LESSON 11 – MARKET FAILURE

When Markets Don't Deliver the Best Outcome

Slide 1 – Introduction

Good morning everyone.

So far, we've studied how markets operate when demand and supply interact freely. Under certain conditions, competitive markets can lead to efficient outcomes. However, in reality, markets do not always work perfectly.

Today, we introduce a crucial concept: Market failure — when markets fail to deliver the best outcome for society.

Slide 2 – Why Market Failure Matters

In real-world economies, we observe many problems that markets alone do not solve.

For example:

- Pollution
- Congestion
- Inequality
- Under-provision of education
- Financial instability

These issues suggest that free markets sometimes produce outcomes that are not socially optimal.

Slide 3 – Definition of Market Failure

Market failure occurs when the free market fails to allocate resources efficiently, leading to a loss of social welfare.

In other words, the outcome produced by the market is not the best outcome for society.

Slide 4 – What Do We Mean for Efficiency?

In economics, efficiency usually means: Resources are allocated in a way that maximizes total welfare.

This includes:

- Producing the right goods
- In the right quantities
- For the right people

When this does not happen, market failure exists.

Slide 5 – Types of Market Failure

There are several key causes of market failure.

1. Externalities

These occur when third parties are affected by production or consumption.

For example:
Pollution affects people not directly involved in the transaction.

2. Public Goods

These are goods that are:

Non-rival

Non-excludable

Examples include national defence and street lighting.

Markets tend to under-provide these goods.

3. Market Power

Monopolies can restrict output and raise prices.

This leads to inefficient allocation.

4. Information Failure

Consumers or producers lack accurate information.

This leads to poor decision-making.

5. Merit and Demerit Goods

Some goods are under-consumed or over-consumed due to imperfect information.

For example:

Education may be under-consumed

Harmful goods may be over-consumed

These are the main sources of market failure.

Slide 6 – Private vs Social Costs and Benefits

A key concept in understanding market failure is the distinction between:

- Private costs and benefits
- Social costs and benefits

Markets typically consider only private costs and benefits. However, they often ignore external effects. For example:

A firm producing pollution considers its own costs, but not the harm caused to others.

This leads to prices that send misleading signals.

Slide 7 – Why Markets Fail

When external costs or benefits are ignored:

- Harmful goods may be over-consumed
- Beneficial goods may be under-consumed

This leads to inefficient allocation of resources. In other words, the market outcome does not maximize social welfare.

Slide 8 – Government Intervention

Because of market failure, governments intervene.

Their goals include:

- Internalising externalities
- Providing public goods
- Improving information
- Regulating monopolies
- Promoting equity

Importantly, the aim is not to eliminate markets, but to improve outcomes.

Slide 9 – Case Study: Education

Let's apply this to education.

Education generates significant social benefits, including:

- Higher productivity
- Lower crime
- Better civic engagement
- Long-term economic growth

However, if education were left entirely to the market:

- Some families might under-invest
- Long-term benefits may be ignored
- Inequality could increase

These benefits extend beyond the individual. So education creates positive externalities, which justify government involvement.

Slide 10 – Government Failure

However, government intervention is not perfect.

Policies may:

- Create inefficiencies
- Distort incentives
- Have unintended consequences

This is known as a government failure.

So economics does not simply assume intervention is good.

It evaluates both:

- Market failure
- Government failure

Slide 11 – What We Study Next

This topic leads us to deeper analysis.

We will study:

- How third-party effects distort markets
- How governments attempt to correct these distortions

This forms the basis of many real-world policy debates.

Slide 12 – Summary

Let's summarize:

Market failure occurs when markets fail to allocate resources efficiently.

External costs and benefits are a key cause of inefficiency.

Governments intervene in improving outcomes.

However, intervention involves trade-offs.

Slide 13 – Conclusion

The key takeaway is this:

Markets are powerful, but not perfect.

They can fail to account for wider social effects.

Economics helps us identify these failures — and evaluate whether intervention improves outcomes.

Slide 14 – Final Close

Understanding market failure is essential for analyzing real-world policy, because many of the most important economic decisions involve balancing efficiency, equity, and government intervention.

Thank you.