Free rider problem

Free rider problem

- Free rider problem is a phenomenon associated with public goods
- It arises because public goods are non-rival and non-excludable
- Non-rival means consumption of public good does not reduce or diminish the availability of others
- Non-excludable means it is impossible to exclude others from consuming the good
- Because of the aforementioned features, some individuals may use public goods without actually contributing to the cost of financing the good

- This would encourage other consumers also to follow the suit and enjoy the public good ‘free’ of cost
- This phenomenon is called free-rider or easy-rider problem
- Eventually there comes a situation where the cost of providing the public good exceeds the benefits to the providers and the incentive to provide the good disappears even though it is needed for the welfare of the society

Solutions to free rider problem

- Coasian solution- a mechanism whereby potential beneficiaries of a public good are willing to combine their resources to create public good. E.g. Apartment Owners Association
- Assurance Contracts- Contracts in which participants make a binding pledge to contribute to a contract for building a public good, contingent on a quorum of a predetermined size being reached. Otherwise the money will be refunded
- Government provision- Taxation/ subsidies to fund the production of public good.
- Privilege groups- public goods are still produced when one individual benefits more from public good than it costs him to produce it.

- Merging free-riders- Eliminate the profit incentive for free riding by buying out all the potential free riders
- Legislated exclusion- intellectual property, patents, copyrights attempts to remove the natural non-excludability by prohibiting reproduction of the good
- Non- individualism- Public spirit can be fostered by non-market solutions to economic problems, such as traditions and social norms

Public good and market failure

- Market failure occurs when free market outcome is not efficient
- Economists have identified 4 major sources of market failures viz., market power, externalities, public good, information problem
- Public goods leads to market failure or “missing markets” because of its two typical characteristics: non-rivalry & non-excludability
- Because of these two characteristics non- paying users are not excluded from the use of public good

e.g. lighthouse

- So, there are considerable free riders for public goods
- Free rider problem and externalities associated with public goods are tow sides of the same coin
- Because of this, public goods are underprovided causing markets for public goods to fail.