**STUDY MATERIAL 2 Module -II ECONOMICS HONOURS SEMESTER –I CC 1-1 2019-20**

**Market failure and Externalities:**

Market failure is the economic situation defined by an inefficient distribution of goods and services in the free market. Furthermore, the individual incentives for rational behavior do not lead to rational outcomes for the group. Put another way, each individual makes the correct decision for him/herself, but those prove to be the wrong decisions for the group. In traditional microeconomics, this is shown as a steady state disequilibrium in which the quantity supplied does not equal the quantity demanded….

Positive externalities are benefits that are infeasible to charge to provide; negative externalities are costs that are infeasible to charge to not provide. Ordinarily, as Adam Smith explained, selfishness leads markets to produce whatever people want; to get rich, you have to sell what the public is eager to buy. Externalities undermine the social benefits of individual selfishness. If selfish consumers do not have to pay producers for benefits, they will not pay; and if selfish producers are not paid, they will not produce. A valuable product fails to appear. The problem, as David Friedman aptly explains, “is not that one person pays for what someone else gets but that nobody pays and nobody gets, even though the good is worth more than it would cost to produce.”…

Research and development is a standard example of a positive externality, air pollution of a negative externality….

Most economic arguments for government intervention are based on the idea that the marketplace cannot provide **public goods** or handle **externalities**. Public health and welfare programs, education, roads, research and development, national and domestic security, and a clean environment all have been labeled public goods….

**Externalities** occur when one person’s actions affect another person’s well-being and the relevant costs and benefits are not reflected in market prices. A positive externality arises when my neighbors benefit from my cleaning up my yard. If I cannot charge them for these benefits, I will not clean the yard as often as they would like. (Note that the free-rider problem and positive externalities are two sides of the same coin.) A negative externality arises when one person’s actions harm another. When polluting, factory owners may not consider the costs that pollution imposes on others….

The Problem of Social Cost,” Coase’s other widely cited article (661 citations between 1966 and 1980), was even more path-breaking. Indeed, it gave rise to the field called law and economics. Economists b.c. (Before Coase) of virtually all political persuasions had accepted British economist Arthur Pigou’s idea that if, say, a cattle rancher’s cows destroy his neighboring farmer’s crops, the government should stop the rancher from letting his cattle roam free or should at least tax him for doing so. Otherwise, believed economists, the cattle would continue to destroy crops because the rancher would have no incentive to stop them.

But Coase challenged the accepted view. He pointed out that if the rancher had no legal liability for destroying the farmer’s crops, and if transaction costs were zero, the farmer could come to a mutually beneficial agreement with the rancher under which the farmer paid the rancher to cut back on his herd of cattle. This would happen, argued Coase, if the damage from additional cattle exceeded the rancher’s net returns on these cattle. If for example, the rancher’s net return on a steer was two dollars, then the rancher would accept some amount over two dollars to give up the additional steer. If the steer was doing three dollars’ worth of harm to the crops, then the farmer would be willing to pay the rancher up to three dollars to get rid of the steer. A mutually beneficial bargain would be struck….

Public goods have two distinct aspects: nonexcludability and nonrivalrous consumption. “Nonexcludability” means that the cost of keeping nonpayers from enjoying the benefits of the good or service is prohibitive. If an entrepreneur stages a fireworks show, for example, people can watch the show from their windows or backyards. Because the entrepreneur cannot charge a fee for consumption, the fireworks show may go unproduced, even if demand for the show is strong….

Underlying both cases is the assumption that free markets determine prices and that there are no market failures. But market failures can occur. A market failure arises, for example, when polluters do not have to pay for the pollution they produce. But such market failures or “distortions” can arise from governmental action as well. Thus, governments may distort market prices by, for example, subsidizing production, as European governments have done in aerospace, as many other governments have done in electronics and steel, and as all wealthy countries’ governments do in agriculture. Or governments may protect intellectual property inadequately, leading to underproduction of new knowledge; they may also overprotect it. In such cases, production and trade, guided by distorted prices, will not be efficient….

National defense is a **public good**. That means two things. First, consumption of the good by one person does not reduce the amount available for others to consume. Thus, all people in a nation must “consume” the same amount of national defense (the defense policy established by the government). Second, the benefits a person derives from a public good do not depend on how much that person contributes toward providing it. Everyone benefits, perhaps in differing amounts, from national defense, including those who do not pay taxes. Once the government organizes the resources for national defense, it necessarily defends all residents against foreign aggressors….

Public goods are freely accessible to all members of a given public, each being able to benefit from it without paying for it. The reason standard theory puts forward for this anomaly is that public goods are by their technical character non-excludable. There is no way to exclude a person from access to such a good if it is produced at all. Examples cited include the defence of the realm, the rule of law, clean air or traffic control. If all can have it without contributing to its cost, nobody will contribute and the good will not be produced. This, in a nutshell, is the public goods dilemma, a form of market failure which requires taxation to overcome it. Its solution lies outside the economic calculus; it belongs to politics….

Since we are ourselves professional economists, we have been particularly mystified by the reluctance of our profession to adopt what we have called the constitutional perspective. Economists in this century have been greatly concerned with “market failure,” which was the central focus of the theoretical welfare economists that dominated economic thought during the middle decades of the century. This market-failure emphasis extended to both micro- and macro-levels of analysis. Scholars working at either of these levels showed no reluctance in proffering advice to governments on detailed market correctives and macroeconomic management. In retrospect, post-public choice, it seems strange that these scholars so rarely showed a willingness to apply their analytic apparatus to institutions other than the market; they paid almost no attention to politics and political institutions. Once a policy recommendation seemed to have emerged from their market-failure analytics, there was no subsequent analysis aimed at proving that persons in their political roles, as either principals or agents, would somehow behave as the economists’ precepts dictated. Implicitly, economists seemed locked into the presumption that political authority is vested in a group of moral superpersons, whose behavior might be described by an appropriately constrained social welfare function. Initial cursory attempts by a few public-choice pioneers to inject a bit of practical realism into our models of individual behavior in politics were subjected to charges of ideological bias.