What causes market failure?

Peter Smith summarises key ways in which markets may fail to produce the best possible allocation of resources within society

In an ideal world, free markets would operate in such a way that the best combination of goods and services was produced making the best use of available factors of production.

Allocative efficiency is achieved when society is producing an appropriate bundle of goods relative to consumer preferences.

Productive efficiency is achieved when firms produce at minimum average cost, choosing an appropriate combination of factor inputs and producing the maximum output possible from those inputs.

However, there are many ways in which markets in the real world may fail to deliver an ideal outcome — see boxes 1–7 for some examples.

1 Imperfect competition

Where a firm in a market has market power, it may be able to restrict output and raise price in order to make abnormal profits. In Figure 1, a monopoly firm maximises profits by choosing output Q_m and setting price at P_m. This price is higher than marginal cost, which means that allocative efficiency is not being achieved.

Furthermore, the firm does not produce at minimum average cost, so the market does not achieve productive efficiency either. Notice that the monopoly firm may not be able to sustain this position if the market is **contestable**, such that the firm faces potential competition.

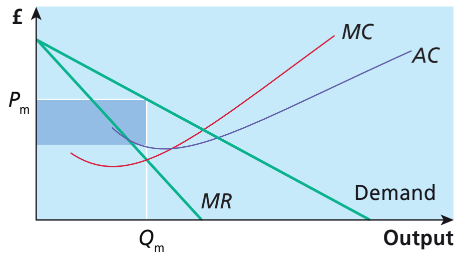

Figure 1 Profit maximisation and monopoly

2 Externalities

If there are costs or benefits that are not reflected in market prices but instead are borne by a third party, then there is an **externality** present. These can occur in production or in consumption. Figure 2 shows a negative production externality. Firms in this market produce pollution as part of the production process, so that the marginal social cost of production exceeds marginal private cost. Firms produce Q_1 output, which is greater than Q^*, which is where marginal social cost equals marginal social benefit.

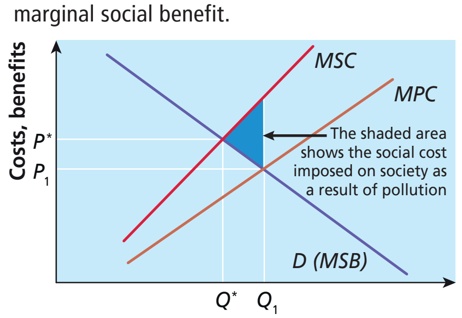

Figure 2 A negative production externality

3 Public goods

There are some **public goods** that have two key characteristics — they are **non-rival** in consumption and are **non-excludable**. This means that if one person consumes the good it does not reduce the amount of the good available for others (non-rival), and consumers cannot be excluded from consuming the good once it is produced (non-excludable). An example would be street lighting, where one person's consumption does not reduce the amount available for others, and where consumption cannot be restricted to some individuals.

This causes market failure because of the **free-rider problem**. If an individual cannot be excluded from consuming a good or service, then they have no incentive to pay for it. The free market will under-provide such goods.

Note that public goods are called 'public goods' because of their characteristics, *not* because they are publicly provided.

4 Price instability

In some commodity markets, there is an inherent instability in prices over time because of shifts in supply or in demand — or in both. Where this is the case, prices may not be able to act as effective signals of market conditions. This provides unreliable incentives to producers in making decisions about which market to join or how much output to produce. This may be seen as a form of market failure.

5 Government failure

Sometimes markets may fail because of government intervention in markets, often designed to tackle some other form of market failure.

For example, minimum wage legislation designed to protect low-paid workers may have the effect (in some markets) of increasing unemployment. Rent controls intended to protect tenants from landlords charging high rates may have the effect of reducing the availability of rented accommodation.

6 Information failure

The free availability of information is important to the free functioning of markets. If some traders in a market (whether buyers or sellers) have more or better information than others, they may be able to take advantage of this and thus use market power to influence outcomes.

Here's an example. You have a leaky tap in your flat and call in a plumber. The plumber fixes it, but tells you that it is really important that you have some additional work done because the pipes are in such a state that you are likely to have major problems in the near future. They know much better than you whether this is a true statement of fact. Unless you have some way of checking the advice, there is likely to be a market failure here.

7 Merit goods

There are some goods and services that the government believes people should consume, even if individuals do not see the benefit. There are also some goods and services that people consume in greater quantities than the government believes to be in their best interests. These are known respectively as merit and demerit goods.

Education might be seen as an example of a **merit good**. This could be an especially important argument in some less developed countries, where many parents may not perceive the value of education for their children, and therefore do not send them to school.

Tobacco might be seen as an example of a **demerit good**. Successive governments have looked for ways of discouraging the smoking of tobacco. This could be seen as an information issue, in the sense that the government may have better information about the health dangers of smoking.

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