Market Failure

Chapter 10

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Learning Outcomes

In this chapter we will:

- discuss the factors that lead to market failure such as externalities, monopoly power and imperfect information
- determine and debate how governments can overcome market failure using factors such as taxation, regulation and direct government intervention

Market Failure

Market Failure – Definition

Market failure occurs when resources are allocated inefficiently, i.e. the price mechanism operates imperfectly.
Complete market failure or "a missing market" refers to a scenario when a market does not exist, e.g. national defence or street lights.

Partial Market Failure

Partial market failure occurs when a market doesn't supply a satisfactory price/quantity for a product, e.g. a company charging an excessive price for a life-saving drug – those who need the drug can't afford it so the market isn't allocating the product efficiently to those in need.

Public & Private Goods

Public Goods – Definition

A public good is one not provided by the free market and is consumed collectively (by a group as a whole). They exhibit non-excludability and non-rivalry.

Private Goods – Definition

A private good is one which exhibits *rivalry* and *excludability*.

What do these terms mean?

Non-excludability means that an individual can't be prevented from consuming a product even if they haven't paid for it – consider oranges vs street lights.
Non-rivalry means that one individual benefitting from a product doesn't stop another individual from also benefitting from it – again consider the same example.

An orange is a private good. If you purchase and subsequently consume an orange, someone else can't also consume or derive utility from it.
A flood defence mechanism is a public good. By reaping its benefits (not getting your property flooded), others can still benefit. This is because the mechanism is a communal/social property.

Public & Private Goods

Asymmetric Information

Asymmetric information is another scenario where the market fails.

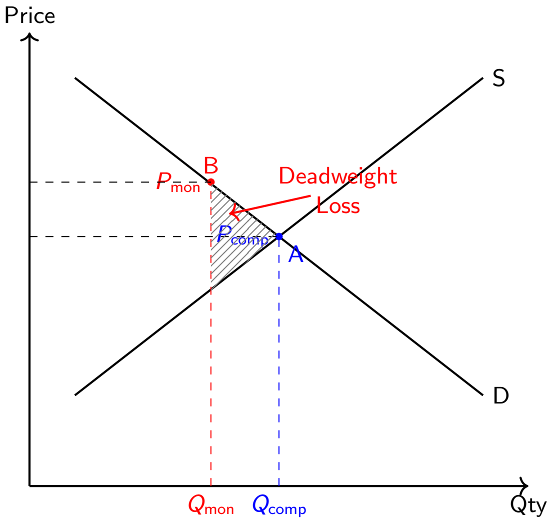
1. One party (e.g. employer) has more information than another (e.g. employee).
2. Market failure occurs as there is no longer perfect information.
3. The party with additional information can exploit their position.

Example – Motor Insurance Industry
This has occurred in the motor insurance industry where companies like AXA, Allianz, and Aviva engage in *price signalling* – discussing or colluding over price increases. This leaves the supplier with more information than the consumer.
These companies have also attempted to exchange information about consumers to exploit their position in the market.

Externalities

- An externality is an unintended impact on any third-party which isn't involved in the market. Externalities arise from the production or consumption of a good or service when someone is impacted despite not being part of the process.
- A positive externality – a farmer who grows apple trees benefits a beekeeper.
- A negative externality – a neighbourhood that suffers noise pollution or disturbance as a result of a drummer who plays a set of drums loudly.
- There are six types of market failures due to externalities which appear in the textbook. A specific question could appear on these terms. So, they should be learned and understood.
- Try question 11 at the end of the chapter to help make some notes on it.

Monopoly Power – Source of Market Failure



Monopoly power refers to the ability of a supplier to influence the price or quantity of a good or service.

Barriers to entry prevent competition and necessary market correction.

As shown in the diagram, the monopolist can restrict quantity supplied from Q_{comp} to Q_{mon}.

Equilibrium moves from A to B.

So the price mechanism is no longer allocating resources efficiently.

How can we solve market failure

✓ Advantage / benefit of the intervention
× Disadvantage / potential drawback

1. **Government provision of public goods**
   - ✓ Consumer benefits from product that wouldn't otherwise be provided.
   - × Disincentive to private sector for an innovative solution.
2. **Competition law/legislation**
   - ✓ Ensures healthy price competition saving consumers time and resources.
   - × Regulatory burden falls disproportionately on small companies.
3. **Deregulation**
   - ✓ Firms operate off a lower cost base, facilitating lower prices.
   - × Consumers must put more time & resources into purchasing decisions.
4. **Taxation on negative externalities / subsidise positive externalities**
   - ✓ Financial incentive to deal effectively with externalities to ensure maximum social benefit.
   - × Small companies may be unable to apply for such grants due to lack of negotiation

2021 HL Paper – Q13 (b)

> *"Technology retailers mislead shoppers with Black Friday deals. Survey of before & after pricing shows that many products are not discounted as claimed."*

– Adapted from the Irish Independent

Explain why misinformation by technology retailers represents a market failure. (10 marks)

2 marks	Identifies information failure as a form of market failure
3 marks	Explains that consumers lack access to retailer's private info
2 marks	States that consumers are at a disadvantage due to misinformation
3 marks	Explains they may be misled to overpaying/misallocating resources

Market failure occurs when the price mechanism in the free market leads to inefficient/inequitable allocation of resources. Production of these goods may lead to consumption of harmful goods, exploitation, or negative externalities for third parties.

1. Information failure is a form of market failure as the consumer can't access to info the retailer has.
2. This asymmetric info disadvantages consumers. They're more likely to be exploited by retailers.
3. The given scenario, where tech retailers knowingly provide pricing misinformation mean consumers are purposely mislead making them more likely to purchase the product at exploitative prices & misallocate their resources.

2021 HL Paper – Q13 (b)

Evaluate how Government intervention could address this market failure. (6 marks)

3 marks	Statement
3 marks	Detailed explanation

Increased public awareness

The solution to information failure is better access to information. If the government allocates more resources to promoting citizens information websites, consumers will be less likely to be exploited in the future and provide examples of past exploitations.

Government legislation/regulation and enforcement

The government could introduce new legislation and regulations in relation to the misleading of consumers where deemed necessary. The Consumer Protection Act 2007 could be amended to ensure these types of behaviours by retailers don't go unchecked.

Increased penalties for offenders: If the likelihood of being caught and the penalty for misinformation of consumers were both increased, firms would likely be deterred from participation.

Increased accuracy of information: The government could make it a requirement of firms to publish their annual product price lists at the end of every year so that consumers can track when the product was the cheapest/ most expensive across the year.