Market Failure

Fundamental Questions

1. Why do markets fail?
2. What is the role of Government in addressing market failure?
3. Why does Government intervene in market allocation of resources even when it is Pareto efficient?
4. What are merit goods?
5. What is Governments role in redistribution?
6. What are the alternative perspectives (other than "market failure" approach)?

Prelude

- We have seen the role of market in achieving Pareto efficiency
- However, some dissatisfactions are always there.
- More pollution, less funding in research for cancer
- Inequality
- Market failure, causes, intervention
- Government intervention even when markets are efficient

Property Rights and Contract Enforcement

- Government must define property rights for markets to function
- Common properties (eg land, Soviet era, etc), insufficient incentives to maintain or improve property
- Market economy – market price of property
- Contracts for transactions
- Protection of private property – otherwise no incentive to save or invest

Property Rights and Contract Enforcement

- Government's role in protecting citizen and property, enforcing contracts, defining property rights is the foundation of working of market economies

Market Failure

- First fundamental theorem of welfare economics
- Market failures – markets are not Pareto efficient
- Rationale for Government acitivities

Failure of Competition

- Perfect competition – price taking
- Monopoly, Oligopoly, Monopolistic Competition
- Limited competition
- Price taking behavior might fail to hold
- IRS – a few firms (or even one single natural monopoly)
- Transportation cost, market segmentation

Failure of Competition

- Collusion, Cartel
- Entry restrictions through credible threats
- Government action like patents also lead to failure of competition
- MR = MC; dead weight loss

Public Goods

- These goods are either not provided at all or under-provided through market

- Navigational aids – example of Anchorage

Externalities

- Private versus social costs/ benefits
- Externalities to inefficient resource allocation
- Government role becomes crucial

Incomplete Markets

- Private markets fail to provided a good or service even though cost of providing is less than willingness to pay - market failure known as incomplete markets

- Insurance and loans

- Why capital and insurance markets are imperfect?

- Three reasons –

1. Innovations in how the economy functions
2. Transaction costs – it's costly to enforce contracts; no effective patent protection
3. Risk and asymmetric information

Incomplete Markets

- Asymmetric information and enforcement problems may lead to non-existence of markets

- Market for "Lemons"

- Complementary Markets – acting alone won't help; acting together can acchieve public interest

- Public urban renewal programmes – game of coordination among a large number of actors (factories, landlords, retailers, other businesses etc)

Information Failures

- Imperfect information – market failure
- Efficiency requires that information is freely disseminated
- Private information
- Imperfect information leading to failure of fundamental theorems
- R&D – information – fundamental theorems

Unemployment, Inflation, Disequilibrium

- View: unemployment means something grossly wrong with the economy
- Macroeconomic issues while designing tax policy
- RBI – exchange rate management and inflation targeting

Inter-relations

- Market failures are not mutually exclusive
- Information – missing markets
- Missing markets – externalities
- Externalities – public goods

Explanations – Excuses

The agricultural price support program provides an illustration of an instance where the appeal to market failures is more of an excuse for a program than a rationale. There are important market failures in agriculture. Prices and output are highly variable. Farmers typically cannot buy insurance to protect them against either price or output fluctuations. Though they could reduce their exposure to price risk somewhat by trading in futures and forward markets, these markets are highly speculative, and farmers worry that they are at a marked disadvantage in trading in them. For example, there are five very large traders in wheat who have access to more information; as a result farmers view trading on futures markets with these informed traders as playing on an unlevel playing field.

What farmers really care about, of course, is not price variability, but income variability. Programs to stabilize prices do not fully stabilize income, since income depends both on the price received and the quantity produced. Indeed, in some cases, stabilizing prices may actually increase the variability of income. Normally, prices rise when, on average, quantities fall. If prices rise proportionately, then income may vary very little, with price increases just offsetting quantity

Explanations – Excuses

decreases. In such a situation, stabilizing prices will increase income variability.

Price support programs are also justified as helping poor farmers—reflecting the failure of markets to provide an appropriate distribution of income. But, critics ask, why are poor farmers particularly deserving of aid, rather than poor people in general? Moreover, the price support programs give aid on the basis of how much a farmer produces. Thus, large farmers gain far more than small farmers.

If the objective of the farm programs were to address these market failures, then the farm program would be designed in a markedly different manner. In fact, a major objective of the farm program is to transfer resources—to subsidize farmers (and not just poor farmers)—not to correct a market failure. The program is designed to keep a large part of its cost hidden: only a part of the cost is reflected in the federal budget; the rest is paid for by consumers in the form of higher prices. The market failure approach has provided some of the rhetoric for the program, but not the rationale. For that, we have to look into politics and the role of special interest groups.

Redistribution and Merit Goods

- Even when market is Pareto efficient, there is need for intervention
- 1st FWT: nothing about equity or distribution
- Government intervention – PDS
- 2nd FWT: people might take "bad" decisions
- Goods that Government compels individuals to consume – merit goods – education, seat belts…
- Paternalism

Redistribution and Merit Goods

- Smoking – cancer – public hospital – cost on non-smokers
- Smoking – tax to cover full cost
- Libertarianism
- Normative analysis
- Positive Analysis

Reference

1. Stiglitz – Economics of the Public Sector – Chapter 4