CIE Economics A-level

Topic 1: Basic Economic Ideas and Resource Allocation

b) Externalities and market failure

Notes

Reasons for market failure

- Market failure occurs whenever a market leads to a misallocation of resources.
- A misallocation of resources is when resources are not allocated to the best interests of society. There could be more output in the form of goods and services if the resources were used in a different way.
- Economic and social welfare is not maximised where there is market failure.

- **Types of market failure:**

  - **Externalities**
    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. Negative externalities are caused by the consumption of demerit goods, such as cigarettes, and positive externalities are caused by the consumption of merit goods, such as recycling schemes.

  - **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.

  - **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.

  - **Monopolies**
    Since the consumer has very little choice where to buy the goods and services offered by a monopoly, they are often overcharged. This leads to the under-consumption of the good or service, and therefore there is a misallocation of resources, since consumer needs and wants are not fully met.

  - **Inequalities in the distribution of income and wealth**
    There is an unequitable distribution in income and wealth. Income refers to a flow of money, whilst wealth refers to a stock of assets. This can lead to negative externalities, such as social unrest.

- **Complete and partial market failure:**

- Complete market failure occurs when there is a missing market. The market does not supply the products at all.

  Partial market failure occurs when the market produces a good, but it is the wrong quantity or the wrong price. Resources are misallocated where there is partial market

- **Positive and negative externalities for both consumers and firms**

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.