Sophia

Regulatory Intervention and Market Failure

by Sophia Tutorial

WHAT'S COVERED

This tutorial will cover regulatory intervention and market failure, focusing on why and when markets fail and how government regulation attempts to address that failure.

Our discussion breaks down as follows:

1. Market Failure
2. Externalities
   a. Negative
   b. Positive
3. Government Regulation
   a. Government Failure

1. Market Failure

Taking a step back, we know that in most cases, free markets function wonderfully, because producers have profit motive to provide consumers with what they want at prices they are willing to pay.

Therefore, generally speaking, unregulated, free markets with no government intervention produce the best outcome that will maximize overall welfare as a society.

When we allow the free market to function on its own, it allows for trade between buyers and sellers.

When the market reaches equilibrium, both consumers and producers are better off and there is no dead weight loss, as indicated by a welfare analysis that shows us how big consumer and producer surplus are.

However, sometimes a market fails to produce the efficient allocation of goods and services for various reasons, which is known as a **market failure**.

Market failure is defined as a situation where the free market does not create an optimal situation between those demanding a good or service and those supplying a good or service.

Market failures are generally addressed through government intervention.

TERM TO KNOW

Market Failure
A situation where the free market does not create an optimal situation between those demanding a good or service and those supplying a good or service. Market failures are addressed through government intervention.

2. Externalities

One of the biggest reasons why markets fail is due to **externalities**, which are either costs or benefits that accrue to third parties who do not participate in that particular market.

These effects of a good or service to a third party can be negative or positive.

2a. Negative

Let's look at some examples of negative externalities, where a third party has to absorb the cost of a good or service.
Consider pollution, for instance. Have you ever been driving behind a truck that is emitting toxic fumes? You are, in essence, paying for that pollution. You have to experience it and you have nothing to do with that company or market or truck driver--but you are stuck behind it.

Secondhand smoke is the same thing, when you are a non-smoker and you have to be around it.

Or, have you ever been subjected to noisy or messy neighbors? In this case, you are the third party paying the cost of somebody or something else.

IN CONTEXT

Suppose a company knows that its production process will emit some levels of pollution. They can decide how much to pollute versus how "green" to make their process.

Producing cleanly is, generally speaking, more expensive, so when they decide whether to "go green" or not, they will weigh costs and benefits to make the most efficient decision for their company. This cost benefit analysis is what any rational firm or individual would do.

Unfortunately, this process leaves something out that is very important. The company does not take into consideration how their pollution will impact the people living downwind.

They are looking at their own costs and benefits of this decision, but they are not considering this third party.

These people will face higher health care costs; they have nothing to do with this market, yet they are faced with the "cost" of the company's pollution.

The company's decision--and pollution output--neglects to take these third party costs into consideration, and for that reason, an inefficient amount of pollution will be produced.

2b. Positive

The positive externalities are the opposite. These are benefits of a good or service to a third party.

EXAMPLE One example is the flu vaccine. If you get the flu vaccine, that actually benefits other individuals, even if those other people choose not to get it, because now they can't get the flu from you. They are not involved in your decision, yet they still benefit from you getting the flu vaccine.

Environmental cleanup is the opposite of what we just talked about. If a company decides to clean up their act and stop polluting as much, many other people are going to enjoy the benefits of that action, even though they didn't pay for it.

So, without government regulation, these positive externalities tend to be underproduced, and negative externalities, unfortunately, tend to be overproduced.

Again, this is because when companies or individuals go through that cost benefit analysis, they are not correctly identifying the *true* costs or benefits.

TERM TO KNOW

Externality
The effects of a good or service to a third party; can be negative or positive

3. Government Regulation

Often, government regulation is suggested as a way to reduce especially negative externalities.

EXAMPLE For instance, in the case of secondhand smoke, in many places it is illegal to smoke in almost all restaurants and bars. Another way of preventing secondhand smoke from becoming a third party cost is to tax cigarettes. Taxes are extremely high on cigarettes, which is meant to curb people's consumption of them.

With pollution, laws can be passed that put pollution limits in place, or impose pollution taxes to encourage companies to "go green."

Consumers and firms weigh costs and benefits when making decisions, and estimating the costs of negative externalities like pollution and the benefits of regulation can be difficult.

Unfortunately, this makes the "optimal" amount of regulation difficult to estimate.

Keep in mind that any regulation takes place through a political process, which is an imperfect process.

Politicians are supposed to keep in mind what is in society's best interest, but we know that sometimes their own interests and their own constituents can cloud what is in society's best interest.

3a. Government Failure

The political process can sometimes lead to **government failure**, which is a situation involving government intervention that results in increased inefficiency in the allocation of goods and services.

The goal of any government regulation is to use the regulation to reduce market failures. However, we need to understand that because of that imperfect political process, it may be worse than the market failure.

We hope that this is not the case, but unfortunately, sometimes it can be.

TERM TO KNOW

Government Failure
A situation involving government intervention that results in increased inefficiency in the allocation of goods and services

SUMMARY

Today we learned that **market failure**occurs whenever there is an inefficient allocation of goods and services. We learned that **externalities** cause market failure due to overproduction or underproduction, and they can be either **negative** or **positive**. Lastly, we learned how **government regulation** attempts to address market failure, but unfortunately, can sometimes make the outcome even worse, resulting in a situation known as **government failure**.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Externality
The effects of a good or service to a third party; can be negative or positive.

Government Failure
A situation involving government intervention that results in increased inefficiency in the allocation of goods and services.

Market Failure
A situation where the free market does not create an optimal situation between those demanding a good or service and those supplying a good or service. Market failures are addressed through government intervention.