Subject: Economics | Topic: Market failure and government intervention | Year Group: 12

Market failure

What is market failure?	When the free market fails to allocate resources in the most efficient manner possible. This leads to either over production/consumption or under production/consumption

Causes of market failure

Public goods	Goods which are non-rival and non-excludable e.g. police, national defence
Merit goods	People underestimate the benefits of the good and under consume them e.g. education
Demerit goods	People underestimate the costs of the good and over consume them e.g. smoking

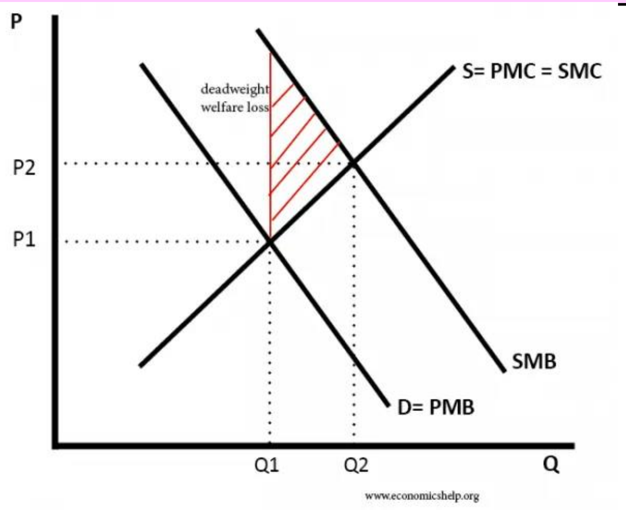

Diagram of Positive Externality (consumption)

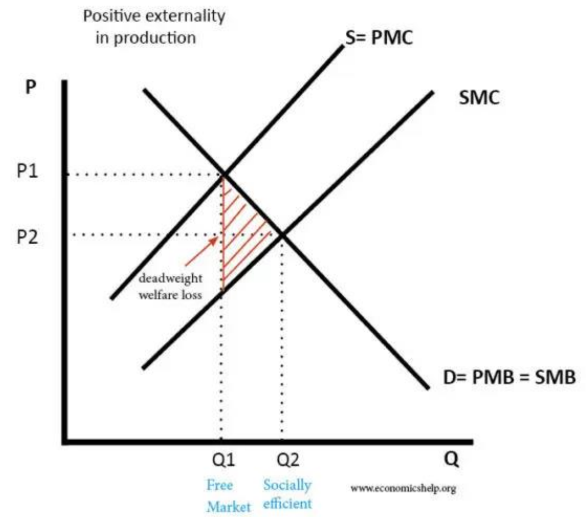

Diagram of Positive Externality (production)

With positive externalities, the benefit to society is greater than your personal benefit.
Therefore with a positive externality the Social Benefit > Private Benefit
Remember Social Benefit = private benefit + external benefit.

With negative externalities, the cost to society is greater than your personal cost.
Therefore with a positive externality the Social cost > Private cost
Remember Social cost = private cost + external cost.

Externalities

1	Positive externalities	Consumption or production that has positive impacts on innocent third parties (these should be encouraged)
2	Negative externalities	Consumption or production that has a negative impact on innocent third parties (these should be discouraged)
3	Private costs + external costs = Social costs	The total cost to society (private costs and negative externalities) from the production or consumption of goods
4	Private benefits + external benefits = social benefits	The total benefits to society from the production or consumption of goods

Examples of negative externalities of consumption of tobacco (smoking)
Huge cost to the taxpayer who pays for the NHS
Litter and clogged drains that councils have to pay to clean up
Health cost to 3rd parties who have to inhale secondary smoke

Examples of negative externalities of production (chemical factory)
Damage to local air quality
Locals have to put up with noise and congestion from the factory
Local house prices may go down as area becomes less desirable due to the factory