

3 Market failure – Part 1

Name: _____ Class: _____ Date: _____

Vocabulary

Write each word three times.

English	Write it 3 times (English)		
Market failure	_____	_____	_____
allocate	_____	_____	_____
externality	_____	_____	_____
third party	_____	_____	_____
negative external- ity	_____	_____	_____
social cost	_____	_____	_____
private cost	_____	_____	_____
positive external- ity	_____	_____	_____
public good	_____	_____	_____
national defence	_____	_____	_____
free-rider problem	_____	_____	_____
merit good	_____	_____	_____
demerit good	_____	_____	_____
information failure	_____	_____	_____

Recall

In topics 1–2 you saw markets set prices and usually work well. Bring this with you:

- A market lets buyers and sellers meet, and the price guides them.
- But the result is not always best for **society** as a whole.

At AS we study **market failure** – when a free market makes too much or too little of a good.

New ideas

■ 1 What market failure is

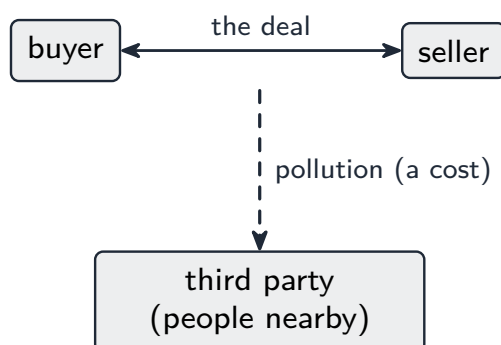
Market failure is when a free market does not **allocate** (share out) resources efficiently – **too much** or **too little** of a good is made. Then the government may step in to fix it.

Micro-check. State what is meant by market failure. [1]

■ 2 Externalities

An **externality** is a cost or a benefit that falls on a **third party** – someone who is not the buyer or the seller.

- a **negative externality** (like pollution from a factory): the **social cost** (to everyone) is bigger than the **private cost** (to the producer), so the market makes **too much**;
- a **positive externality** (like a vaccination that protects others too): the market makes **too little**, because buyers ignore the benefit to others.



Micro-check. A factory pollutes a river. Is this a negative or a positive externality? [1]

■ 3 Public, merit and demerit goods

- a **public good** (street lighting, **national defence**) cannot shut out non-payers, so private firms make no profit and supply none – the **free-rider problem** ;
- a **merit good** (like education) is **under-consumed** – people buy too little;
- a **demerit good** (like cigarettes) is **over-consumed** – people buy too much, because of **information failure** (they misjudge the harm).



Micro-check. Is education a merit or a demerit good?

[1]

Watch out: a *negative* externality (pollution) → social cost > private cost → market makes *too much*; a *positive* externality (vaccination) → market makes *too little*. Merit goods are under-consumed; demerit goods over-consumed.

Practice

3.1 Explain what is meant by **market failure**.

[2]

3.2 A factory's smoke harms people living nearby. State the type of externality, and whether the market makes too much or too little.

[2]

3.3 Explain why private firms will not supply a **public good**.

[2]

3.4 State whether each is **under-** or **over-**consumed: (a) a merit good; (b) a demerit good. [2]

3.5 Give one example of (a) a merit good and (b) a demerit good. [2]

3.6 Challenge. A coal-burning power station causes pollution. Explain why the free market produces *too much* electricity, using the ideas of private and social cost. [2]
