

Market failure

In this centrespread,
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outlines the main types
of market failure

What is market failure?

- Market failure occurs when the free market fails to achieve an efficient or equitable allocation of resources.
- Types of market failure include:
 - public goods
 - merit goods
 - demerit goods
 - externalities in production
 - inequality
 - factor immobility
 - imperfect information
 - imperfect competition
- Complete market failure occurs when the free market fails to create a market for a good or service, i.e. the good or service would not be produced at all, creating a missing market.
- Partial market failure occurs when a market exists but does not provide resources in the optimum quantities, i.e. there is either too much or too little production or consumption of a good or service.

Public goods

- Public goods are those that are non-excludable and non-rival in consumption.
- Non-excludable means that it is not possible to prevent non-paying customers from consuming a good.
- Non-rival means that one person's enjoyment of a good does not diminish another person's enjoyment of the good.
- Public goods are an example of complete market failure as producers in the free market would have no incentive to produce them, because they would be unable to charge consumers for the use of a public good and would therefore not be able to make a profit.
- Examples of public goods include street lighting, national defence, flood defences and policing.

Merit goods

- Merit goods are those that are underprovided and underconsumed in a free market because individuals do not fully perceive the benefits of these goods or undervalue them, thus leading to positive externalities.
- This is because people either are not fully aware of the benefits of consuming merit goods to themselves or to society as a whole, and/or because some individuals would be unable to afford them in a free market.
- Merit goods are an example of market failure because the level of provision in a free market is lower than that which would maximise the overall benefit to society.
- Examples of merit goods include healthcare, education, healthy food, exercise and car insurance.

Demerit goods

- Demerit goods are those that would be over-consumed in a free market.
- This is because people either are not fully aware of the harm of consuming demerit goods to themselves or to society as a whole, and/or because they are too affordable.
- Demerit goods are an example of market failure because the level of provision in a free market is greater than that which would maximise the overall benefit to society.
- Examples of demerit goods include alcohol, tobacco and junk food.

Externalities in production

- Producers are assumed to be profit maximisers who will only take into account the internal or private costs necessary to produce a good or service, along with their anticipated private benefits in the form of sales revenue.
- This means that firms are unlikely to care about the wider costs or benefits to society arising from their production decisions.
- Negative externalities in production occur where there are spillover costs to society from production, for example air and noise pollution caused by the excavation of a diamond mine.
- Positive externalities in production occur where there are spillover benefits to society from production, for example the extra revenue to local business created by the building of a new railway station.

Inequality

- In most societies, income, wealth and access to resources are not equally distributed across all households.
- While some degree of inequality might be acceptable in most societies, some societies may decide that too much inequality is unacceptable or unfair.
- Inequality can be measured by the percentage of total disposable income earned by households in various percentiles, such as the highest-earning 20%.
- This information can be presented on a Lorenz curve diagram such as that shown in Figure 1. The 45-degree diagonal line shows a perfectly equal distribution of income with the poorest (and richest) 50% of the population earning 50% of the total disposable income. Lorenz curve LC_1 shows some inequality with the poorest 50% of the population earning 40% of the disposable income while LC_2 shows a more unequal distribution with the poorest 50% earning 25% of the disposable income.
- Inequality can perpetuate poverty and deprivation.
- Inequality is often linked to factor immobility.

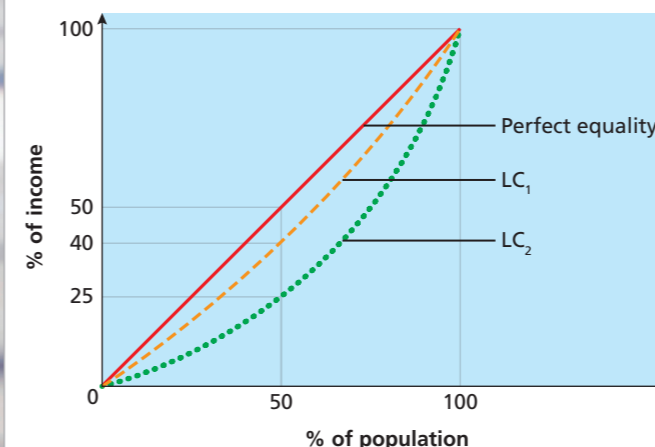


Figure 1 A Lorenz curve diagram illustrating inequality

Factor immobility

- Factors of production, especially labour, may not be perfectly mobile, or free to move, between different uses or occupations.
- Two types of factor immobility are occupational immobility and geographical immobility.
- Occupational immobility is where a lack of relevant skills or qualifications restrict movement between occupations. Examples include former steelworkers and coal miners who may not find it easy to switch to a new job in IT or finance.
- Geographical immobility is where workers have difficulty in moving locations to where jobs are available due to reasons such as a lack of affordable housing or family commitments.

Imperfect information

- Imperfect information means that economic agents do not know everything they need to know in order to make a fully informed decision.
- Economic agents can be faced with too little information or too much information, or find themselves knowing more or less information than other parties in a transaction.
- Information can also be presented in a way that excludes some people while being meaningful to others, e.g. technical or legal jargon.
- There can be costs involved in accessing information, which deters people from doing so, e.g. house surveys or mechanical checks on cars.

Imperfect competition

- Imperfect competition covers any market structure other than perfect competition.
- Market structures such as monopoly and oligopoly have features that restrict competition and give firms in the market the ability to set prices at a level that may exploit consumers.
- Firms in imperfect competition may also be productively and allocatively inefficient.

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