Chapter 4: Market Efficiency, Market Failure, and Government

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Chapter Outline

- Markets and Efficiency
- Market Failures
- Government Intervention
- Paul A. Samuelson

Learning Objectives

- At the end of this chapter, the student will be able to:
  - Understand how markets allocate resources
  - Define the conditions needed for markets to be efficient
  - Understand how markets impose discipline on producers and consumers
  - Understand and be able to use the concepts of consumer and producer surplus

Learning Objectives

- At the end of this chapter, the student will be able to:
  – Understand what market failure is, and when it occurs
  – Describe the different types of market failure
  – Understand the history of the changing landscape between free markets and government intervention

Efficient Markets

- Requirements for an efficient market:
  - Accurate information is available
  - **Property rights** are protected
  - Contract obligations are enforced
  - No **external costs or benefits**
  - Competitive markets prevail

Competitive Markets

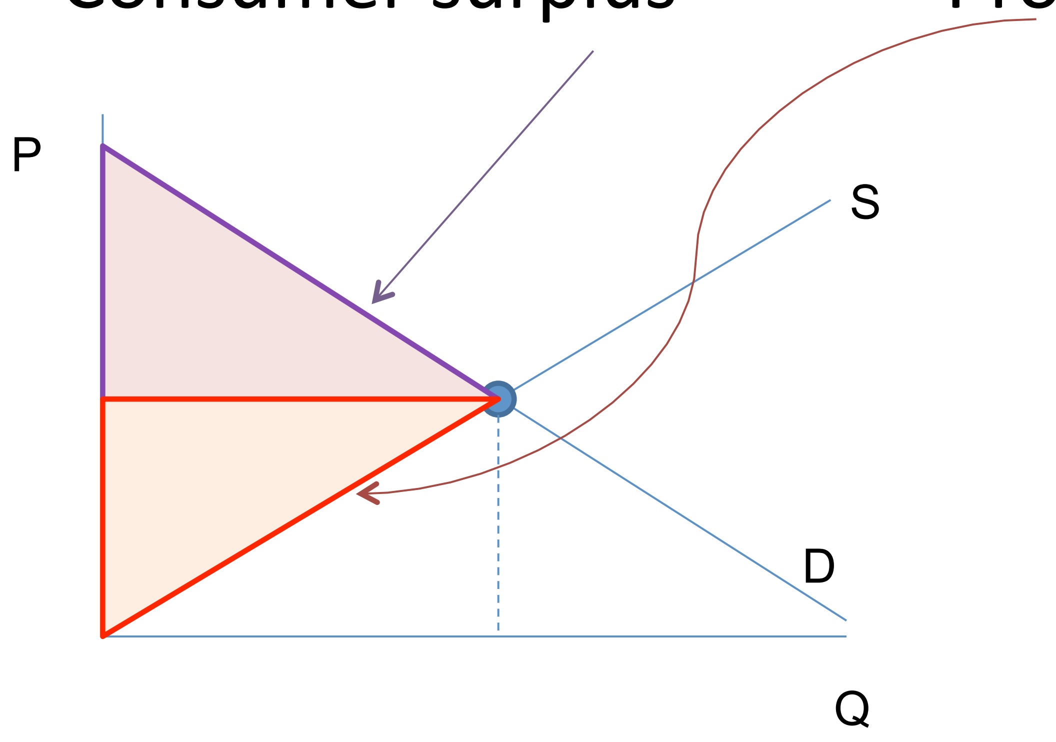
- In a market system, resources are allocated according to the interaction of supply and demand.

- Through the price mechanism, markets ration scarce resources to their most highly valued uses.

Consumer and Producer Surplus

Measures of the gains from trade:

- Consumer surplus
- Producer surplus



Consumer and Producer Surplus

- **Consumer surplus** is the difference between the amount a consumer would be willing to pay and the actual price.
  - Someone who receives a lot of consumer surplus might feel that he or she found "a bargain."

Consumer and Producer Surplus

- **Producer surplus** is the difference between the actual price and the minimum price the firm requires in order to supply the good.
  - A firm receiving a lot of producer surplus might consider themselves to be selling "at a market premium."

Consumer and Producer Surplus

- Measures of producer and consumer surplus help us determine the amount of net benefit created by a market.
- This determination usually rests on considerations of efficiency, rather than fairness.

Efficient Markets

- If a market rations efficiently, it will allocate goods to those who value them the most.
- **Market failure** refers to those instances in which the allocation does not achieve the best possible outcome, from society's point of view.

Markets and Efficiency

- Markets are efficient mechanisms for allocating resources.
- Efficient markets require
  - Property rights
  - Contracts
  - Minimum of spillovers
  - Competition
  - Accurate information made widely available

Market Failure

- When the efficient market requirements are not met, market failure occurs. We consider each of these in turn.
  - Asymmetric information
  - Public goods
  - Externalities
  - Common property resources

Asymmetric Information

- Asymmetric information occurs when one party to a transaction knows more than does the other.
- Some otherwise efficient trades may be prevented.

Adverse Selection

- **Adverse selection** occurs when products of different qualities are sold at the same price because of asymmetric information.
  - This is apparent in insurance markets.
  - Deductibles and co-payments are attractive to low-risk individuals.

Problems with Property Rights

- There are two general instances of market failure caused by property right issues:
  - Public goods
  - Common property resources

Public Goods

- **Public goods** are non-exclusive, and they arise in situations of non-rivalry.
- This means that they can be consumed by one person without diminishing what is left for others.
- And if they are provided for one person, others can enjoy them as well.

Public Goods

- Public goods give rise to the free rider problem. On its own, the free market will not provide enough of these goods.
- Examples:
  - Weather forecasts
  - Lighthouses
  - National defense
  - GPS satellites
  - Mosquito eradication
  - Immunization

Common Property Resources

- The "tragedy of the commons" arises when an open-access resource is overused.
  - Ocean fisheries are an example. Because no one "owns" the stock of ocean fish, there is not an incentive to preserve its value.

Common Property Resources

- The “tragedy of the anticommons” arises when one owner of a resource can block development of a good that would have benefits to many, such as an airport.

Contract Enforcement

- When there is no legal system present to guarantee the execution of a contract, then the scope of commercial transactions will be limited.
- When corruption prevails in the political structure, businesses will invest less.

Externalities

- When externalities are present, the free market will overproduce or underproduce the good in question.
- Government intervention may be required to correct the market failure.
- One of the tools used by government could be the market itself, as in the case of trading permits for pollution emissions.

Monopoly Power

- Antitrust legislation is employed to create a competitive environment when monopolistic practices threaten to establish non-competitive prices.
- The aim of such legislation is to create a more efficient outcome.

Market Failures

- When markets fail, they do not totally collapse; they simply fail to create the socially optimal outcome.
- Asymmetric information – when one party to a transaction has better information than another – can lead to market failure.

Market Failures

- Adverse selection occurs when products of different qualities are sold at one price.
- Moral hazard occurs when an insurance policy or other arrangement changes the economic incentives people face and so leads them to change their behaviors.
- Public goods give rise to the free rider problem.
- Common property resources are typically subject to overexploitation.

Market Failures

- Markets rarely are efficient when external benefits or costs are present.
- Monopoly markets result in prices higher than what is socially optimal.