**Dealing with the Economic Problem: Markets or Government?**

MICROECONOMICS: RECAP of RWS 4 (The Role of Markets) and INTRO to RWS 5 (The Role of Governments)

**Market Success: Why are ‘free markets’ considered to be the best outcome for society?**

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| A  Figure 1: Market for Alcohol Beverages | So far, we have been studying in RWS 4 and the “Role of markets”, why ‘free markets’ or ‘capitalism’ lead to the best outcomes for society through the price mechanism allocating scarce resources through competitive markets made up of firms and consumers with very little interference from the Government. The Government’s role is simply to establish property rights through a legal system.  **IMPORTANCE OF EQUILIBRIUM IN THE FREE MARKET**   1. Importance of prices (and value): leads to allocative efficiency and maximization of welfare (i.e. no deadweight loss) 2. Importance of competition: leads to productive efficiency amongst firms |
| **TASK: Write a paragraph (150-200 words) on why markets work effectively in allocating resources to the production of alcohol.**   |  | | --- | |  |   **EXEMPLAR PARAGRAPH FOR THE ABOVE TO CHECK (a student wrote this)**  *“Consumers place a value on alcohol as it provides a way to relax and have fun and therefore they are willing to pay a price for it. This price sends a signal to private firms to move their scarce resources (labour and capital) to produce alcohol beverages for the consumers in society who are willing to pay this price. Firms are incentivized as they may be able to make profit if the price is higher than the cost of producing alcohol. Scarce resources are being used in the best way as the market clears at the equilibrium price implying that every consumer who wanted the good at that price has received it; there is not deficit or surplus in supply. The market has therefore allocated the scarce resources efficiently. The equilibrium also suggests welfare is maximized for all those who want alcohol as there is no deadweight loss (consumer and producer surplus could not be any higher at this price without making either worse off). Additionally, as there are lots of competition in providing alcoholic beverages, it is produced at the lowest possible cost and best available price maximizing the utility of consumers. Therefore the free market has led to the best outcome for society through the price mechanism.”* | |

**Market Failure: Why might markets not always work perfectly?**

The market does not always work. By work, economists mean that efficiency (allocative and/or productive) are not achieved and/or welfare might not be maximized (i.e. there is a deadweight loss). This could even occur if the free market was in equilibrium. There are plenty of reasons as to why the assumptions about the free market above might be wrong and I have put these into four broad areas:

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| **MARKET ASSUMPTIONS** | **What Free Market Economists might say** | | | | | **What opponents to Free Market Economics might say** |
| ***Information:*** Information about the quality of products, the price of products, where to source them, how to make them…everything. | **Perfect Information:**  Conusmers and producers have perfect information about prices and the quality of goods so they are able to make informed choices about which is the best option to buy and will know exactly how they can maximise their utility or benefit to them.  Equally firms are able to calculate costs and revenues very easily and therefore see how much profit they will be able to make. In this way, both consumers and firms can make ‘perfect decisions’. | | **Imperfect Information:** Information is not perfect in that:   * *‘Asymmetric Information Issue’:* (which means firms, for example, might have more information than consumers). A classic case study is the ‘Market for Lemons’ involving second-hand Cars! A bad second hand car is called a “lemon” in the USA. When a consumer goes to buy the car, they do not have perfect information. They do not know the service history of the car and whether it has any unforeseen problems with it (dodgy engine etc.) whereas the seller (the firm) does have that information. Therefore the firm can charge an overinflated price for a poorer quality car which the consumer would not know about until the transaction had taken place. * *‘Bounded Rationality’* – consumers and firms often ‘satisfice’ (i.e. make a decision based on what might satisfy them rather than maximize their utility or profit). The reason for this is because they will use approximate rules of thumb as they do not have all the info available to them and do not have the time to necessarily ‘shop around’ to exhaust all options. * *‘Anchoring Bias’* They might see two pairs of jeans for £30 and £80 and then think that £50 for a pair of jeans is reasonable because it must be better quality than the £30 jeans AND it is not as expensive as the £80 jeans, when in fact the average price is £30 and the £50 and £80 jeans is not good value. They have been ‘anchored’ to the belief that the average price range of jeans is between £30 and £80 and feel they have got good value when they haven’t! * *‘Availability or ‘Social Norm’ Bias’:* Consumers and firms do not hold perfect information and may be racist or prejudice towards purchasing or selling particular goods. * *‘Framing’:* Consumers might be affected by how the information is presented. Saying a gym membership costs £500 a year sounds a lot worse than saying £42 a month…consumers might therefore sign up to £42 a month but £500 a year is well beyond what they would normally be prepared to pay. They have based their decision on imperfect information because of the way it was presented to them. | | | |
| ***Competition:*** To have lots of competing firms in a market producing the same good/service. | **Perfect Competition:** Free markets assume there are lots of buyers and sellers all competing in a market to buy and sell goods and services. This therefore drives down costs and prices for consumers, thus leading to productive efficiency. | **Imperfect Competition:** Although competition is present in lots of markets, it often is not between lots of little sellers, all competing for your business. The reality is that lots of markets face a lack of competition because there is:   * *Monopoly:* In it’s purest sense, one firm controls the whole market and therefore is able to influence the price. Thames Water might be a good example in your local area for water supply? There is no alternative really (you are not going to bathe yourself continuously with bottled water!) * *Oligopoly:* Where there are several large firms in the market, dominating production (and preventing competition from entering the market). They might even collude to form an effective pure monopoly and drive up prices.   Some economists even argue that free markets are doomed to fail as the incentive of firms is to destroy their competitors (‘dog eat dog’) and thus monopoly formation is inevitable! Other economists such as Joseph Schumpter argue that Monopolies can be broken over time in a process called ‘creative destruction’. | | | | |
| ***Mobility of Factors of Production:*** How quickly factors of production (land, labour, capital, enterprise) can be moved geographically or occupationally (from one use to another). | **Free Mobility of Factors of Production:** Land and Capital are interchangeable between different uses. Land to grow carrots, could grow potatoes. Machinery to construct cars, could construct aircraft. Equally, Labour and Enterpreuners can move geographically to any area of the economy quickly – someone could move from Newcastle to London very quickly and easily for example. Equally, skills needed to work in retail outlets could quite easily be employed in being a train conductor or working with customers. | | | | | **Immobility of Factors of Production:** Factor immobility occurs when it is difficult for factors of production (e.g. labour and capital) to move between different areas of the economy. Factor immobility could involve:   * *Geographical immobility –* When it is difficult to move labour and capital from one geographical area to another. It maybe very hard to move machinery easily from one area of the country to another. Equally, labour might find it hard to move between Newcastle and London due to higher costs of living in London compared to Newcastle and also the importance of community ties to individuals. * *Occupational immobility –* difficult to move labour and capital from one type of production process to another. If there is a rapid structural change in the economy. It may take time to alter machines and capital to keep up to date with changing nature of the economy. Or if coal mines or steel factories closed down in South Wales, it may be very difficult for the unemployed coal miners to find work in new industries in the service sector. |
| ***Rationality:*** Economic agents (consumers and firms) and that they act logically and consistently (you can predict their behaviour because they all hold similar norms and values) | **Agents are Rational:** Economic agents will always try to maximize their own welfare, even at the expense of others…they are selfish and only consider their own costs/benefits. For example, consumers will always try to maximize their utility by purchasing more goods/services at the lowest price possible. Firms will always try to maximize their profits. | | | **Agents are irrational and do not always try to be ‘logical’:**   * *Bounded Self-Control:* Consumers sometimes are unable to stop consuming even though they are hurting their utility in the longer run. An example might be overeating. * *Altruism and Perceptions of Fairness:* Often consumers and firms might not maximize in their own self-interest but help others out even though this will be at the cost of their welfare. Equally, it could be that getting £5 is a benefit to a worker but if their workmate gets £10 then suddenly they may feel it is unfair and not value the £5 as much even though it is still £5! * *Loss aversion:* Often studies show that consumers and firms are more concerned with the potential loss they may face from a decision rather than the potential GAIN from that decision. Therefore they will appear to react irrationally when they make a decision based on loss rather than gain. For example, if somebody gave us a £300 bottle of wine, we may gain a small amount of happiness (utility). However, if we owned a £300 bottle of wine and it got dropped, we would be more unhappy. | | |
| ***Overall benefit to society:*** Who gains and loses within the economy | Leads to the best outcomes for all. The selfish gene in all humans, where we look out for ourselves and our ability to value the goods/services that benefit us leads to overall a better outcome of welfare as the ‘invisible hand’ moves and allocates resources from one area to another quickly and efficiently, ensuring very little waste. Everyone who wants the good, gets the good at the equilibrium price which is ‘fair’. | | | | **Winners and Losers:**  Price equilibrium assumes perfect allocation with everyone who wants the good, getting the good but this does mean that some consumers might be excluded from what is a vital good for survival (like food or water). It is not like there are available substitutes for some of these goods…you either have them or you die in an absolute sense. Equally, it might be that there is a relative lack of needs being met within a society. So you will not die if you do not have access to education but equally you will still not have the same opportunities as others. So poverty is where your needs are not being met and the free market does not necessarily take this into account. Inequality between regions and individuals in an economy can lead to tension and unrest if it is of a large magnitude…no one is necessarily saying we should be equal but the gap between the rich and poor tends to widen when free markets are in operation. So there are some losers. | |

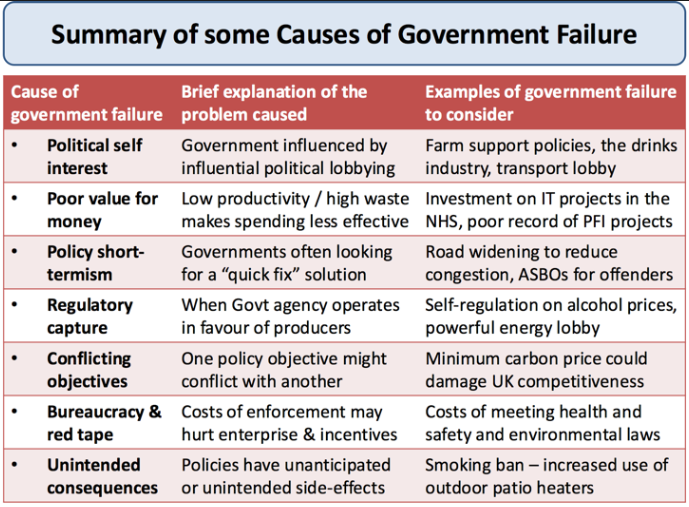
**Government Intervention: How might Governments succeed in correcting failures of the market?**

The opposite of ‘free markets’. In its extreme form, the Government is in control of the allocation and distribution of resources. Some commentators call this ‘Socialism’ and an economy that has significant Government intervention is called a ‘planned economy’ rather than a ‘market economy’. The state can intervene to correct market failures in three broad ways:

1. **Direct Controls and Provision –** Legislation (regulation), actual provision (Government ownership) and price controls (implementing maximum and minimum prices in a market)
2. **Price Mechanism alterations –** indirect taxation on goods/services (to raise the price by increasing the costs of production of firms) and subsidies on other goods/services (to lower the price by decreasing the costs of production of firms). Both actions will lead to consumers buying less of the good/service (taxation) or more of the good/service (subsidy)
3. **Persuasion –** guidance (education) and nudge theory

**Government Failure: Why might Government’s fail to solve the problem or make the situation worse?**

Critics of the state including prominent right wing (and free market) economists such as Frederik Hayek and Milton Freidman feel that the Government are either incapable of achieving efficiency and maximum welfare and/or do not want to try and make things better. In which case, they argue, the Government will fail and misallocate resources. They could even make the situation worse than the market failure. There are several reasons and effects of Government failure



These again can be categorized further into the following:

1. **Political Conflicts:** This can include corruption, over-bureaucratic influences, excessive lobbying by a minority group which affects the majority (leading to conflicting objectives), regulatory capture and the idea that individuals are selfish and therefore no politician will put society first as they will always be trying to retain power (policy short-termism). Political conflicts can occur in both dictatorships and democracies.
2. **Imperfect Information:** This can lead to administrative errors and excessive costs. It could be that the Government does not know how much it should increase a tax? Or perhaps the cost of collecting a tax would be too much? Perhaps a Government run project or regulatory network has low productivity, high waste and is poor value for money?
3. **Unintended Effects:** Imperfect information can lead to unintended effects; so the Government solves one problem but this opens up another issue. The perfect example is the prohibition of alcohol by the US Government from 1920 to 1933. Reduction of alcohol was achieved to some extent but the smuggling and crime created led to the growth of crime bosses such as Al Capone.

**Market Success and Government Failure .v. Market Failure and Government Intervention: How does this tie up together?**

So far you have been reading about four concepts: Market Success and Failure and then Government Intervention and Failure. Market success and Government failure are clear rationale for following a more ‘capitalist’ or ‘free market’ approach to the distribution of resources. Economists who are perhaps more ‘right-wing’ in their political bias often suggest that markets SHOULD be run through free market principles. Their normative statement is essentially saying that ‘free markets’ lead to better outcomes and Government’s cannot be trusted to deliver the same benefits.

On the other hand, market failure and government intervention are the rationale for Government’s being more actively involved in the workings of the market which can be considered a more ‘socialist’ or ‘planned’ approach to the distribution of resources. Economists who are perhaps more ‘left-wing’ in their political bias often suggest that markets SHOULD be regulated or run by Government’s. Their normative statement is essentially saying that Government intervention leads to better outcomes and markets cannot be trusted to deliver the same benefits.

Below is a table, explaining the four concepts in relation to two possible real life markets.

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|  |  | **MARKET SUCCESS** | **MARKET FAILURE (causes underlined)** | **GOVERNMENT INTERVENTION** | **GOVERNMENT FAILURE** |
|  | **Agriculture Markets**  **(food)** | *Consumers demand food to survive and enjoy a higher standard of living (avoid getting hangry!) therefore they place a value on food and are willing to pay a price. Firms are then able to make profit by producing the food that consumers want.* | *Unstable prices and falling revenues for farmers, many of whom start to go out of business, increasing rural poverty as there is limited mobility of factors of production to change the use of their resources into the production of something else. Equally, farm workers might find it hard to get jobs in urban areas perhaps? End up relying too much on imported food.* | 1. *Direct Control and Price Mechanism Alt: Intervention by the EU Government through the EU’s CAP (Common Agricultural Policy) providing subsidies to Farmers and guaranteed high or ‘minimum’ prices for certain goods has been in place since 1962 and applies to all countries within the EU including the UK (for the moment!)* | * *Political Conflicts: Cost to taxpayer of subsidies and guaranteeing higher prices is excessive and influenced by powerful farmer lobby groups* * *Imperfect Information: Over production of food is inefficient if subsidies encourage ↑supply* * *Unintended Effects: guaranteed higher food prices might lead to greater poverty.* |
|  | **Housing Markets (rental and home ownership)** | *Consumers demand housing to provide shelter and therefore they place a value on shelter and are willing to pay a price. Firms are then able to make profit by producing the shelter that consumers want.* | *Consumers unable to afford housing, especially in shortage areas such as the South East. ‘Boomerang Kids’ living back with their parents etc. Increased poverty as more people homeless. Increased inequality as richer homeowners become wealthy leaving the rest behind.* | 1. *Direct ControL: Governments could impose maximum rents that landlords could charge* 2. *Price Mechanism Alterations: Government’s could impose taxes on landlords’ profits* 3. *Direct Control: Government’s could reduce planning regulations* | * *Political Conflicts: Government’s unable to impose taxes on landlords as they are another powerful lobby group. Basically very wealthy individuals.* * *Imperfect Information: What would be the ideal maximum rent to charge? It might be too low in which case there could be excess demand and an even bigger shortage of housing.* * *Unintended Effects: Landlords go out of business, environmental costs of greater housebuilding on ‘greenbelt’ land and areas of natural beauty?* |

**TASK 1: APPLICATION EXERCISE: Fill in the gaps below and answer any questions (use the internet to look up these two case studies)**

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|  |  | **MARKET FAILURE**  Explain why there was a failure of the market | **GOVERNMENT INTERVENTION**  The Government intervened in the following ways – use the internet to add more detail about how each intervention works and why it might have been a success. | **GOVERNMENT FAILURE**  Explain why the Government may have failed using headings of ‘political conflicts’, ‘imperfect information’ and ‘unintended effects’ |
|  | **Healthcare in the UK (Birth of the NHS in 1948)** | **EXAMPLAR:**  “Under-provided by free markets (due to imperfect information – consumers do not value healthcare as much as they should unless they fall seriously ill and so there is not enough production by firms). This is especially true of those on low income.  Therefore life expectancy is lower and days are lost from working because of illness” | *Direct Control - Established the NHS in 1948 providing free healthcare at the point of use.* |  |
|  | **Alcohol in the US 1920-1933**  **(Era of “Prohibition”)** |  | *Direct Control – Complete ban on all alcohol between 1920 and 1933.* |  |

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| **How does the UK Government intervene in the market for alcohol in the UK? (there are several ways!).** | **What possible Government failures might there be in your opinion?** |
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**TASK 2: MULTIPLE CHOICE QUESTIONS on Markets and Government**

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| 1. Which one of the following is most likely to reduce market failure?    1. Increased production from firms    2. Underproduction of the goods due to a an under valuation of the product    3. Improving the information available to consumers    4. A company going out of business | **(6)** Which of the following Government interventions is the **most appropriate** method of solving market failure?  **A.** Reduced subsidies for public transport, such as trains and buses  **B.** Relaxing laws that currently prevent happy hours, such as in clubs & bars  **C.** Introducing regulations to reduce CO2 emissions  **D.** Imposing taxation on goods which are underprovided |
| **(2)** | **(7)** Which of the following Government interventions could help solve market failure?  **A.** Subsiding goods and services with high external benefits to the rest of society  **B.** A ban on public goods, such as defence  **C.** Provision of more information to the informed party when there is asymmetric information (a lack of information for one side of a transaction)  **D.** Taxing goods and services with high benefits |
| **(3)** | **(8)** Which of the following is most likely to be considered to be a market failure   1. The NHS costs too much money 2. Some consumers have higher incomes than others 3. Certain goods are not provided by private firms even though there is demand for them 4. A firm operates in a competitive market |
| **(4)** A misallocation of resources is most likely to occur in monopoly if   1. other firms enter the industry 2. higher prices are charged than under competitive conditions 3. market output increases 4. average costs are reduced because of the large size of the firm | **(9)** What is the most appropriate Government intervention to prevent the overconsumption of alcohol?   1. Subsidise the production of alcohol 2. Reduce the legal age of drinking from 18 to 16 3. Ban alcohol completely (prohibition) 4. Implement a higher tax on alcohol |
| **(5)** Market failure arises when   1. prices rise in response to excess demand 2. the true benefits of consuming a good are not fully considered by the market (and so the good is undervalued) 3. firms are unprofitable and go out of business 4. costs increase as firms expand their production | **(10)** An example of Government failure is most likely to be   1. an uncompetitive market place 2. a private firm being inefficient 3. increased crime rates due to an intervention by the Government 4. a tax on the overconsumption of alcohol |

**ANSWERS: 1-C 2-D 3-D 4-B 5-B 6-C 7-A 8-C 9-D 10-C**