Chapter 2

When is a Market Socially Optimal?

Contents:

Basic Definitions

Competitive Economy: An economy that consists of many small economic units, each with no market power.

Pareto Optimal: A resource allocation such that you cannot improve any individual's welfare without hurting the welfare of at least one other individual. Such resource allocations are said to be efficient.
Kaldor-Hicks criterion: potential Pareto improvements. Basis for Cost-Benefit analysis.

The Main Theorem of Welfare Economics: A competitive economy will result in a Pareto optimal resource allocation when:

- Full information exists
- No externalities exist
- There are no increasing returns to scale in technology

Potential Reasons for Government Intervention in the Market

- Facilitate information flow
- Manage externalities
- Provide public goods
- Adjust income distribution
- Manage non-competitive behavior

Government Policies to Disseminate Information

- Education and extension
- Public supported media and information delivery
- Collection and distribution of price and other economic data
- Labeling requirements (truth-in-advertising policies)

Externalities

Externalities exist when the activities of one or more agents affect the preferences or technologies of other agents. When externalities occur, markets may lead to suboptimal outcomes.
Negative externalities (i.e. pollution) reduce utility or productivity. Positive externalities (i.e. bees and pollinating trees) increase utility or productivity. Production externalities (i.e. smoke from a factory decreases the productivity of a nearby "air-dry" laundry) occur when the productivity of an individual is affected by activities of others. Consumption externalities (i.e. noise pollution) occur when the welfare of some individuals is affected by the consumption activities of other individuals.

Public Goods

Public goods are goods that cannot be charged for because of open access and use by many people. Public goods are characterized by two features:

1. Nonrivalry: can be consumed concurrently by more than one individual. MC=0 of adding another consumer
2. Nonexcludability: can be accessed freely

Examples of Public Goods:

- Knowledge from education and public research
- National Security
- Parks
- International Trade Agreements
- Infrastructure, such as roads, bridges, etc. (congestion)
- Environmental Amenities, such as clean air

Transfer Policies

Transfer Policies are policies designed to change the distribution and/or wealth in society.

Examples of transfer policies:

- Income taxes
- Inheritance taxes
- Social Security
- Medicare, Medicaid, and AFD
- Tax breaks of various kinds to corporations
- Subsidized loans for home buying

Noncompetitive Behavior

There are many forms of noncompetitive behavior including the following three forms as the extremes:

Monopoly: One-agent controls supply of a good.
Monopsony: One agent controls demand for a good.
Middleman: One agent buys the product from the supplier to sell to demanders.