Policies to achieve Efficient Resource Allocation

A2 Economics

Market Failure

- What is market failure?

When free markets/private sector fails to achieve economic efficiency concerning the use of economy's resources.

Market Failure

- Why is market failure a cause of concern for economies' governments?

Since all economies are faced with the problem of scarcity (desire to achieve unlimited wants/needs with finite amount of resources), economic efficiency is the best possible solution to basic economic problem.

- Why is monopoly considered to be a case of market failure?

Monopoly being the least competitive market structure results in economically inefficient use of economy's resources.

Apart from under-production of goods/services produced by monopolistic markets which prevents achievement of Allocative Efficiency, monopolistic firms also often fail to achieve productive efficiency.

Monopolies and Market Failure

- Since monopolists do not produce at a quantity where P=MC and instead they maximize their profits by producing at an output that corresponds to MR=MC quantity; they are Allocatively Inefficient.
- Moreover since monopolies do not face the threat of losing market share by being Productively Inefficient, they are often not producing at their lowest possible ATC curve.

Deadweight Loss

- Loss of economic welfare due to under-production of any good/service is known as deadweight loss. Net loss of consumer and producer surplus is known as deadweight loss.

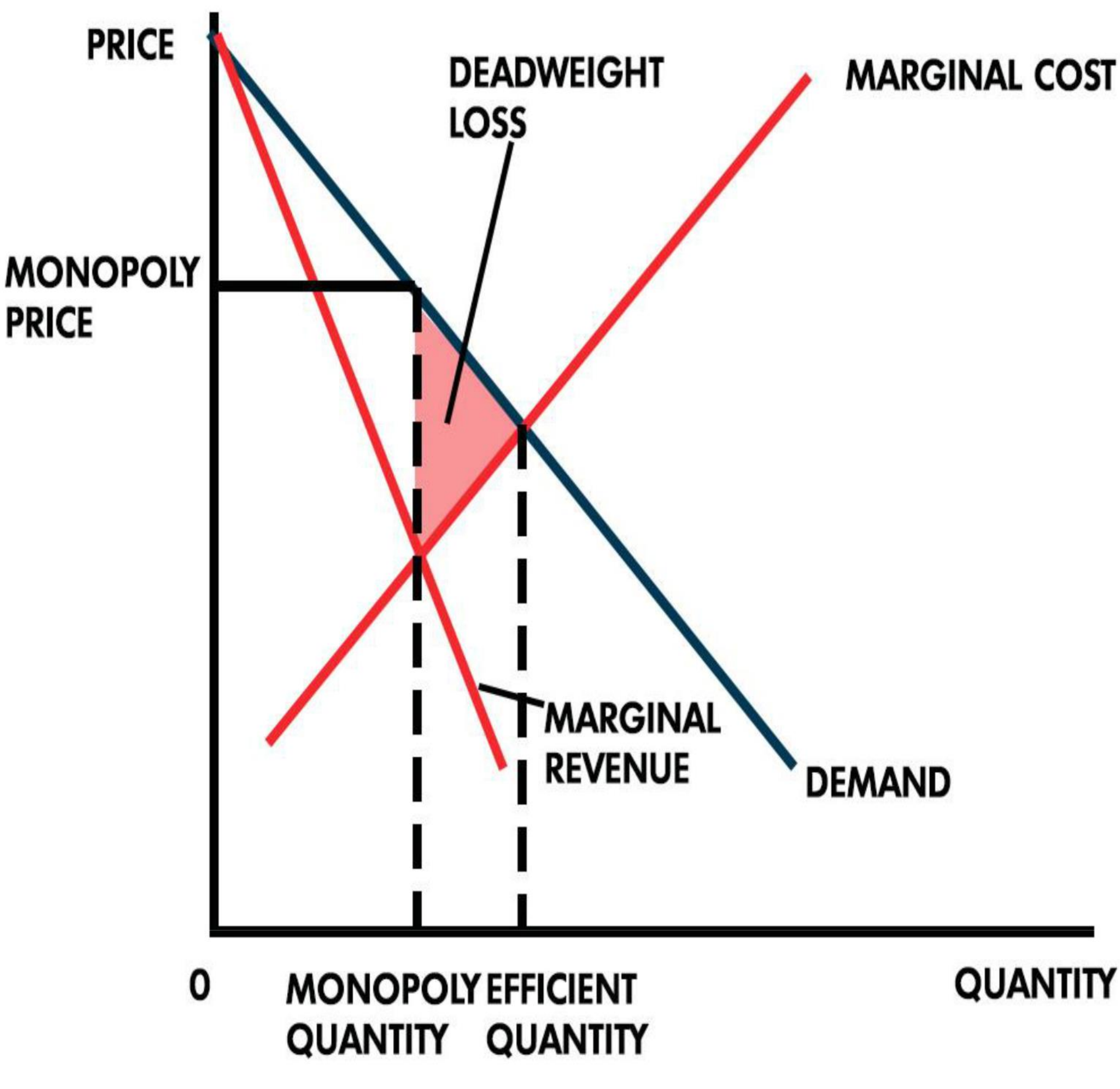
- Deadweight loss is another indicator of market failure other than economic efficiency.

Deadweight Loss

- At times government intervention results in creation of deadweight loss and hence economic theory is clueless at analyzing such examples of market failure.

Deadweight Loss in Monopolies

FIGURE 8 THE INEFFICIENCY OF MONOPOLY



Government Regulations for Monopolies

- **Legislation that outlaws formation of monopolies:** Apart from monopolies formed due to patents/copyrights known as legal monopolies governments can control formation of other types of monopolies. For instance through legislation regulatory bodies can restrict potential mergers/take-overs that are expected to create monopolies.

Government Regulations for Monopolies

- Legislation that restricts certain type of monopolistic behavior: For instance Predatory Pricing strategy might be classified as anti-competitive by regulatory authorities and hence they may restrict their use.
- Laws that insist on certain standards of provision: Governments can set certain product quality standards for monopolistic producers to limit their abnormal profits and also to ensure provision of better quality products for consumers in monopolistic markets.

Objectives of Governments' Microeconomic Policies

1. Apart from government intervention to correct market failure that is to improve market outcome by encouraging more economically efficient use of resources
2. Governments also intervene in markets to ensure more "fair" distribution of resources/wealth and income. This is to achieve more equitable distribution of national income among country's citizens.

Strategies to tackle Income Inequality

1) Monetary Benefits:

- Providing financial assistance to low-income individuals/families. Different income indicators are used to directly people who are in most need of government's financial assistance.

2) Taxation System:

- Using progressive taxation system.

3) Direct provision of goods and services:

- Providing basic goods/services "free of charge".

Monetary Benefits

- Often governments provide direct financial assistance to low income families. Such social welfare programs are funded by country's tax funds. Hence high income individuals technically pay for financial assistance of less-privileged members of their society.
- Benazir Income Support program that has been perhaps renamed as National Income support program can be an appropriate example of such government intervention.

Categories of Monetary Benefits

- Means-tested:

Financial assistance is only extended to people who are in need of it.
Benazir Income Support can serve as an example.

- Universal benefits:

Financial assistance provided to all who have particular consumption patterns. The beneficiaries of such social welfare schemes are selected regardless of their income and hence all individuals with certain consumption patterns benefit from governments' financial assistance.

Types of Taxation Systems

- Progressive Taxation

Wealthy people paying larger proportion of their income towards tax funds. Percentage of applicable income tax increases with increase in individual's income.

- Proportional Taxation

All people paying similar proportion of their income towards tax funds. Zakat, 10% capital gains tax.

Types of Taxation Systems

- Regressive Taxation

Less wealthy people paying larger proportion of their income towards tax funds. GST, VAT, all types of indirect taxation.

Direct Provision of Good/Services

- Government being the producer of basic necessities ensure their provision at reasonable rates to all of country citizens and hence the monetary benefit that less-privileged people get is much greater as a percentage of their income as compared to rich people.

Direct Provision of Good/Services

- Public health care and education is more of financial benefit for less wealthy people. Especially when these goods/services are financed from progressive and/or proportional taxation system it has more of income distributional effect.

The Effectiveness of Government Policies

- Though Market Failure and achievement of more equitable distribution of income do provide economic justification for government intervention in private sector but government interference in private sector operations at times results in greater economic efficiency.

The Effectiveness of Government Policies

- Government Failure is the term used to refer to government policies that instead of improving the market outcome results in greater economic inefficiency.

Why factors might result in Government Failure?

- Lack of information available to government authorities/bodies that are responsible for market regulation.
- Government policy instruments creating wrong/inappropriate incentives resulting in inefficient use of economy's resources.
- Government policies adversely affecting income distribution in an economy.

Lack of Information

- Since at times it is difficult for governments to gather all required information, they might need to devise policies with incomplete information available. Such government policies might be very effective at resolving the market failure that they intended to.

Lack of Information

- For instance exact calculation of negative externality associated with any production or consumption process is difficult and hence incorrect amount of indirect tax might be imposed on certain goods.

Lack of Information

- And since government is mostly the sole provider of all public goods, hence unlike the private goods where consumers can purchase substitute goods for public goods provision they are completely dependent upon their governments.

Lack of Information

- Similarly, at times, governments might miscalculate the citizens' demand for certain public goods. For instance if due to lack of information government under-invests in judiciary/police services then obviously economy will be Allocatively Inefficient because of under-provision of certain public goods.

Disincentives

- At times governments create wrong incentives for people including consumers and producers and hence it results in inefficient allocation of economy's resources.

Disincentives

- For instance setting too high marginal tax rates will create disincentives for people in high earning professions to work harder and in fact at time they might decrease their labor supply. Now since economy is not making the best use of its resources such policies should be classified as government failure.

Policies having adverse effects on economy's income distribution

- At times government policies instead of reducing create more income inequality.
- This is the case when economies have to rely on indirect tax revenue because collection of direct taxes is difficult due to tax evasion.

Policies having adverse effects on economy's income distribution

- Similarly imposition of indirect tax on food items mean that it will more of a burden on poor than rich members of any society and hence instead of decreasing income inequality governments will contribute towards widening the income gap.

Privatization

- Privatization refers to sale of state owned enterprises to private sector. It is opposite to Nationalization which refers to government purchasing or taking over the control of previously private owned firms/businesses/organizations.

Possible Strategies for Privatization

- Apart from direct sale of state owned enterprises, government might also privatize an industry through following polices:

- Deregulation: Allowing private firms to establish in industries where previously only state owned firms existed.

Possible Strategies for Privatization

- Partial sale of state owned enterprises: Selling certain proportion of ownership to individuals belonging to private sector. For instance employees of Karachi Steel Mill purchasing its shares.
- Franchising: Allowing private firms to franchise state owned businesses. These businesses are privately managed. For instance KESC.

Possible Strategies for Privatization

- Outsourcing certain operations of government organizations to private sector firms: Since government often does not has the expertise to execute certain operations concerning the management of any particular business activity hence some of its operations might be outsourced to private sector firms.

Case for Privatization

- Economic theory supports privatization of state owned enterprises for following reasons:
- Improved efficiency of privatized firms. Since governments are not always producing public goods it will be more economically efficient if their management is handed over to private firms. For instance electricity.

Case for Privatization

- Higher employees' motivation due to their ownership of the firm. This is when shares of state owned enterprises are sold to its employees.
- Generation of revenue for government to undertake other important tasks/projects.

Case for Privatization

- Minimal government involvement in economic activity results in lesser cases of government failure.
- State owned enterprises/businesses can not be used for promotion of political interests. For instance nepotism can be prevented through minimal of government participation in economy's economic activities.

Nudge Theory

- Nudge Theory is a concept in behavioral science, which argues that positive reinforcement can influence motives, incentives and decision making of groups and individuals, at least as effectively (if not more effectively) than direct instruction and legislation.

Nudge Theory

- For instance governments' use of positive reinforcements like provision of subsidies and grants to more productive and cost effective firms will incentivize them to improve their existing efficiency levels.

Nudge Theory

- Therefore Nudge Theory can be used to argue against governments' excessive reliance on regulations and legislation to control private businesses' operations. Instead it advocates for establishing positive reinforcements to motivate firms to take initiatives that will be socially desirable.

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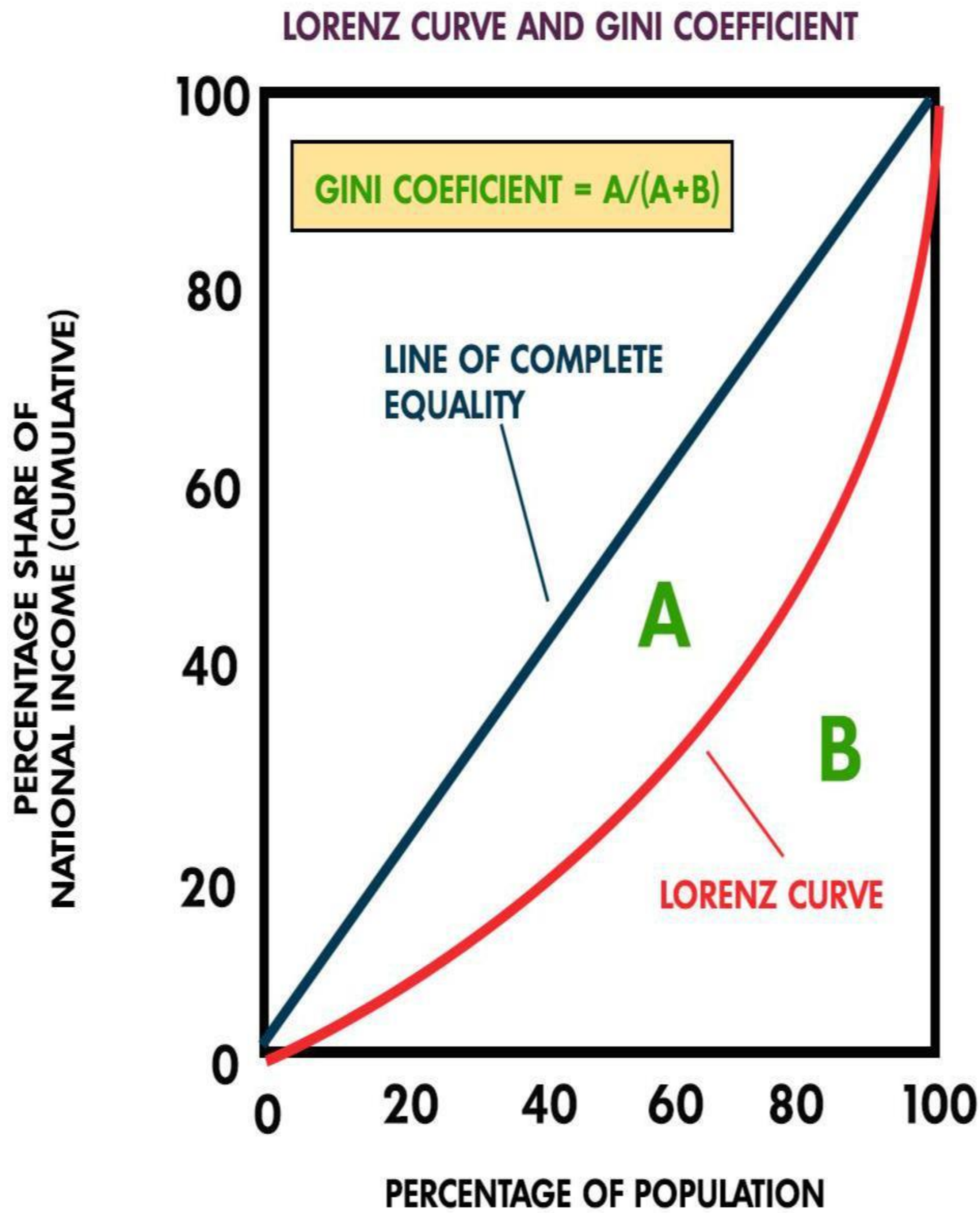
- Patents and Intellectual Property Rights can be justified in light of Nudge Theory which aims at providing economic incentives for firms engaged in research and development.

Income Distribution and Lorenz Curve

- An economy’s Lorenz Curve estimates its income/wealth distribution. The graph also includes perfect equality line that works as a benchmark for estimation of how unequal income/wealth distribution of any particular economy is.
- GINI Coefficient is quantitative measure that estimates economy's income inequality.
- The larger the GINI Coefficient more unequal will be economy’s income distribution.

Lorenz Curve



Kuznets Ratio

- Kuznets ratio is another quantitative measure used to gauge economy's inequality.
- It is ratio of richest 20 percent individuals' income with regards to poorest 20 percent individuals' income. Higher the value of Kuznets Ratio more unequal will be economy's income distribution.
- GINI Coefficient and Kuznets Ratio should be collectively used to gauge changes in economies' income inequality over time.

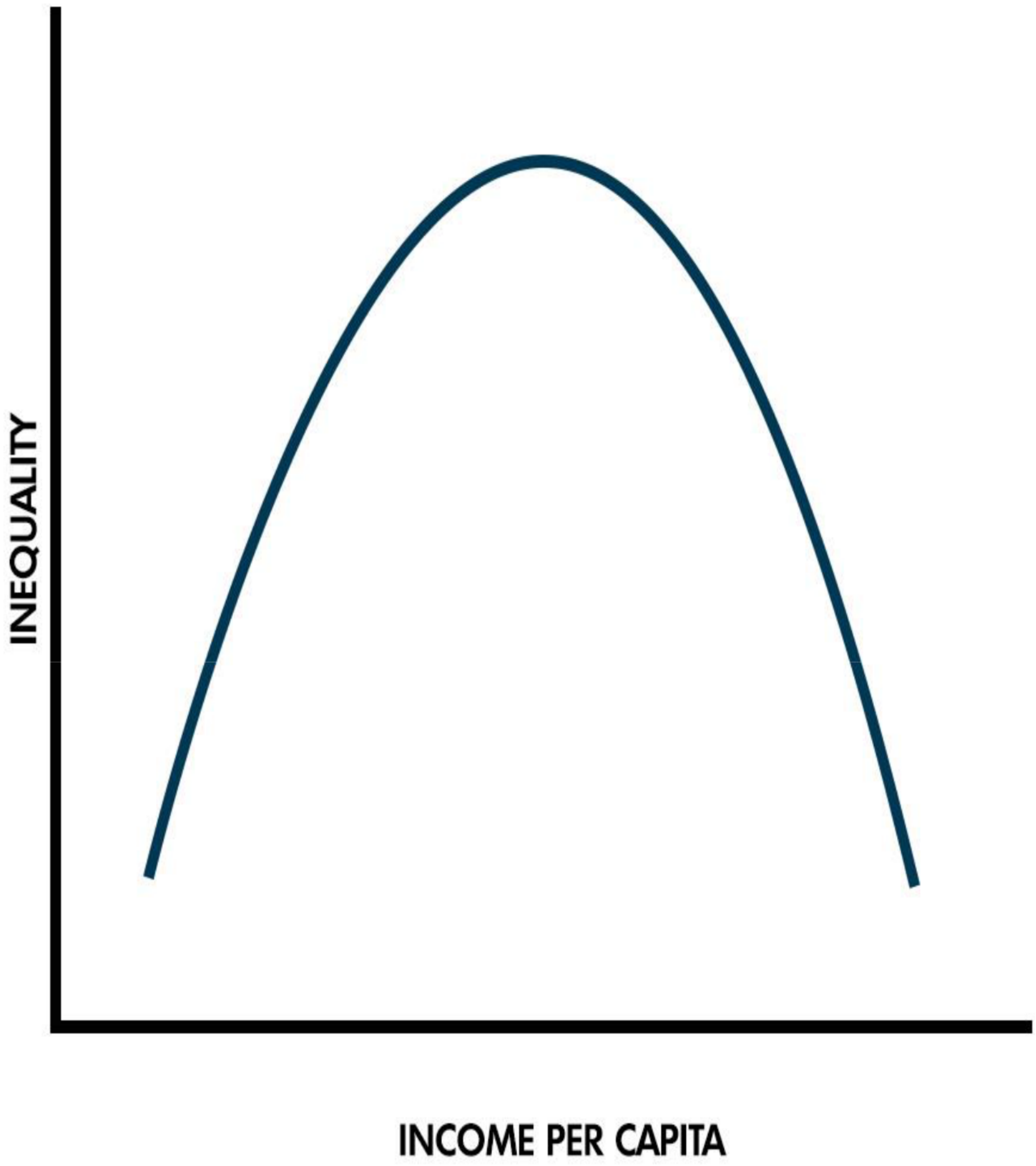
Intergenerational Equity

- The concept refers to the idea that children belonging to all income classes should have equal opportunities to professionally and personally develop.
- Equal access to education, health care and other basic facilities to life are utmost necessary to ensure level playing field for all of economy's citizens.

Intergenerational Equity

- Intergenerational Equity prevents disadvantaged classes to get trapped in "viscous circle of poverty" that arises from their constant seclusion from opportunities that privileged classes get to enjoy.

Kuznets Graph



Explanation for Kuznets Graph

- The Kuznets curve implies that as nation undergoes industrialization and especially mechanization of agriculture significance of urban economies increase relative to rural economic activities which results in high rate of rural urban migration.

Explanation for Kuznets Graph

Initially producers/industrialists get to profit more from cheap labor entering urban centers and therefore income inequalities increase with initial rise of economy's GDP per capita. Later when state's economic objectives tend to become more welfare oriented then there is more equal access to economic opportunities that results in reduction of income inequalities.