**Causes of Market Failure**

Mixed economies exist because in a free-market, market forces (and the price mechanism) fail to allocate resources efficiently. Some markets fail to supply the market with the quantity that consumers demand; leaving some consumers without the good/service. This is called market failure. It isn’t such a problem if the good in question is something like diamonds, but when the good/service is a necessity (healthcare, education) then the government intervenes in order to correct the market failure.

But what causes the market to fail?

**Public Goods**

There is a category of goods known as public goods, which because of their characteristics **cannot be provided by a purely free market**. Street lighting is one example: there is no feasible way in which a private firm could charge all the users of street lighting for the benefits that they receive from it (this is known as the free-rider problem) and thus has no incentive to produce the item, as receiving an income and making a profit is not possible. The characteristics of public goods are below:

* *Non-excludability:* ‘free rider’ – individuals cannot be excluded from usage
* *Non-rival*: Consumption by one person, does not prevent consumption of another person.

Sometimes a good may show *some* of these characteristics, but not entirely. For example, it is possible to exclude some people from using a road with a toll – but this isn’t always possible. This is known as a quasi-public good.

**Information Gaps**

Sometimes known as ‘asymmetric information’ - if markets are to perform a role in allocating resources, it is extremely important that all relevant economic agents (buyers and sellers) have good information, in order to make informed and accurate decisions. In order for consumers and suppliers to make rational decisions regarding production and consumption, they need to be aware of all information.

It is important that consumers can clearly perceive the benefits to be gained by consuming particular goods and services, in order to determine their own willingness to pay. Such benefits may not always be clear. For example, people may not fully perceive the benefits to be gained from education – or a lack of nutritional information could lead to consumers not fully appreciating their calorie intake.

In other market situations, buyers and sellers may have different information. For example, sellers may have information about goods that buyers cannot discern. One such scenario could be a house with damp or a faulty roof – the buyer would be unaware and so the price paid would not be fully reflective of the actual worth of the property.

**Externalities**

If market forces are to guide the allocation of resources, it is crucial that the costs that firms face fully reflect the actual costs and benefits associated with the production and consumption of goods. This can sometimes not happen due to externalities. In the presence of such externalities, a price will emerge that is not equal to the ‘true’ cost. For example, the price of cars does not fully take into account the cost in terms of pollution and congestion.

We study this topic in much more detail next lesson.