Sources of market failure

- **Market failure** is inefficiency in resources allocation. There is over/under allocation of resources

1. No provision or under provision of public goods.

- Public goods are non rival & non excludable
- Product which is non-rival and non-excludable, it is under-provided in the free market.
- e.g. road and street light
- Non-excludable means no one can be excluded from the consumption.
- Non-rival means the consumption by one person does not reduce the consumption to the next consumer.

2. Under consumption of merit goods

- Products which are under consumed in the free market. Merit goods generate positive externalities (Positive effect to the third party)
- e.g. Education, training and healthcare

3. Overconsumption of demerit goods

- Products which are over consumed in the free market. And, the goods generate negative externalities (negative effect to the third party)
- e.g. Alcohol, cigarette

4. Information failure/Imperfect market information

- when consumers and producers do not have equal access to information. It leads to the wrong decision.
- e.g. consumers do not have full information of second hand car or car sellers have more information about the product than consumers.

5. Moral Hazard

- Moral Hazard : a person may take higher risk decision, if he/she knows the negative consequence will fall to another party.

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- When an economic agent e.g. banker make a decision in their own best interest knowing that there are potential adverse risks and that, if problems result, the cost will be fallen to other agents.
- E.g. bankers who sold mortgages to risky customers knowing that there were high risk of default. But the employees were paid based on how many mortgages they sold. A collapse of a mortgage was a problem for their banks, not for them.
- E.g. In insurance market, people who have insurance may take higher risk as they know that insurance company has to cover that healthcare treatment.

5. Speculation and market bubbles

- Speculation and market bubbles: price cannot reflect the true value of assets when there is speculation

  E.g. people speculate to buy stock of a company

  ↳ Demand for a stock rises.

  ↳ Price of stock of the company rises.

  ↳ It creates incentive to buy more stock to make speculative gains

  ↳ One day when the company cannot make profit as much as people expected.

  ↳ People sell off a lot of the stock

  ↳ Price of stock will fall dramatically called " bubble burst "

6. Externality

- Market fails to take into account all costs and benefits.

  ↳ There is **overproduction and overconsumption** in some goods which generate external cost e.g. pollution and alcohol.

  ↳ There is **underproduction and underconsumption** in some goods which generate external benefits e.g. research on medicine and education.

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