sdg economic development

A brief on market failure and public good

INSIGHT

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The case for public sector intervention in a market is often set out in terms of arguments about market failure and public good. But, the technicalities and the everyday meanings of the terms do not necessarily coincide. Here is a quick summary of the classic market failures.

Externalities or spillovers

Externalities (or spillovers) occur when an individual's or a firm's activities have a (positive or negative) impact on others, but the effect does not form part of the person's or the firm's decision-making process. Manmade climate change is perhaps the most high-profile current example of a negative externality, and contamination of land by previous users is one of the most common negative externalities encountered in regeneration and land re-use projects.

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When there are negative spillovers (such as air pollution) there tends to be overproduction of a good or service, as the full costs of a firm's activity are not borne by the firm. Taxation may ensure a firm's costs approach the social costs of its activities. Conversely, where there are positive spillovers (such as farmers' management of the countryside for the benefit of biodiversity) there tends to be underproduction of a good or service. Another important example of positive externality is the agglomeration and clustering of business, especially in urban centres, where the benefits of the whole are greater than the sum of the parts – for example, increases in activity in a location attract associated activities, such as suppliers, and individuals with the skills and qualities needed to create new and innovative business streams are also attracted, thereby increasing the potential for further economic growth. These positive effects explain why cities are so important to public policy across the world.

Public goods

Public goods, in the terminology of economics, are not necessarily things that are good for the public; for the record, these are known as merit goods.

Public goods arise where one person's consumption of a particular good or service does not limit anyone else's use of it (this is known as a non-rival good) *and* where a service provider cannot enforce a payment for the good or service that they provide (this is known as a non-excludable good). The generation of scientific knowledge in its pure form in universities, which then drives innovation, is a classic public good.

A common good arises where one person's consumption of a good limits another person's use of it but charges cannot be levied. In other words, it is non-excludable but it is not non-rival. This can lead to overconsumption, sometimes known as 'the tragedy of the commons'. This issue is sometimes addressed through regulation.

A club good arises where one person's consumption of a good does not limit another person's use of it but where a fee for usage may be charged. In other words, it is non-rival but it is not non-excludable.

Museums and art galleries can operate on this basis – as one person viewing a painting does not stop another person from seeing it the next day; but visitors can be charged an entrance or a membership fee. The fact that entry to many museums and art galleries is free to users is because they are seen as merit goods; not because they are public goods as defined in economics.

Information failures and coordination failures

Information failures occur where one party has more information about what is being bought or sold than the other party or parties to a deal.

This inequality in information may be due to the withholding of information by the vendor or because buyers wish to avoid the cost of searching for and processing information. Either way, decisions are not likely to be optimal (or fair) often because costs and befits are not properly understood. So, for example, small firms often do not engage in workforce training because their lack of knowledge of the benefits that can flow means training costs are always seen as 'too expensive'.

Government interventions, such as licensing or regulation, or 'try it and see' programmes can be used to address these situations.

Coordination failures arise out of information failures, often when a series of decisions are interdependent; but those making the decisions do not know what each other is proposing to do. A classic example of this is firms which are in competition with each other. Sometimes coordination problems can be overcome by establishing common rules and standards, so that behaviour is knowable and predictable; or by a negotiation or mediation process to build trust and understanding between the parties involved. A good example of coordination failure in the economic development arena is in the labour market, where people do not necessarily find the job in which they will be most productive, as the search costs are too high.

Monopoly

Monopoly is where a single producer limits the supply of a good or service, in order to maintain high prices and above normal profits. Removing barriers to entry to enable competition, breaking a monopolist into a number of firms or removing the monopolist's price-setting power are ways to avoid the negative consequences of monopoly. The recent work by government to create a new range of challenger banks is a good example of attempts to widen markets generally controlled by dominant and well-established providers.

About us

SDG Economic Development:

- Progressive thinking
- Challenging the norm
- Remaining objective
- Ensuring practical outcomes

Contact us

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