

3.1 Government microeconomic intervention: reasons

Name: _____ Class: _____ Date: _____

Total: 26 marks

KEY WORDS demerit good • merit good • externality
 • market failure • negative externality

Objective

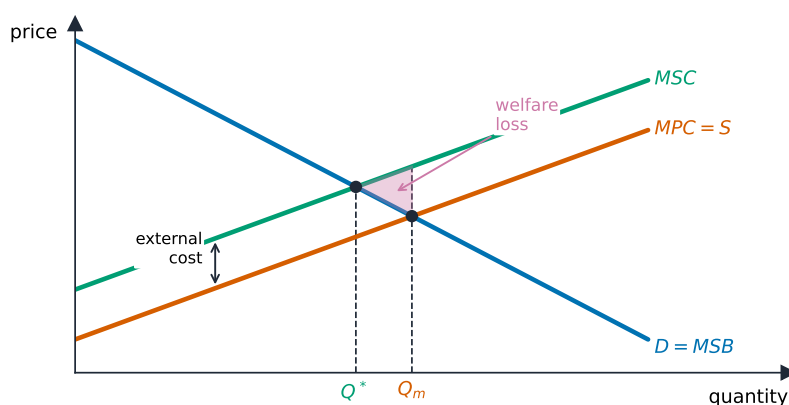
Build the skills to answer exam questions on the **reasons for government intervention**
 – market failure from externalities, public goods
 , merit/demerit goods / , monopoly power and
 asymmetric information .

You must be able to:

- define market failure and externalities (private, external and social cost/benefit)
- draw the externality diagram and identify the welfare loss
- explain the other sources of market failure

1 Key knowledge and worked examples

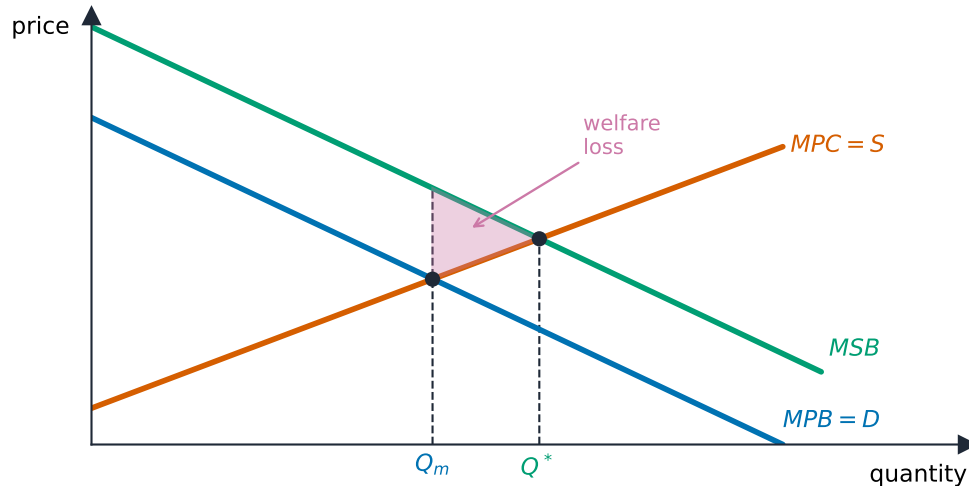
■ Externalities and market failure



$$MSC > MPC \Rightarrow Q_m > Q^* \cdot \text{DWL from over-production}$$

A negative externality: the market produces Q_m , above the social optimum Q^* ; the triangle is the welfare loss

- **Negative externality** : social cost > private cost
→ market makes **too much**.
- **Positive externality** : social benefit > private benefit → market makes **too little**.



$MSB > MPB \Rightarrow Q_m < Q^*$
Welfare loss from under-consumption

*A positive externality: the market under-produces, below the social optimum Q^**

- Other failures: **public goods** (free-rider), **merit/demerit goods** (information failure), **monopoly power**, **asymmetric information**.

Answer shapes: an **Explain** [up to 8] answer should use a labelled externality diagram (AO3); **Discuss** [12] adds a judgement (AO4).

2 Practice

2.1 Define the term *negative externality*. [2]

2.2 State the relationship between social cost and private cost when there is a negative externality. [1]

2.3 State two sources of market failure other than externalities. [2]

3 Exam-style questions

3.1 A negative externality of production means that:

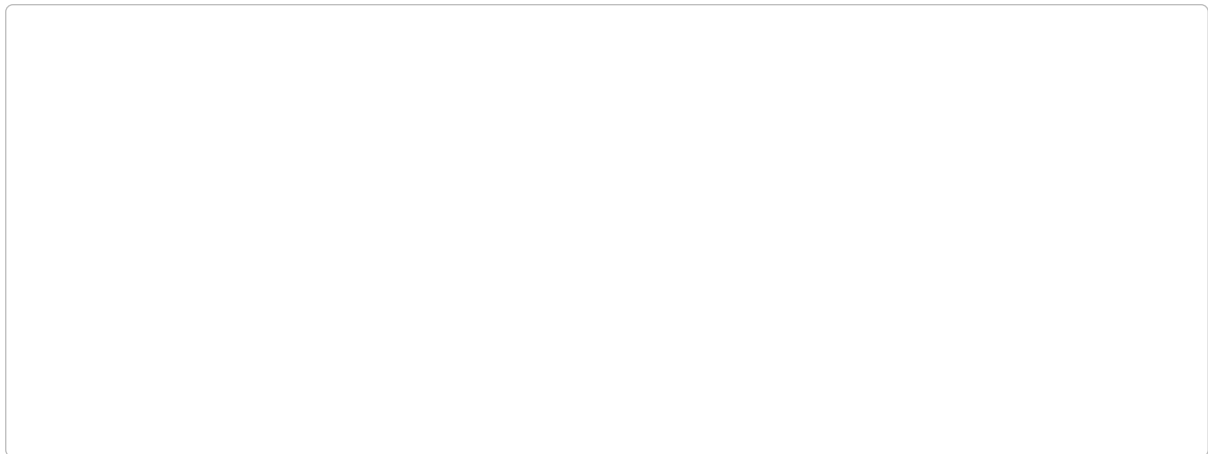
[1]

☐

- A** marginal social cost is below marginal private cost
- B** marginal social cost is above marginal private cost
- C** marginal social benefit is above marginal private benefit
- D** the good is under-produced

3.2 Using a diagram, explain why a good with a negative externality is over-produced by a free market.

[8]



3.3 Discuss whether externalities are the most serious cause of market failure. [12]