UNIT 3

MARKET FAILURE AND CONSUMER PROTECTION

Introduction

In a free market, the equilibrium price and quantity of goods are determined by the forces of demand and supply. However, this equilibrium might not always lead to the most efficient or desirable outcomes for society. For instance, products like tobacco and alcohol tend to be over-consumed, while essential services like education and healthcare may be under-consumed without government intervention. This inefficiency is known as **market failure**, which occurs when the market fails to allocate resources effectively or equitably distribute goods and services.

Allocative efficiency is achieved when resources are allocated in a way that maximizes societal welfare. This happens when the **marginal social benefit (MSB)** equals the **marginal social cost (MSC)**. MSB is the total benefit society gains from consuming a good, including both private and external benefits. MSC is the total cost to society from producing a good, including both private and external costs. When markets fail, these benefits and costs are not aligned, leading to inefficiencies.

This unit explores the concepts of market failure, public goods, externalities, asymmetric information, and consumer protection.

3.1 Market Failure

Definition of Market Failure

Market failure is an economic situation where the free market fails to distribute goods and services efficiently. This occurs when the price mechanism does not account for all the costs and benefits necessary for optimal production and consumption.

Types of Market Failures

- **Externalities:** Costs or benefits of a product that affect third parties who are not involved in the transaction. Externalities can be positive (e.g., education) or negative (e.g., pollution).
- **Public Goods:** Goods that are non-rivalrous and non-excludable, meaning one person's consumption does not reduce the amount available for others, and it's difficult to exclude anyone from using them.
- **Monopoly Power:** When a single firm controls a market, leading to higher prices and reduced output compared to a competitive market.
- **Information Asymmetry:** Occurs when one party has more or better information than the other, leading to an imbalance in transactions.

Solutions to Market Failure

Governments can intervene to correct market failures through:

- **Legislation and Regulation:** Implementing laws to control harmful activities.
- **Taxes and Subsidies:** Imposing taxes on goods with negative externalities (e.g., tobacco) and providing subsidies for goods with positive externalities (e.g., education).
- **Public Provision of Goods:** Directly providing essential services like national defense or public healthcare.
- **Tradable Permits:** Allowing the market to determine the distribution of rights (e.g., pollution permits).

3.2 Public Goods

Definition and Characteristics

Public goods are goods whose benefits are shared by everyone, regardless of whether they pay for them. They have two main characteristics:

- **Non-Rivalry:** One person's consumption of the good does not reduce the quantity available for others.
- **Non-Excludability:** It is difficult or impossible to prevent anyone from using the good.

Examples of public goods include national defense, clean air, and public parks.

The Free Rider Problem

A free rider is someone who benefits from a public good without contributing to its cost. This problem arises because public goods are non-excludable, meaning people can enjoy them without paying. For example, individuals may benefit from national defense without directly paying for it through taxes. This can lead to under-provision of public goods, as private markets may fail to produce them due to the lack of profitability.

Providing Public Goods Efficiently

When the market fails to provide public goods efficiently, collective action or government intervention is needed. This can include:

- **Private Provision:** Businesses may provide public goods if they can exclude non-payers (e.g., pay-per-view television).
- **Public Provision:** Governments may fund public goods through taxes (e.g., roads, schools).
- **Voluntary Contributions:** Communities may collectively fund public goods (e.g., crowdfunding for local projects).

3.3 Externalities

Definition and Types of Externalities

An externality occurs when the consumption or production of a good affects third parties who are not directly involved in the transaction.

- **Positive Externalities:** Benefits that spill over to others, such as education improving societal knowledge or vaccination preventing disease spread.
- **Negative Externalities:** Costs imposed on others, like pollution harming the environment or secondhand smoke affecting non-smokers.

Externality and Efficiency

In a market with externalities, the free market does not allocate resources efficiently because the full social costs or benefits are not reflected in market prices.

- **Negative Externality Example:** Pollution from a factory imposes health and environmental costs on the community, which are not reflected in the price of the factory's products. This leads to overproduction and social inefficiency.
- **Positive Externality Example:** A beekeeper's bees pollinate nearby crops, benefiting farmers who do not compensate the beekeeper. This leads to underproduction of the beneficial activity.

Governments can intervene to correct these inefficiencies through regulations, taxes, subsidies, or direct provision of services.

Suggested Solutions to Avoid Externality

1. Solutions for Negative Externality

Negative externalities occur when the cost of a good or service affects others who are not involved in the transaction. To address this, several solutions can be applied:

a. **Per Unit Tax:**

- This tax equals the difference between the Social Marginal Cost (SMC) and Private Marginal Cost (PMC) at the socially optimal output level.
- For example, if the tax amount per unit is "Oe'e*", the total tax imposed should be "Oe'e*".
- This concept, introduced by A.C. Pigou in 1920, assumes:
  - Externality is the difference between MSC and MPC.
  - The industry is competitive.
  - A firm is producing output while emitting smoke.
  - Pollution per unit of output is constant.
  - The external cost of pollution is borne by others.

b. **Private Bargaining (Coase Theorem):**

- Proposed by Coase in 1960, this solution suggests that private parties can negotiate solutions to externalities without government intervention, provided:
  - Transaction costs are minimal or zero.
  - The number of individuals involved is small.
  - Property rights are well-defined.
- The outcome depends on the bargaining power of the parties. Note that optimum pollution does not imply zero pollution, as zero pollution could mean zero production.

c. **Defining and Enforcing Property Rights:**

- Property rights are assigned or sold to those who wish to pollute. As a result, producers incur additional costs, leading them to reduce production, thus decreasing pollution.
- The main limitation is that the market for these property rights may not be perfectly competitive.

2. Solutions for Positive Externality

Positive externalities occur when the benefits of a good or service affect others who are not involved in the transaction. Solutions include:

a. **Per Unit Subsidy:**

- The government provides a subsidy equal to the difference between Social Marginal Benefit (SMB) and Private Marginal Benefit (PMB) at the socially optimal output level.
- If firms are subsidized, they will supply the optimal output. For example, the subsidy per unit should be "de'e*", with the total subsidy being "de'e*".

b. **Government Supply:**

- The government can supply the product at a socially optimal price and bear any resulting losses to ensure the good is available at the optimal level.

3.4 Asymmetric Information

Definition:

- Asymmetric information occurs when one party in a transaction has more information than the other, leading to an imbalance of power. This often causes market inefficiencies.

Problems Associated with Asymmetric Information:

- **Adverse Selection:**
  - Occurs when one side of the market cannot observe the quality of goods on the other side, leading to the selection of inferior goods or customers.
  - Examples:
    - Bad products or customers are more likely to be selected due to information asymmetries.
    - People more likely to get sick are more likely to purchase health insurance.
- **Moral Hazard:**
  - Arises when one party cannot observe the actions of the other, leading to riskier behavior since the consequences are borne by another party.

- Examples:
  - A person with car theft insurance may be less vigilant about locking their car.
  - After obtaining health insurance, some individuals may seek medical treatment they would not have otherwise considered due to costs.

Solutions to Moral Hazard and Adverse Selection:

- **Signaling:**
  - One party conveys meaningful information to the other. For example:
    - Employees signal their skills through education.
    - Sellers of good used cars offer warranties to signal quality.
  - Limitations include the cost of sending signals and the trustworthiness of signals.
- **Screening:**
  - The less informed party seeks to learn more about the other party to reduce information asymmetry. For example:
    - Banks screen loan applicants to assess their ability to repay.
    - Employers may offer health insurance as a fringe benefit to reduce adverse selection.

3.5 Consumer Protection

Concept:

- Consumer protection involves safeguarding consumers' rights and interests from unethical business practices, such as the sale of adulterated or substandard goods, misleading advertisements, and overcharging.

Need for Consumer Protection:

- **Social Responsibility:** Businesses have a moral duty to serve consumers' interests.
- **Increasing Awareness:** Consumers are becoming more aware of their rights and demand fair treatment.
- **Consumer Satisfaction:** Satisfied consumers are crucial for business success.
- **Social Justice:** Businesses should refrain from malpractices to protect consumers.
- **Principle of Trusteeship:** Businesses are trustees of societal resources and should use them responsibly.
- **Survival and Growth:** Businesses that exploit consumers risk losing their customer base.

Consumer Protection in Ethiopia:

- The Consumer Proclamation No. 813/2013 grants rights such as:
    - Access to accurate information.
    - Freedom to choose goods and services.
    - Protection from unethical business practices.
- The main objectives are to protect consumers from misleading market practices and ensure they receive safe and suitable goods and services.