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Market Failure: Reasons and Its Accomplishments

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Abstract

In free market economy; at present there are lots of reasons of market failure. The aim of this paper is to find out those reasons and analyses the probable solutions for recovering those market failures. This paper shows that market failure mostly resulting from an incomplete information as well as information asymmetry between providers and consumers, the effect of externalities, imperfect information, imperfect mobility of factors of production, income inequality, market dominance, negative externalities, positives externalities, public goods and the divergence between social and private time preference rates. Lot of solutions have been found out to overcome the market failure includes Tax on Negative Externalities, Subsidy on positive externalities, Laws and Regulations, Buffer stocks, Government advertising and campaigns. The conceptual framework has been developed by finding and evaluating the market failure overcoming factors where the free market economy can reach to the market equilibrium position from the market disequilibrium condition. Thus, the recommendations of this research will be helpful for home govt. and Businessman to keep the open market in equilibrium position.

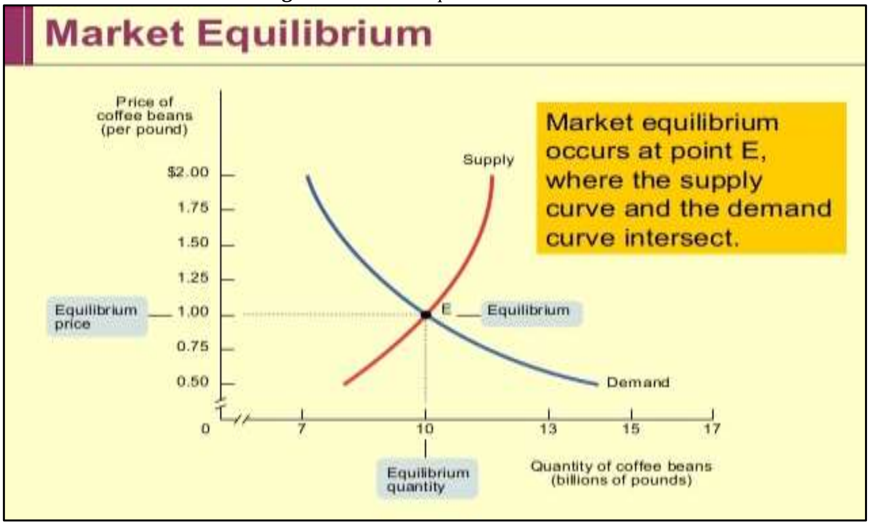
Keywords: Market failure; Market equilibrium; Market disequilibrium; Overcoming market failure; Free market economy.

1. Introduction

Present as well new market in the business may face some challenges and in some cases market may fail for some general cases. Market failure is the state in which equilibrium condition does not exist. Equilibrium is a situation in the market where both buyers and sellers are agreed to exchange a require quantity of goods at an agreed price (Klaassen and Opschoor, 1991). It is a point of rest (Extra / additional one) where a consumer is supposed to have attained maximum satisfaction and an entrepreneur have attained maximum profit. Market failure is the mostly results of ignorance of the consumer, ignorance of the consumer, natural monopolies, absence of relevant information, allocation of resources in times of emergencies, speculation, inequalities in the distribution of income and wealth, restrictions on imports, optimization of the rate of savings, provision of humanitarian services and so on. Traditional reasons of market failure that have special relevance to energy efficiency include public goods, externalities, decreasing-cost industries and institutional barriers to the transmission of clear prices signals (Bostedt and Thomas, 2003). Other study show that causes of market failures include common property resource management, non-competitive markets and the assignment and defense of property rights (Bohm and Russell, 1985).

In the following assumed figure point "E" refers the Market equilibrium position refers the equilibrium price and equilibrium quantity match in the position where the demand curve and supply curve intersect.

Figure-1. Market Equilibrium condition



2. Objectives of the Study

The main purpose of this research is to evaluate and determine the reasons of market failure and make some accomplishment and solutions to overcome this problem.

The specific objectives of this study are:
a) To identify the effective reasons for market failure.
b) To develop the theoretical framework for market failure and recovery.
c) To provide some recommendations and solutions to overcome the market failure.

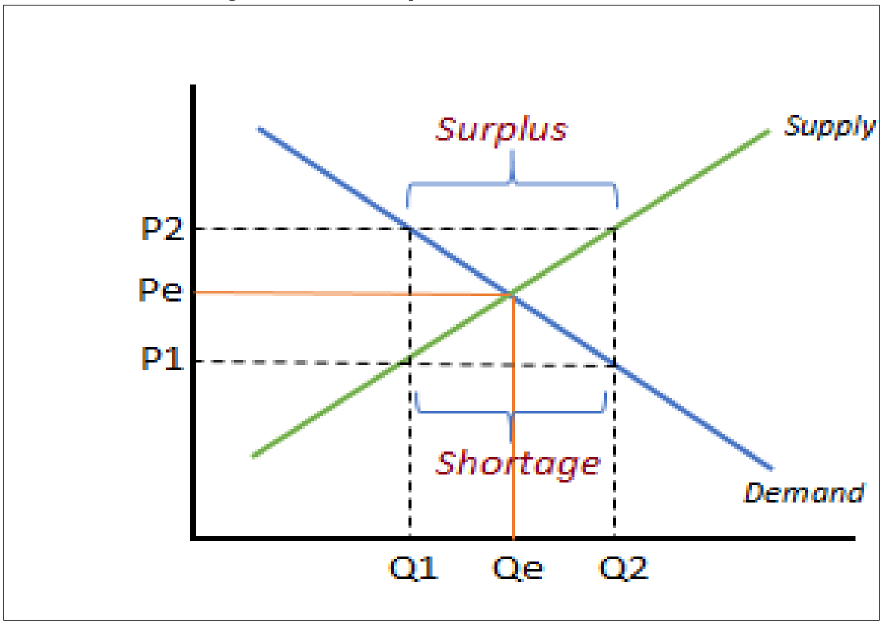
3. Research Methodology

The descriptive research design has been used for conducting the research process. Actually it is literature review based research paper. Secondary data has been used to conceptual framework. Secondary data has been collected from books, journals and articles and mostly from the websites.

4. Market Failure

To know about market failure the term Market 'Disequilibrium' is needed to know first. Here Disequilibrium is a situation where internal and/or external factors confine market equilibrium from being reached or cause the market to fall out of the balance. This can be happen by a short-term byproduct of a change in variable factors or a result of long-term structural imbalances.

Figure-2. Market Disequilibrium and failure condition



A market in equilibrium is said to be operating efficiently where the quantity supplied equals to its quantity demanded at an equilibrium price showed in the graph where the line P_e and line Q_e amalgamate each other. In any equilibrium situation there are neither surpluses nor shortages. In the above graph the price at Pe is the single price at Qe quantity where farmers and consumer engage to exchange. Intersection point of Pe and Qe is the balance of supply and demand of product but above or below the Pe point and forward or backward the point Qe will make surplus or shortage of supply and demand. Market Failure- This occurs when there is an inefficient allocation of resources in a free market. Market failure can occur due to a variety of reasons, such as monopoly (higher prices and less output), negative externalities (over-consumed) and public goods (usually not provided in a free market) (Randall, 1983).

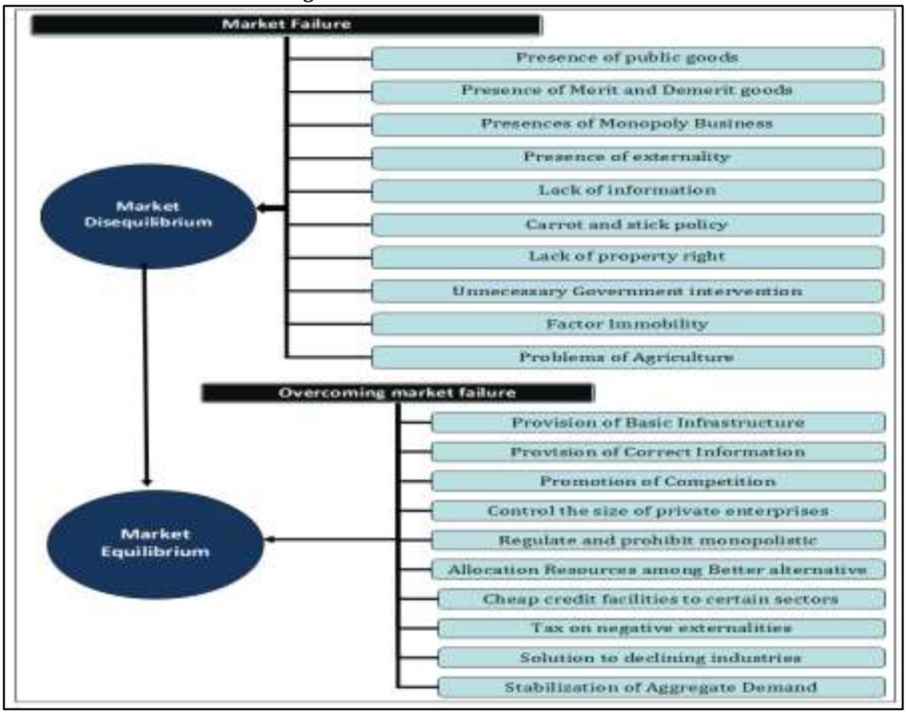
Market failure occurs when the price mechanism fails to account for all of the costs and benefits necessary to provide and consume a good. Market failure occurs when the price mechanism fails to account for all of the costs and benefits necessary to provide and consume a good. The market will fail by not supplying the socially optimal amount of the good. Market failure occurs due to inefficiency in the allocation of goods and services. A price mechanism fails it will be over or under produced (Stiglitz, 1989). Inefficient allocation of goods and services in an economy are the main reason for Market failure. From the various reasons of market failures a monopolistic structure and negative externalities are the main reasons. Actually subject of market failure comes to the light when the competitive outcome of markets is not satisfactory (value judgments) for the society. Mostly market failure is Complete and partial market failure. Complete market failure- When the market simply does not supply products at all according to the market demand (Booth and Snower, 1996).

Partial market failure- When the market produces either the wrong quantity of a product or at the wrong price although the does function well. Example of Market failure- Monopoly privileges leads to market failures when the goods produced are not consumed by consumers for the high prices or when they fail to meet consumer expectations. Market failure may arise when the market is a monopoly where a single producer or group of producers control the market by deciding the price of the commodity they produce named price setters (Bator, 1958).

So in a nutshell market Failure is the condition where economy did not meet the needs of consumers or benefit society in highest degree.

5. Conceptual Framework

Figure-3. Market Failure and Solutions



6. Reasons of Market Failure

In the book of "Market failure or success" the Authors has discuss about the new theories of market failure based on asymmetric information and network effects. They also provide the examination of real markets and careful experimental studies for substantial failure in the markets for labor, credit, insurance, software, new technologies (Cowen and Crampton, 2002).

No market is perfect due to the market structure and this occur when an inefficient allocation of resources in a free market. Market failure can occur owing to various reasons mainly includes- Presence of public goods, Lack of public goods, Presence of Merit and Demerit goods-, Underproduction of merit goods, Overprovision of demerit goods, Presences of Monopoly Business, Presence of externality, Lack of information, Lack of property right, Carrot and stick policy, Unnecessary Government intervention, Factor Immobility and environmental concern.

Gillingham, K., & Sweeney, J. shows some policy instruments in case of some sources of market failure like environmental externalities, national security externalities, network externality, regulatory failure, imperfect foresight , economic of scale, market power , R&D spillovers (Gillingham and Sweeney, 2010). Andrew, B. have observed and implied the market failure, government failure as well as externalities. The author has analyzed some factors in case market failures like – feature of market, information problems, market power, externality effects, public goods, economics of scale, free-rider problems and the author also states that where the market failure there are also cases of government failure like - Information problems, A mix of social and economic goals, Poor management resulting from weak incentives and Regulatory capture (Andrew, 2008).

Figure-4. Reasons of Market failure

Presence of public goods- Public goods are those usually supplied by the government at a free of cost and total cost of production does not increase with the number of consumers. Therefore consumers are free rider. On the other hand goods or services those have to be purchased called private goods. The general tendency is that when two goods exist simultaneously; someone gets benefit from resources or goods and services without paying for the cost of the benefit – is known as the free rider problem and by this way demand for public goods is higher than private goods. This imbalance leads to market failure (Cowen, 1992).

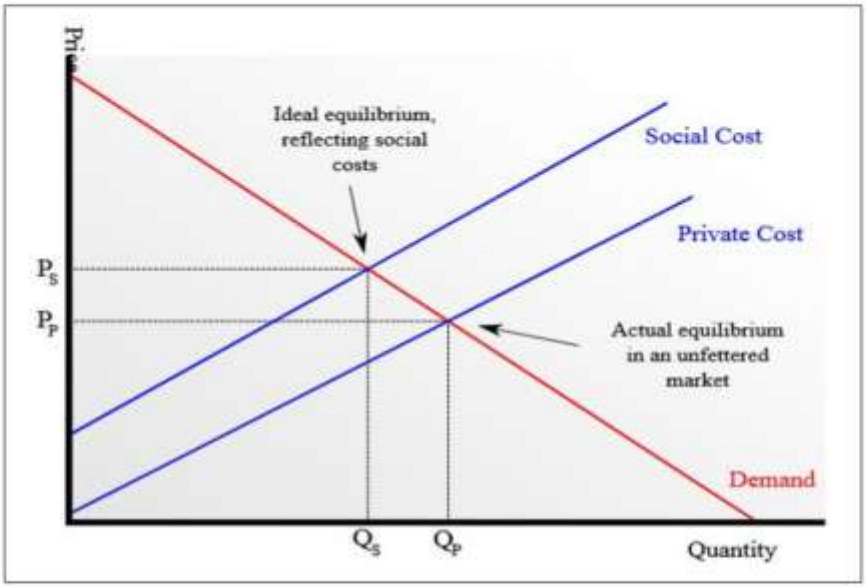
Presence of Merit and Demerit goods- Merit goods are those which are beneficial to the society (school, hospital, church etc.). On the other hand demerits goods are those that are harmful for the society. Historically it is proved that demerit goods are overproduced because of higher demand than the merit goods. Markets may also fail to control the manufacture and sale of goods like cigarettes and alcohol, which have less merit than consumers perceive. This imbalance brings about market failure.

Presences of Monopoly Business- There are two definition of monopoly. When a single seller dominates the market this is called pure monopoly but recent definition of monopoly is when a company individually occupies 33% market share. Whatever may be under monopoly situation; customer lacks bargaining power. Price is set by the seller himself. Lack of bargaining power is another cause of market failure. This market failure causes the imperfect markets which restrict output to maximize profit because one firm can control the market and can set higher prices.

Presence of externality- There are two types of costs and benefits. (i) Private cost- Which is born by the individual person. (ii) External cost- which is born by the 3rd person although he is not the owner but being affected. These two costs together is called social cost. (i) Private benefits- The benefits that the owner himself enjoys alone. (ii) External benefits- Where a 3rd person will be benefited due to the owner of the 1st person. These two benefits together is called social benefits. For equilibrium, social benefit must be equal to social cost. In reality this never happen causing market failure. The market failures, externalities are probably the easiest to understand and accept, particularly those related to environmental quality(Fisher and Rothkopf, 1989).

Positive externality occurs from the production or consumption of goods and service which refers the positive externality- There are two types of costs and benefits. (i) Private cost- Which is born by the individual person. (ii) External cost- which is born by the 3rd person although he is not the owner but being affected. These two costs together is called social cost. (i) Private benefits- The benefits that the owner himself enjoys alone. (ii) External benefits- Where a 3rd person will be benefited due to the owner of the 1st person. These two benefits together is called social benefits. For equilibrium, social benefit must be equal to social cost. In reality this never happen causing market failure. The market failures, externalities are probably the easiest to understand and accept, particularly those related to environmental quality (Fisher and Rothkopf, 1989).spillover. One of the examples of positive externality is less congestion from cycling. Negative externality occurs from the negative spillover which effect by third parties. One of the examples of negative is cancer from passive smoking which negatively impact on the health of people. The following graph presents the negative externality where the social cost is higher than private cost and here industry will produce more until than is socially optimal.

Figure-5. Negative Externality



Lack of information- It's also the vital reason of market failure because sometime marketers may not supply the enough information in the time of market transaction. Providing full information about product and market transaction to other party may not be in the interests of one party (Ledyard, 1991).

One of the preconditions for equilibrium is that both the buyers and sellers will freely exchange information to each other. However in real life neither buyers nor sellers share information. This is called Asymetrix information (imperfect knowledge, it occurs where one party has different information to another party, it could lead to adverse selection) leads to market failure (Akerlof, 1978).

Carrot and stick policy- Govt. should provide various incentives to the businessmen who are doing honest business and also gives punishment to the corrupt businessman. Reality is that across the globe government does provide carrot to the dishonest people and provide stick (punishment) to the carrot business people. This inverse practice is responsible for the market failure.

Lack of property right- When in the market, the property right of the owner is not ensured by the government. Entrepreneur will be demotivated for further production. Thus economy will face under production leads to market failure. When consumers and producers get their property right to own property than markets work most effectively but in some cases property rights cannot easily be allocated to certain resources and in that cases market failure comes to light.

Unnecessary Government intervention- An effective market always makes distorted and inefficient market when government intervened (Samulson and Nordhaus, 2001).

Agriculture - Due to volatile prices and externalities of Agriculture the market failures may occur.

Factor immobility– Factor immobility like geographical or occupational immobility is also responsible for market failure.

Environmental concerns: effects on the environment as important considerations as well as sustainable development.

7. Accomplishment (Overcoming Market Failure)

To overcome those market failures some recommendations and accomplishments are given below-

Mostly the home government can contribute to overcome the causes for market failure.

Provision of Non-market Products and Indivisible Services- To maintain the supply and demand in the equilibrium point provision is must. By applying various provisions like Provision of Basic Infrastructure, Provision of Correct Information, Promotion of Competition and Improvement in Market Functioning it is possible to overcome the market failure.

Control the size of private enterprises- Government can control the market failure by regulating and prohibiting monopolistic (monopoly houses), restrictive and unfair trade practices (Kahn, 1995). According to the above findings and analysis following solutions can be follow to overcome the market failure and to make the market equilibrium position.

a) Prevent mergers and amalgamation of competing units.
b) Allocation of resources among better alternative uses, provision of institutional support.
c) Stabilization of aggregate demand.
d) Provide cheap credit facilities to certain sectors and stimulate their growth.
e) Standardization of business practices.
f) Emendation of inherent drawback in the market mechanism.
g) Providing necessary rules and procedures to regulate and control the speculative transactions.
h) Hold down the equality of opportunity for all market stakeholders regardless of their gender, national origin or religion.
i) Put down the business from engaging in practices that would be harmful to the public.
j) Protect and save small firms from unfair competitive abuses by the big firms.
k) Provide various incentives to the honest businessmen and must use the carrot and stick policy properly.
l) Prevent unfair practices resulting from mergers or other forms of combinations such as price fixing.

Government intervention to overcome market failure:

a) Public goods- In a free market, public goods such as public parks, street lights, air and so on. Consumers need not pay for enjoying those. Government should make a low and policy to make the balance between private and public goods to overcome the market failure.
b) Merit goods / Positive externalities- In a free market, demerit goods are overproduced because of higher demand than the merit goods so to prevent this imbalance government should provide the universal and moral education which has a strong social benefit.
c) Negative externalities- In the free market negative externality occur from the negative spillover which effect by third parties that does not provide efficient social outcome. Government can control the negative externality by taxing production which causes pollution and harmful costs and in the other hand Government should provide the subsidy to encourage other forms to produce positive externality to gain the social welfare.
d) Regulation of monopoly power- In a free market, Government policy and regulation of monopoly can lead to lower prices and greater economic efficiency.
e) Overcoming Asymmetric information- To overcome the asymmetric information and market failure, Government need to invest in the business, gives signals, gives warranties and should maintain no claims bonuses.

8. Conclusion

Market should behave natural, which is demand, supply and price will operate in normal condition. Key findings of this research are market failure arise from the incomplete information, information asymmetry between providers and consumers, the effect of externalities, imperfect information, imperfect mobility of factors of production, income inequality, market dominance, negative externalities, positives externalities, public goods, and the divergence between social and private time preference rates. This study also find out the ten variables to overcome market failure major of those are- tax on Negative Externalities, Subsidy on positive externalities, Laws and Regulations, Buffer stocks, Government advertising and campaigns.

As the time and research budget was limited so it did not review and analyses the huge literature and supporting information. This exploratory research study help for further research by providing its conceptual framework. The theoretical framework can also contribute for farther conclusive research.

However, this study will help to the government, policy taker and marketers to takes necessary improvement for market it becomes most inefficient, leading to market failure. Without the government intervention market failure cannot be mitigated. There is no real model of a society to make the balance between the demand and supply. So here needs to be some state protection of property rights and spending on national defense to bring the equilibrium situation of inefficient allocation of resources in a free market. Although it is very difficult for the government to intervene in macro-economic stabilization but without intervene it is not possible to overcome the problems of market failure.

If the Government can make policies, apply and practices by considering the above key factors (market failure solutions) then free market can reach the equilibrium position and can overcome the market failures.

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