Market Failure

Market Failure

Definition:

where the market mechanism fails to allocate resources efficiently

- Social Efficiency
- Allocative Efficiency
- Technical Efficiency
- Productive Efficiency

Efficiency

- **Social Efficiency** - External costs and benefits are accounted for.
- **Allocative Efficiency** - Society produces goods and services at minimum cost that are wanted by consumers.
- **Technical Efficiency** - Production of goods and services uses the minimum amount of resources.
- **Productive Efficiency** - Production of goods and services is at the lowest factor cost.

Efficiency

Allocative efficiency

- Also referred to as **Pareto Efficient Allocation**.
- Resources cannot be readjusted to make one consumer better off without making another worse off … zero opportunity cost!
- Named after Vilfredo Pareto (1848–1923).

Causes of Market Failure

Market Failure occurs where:

1. Knowledge is not perfect - ignorance
2. Goods are differentiated
3. Resource immobility
4. Market power
5. Services/goods would or could not be provided in sufficient quantity by the market
6. Existence of external costs and benefits
7. Inequality exists

Imperfect Knowledge

1. **Imperfect Knowledge**
   - Consumers do not have adequate technical knowledge.
   - Advertising can mislead or misinform.
   - Producers are unaware of all opportunities.
   - Producers cannot accurately measure productivity.
   - Decisions are often based on past experience rather than future knowledge.

Differentiated Goods & Services

2. **Goods & Services are differentiated**
   - Branding
   - Designer labels - Cost 3 times as much but are they 3 times the quality?
   - Technology – lack of understanding of the impact
   - Labelling and product information

Which one is the 'quality' item & why?

Resource Immobility

3. Resource Immobility

- Factors are not fully mobile.
- Labor immobility – geographical and occupational
- Capital immobility – What else can we use the Channel Tunnel for?
- Land – Cannot be moved to where it might be needed, e.g. London and South East!

Market Power

4. Market Power

- Existence of monopolies and oligopolies
- Collusion
- Price fixing
- Abnormal profits
- Rigging of markets
- Barriers to entry

Inadequate Provision

5. **Inadequate Provision**

a. **Merit Goods**

- Could be provided by the market but consumers may not be able to afford or feel the need to purchase them.
- Market would not provide them in the quantities society needs.
- Sports facilities?

Inadequate Provision

a. Merit Goods

- All education could be provided by the market but would everyone be able to afford them?

Schools: Would you pay if the state did not provide them?

Inadequate Provision

b. **Public Goods** - Markets would not provide such goods and services at all!

– Non-excludability – Person paying for the benefit cannot prevent anyone else from also benefiting - the 'free rider' problem.

– Non-rivalry – Large external benefits relative to cost make them socially desirable but not profitable to supply.

A non-excludable good?

Would you pay for this?

Inadequate Provision

c. **De-Merit Goods**
- Goods which society over-produces.
- Goods and services provided by the market which are not in our best interests.
- Tobacco & alcohol, drugs, gambling

External Costs & Benefits

6. External Costs and Benefits

- External or social costs - the cost of an economic decision to a third party
- External benefits - the benefits to a third party as a result of a decision by another party

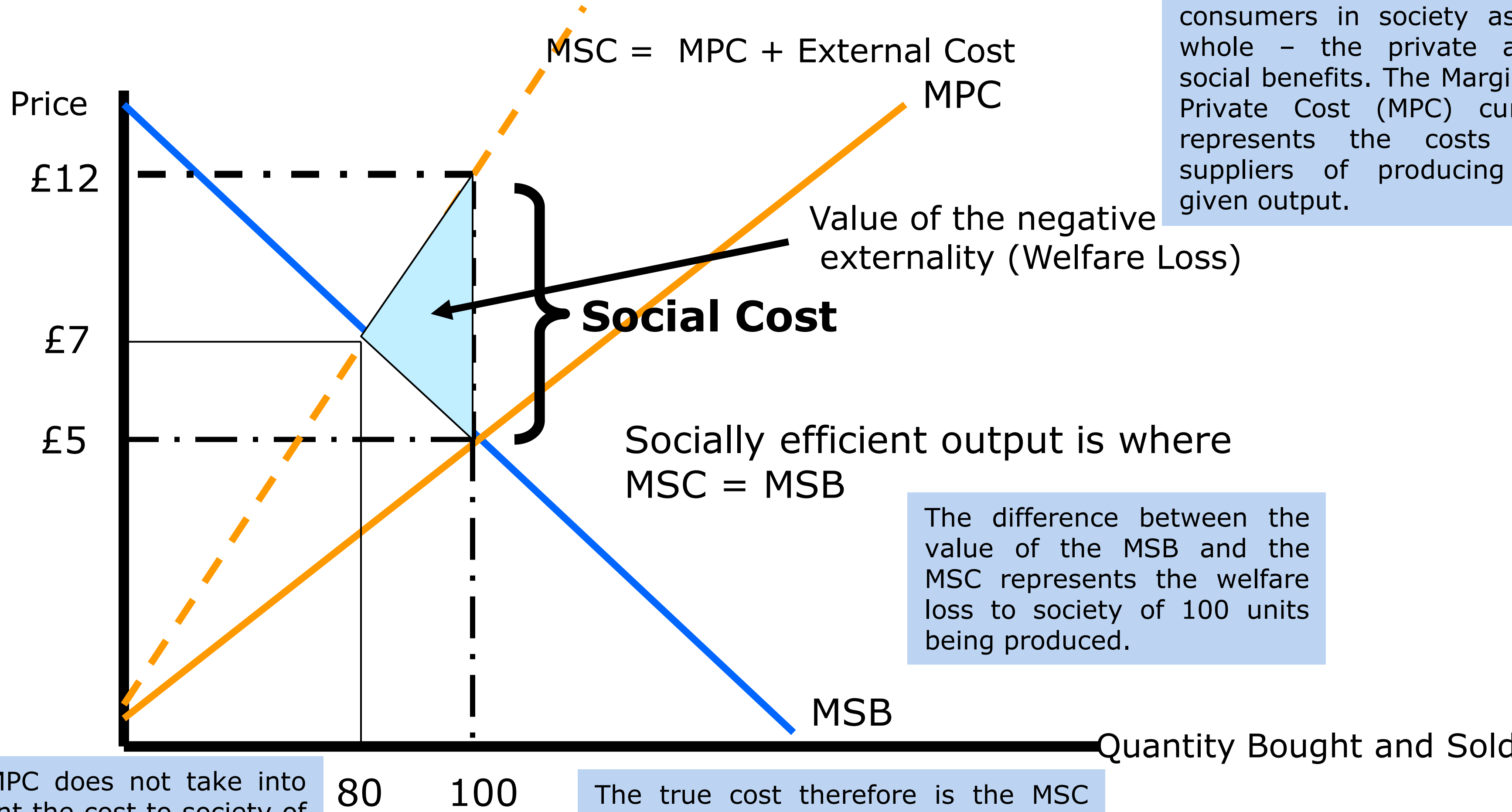
External Costs & Benefits

a. External Costs

- Decision makers do not take into account the cost imposed on society and others as a result of their decision.
- e.g. pollution, traffic congestion, environmental degradation, depletion of the ozone layer, misuse of alcohol & tobacco, anti-social behaviour, drug abuse, poor housing

External Costs

The Marginal Social Benefit curve (MSB) represents the sum of the benefits to consumers in society as a whole – the private and social benefits. The Marginal Private Cost (MPC) curve represents the costs to suppliers of producing a given output.



The difference between the value of the MSB and the MSC represents the welfare loss to society of 100 units being produced.

The MPC does not take into account the cost to society of production. At an output level of 100, the private cost to the supplier is £5 per unit but the cost to society is higher (£12).

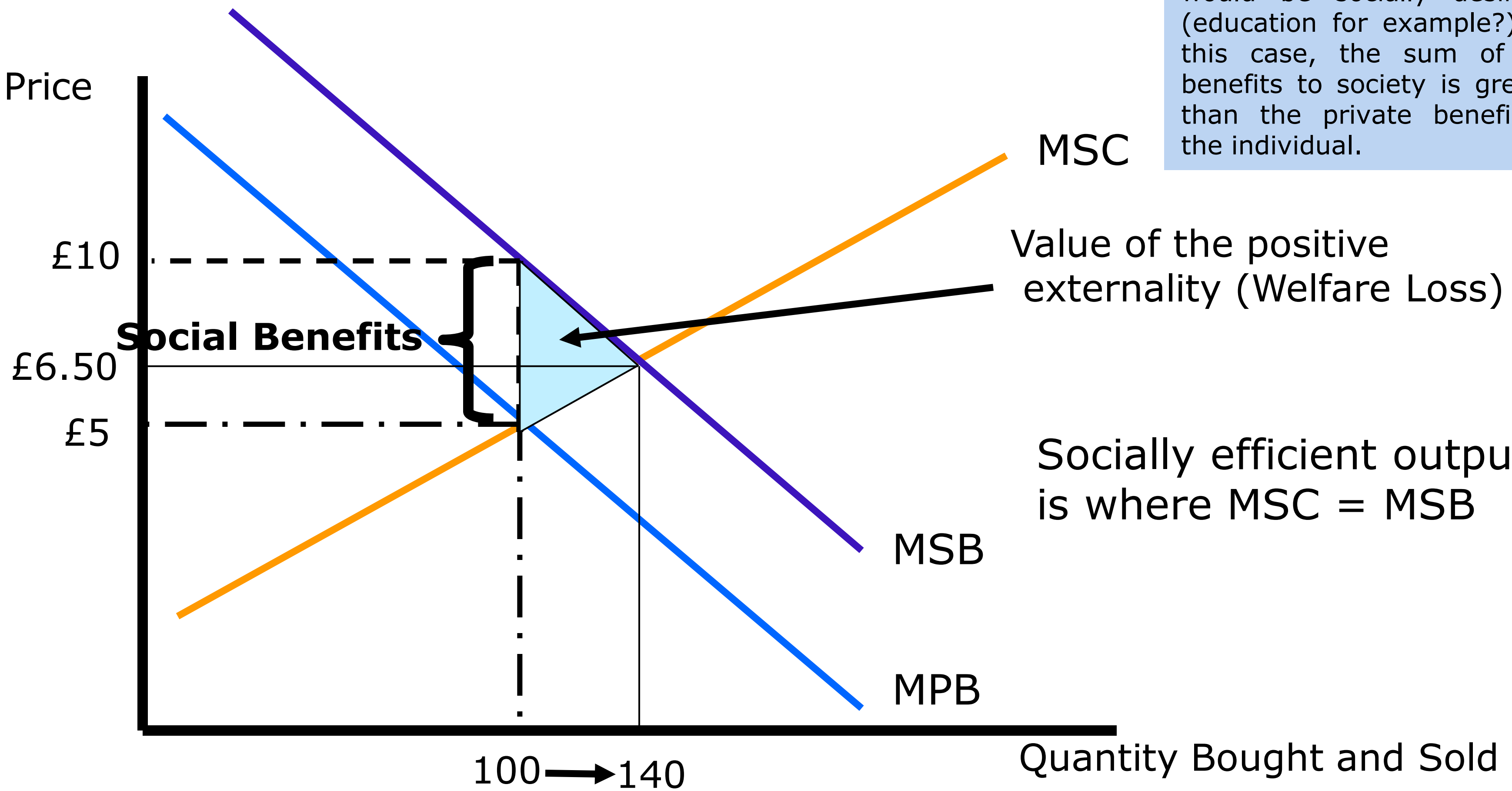
The true cost therefore is the MSC (the MPC plus the external cost). Current output levels therefore (100) represent some element of market failure – price does not accurately reflect the true cost of production.

External Costs & Benefits

b. **External benefits** –
   - by products of production and decision making that raise the welfare of a third party
   - e.g. education & training, public transport, health education & preventative medicine, trash collection, investment in housing maintenance, law & order

External Benefits

There can be a position where output is less than would be socially desirable (education for example?). In this case, the sum of the benefits to society is greater than the private benefit to the individual.



Socially efficient output is where MSC = MSB

Inequality

7. Inequality

- Poverty – absolute and relative
- Distribution of factor ownership
- Distribution of income
- Wealth distribution
- Discrimination
- Housing

Measures to Correct Market Failure

- State provision
- Extension of property rights
- Taxation
- Subsidies
- Regulation
- Prohibition
- Positive discrimination
- Redistribution of income