

**Task:** Write a viable market failure theory.

**Topic:** Market Failure Theory

**Type:** Analytical Essay

**Length:** 16 pages

**Formatting:** MLA

**Requirements:** Write a market failure theory that would work well and provide a few valuable examples of mechanisms that lead to unproductive results.

Name

Course

Instructor

Date

### Market Failure Theory

Market failure has for a long time been among the most controversial arguments in regard to the role of the government and its interventions. Li (2011) argues that in the recent decades, the arguments of market failure have been largely centered on the public goods and extremity theories (Li 1-29). According to these theories, therefore, market participants are bound to fail in the production of the services and goods that are of mutual benefit. Economists describe market failure as the state where service and good allocation within a free market fails to reflect efficiency. In line with the allocation theory, market failure is considered as being the failure of the general idealized price-market institution system in order to sustain the wanted activities or shun the activities considered undesirable, where the desirability of the given activity is determined on the basis of its solution values towards the implied or explicit highest welfare problem. Therefore, in this paper the main objective is to evaluate the effectiveness of the market failure theory as a consumer oriented theory, and as a regulatory theory in the in the UK financial services.

### The Financial Service Regulation

The financial sector is important in providing some power needed for the country's economy to attain the potential growth, and must be designed in a manner that improves the potential for productivity for the entire economy. The financial regulation is, thus designed to

enhance the efficiency of financial market functioning through increased financial stability, consumer protection, limited risks, and improved information (Black 7-54). The of these regulations is through supervision and regulation, where there is a regulated disclosure in regard to complex financial products, and definition of the standards of accounting. The UK Financial Act 2012 is inclusive of the reforms by the UK government for the financial service regulation, as well as the creation of a new framework of regulation for the management and supervision of the financial and banking services within the UK (Government of UK). In addition, the Act provides the Bank of England with the macro-prudential duty of overseeing the financial system as well as the daily prudential supervision of the firms within the financial services, and management of essential balance-sheet risks.

The regulations within the financial services result in a complex state of benefits and costs. It is expected that the UK enjoys sustained level of freedom in its move to shape its regulations for the purpose of achieving what is considered the ideal cost-benefit balance, while considering the risk aversions and the preferences for current practices among other things. However, the regulations have attracted a fair share of criticism from different parties. For instance, some believe that what the current market needed was not mere tougher and more regulation, but smart requirements as well as supervisions that are better funded, and independent from political and industry pressure ( Cartwright, Crown and Ingram 1-3).

The banking sector is seen as one of the heavily regulated sectors, but still demonstrated to be vulnerable to systematic shock in certain jurisdictions due to the limited resources and information, whereas the regulation led to creation of incentives that moved the risks beyond the boundaries of regulations and diluted the desire for shareholders and creditors to monitor the taking of risk (Delis, Molyneux and Pasiour 2-19). Therefore, the regulation costs could affect

beyond the institutions that are directly affected by the regulation. There could be the effect on the general economy, for instance, if the regulation leads to a reduction of the innovation that could otherwise enhance the economy functioning.

### **Market Failure Theories**

It is in accordance with the central modern welfare economics theorem that under particular assumptions in regard to taste, technology, and the motivation of the producers, the equilibrium conditions that characterize the competitive market system will effectively correspond to the respective Paretian requirement efficiency (Bator 351-379). In addition, if the incomes that are competently input are redistributed continuously within a lump-sum fashion costlessly, in order to attain the implied income-distribution as per a social welfare function, the solution of competitive market will have a perfect correspondence to the Pareto-efficient solution, which is electronically calculated, and maximizes, as determined by taste, initial endowment and technology. There is no absolute correspondence in the real world for the majority of the things, including the lack of perfect information, resistance to change, the desire for a quiet life by business, lack of feasibility in costless taxes, inconsistent and uncertain expectations, and the aggregate demand vagaries among others ( Keech , Munger and Simon 1-39).

According to the modern welfare economic theorem, which is also referred to as the duality theorem, there is a correspondence between the performance of the market and Pareto efficiency. The essence of this analysis lies in its remarkable record with convexity that is all-round, and not dependent on tastes, the high level of technocratic formulation, and neutrality to the institution (Aronsson and Löfgren 901-987). Within the problems of Paretian maximum-of-welfare is a constraint set, namely; Lagrangean multipliers, duals, shadow prices, all of which

have the price, rent, wage, and interest rate analytic characteristics. The existing correspondence between market performance and Pareto-efficiency demonstrates that decentralization of decision making as a response to prices by very small profits, lead to the sustenance of output, input and distribution of commodity constellation by maximizers, as called upon by the social welfare function maximums ( Laekhanukit, Naves and Vetta).

The new economists in market failure study single out the information problem within all sectors as being the reason for the ever growing market failure. In the western countries, among which is the UK, the governments are responsible for at least forty percent of the total gross product domestically. The regulations imposed on these, particularly the financial regulations, make the government intervention scope much greater. In essence, market failure has been witnessed in virtually all sectors including, labor market, agriculture, health, education, electricity, and the scientific research sector among others ( Simon and Keech W.).

Within the UK context, therefore, market failure could be perceived as the standard justification for governmental actions within the neoclassical welfare economy. It can be presumed that the market processes are a default in the allocation of the otherwise scarce resources (Bator 351-379). However, this constitutes an assumption of ideal competition, in which price information directs the participants in the self-interested market to rectify mistakes or locations that are Pareto-dominated in the usage of resources. In addition, the market failure theory makes the assertion that in the situation of imperfect competition, the government can and should correct the situation. In line with this claim, therefore, it is assumed that the political actors have the required information and the appropriate incentives to facilitate Pareto optimal resource allocation.

Based on this interpretation, however, there appear to be two assumptions that are in direct contradiction with each other in regard to the human capacity and motivation. It is assumed that the consumers have no relevant information, but become fully informed when voting for a certain course of their choice. The economic elites, among which are the CEOs are portrayed as the selfish maximizers of utility, whereas the political elites, who in this case include the UK government officials, are portrayed as being altruistic public trust servants (Munger, Simon and Keech 1-7).

Various models have been applied in the description of the market failure, including the antitrust policy, the public good model, Pigouvian taxes and subsidies, as well as the information provision regulation. The world, which is virtually invisible, is seen as having market discipline and efficiency that is brutally impersonal. Profit is generally dissipated within competitions, and the firms that have negative returns cannot survive (Simon and Keech W.). This implies that when the firms are in a dilemma, they lack sufficient means to enable them act unilaterally in order to initiate internalization of the externalities even if they tried hard to do it.

The competitive equilibrium theory is apparently static based on the assumptions made in relation to the market failure, especially because it shows no profit, growth or innovation. The theory gives no role for human agency and entrepreneurship, since all the profit dissipation is done in competition. In addition, there are hardly real world markets that reflect the predictions made in relation to the competitive equilibrium theory, since there is profit and profit, whereas production is often characterized by increasing returns and externalities.

Even with the various demerits identified within the Competitive Equilibrium Theory, there is no doubt that it gives the Archimedean analysis point of market failure and market perfection. However, it lacks the analogous fixed eye basis to facilitate a comparison of the

actions by the government in correcting the arising failures within the market. There may be a distinction between the passive government failures, in which the inaction by the government leads to Pareto inferior results, while the active government failure is characterized by government actions leading to worse consequences than if the government never did anything.

#### The Core Problems: Incentives, Information, and Incoherence

It is not realistic to believe that the actions taken by the government would result in an automatic impact on the market failures. The ideal could be best described as naïve, similar to what free market fundamentalism, where it is assumed that the markets are bound to perform optimally when no government interventions are involved. Applying the realistic empirical performances in making for the right mix between government and market organizations could place both the government failures and the market failures on a similar level. If markets are left to do what they prefer in terms of distribution and action, there would equally be pervasive and deep failures. Therefore, it is not enough to simply identify the market failures, while assuming that the government would effectively correct them. Certain problems exist for the purpose of spanning all types of attempts in order to organize the society for the capture of gains accrued from the corporation and exchange (Coleman). There are three major problems that hinder the realization of optimum Pareto results within a social mechanism or organization, thus constituting the organizational failure.

#### Incentives

Government agencies have the ability to lure activists with the desire to expand the scope and size of the activities of their agencies. Such desires could be a pure belief in work as an important component of public welfare, although this may fail to coincide with the general public goal. The goal and motivation system is made more complex due to the lack of units for

output measurement, lack of productive efficiency, cost incentives, as well as the lack of mechanisms for feedback attached to profit motive, in which economic firms have to capture a greater or equal value to that of their cost ( Grajzl and Murrell 520-545). In this case, virtually all problems are relevant to large corporations, with ownership control separation, incentive problems that give agents the reasons to work on principle goals, as well as the impactness of the information within agencies that do not encounter direct feedback tests like profits. The decisions on production, enforcement and monitoring, as well as employee direction create serious incentive problems within large organizations, whether government-created or market-based.

#### Information

Externalities problem is partly due to information problem. Prices fail to portray the full resource opportunity cost as used in the activities that produce externalities. As a result, most of the activities are carried out within unfettered private market settings. It is expected that when the state moves in to make corrections on the incorrect prices, everything will become good. However, the same lack of information that disables the private action hampers the state's efforts in correcting. The lack of market data to both the state and the market makes the entire system vulnerable to market risks ( Stucke 162-197).

#### Aggregation Incoherence and Arbitrariness

The theory of general equilibrium depends on several claims, including that there must be equilibrium, where the price vector adjustment occurs in a manner that damp down, as opposed to exploding the changes in other factors for economy that include technology, taste, income, and the complement and substitute prices. Within the equilibrium, it is possible to examine whether the market process results suffice the Optimality of Pareto. Similarly, the government actions encounter the aggregation incoherence problems. When numerous public properties is at stake,

no general solution exists, particularly in case of non-separable preferences. The competitive markets that sufficiently fulfill the competitive equilibrium theory assumptions discipline the selfish behavior automatically, thus making the maximization of profit by firms proportional to the maximal consumer welfare ( Stucke 162-197). However, this legerdemain accomplishment is realized through assuming away all possible problems that could result in conflicts between public goal and individual incentives.

### **Classic market failures in the world of increasing returns**

A classic market failure perception sees the CET generated equilibrium as unrealistic. The belief that all processes of production are dependent on the diminishing returns does not look likely. Therefore, there is no doubt that both consumption and production decisions are affected by external factors. Majority of the durable and complex commodities have the stark information asymmetries, and in certain circumstance, very severe differences between the desires of the consumers and the production of the firms. The market failure theory starts by the competitive equilibrium theory assumptions and uses the same assumptions in establishing a performance benchmark. In cases where the actual performance of the market varies from this benchmark, there is a need for implementation of the financial policy by the government, with the focus on reducing the variation between the idealized CET point and world of realized results within the imperfect market. Increased productivity and the eventual causes of growth lead to reduced output prices as well as increased labor wages. Similarly, the basic opulence causes, or the increase in prosperity, leads to increased returns. It is evident that the nation's wealth is a result of increased returns to the scales occurring because of labor division. The increasing returns could be a result of combined improvement in dexterity, tool use and design, or the increase in stage mechanization in the process of production ( Beaulier and Subrick 444-463).

In essence, the cause for prosperity and growth within the realistic world characterized by increasing returns could be regarded as pathology, and a market failure that needs government action, if the action reference frame remains the CET that is virtually static. Similarly, there surely exist genuine market failures within much more complex worlds with ever growing returns. For instance, the chances for information asymmetry exploitation, in order to engage in fixing of prices, or for imposition of catastrophic externalities within the wider environment, have higher prevalence within the world that experiences increasing returns. Negative externalities, among which is pollution are still evident within the worlds characterized by increasing returns, but as opposed to making comparison between the results and the proposed CET benchmark, consent and property rights could be used, and adjudicated upon by courts representing small citizen number, and be regulated by relevant agencies of the government towards the deciding where collective action and transaction costs enable private solutions (Grote and Marauhn 25-178).

There is a need for accountability for the information asymmetries, as well as punishment for fraudulent transactions. The sole classical market failure that fails to go through to the increasing return world unscattered is the supposed desirability of market structure in which all agents of economy are price takers. The agreements on price-fixing, together with the attempts to institute monopolies would be equally illegal. However, successful network economy captures have vast implications for higher output and lower cost that the most ideal structure of competitive market, without profits and innovations or research, should be put aside. Competition is warranted in the market, and the government policy must be evaluated to see that it does not block competition by artificial barriers to entry. However, there could be benefits of compensation to other large firms, which have the liberty to choose their prices. One of these is

product differentiation, while the other is development and research that results in more innovation (Coleman 76-125).

In general, market failures can be perceived as a world of increasing returns. However, the problem for market failure address is more critical as opposed to the theoretical aspect. Considering the real incentives facing governmental policy and actors, the actual information and expertise levels that could be realized through regulatory institutions, such as the UK financial regulation authority, there comes the question of whether or not the actions of the government could lead to a net performance improvement. In cases of market failure, the actions by the government through their regulation policies can only get justifications through empirical realistic claims that the actions are bound to make things better than before, for both long and short terms to allow destruction of inefficiency and promote innovations in production (Ngo 3-16).

Luckily, the market failure theory must not depend on the competitive equilibrium theory (CET) for its validity. The supply of public goods is still underperforming in the hands of unregulated markets, but the undersupply is compared to the optimal results of Pareto as implied by preference mechanisms of revelation by Lindahl-style. Certain aspects of voluntary coercion, in which the citizens comply with the punishment given to them upon failure to make their payments for tax in order to fund the public goods, is still evident in the Lindahl logic, and the capture of Pareto improvements can facilitated by the use of government actions.

There is no doubt that the public interests and perceptions are relatively variable in relation to the different forces impacting on the integrity of the market. Private markets are determined to solve the problem, though imperfectly, by admitting variations in choices ( Keech , Munger and Simon 3-47). However, with the financial policy and regulations put in place, the

public must adopt the formulated perception, hence forced into accepting the policy despite their contrary perception to the policy. If every agency has the information advantage, while the authority enforces in its discretion, then there is bound to be a government whose activities surpass the optimal levels. Eventually, the markets systematically underproduce the public goods, while the public agencies could be protected for overpayment of input factors and overproduction of services and goods. The problem encountered in the aggregation of conflicting, different preferences for the mix and levels of public activities is important.

The services offered by the government are not subject to any test in regard to profit or test, since the government specializes in producing services and goods that are characteristically too expensive and prohibitive under the available arrangements for pay-for-consumption. In addition, the bureaucratic agencies have profound and probably insurmountable privileges in terms of the information asymmetries regarding the costs of services and activities of the agencies. It is not possible to imagine any firm that can survive beyond 50 years, since it is not easy to pass continuously in the profit test within such much time. However, the bureaucratic agencies do not need to prove themselves in any test, or be exposed to any mechanisms of feedback that could otherwise lead to disappearance (International Center for Monetary and Banking Studies (ICMB) 15-68).

In contrast, successful and entrenched agencies measure their successes in terms of the amount of money they can afford to give away. Apart from the costs accompanied by these transfers, there is the creation of organizational incentives in organizations with powerful lobbying, which defend their agencies against the attempts made to reduce their budget or eliminate them. For instance, the wasteful program's survival, which range from the supports given for tobacco prices, as well as the dispersion of contracts on the geographical basis for the

defense projects, indicates that the government has clearly failed, since it would be cheaper to pay give payment to the transfer recipients compared to continuing the programs. In essence, there is never a theory of the government, not any with so much fancy as the assumptions attached to the CET posits for an ideal market, which can effectively give a description of mechanisms that are incentive compatible for the actions of the government to yield optimum Pareto in equilibrium ( Weitzman 403-409).

### **Conclusion**

This indicates that the UK-based firm that operate within the world of increasing returns, together with the government agencies tasked with financial regulation that operate as monopolies, operate on a virtually similar footing in terms of discipline. The consumers hardly have any power to instill discipline to the corporations that enjoy overwhelming returns, while the citizens have no power to discipline the governmental institution, together with the officials appointed that are protected by strong barriers. There is a need for re-balancing of the scales in the market. Questioning which of the government or the market is better is a comparison of two extreme alternatives that are not in existence. The real question should focus on what mix of the financial policy as instituted by the government, and the market could lead to desired efficiency and maximum responsiveness. There is no doubt that public interest conceptions are significantly variable, hence very insatiable by any of the government policies put in place. In response to this, the private markets move to solve this by providing varying choices for the consumers.

At this level, therefore, the most important approach is that the statistical efficiency of the market is neither necessary nor sufficient for the institutions in the market to be declared as preferred social organization modes. Different from the institutional considerations, the efficiency of Pareto may not be of so much necessity. For instance, people are quite sensitive to

both their jobs and those of others. On the other hand, if such things that include relative status and power matter, then the injunction for output maximization, to hug the frontier of production possibilities, cannot be considered neutral. And the utility frontier points could associate with the points beneath the frontier of production. In addition, there is never anything pre-ordinate in regard to welfare functions that are quite sensitive strictly to the preferences of the individual consumers. It is hardly expected that people take the proposed preference with a lot of seriousness in order to argue against all and any individual protection from their respective misdeeds.

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**Overall Impression**

It seems like you did your best. No, you just outperformed yourself. There's approximately one paper in a dozen that would be written as badly as yours—congratulations, you are the winner of the day.

First of all, what's with all these words used completely out of place? You seem to like “smart” sounding words such as “therefore”; I can understand that, but why squeeze them in wherever possible and impossible? What, you tried to match the word count desperately?

And why so many typos? Did you read through your paper at least once after you finished it? Repeating words, articles, and conjunctions, misspelled words--is it trendy or what?

Some phrases of your authorship almost made my eyes bleed: “distribution of commodity constellation my maximizers,” what the bloody hell is that?! Or, “the info ration provision regulation.” Do you even speak English, bro?

This is not to mention a number of incomplete sentences—it seems like you simply forgot what you were writing about, and jumped to the next sentence without finishing the previous one. This, as well as frequent cases when two or more clauses in a sentence simply did not relate to each other in any way makes me want to tear this paper into pieces so tiny that even scientists with their advanced microscopes would not be able to see them.

Whenever you decide to write another paper, I strongly advise you to reconsider.