

Market Failure Responses – Important inclusions in your analysis

1. **What is market failure?** – (This is not a definition) Market failure focuses on issues that prevent the price mechanism in a free market in allocating resources efficiently. So always remember to eventually link your explanations to how resource allocation has been affected.
2. **Always provide definitions** – Market Failure, Externalities, etc.
3. **Avoid generalisations in your analysis** - Provide specific examples. For example, with negative externalities; highlight whether it's consumption or production borne and most importantly all examples must be specific to a market.
For instance, highlight if market failure has arisen in a steel producing market that you have researched. Do not analyse pollution of industries in general. This also applies to analyses involving Public Goods and Common access resources.
4. **Explain diagrams** – This is critical to all economics topics. It is a skill that distinguishes economics from most other social science subjects.
 - Sources of market failure that stem from externalities and market power have diagrams. (Public Goods and Common Access resources do not require diagrams).
 - For externalities, the most important parts of the diagram to explain would be the MPC (Sp) MPB (Dp) and the MEC/MEB.
 - For example, in the market for cigarettes; the MPB of smoking represents the satisfaction experienced by the smoker. The MPC would be the cost of the cigarette and the eventual health cost to the smoker. The MEC (externality) is the 2nd hand smoke that impacts those that are not part of the transaction with a health cost. This is not captured by the price mechanism and has the effect of understating the true cost (MSC) ($MPC + MEC = MSC$) of smoking.
 - Therefore, explaining the curves (the diagram) has to be done for failures that have diagrams.
5. **Necessary analysis in Market Failure.**
 - For explanations involving causes of market failure, it is always necessary to mention how a given situation leads to either an over/under consumption or over/under production situation. This point should then link to how there would be either an over (negative ext.) or under (positive ext.) allocation of resources. Then show, on your diagram, how Qty is now less or more than the socially optimal level of output. Additionally, highlight in the diagram the resultant Deadweight Loss (DWL) present as justification (proof) that there is an inefficient allocation of resources.
 - **Public Goods** - always explain examples you have identified (identified) in terms of the characteristics of **Non-Excludability** and being **Non-Rival**. For example, explain why street lighting is Non-Excludable and also Non-rival. Highlight that due to these factors a market for a product that provides **significant social benefit** fails to arise. There is no allocation of resources for a market that is very obviously important to society.
 - **Common access Resources** is a source of market failure due to it being Rival but Non-excludable. Use an example you have researched to explain your point. **The focus of the failure is** that due to **non-excludability** there is over consumption/production which leads to an over allocation of resources in the market. This imposes a significant (external) cost onto society that is not factored into the activity. **(remember it is always about allocation of resources)**
 - **Market power** (due to barriers to entry) - highlight how when a firm or firms with market power restrict output to raise price it leads to a situation where there is a higher price and lower output as compared to a free market socially optimal level (use your diagram to show this). Highlight in the diagram how there is DWL loss created and there are less resources channelled into the market. There is an under allocation of resources and therefore market failure arises due to market power.

Policy

6. **Taxes and Subsidies** - **ONLY** For market-based measures like Taxes and Subsidies **ALWAYS MENTION** how the policy '**INTERNALISES**' the external cost or benefit. In your explanation, for example an indirect tax, state that the tax causes the firm's MPC to fall (Shift left) allowing the external cost to be internalised in the market. Explain that in the diagram the tax shifts the MPC curve to the left and converges with the MSC, eliminating DWL and bringing Qty to the socially optimal level of output (Q_s). The market, in theory, is now efficient.
7. **Common Access Resources** - For solutions that address Common Access Resources highlight how the specific policy action limits the activity and hence, reduces over production. This reduces an overallocation of resources and minimises the externality.

Good Luck!