| BUSINESS ECONOMICS | MICROECONOMIC ANALYSIS |
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| | 1: INTRODUCTION |

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## EXTERNALITIES

Externalities are the harmful or beneficial effects of activities that are borne by people who are not directly involved in the market exchanges. If externalities are present, the outcome of a competitive market is unlikely to be Pareto efficient. However, government intervention and the legal system can ensure that property rights are well defined, so that efficiency enhancing trades can be made.

If preferences are quasilinear, the efficient amount of a consumption externality will be independent of the assignment of property rights. Cures for production externalities include the use of Pigouvian taxes, setting up a market for the externality, or allowing firms to merge.

## PUBLIC GOODS

Public goods are goods which are non-rival and non-excludable in nature. They are goods for which everyone must consume the same amount, such as national defense, air pollution, and so on. The free rider problem is associated with this type of goods, which refers to the temptation of individuals to let others provide the public goods. In general, purely individualistic mechanisms will not generate the optimal amount of a public good because of this free rider problem. Various collective decision methods have been proposed to determine the supply of a public good. Such methods include the command mechanism, voting, and Vickrey-Clarke-Groves auction mechanism.



## ASYMMETRIC INFORMATION

Markets fail to perform when there is asymmetric information. Asymmetric information is a situation where one side in a transaction has more information than the other side. It can arise from a hidden action, an action that one side can take, but which cannot be observed by the other side. In situations of hidden actions, it is likely that the more informed side will indulge in wrong actions, leading to the problem of moral hazard. In the presence of moral hazards, the more informed side or the insured person tends to undertake low levels of preventive care, leading to inefficiency in pricing. To cope up with the problem of moral hazard, insurance companies carry out different practices in the form of co-insurance and deductable. This helps in reducing the intensity of moral hazard.

The asymmetry in information can also arise from hidden characteristics, wherein one party knows some characteristics which the other party would like to know, but does not know. Hidden characteristics lead to situations where the type of the agents is not observable so that one side of the market has to guess the type or quality of a product based on the behaviour of the other side of the market. This leads to the problem of adverse selection. In markets involving adverse selection too little trade may take place. A buyer of a car gets to trade with sellers of bad cars only; a health insurance company gets to trade with only unwell people. In such situations, the informed party looks for indicators of hidden characteristics called signals, and often use a screening device to differentiate customers according to their willingness to pay.