3 Market failure – Part 1 — Answers

Answers

3.1 When a free market does not allocate resources efficiently — it makes too much or too little of a good, so society's welfare is not at its best.

3.2 A negative externality; the market makes **too much** (because the producer ignores the cost falling on others).

3.3 Non-payers cannot be excluded (non-excludability), so people free-ride — they use it without paying. A firm cannot make a profit, so it supplies none; the government must.

3.4 (a) under-consumed; (b) over-consumed.

3.5 (a) merit: education or health care; (b) demerit: cigarettes or alcohol.

3.6 The power station bases its output only on its *private* cost (fuel, wages). It ignores the *social* cost of the pollution, which falls on third parties. Because the true social cost is higher than the private cost, the market produces *more* electricity than the level that would be best for society — so it over-produces.