Market Failure

Chapter 14 Other Failures

Public Goods*

- A ***public good*** is nonexclusive and nonrival.
  - ***Nonexclusive*** – no one can be excluded from its benefits.
  - ***Nonrival*** – consumption by one does not preclude consumption by others.

Public Goods

- There are no pure examples of a public good.
  - The closest example is national defense.
- Technology can change the public nature of goods.
  - Roads are an example.

Public Goods

- Once a pure public good is supplied to one individual, it is simultaneously supplied to all.
- A private good is only supplied to the individual who bought it.

Public Goods

- With public goods, the focus is on groups.
- With private goods, the focus is on the individual.

Public Goods

- In the case of a public good, the social benefit of a public good is the sum of the individual benefits.

Public Goods

- Adding demand curves vertically is easy to do in textbooks, but not in practice.
- This is because individuals do not buy public goods directly so that their demand is not revealed in their actions.

Market Failure as a Result of Common Ownership

- The lack of private property rights is a common problem in the natural resources area.
- If no one has (exclusive) ownership in a resource, no one seeks to optimize its use. Since the benefits do not accrue to a specific owner exclusively, market allocation fails.
- Solution: create and enforce private property rights where possible.

Public Goods

- According to the **principle of mutual exclusivity**, the owner of private property is entitled to enjoy the consumption of that property **privately**.
- A **public good** is a good whose consumption by one person does not diminish the quantity or quality available for others. Therefore, consumption by one person does not preclude consumption by others as well.
  - Exclusivity cannot be guaranteed for public goods. An exclusive property right cannot be enforced.
- This leads to **free riders**—consumers or producers who enjoy the benefits of a good or services without paying for them.

Solutions to the Public Goods Problem

- A common solution is for the government to provide the good, but government is not the only solution.
- Other solutions are charities and advertising.

Asymmetric Information

- Exchange that occurs when one party has more information than the other is called **exchange with asymmetric information**.
- One manifestation of this is called **adverse selection**: the problem that occurs when higher-quality consumers or producers are driven out of the market because unobservable qualities are incorrectly valued.

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.

Solutions to Asymmetric Information

- Asymmetric information can cause markets to fail – to not allocate goods and services to their highest value use.
- A seller must provide credible information about the quality of the good. One approach is to devote considerable resources—to spend money—to demonstrate that the seller is credible.
- Another way to inform consumers of the quality of the product is to provide a guarantee against product defects

Demonstrating Credibility

Government Failure

- James Buchanan, who received the 1986 Nobel Prize in Economics, argues that inefficiencies arise when decisions are removed from the private sector and turned over to elected representatives.
- **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** and **logrolling**, an inefficiency in the political process in which legislators support one another's projects in order to ensure support for their own, can lead to government failure.
- Since the government is not a profit-maximizing entity, it has no incentive to minimize costs. Instead, what often occurs is bureaucracy building.