PUBLIC FINANCE

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Chapter 7 (Continue)

Unit 2 (Notes)

Market failure

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Inefficient allocation of resources in an economy

Two aspects of market failure → 1.) Demand side market failure
2.) Supply side market failure.

Two types of market failure

Complete market failure

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case of "missing markets" (market does not supply at all)

Partial market failure

↓

functions but produces wrong quality of product at wrong price

Four major reasons for market failure

1. **Market Power**
   - monopoly power
   - firm have the ability to raise market price and make profits ~~Thes~~ (price makers)
   - Positive Economic Profit is achieved.
   - Excessive market power leads to → sale of less output + charging of higher prices {perfect competition}
   - It is achieved due to dominance and not operating efficiency

+

2) Externalities

(also called spill over effects, neighbourhood effects, third-party effects or side effects)

- occurs when action of consumers / producers results in costs or benefit that do not become part of market price

costs - negative externalities	- BAD
benefits - positive externalities	- GOOD

- They can be positive or negative

↓ positive: action of one party confers benefits to a third party.

↓ negative: action of one party imposes cost on third party who is not part of transaction

Types of Externalities

Production Externality

- Positive Production externality
  - ↳ initiated in production but benefit received by others in production / consumption
  - E.g. firms offer training to employees to for better efficiency but employee leaves job thus benefit derived by other firm.
- ~~Positive~~ Negative production externality.
  - ↳ imposes external cost on others → may be received by another in consumption or production.
  - E.g. pollution of river affects fish output → less catch for fisherman → loss

- Positive consumption externality
  - ↳ external benefit received by others
  - E.g. vaccine for diseases → benefits others from

being infected.
- Negative consumption externalities
  ↳ external cost on others.
Eg. smoking cigarettes in public place leads to passive smoking by others.

3.) Public Goods (also called collective consumption good)
Paul A. Samuelson → concept of 'collective consumption good' → "The Pure Theory of Public expenditure" - (research paper) [1954]

- also called social good
- one which all enjoy in common which leads to no reduction in another individual's consumption.

They are
- indivisible, non rival, non excludable and enjoyed by all
- ~~vulnerable~~ vulnerable to externalities & free rider problems.

Types of Public Goods
1.) Pure Public goods. [non excludable & non rivalrous]
2.) Impure Public goods [partially rivalrous & congestible]
3.) Quasi-Public goods (Mixed goods) (provision of the good)
4.) Common Access Resources (non excludable & non-rivalry)
5.) Global Public goods. [impacts different countries/regions/generations/population → indivisible]

4) Incomplete Information

- Complete information is essential element of competitive market.
- But it is,
  1. difficult to get correct information
  2. complexity of goods & services.
  3. deliberate misinformation

Asymmetric Information

(imbalance of information between buyer & seller – one party knows more than the other)

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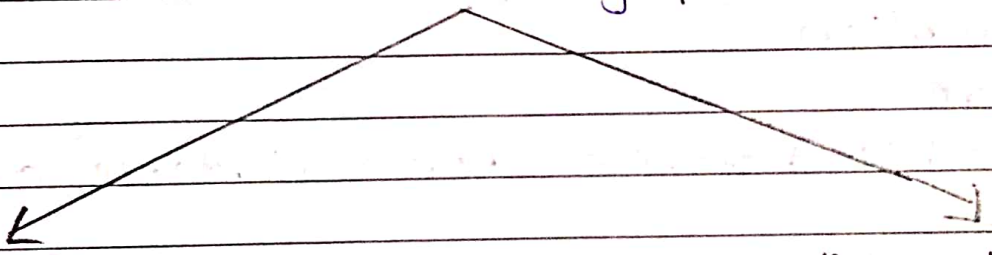
central concept related to information gaps



Adverse Selection

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Situation in which asymmetric information about quality eliminates high quality products from market

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Lemons problem (By George Akerlof)

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Eg: Second hand cars (Owner knows about its quality, does not reveal defects)

Moral Hazard

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Opportunism characterised by an informed person taking advantage of less informed person

↓

Eg Insurance company (not revealing information about market)

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To correct market failure :- Govt. Intervention

Govt. intervention to minimise market power

Government intervene by establishing rules and regulations which are designed to promote competition and regulate the prices (through natural monopoly)
(Prohibit actions which restrain competition)

To minimise market power

Competition-based Regulations

ensure proper use of intellectual property rights and avoiding misuse.
Eg. Competition law (2002)
Patent law etc.

Price-Based Regulations

Price caps based on firms variable cost, Past prices etc.
Permitted natural monopoly
Eg. Electricity, water etc

To correct Externalities government intervene

Promoting Positive Externalities

Subsidies
↓
giving subsidies for promotion of positive externality

Production & supply
↓
producing items positively
E.g. Afforestation, Clean River etc.

Reducing Negative Externalities

Direct control
↓
regulating generation of Negative Externalities
↓
E.g. Laws, Total Prohibition, Licensing etc.

Indirect Control (market based)
↓
incentives to achieve Socially Optimal Solution
↓
convert negative (social cost) externality into private cost
↓
E.g. Pollution Tax, Pigouvian Tax Permits ~~etc~~ Tradeable Emissions permit (Cap-trade) etc.

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Government Intervention in case of merit goods and demerit goods

Concepts	Merit Goods	Demerit Goods
Meaning	Socially desirable → Goods that have substantial positive externalities.	Socially undesirable → Goods that have high negative externalities.
Need for govt intervention.	1) Lower output 2) Equity / Fairness 3) Uncertainty in Consumption 4) Imperfect information	1.) Private < Social costs costs 2.) Over production & over consumption 3.) Overvalue of Demerit goods due to imperfect information
Forms of govt intervention.	①Regulations: → checking how private activity are conducted → prohibit certain goods & activities → set standards & issue mandates. → enhance consumption → ensure quality of merit goods. ② Subsidies ③ Direct government provision ④ Supplementing	Regulations: ① Complete Prohibition ② persuasion ③ No. Promotion ④ Regulations as to sale ⑤ Time and space restrictions ⑥ Higher Tax Rates ⑦ Price controls.

	Concept	Merit Goods	Demerit Goods
		market provision.	
4)	Examples	Education, Health care, welfare services, Housing waste management, public parks etc.	Tobacco - Cigarettes, Alcohol, Intoxicating drugs, narcotic substances

Government Intervention in the case of Public Goods

1) Certain Public goods are produced by the government Eg: ~~Atomic~~ Atomic Energy, Nuclear Power facility ~~etc~~, Defence etc. (strategic & security reasons)
   ↳ Direct Provision of Public goods

2) Excludable Public goods
Some public goods like parks & universities are ~~providided~~ provided & financed by government, which helps in equitable distribution of welfare

3) Voluntary Contribution and Private Donations
Certain public goods are funded through voluntary contribution and private donation from corporate entities and non government organizations eg: community parks, cultural activities

4) Public Goods Produced / Consumed as Private goods
This is done to avoid dangers to the society
Eg. airport security, atomic energy etc.

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Price Intervention : Non Market Pricing

1. It involves implementation of price controls which are legal restrictions placed on prices.
2. Price control

Price Floor	Price ceiling
(a minimum price buyers are required to pay)	(maximum price sellers are allowed to charge)

3. Govt intervene in primary market that experience extreme and unpredictable price fluctuations E.g. MSP
4. Price of essential commodities ↑ : govt may implement price ceilings.
5. To ensure price stability and proper distribution → govt intervene in grain market by building & maintaining buffer stocks.

Govt Intervention for correcting information failure

1. Mandatory Labeling and content Disclosures.
   eg: cigarettes packets must display health warnings
2. Disclosure requirement
   E.g. SEBI
3. Public Dissemination of Information

To improve knowledge

4. Regulation of advertising and setting of advertising standards
   more responsible, informative and less persuasive

Govt. Intervention for Equitable distribution

1. Progressive Income Tax
2. Targeted Budgetary Allocations
3. Unemployment Compensation
4. Transfer payments
5. Subsidies
6. Social security schemes
7. Job Reservations
8. Land Reforms
9. ~~Land~~ Gender-sensitive Budgeting

Govt. intervenes bt to combat ~~to~~ black economy and market distortions associated with parallel black economy.

Government failure occurs when:
→ intervention is ineffective causing wastage of resources expended for intervention
→ intervention produces fresh and more serious problems.