Maharshi Dayanand College of Arts, Science and Commerce, Parel, Mumbai- 12.

Department of Economics

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Topic: market failure, externality, public goods and economic role of Government

Market Failure:

Market failure is bound to happen when price mechanism is inefficiently operating leading to distortion in the stability of demand and supply. Market is not perfect in the real world. Imperfections ridden market results into failure. These imperfections are outcomes of externalities, inefficient production, environmental problems, public goods and so on.

When market failure occur the usual response from the Government includes:

- Legislation (with specific laws enforcing the correction in the system. For e. g. Smoking is banned in the public place)
- Direct provision of merit goods and public goods (Those merits and public goods which have high positive externality Government tries to provide them by itself to the public, For e. g. Education is provided by the government)
- Taxation (Government imposes tax on certain products and services to discourage its consumption. For e. g Tabaco products are heavily taxed)
- Subsidies (Government provides subsidy on certain goods and services which are essential for a society. For example Gas subsidy, Food Subsidy)
- Tradable permits(**The Copenhagen UN Climate Change Summit, 2009** suggested remedy of Emission Trading Market i. e. Tradable pollution permits. It provides an incentive to polluters to 'internalise' the externality. It implies the government, or an appointed agency, selling the right to generate a given quantity of pollution to firms in an industry. These can be bought, and traded.)
- Extension of property rights (it implies certain public goods are handed over as private goods and penalties will be imposed in violation of its natural status.)
- Advertising (in order to encourage or discourage the consumption. For example advertisement to show how Tobaco products are Injurious to health)

- International cooperation among governments (governments work together on issues that affect the future of the environment. For instance **The Kyoto Treaty signed by 156 countries in 1997.)**

Reasons for market failure:

1. Positive and Negative Externalities
2. Environmental concern
3. Provision of Public Goods
4. Merit Goods are Produced lesser than the demand.
5. Monopolization of the production and supply
6. Consumption of the demerit goods from the society keep on rising.

The Government must intervene into the economy when market fails due to any reason. Rather Government should make such laws and implement them to prevent market failure

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Public Goods

Non-Rival in Consumption

Non-Excludability

Over Consumption

Under Production (If Govt is not intervening the production)

Market Failure

Asymmetric Information and Abuse of the Market Power

One party knows more than another concerned party

Either Seller or Buyer influences supply or price of the Product

Externalities

Positive

Negative

Impact of Economic Activities (Consumption and Production) on Unrelated Third Party

Externality:

Externalities occur when the action of one party leads to either benefits or loss to another party in the economy. For instance the production or consumption of a good by one faction of the society cause an impact on third parties not directly related to the transaction.

Externalities are usually the major cause of market failure and it happens in every type of market. Price mechanism of the market do not take into account social costs and benefits of production and consumption.

We can say that externalities are nothing but the spill over effect of production and consumption for which no such appropriate compensation is paid to the affecting people.

Externalities arising due to production and consumption process are either positive or negative.

A negative externality is result of a production and consumption activities that inflicts a negative effect on a third party. In contrast, positive externality is an action of a producer or consumer that provides a positive effect on a third party.

The third parties who bear an external costs of a negative externality do so without their consent, while the individuals who receive external benefits do not pay or contribute into the cost.

For example:

- Air pollution caused by motor vehicles emitting gasses is an example of a negative externality.
- A farmer grows apple trees. An external benefit is that he provides nectar for a nearby beekeeper who gains increased honey as a result of the farmers' orchard.

Externality if it is negative of type it reduces efficiency of the economy as a whole.

Economic Efficiency and Externality:

In economics, the term “economic efficiency” is defined as the use of resources in such a manner to maximize the production of goods and services. A market is said to be economically efficient i.e. optimum utilization of the resources of the economy iff:

- No one can be made better off without making someone else worse off.
- No additional output can be obtained without increasing the amounts of inputs.
- Production is possible at the lowest possible cost per unit.

To internalizing costs and benefits is not always feasible, especially when the monetary value or a good or service cannot be determined. In order to maximize economic efficiency, regulations are needed to reduce market failures and imperfections.

Public Goods:

Public goods are most of the time provided by the Government.
Example for public goods are national defense, public parks, street lights, Railways, National Highways, Flood control or Disaster management system and so on.

Source: Google Image

The expense for providing public goods are met by the government out of taxes. It implies that an individual (with the ability to pay taxes) who avoids or evades taxes enjoy public goods and he became a ‘free rider’.

Pure Public Goods are usually not supplied by the private sector because private sector wont be able to provide such goods without profit. As it is difficult to charge people for benefitting from a good or service once it is provided.

It is up to the government to decide what output of public goods is appropriate for society.

Some goods are semi-public goods. They are also known as quasi- public goods or near public goods. These quasi public goods are semi non rival in nature along with partly excludable.

For Examples:

- Public Parks
- Beaches

Because of changing nature of the technology the private goods and services are becoming public in nature where as public goods are becoming private of type. The distinction settled between public and private goods is thinning day by day.

For example:

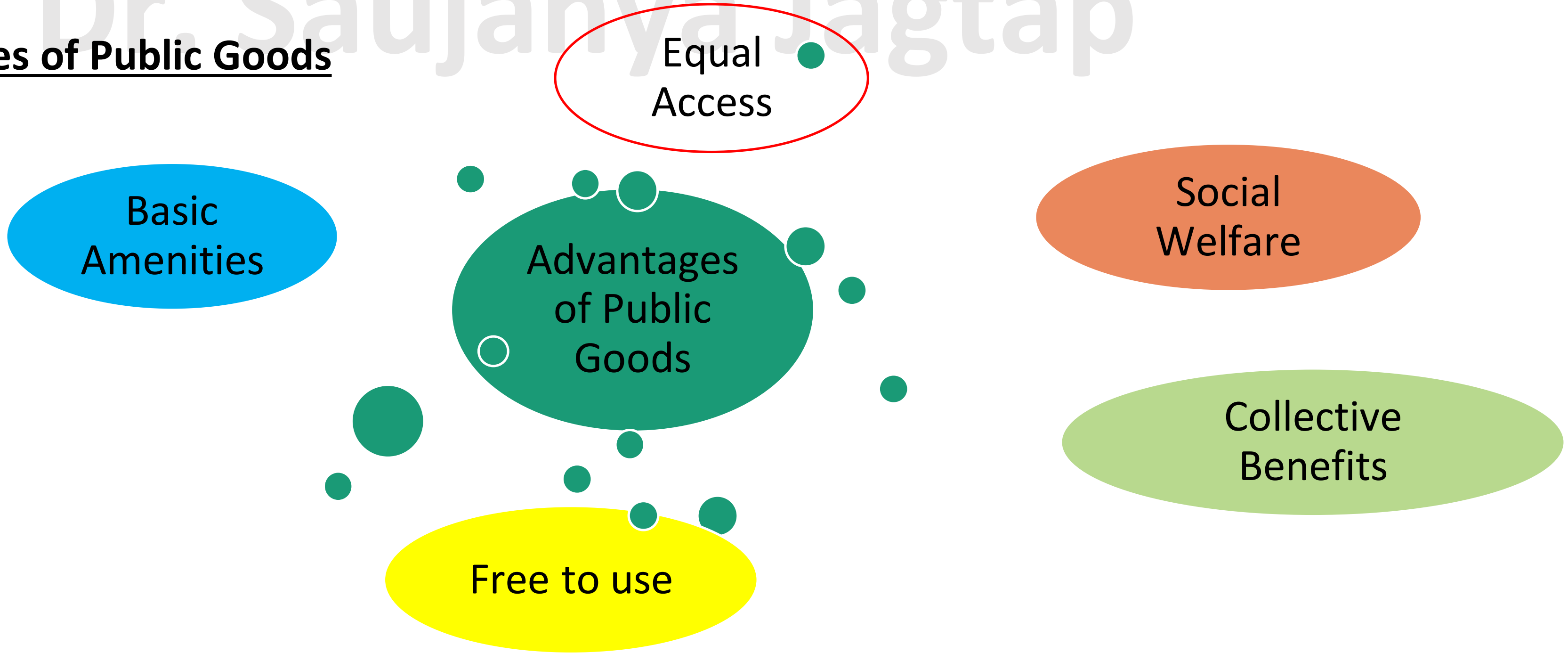
- Cost of smart metering (Road Tax) used on road pricing has reduced the cost charged on users therefore roads are becoming private goods in these years.

Public Goods and Private Goods:

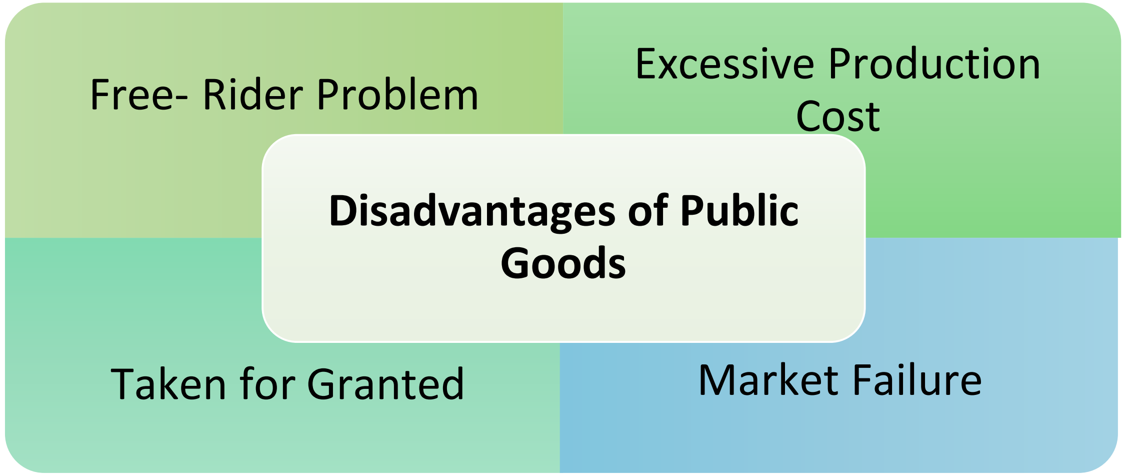
	Rival in consumption	Nonrival in consumption
Excludable	**Private goods** • Wheat • Bathroom fixtures	**Artificially scarce goods** • On-demand movies • Computer software
Non-excludable	**Common resources** • Clean water • Biodiversity	**Public goods** • Public sanitation • National defense

Source: Google Image

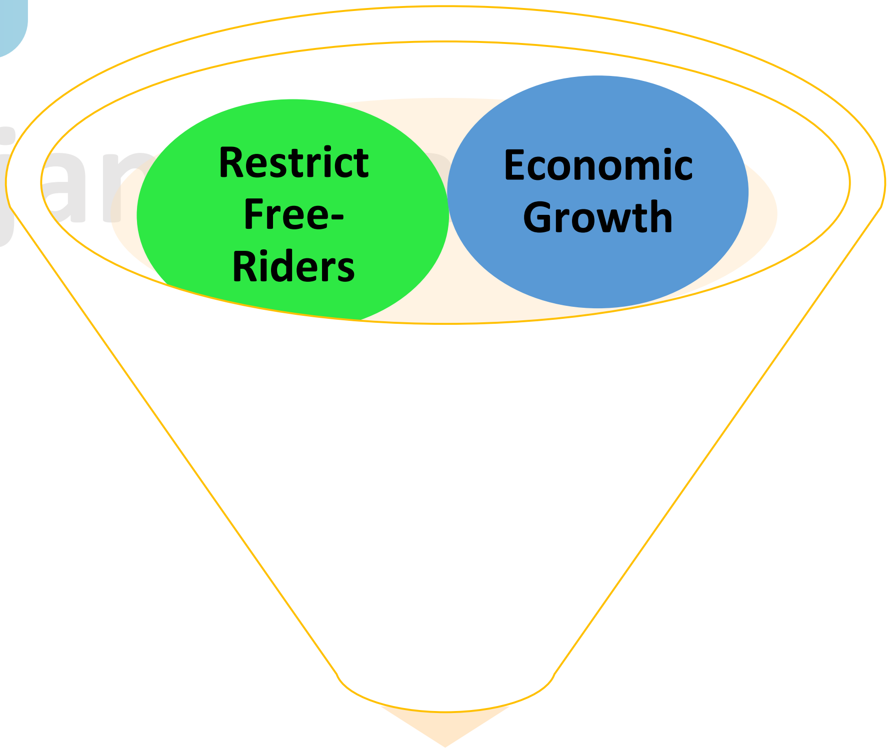
Advantages and Disadvantages of Public Goods



Topic: market failure, externality, public goods and economic role of Government

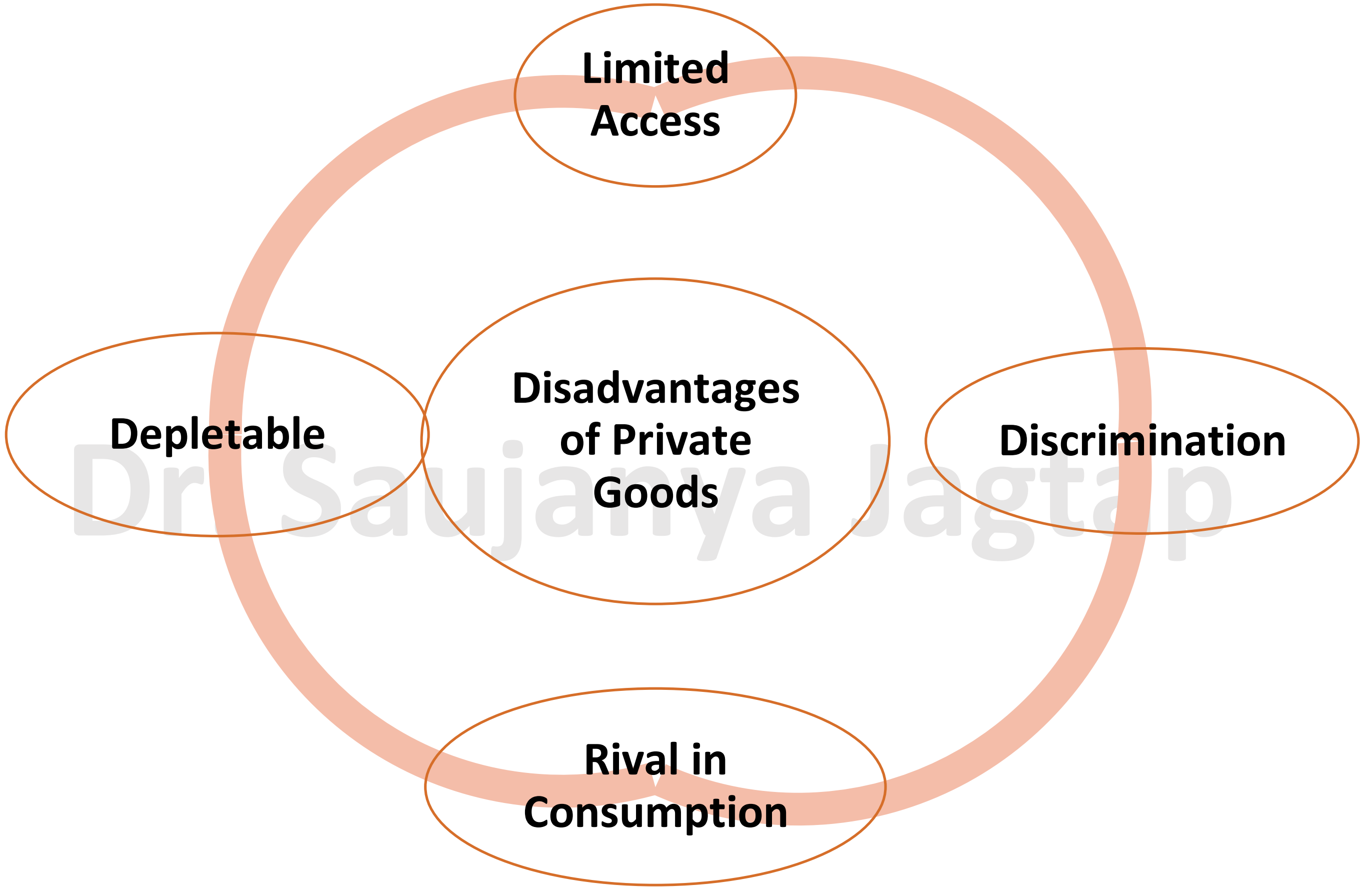


<u>Advantages and Disadvantages of Private Goods</u>



Advantages of Private Goods

Disadvantages of Private Goods



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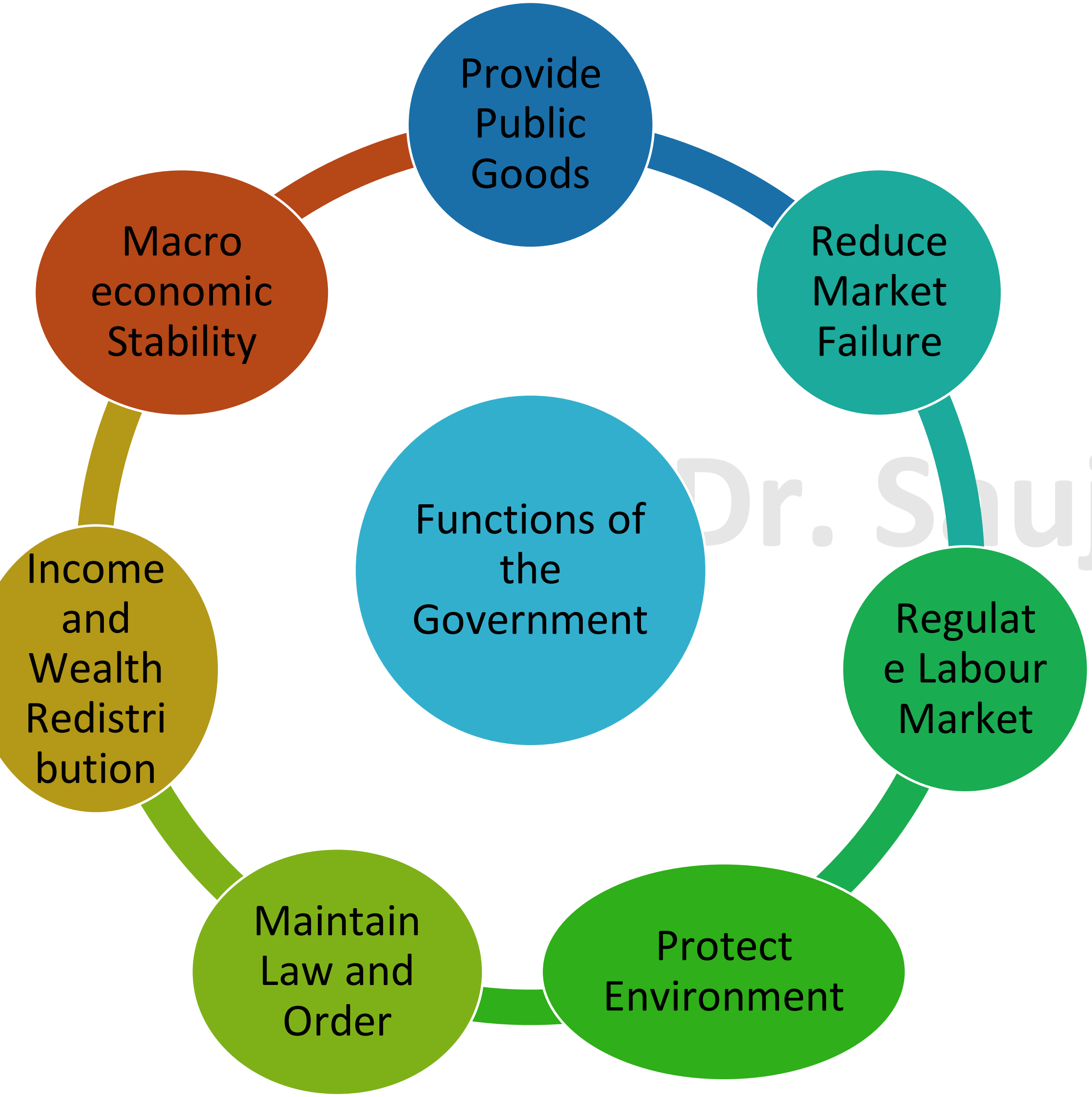
Economic Role of the Government:



If Government has been assigned with minimal role in the economy which is the fact of the market capitalist economies then:

- To address the Market Failure in public goods Government under takes only functions such as
- Providing Defence, Law and Order, Protecting Property Rights
- Macro economic Management, Public Health
- To improve the equality (to protect the poor in Capitalist economies)
- Anti-poverty Programs and Disaster Relief

If Government is actively participating into the economic activities then:

- To address the market failure due to externalities, Monopolisation of the market and asymmetric information problem government undertakes following actions:
- Making Environmental Laws, Providing basic education and regulation regarding protection of the environment
- Framing the Anti-monopoly Policies. (For example: MRTP Act)
- Making Financial regulations to overcome the asymmetric information problem faced by Insurance and Financial sectors.

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When we are reviewing the economic role of the Government in the economy the we must study its Allocation, Distribution, Stabilization and Growth functions in detail.

Allocation Function

- This is most important function in political as well as economic terms
- Allocation or provision of the social goods between private and social use primary function of the fiscal policy
- Social or public goods if provided by private players then negative externality may arises leading to market failure
- Public goods are non rival in consumption and excluding some people from consuming it is not possible, rather it is more expensive.
- So, allocating scarce resources to different sectors is important function of the government

Distribution Function

- Fair and Just distribution of Income and Wealth
- Law of inheritance generates income inequality along with different market forces, so its task of the govt to bring harmony in the society by minimising income gap with various measures.
- For e.g Tax Transfers, Direct Money Transfers, Providing Subsidies on education, healthcare and housing to low income category people of the society

Stabilization function

- Having full employment and low inflation in the economy is major objective
- Both these things won't realize automatically in the system
- Economy either faces unemployment or inflation if timely intervention of fiscal policy is not allowed
- Stagflation could also be the outcome in the economy. This can be targeted with monetary policy, to target either inflation or to encourage economic growth, and fiscal policy directed towards increasing productive investment.

Economic Growth

- Fiscal policy influences consumption, saving and investment pattern in the economy and therefore the rate of capital formation in the country
- So, its effect on maintaining high employment and low inflation must be considered
- Capital formation defines the productive level of the economy

In order to disseminate its role in the economy Government follows Fiscal Policy. The Budget is miniature version of the fiscal policy announced for every financial year.

A budget is an estimation of revenue and expenses over a specified future period of time (mostly for a year)and is usually compiled and re-evaluated on a periodic basis.

In **India** The **Union Minister of Finance** presents budget in the Parliament.

According to **Article 112** of the Indian Constitution, the Union Budget of a year is referred to as the **Annual Financial Statement.**

It is a statement of the **estimated receipts and expenditure of the Government** in a financial year (which begins on 1st April of the current year and ends on 31st March of the following year). In addition to it, the Budget comprises:

- Estimates of revenue and capital receipts,
- Ways and means to raise the revenue,
- Estimates of expenditure,
- Details of the actual receipts and expenditure of the closing financial year and the reasons for any deficit or surplus in that year, and

- The economic and financial policy of the coming year, i.e., taxation proposals, prospects of revenue, spending programme and introduction of new schemes/projects.

Changes introduced in 2017

1. **Advancement** of Budget presentation to February 1st (earlier it used to be presented on the last working day of February)
2. **Merger** of Railway Budget with the General Budget
3. Doing away with **plan and non-plan expenditure.**

Different Types of Budget

1. Surplus, Balanced and Deficit Budget
2. Revenue and Capital Budget
3. Performance Budget or Outcome Budget
4. Zero Based Budget
5. Gender Budget

THANKS