

Market failure: the core idea

Market failure is when the free market leads to a misallocation of resources, so the outcome is not allocatively efficient from society's point of view. In practice, this usually shows up as over provision or under provision of goods and services, meaning too many or too few resources are allocated to producing them.

Main sources of market failure

Externalities

Externalities are spillover effects (costs or benefits) on third parties not involved in the transaction. These spillovers create a gap between what is best for the market participants and what is best for society.

Under-provision of public goods

Public goods benefit society but are often under-provided by a free market because firms struggle to make profits from supplying them. Common examples include national defence, parks, libraries and lighthouses, which is why the government typically provides them.

Information gaps (asymmetric information)

Free markets assume perfect information, but in reality buyers and sellers often have different information. This can distort prices and quantities, creating market failure, for example when people would buy less of a product with hidden harmful side effects, or more of a product if they fully understood its benefits.