

## 2 Questions

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Q- Discuss in detail the four classical types of market failure with examples.

### 1. Introduction:

Usually markets are considered more efficient than other institutional arrangements such as monopolies or oligopolies etc. Under certain conditions, markets produce the best outcomes for society and consumers. However, markets are not always perfect and certain conditions prevent economic market equilibrium.

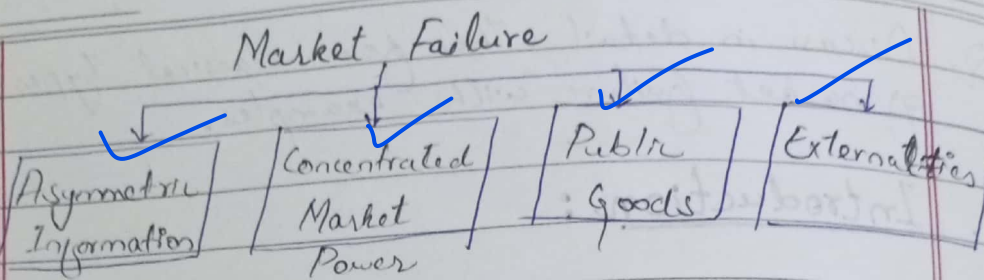
### 2. Market Failure:

Market Failure is an economic term applied to a condition where,

“Consumer demands are not equal to the supplied items or services and is therefore, inefficient.”

This results in change in prices and corresponding change in other forces. The changes lead to a price inequilibrium. Market failures occur due to distortions in market. These distortions includes monopoly power, price limits, minimum wage requirements and government regulations.

### 3. Types of Market Failure:



## 1- Information Asymmetry:

Efficient markets requires high level of transparency and free flow of information. Market failures occurs when one party has better information than other party, and it uses this opportunity for exploitation.

### Examples:

#### a- Lemon problem in market of Automobiles:

In market of used automobiles, the seller has more information about the car than the buyer. The consequence is that buyers may buy the defected car at higher price.

#### b- Problems in Health Insurance Market:

In the Health insurance market, buyer know more about their health conditions than the insurance agent. With this better information, client may hide their health problems in attempt to get lower insurance premium. If insurance provider had knew

that his client had history of cardiac issues, he could charge him at higher rate. This information disparity is known as asymmetric information which affects economy and leads to market failure.

## 2- Concentrated Market Power:

In market with high level of competition companies have to produce an item at low cost with good quality else customers will find an alternate option. However, in case of monopoly where market power is concentrated in the hands of a single producer, there are no other appealing substitutes and no other competitor has the power to gain such footing in the market without external intervention. As a result, consumers are in a weak position to influence the monopolist behaviour as they have nowhere to substitute. Monopolist companies sell their low quality products at high costs. Markets like this operate inefficiently too.

### Examples:

#### a. Case of Martin Shkreli:

Forbes have described the monopolist nature of Martin Shkreli, a pharmaceutical firm. They raised the price of a kidney drug, that has been around for

decade. They increased the price from \$13 to \$750 with 5000% increase in original price. This resulted in widespread outrage in public.

### 6- De Beers Monopoly:

De Beers is great example of monopoly and how it led to market failure. The South African company was controller of world's 80% <sup>rough</sup> diamond production in 1902. With its aggressive marketing strategies, and controlling diamond demand acutely, the company sales in 1930s were hugely declined.

### 3- Public Goods:

A public goods have two features: non-rival and non-excludable. Non-rival means consumption of a good by one party will not prohibit the consumption of same good by another party. Non-excludable means non-paying customers could not be stopped from accessing public goods or services.

Public goods create market failures when a section of a population that consumes the good fails to pay but continue using the services like actual payers.

Examples:

### a- National Defense :

Taxpayers fund the national defense, but it is impossible to prevent individuals who do not pay taxes.

### b- Protection by Police :

If 25% of the population pays a private company to provide security services, all people of the area would be benefitted from the service.

## 4- Externality :

It refers to cost or benefit that results from a transaction and affects a third party who did not decide to be associated with cost or benefit.

Externality may be positive or negative. Externality leads to market failure because a product or service does not reflect the true cost and benefit of that product. As a result, company may produce too many or too few goods, depending on externality.

### Examples :

#### a- Workers living around The industries :

A classic example of negative externality is pollution that results from production of

goods in a factory. Individuals living around are exposed to pollution and may cause them health problems.

### b- Impact of pollution on tourism:

The pollution which is originated as result of industrial activities will affect tourism.

## → Tying It All Together

Market failure can occur when:

- i- Sellers in the market have access to information that would affect buyer decision-making.
- ii- The <sup>market</sup> buyers lack competition due to concentration of power in one hand.
- iii- an individual ~~consumption~~ of goods in market does not affect the another's ability to access that good and non-taxer enjoys benefits like tax-payers.
- iv- Cost and benefits are unbalanced for providers in the market.

## → Solutions to Market Failures:

In order to eliminate market failures, following steps can be taken:

- i- Use of legislation
- ii- Price mechanism

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## Conclusion :

Market failure is state of disequilibrium in the market due to market distortions. It happens when demanded products are not equal to the supplied products. There are different underlying causes of market failure which needs to be corrected.

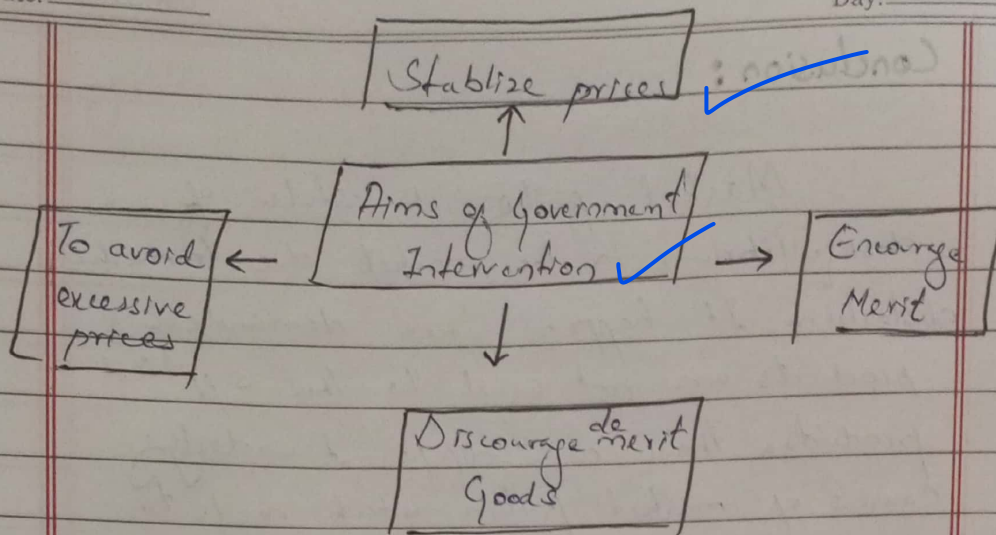
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Q- What is relevance of concept of market failure to government intervention in the economy? Explain. Discuss the functions and organisational structure of federal government of Pakistan including administrative relations between federal ministries and federal bodies such as commissions, authorities, boards and state owned enterprises.

## 1- Concept of Market Intervention: Introduction

Market failure is a condition when there is a distortion in the market i.e. demands and supply are not equal led to disequilibrium in market. To control the market failure, government intervene and adopt different methods to rectify the market.

## 2- Government Intervention to Address Market Failure :



Four of most common methods of government intervention in market failures are:

- i- Maximum price
- ii- Minimum price
- iii- Indirect taxation
- iv- Subsidies.

Additional methods of intervention includes regulation, nationalization and privatization of public goods.

### i- Maximum Prices :

Maximum price is set by government below the <sup>existing</sup> free market equilibrium price and sellers cannot legally sell the goods or services at higher price. It helps the customers by achieving services at low prices.

### ii- Minimum Price :

A minimum price is set by the government above existing free market equilibrium price and sellers cannot legally sell the goods at lower price.



Government often use the minimum prices in order to help producers or to decrease consumption of demerit goods e.g. Alcohol.

### iii- Taxes :

Tax is a method to discourage consumption of certain goods. For Example, tax on demerit goods or goods with negative externalities. Taxes both discourage the consumption of a good and raise revenue for the government.

### iv- Subsidies :

The government may subsidize the goods with positive externalities e.g. Public transport or education. However, problems related to subsidies are cost to government and inefficiencies of firms due to reliance on government for aids.

### v- Nudges :

Nudges is a different kind of intervention to influence demand directly. For Example, putting cigarettes behind closed covers make it harder for people to buy.

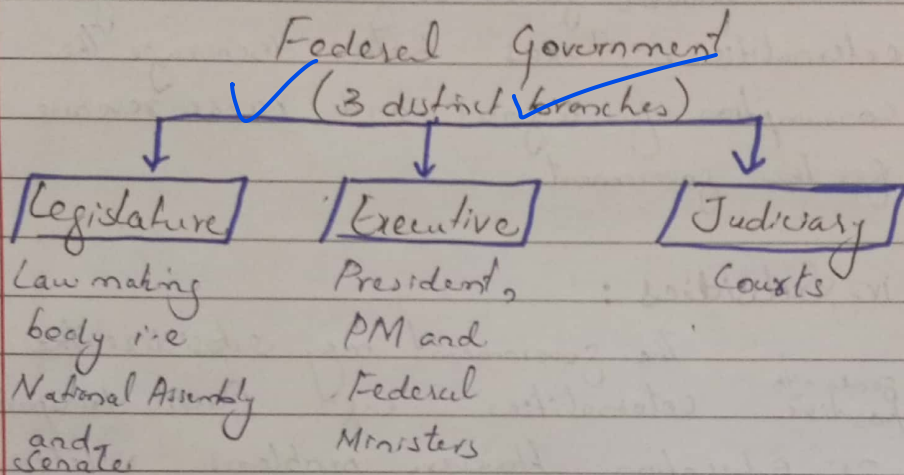
## 2- Federal Government of Pakistan :

### Introduction

Pakistan is working under federal system where federation and units derive

their authority from Constitution of 1973. The federation and provinces are working independent of other's control in the spheres assigned to each by the Constitution.

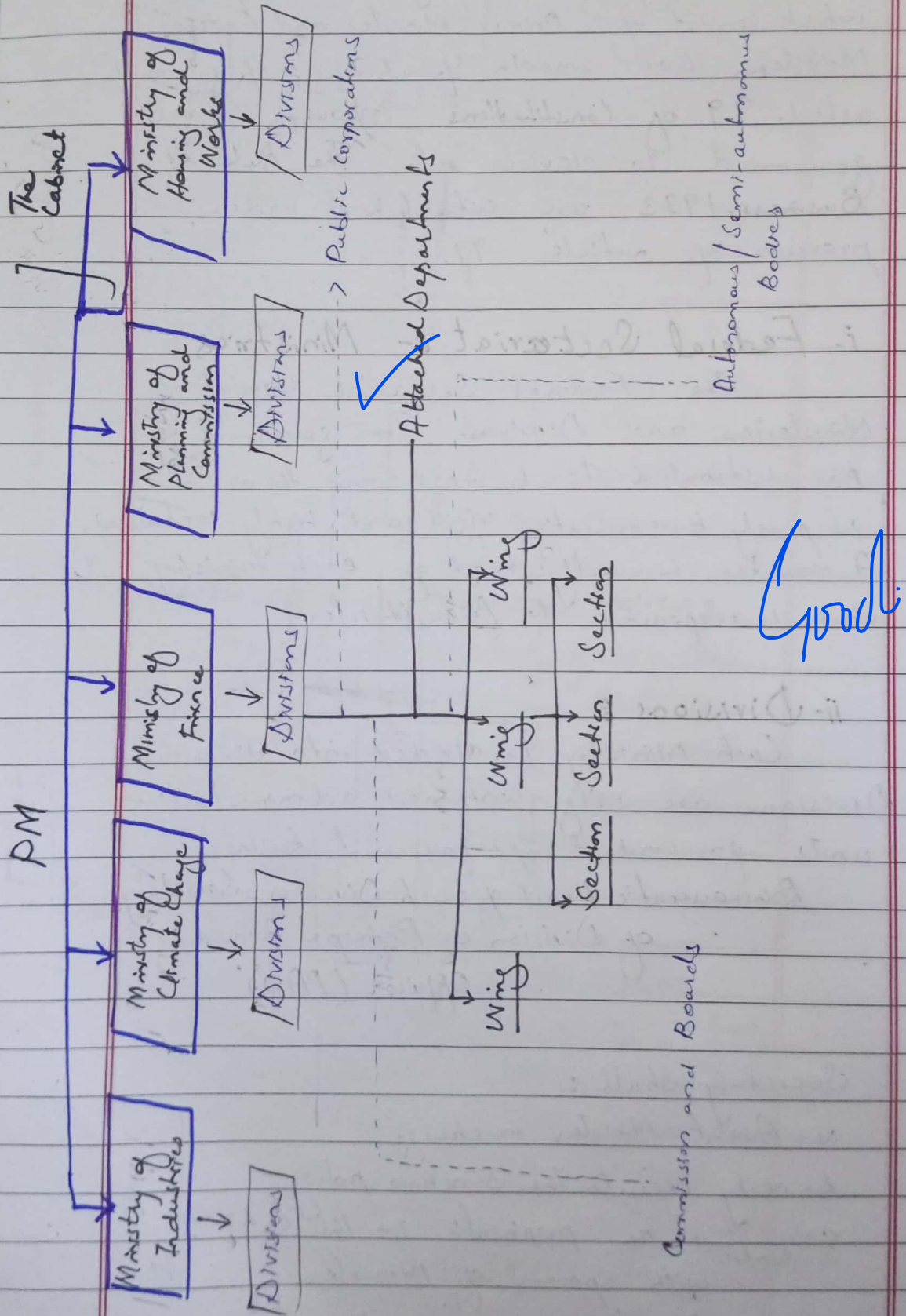
## Functions of Federal Government



Quaid-e-Azam while addressing the public meeting at Dacca in 1947 said that,

“The Government can only aim for one objective which is how to serve the people, how to devise ways and means for their betterment. What other objective can the government have.”

## Organizational Structure of Federal Government of Pakistan:



Under Article 90 of Constitution of 1973, federal government exercise its executive function in name of President by Federal Government, which consist of Prime Minister and Federal Ministers. For smooth functioning of government, article 99 of Constitution empowers federal government to devise rules. The Rules of Business-1973 are established under provision of article 99.

### i. Federal Secretariat :- Ministries

The Federal Secretariat consist of Ministries and Divisions. The government has distributed its business among them. It is purely bureaucratic, rigid and highly centralized. A minister is usually head of each ministry which is responsible to Prime Minister.

### ii. Divisions :-

Each Ministry is divided into divisions. Divisions are self-contained administrative units for conduct of government business.

Bureaucratic Head of each Division = Secretary of Division or Principal Accounting Officer (PAO).

Secretary shall :

- a. Assist Minister in-charge
- b. duly execute the sanction policy
- c. submit the proposals to the cabinet with approval of Minister
- d. Keep Minister informed about working of division.

iii. **Attached Departments:** They are usually led by the head called Director General. These departments carry out administrative tasks of technical nature assigned to them e.g. Pakistan Public Works Department is attached department of Ministry of Housing and Works.

iv. **Sub-ordinate offices:**

They are offices other than attached departments and Ministry or Division. Their structure and functions are designed on functional cum-geographical basis.

v. **Autonomous / Semi-autonomous bodies:**

They are established under the trend of decentralization and autonomy from bureaucratic controls. They govern under the act of Parliament and have their own board of directors or governors.

vi. **Boards and Commissions:**

They are public agencies which exercise quasi-judicial role and are headed by a body of commissioners or board members rather than a single political or a top bureaucrat. For Example Pakistan Atomic Energy Commission which consist of chairman and 9 members. Similarly Election Commission of Pakistan, National Finance Commission are examples of boards and commissions.

## vi. State Owned Enterprises: (SOEs)

As per MOF Pakistan, there are around 200 SOEs in the country which are engaged in diverse range of activities represent a significant part of economy. eg Pakistan International Airlines, Pakistan Railway, Pakistan Steel Mills etc.

## Conclusion:

Government play a significant role through intervention in market failure. In Pakistan, federal government and provincial governments are working under Constitution of 1973 with wide range of responsibilities and functions.

Govt 10/20