Describe market failure and government interventions to correct for market failure

Scholarship Economics

Achievement Standard 90631 (Economics 3.3) — Chapter 3

Market failure occurs where a market is not allocatively efficient or the outcome is not equitable. A market will be allocatively efficient if the following conditions apply:

- Perfect competition.
- Perfect information.
- Perfect mobility of resources.
- Consumer sovereignty rules.
- No externalities or public goods exist.

Where these conditions are not achieved, market failure occurs.

Externalities

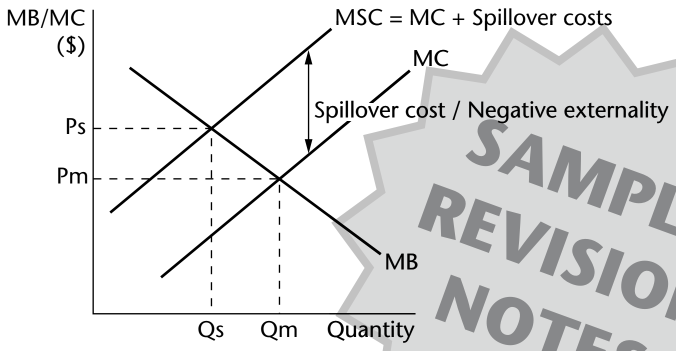
Externalities are spill-over costs or benefits to a third party from production or consumption.

Negative externalities of production occur when production of a good or service negatively affects a third party (eg pollution affecting local residents' health). These goods are over-produced and under-priced compared with the socially desirable equilibrium.

Negative Externalities of Production

Pm, Qm are the market price and quantity.

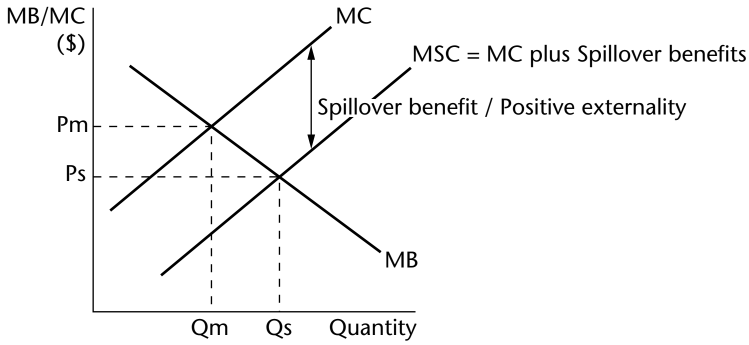
Ps, Qs are the socially desirable price and quantity.



SAMPLE REVISION NOTES

Positive externalities of production occur when production of a good or service positively affects a third party (eg literacy training of staff has a positive impact on their family members). These goods are under-produced and over-priced compared with the socially desirable equilibrium.

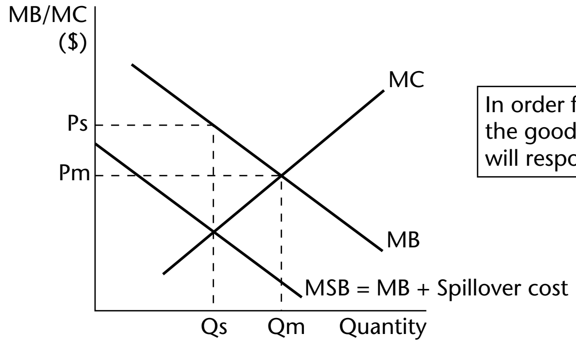
Positive Externalities of Production



Negative externalities of consumption occur where consumption of a good has a negative effect on a third party (eg cigarette consumption results in passive smoking).

These goods are over-produced and under-priced compared with the socially desirable equilibrium.

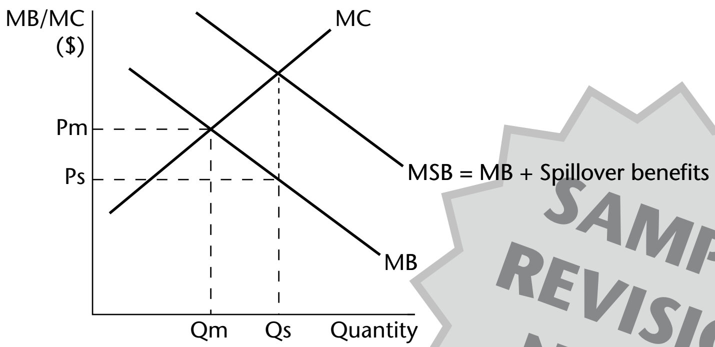
Negative Externalities of Consumption



In order for the socially desirable quantity to be consumed, the good must be priced at a level that private individuals will respond to (ie from the MB curve).

Positive externalities of consumption occur when consuming a good results in a positive effect on a third party (eg exercise results in lower healthcare costs for taxpayers). These goods are under-produced and over-priced compared with the socially desirable equilibrium.

Positive Externalities of Consumption



SAMPLE REVISION NOTES

Internalising Externalities

Internalisation refers to passing the third-party costs or benefits (or the responsibility for them) back to the party that created them. Negative externalities could be internalised by taxes, fines, tolls or regulations. Positive externalities can be internalised by subsidies or tax breaks.

Property Rights

Property rights are a person's legal right to own, use, earn an income from, and sell, their property. If ownership can be established for a resource, then the market can help to reduce negative externalities or reward positive externalities (eg ownership of a river allows the owners to limit usage and pollution in a way that preserves its value).

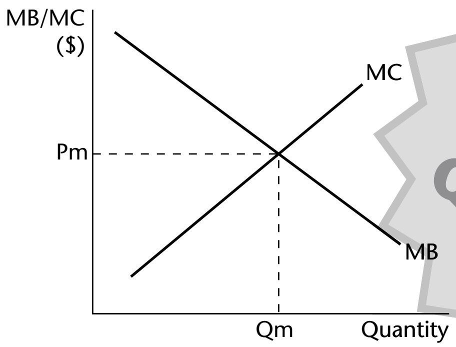
Questions

Externalities and Property Rights

1. Explain the difference between the private and social cost of production of a good or service.

2. a. The graph following shows the private marginal benefit/marginal cost diagram for the market for 'alcopop' drinks (premixed alcoholic drinks). Explain why it might be argued that this market is allocatively inefficient.

Market for 'Alcopop' Drinks



SAMPLE NCEA QUESTIONS

b. On the graph in **a.**, illustrate the likely marginal social benefit and marginal social cost curves.

c. Assume that the government levies a $2 per bottle tax on 'alcopops'. Explain how this affects the market.

3. Explain how establishing property rights for a polluted harbour could help to reduce negative externalities.

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Chapter 3: Achievement Standard 90631 (3.3)

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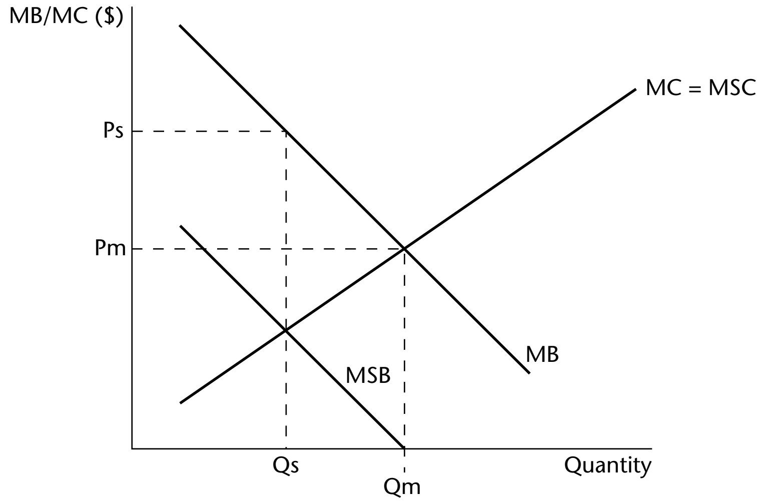
Ch 3 Externalities and Property Rights (page 29)

1. The private cost is the actual dollar cost of the resources used in production. The social cost includes this plus any spill-over costs to third parties (like pollution).

2. **a.** The market is allocatively inefficient because the market equilibrium fails to take the social costs of alcohol into account, such as drink-drive accidents and domestic violence. The allocatively efficient equilibrium would have a lower level of consumption and a higher price charged.

b.



c. This would cause MC or the supply curve to move up vertically by $2 per bottle, in turn increasing the price and reducing the quantity consumed. In effect, it would move the market towards the allocatively efficient equilibrium.

3. This would give the owner a greater interest in maintaining the value of their asset. For this reason, they are likely to sue those who pollute the harbour or charge them for the privilege of doing so. In either case, the social cost of the pollution would be internalised by those causing it, with the likely result of the polluters reducing their pollution in a bid to reduce costs.