

# Edexcel (B) Economics A-level

## Theme 4.3: Market Failure Across the Economy

### Flashcards

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# When does market failure occur?



# When does market failure occur?

When the free market fails to allocate resources to the socially optimal level of output



What is the equation for the total social cost?



What is the equation for total social cost?

Social cost = Private Costs + External Costs



How would you calculate the external costs from a graph?



How would you calculate the external costs from a graph?

Measure the vertical distance between the Marginal Social Cost (MSC) line and the Marginal Private Cost (MPC) line.



Do the MPC and MSC lines move parallel to each other?





Do the MPC and MSC lines move parallel to each other?

No, both lines diverge from each other, as external costs increase disproportionately to output.



Draw a graph showing external costs of production in a market, labelling the area of welfare loss.

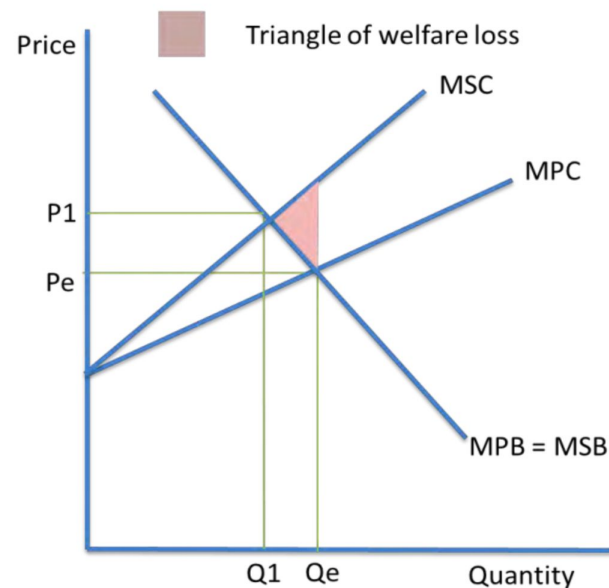


Draw a graph showing external costs of production in a market, labelling the area of welfare loss.

PeQe represent the market equilibrium.

When negative externalities are present,  $MSC > MPC$ , which results in welfare loss.

The goods are overproduced by  $Q_e - Q_1$ .



Draw a graph showing external benefits of production in a market, labelling the area of welfare gain.

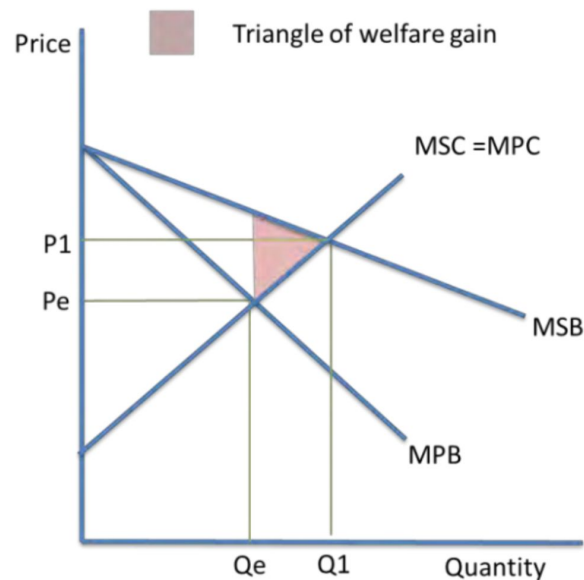


Draw a graph showing external benefits of production in a market, labelling the area of welfare gain.

$P_e Q_e$  represent the market equilibrium.

When positive externalities are present,  $MSB > MPB$ , which results in welfare gain.

The goods are underbought by  $Q_1 - Q_e$ .



# Define externality



## Define externality

A cost or benefit to a third-party member outside the market transaction.



Where on a graph is the socially optimal point in a market?





Where on a graph is the socially optimal point in a market?

Where  $MSC=MSB$



Describe the difference between public  
and private goods



Describe the difference between public and private goods

Public goods: Non-excludable & non-rival

Private goods: Excludable & rival



# Why are public goods underprovided in a free market?



# Why are public goods underprovided in a free market?

People who do not pay for the good receive the same benefits from it compared to the ones who do pay. Therefore it is underprovided by the private sector as there is no potential for profit.



Recall the link between market failure  
and perfect information



Recall the link between market failure and perfect information

Rarely do both parties of a market transaction have perfect information, and so there is usually a misallocation of resources, hence market failure.



# Why do governments often intervene in free market?





Why do governments often intervene in free markets?

Governments usually intervene to correct the market failure.



Recall three examples of government intervention



# Recall three examples of government intervention

1. Regulation
2. Indirect taxes
3. Subsidies



Name the two different types of indirect taxes

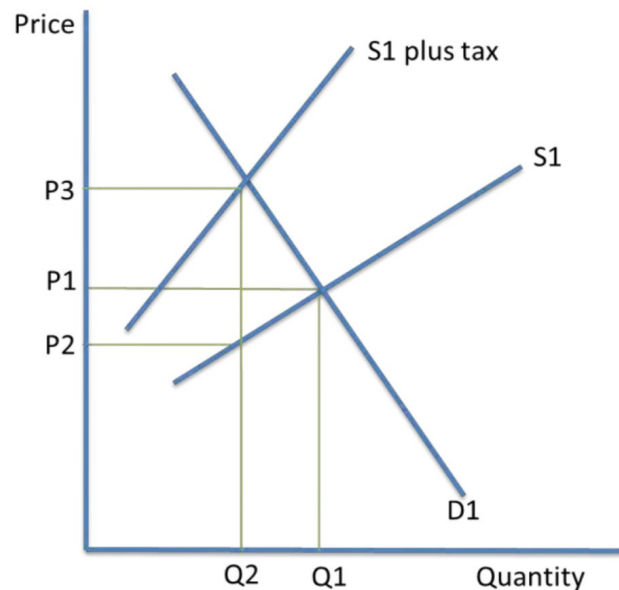


Name the two different types of indirect taxes

1. Ad valorem tax
2. Specific tax



Which type of indirect tax is represented on this graph?



What type of indirect tax is represented on this graph?

Ad valorem tax



How do indirect taxes reduce the quantity of demerit goods consumed?





How do indirect taxes reduce the quantity of demerit goods consumed?

Firms that have to pay the taxes pass them onto consumers in the form of higher prices, thus reducing the quantity demanded.



# Define subsidy



## Define subsidy

A payment from the government to firms in order to lower their costs of production and encourage them to produce more.



Would the government subsidise alcohol products or education, and why?



Would the government subsidise alcohol products or education, and why?

Education, because this is a merit good and so subsidising it would encourage learning and improve the quality of the labour force.



Which way would a subsidy shift the supply curve?



Which way would a subsidy shift the supply curve?

To the right (as it reduces the cost of production which encourages firms to produce more).



How could a subsidy potentially become a source of government failure?





How could a subsidy potentially become a source of government failure?

It could distort price signals by distorting the free market mechanism.



Give an example of unintended consequences when implementing government policies



Give an example of unintended consequences when implementing government policies

The policy could be expensive to implement

