## **Types of goods**

* Goods are classified based on two main dimensional notions, the notion of excludability and the notion of rivalry (Refers to classification and main definitions from list of definitions)
* Explain how these types of goods will cause market failures
* Distinguish the types of goods
* Reasons for and against producing merit and public good

12.1 Distinguish the types of goods

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Types of good** | **Public Good** | **Private Good** | **Merit Good** | **Demerit Good** |
| **Notion of rivalry** | Non-rivalry in consumption – its use will not deprive others – MC of additional user is zero | Rivalry in consumption – its use by a consumer will deprive others of its consumption | Rivalry in consumption – its use by a consumer will deprive others of its consumption | Rivalry in consumption – its use by a consumer will deprive others of its consumption |
| **Notion of excludability** | Non-excludable – not possible to exclude people from using once provided | Excludable – possible to exclude non-payers from using the good | Excludable – possible to exclude non-payers from using the good | Excludable – possible to exclude non-payers from using the good |
| **Degree of Externalities** | Huge positive externalities | No externalities | Positive externalities | Negative externalities |
| **Source of production** | Not profitable and not marketable because non-rivalry in consumption implies that there is no market price since P=MC at market equilibrium. Non-excludability will lead to people refraining from expressing demand due to free-rider problem 🡪 stop private firms from producing | Profitable and produced by private sector. Market equilibrium is allocative efficient | Profitable and can be produced by private sector but due to external benefit that is not taken into account by private individuals – market produce too little/under-consumption | Profitable and can be produced by private sector but due to external cost incurred, regulation will be made to reduce consumption or production |
| **Degree of government intervention** | Government takes over the production | No need for government intervention, unless government deems intervention is necessary | Government needs to intervene to increase production/consumption | Government needs to intervene to reduce production and consumption |
| **Examples** | Defence, street lights, overhead bridges | Shoes | Education, health services | Smoking, Cars |

**12.2 Reasons for government to provide all public goods**

* To prevent the occurrence of complete market failures which will lead to complete welfare loss as there is no provision of public goods by the public sector.
* The government can provide source of finance as it is able to collect taxes from the public as it has the legal and moral authority to do so.
* Most of the public goods require huge financing and have a slow rate of returns which will discourage the private sector from producing it.
* The government can ensure that the firm will produce at the production level at allocative efficient level despite the fact that the firm will make losses in the case of a natural monopoly as it can finance the loss through subsidy
* To raise the standard of living of the people especially the lower income group as the provision of public facilities will make their lives more convenient and comfortable for them to live.
* To ensure that the industries will be supported by the public facilities to raise the efficiency of production and thus, lower cost of production to increase competitiveness.

**12.3 Reasons for the government to produce merit goods**

* To ensure that the production and consumption is at social optimum level of production so as to reap maximum net social benefit gain, ensuring that there is no welfare loss in the society.
* To ensure that the welfare of the lower income group is taken care of as in the case of provision of merit goods like education
* The lack of capable and efficient private producers to ensure that there is efficient production of the merit goods

**12.4 Reasons against the government for producing merit goods**

* Undermine the advantages of the price mechanism in the allocation of resources which is based on price signals – swift and less administrative cost in the production and distribution process
* The possible rise of government failures will make it not productive for government to be involved in the provision of merit good

**12.5 should government provide merit good free to the people?**

Yes

* Eradicate DWL and prevent market failures – achieve social efficient resource allocation
* significance of external benefit – raise efficiency of production – induce investment – promote econ growth – higher level of employment

No

* Overconsumption – give rise to deadweight loss 🡪 cost of financing

1. **Main Areas of Discussion**

(Is it necessary for government to intervene into the market to correct allocative inefficiency?)

**Many economists strongly oppose to government intervention in the allocation of scarce resources. Their basic presumption is that markets generally work well by themselves and that there are just a few limited instances in which government action is needed.**

**(a) Explain the circumstances in which the government should intervene in resource allocation. [10]**

1. **Why government needs to intervene into the market to correct market failures? (consider the negative impact of market failures)**

* To correct inefficient allocation of resources so as to attain maximization of net social welfare gain
* To reduce the cost of the deadweight loss that will be paid by the government
* To prevent the consumers from experiencing consumer exploitation whereby they will be charged higher price and sold with poor quality product
* To prevent the complete loss of welfare due to the absence of the provision of public goods
* To prevent unequal distribution of net social benefit of gain due to unequal distribution of income and wealth

1. **Why government may not need to correct market failure?**

**Possibility of government failures**

**limitations of the government policies**

* High cost of financing is needed for government to incur in the provision of public goods will discourage the government from providing public goods
* Lack of technological expertise in the production and distribution in the public good will hinder government from the provision
* Government may not correct market failures due to market power as the firm with large market power offers other areas of advantages which may benefit the firm the cost advantages of large scale production
* Government may also find it difficult to estimate the monetary value of externality and thus, it may not want to intervene as the cost of intervention may be higher than the cost of welfare loss
* Complexity of the production and distribution of goods and services will make it difficult for the government to intervene

**To what extent is government intervention in resource allocation desirable? [15]**

* Strengths of government intervention
* Limitations of government intervention
* (Reasons for government failures)

1. **Comparison bet taxation and quotas as solutions for writing negative externalities**

The imposition of a ban can ensure that the effect of deadweight loss is eliminated but the society may not lose out as it has to forgo the net social benefit gain as there is no production and consumption at all. This form of banning is only introduced when the net social benefit social is less than the dead weight loss the society will incur.

On the other hand, taxation will simply adjust the production level to the social equilibrium level of production where the SMC=SMB and there is no deadweight loss but the maximization of net social benefit gain, implying that there is social optimization of allocation of resources.

Furthermore, the government can enforce the producers and consumers to internalize the external cost as part of the cost of consumption and production which will influence to reduce external cost by using other methods of consumption and production that will not produce externality. The use of taxation will also provide the government the tax revenue to nullify the effect of externalities imposed on the society.

1. **Explain how market failures is seen in the health care industry**

* Imperfect market information and market power (Oligopolistic market structure) /inadequate information for consumers.
* presence of positive externalities
* problem of unequal distinction of income

Other industries to consider:

1. education
2. transportation industry

## **14. List of Definitions**

### **14.1 Scarcity**

* It refers to the problem that limited amount of resources available is unable to meet man’s unlimited wants
* As a result, the economy will have to conduct resource allocation whereby the economy will need to resolve the three fundamental economic problems of choice to maximise resource allocation. In the process, it will incur opportunity cost.
* It is therefore important to achieve allocative efficiency in order to maximise welfare for society

### **14.2 Resource Allocation**

* The process of allocation of scarce resources for utilization of the production of goods and services for the consumption for the economy

### **14.3 Method of Resource Allocation**

* Command or planning economy: All decisions are made by government, relies on government’s direction and coordination
* Laissez-faire system: Decisions are made by demand and supply forces of the market
* Mixture of both

### **14.4 Free Market Economy**

* No governmental interference on market activities. People produce accordingly and voluntarily to the market demands.

### **14.5 Imperfect Market**

* Market condition that does not fulfil the perfect competition
* Firms and consumers have imperfect knowledge
* Firms have some degree of influence on market price due to their market power and the demand curve is downward-sloping from left to right

### **14.6 Market Failures**

* Market failures refer to the failure of price mechanism to conduct resource allocation efficiently and thus, calls for the intervention by the government.
* The price mechanism fails under the conditions when it is unable to provide public goods, the presence of externalities and the presence of imperfect market.

### **14.7 Allocative Inefficiency**

* Occurs when the firm and the industry’s level of production is not at the social equilibrium level of production where price level is equal to marginal cost and when this occurs, the industry will experience dead-weight loss as the production level at market equilibrium is below the social equilibrium.

### **14.8 Productive Inefficiency**

* Occurs when the firm is unable to attain a level of production where the firm is at the minimum cost of production at the respective level of production.

### **14.9 Static Efficiency**

Efficiency at a given point in time

### **14.10 Dynamic Efficiency**

Experienced over a period of time where changes are occurring at the best rate.

### **14.11 Private Benefit**

The level of utility that an individual or firm is able to receive from the consumption or production of goods and services.

### **14.12 Private Cost**

The cost of consumption and production that an individual or a firm will incur in the process of production or consumption.

### **14.13 Social Benefit**

The total welfare received by the entire society measured in term of the benefit gained by the society which may include the external benefit that the third parties can reap.

### **14.14 Social Cost**

The total cost paid by the society measured in term of the monetary cost or opportunity cost incurred the society which may include the external cost that the third parties will incur.

### **14.15Marginal Private Benefit (MPB or PMB)**

Amount of private benefit received for an additional unit consumed or produced

### **14.16 Marginal Social Benefit (MSC or SMC)**

Amount of social benefit received for an additional unit consumed or produced

### **14.17 Marginal Private Cost (MPC or PMC)**

Amount of private cost incurred for an additional unit consumed or product.

### **14.18 Marginal Social Cost (MSC or MPC)**

Amount of social cost incurred for an additional unit consumed or produced

### **14.19 Externalities (Positive and Negative)**

* It refers to the third-party effects that the society will experience despite not engaging in the direct consumption and production.
* The effect of production or consumption of good or service on the welfare of the 3rd party, who neither pays or receives any compensation

### **14.20 External Marginal Benefit (EMB or MEB)**

Refers to the additional benefit attained due to the effect of positive externalities when the society produces additional output.

### **14.21 External Marginal Cost (EMC or MEC)**

Refers to the additional cost incurred due to the effect of negative externalities when the society produces additional output.

### **14.22 Deadweight Loss (DWL)**

The welfare loss of efficiency incurred by the society when there is an over or underproduction of goods and services, indicating that the society has failed to attain social optimization of resources. For Deadweight Loss incurred by positive externalities, the welfare loss is seen in term of the external benefit the society fails to reap due to under-production but negative externality, it will be seen in term of the external cost the society need to incur.

### **14.23 Social Optimization of Resources**

Refers to the maximization of resource allocation for production of goods where the net social benefit gain that the society will derive is maximized and there is no deadweight loss experienced by the society.

### **14.24 Government Failure**

The situation where government’s interference reduces allocative efficiency as cost of intervention may exceed the cost of dead weight loss incurred.

### **14.25 Nationalization**

Firms are being bought over by the government and the production and distribution of the business will be handled by the government.

### **14.26 Merit Goods**

* A good that has positive externalities in its production or consumption will lead to occurrence of external benefit that will benefit the society as a whole.
* Note that not all goods with positive externalities are merit goods

### **14.27 Demerit Goods**

A good that has negative externalities associated with the production and consumption that will lead to the occurrence of external cost that will undermine the society as a whole.

### **14.28 Public Goods**

A goods that is non-rivalry and non-excludable in consumption

### **14.29 Non-Rivalry**

Refers to the condition when the consumption of a good by an individual will not deny another from consuming the goods. (Note: marginal cost of the good is zero)

### **14.30 Non-Excludable**

Refers to the condition when the non-payers of the consumption of a good cannot be denied from consumption. (Note: the private sector will not produce the goods as it is not profitable since it cannot charge the consumer)

### **14.31 Market Power**

The extent to which a firm can manipulate price of the market or the control of the level of production and this can be seen by the downward-sloping demand curve. (Note: the degree of market power is reflected by the price-elasticity of demand)

### **14.32 Cost Benefit Analysis (CBA)**

A method for evaluating all cost and benefits associated from a particular economic action.

### **14.33 Income**

* Viewed as a **flow**
* The receipt of money period time

### **14.34 Wealth**

* Viewed as a **stock**
* Values of a person’s total assets at a particular point in time

### **14.35 Equality and Equity**

* Equality is defined in absolute quantities, having an equal outcome. E.g. Government redistributing income to the poor.
* Equity can be defined as having the same opportunity to achieve similar outcomes. E.g. Feminism movement to eliminate the gender discrimination so that women can have the opportunity to compete on equal footing as man.

### **14.36 Lorenz Curve**

* Developed by Max Lorenz
* A graphical representation of income inequality
* Gini co-efficient is derived from the curve to give a numerical representation of inequality in income distribution

**Explain how market failures will occur in the education industry.**

* definition of market failures and
* how this will occur (merit good, positive externality, external benefit, DWL
* draw diagram / description of diagram
* conclusion