

## What is market failure? Explain with examples

### Answer:

- The study of economics relates to how to efficiently allocate scarce resources within the economy
- Market failure is the inefficient allocation and distribution of resources in a free market economy. This leads to social welfare loss.
- Market failure arises due to the main objective of firms to profit maximise, and would allocate resources to areas that causes the most profits, which causes overconsumption in demerit goods and underconsumption of merit goods
- Another market failure occurs when one side of the party possesses greater knowledge, information or understanding than another party, which is known as asymmetric information that leads to
  - A lack of balance in the way markets or firms trade
  - Causes price not to equal value
  - The creation of fraudulent schemes such as Ponzi schemes
  - Reduces rationality as consumers make decisions that are not rational due to the effect of media and advertising
- Market failure stems from the existence of negative externalities, which is when Marginal social cost exceed Marginal social benefit, this implies that society pays the price for individual consumption. An example of this is Alcohol consumption, which causes individual health effect but the effect on society is far greater such as antisocial behaviour and adverse health effects that the NHS will need to treat, which based on its scarce resources will cause the NHS to suffer.
  - Market failure stemming from negative externalities also relates to the resultant of firms meeting the demands of the market. This relates to the pollution and degradation of natural resources in order to produce products for consumers. The private consumption and satisfaction can last for a very short period of time, however the effect on the environment cannot be reversed. For example, in a recent study shown that the CO<sub>2</sub> effect from producing a Toyota Prius Hybrid is far greater than a normal combustion engine will emit over its lifetime. Also there is no or very low level of recyclability of the batteries used in these Hybrid vehicles. Therefore, what is assumed to be of benefit to the environment is actually worse than the vehicles that these Hybrid engines are trying to replace.
- These market failure if left to the market may not be resolved as firms do not want to bear the cost of correcting the failures. Therefore, the government should step in (intervene) and correct the failure, through:
  - Outright ban and fines to discourage consumption
  - Subsidies to clean and effective production of goods that possess positive externalities and merit goods
  - Extend property rights in order for people or firms to feel obliged to clean up and maintain
  - Markets are efficient at producing private goods, largely because producers and consumers have the right of ownership of the resources exchanged in an economic transaction involving a private good. However, markets are less efficient when property rights do not exist.
    - The absence of property rights can lead to a number of consequences:
      - Opportunism may be encouraged, with individuals or groups exploiting the lack of private ownership. For example, because it is not possible to put a 'boundary' around a song, other individuals can 'steal' the music and lyrics. With modern technology, it is easily possible to copy

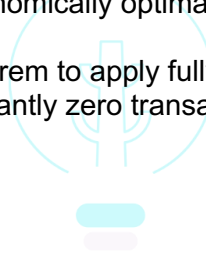
MP3s without paying for them. This is another example of the 'free rider' problem, which means that the price mechanism is less effective at pricing goods that can easily be stolen.

- Misuse of scarce resources is also likely, such as dropping litter on pavements, or deliberately spilling oil in the sea. This problem is made worse is accompanied by moral hazard that is, assuming that someone else will pick up the litter, or clean the seas.
- Overuse of resources, such as the depletion of rainforests, overfishing, and traffic congestion, is also associated with a lack of property rights. Overuse can also result in the general exhaustion of other natural resources, including the environment itself. The environment is, indeed, a scarce resource which can be depleted at will because so much of it cannot be protected by establishing property rights.

Coase Theorem is a legal and economic theory developed by economist Coase that affirms that where there are complete competitive markets with no transaction costs, an efficient set of inputs and outputs to and from production-optimal distribution will be selected, regardless of how property rights are divided. Further, the Coase Theorem asserts that if a conflict arises over property rights under these assumptions, then parties will tend to settle on the efficient set of inputs and outputs.

The Coase Theorem argues that under the right conditions parties to a dispute over property rights will be able to negotiate an economically optimal solution, regardless of the initial distribution of property rights.

However, in order for the Coase Theorem to apply fully, the conditions of efficient, competitive markets, and most importantly zero transactions costs must occur, which is not realistic.



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