Jargon Alert

Market Failure

BY RENEE COURTOIS HALTOM

A basic economic principle is that free markets produce outcomes in which resources are generally allocated efficiently. By "efficient," economists mean that all the mutually beneficial trades which are possible have been exhausted. Free markets accomplish this feat by coordinating willing buyers and sellers through prices.

Sound too good to be true? It can be. There are special circumstances that economists call "market failures" in which a freely functioning market is unable to produce an efficient outcome. When there are market failures, government intervention may be justified to correct the failure and, ideally, drive the outcome closer to efficiency.

Economic theory has identified a limited number of market flaws that can lead to market failure. One is when a good's consumption or production comes with externalities. Consider a factory that produces smog with each unit of output. The smog harms nearby households and businesses. But if producers can pollute for free, the production costs faced by the producer are lower than the true costs to society. The price of the good will be artificially low, and too much of the good, and its associated pollution, will be produced.

A "public good" can also be an example of a market failure. Sometimes it is not possible to exclude nonpayers from consumption of a good or service. A local fireworks display is a common example. It would be hard to exclude anyone in the surrounding area that chooses not to pay, so few people have incentive to fork over the entrance fee. As a result, a private party will be less likely to put on the show at all, even though many people would derive value from it. In the case of public goods, the government may step in to provide the service, inducing everyone to pay through taxation. This is why one often sees city governments at the helm of local Fourth of July celebrations.

Though market failures may at first blush appear to be about fairness — the smog producer harms its neighbors, or people free ride on the fireworks display — this occasional feature is not what concerns economists. The primary cost associated with market failure is that an inefficiently high or low amount of the good in question is produced. That causes resources to be directed to places other than where they are most highly valued. Society as a whole is richer when resources go to their highest-value uses.

In fact, plenty of market outcomes that reasonable people may view as undesirable or unfair are not market failures at all. Take, for example, a market-oriented economy that produces income inequality. If a person becomes very rich by inventing a product that a lot of people value highly, that may be a perfectly efficient outcome even if no poorer person benefits in the slightest. A society that spends an exorbitant amount of money on gambling or unhealthy foods reflects that people place different values on how to spend their time and money. Distasteful to some people, perhaps — but not a market failure.

One must also be careful about alleging market failure — especially if that allegation is used to justify government intervention — in instances where markets are not truly free. The recent financial crisis is an example. Financial markets are heavily regulated, which necessarily alters the incentives that market participants would face in a truly free market. Most financial markets are far from being truly "free" markets. It is important to separate the effects of market failure, if any, from the unintended side effects of the regulations.

As for correcting market failures, a good rule of thumb is that successful methods replicate market behavior as closely as possible. For example, in the case of the smog-producing factory, the government could simply place a ban on smog production, but that would deprive consumers of the benefit of the good that was being produced. A more efficient arrangement would be for the government to assign property rights to the surrounding air. This would force the producer to "internalize" the externality by compensating its neighbors for the right to pollute their air, raising production costs.

Private producers have often found ways to correct market flaws in order to produce efficient outcomes. When there are externalities, private parties have sometimes been able to divvy up property rights with no government intervention whatsoever. Private entrepreneurs have also found ways to exclude nonpayers to profitably produce roads (through tolls) and radio signals (through scrambled signals) even though both are commonly cited examples of public goods.

In addition, government interventions can themselves reduce efficiency through unintended consequences, distortionary taxes, special interests, or simply errors in judgment. That's why not all market failures warrant policy action. When considering policy intervention to correct a market failure, the relevant question is whether the costs associated with government action are likely to be greater than those of the initial market failure. **RF**

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