

V. The General Theory of the Second Best

The theory of the second best says that if more than one market failure exists in an economy, eliminating some but not all of the market failures will not necessarily increase efficiency. For example, if all firms are monopolies, making one monopoly a competitive industry will not necessarily make the allocation of resources more efficient (in fact, in this case, the allocation will likely become more inefficient). As other possible examples, consider cases where all the externalities associated with toxic waste dumps have been eliminated but the externalities associated with illegal dumping have not been internalized, or a monopolist that pollutes, and where the externality associated with the pollution has been internalized.

This theorem has important implications for applied welfare economics. It has led some individuals to suggest that it is impossible to make policy prescriptions. However, policy decisions have to be made on a daily basis, so we have to do the best we can, and figure out the general equilibrium implications of proposed policies.