

Essay Q3: Market Failure

- (a) Explain, using examples, how public goods and merit goods can lead to inefficiency in resource allocation. [10]
 - (b) Discuss the view that the best way for governments to respond to the existence of merit goods is to regulate their production directly. [15]
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Suggested answers:

- (a) Explain, using examples, how public goods and merit goods can lead to inefficiency in resource allocation. [10]**

Introduction

Public goods and merit goods lead to inefficiency in resource allocation, thereby leading to market failure. Allocative inefficiency occurs when the right amount of the right good is not being produced.

Development 1: Explain how the market fails in the case of public goods

Public goods are goods that exhibit characteristics of non-excludability and non-rivalry in consumption, e.g. traffic lights.

Explain how these two features cause underproduction and underconsumption of the goods in the market.

Non-rivalry means the marginal cost of admitting one more user of the good is zero. Since the marginal cost of admitting one more user is zero for a public good and the socially optimal number of users occurs when $MSB = MSC$, the socially ideal price to charge each user will be zero. **It will be inefficient to charge a price.**

The free market will not allocate resources for the provision of public goods which are essential for the economic welfare of the society as no profit maximising firms will be willing to supply these goods at zero price. **It will lead to market failure due to a missing market.** Thus, the government has to **intervene to undertake the provision of public goods.**

Development 2: Explain how the market fails in the case of merit goods

Merit goods, **such as healthcare and education** are goods that the government believes consumers will buy too few units if provided by the market because of information failure and positive externalities in consumption. In the case of healthcare market, consumers of healthcare underestimate the true private benefits of healthcare services & ignore the positive external → underestimate the demand for the good → underproduction and underconsumption of good

Conclusion:

Government intervention in the above two scenarios is required to improve efficiency in resource allocation.

Mark scheme:

Level	Knowledge, Comprehension, Application and Analysis	Marks
L3	There is an accurate & developed explanation on the key features that determine the nature of public goods & merit goods on impact on resource allocation. Good use of diagram as an analytical tool.	7-10
L2	Some attempt to respond to the question by making comments on the key features that determine the nature of public goods & merit goods on impact on resource allocation	5-6
L1	The answer is mostly irrelevant and contains only a few valid points made incidentally in an irrelevant context. OR The answer contains a list of relevant points given with key theory/economic ideas identified without explanation. <i>E.g. meaning of public goods, merit goods and market failure</i>	1-4

(b) Discuss the view that the best way for governments to respond to the existence of merit goods is to regulate their production directly. [15]

Development 1: Direct regulation of production of merit goods such as healthcare can be effective in correcting the market failure.

[What it is] Direct regulation is a command and control measure in the form of standards, rules and regulations for compliance.

[How it works]

Direct regulation lowers the MPC causing the MPC to shift rightwards resulting in a new market outcome closer to the social optimum outcome. Hence, the under-production and under-consumption is reduced leading to a smaller deadweight loss.

[How well it works] EV: The use of laws is a powerful tool because it is mandatory and is useful when the extent of the market failure is big.

Development 2: The government can consider alternative solutions; e.g. market-based solution such as subsidies, and provision of information to correct the market failure in the market for healthcare.

Subsidies

Subsidies are transfers from the government to the firms (healthcare providers) producing the healthcare service.

The government gives a per unit subsidy → lowers the firm's unit cost of production. Hence, at each possible price, more units will be supplied. Supply rises and the supply curve shifts right. This results in a rise in equilibrium quantity to the socially optimal level, eliminating the welfare loss due to market failure.

EV: Compared to regulations, subsidies are easy to implement but accuracy of the measurement of the level of positive externalities is difficult to achieve.

Provision of information

The direct provision of information by the government may help to encourage the consumption of merit goods. This can be done through educational campaigns, for example. Once individuals are fully aware of the full private benefits, they would demand more of the good. The demand curve would shift to the right and thus, as the private optimum output increases closer to the social optimum output, the underproduction and underconsumption of healthcare is reduced, thereby reducing the deadweight loss and hence market failure.

Synthesis and Conclusion:

Make evaluative assessment based on economic analysis of alternative means that might be adopted to address market failure due to merit goods

Level	Knowledge, Application, Understanding & Analysis	Marks
L3	Analysis of how regulation of production and alternative policies address market failure caused by merit goods	9-11
L2	Analysis of how regulation of production addresses market failure caused by merit goods OR Description of how regulation of production and alternative policies address market failure caused by merit goods	6-8
L1	Description of how regulation of production addresses market failure caused by merit goods	1-5
	Up to 4 additional marks for evaluation	
E2	For an evaluative assessment based on economic analysis of alternative means that might be adopted to address market failure due to merit goods	3-4
E1	For an unexplained assessment or one that is not supported by analysis	1-2