

OCR Economics AS-level

Microeconomics

Topic 3: Market Failure and Government Intervention

3.1 Market failure

Notes



- 📖 Market failure occurs when the free market fails to allocate resources to the best interests of society, so there is an **inefficient allocation of scarce resources**.
- 📖 Economic and social welfare is not maximised where there is market failure.

📖 Types of market failure:

- **Externalities**

An externality is the cost or benefit a third party receives from an economic transaction outside of the market mechanism. In other words, it is the spill-over effect of the production or consumption of a good or service.

- **The under-provision of public goods**

Public goods are non-excludable and non-rival, and they are underprovided in a free market because of the free-rider problem.

- Public goods are missing from the free market, but they offer benefits to society. For example, street lights and flood control systems are public goods.
- They are **non-excludable** so by consuming the good, someone else is not prevented from consuming the good as well, and they are **non-rival**, so the benefit other people get from the good does not diminish if more people consume the good.
- The non-excludable nature of public goods gives rise to the **free-rider** problem. Therefore, people who do not pay for the good still receive benefits from it, in the same way people who pay for the good do. This is why public goods are underprovided by the private sector: they do not make a profit from providing the good since consumers do not see a reason to pay for the good, if they still receive the benefit without paying.
- Public goods are also underprovided because it is difficult to measure the value consumers get from public goods, so it is hard to put a price on the good. Consumers will undervalue the benefit, so they can pay less, whilst producers will overvalue, so they can charge more.
- Governments provide public goods, and they have to estimate what the social benefit of the public good is when deciding what output of the good to provide. They are funded using tax revenue, but the quantity provided will be less than the socially optimum quantity.



- **Private goods** are rival and excludable. For example, a chocolate bar can only be consumed by one consumer. Moreover, private property rights can be used to prevent others from consuming the good.

- **Information gaps**
It is assumed that consumers and producers have perfect information when making economic decisions. However, this is rarely the case, and this imperfect information leads to a misallocation of resources.

