


Causes of Market Failure

- Externalities 
- Decreasing costs
- Public goods
- Imperfect information/ asymmetric information
- Non-competitive practices: contracts/collusion

Term Definition:

Externalities occur when "... an activity of one entity affects the welfare of another entity in a way that is outside the market. In other words, an 'externality' exists when the market price of a good does not reflect its true benefit or cost to society.

Externalities – What is the Problem?

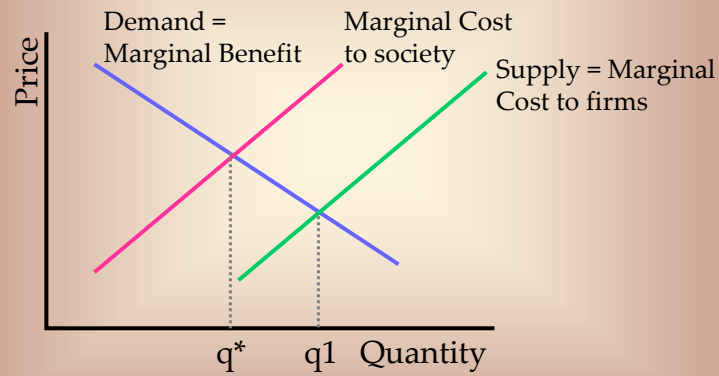
“An *externality* exists when an economic agent is affected by the activity of another agent without being a direct party to that activity”.

Some simple examples: if I burn a pile of leaves on my property, the smoke from the leaves blows into your yard where you are having an outdoor party. My burning of the leaves has imposed an *external cost* on you. You were affected by the leaf burning without being directly involved.

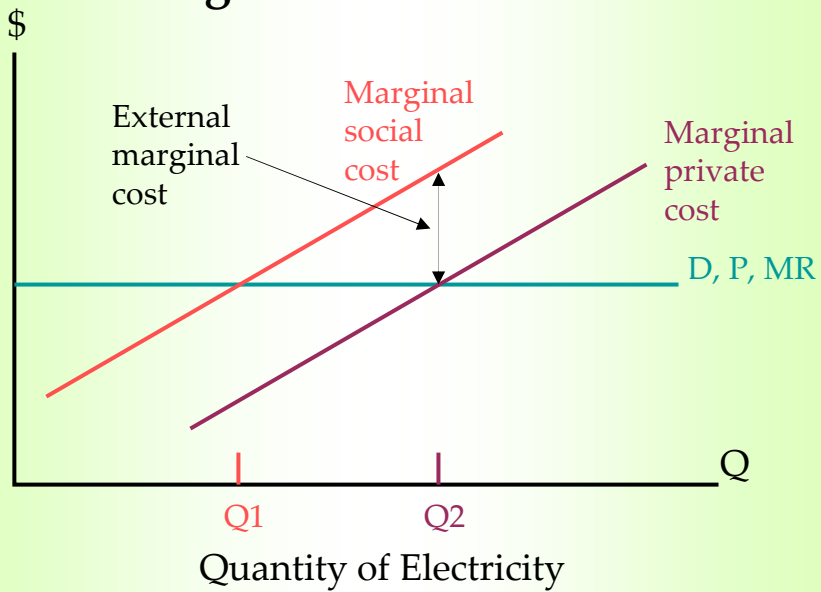
Negative Externalities

- Externalities are “external effects,” i.e. cost & benefits external to the pricing system.
- Negative externalities are costs that do not get incorporated into prices.
- Example: The cost of pollution is not included in the purchase price of a car.

With externalities, some effects of decisions are ignored by those making decisions, so results are not optimal.

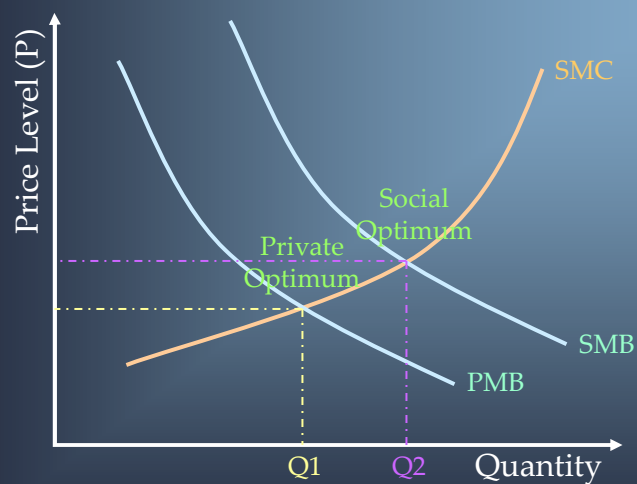


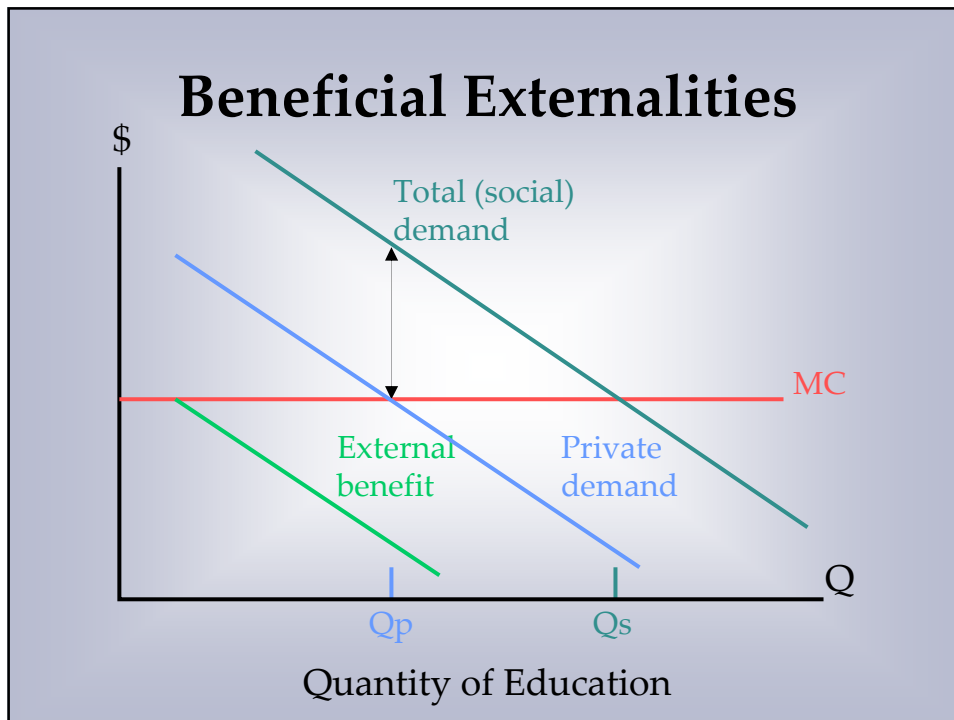
Negative Externalities



Positive Externalities

When you produce or consume a commodity or service within your private property rights that bestows a benefit on a third party not directly involved in the market transaction.





What should we do about it?

⇒ Rationale for government intervention

Q: What kinds of policies?

Policy Options

1. State provision
2. Pigovian tax
3. Coase solution
4. Laws, regulations, standards
5. Moral suasion

Coase and Externalities

- **Bee and Plant-Grower Example**
 - Bees provide positive externality of pollination
- **Consequence/Solutions**
 - Traditional
 - Inefficiently few bees and plant growers
 - Coasian
 - Private contracts between growers and bee keepers that internalize the externality



Coase and Public Goods

- Lighthouse Example
 - Pure public good
- Consequence/Solutions
 - Traditional
Public supply
 - Coasian
Private supply
Fees in local ports



Public Goods

- Non-rivalry
- Non-excludability
- Private good $\sum X = X_A + X_B + \dots + X_N$
- Public good $\sum Y = Y_A = Y_B = \dots = Y_N$

| | | Rival? | |
|-------------|-----|------------------|----------------------------|
| | | Yes | No |
| Excludable? | Yes | Private goods | Club goods eg. Cable TV |
| | No | Roads? Parks? | Pure public goods |

Local public goods
Semi-public goods

Public Goods

- A pure public good is a good or service that can be consumed simultaneously (nonrival) by everyone and from which no one can be excluded (nonexcludable).

- Public radio

- National defence

- Some goods have a “public” element. For example, a highway may be a public good until it becomes so congested that additional cars lower the quality of services available to everyone else.

Public Goods Production

• Private companies will under-produce public goods because free-riders will not pay them the value the free-riders receive from the goods. As a result, we either

- turn to public production (defense)
- or allow private companies to exclude free riders from consuming the goods – i.e. convert otherwise public goods to private goods. (Scramble TV signals)



| Research Hypotheses | Supporting Literature |
|--|--|
| H1: An altruistic personality would be positively related to membership to GPTV | Andreoni (1988, 1990), Oswald and Hoff (1975) |
| H2: Collectivism will influence free riding in such a way that collectivism will be positively related to membership to GPTV | Triandes (1995), Wagner (1995) |
| H3: Identifiability will influence contributing in such a way that individuals looking for a high level of identifiability are more likely to be members of GPTV | Glazer and Konrad (1996), Wagner (1995), Olson (1965), Ostrower (1996) |
| H4: Perceived need is positively related to membership to GPTV | Smith and Berger (1996), Olson (1965), Doves et al. (1986) |
| H5: Feelings of guilt and shame are positively related to membership to GPTV | Ostrower (1996), Andreoni (1988) |
| H6: Religiousness is positively related to membership to GPTV | Pessemier, Beanmmaor, and Hansen (1977), Burnett(1981) |
| H7: The level of education is positively related to membership to GPTV | Burnett (1981), Jenks (1987), Magat (1989) |
| H8: Income is positively related to membership to GPTV | Zalesky and Zech (1992), Jenks (1987), Drollinger and Johnson (1987) |
| H9: Itemizing on income tax return is positively related to membership to GPTV | Boskin and Feldstein (1977), Magat (1989) |
| H10: Age is positively related to membership to GPTV | Reese (1979), Auten and Rudney (1989), Jenks (1987) |
| H11: Frequency of use is positively related to membership to GPTV | Ostrower (1996), Marwell and Ames (1979) |
| H12: Perceived quality is positively related to membership to GPTV | Rotfeld (1998), Postrel (1998) |

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