When is a Market Socially Optimal?

· **Competitive Economy:** An economy which 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 at least one other individual. Such resource allocations are said to be **Efficient**.

· **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 Gov't Intervention in the Market

1. Facilitate information flow
2. Manage externalities
3. Provide public goods
4. Manage non-competitive behavior
5. Adjust income distribution

Gov't Policies to Disseminate Information

1. Education and extension
2. Public supported media and information delivery
3. Collection and distribution of price and other econ data
4. 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.

Negative externalities reduce utility or productivity.

- pollution

Positive Externalities increase utility or productivity.

- bees and pollinating apple trees

Production Externalities occur when the productivity of an individual is affected by activities of others.

- smoke from a factory decreases the productivity of a nearby "air-dry" laundry

Consumption Externalities occur when the welfare of some individuals is affected by the consumption activities of other indivduals.

- noise pollution

Public Goods

Public Goods are characterized by two features:

Nonrivalry: can be consumed concurrently by more than one individual

Nonexcludability: can be accessed freely

Examples of Public Goods

- Knowledge from education and public research
- National Security
- International Trade Agreements
- Infrastructure, such as roads, bridges, etc.
- 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 AFDC
- Tax breaks of various kinds to corporations
- Subsidized loans for home buying

Welfare Analysis

Welfare analysis is a systematic method of evaluating the economic implications of alternative resource allocations.

Welfare analysis answers the following questions:

- Is a given resource allocation efficient?
- Who gains and who loses under various resource allocations and by how much?