1.3.1 Types of market failure

a) *Understanding of market failure*
b) *Types of market failure*
   - *externalities*
   - *under-provision of public goods*
   - *information gaps*

- Market failure occurs when market forces do not result in the efficient allocation of resources
- Efficiency: making optimal use of scarce resources to help satisfy changing needs and wants
- Market failure occurs because social marginal costs should equal social marginal benefits but in practice some costs and benefits are unknown or difficult to quantify. Only private costs and benefits are considered not external or social ones
- Social marginal cost (SMC) refers to the addition to the total cost of producing an extra unit and social marginal benefit (SMB) refers to the addition to total benefits of consuming an extra unit
- Types of market failure
  1. Externalities: negative and positive
  2. Under provision of Public goods
  3. Information gaps
  4. Others: labour immobility, monopoly, inequality…
- Allocative efficiency:
  - An output which maximises total consumer and producer surplus and welfare
  - Pareto efficiency: nobody can be made better off without somebody being worse off
  - All points on the PPF are allocatively efficient because we can produce more of one product without affecting the amount of other products available
  - Market price must equal marginal cost of supply
  - It occurs when the value of goods and services equals the cost of the factor inputs used up in production
- Productive efficiency:
  - A firm is operating at the lowest point on its average costs curve
  - Producers minimise the wastage of resources and an economy is on the PPF
  - It can produce more of one good only by producing less of another
- Dynamic efficiency:
  - It is strongly linked to the pace of innovation within a market and improvements in both the range of choice for consumer and the performance of products
  - Process innovation is changing the way production takes place

- Product innovation is small scale and frequent subtle changes to the characteristics and performance of a good or service
- Innovation has demand and supply-side effects on the economy as a whole