocated, or allocated inefficiently. The result is waste or lost value. Evidence of market failure is revealed by the existence of:
 - Imperfect market structure
 - Public goods
 - External costs and benefits
 - Imperfect information

Imperfect Markets

- ***Imperfect competition*** is an industry in which single firms have some control over price and competition. Imperfectly competitive industries give rise to an inefficient allocation of resources.

Imperfect Markets

- ***Monopoly*** is an industry composed of only one firm that produces a product for which there are no close substitutes and in which significant barriers exist to prevent new firms from entering the industry.

Imperfect Markets

- In all imperfectly competitive industries, output is lower—the product is under produced—and price is higher than it would be under perfect competition.
 - The equilibrium condition $P = MC$ does not hold, and the system does not produce the most efficient product mix.

Public Goods

- ***Public goods***, or ***social goods*** are goods and services that bestow collective benefits on members of society.
 - Generally, no one can be excluded from enjoying their benefits. The classic example is national defense.

Public Goods

- ***Private goods*** are products produced by firms for sale to individual households.
 - Private provision of public goods fails. A completely laissez-faire market will not produce everything that all members of a society might want. Citizens must band together to ensure that desired public goods are produced, and this is generally accomplished through government spending financed by taxes.

Externalities

- An ***externality*** is a cost or benefit resulting from some activity or transaction that is imposed or bestowed on parties outside the activity or transaction.
 - The market does not always force consideration of all the costs and benefits of decisions. Yet for an economy to achieve an efficient allocation of resources, all costs and benefits must be weighed.

Imperfect Information

- ***Imperfect information*** is the absence of full knowledge concerning product characteristics, available prices, and so forth.
 - The absence of full information can lead to transactions that are ultimately disadvantageous.

Markets Solutions

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Government Inefficiency

- Government officials are assumed to maximize their own utility, not the social good.
- To understand the way government functions, we need to look less at the preferences of individual members of society and more at the incentive structures that exist around public officials.

Government Inefficiency

- Like voters, public officials suffer from a lack of incentive to become fully informed and to make tough choices.
- This is the viewpoint of what is called the *public choice* field in economics that builds heavily on the work of Nobel Laureate James Buchanan.

Rent Seeking

- There are reasons to believe that government attempts to produce the right goods and services in the right quantities efficiently may fail.
- The existence of an “optimal” level of public-goods production does not guarantee that governments will achieve it.

Government Solutions

- Information is non-rival in consumption.
- When information is very costly for individuals to collect and disperse, it may be cheaper for government to produce it once for everybody.

Government and The Market

- Governments can fail to produce an efficient allocation of resources for a number of reasons:
 - Measurement of social damages and benefits is difficult and imprecise.
 - There is no precise mechanism for determining citizens' preferences for public goods.
 - Government agencies are not subject to the discipline of the market.
 - It is naïve to expect elected and appointed officials to act selflessly for the good of society.