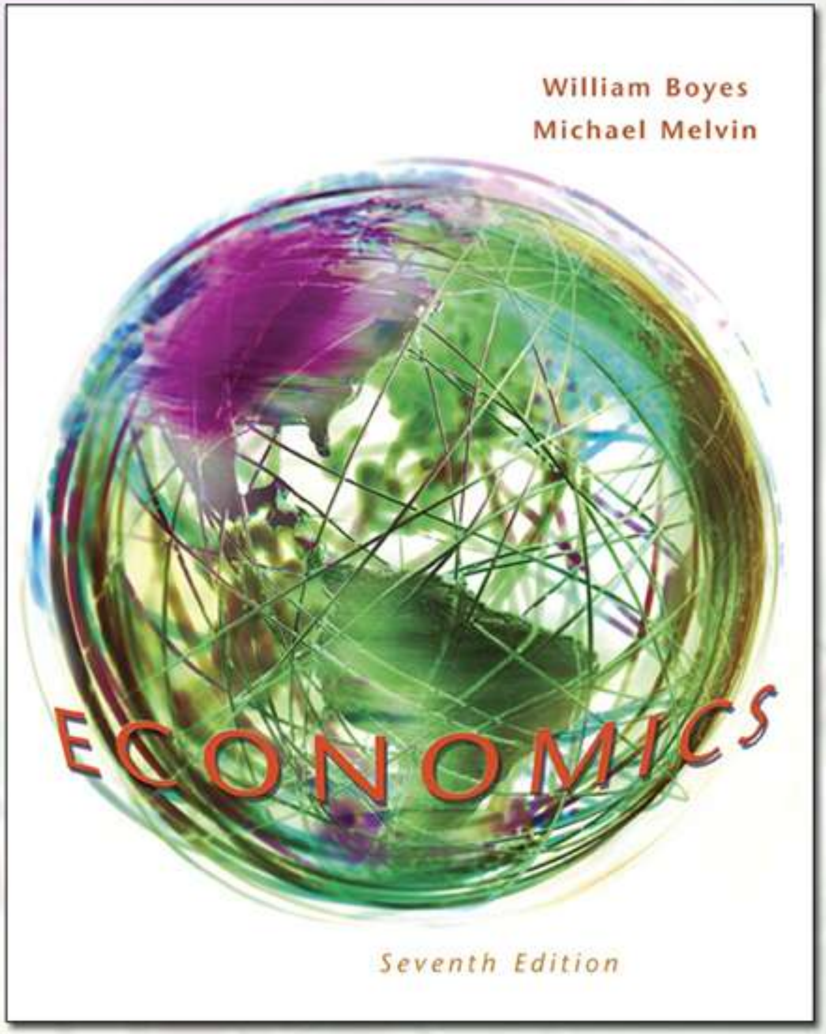


Chapter 28

Government and Market Failure

Economics, 7th Edition
Boyes/Melvin

Market Failure-define

- A **market failure:** when market forces fail to provide the socially optimal amount of a good or service.

Externalities

- **Private costs and benefits** are costs and benefits that are borne solely by the individuals involved in the transaction.
- An **externality** is a cost or benefit that accrues to someone who is not the buyer (demander) or the seller (supplier).
- As a result, **the market fails** to yield optimal results.

Examples of Negative Externalities

- Air pollution from a factory
- Noise pollution
- Second-hand smoke
- Talking on cell phone while driving

Examples of Positive Externalities

- Being vaccinated against contagious diseases

- People going to college

More on Externalities

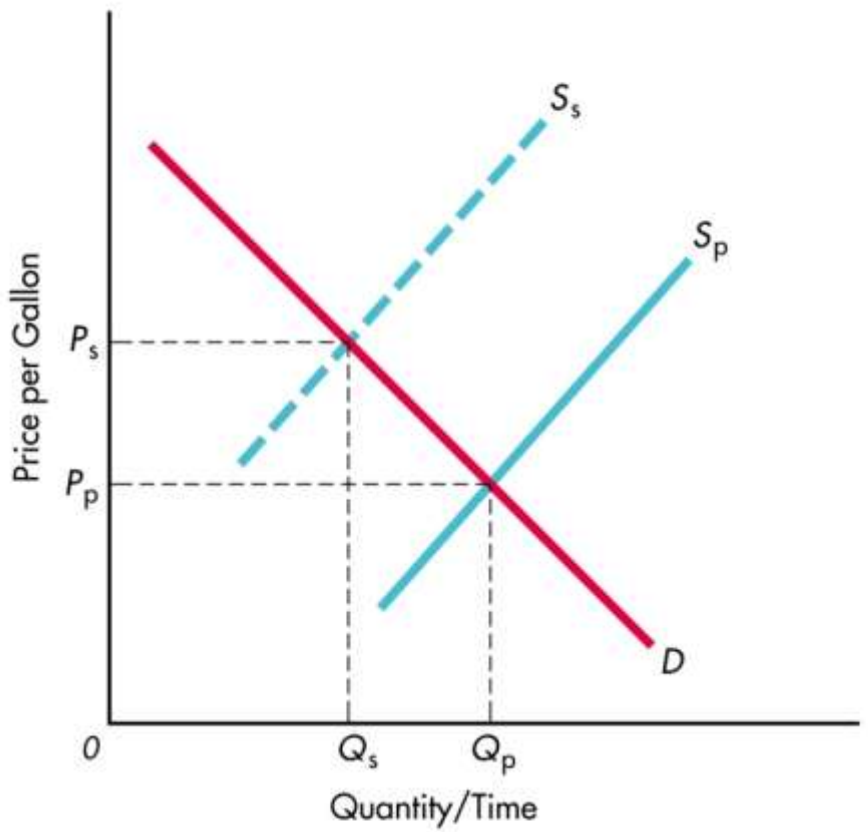
- A **positive externality: demand is too low.**
- A **negative externality: supply is too great.**

Social Cost

- **Social cost**: the private cost plus the external cost.
- If no externality, no external cost

Negative Externalities

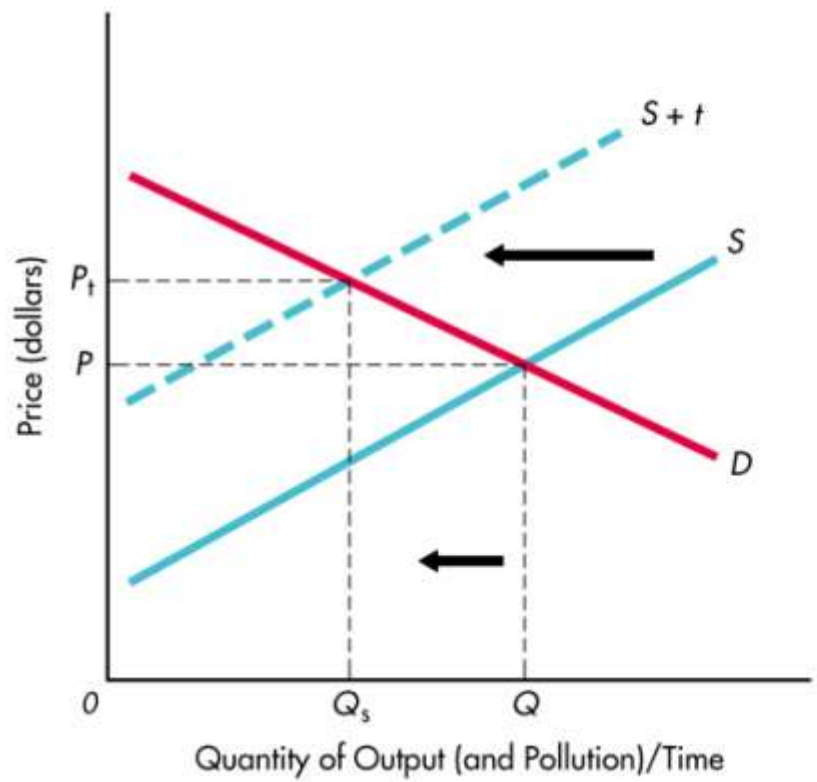
FIGURE 1 **Negative Externalities**



When a private transaction imposes costs on society that are not paid by the private transactors, a negative externality exists. With a negative externality, the supply of a product that is provided, S_p, is greater than it would be if the suppliers had to pay the externality, as shown by S_s.

Pollution Tax

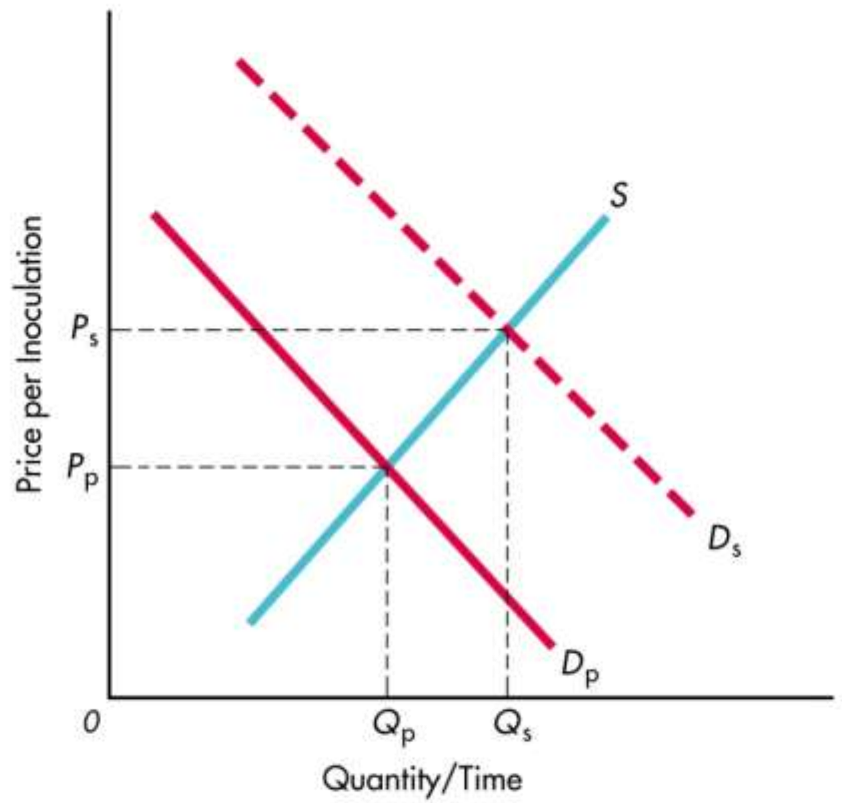
FIGURE 3 Pollution Tax



A tax on a firm that creates a negative externality reduces the quantity supplied and thus forces the firm to internalize the externality. Q_s is produced rather than Q.

Positive Externalities

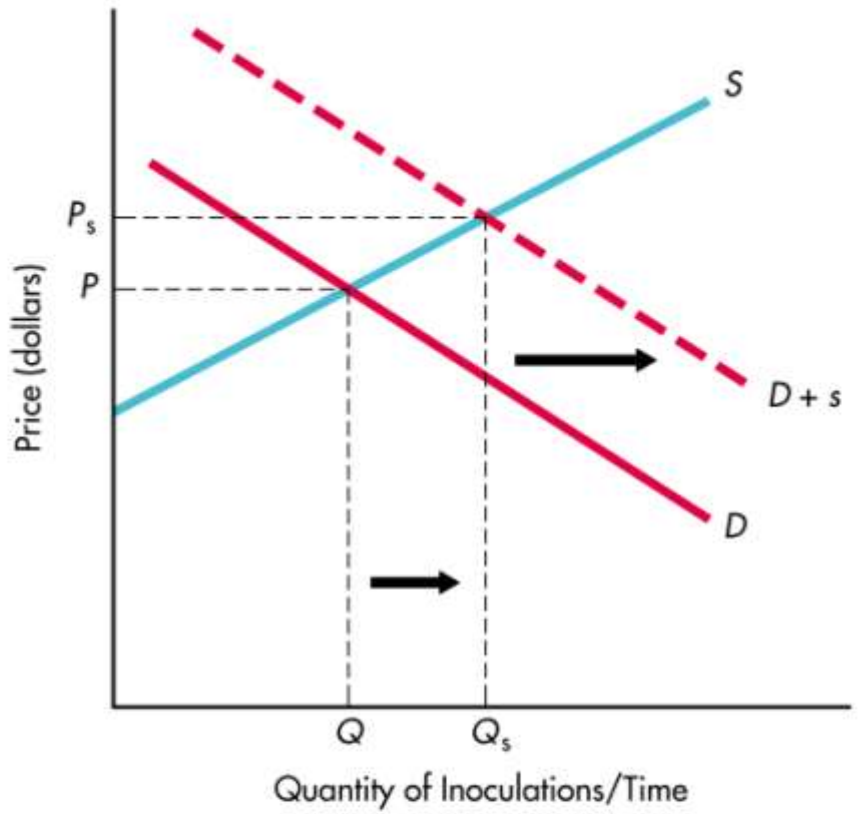
FIGURE 2 **Positive Externalities**



When a private transaction creates benefits for society that exceed those involved in the private transaction, positive externalities exist. D_p represents the demand for inoculations against a communicable disease when there is no externality. D_s represents the demand with an externality. Fewer people get the inoculations than would be desired by society.

Subsidy for Inoculations

FIGURE 4 **Subsidy**



A subsidy to people getting inoculated increases the demand for inoculations, leading to more inoculations being obtained, Q_s.

Command

- Another approach is **command**:
  - For a **negative externality** like pollution, the government simply requires the company to stop polluting.
  - For a **positive externality**, like inoculation, the government requires certain classes of citizens to be inoculated.

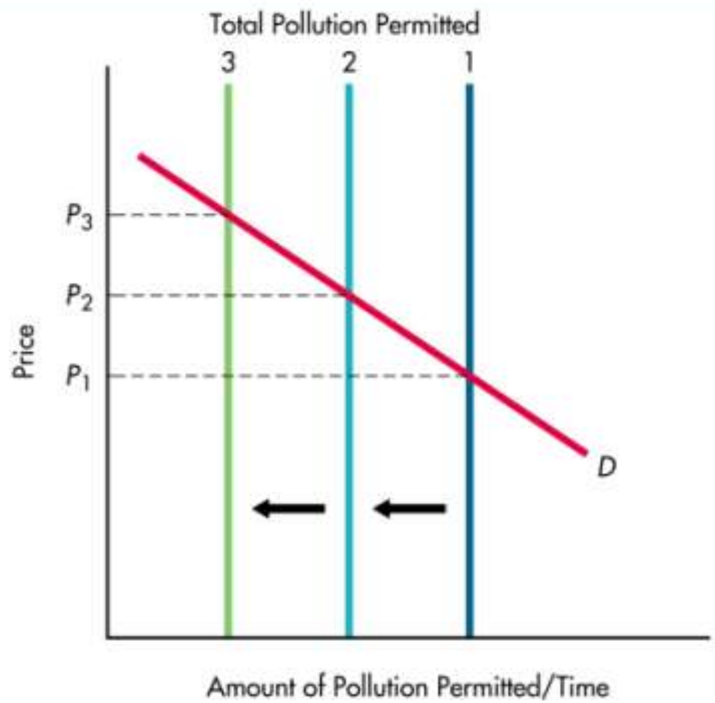
Marketable Pollution Permits

- Another approach to pollution is the introduction of **marketable pollution permits**.

- http://www.americanprogress.org/issues/2008/01/capandtrade101.html

Market for Pollution Permits

FIGURE 5 **The Market for Pollution Permits**



The government establishes the amount of pollution to be permitted. It then issues permits, each allowing a certain amount of pollution. To be able to pollute, a firm, individual, or group must have a permit. The price of permits is determined by demand and supply. As the government reduces the amount of pollution allowed, the price of the permits increases.

The Coase Theorem

- Ronald Coase: of the University of Chicago
- **Coase Theorem**: If people can negotiate with one another at no cost over the right to perform activities that cause externalities, they will always arrive at an efficient solution.

Asymmetric Information

- Exchange that occurs when one party has more information than the other

Examples of asymmetric information

- **adverse selection**: higher-quality consumers or producers are driven out of the market because unobservable qualities are incorrectly valued.

- Ex: used car market

Moral Hazard

- A related issue is **moral hazard**—the problem that arises when people change their behavior from what was expected of them when they engage in a trade or contract.

- Ex: being more reckless after buying insurance

Solutions to Asymmetric Information

- Asymmetric information can cause markets to fail – to not allocate goods and services to their highest value use.

- For adverse selection:

  - Provide info about goods
  - Create brand name trust
  - Give warranties or guarantees

Solutions to Asymmetric Information

- For Moral Hazard: mandate copays or coinsurance
- Drop people who change behaviors
- Consumers need “skin in the game”

Government Failure

- **The government is a market**—a market for votes, power, etc., and the same problems that arise in all markets arise in government decision making.

Bureaucracy Building

- **Rent seeking:** movement of money or resources from one group of people to another with no change in total production or wealth

- **Logrolling**, legislators support one another's projects in order to ensure support for their own

- Since the government is not a profit-maximizing entity, it has no incentive to **minimize costs**. Instead, what often occurs is bureaucracy building.