Edexcel (B) Economics A-level

Theme 4: Making Markets Work

4.3 Market Failure across the Economy

4.3.1 Market failure in society

Notes

- Market failure occurs when the free market fails to allocate resources to the best interests of society, so there is an **inefficient allocation of scarce resources.**
- Economic and social welfare is not maximised where there is market failure.

Positive and negative externalities; merit goods; demerit goods

- An externality is the cost or benefit a third party receives from an economic transaction outside of the market mechanism. In other words, it is the spill-over effect of the production or consumption of a good or service.

- Externalities can be **positive** (external benefits) or **negative** (external costs).

- Negative externalities are caused by **demerit goods.** These are associated with information failure, since consumers are not aware of the long run implications of consuming the good, and they are usually overprovided. For example, cigarettes and alcohol are demerit goods. The negative externality to third parties of consuming cigarettes is second-hand smoke or passive smoking.

- Positive externalities are caused by **merit goods.** These are associated with information failure too, because consumers do not realise the long run benefits to consuming the good. They are underprovided in a free market. For example, education and healthcare are merit goods. The positive externality to third parties of education is a higher skilled workforce.

- The extent to which the market fails involves a value judgement, so it is hard to determine what the monetary value of an externality is. For example, it is hard to decide what the cost of pollution to society is. Different individuals will put a different value on it, depending on their own experiences with pollution, such as how polluted their home town is. This makes determining government policies difficult, too.

- The over-provision of demerit goods and the under-provision of merit goods may result from imperfect information about the long term implications of consuming the good. For example, education would be under-provided in a free market, because the long term benefits of it are not accounted for in society.

- Not all products that result in positive or negative externalities in consumption are either merit or demerit goods.

Factor immobility (occupational and geographical)

- The **geographical immobility** of labour refers to the obstacles which prevent labour from moving between areas. For example, labour might find it hard to find work due to family and social ties, the financial costs involved with moving, imperfect market knowledge on work and the regional variations in house prices and living costs across the UK.

- The **occupational immobility** of labour refers to the obstacles which prevent labour from changing their use. For example, labour might find it difficult to change the occupation. This occurred in the UK with the collapse of the mining industry, when workers did not have transferable skills to find other work. The causes include insufficient education, training and skills.

- The flexibility of the labour market is how willing and able labour is to respond to changes in the conditions of the market. It is important for labour to be able to adjust to changes in demand, and it is vital for the supply-side of the economy.

Imperfect and asymmetric information

- ### The under-provision of public goods
  Public goods are non-excludable and non-rival, and they are underprovided in a free market because of the free-rider problem.

- Public goods are missing from the free market, but they offer benefits to society. For example, street lights and flood control systems are public goods.

- They are **non-excludable** so by consuming the good, someone else is not prevented from consuming the good as well, and they are **non-rival,** so the benefit other people get from the good does not diminish if more people consume the good.

- The non-excludable nature of public goods gives rise to the **free-rider** problem. Therefore, people who do not pay for the good still receive benefits from it, in the same way people who pay for the good do. This is why public goods are underprovided by the private sector: they do not make a profit from providing the good since consumers do not see a reason to pay for the good, if they still receive the benefit without paying.

- Public goods are also underprovided because it is difficult to measure the value consumers get from public goods, so it is hard to put a price on the good. Consumers will undervalue the benefit, so they can pay less, whilst producers will overvalue, so they can charge more.

- Governments provide public goods, and they have to estimate what the social benefit of the public good is when deciding what output of the good to provide. They are funded using tax revenue, but the quantity provided will be less than the socially optimum quantity.

- **Private goods** are rival and excludable. For example, a chocolate bar can only be consumed by one consumer. Moreover, private property rights can be used to prevent others from consuming the good.

- **Information gaps**
  It is assumed that consumers and producers have perfect information when making economic decisions. However, this is rarely the case, and this imperfect information leads to a misallocation of resources.

Consequences of environmental change

- High and fast levels of economic growth could mean that production levels are high. This could use a lot of natural resources, such as coal, oil and natural gas. There could also be deforestation. However, governments might try and implement policies to reduce this depletion.

- The production and transportation of goods can also negatively impact the environment. This could mean that natural resources, such as oil, are not used sustainably. Sustainable development is when the stock of natural resources does not decline over time. It allows the needs of the present generation to be met without compromising the ability of future generations to meet their needs.