**Market Failure Review**

**Definitions and Key Points:**

**Externalities (Different ways to explain/define externalities. You need to know how to paraphrase.)**

*Externality* happens when a voluntary exchange/transaction affects a third party who is neither the buyer nor the seller.

*Externalities* occur in an economy when the production or consumption of a specific good impacts a third party that is not directly related to the [production](https://www.investopedia.com/terms/f/factors-production.asp) or consumption of the good.

*Externality:* The effect of a market exchange/transaction on a third party who is outside or “external” to the exchange.

*Negative externality:*  A situation where a third party, outside the transaction, suffers from a market transaction by others. It results in external cost for third parties.

*Positive externality*: A situation where a third party benefits from a market transaction by others. It results in external benefit for the third parties.

*External Cost****:***  costs incurred by third parties as the result of a market transaction

*External Benefits***:**  benefits enjoyed by third parties as the result of a market transaction.

Bystander: a third party, someone who is not involved in the decision making process.

**Market Failure**

Market failure happens when the market on its own fails to allocate resources efficiently; in other words, resources are not being allocated to the highest-valued activity.

**Private costs:** costs suffered by the decision maker.

**Private benefits:** benefits enjoyed by the decision maker.

**Social Costs**

Costs that include both the private costs incurred by firms and individuals involved in the decision making process and additional/external costs incurred by third parties that are outside of the decision making process, like costs of pollution, second hand smoke, noise, etc.

Social costs = private costs + external costs

**Social Benefits**

Benefits that include both the private benefits to the firms and individuals involved in the decision making process and external benefits to the third parties outside the decision making process.

Social benefits = private benefits + external benefits

# Correcting or ‘Internalizing’ an external cost:

* Laws and regulations
* Taxation

**Internalizing an external benefit:**

* Subsidies (various ways to explain/define a subsidy)

A **subsidy** is money that is paid by a government or other authority in order to help an industry or business, or to pay for a public service.

Money given by a government or an organization to reduce the cost of producing a product, such as food, and to help to keep prices low.

A sum of money granted by the government or a public body to assist an industry or business so that the price of a commodity or service may remain low or competitive.

**Positive Externality and Market Failure:**

Market failure exhibits itself not just in the form of over production of negative externality, but also under production of positive externality, such as in the case of a public good and merit good.

* A **public good** or service is a good or service that can be consumed without reducing the amount available for others (non-rival), and cannot be withheld from those who do not pay for it (non-excludable). Often the government provides subsidies or collects taxes to fund such goods and services.
  + Police patrol
  + Military protection
  + public roads, parks
  + water fountains

**Merit goods** provide **positive** **externalities** but if left wholly to the **private** sector, it is likely to be **under-consumed**. In other words, the consumption of merit goods, benefit not only the decision maker, but also the society as a whole. However, since rational people make decisions based on private costs and benefits, the consumption of merit goods is likely to be less than what is optimal for the society. It is therefore argued that the government should provide such goods and services for free or subsidize them.

* + - Education
    - Vaccination

Graphs: You will need to understand how taxes and subsides affect the market equilibrium.

Know how to evaluation of the effectiveness of government initiatives combating externalities such as air pollution and second-hand smoke. You should prepare yourself with real life examples of actual policies in place regarding such externalities. To evaluate:

Step 1: Look up online for examples of policies in place (That needs to be done now, not during the test)

Step 2: Identify the problems the policy intends to solve.

Step 3: Analyze the root cause of the problems: who are the people? What are they doing? How does what they do cause the problems?

Step 4: What needs to be done differently so that the behaviors in step 3 will change?

Step 5: Will the policy in place change those behaviors? Why and why not?

Step 6: If not, can you propose something different? How will your proposed policy change people’s behavior?

Step 7: a short conclusion about the effectiveness of the policy.

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