**Economics Essays – Chapter 2 – The Allocation of Resources – Market Failure**

**Q1(a) Identify and explain possible factors contributing to market failure [10].**

Introduction

Market failure refers to the failure of the price mechanism to conduct efficient resource allocation and thus, calls for the intervention of the government. The price mechanism will fail under the conditions when there is an absence of the provision of public good, imperfect market information, the imperfect market condition, presence of externalities and income inequality.

Main Body

The causes of market failure are the absence of the provision of public good, imperfect market information, imperfect market condition and presence of externalities.

First, the lack of provision of public good will contribute to market failure. Private firms will not produce public goods due to the problem of free-ridership. Public goods are non-excludable and non-rival in production and consumption. Hence, the absence of public good will lead to complete market failure.

Second, imperfect market information will contribute to market failure. Consumers do not have enough knowledge on the types of goods and services, such as identifying goods of good quality and poor quality. Hence, imperfect market information will lead to market failure.

Third, the presence of market power will lead to market failure. Firms that have market power can set price and output of goods at a level where price is greater than marginal cost, thus resulting in allocative inefficiency. Hence, there will be deadweight loss and market failure.

Fourth, the presence of externalities would contribute to market failure. For merit goods, positive externalities will create external benefit that will lead to underproduction. For demerit goods, negative externalities will create external cost that will lead to overproduction. Hence, there will be deadweight loss and market failure.

Fifth, unequal distribution of income will contribute to market failure. Income inequality implies that there is an uneven distribution of social benefits. This will undermine the interest of the poor as they will receive lesser benefit than the rich from the production of the good despite the presence of maximization of net social benefit gain, which is a form of market failure because total net social benefit gain is unevenly distributed.

Conclusion

In sum, the above-mentioned factors would contribute to the failure of the market mechanism, which implies the occurrence of market failure. In view of these factors, government intervention is necessary to eradicate the deadweight loss, so as to maximise social benefit.

**Q1(b) Explain and evaluate the policies implemented to correct market failure [10].**

Introduction

In view of the factors contributing to market failure, government intervention is necessary to correct market failure. This essay will analyse the various forms of government intervention, seen in terms of the advantages and disadvantages of every policy.

Main Body

There are several solutions to correct market failure as a result of the presence of negative externalities. One such policy is the use of taxation. Taxation will internalize the external cost as part of the cost of production by raising the price of the goods and thus reduce the market equilibrium to the socially efficient level. As a result, the deadweight loss is eradicated and maximization of welfare gains is attained. For instance, tobacco tax is imposed to lower the production of cigarettes to the social optimal level.

Taxation is effective as it reduces the external cost due to lower quantity of production by forcing the consumers and producers to cut down production and consumption. Also, taxation provides revenue for the government to improve the public project to minimize the effects of negative externalities. However, there are limitations. It is difficult to quantify the external cost incurred, thus taxation may not lead to a social optimal level. Also, taxation may lead to the creation of black markets. For example, the sale of contraband cigarettes.

Another policy is the use of rules and regulation to reduce negative externalities. Rules and regulation are implemented to ban or directly control the amount of consumption. For instance, the implementation of bus lanes for road usage to reduce traffic congestion as well as the restriction of smoking areas in enclosed spaces.

Rules and regulation is effective as it is forceful and direct, such that the desirable outcome can be attained. Also, it is easy to implement as government regulation is forceful. However, there is a high cost of administration that will lead to inefficient administration. Also, the effectiveness of the regulation greatly depends on the efficiency of the administrative bodies. Besides, excessive regulation may undermine the functioning of the economy.

The third policy is state provision to reduce negative externalities, so as to correct market failure. State provision involves the government taking over the production of goods to ensure the negative effects of the production will not affect the society as the level of consumption and production will set at the social optimal level. For instance, the state provision of nuclear plants in Japan.

State provision is effective as the government can directly regulate and control the problem by focusing on the root cause of the problems. Also, the government has the legal authority to deal with social and political complexity of the issues. However, state provision may lead to wastage if the good is provided free as it will encourage excessive consumption.

On the other hand, there are also policies to correct market failure as a result of the presence of positive externalities. One such policy is the provision of subsidies to consumers. Subsidies are given to consumers which will increase their disposable income and purchasing power of the consumers. As such, demand for the goods increases, inducing an increase in quantity demanded. Therefore, this will prevent the occurrence of deadweight loss, thus enabling the economy to attain social efficient level of production. For instance, the provision of subsidies for university education.

Provision of subsidies is effective in correcting market failure as it will encourage greater consumption of merit goods. However, extensive provision of subsidies would give rise to greater government spending, which may raise debts.

Another policy is the use of educational public campaigns to correct market failure. The government can use educational campaigns and advertisements to change the mindsets of the people in term of their production and consumption behaviour. The aim of the campaign is to correct their consumption and production behaviours such that they take note of the desirable third party effects, known as external benefits. For instance, public campaign is used to promote lifelong education and skills upgrading for older workers.

Public campaign is effective as it corrects market failure by focusing on the root of the problem. However, educational campaigns incur additional costs and the effectiveness depends on the design of the promotion and the receptiveness of the target audience.

Conclusion

In sum, these policies are used to correct market failure. In view of the advantages and disadvantages of every policy, it is important for the government to implement various policies together to complement the advantages of the policies, so as to eradicate welfare loss and maximise social net benefit gain.