

Market failure and government intervention

Edexcel IAL Economics WEC11 sections 1.3.5-1.3.6 full package on the shared market model

1. Topic 2 at a glance

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WEC11 second half: spec sections 1.3.5 and 1.3.6 in full - market failure (six rows) and government intervention (two rows). The shared model continues, drawn in inverse form: demand $P = 70 - Q/2$, supply $P = Q/4 - 5$, market (100, 20). An external cost or benefit of 6 per unit reproduces the topic-1 tax and subsidy equilibria, so every welfare area cross-checks.

Must-know: $MSC = MPC + \text{external cost}$; $MSB = MPB + \text{external benefit}$; optimum where $MSB = MSC$; welfare areas here are half of 8 times 6 = 24; maximum price 16 gives a shortage of 24; minimum price 24 a surplus of 24; permits fix quantity and let demand price them.

2. Sources of market failure

Sources of market failure

Market failure is output above or below the socially optimal level (1.3.5.1a). Five sources (1.3.5.1b): externalities; the free-rider problem and non-provision of public goods; imperfect market information; moral hazard; speculation and market bubbles.

Each source is a reason the price mechanism's signal is incomplete - some cost or benefit never reaches the decision-maker, so the market equilibrium stops being the social optimum.

3. Externalities

Externalities

Social benefit = private + external benefit; social cost = private + external cost (1.3.5.2a-b); externalities arise from production or from consumption (1.3.5.2c).

Marginal analysis: with external cost 6, $MSC = MPC + 6$ crosses MSB at $Q = 92$ against the market's 100 - over-production of 8 with a welfare-loss triangle of half of 8 times 6 = 24; with external benefit 6, $MSB = MPB + 6$ crosses MPC at 108 - under-consumption of 8 and 24 of welfare gain available (1.3.5.2d).

Contexts (1.3.5.2e): transport congestion and pollution; health vaccination and passive smoking; education spillovers; environment emissions; financial risk externalities.

4. Public goods, information and bubbles

Public goods, information and bubbles

Private goods are rival and excludable; public goods are non-rival and non-excludable, so the free-rider problem means private revenue cannot cover costs and the state must provide (1.3.5.3). Asymmetric information - seller knows the car, applicant knows the health - creates gaps that misallocate resources in healthcare, education, pensions and insurance (1.3.5.4).

Moral hazard strikes AFTER the contract: insured drivers, bailed banks; consumers pay premiums, producers and workers carry risk, governments face bailouts (1.3.5.5). Bubbles arise when buyers buy only to resell - prices detach from fundamentals then crash, hitting housing and shares, consumers, producers, workers and governments (1.3.5.6).

5. Government intervention

Government intervention

Intervention corrects market failure towards the social optimum (1.3.6.1a). Eight methods (1.3.6.1b): indirect taxes (a Pigouvian 6 reaches the optimum 92); subsidies (6 corrects to 108 at a cost of 648); maximum prices (16: Qd 108 against Qs 84, shortage 24, queues and black markets); minimum prices (24: surplus 24, the state may buy and store); tradeable permits (cap 84, demand prices them at 28); property rights; state provision; regulation; information provision.

Contexts (1.3.6.1c): health, housing, education, transport, environment, energy, agriculture, commodities.

6. Government failure

Government failure

Government failure is intervention that results in a NET welfare loss (1.3.6.2a). Five causes (1.3.6.2b): information gaps (a 6-tax overshoots a 4-cost externality); unintended consequences (floors create surpluses, caps create black markets); excessive administrative costs; lack of incentives in state providers; moral hazard from guarantees.

Close every intervention answer by weighing the correction against these costs - the examiner's evaluation marks live there.

Check yourself

Check yourself

Market failure and its five sources; private, external and social benefits and costs; production and consumption externalities with diagrams and welfare areas.

Public goods by rivalry and excludability; free-riding; information gaps; moral hazard; bubbles.

The eight intervention methods with the computed shortage, surplus, optimum and permit price; the eight contexts.

Government failure with its five causes.