

Appendix A:

Types of Market Failure

Competitive markets:

- provide the most efficient means of allocating resources to maximise the benefits to the community
- ensure the goods and services that consumers demand are produced efficiently, and
- encourage innovation and broader consumer choice.

'Market failure' has a very precise meaning in economics. It does not simply mean dissatisfaction with market outcomes. It refers to a situation when a market left to itself does not allocate resources efficiently. Where market failures exist, there is a potential role for government to improve outcomes for the community, the environment, businesses and the economy.

Governments may intervene to change the behaviour of businesses or individuals to address market failure or to achieve social and environmental benefits that would otherwise not be delivered. Government intervention is not warranted in every instance of market failure; in some cases the private sector can find alternative solutions. There are four main types of market failure which are outlined below.

Public Goods

Public goods exist where provision of a good (product, service, resource) for one person means it is available to all people at no extra cost. Public goods are therefore said to be 'non-excludable' and 'non-rival'.

Free-riding is a problem with public goods. Because the good is non-excludable, everyone can use it once provided. This makes it impossible to recoup the costs of provision by extracting payment from users.

The definition of a public good should not be confused with phrases such as 'good for the public', 'public interest' or 'publicly produced goods'. There are very few absolutely public goods. Examples include national defence, law enforcement, clean air, street lights and flood control dams.

There may be a role for government in providing public goods or funding private provision. However, such intervention should only take place where it is clear the market would not find a solution to this form of market failure. Government intervention should not stifle private innovation.

Externalities

Externalities are costs or benefits arising from an economic transaction received by parties not involved in the transaction. Externalities can be either positive (external benefit) or negative (external cost). The existence of externalities can result in too much or too little of goods and services being produced and consumed than is economically efficient. For example, where the cost of producing a good does not include its full costs, say in relation to environmental damage, then a negative externality is said to exist. This results in the good being over-produced (and under-priced).

The government may try to address negative externalities through:

- regulation that mandates corrective measures
- persuasion (eg an advertising campaign to 'Do the right thing' and not litter)
- establishing property rights in the externality, and
- charging for pollution generating behaviour.

Goods associated with positive externalities are sometimes termed 'merit goods'. Governments may have a role in encouraging increased consumption of merit goods through subsidisation of or public provision of such goods (eg free access to vaccinations). Mandating consumption is a regulatory alternative (eg compulsory schooling for all children).

Information Asymmetry

Information asymmetry occurs when one party to a transaction has more or better information than the other party. Typically, it is the seller that knows more about the product than the buyer, however, it is possible for the reverse to be true. Information asymmetry can prevent consumers from making fully informed decisions.

Regulation requiring information disclosure or placing restrictions on dangerous goods can be used to address this type of market failure. For example, when providing financial advice, financial service providers are required to disclose information about significant benefits and risks, and the fees and charges associated with the financial products, as well as remuneration they receive in relation to the services offered.

It should be noted, however, that information disclosure alone may not be sufficient to change behaviour where there is information asymmetry. Behavioural economics suggests that individuals do not always make decisions in their best interests based on the information provided. It may be necessary to use other instruments in conjunction with providing information to overcome this market failure.

Imperfect Competition and Market Power

Market power exists when one buyer or seller in a market has the ability to exert significant influence over the quantity of goods or services traded, or the price at which they are traded.

In perfectly competitive markets, market participants have no market power. The ability of an incumbent firm to raise its price above competitive levels is limited by the existence of or threat of competition.

The existence of market power can result in economic inefficiency because it may:

- allow firms to increase prices without a commensurate reduction in demand
- restrict competition by creating barriers to entry by other firms.

Examples of market power include monopoly (where there is a single supplier) and oligopoly (where a small number of firms control the market). Where market power exists, governments may intervene to correct the operation of the market or set prices at a competitive level.