The causes of market failure

[Finance](), [Market]()

Why do markets fail to generate socially desirable outcomes? Markets are not infallible. They can fail to organize economic activity in a socially desirable fashion. Marketsfailureare due to social inefficiency and inequity. In the real world, the market rarely leads to social efficiency: the marginal social benefits of most goods and services do not equal the marginal social cost. Part of the problem is the existence of 'externalities', part is a lack of competition, and part is the fact that markets may take a long time to adjust to any disequilibrium, given the often inconsiderable short-run immobility of factors of production.

Let's analyses the types of market failure. Externalities The market will not lead to social efficiency if the actions of producers or consumers affect people other than themselves. These effects on other people are know as externalities: they are the side effects, or 'third-party' effects, of production or consumption. Externalities can be either desirable or undesirable. There are four major types of externalities. 1)External cost of production (MASC.. > MAC) The marginal social cost (MASC..) of chemical production exceeds the marginal private cost (MAC).

For example, when a chemical firm dumps waste in a river or pollutes the air, the community bears cost additional to those borne by the firm. The problem of external costs arises in a free-market economy because no-one has legal ownership of the air or rivers and can therefore prevent or charge for their use as a dump for waste. Control must, therefore, be left to the government or local authorities. 2) External benefits of production (MASC.. < MC) Marginal social cost is less than marginal private cost. One of the example of external benefits in production is that of research and development.

If other firms have access to the results of the research, then clearly the benefits extend beyond the firm which finances it. The firm only receives the private benefits, it will conduct a less than optimal amount of research. 3)External cost of consumption (MS < MB) The negative externalities make the marginal social benefit less than the marginal private benefit. Example, the usage of cars would caused others to suffer from their exhaust, added The Causes of Market Failure By skedadle 4)External benefits of consumption (MSB> MBA) Marginal social benefit is greater than marginal private benefits.

For example, Some people prefer to travel by MR.. Trains than by car. They benefit by being less congestion and exhaust and also fewer accidents on the roads. Public Goods This is another source of market failure which is similar in nature to the problem posed by the commons. These category of goods of free market, whether perfect or imperfect will underproduction or may not produce at all. Public goods, such as national defense, are non-rival and non-clubbable.

Consequently, they give rise to the problem of free-riding: everyone wishes to free-ride on the efforts of others. This implies that the market cannot supply such goods, and a non-market mechanism has to be found. Ignorance and Uncertainty There is often a great deal of ignorance and uncertainty in the real world which result in market failure. Perfect competition assumes that consumers, firms and factor suppliers have perfect knowledge of costs and benefits. Thus people are unable to equate marginal benefit with marginal cost.

Immobility of Factors and Time-Lags in Response Even under conditions of perfect competition, factors may be very slow to respond to changes in demand or supply. For example, Labor, maybe highly immobile both occupationally and geographically. This can lead to large price changes and hence to large supernormal profits and high wages for those in the sectors of rising demand or falling cost. Protecting People's Interests The government may feel that people need protecting from poor economic decisions that they make on their own behalf.

It may feel that in a free market, people will consume too many harmful things. For example, the government wants to discouragesmokingand drinking, it can put taxes on tobacco and alcohol. In more extreme cases it could make various activities illegal which make also caused market failure. Changes in Property Rights Limited nature of property rights. Property rights define who owns property, to what transferred. By extending these rights, individuals may be able to prevent other people imposing costs on them, or charge them for doing so.

For example, the rich can afford 'better' Justice for top lawyers. Thus even you have a right to sue a large company for dumping toxic waste near you, you may not have the legal muscle to win. Taxes from the Government When there are imperfections in the market, social efficiency will not be achieved. Marginal social benefit (MS) will not equal social cost (MASC..). A different level of output would be more desirable. It forces firms to take on board the full social costs and benefits of their actions. For example, the bigger the external costs of a firm's actions, the bigger the tax can be.

Behavior of Monopolies and Oligopolies Monopolies may lead to 'inefficient allocation' of resources because they may encourage suppliers to charge an abnormally high price and produce too little, hereby diminishing overall social welfare. They also have important distributional effects, leading to a redistribution of gains from exchange away from the consumers to the monopolist. If the monopoly continues to persist in the long term, then it may blunt any incentives for the supplier to innovate and reduce cost.

Other important causes of market failure include the absence of information required to make rational choices or to co-ordinate the activity of different economic agents, the existence of uncertainty, immobility of factors of production, and 'inappropriate' consumer preferences. We have already seen that abuse of market power by monopolies or oligopolies may lead to higher prices and lower production than the socially desirable levels. Differences in the market power exercised by various economic agents may also lead to an undesirable degree of inequality in the distribution of income and wealth.

Ken's model draws attention to the conflictive nature of markets rather than their harmonious aspects. According to Seen, the distribution of gains that accrue from an exchange between trading parties depends on the relative economic power of the transacting parties. Since many market situations are accompanied by imbalances in economic power, the distribution in gains from the exchange is consequently also unequal, often leading to high income inequalities in market economies. This inequality may be reduces somewhat by the redistributive actions of the welfare state.

Nations of course differ withrespectto the extensiveness of the welfare state, and most developing countries have very limited welfare state provisions. If you compare Ken's model to Summerset's model. Schumacher stressed the dynamic nature of competition, and felt that competition over innovations in ERM, For him, cost are reduced by advances intechnologyand through economies of scale achieved by successful firms. Firms that cannot keep up in this innovation race go bust: he called this the process of 'creative destruction'.

Schumacher did not regard the presence of monopoly in the short term to be necessarily harmful because he thought that firms often require large financial resources to be able to invest in the developments of innovations, and the existence of short-term monopolies enabled firms to accumulate the required resources. However, monopolies do remain of concern to economists and governments because monopolies can sometimes lead to excessively high prices for the consumers, and abnormally high profits for the supplier.

In contrast to Summerset's model, in the neoclassical model (or the 'perfect competition' model) competitive markets work best when there is an absence of corporate power and the market contains a very large number of firms producing similar products. Under such conditions no single firm can influence the market price through its actions: all the firms are price takers. Under the assumptions of the neoclassical model, this ensures that all the firms produce at the minimum possible cost, charge the minimum prices necessary to keep the firms in business, and the interests of consumers and suppliers are harmonize-brought into equilibrium.

Recollect that the neoclassical model is rather weak on the process by which the equilibrium is achieved. For Hayes and his followers, markets are never in equilibrium. The market mechanism is nevertheless very useful for co-ordination economic activity among economic participants, because prices and changes in ricers convey information about preferences of consumers and conditions of production faced by suppliers.

Hayes contends that it is this transmission of information through prices that is so invaluable, and this process is less costly than alternative mechanisms of transmitting information such as state planning. However, economists have come to realize that although the information signaling role of price is extremely important, this mechanism is not free of cost. These views argue that the role of modern business has changed, and the society expects business to adhere to certain moral and social responsibilities.

Market research is of equal importance to a business. Our economy is very diverse and constantly changing. A business must study theenvironmentand population so as to comply with the consumers buying patterns, needs and wants. A company can do this through market segmentation, demography, and by the use of questionnaires and surveys. Market research can be carried out by the use of market segmentation, which is the dividing up of the market into similar groups so that each group may be studied and carefully examined which I have covered earlier.