##### Market failure

# resource 1.0 - What is meant by the term ‘Market Failure’

**Examples of market failure**

## 1. Labour immobility

The free market economy assumes that labour is completely free flowing to its most lucrative use.

**EXAMPLE:** Demand for a product rises 🡺 this pushes up price 🡺 firms see potential extra profit 🡺 recruits or moves staff and may offer higher wages 🡺 labour exits to meet the firms increased demand and are suitably trained and skilled to enter this new market.

Assumption – labour is perfectly mobile from job to job and area to area.

**Where is the market failure?**

However in reality the firm has trained staff in particular skills that may not be transferable to making the new product so it will displace workers who do not have the new skills needed. These workers may now become unemployed.

Other workers may not be able to move into the new jobs because they are located in a different area of the country. So, despite a demand for new workers, some unemployment will remain.

## 2. Income Inequality

Income is received as payment for owning and supplying a factor of production

|  |  |
| --- | --- |
| Land | Rent |
| Labour | Wages / Salaries |
| Capital | Interest |
| Enterprise | Profit |

Because there is not equal ownership of factors and the quality of each factor can vary, the level of supply varies and the level of demand varies. The resulting price may result in an unequal distribution of income.

**Where is the market failure?**

As goods are allocated according to the ability to pay some may be left with having very little. This is considered to be **socially undesirable** as it causes severe hardship such that people might resort to crime; it may cause homelessness and in general it reduces the quality of life. In other words, it can result in a large increase in **external costs**.

## 3. Imperfect information

For market forces to work perfectly we need perfect information between consumers and producers. This is unlikely. Often producers know lots more about their products and probably their rival’s products than consumers do. When one side has more information it is called **asymmetric** information.

1. Consider the market for second hand cars, who has the most knowledge?
2. What about the market for cosmetics or processed foods, who has the most knowledge about how they are produced?

**Where is the market failure?**

The effect of this is that the market economy may allocate resources according to the preferences of the side which has the most knowledge, rather than on an equal basis.