presentation 21 :
Failures & market by-products

The sectorial analysis of firms/markets shows that the following features are highly debatable:

- Size of industry relative to the market: perfect concurrence wants small firms to supply the markets whereas in reality firms, especially those operating globally, can be colossal
- Knowledge of products: perfect competition assumes a perfect knowledge whereas no consumer knows all what is available – the purpose of shopping is to constitute this knowledge
- Knowledge of consumer desires: perfect competition assumes this to be perfect; despite consumer studies aimed at this, a 40% of consumer decisions are unpredictable

- Ease of entry and exit from the markets; the administrative requirements for setting up businesses and for foreclosing them makes such processes no easy task
- Competitive element: perfect competition = perfect concurrence = absence of competition, whereas in reality firms try their best to be unique, different and appealing otherwise the consumer they do not get is the consumer of another firm

All things considered markets are NOT and CANNOT BE perfectly concurrent.

Does this mean that markets are NOT Pareto efficient?

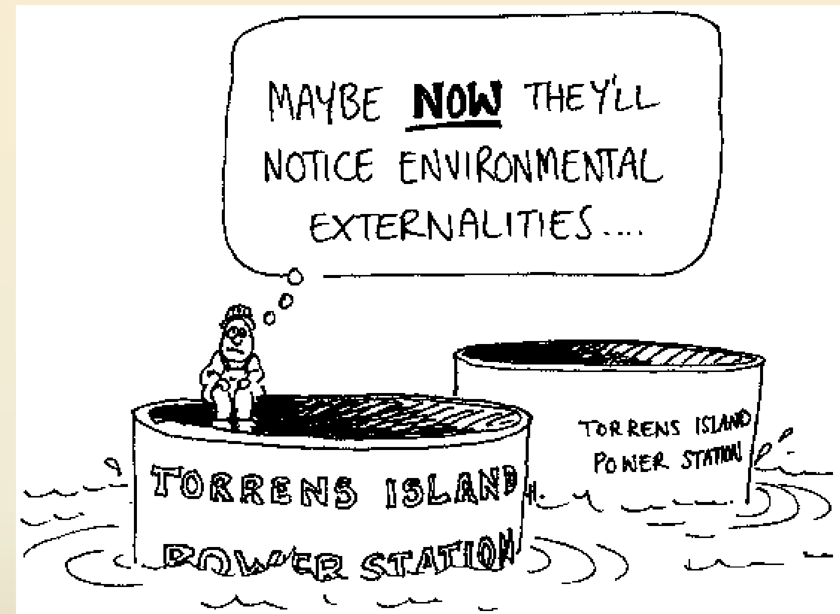
To answer, first an observation: welfare economics fails to account for the effects of economic activity to third parties because it assumes there are no such effects.

However, all economic/human activity produces byproducts that affect third parties. Formally, an externality – spillover effect - arises when a person engages in an activity that influences the well-being of a bystander who neither pays nor receives any compensation for that effect.

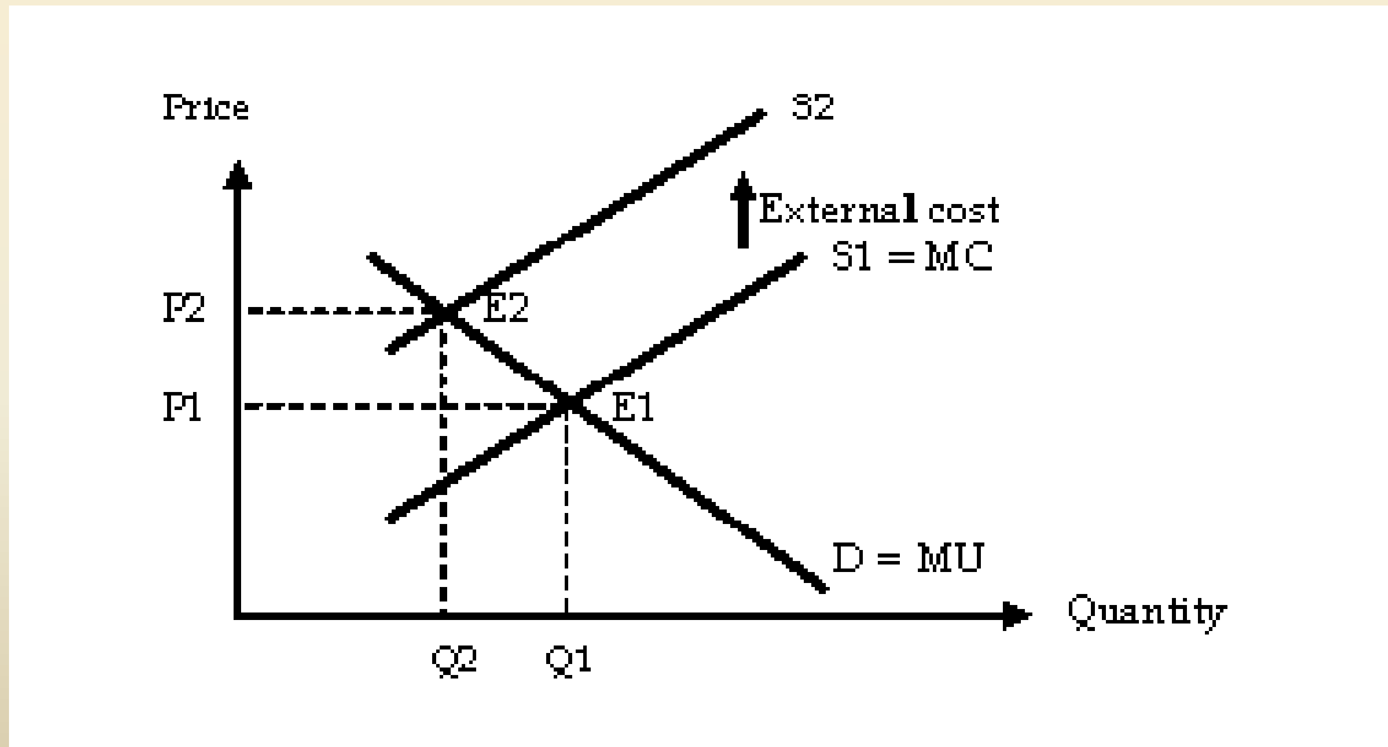
Externalities, it is to be noted, CANNOT be corrected by the market itself.

Externalities can be

- Negative: the cost to society is larger than the cost of its production (e.g. pollution, waste).
- Positive: the benefit to society is larger than the benefit received through production (e.g. education – merit goods).



Graphically, an externality affects the allocative (Pareto) efficiency of the market by upsetting the equilibrium E1



The solution to the above is to internalize the externality, implying state involvement via:

- Regulations to reduce the effect
- Corrective taxes at the amount of the cost to society
- Permits & licences

Additionally, what the perfect concurrent market assumes is that the price in the markets is correct for all, both producers and consumers, and that under these conditions all types of products / services can be offered.

Yet is it so?

The fact that there are different incomes shows that the flow of income/money is not in equilibrium between the labor and goods/services markets.

An explanation may lie in

- The amount of leakages (especially savings) not being correctly balanced out by the injections (investments)
- Time lags
- Wrong expectations

The end result is that there are different income levels in a given society which shows that the flow of income is not in equilibrium between the labor and goods markets.

This in turn makes that some consumers can afford to purchase the products offered and others not.

It also means that firms will be supplying less products than they would have otherwise been able to – not to say that for strategic reasons they may choose to supply a lot less than they could.

There is in other words, a "natural economic imbalance" – testament to this is our constant obsession for improvement so as to tilt the balance in our favor.

Hence the role of the state to ensure that all have access to products/services that are perceived to be trivially necessary such as health care. Hence the distinction between:

- Private goods which are excludable and rival e.g. car.
- Public goods which are neither excludable nor rival e.g. army

The state is necessary to provide the latter. Or is it?

View 1: https://www.montpelerin.org/

View 2: https://www.marxists.org/archive/draper/1970/xx/state.html