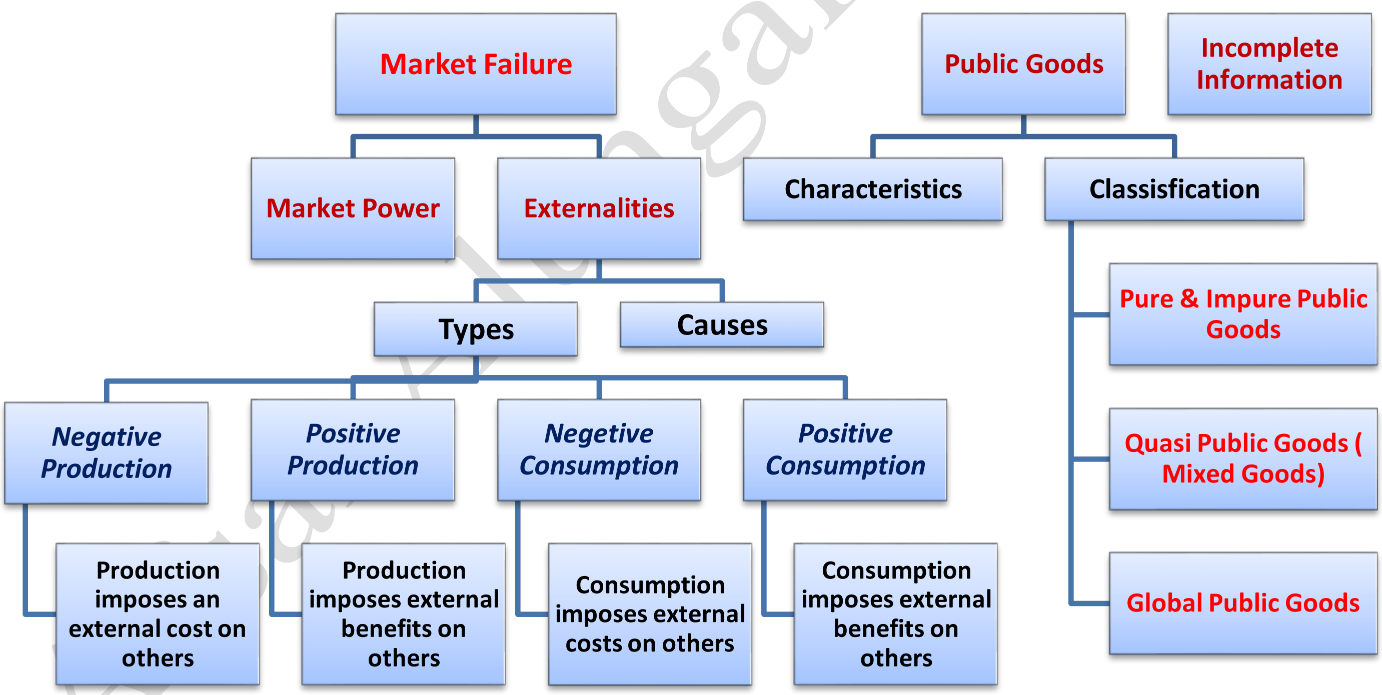
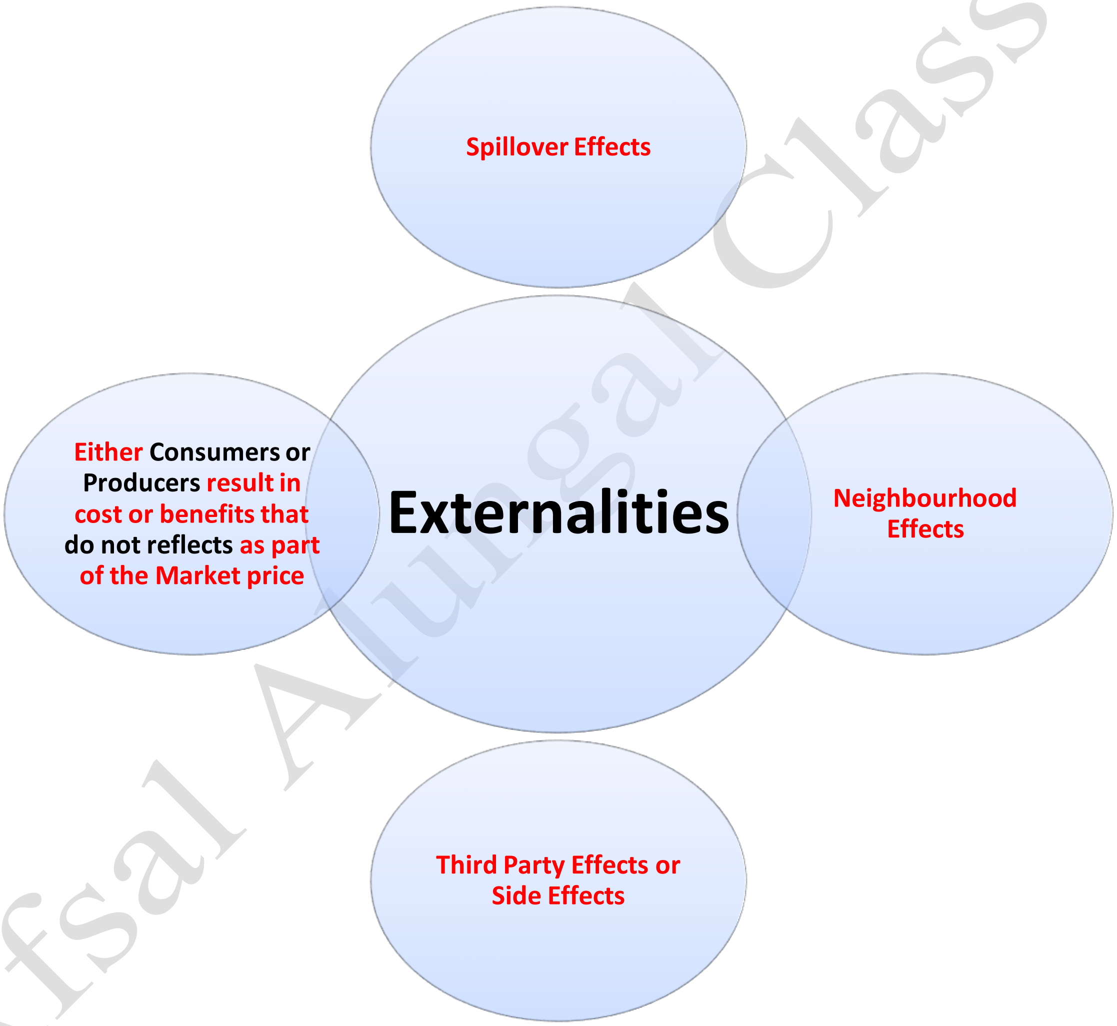
Unit-II Market Failure

Market Failure is a situation in which the free market fails to allocate resources efficiently in the sense that there is either overproduction or underproduction of particular goods and services leading to less than optimal market outcomes.



Market Power
Excess market power causes the single producer or small number of producers to produce and sell less output than would be produced in a competitive market.

Externalities
Externalities are initiated and experienced, not through the operation of the price system, but outside the market and therefore are external to the market.



Externalities cause market inefficiencies because they hinder the ability of market prices to convey accurate information about how much to produce and how much to buy. Since externalities are not reflected in market prices, they can be a source of economic inefficiency.

Examples of Externalities

1. Negative Production Externalities

When a factory which produces aluminum discharges untreated waste water into a nearby river and pollutes the water causing health hazards for people who use the water for drinking and bathing. Pollution of river also affects fish output as there will be less catch for fishermen due to loss of fish resources.

2. Positive Production Externalities

A firm which offers training to its employees for increasing their skills. The firm generates positive benefits on other firms when they hire such workers as they change their jobs. Another example is the case of a beekeeper who locates beehives in an orange growing area enhancing the chances of greater production of oranges through increased pollination.

3. Negative Consumption Externalities

Smoking cigarettes in public place causing passive smoking by others, creating litter and diminishing the aesthetic value of the room and playing the radio loudly obstructing one from enjoying a concert.

4. Positive Consumption Externalities

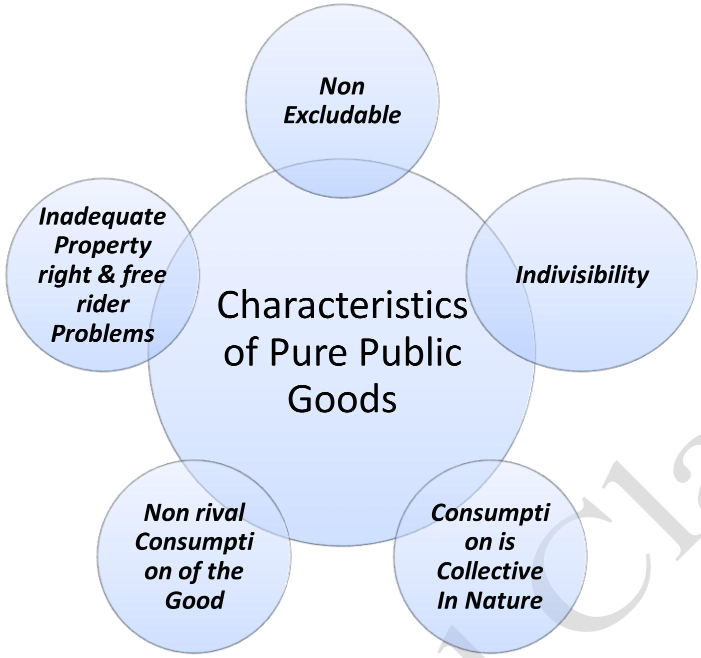
Consumption of the services of a health club by the employees of a firm would result in an external benefit to the firm in the form of increased efficiency and productivity.

Public Goods

A public good (also called collective consumption good or social good) is one which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction of such a good leads to no subtraction from any other individual's consumption of that good.

Asymmetric Information (Incomplete Information)

- Asymmetric information occurs when there is an imbalance in information between buyer and seller i.e. when the buyer knows more than the seller or the seller knows more than the buyer. This can distort choices. With asymmetric information, low-quality goods can drive high-quality goods out of the market.
- Asymmetric information, adverse selection and moral hazard affect the ability of markets to efficiently allocate resources and therefore lead to market failure because the party with better information has a competitive advantage.



Classification of Public Goods		
	Excludable	**Non-excludable**
Rivalrous	A Private goods food, clothing, cars	B Common resources such as fish stocks, forest resources, coal
Non- rivalrous	C Club goods, cinemas, private parks, satellite television	D Pure public goods such as national defense

Quasi-public goods

The quasi-public goods or services, also called a near public good (for e.g. education, health services) possess nearly all of the qualities of the private goods and some of the benefits of public good. They exhibit market failure as incomplete markets.

Private goods

Private goods are ‘rivalrous’ ‘and excludable’ and less likely to have the free rider problem. Additional resource costs are involved for providing to another.