15 MARKET FAILURE AND GOVERNMENT INTERVENTION

15.1 An Introduction to Market Failure

Market failure is currently one of the most important topics in economic theory and real-world policy-making. It can manifest itself in a variety of ways – but the essential point is that the free market mechanism might **fail** to achieve a **socially efficient allocation of scarce resources**.

In theory, free and competitive markets produce the goods and services we want in the right quantities and at the lowest feasible cost. This is why markets are so powerful.

15.2 Defining Market Failure

Market failure occurs when freely functioning markets, operating without government intervention, fail to deliver an efficient or optimal allocation of resources - Therefore - economic and social welfare may not be maximised – leading to a loss of allocative and productive efficiency

When this happens there is market failure - In reality – all markets fail at some time or other

Market failure exists when the competitive outcome of markets is not efficient from the point of view of the economy as a whole. This is usually because the benefits that the market confers on individuals or firms carrying out a particular activity diverge from the benefits to society as a whole

Markets can also fail when the individual or firm does not have sufficient information to recognise the returns from undertaking an action

Markets fail when the private returns which an individual or firm receives from carrying out a particular action diverge from the returns to society as a whole – resulting in a sub-optimal amount of it being done

15.3 Main Causes of Market Failure

There are many potential causes of market failure: Markets can fail because of

- **The existence of externalities** causes private and social costs and/or benefits to diverge
- **Imperfect information** which means merit goods are under produced or under-consumed by the market while de-merit goods are over produced / over-consumed
- Freely functioning markets cannot make a profit from producing **pure public goods** and quasi-public goods
- **The concentration of power** in the hands of a few suppliers results in market dominance and can lead to an abuse of monopoly power which damages consumer welfare
- **Factor immobility** such as the geographical & occupational immobility of labour causes unemployment hence productive inefficiency
- **Equity (fairness) issues**. Markets can generate an ‘unacceptable’ distribution of income and social exclusion where people on low income – the relatively poor - are denied access to essential goods and opportunities considered ‘normal’ by a society e.g. food, clothing, housing, and education

15.4 How does the Government Intervene in Markets?

The government can use a range of policies to intervene in market to attempt to correct for what is considers being examples of market failure:

- **Government legislation** - Legislation includes laws passed by Parliament that prohibit (ban) the sale of cigarettes to children, laws to prevent price fixing cartels or which require compulsory school attendance up to the age of 16. Laws might also seek to protect workers by defining maximum working hours and minimum wages at the workplace.
- **Regulation of markets and industries** - There is a huge amount of regulation in both the UK and European Union. Regulation in the UK has included the creation of government appointed utility regulators who impose price controls on privatised monopolists e.g. electricity supply and telecommunications. Regulatory bodies in Britain act as a ‘surrogate competitor’ in the market. In recent years the regulator has set price caps – but as markets become more competitive (e.g. gas and electricity supply) then the price caps are gradually lifted and in some cases abolished completely. The European competition authorities have an important role to play

- **Direct State provision** - **State production** e.g. nationalised industries such as Consignia or **State funding** e.g. the government pays private sector health firms to carry out operations for NHS patients to reduce waiting lists
- **Fiscal measures** (financial intervention) **-** Fiscal policy can be used actively to correct for market failure. This includes making changes to the tax and welfare benefit system to alter market prices or affect the overall income distribution: **Indirect taxes** to raise the price of demerit goods and products with negative externalities
- **Subsides to consumers** to lower the price of merit goods (e.g. grants to students to reduce the private costs of education and also subsidies to companies employing workers on the New Deal programme) and products with positive externalities – a subsidy causes an increase in market supply and leads to a lower equilibrium price
- **Other forms of government financial assistance** such as tax credits and tax relief on investment in research and development
- **Direct taxes on the rich** and benefits in cash or kind for the poor to improve the distribution of income
- Universal benefits are available to people as of right (e.g. Child Benefit and the State Pension
- Means-tested benefits are provided to people according to the financial situation of a benefit claimant – the aim of means-tested benefits is to target welfare assistance on those people most in need