

## Markets and Market Failure

### What makes markets efficient?

- Welfare gains from trade.
- Market prices communicate what people want and what should be produced (better than other methods).
- Competition drives prices down.
- End result: Resources directed to most highly valued use (MHVU).

Also: from two weeks ago:

- No need for centralized, pre-planned decisions. Invisible Hand
- Willingness to pay is **most accurate** measure of value.
- Only need individual self interest.
  - Consumers want lowest price.
  - Producers want most profit.
- Slime-bag-proof (no need for ‘moral economy’ and trust)

How economists think of normal markets  
Economists’ jargon: Equilibrium Price

- Balance between:
  - Consumers willingness to buyAnd:
  - Producers willingness to sell
- Most efficient allocation of resources among alternative uses.

Types of markets

- **Product markets:** ensure resources directed to MHVU.
- **Labour markets:** ensure right people given right jobs.
- **Capital markets** (stock market): ensure best mgrs control the most investments.
- **Emissions markets:**
- **Idea markets?** Terrorism futures as alternative to gov’t intelligence.

Ideal Market – perfect competition

- Large numbers of buyers and sellers.
  - Each firm is a price taker
- Each firm produces perfect substitutes for the output of other firms.
- Perfect info.
- Equal access to technology.
- No barriers to entry and exit.
- No externalities. All costs and benefits priced.
- Accurate expression of individuals preferences.
- Low transaction costs.

### What is market failure?

- Ideal markets → efficient.
- Market failure → inefficient.
- When prices don't give right information or incentives
- Examples:
  - Gullible consumers.
  - Prisoners' dilemmas

Does advertising lead to market failure? Poorly informed consumers.

- Overturns consumer sovereignty.
- Do corps 'create demand'? False desires?
- Are there 'true' desires?
- Trashy culture?
- Persuasion rather than *information*?
- Favors big companies (monopolies)?
- What does Rhoads say to these criticisms?

### What to do about informational market failure?

- Regulate drug advertising.
- Prohibit false claims by sellers.
- Provide (subsidize) public media (ad-free).

### Negative Externalities

- **Unpriced costs** (pollution). Shifted to people not in the transaction.
- Neither seller nor buyer pays full cost. (subsidy)
- Inefficient: Market doesn't price.
- 'Too much' is produced. Social costs exceed private costs.
- Govt's role:
  - Subsidize alternatives.
  - Tax? Etc...

### Positive externalities

- **Unpriced benefits** (education, news and ideas, vaccinations, tree in my yard).
- Typical of 'public goods'
  - Jointness of supply and non-excludability– anyone (including non-payers) can enjoy.
  - Non-rivalry – my use doesn't diminish yours.
- Problem of free-riders.
- Collective action failures. Too little produced.

Other Public Goods problems  
(goods inefficiently under-supplied in markets)

- Street lights.
- Why gov't partially subsidizes your PSE.
- Hobbes: social order.
- Fire protection services.
- Community health (vs. prescription drugs)
- Tragedy of the Commons

Monopoly

- What if competition leads to its opposite: one seller?
- Are all monopolies inefficient?
- Case of natural monopolies: Microsoft.
- Gov't response?
  - Restore competition.
  - Regulate prices and service.
  - Limit intellectual property protection, etc.

Other inefficient forms of competition.

- When do the costs of competition outweigh the benefits?
- Beauty contests. Status competition (comparative goods)
- Patent races. (small differences, big gains)
- Technical standards.

Heath on Competition

- Good competition: hard on competitors, good for society.
- What do businesses think of competition?
  - Are the winners champions of the social good?
- Avoid 'race to the bottom'
  - Tax competition.
  - Countries lowering wages, environmental standards.

Problem of high transaction costs

- Why is the Canadian Health care system more efficient?
- Private insurance vs. Gov't monopoly of insurance.
- Example of Ebay seller/buyer ratings.

Role of Gov't in correcting mkt failure (see Buchanan, p. 32)

- Bans and prohibitions – why economists often frown on these.
- Standard-setting.
- Taxes, fines, tolls.
- Gov't subsidy or direct provision (parks).
- Artificial markets.
- Legal system – civil and private law remedies.

#### A final issue: Markets and Inequality

- Should inequality or unemployment be considered a market failure?
- No: unemployment or low wages is a useful market signal.
- Yes: if people can't express preferences as consumers, can market do its work?
  - 'Effective' demand vs. people's needs and wants