

Book 2 Overview

Achievement Criteria

90631: Describe market failure and government interventions to correct market failure		
Achieved	Merit	Excellence
<ul style="list-style-type: none"> • Describe market failure. 	<ul style="list-style-type: none"> • Explain market failure. 	<ul style="list-style-type: none"> • Explain market failure.
<ul style="list-style-type: none"> • Describe government interventions used to correct for market failure. 	<ul style="list-style-type: none"> • Explain government interventions used to correct for market failure and their impact on equity and efficiency. 	<ul style="list-style-type: none"> • Fully explain government interventions used to correct for market failure and evaluate their impact on equity and efficiency.

Overview

In **Book 1**, we looked at the **economic problem** and how, given that we can never totally solve it, the goal of all economies is to achieve **allocative efficiency**. This is when an economy makes the best technical use of all available resources to produce the goods and services demanded by consumers.

We then looked at how markets are good at achieving allocative efficiency, allocating resources to the production of goods and services demanded by consumers.

When the conditions are right, market forces do a good job of achieving allocative efficiency – both within a market when supply equals demand and between markets.

Book 2 looks at when markets do not achieve allocative efficiency, i.e. **market failure** occurs.

This is shown in *Figure 1* alongside. This shows a situation where markets are being productively efficient, i.e. using all available resources but for some reason are not producing the combination of goods demanded by society as a whole.

In this case the market failure is said to have occurred, having failed to achieve allocative efficiency. We will examine how this can happen and its consequences, in *Unit 11* (externalities).

Market failure also occurs when somehow the market cannot work properly. We saw this when we looked at monopolies and imperfect competition. As *Figure 2* shows, a monopoly results in deadweight loss, as the firm produces a less than allocatively efficient level of output. We will look at this in more detail in *Unit 13* (natural monopolies).

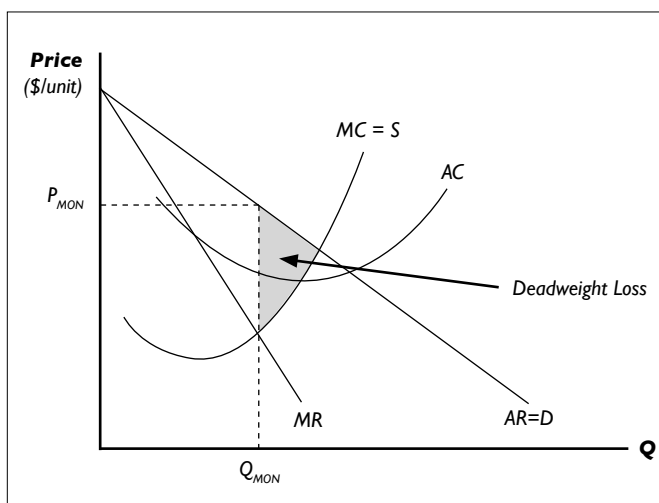
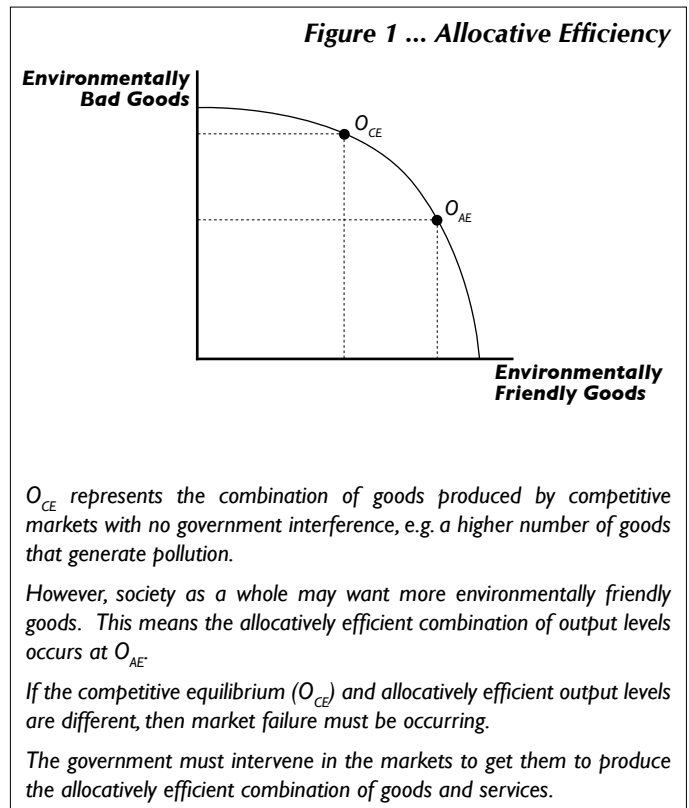


Figure 2 ... Monopolies and Market Failure

In a monopoly, the profit-maximising level of output is below the allocatively efficient level of output . . . i.e. where supply (MC) equals demand (AR).

This results in less goods being produced than consumers demand and them being sold at a higher price that consumers would choose to pay . . . i.e. deadweight loss.

This typically occurs because at least one of the assumptions of a perfectly competitive market has been broken - in this case the existence of barriers to entry.

Because price mechanism (S and D) is unable to achieve allocative efficiency, the monopoly is an example of market failure.

This section of the course examines these and other market failures and how the government can intervene in markets to try and better achieve allocative efficiency.

In particular, we study the following:

Market Failure (*Unit 10*)

This unit defines what is meant by market failure and why it occurs, and the economic roles of the government in a mixed economy, i.e. an economy where there are competitive markets and some government provision and intervention.

Externalities (*Unit 11*)

This unit examines how markets do not always consider all benefits or costs that arise when a good or service is produced and consumed.

Public Goods (*Unit 12*)

Due to their nature, markets will not produce certain goods. These are called 'public goods'. This unit looks at what these are and what can be done to provide them. It also examines merit, demerit and collective goods.

Natural Monopolies (*Unit 13*)

Occasionally a monopoly in a market is inevitable or even desirable. This unit looks at these situations and how the government should manage them.

Equity and Equality (*Unit 14*)

This unit explores how inequality is essential to a market economy to encourage the flow of goods and services demanded by consumers but it is not always socially desirable. It looks at the difference between equity and equality and the trade-off that must sometimes occur between equity and economic efficiency.

What's Next?

In **Book 3** (90632) we will look at the economy as a whole, i.e. macroeconomics. We take the analytical tools developed in **Books 1** and **2**, and apply them to the whole economy. Whereas the first two books look at the behaviour of individuals and how individual markets work, **Book 3** examines the large sectors of the economy that include many sub-markets. This helps us to analyse economic events and policies, and predict their effect on the economy.

Study Notes Market Failure and Government Intervention

Achievement Standard 90631

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Overview

This unit defines the concept of market failure, linking it to the idea of allocative efficiency.

It describes how markets can achieve allocative efficiency . . . but often do not due to various factors.

In the event of market failure, the government must intervene in markets, to help them achieve allocative efficiency.

Allocative Efficiency and the Market

Describe the Economic Problem

At the start of **Book 1**, we looked at the economic problem – the fundamental issue in economics. This states that there are insufficient resources in the world to satisfy everyone’s wants and needs.



Economic Problem: There are less resources than people’s unlimited wants and needs.

Describe Allocative Efficiency

So if we cannot meet everyone’s wants and needs, our next best alternative is to try and use the available resources to meet as many people’s wants and needs as possible, i.e. achieve allocative efficiency.



Allocative Efficiency: The best technical use of all available resources to produce the goods and services demanded by consumers.

In *Unit 1*, we showed the idea of allocative efficiency by using production possibility curves, as in *Figure 10.1* to the right.

Production or technical efficiency occurs when the combination of resources produced occurs on the PPC. Any point inside the PPC is an inefficient use of resources.

Only one point on the PPC however is allocatively efficient.

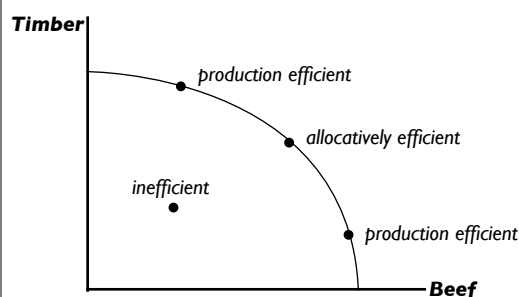
Describe the Market Solution

Having identified allocative efficiency as our main economic goal, the next question is “What economic system is the best for achieving allocative efficiency?” To answer this question, we looked at the ‘market’ solution.

While many different types of markets exist (see *Unit 8*), in theory the most allocatively efficient markets are perfectly competitive ones. These are typified by many sellers and buyers, an identical product, perfect knowledge and no barriers to entry and exit (i.e. perfect mobility of resources). In theory, a perfectly competitive market or rather a collection of perfectly competitive markets, should achieve allocative efficiency.

Figure 10.1 ... Allocative Efficiency

Any point along the PPC is equally desirable from a technical point of view, i.e. they are all productively efficient. Only one point along the PPC is allocatively efficient.



For this to happen certain conditions must occur:

- perfect competition: Four market conditions exist (many buyers and sellers, identical product, perfect knowledge, no barriers to exit and entry).
- consumer sovereignty: Consumers are free to choose what they buy and are the final deciders of what is produced in markets.
- no externalities: All costs and benefits from producing or consuming a good are included in its price.
- no public goods: All goods are excludable by price and are depletable.

Market Failure

Explain Market Failure

The problem with markets however, is that it's rare for all of the above conditions to exist. When they do not exist, then markets cannot work properly and *market failure* is said to occur. In this situation, the market is failing to produce the goods and services demanded by society, i.e. it is not achieving allocative efficiency.



Market Failure: The conditions needed for a market to work perfectly don't occur and so the price mechanism cannot achieve allocative efficiency.

Figure 10.2 summarises the conditions needed for markets to work perfectly and links them to examples of market failure. The last two of these are externalities and public goods and will be explored in more detail in Units 11 and 12.

Figure 10.2 ... Market Failure

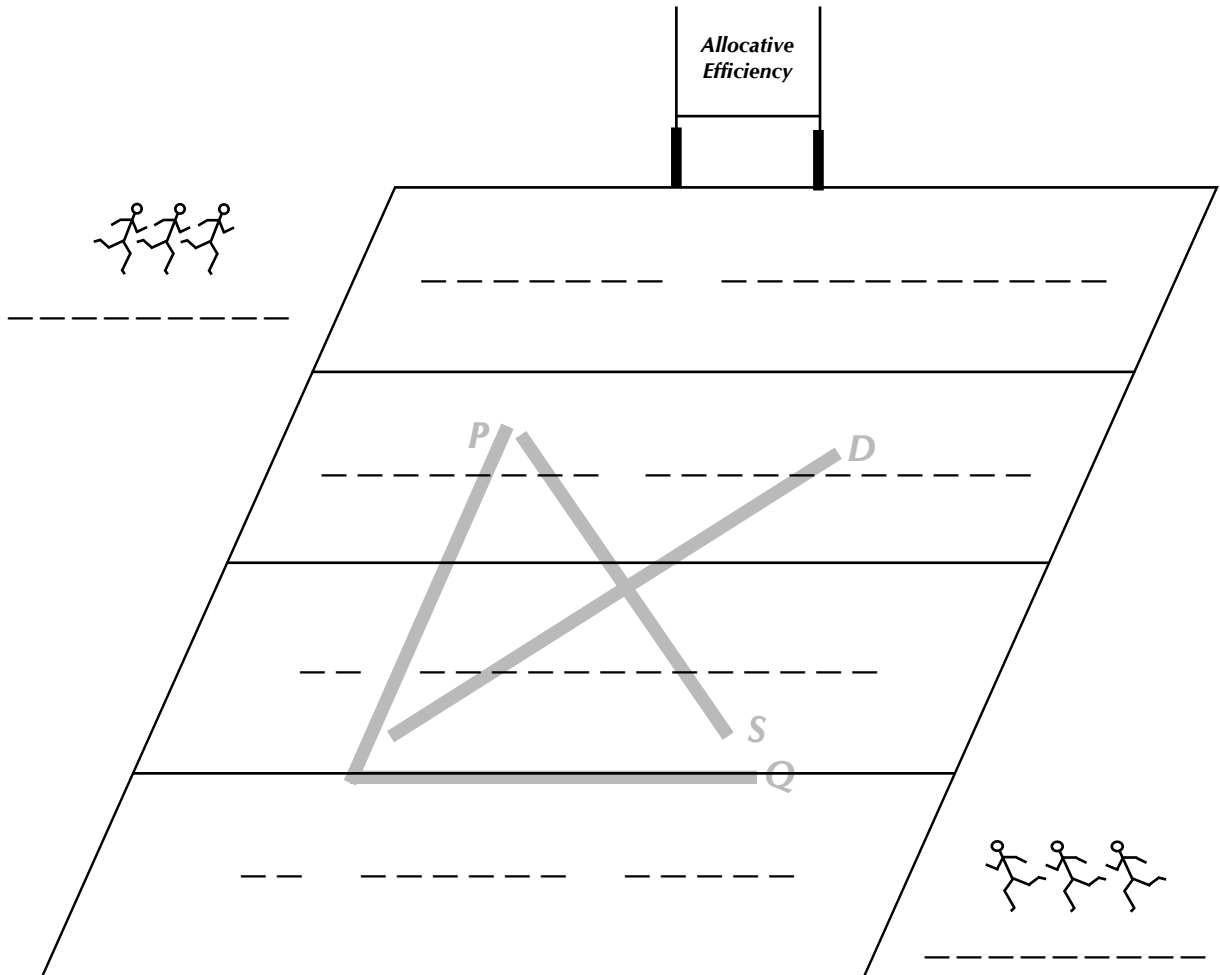
CONDITION	MARKET FAILURE OCCURS WHEN ...	POSSIBLE RESPONSE
Consumer Sovereignty		
... consumers choose what to buy	... the government chooses to restrict consumers' choices, e.g. heroin, fire crackers, guns	... government regulation
... consumers have the final say in what is produced		
Perfect Competition		
... all four assumptions are true: many buyers and sellers perfect knowledge identical product no barriers to exit and entry	... one of the assumptions is broken e.g. barriers to entry exist one firm dominates the market and produces a level of output below market equilibrium and allocative efficiency. e.g. imperfect knowledge misleading advertising results in consumers making incorrect decisions.	... anti-monopoly legislation ... consumer laws (e.g. Fair Trading Act, Consumer Guarantees Act)
No Externalities		
... no unintended (and unpaid for) side-effects occur when people make or consume goods and services	... factories produce smog, but don't pay for it ... consumers create pollution (e.g. 2nd-hand smoke) that others suffer	... regulation of production or consumption ... subsidies or sales taxes ... identify property rights
No Public Goods		
... firms can restrict access to their goods or services and so charge consumers for them	... unable to stop people accessing a good or service for free, firms will choose not to produce them, e.g. national parks, national defence, roading	... government provision of these goods services.

Market failure is the loss of allocative efficiency. The socially desirable level of outputs is not achieved due to externalities, public goods, or natural monopolies occurring. Or the four assumptions of a perfectly competitive market are not in place and so the markets are unable to allocate resources efficiently to the goods and services most demanded by consumers.

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The Free Market Model . . . Fact or Fiction?

1. The diagram below represents the idea of free markets providing a 'level playing field'. Identify the conditions necessary for markets to achieve allocative efficiency and then complete the text below.



2. Use the words listed in the box below to complete the text that follows.

outcomes inequity allocative efficiency externalities solution intervention economic problem

The Free Market Model

We study one _____ to the _____ – the free market solution. This is the typical way most economies in the world try to achieve _____. But not entirely. Most also have some form of government _____. This is usually necessary because the market does not work properly and the Government has to fix it or because the market outcomes are considered socially undesirable, i.e. _____ or _____ exist.