

# Economics for Business Environment

## *Unit 6*

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# Lecture Outline

- ① Introduction
- ② Efficiency
- ③ Market Failure
- ④ Government Intervention
- ⑤ Conclusion

## Last Time

- Last time we talked about the different types of market structures
- From perfect competition to monopoly we analysed how the equilibrium is achieved
- In perfect competition firms are price takers. There are many firms in the market and the product is identical so no firm has power over the price of the good.
- But the assumptions for perfect competition are not realistic.

## Last Time

- In monopolistic competition, products are similar but not identical and firms have power over the price.
- In oligopoly we have a small number of firms operating in the market. They have enough power to set their price. They can compete with each other, or act as a single firm and gain monopoly power (cartel).
- In monopoly there is only one firm in the market. Monopolies are the result of high barriers due to the nature of the product. Monopolies have the power to charge any price.

# Today

- Do firms meet the interest of consumers and the society?
- Does achieving equilibrium in a free market automatically achieve the best outcome for society?
- How governments intervene in markets?
- Is government intervention effective?

# Learning Outcome

- Market failures
- Market Efficiency
- Government intervention

# Efficiency under perfect competition

## Private efficiency

The consumer or the firm are acting "rationally" when:

- Expanding activity if  $MB > MC$
- Contracting activity if  $MC > MB$

## Marginal Benefit and Marginal Cost

### Marginal Benefit (MB)

The extra benefit you get if you change your activity by one unit.

### Marginal Cost (MC)

The extra cost you face if you change your activity by one unit.

The person acts efficiently in his or her own private interest if:

$$MB = MC$$

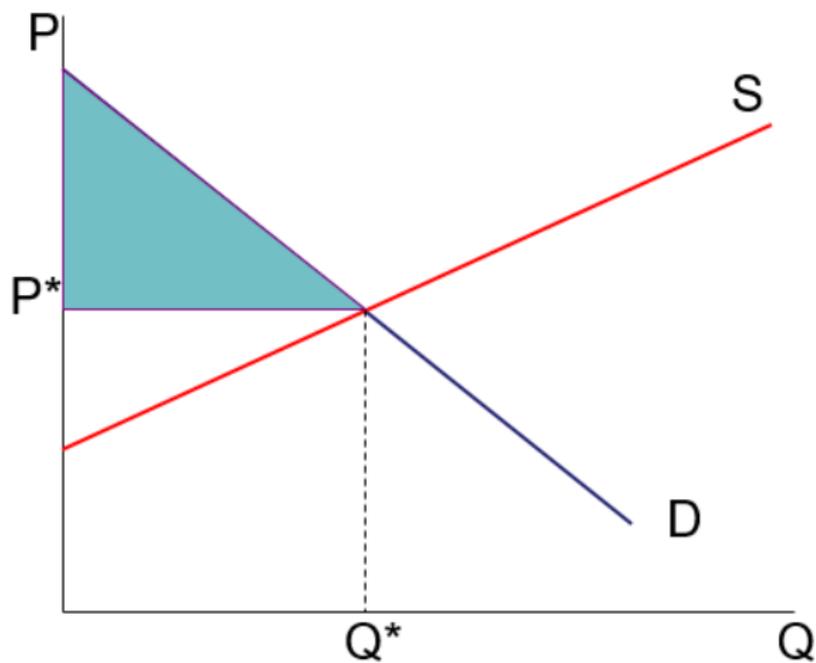
## Efficiency and Perf. Competition

- Perfect competition will ensure private efficiency is achieved:  
 $MB = MC$
- No externalities, all costs and benefits are included in the price of the product.
- $MSB = MB = MC = MSC$

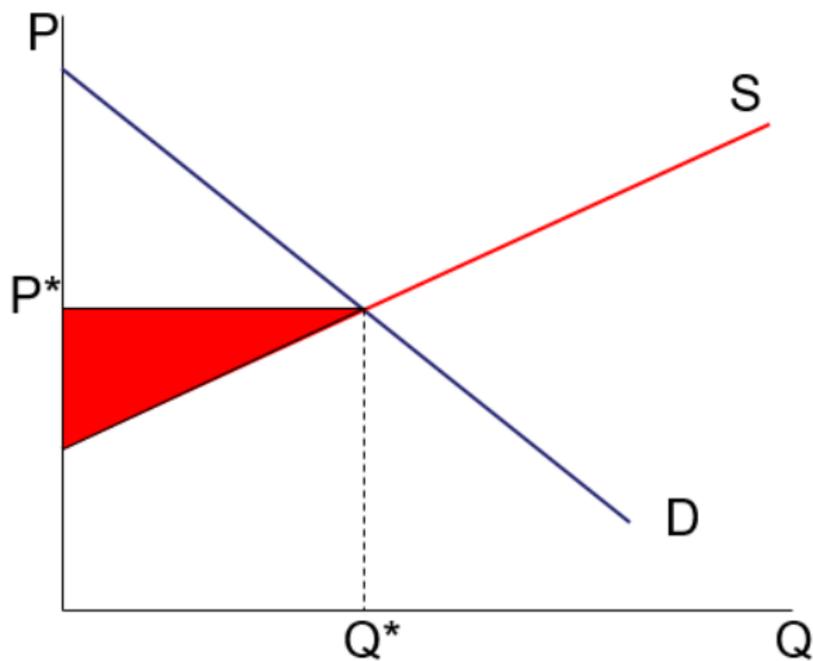
## Social efficiency

- *Consumer surplus (CS)* is the difference between the price that the consumer has to pay for a good and what he is willing to pay.
- *Producer surplus (PS)* is the difference between the price that the producer receives for the good and what he must receive to provide the good.
- Social welfare =  $CS + PS$

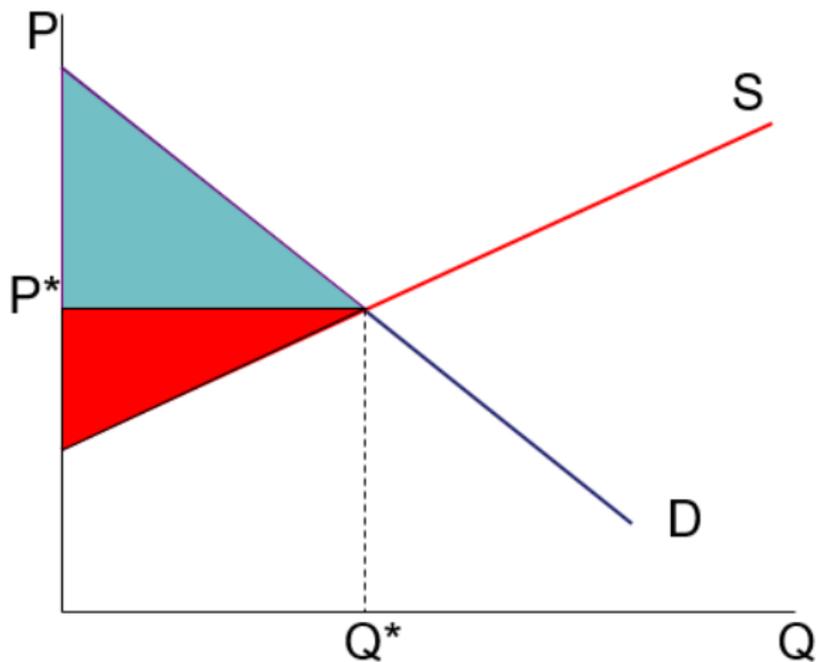
## Consumer Surplus



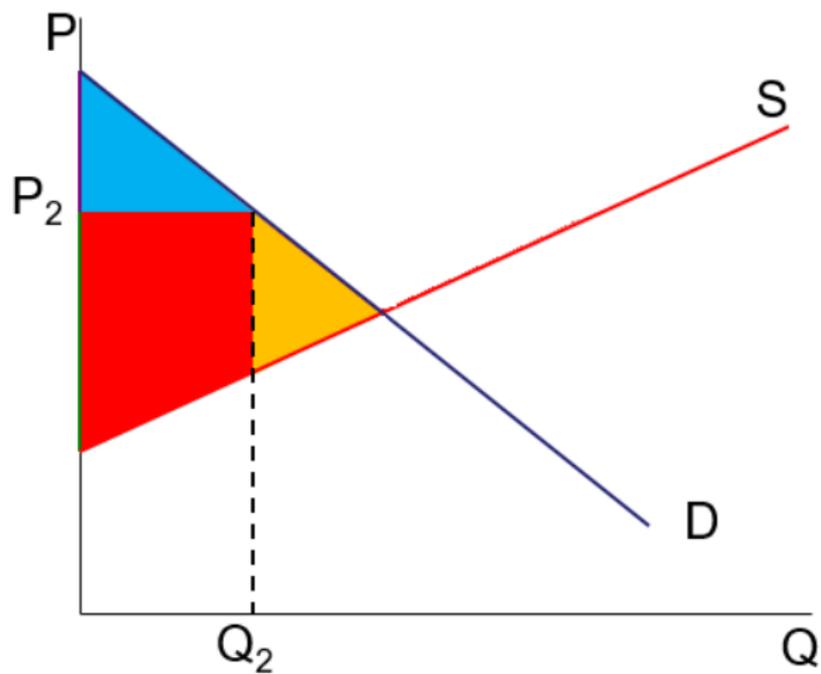
## Producer Surplus



## Total Surplus



## Inefficiencies



## Inefficiencies

- In case of inefficiencies the price is not at the equilibrium level.
- The yellow area is called **deadweight loss**
- **Deadweight loss** is a loss of economic efficiency that can occur when equilibrium for a good or service is not achieved or is not achievable.

## Social efficiency

### Pareto optimality

A Pareto optimal outcome is one such that none could be made better off without making someone else worse off.

This means that resources are allocated efficiently, e.g. we produce the maximum possible with some specific resources.

## Social efficiency

### Pareto Improvement

A reallocation of resources that makes at least one person better off without making anyone else worse off

## Definition

### Market Failure

Market failure refers to situations in which the market, absent government intervention, leads to inefficiencies.

Refers to a situation where the quantity of a product demanded by consumers does not equate to the quantity supplied by suppliers. This is a direct result of a lack of certain economically ideal factors, which prevents equilibrium.

- The allocation of goods and services is not efficient

# Market Failure

Markets can fail to be efficient:

- Insufficient Competition
- Externalities
- Public goods

And Markets can be unfair:

- Inequality
- Poverty

# Externalities

Some economic activities have effects that may not be intended, i.e. the effect of things I do or produce do not fully capture the benefit. These effects are called externalities.

- **Positive externalities** are benefits that are infeasible to charge to provide
- **Negative externalities** are costs that are infeasible to charge to not provide

**Example:** Pollution or education.

# Externalities

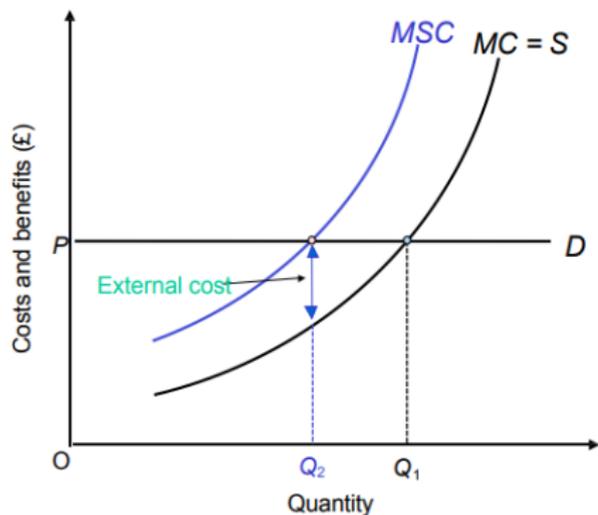
## Externalities

Externality is the cost or benefit that affects a party who did not choose to incur that cost or benefit.

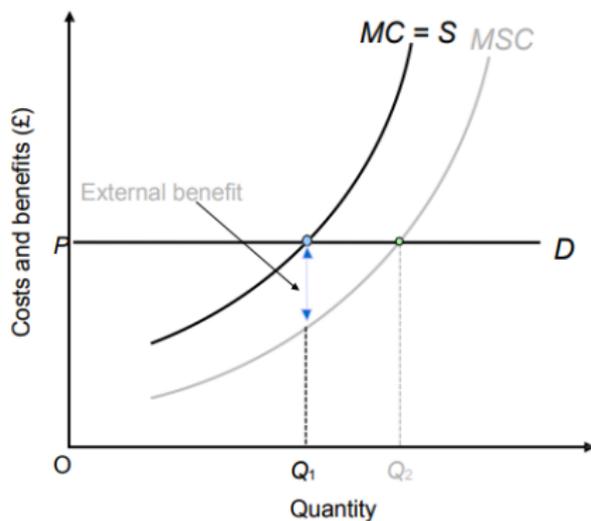
To overcome externalities, we require some form of government intervention

- **Tax.** To reduce consumption of negative externalities, we can place a tax on goods with negative externalities
- **Subsidy.** To increase consumption of positive externalities, we can place a subsidy on these goods.
- **Regulation.** The government may place regulations which limit the amount of pollution

# Externality and Supply

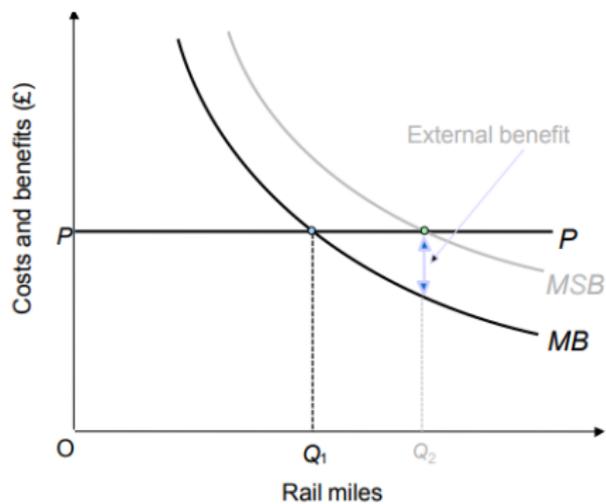
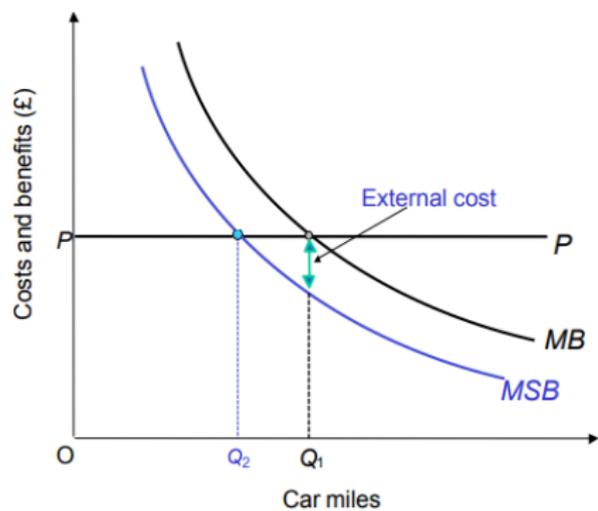


(a) External costs



(b) External benefits

# Externality and Demand

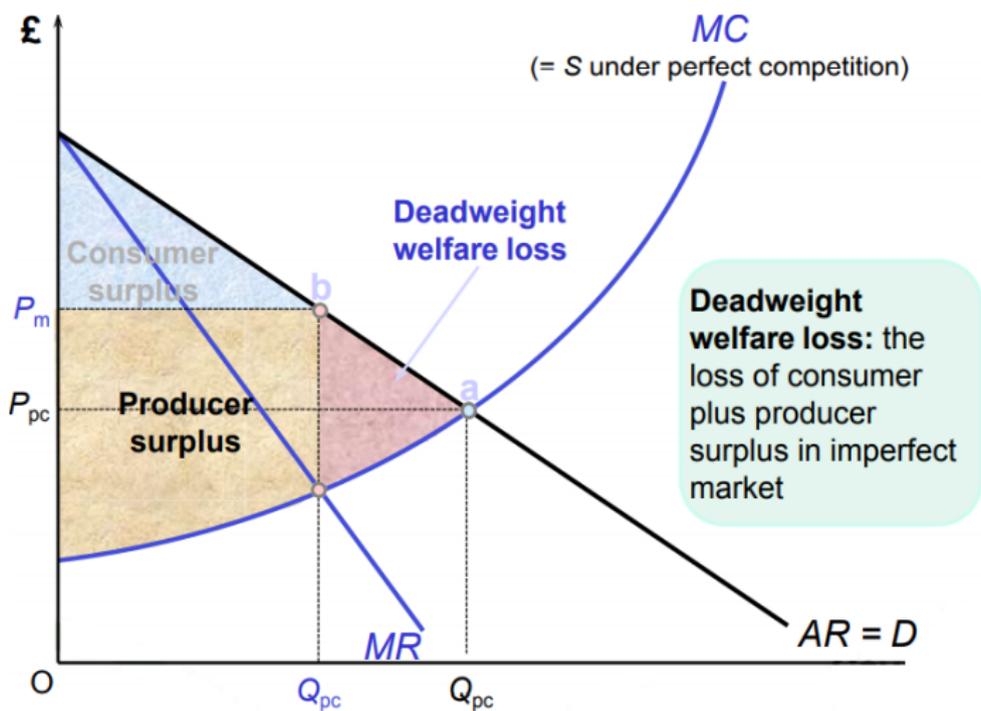


# Government Intervention

Government can intervene to correct inefficiency.

- Market power
- when markets are imperfect, i.e. monopoly
- government can use taxes or regulations

# Deadweight Loss in Monopoly



# Government Intervention

## Public goods

- Because public goods are non-excludable it is difficult to charge people for benefitting once a product is available
- The free rider problem leads to under-provision of a good and thus causes market failure with public goods, private sector markets may fail to supply in part or in whole the optimum quantity of public goods

# Government Intervention

## Common resources

- Not owned but are available free of charge to anyone
- Non government intervention will result overuse of these common resources

Example: the rain forest, fish stocks

# Government Intervention

## Other cases

- Ignorance and uncertainty
  - the problem of asymmetric information
- Protecting people's interests
  - the principal–agent issue
- Merit goods
  - goods and services that the government feels that people will under-consume, e.g. education

# Forms of Government Intervention

## Other cases

- Price controls
  - high minimum prices
  - low maximum prices
- Direct provision of goods
  - providing public goods
  - other goods
- Taxes and subsidies
- Legal controls
- Regulatory bodies
- Provision of information

# Government Intervention

## Drawbacks of government intervention

- shortages and surpluses
- poor information
- bureaucracy and inefficiency
- lack of market incentives
- shifts in government policy
- lack of freedom for the individual

## Advantages of the free market

- automatic adjustments
- dynamic advantages of capitalism
- high degree of competition even under monopoly/oligopoly

## Conclusion

- Review today's lesson.
- Read the relevant chapters in the book (Including all boxes and case studies)
- Search online for more sources.
- Ask questions in seminar if anything is unclear.
- Do self-test questions at the end of the chapter and online.