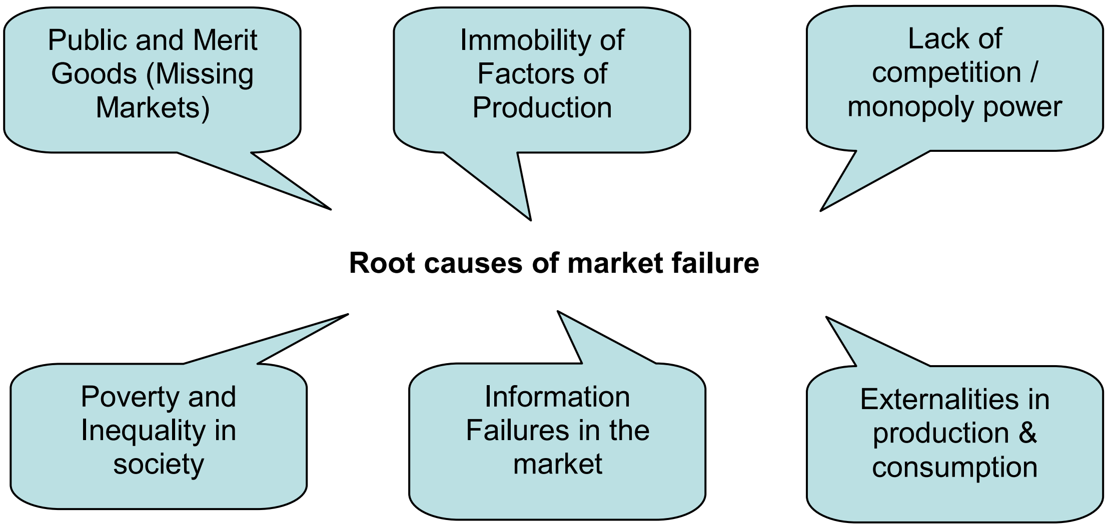
Introduction to Causes of Market Failure



- Market failure occurs whenever markets **fail to deliver an efficient allocation of resources** and the result is a loss of economic and social welfare.

- Market failure exists when the competitive outcome of markets is not satisfactory from the point of view of society. What is satisfactory nearly always involves **value judgments**.

Complete and partial market failure

One useful distinction is between **complete market failure** when the market simply does not supply products at all (i.e. we see “missing markets”), and **partial market failure**, when the market does actually function but it produces either the wrong quantity of a product or at the wrong price.

Markets can fail for lots of reasons:

(1) **Negative externalities** (e.g. the effects of environmental pollution) causing the social cost of production to exceed the private cost

(2) **Positive externalities** (e.g. the provision of education and health care) causing the social benefit of consumption to exceed the private benefit

(3) **Imperfect information** or **information failure** means that merit goods are under-produced while demerit goods are over-produced or over-consumed

(4) The private sector in a free-markets cannot profitably supply to consumers **pure public goods** and **quasi-public goods** that are needed to meet people’s needs and wants

(5) **Market dominance by monopolies** can lead to under-production and higher prices than would exist under conditions of competition, causing consumer welfare to be damaged

(6) **Factor immobility** causes unemployment and a loss of productive efficiency

(7) **Equity (fairness) issues**. Markets can generate an ‘unacceptable’ distribution of income and consequent social exclusion which the government may choose to change

In subsequent chapters we will explore each of these different types of market failure and then move on to consider examples of government intervention.