Starting Policy Analysis:
Market and Government Failures

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Weimer and Vining, Policy Analysis, 5th Edition, Longman, 2011. Chs. 5 - 8

Questions to ask

▸ Is your project (or policy) sustainable?

  ▸ Financial feasibility:

    ▸ Example: Is the subway project financially sustainable? Can the government provide a sufficient amount of subsidy?

  ▸ Political feasibility

▸ Are there market failures that may justify public interventions?

▸ Are there government failures that require improvements?

  ▸ Can the government failure be corrected directly?

  ▸ Are there any policies that reduce the social costs of the government failures?

Fundamental Theorem of Welfare Economics

▸ Fundamental Theorem of Welfare Economics (First):

  ▸ Competitive equilibrium for all goods and bads → Pareto optimum
    (No one can be made better off without making somebody worse off.)

▸ Assumptions

  ▸ Prices exist for all goods and bads

  ▸ Both demanders and supplier are price takers

  ▸ Buyers and sellers have the same information in all markets

▸ Prerequisite

  ▸ Meaningless if a competitive equilibrium does not exist.

  ▸ Consumers and producers are rational (optimizing given consistent preferences)

▸ Pareto optimality

  ▸ Equity issues are ignored.

Market failure

▸ Externality: missing markets, no prices for some goods and bads

▸ Public goods: collective consumption, nonexcludability

▸ Asymmetric information: One side of the market has more information than the other.

▸ Scale economy (Nonconvexity)

  ▸ Monopoly: Networks (water, sewage, electricity, roads, railway, gas, etc.)

  ▸ Small number of suppliers: Oligopoly

  ▸ Large number of suppliers with product differentiation

    ▸ Urban agglomeration economies

▸ Equity

  ▸ Poverty, Crime

▸ Irrational behavior

  ▸ Behavioral economics, Economic Psychology

Government failure

▸ Example: Urban policy (Mass transit investment, Land use regulation, etc.)

   ▸ A policy maker cannot fully understand complicated economic activities in a city

   ▸ Political decision making is imperfect: Example) rigidity in land use regulation

   ▸ Corruptions and distorted incentives of policy makers and government empoyees

▸ Market failure and government failure

   ▸ Case-by case evaluation of social benefits and costs of policy intervention is necessary

   ▸ Variety and complexity in policy design

      ▸ Example: policies to deal with market failure caused by asymmetric information about housing quality

         □ Quality regulation (building standards); Supply of quality information by private organization, e.g., consumer's union; Quality guarantee by producers; Product liability law

Second Best

▶ **Unavoidable market distortions**

  ▶ Prices often do not equal the Marginal Social Costs

    ▶ Taxes, Medical insurance, Nursing-care insurance, Externalities, Government regulations, Monopoly power, Asymmetric information

  ▶ Policy examples: Income tax distortions might justify subsidies on child care; Health insurance might justify a subsidy on health check; Monopoly power distortion in urban production might justify a subsidy on intra-urban transportation

▶ **How to design and evaluate second-best policies?**

  ▶ Must consider the impacts on the existing distortions

  ▶ Harberger's measure of excess burden