Past-paper walk-through

Private costs and benefits, externalities and social costs and benefits ▪ 7.4

eXercise

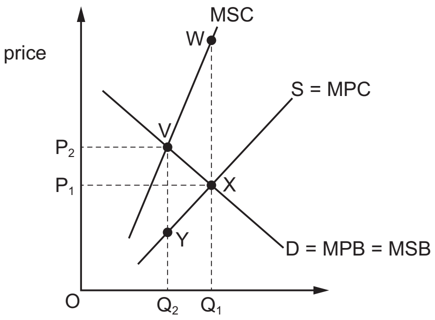
Questions in this set

- 9708/31 N25 Q6 ▪ 1 mark
- 9708/32 N25 Q3 ▪ 1 mark
- 9708/34 N25 Q4 ▪ 1 mark

Question 6

9708/31 N25 ▪ Q6 ▪ 1 mark

6 The diagram shows market failure caused by negative production externalities.



Question 6

quantity

Identify the correct combination of the result of the market failure and the area on the diagram that shows deadweight welfare loss.

	result of market failure	area showing deadweight welfare loss
A	overproduction	VWX
B	overproduction	XYV
C	underproduction	VWX
D	underproduction	XYV

Solution 6

Answer: **A**

Why

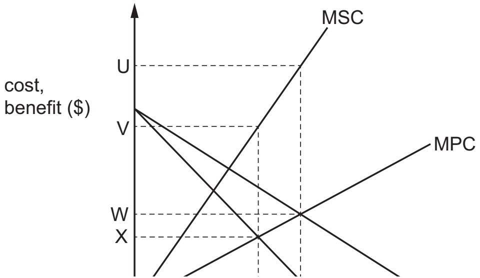
- With a negative production externality, marginal social cost lies above marginal private cost.
- The market produces at Q_1 where MPC meets demand, but the optimum is at Q_2 where MSC meets it.
- The welfare loss is the triangle between MSC and MPB over the over-produced output.

Question 3

9708/32 N25 ▪ Q3 ▪ 1 mark

3 The diagram shows the marginal costs and marginal benefits of producing a good in a free market.

What is the marginal external cost when the free market is in equilibrium?



Question 3

A UW **B** UO **C** VX **D** VO

Solution 3

Answer: **C**

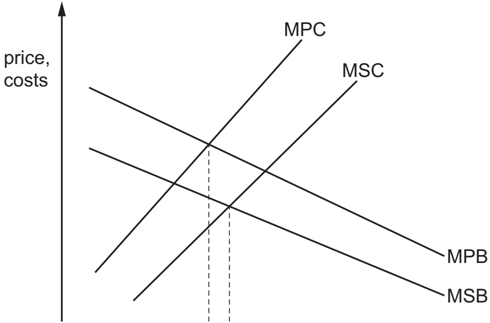
Why

- Marginal external cost is the vertical gap between marginal social cost and marginal private cost.
- The free market equilibrium is where marginal private cost meets marginal private benefit.
- So measure the MSC–MPC gap *at that output*, not at the social optimum.

Question 4

9708/34 N25 ▪ Q4 ▪ 1 mark

4 The diagram shows positive and negative externalities of production and consumption.



Question 4

Which row shows the correct combination of production and consumption externality when economic welfare is maximised?

	position of economic welfare	production externality	consumption externality
A	X	negative	negative
B	Y	positive	negative
C	X	negative	positive
D	Y	positive	positive

Solution 4

Answer: **B**

Why

- A negative externality puts marginal social cost above marginal private cost.
- A positive externality puts marginal social benefit above marginal private benefit.
- So read which pair of curves diverges, and in which direction, to identify the type.