



# **THEME 2**

## **THE MARKET SYSTEM AND ALLOCATIVE ROLE OF THE GOVERNMENT**

# OVERVIEW THEME 2

## THE MARKET SYSTEM AND ALLOCATIVE ROLE OF THE GOVERNMENT

- Price mechanism in non-competitive markets: monopoly, oligopoly and monopolistic competition
- Government measures against market failure: external effects, asymmetric information and market dominance
- Public goods

# **CHAPTER 2: GOVERNMENT MEASURES AGAINST MARKET FAILURE: EXTERNAL EFFECTS, ASYMMETRIC INFO AND MARKET DOMINANCE**

## **1. External effects**

**a. What are external effects?**

**(see pre-teaching and separate slides)**

**b. Free market and optimal wealth (classical economics)**

**c. Government measures (neoclassical economics):**

- taxes, subsidies, minimum prices, maximum prices**
- wealth impact**

# **CHAPTER 2: GOVERNMENT MEASURES AGAINST MARKET FAILURE: EXTERNAL EFFECTS, ASYMMETRIC INFO AND MARKET DOMINANCE**

## **2. Asymmetric info**

- a. What is asymmetric info?**
- b. Government measures**

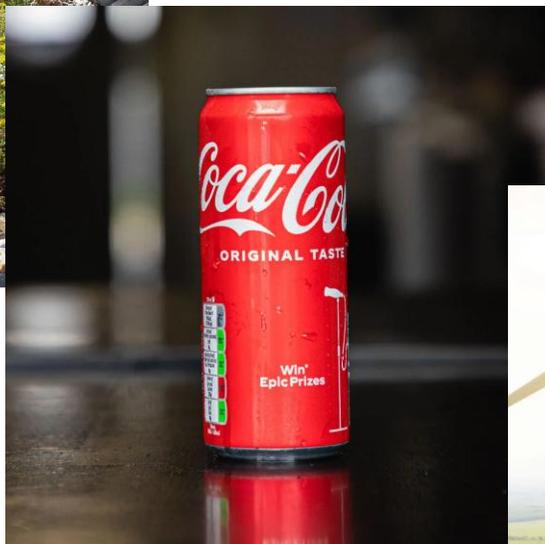
## **3. Market dominance**

- a. What is market dominance?**
- b. Government measures**

# **CHAPTER 2: GOVERNMENT MEASURES AGAINST MARKET FAILURE: EXTERNAL EFFECTS, ASYMMETRIC INFO AND MARKET DOMINANCE**

- 4. Other government measures**
  - a. Marketable permits and patents**
  - b. Social and moral standards**
- 5. Cases: examples of government measures at local, regional, national and European level critically examined**

# 1. EXTERNAL EFFECTS



## 1.a WHAT ARE EXTERNAL EFFECTS?

See pre-teaching and separate slides

## 1.b FREE MARKET AND OPTIMAL WEALTH (classical economics)

### **ADAM SMITH:**

“The way to wealth is through the free market.”

### **ALFRED MARSHALL:**

“Wealth is the sum of consumer surplus and producer surplus.”

**An economic mechanism that Adam Smith called the ‘invisible hand’ ensures that people's behaviour benefits everyone in society.**

## **SELF-INTEREST SERVES THE COMMON INTEREST**

**That invisible hand is the sum of all individual actions in market.**

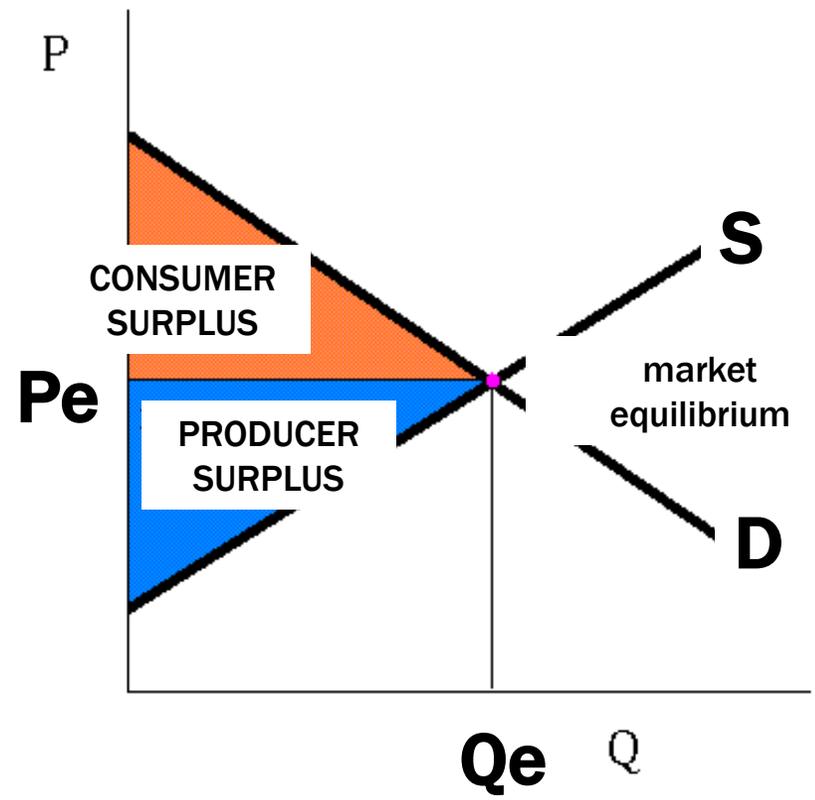
**For example, if a product is in high demand and the price rises, manufacturers will automatically produce more of it. Then the price will fall again - to the benefit of the less rich.**

**Adam Smith therefore proposed that the market should regulate itself.**



Alfred Marshall builds on Adam Smith's theory:

**WEALTH IS SUM OF CONSUMER SURPLUS AND PRODUCER SURPLUS**

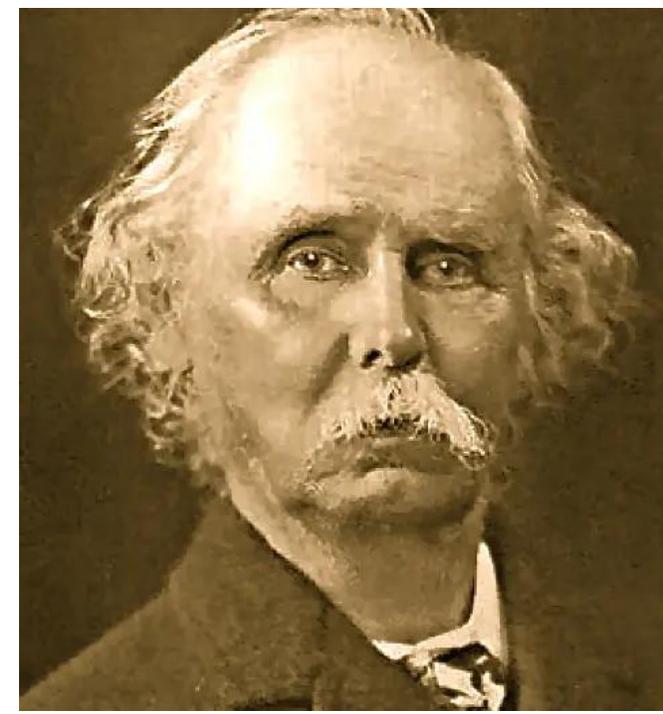


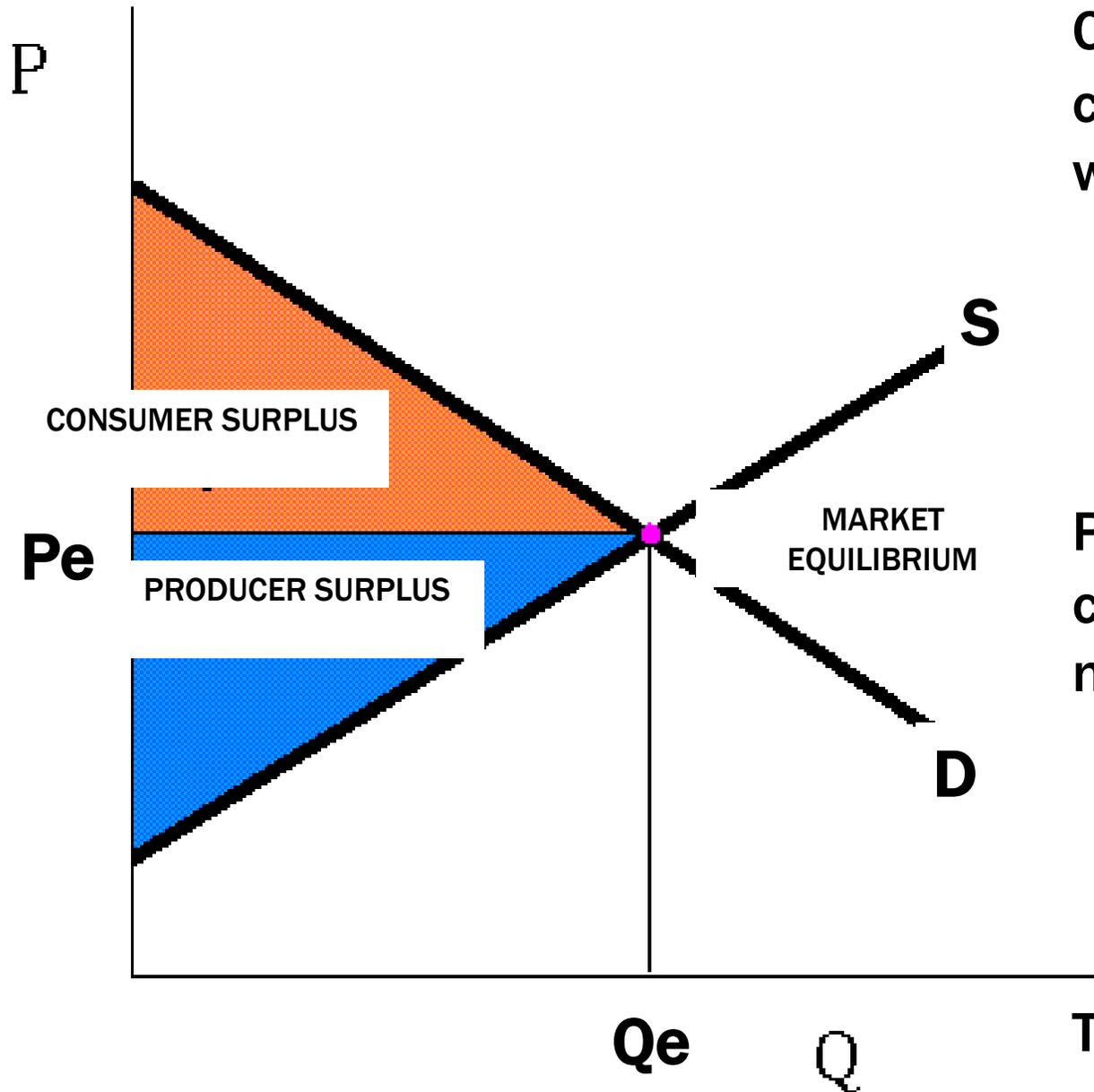
Marshall develops the supply and demand model to illustrate market forces and the price mechanism

Market equilibrium occurs when demand equals supply:

equilibrium price  $P_e$

equilibrium quantity  $Q_e$





Consumer surplus is **CS**:  
cumulative difference between the  
willingness to demand a good or  
service and the market price

>>> surface orange triangle

Producer surplus is **PS**:  
cumulative difference between the  
market price and the willingness to  
supply a good or service

>>> surface blue triangle

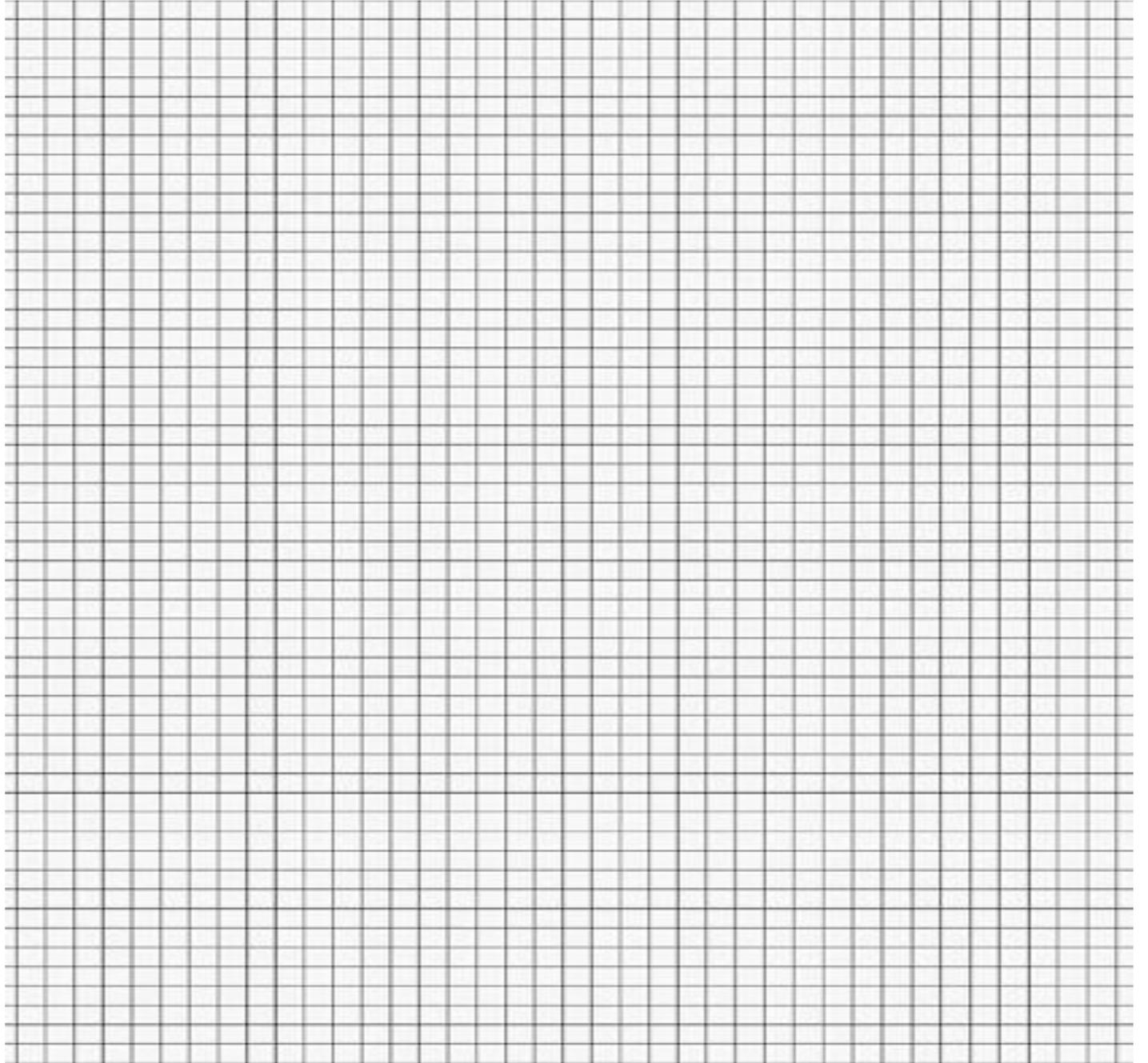
Total wealth **TW** is sum of both  
triangles

**Example:**

$$Q_d = 100 - P$$

$$Q_s = P$$

**1) Demand and supply model:**



**2) Formulas CS, PS and TW:**

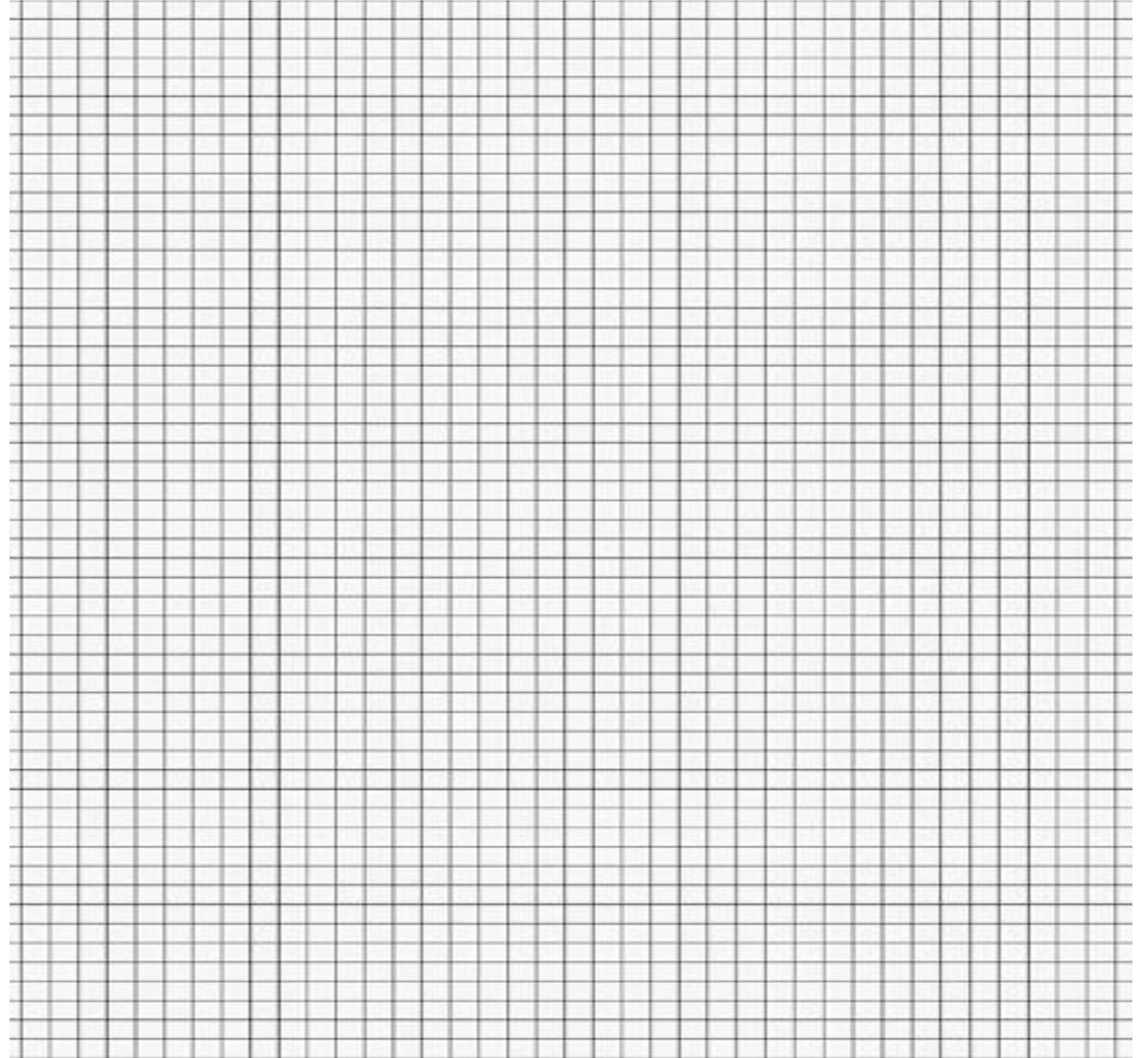
**3) Calculation CS, PS and TW:**

**Exercise:**

$$Q_d = -0,25P + 250$$

$$Q_s = 0,75P - 150$$

**1) Demand and supply model:**



**2) Formulas CS, PS and TW:**

**3) Calculation CS, PS and TW:**