

Lesson 22 Market Failure

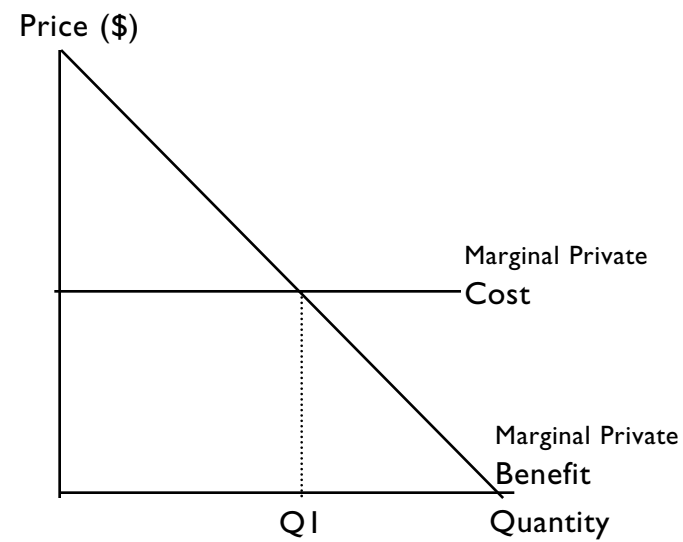
As we have learned, markets work when they manage to allocate resources to where they are most needed. Price information helps producers make choices as to what to produce and which factors of production to use and helps consumers make choices as to what to purchase.

Given this definition of what makes markets work, we can judge a market to have failed whenever it has failed to allocate resources efficiently (ie has not delivered allocative efficiency). Generally, **market failure** is said to exist wherever good things that people want are underprovided by markets or bad things that people don't want are overprovided by markets.

Market failure generally occurs in two situations. The first is when the people who are making decisions do not enjoy (or suffer) all of the consequences (ie benefits or costs) of their decisions. The second is when different people participating in a market have different amounts of information.

Key to understanding market failure is an understanding that behind supply and demand lie costs and benefits. Firms are limited in what they supply by costs, and people demand things that give them benefits. Generally, it makes sense to do things so long as the benefits exceed the costs. We can draw a normal supply and demand diagram with different labels to express this for something as dull as the decision as to whether or not to eat organically and sustainably grown apples (sustainability is important as I want to ensure that all of the costs of growing the apples are borne by the grower).

Observe that until Q_1 , the benefits I derive from eating apples (in terms of pleasure and perhaps health) are greater than the costs I pay (which reflect the costs incurred by growers, which they pass on to me) in order to eat apples. Therefore, rationally, I should eat Q_1 apples. If I were to continue buying and eating



apples beyond Q_1 I would clearly be crazy as the enjoyment I get from doing so is less than the cost. If I were to stop eating apples somewhere to the left of Q_1 I would also be crazy as I have given up opportunities to do something that brings me more enjoyment than it costs.

Basically, consumer surplus and overall welfare is maximized at Q_1 apples. This maximization of welfare is allocatively efficient. However, the eating of either more or less than Q_1 apples would constitute market failure as doing so would lead to a failure to maximize welfare, and would therefore be allocatively inefficient.

Exercise 22

1. Define
MARKET FAILURE

2. In words, try to explain likely reasons why resources are often over-allocated to the production of the following goods. Why are they produced and consumed to the point where the sum of their costs exceeds the sum of their benefits?

- Cigarettes
- Liquor
- Cocaine
- Is there a common theme to the three cases above? Explain.

3. In words, try to explain likely reasons why resources are often under-allocated to the production of the following goods. Why does their production and consumption stop while the benefits of further production and consumption still exceed the costs?

- Education
- Health care
- Public gardens
- Is there a common theme to the three cases above? Explain.

4. In words, try to explain why while some people may want to buy a quality used car and other people may want to sell a quality used car, mutually beneficial transactions of this nature often do not take place.

5. Explain the idea of allocative efficiency by referring to one of the goods in questions 2 and 3.