

3.1 Government microeconomic intervention: reasons

Name: _____ Class: _____ Date: _____

Total: 26 marks

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

Objective

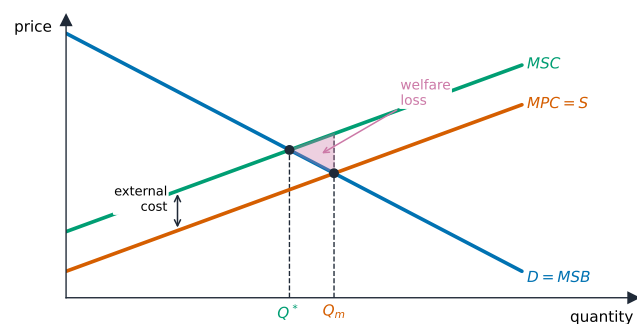
Build the skills to answer exam questions on the **reasons for government intervention**
 – **market failure** from **externalities**, **public goods**, **merit/demerit goods** / **monopoly power** and **asymmetric information**.

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

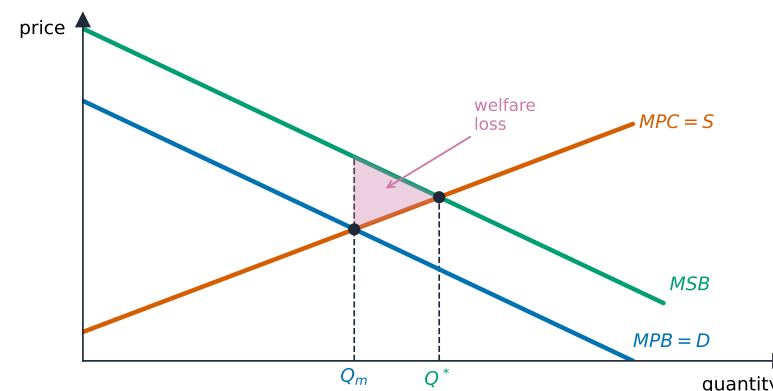
■ Externalities and market failure



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

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]