TOURISM POLICIES AND FASHION, ART AND FOOD INDUSTRIES

Market failures and government intervention

Lecture 15

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Learning Objectives

- ✓ Theorems of welfare economics
- ✓ Market failures
- ✓ Externalities
- ✓ Public good
- ✓ Market power
- ✓ Non-market failure rationales

Fundamental theorems of Welfare Economics

- The branch of economics called **welfare economics** is the economic theory of measuring and promoting social welfare.
- **First fundamental theorem of welfare economics**: any competitive equilibrium leads to a **Pareto efficient allocation** of resources.
- **Second fundamental theorem of welfare economics**: any efficient allocation can be attained by a competitive equilibrium, given the market mechanisms leading to redistribution.

Market failures

A **market failure** is a situation where free markets fail to allocate resources efficiently.

Economists identify the following cases of market failure:

- An **externality** refers to a cost or benefit resulting from a transaction that affects a third party that did not decide to be associated with the benefit or cost.
- **Public goods** are goods that are consumed by a large number of the population, and their cost does not increase with the increase in the number of consumers.
- **Market power** occurs when either the buyer or the seller possesses the power to determine the price of goods or services in a market.
- Market failure may also result from the **lack of appropriate information** among the buyers or sellers.

Rationales for Government intervention in Tourism Industry

- It is an industry of growing economic importance
- It can bring about sustainable development and can be an instrument of regeneration
- It can build a more inclusive society
- It is a diverse industry that does not act strategically
- Demand is seasonal and variable

Externalities

Figure 1: An external cost, and the effects of a tax to correct it.

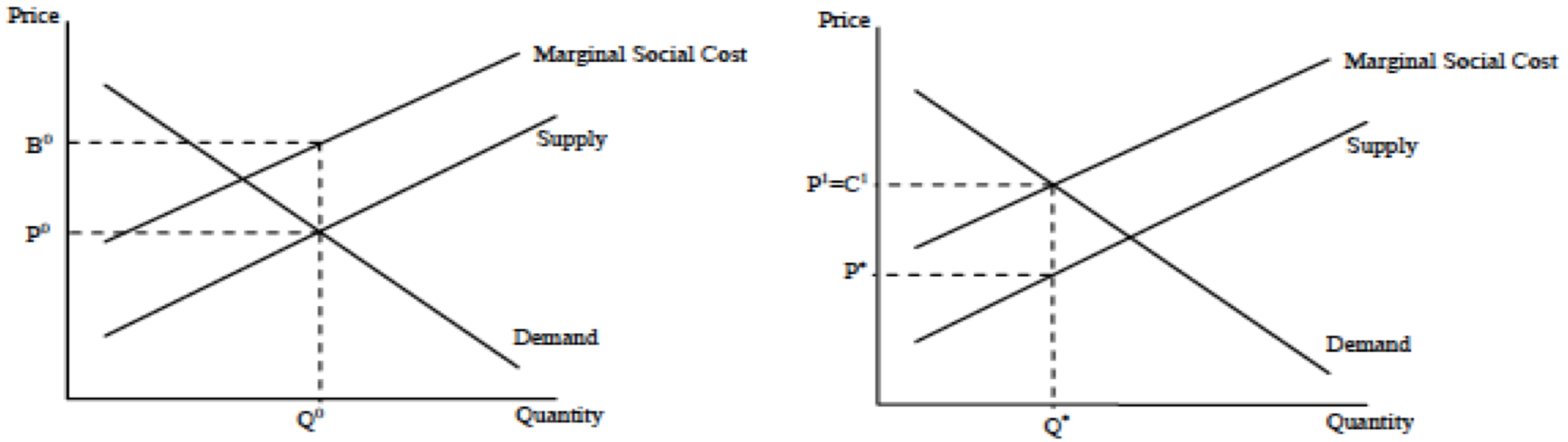
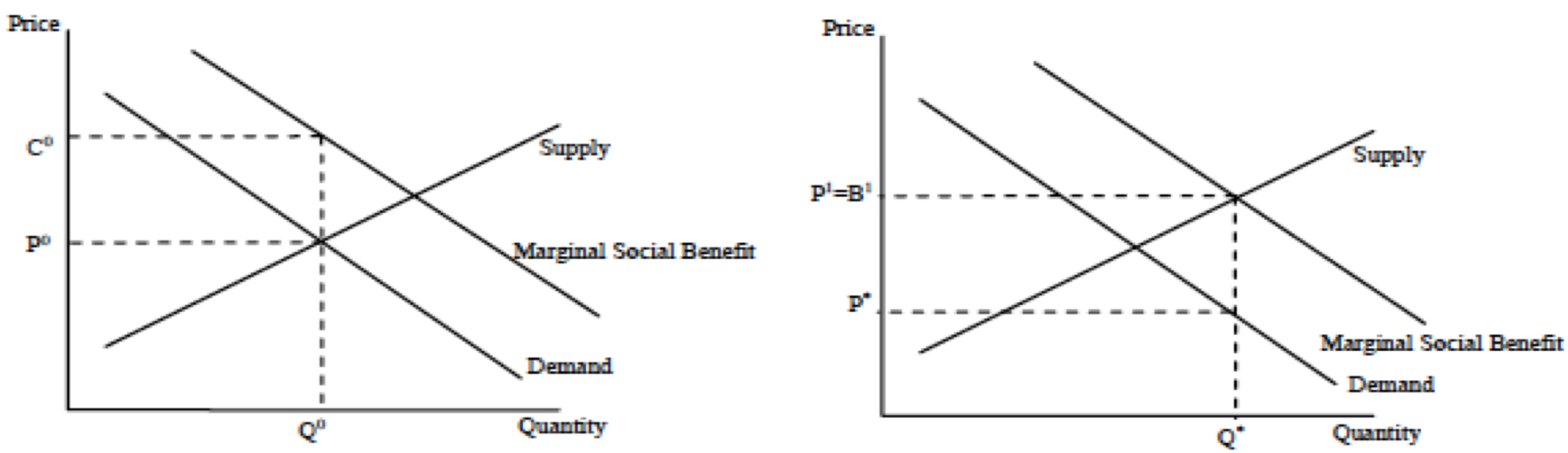


Figure 2: An external benefit, and the effects of a subsidy to correct it.



Externalities: Economic and Environmental impacts

Literature demonstrates that tourism expenditures not only have direct economic impacts on the firms from which tourists purchase products, but also a range of indirect impacts on firms in their supply chains.

A positive external effect of a firm considering promotional activities producing benefits to agents outside the decision-making firm is a **positive externality**.

If the impact of a tourism activity on the environment is detrimental, a **negative externality** arises.

The economic prescription would be to measure the effects of this externality and impose a tax to compensate for it.

PAUSE

Dealing with externalities reduction: How to internalize social costs

Negative externalities should be internalized by governments by introducing specific taxation.

Taxes can be imposed both on tourism enterprises and on tourism consumers. The most common method is to use a **Pigouvian tax** (a tax whose value is equal to the one of the external cost).

As the UNWTO noted: "*Not only are tourists easy to collect taxes from, but it is often the case that the tourist will not be a voter in the country or region where the tax is levied*".

Public Goods

A public good refers to a commodity or service that is made available to all members of a society.

All public goods exhibit two important characteristics:

- **non-rivalry**. The consumption of the product by one person does not affect the ability of others to consume it.
- **non-excludability**. It is not possible to provide the product to one person without the benefits of the product being available to others

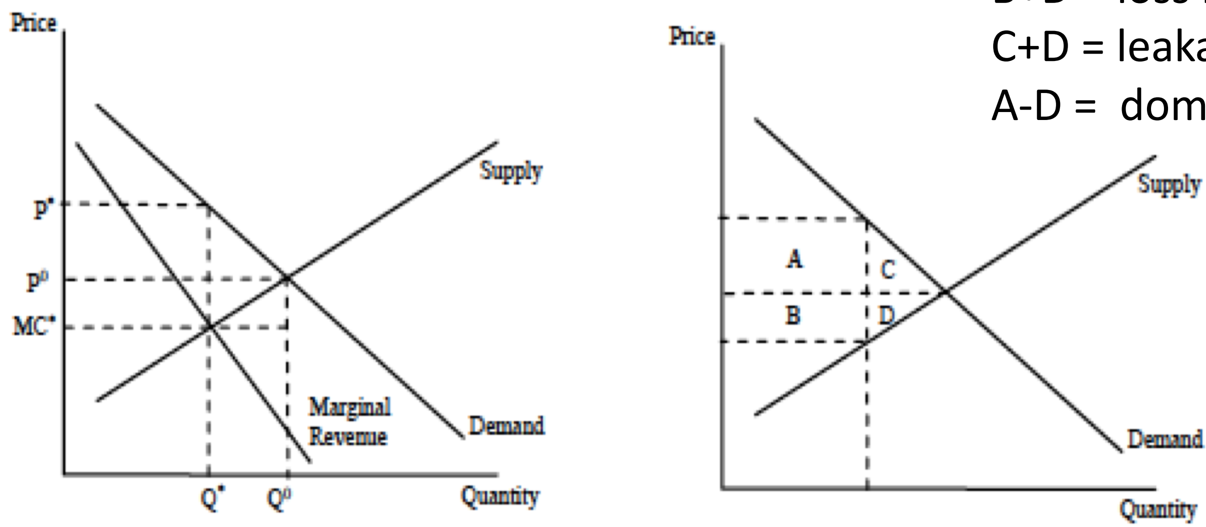
- Public goods should be provided collectively in some form (e.g. Destination and National Promotion, Infrastructures, Coordination and Planning).

Market Power

Market power is the ability of a firm to profitably raise the market price of a good or service over marginal cost.

Figure 3: The Effects of an Export Tax

A+B = tax revenue
B+D = loss in producer surplus
C+D = leakage
A-D = domestic economy gain



Non-Market Failure rationales

A range of other issues become reasons for government intervention:

- Regeneration
- Seasonality
- Wider aims
- Addressing the variable nature of demand
- Skills and training

Contacts and office hours

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