

H2 Economics – Essay Model

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Topic: Market Failure

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Explain how market failure can be caused by immobility of factors if production and inequity in income distribution. [10]

The free market is expected to allocate resources efficiently using the price mechanism that would provide as signals for demand and supply, moving resources to the areas where they will be utilized most efficiently and such that welfare of the society is maximized. Market failure results when the market fails to deliver an efficient allocation of resources and thereby compromising social welfare. They can be caused by inherent market imperfections, the nature of goods and service in the markets as well as the presence of dominance in the market. In the case of immobility of factors of production and the inequity of income distribution, they are results of inherent imperfections in the market.

For the immobility of factors, resources might not be employed efficiently and thus allocative inefficiency arises despite the market. As for inequity in income distribution, it causes the price mechanism to cease to function properly, resulting in the failure of the market to allocate resources properly.

Factor immobility, like scarcity, is a fact of economic life. While technology can help ease the degree of immobility, it cannot eradicate the problem. The factors of production, land, capital, labour and entrepreneurship (risk-taking) are not perfectly mobile and therefore, costs are incurred when attempting to move these factors from where they occur to the place where they're needed for production to take place. As a result, goods may be produced less efficiently than ideal. For example, large swathe of arable land may be available in USA for production of crops that China demands for. Unfortunately the land cannot be made available in China and transporting the harvest from USA to China is too expensive. Eventually, marginal land in China is used for the crops, while arable land in USA stays uncultivated. Wherever there exists such geographical immobility, transport cost will have to be incurred, reducing the efficiency of the resource allocation in the market.

Factors may also suffer from occupational immobility in the case of labour and inability to substitute in terms of resources. Doctors require many years of training and a shortage of doctors cannot be immediately solved by getting the unemployed to become doctors. Likewise, when they are in excess and another skill set; when lawyers are in shortage, the doctors are unable to fill the gap. The training that is required for these jobs to be taken up would require much time to ensure that the existing unemployed labour qualify for those specialized jobs. This means that the market may simultaneously have a shortage of labour in one area and a surplus in another, a less than ideal allocation of labour resources.

As for inequity in income distribution, the price signals in the market would be distorted as it could disproportionately reflect the demands of the rich, making certain essential goods too expensive for the poor. In an extreme case, if there're 2 individuals, one earning a daily income of \$1 and another \$100; and the poor is willing to pay \$1 for the good while the other is willing to pay \$10, the good goes to the rich man. Nevertheless, the poor man is willing to pay 100% of his day income while the rich only willing to pay with 10%. In such extreme inequality, demand transmission through price signal becomes rather distorted and allocation of resources ceases to be efficient from the perspective of social welfare.

Evaluate the policies used by the Singapore government to correct these causes of market failure. [15]

When the market fails to achieve an optimal allocation of resources, the presence of government intervention is justified only if it produces a superior outcome to the market. In this case, the market failures are caused by factor immobility and inequality of income distribution. The Singapore government reduces the market failure caused by geographical immobility factors through improvements in the transport networks while reducing

occupational immobility through supply-side policies to retrain workers. As for inequality in income distribution, a combination of welfare policies and the progressive tax regime plays an important part.

Geographical immobility of factors cannot be completely overcome so the government can only lower transport costs of moving factors to the places where they are needed more quickly. By building efficient and better public transport, the government helps to smoothen the movement of labour force to their workplace. With proper congestion management of the road networks, the government is also effectively minimizing delays for transportation of goods in the economy. Nevertheless, we are unable to move certain factors of production such as 'low-wage workers' into the country and thus factories will have to be relocated overseas in order to increase productive efficiency. The extent by which the Singapore government can manage geographical immobility is extremely limited.

The government can play a greater role in the area of occupational immobility by putting in place training programs that would enhance the flexibility of the labour market and help people acquire the necessary skills to take on new jobs and roles. Since occupational immobility is very much the imperfection in the market that increases the time needed to solve structural unemployment, supply-side policies would help. While highly specialized jobs like that of doctors, lawyers, accountants and architects may still have the problem of occupational immobility, many skills are mobile across the lower level jobs. Receptionist can be trained to become typist, clerks, call-center officers, customer service consultants and cleaners may have their skill upgraded to operate machinery in factories. Nevertheless, the willingness to pick up the skills required to get another job depends much on the employees themselves. The government can only provide the platforms to reduce occupational immobility. For the high level jobs, due to the long training and high education required, it is not possible for the government to achieve improvement in occupational immobility.

As for the inequity in income distribution, the progressive tax regime as part of the automatic stabilizer of the fiscal policy would help to make income distribution slightly more equal than it otherwise would be. By taxing more at higher income brackets, the rich are made to put with a higher proportion of their income than the poor. At the same time, some of these government revenues are channeled to the low income groups through subsidies, grants and handouts. For example, in the case of the GST offset package introduced in 2007, the people living in HDB flats (assumed to be less well off) are given a higher handout than their richer counterparts living in private housing. Likewise, the lower income groups are offered higher subsidies for healthcare services and bursary for education.

The policies used by the Singapore government are only able to mitigate the degree of market failure resulting from factor immobility since they are limitations of nature; often it requires improvement in technology and vast improvement in human capital. As for the policies to cope with inequity in income distribution, they are often pursued half-heartedly since these policies often distort the incentives to work and can reduce productivity of the economy. In addition, with the rich becoming more mobile, the government would be reluctant to institute policies that will drive them out of the economy. As a result, inequity of income distribution would remain and possibly become worse as the government prioritizes growth above equalizing income distribution.