**KEY CONCEPTS AND SKILLS: Unit 1.4 – Market Failure**

**Definitions:**

* **Market Failure**: the failure of a market to allocate resources efficiently, resulting in too much or too little of a good being produced and consumed from the point of view of what is socially most desirable.
* **Externalities:** When the actions of consumers or producers give rise to positive or negative side effects on other people who are not part of these actions and whose interests are not considered.
* **Demerit Goods**: Goods that are considered to be undesirable for consumers but which are overprovided by the market (e.g., cigarettes, alcohol, gambling)
* **Merit Goods**: Goods that are considered to be beneficial for consumers but which are underprovided by the market (e.g., education, vaccinations, recreational facilities)
* **Common Access Resources**: resources that are not owned by anyone, do not have a price, and are available for anyone to use without payment (e.g., water from lakes or rivers, open grazing land the ozone layer, etc.)
* **Sustainability**: the ability of something to be maintained and preserved over time
  + **Sustainable Growth**: economic growth that meets the needs of the current generation without compromising the ability of future generations to meet their needs
* **(HL) Asymmetric Information**: a situation where buyers and sellers do not have equal access to information
  + **(HL) Adverse Selection**: a transaction in which a negative outcome results due to information asymmetry
  + **(HL) Moral Hazard**: a situation where one party takes risks but does not face the full cost of those risks

**Concepts and Applications:**

1. ***Market Failure and Externalities***
2. Analyze the concept of *market failure* as the failure of a market to achieve allocative efficiency.
3. Describe the concepts of *marginal private benefits (MPB)*, *marginal social benefits (MSB)*, *marginal private costs (MPC) and marginal social costs (MSC).*
4. Describe and give examples of the difference between positive and negative, consumption and production externalities.
5. Describe the meaning of externalities as the failure of the market to achieve a social optimum where MSB=MSC.
6. ***Negative Production and Consumption Externalities***
7. Explain, using diagrams and examples, the concept of *negative externalities of production*.
   * Describe how negative externalities lead to a welfare loss.
8. Describe, using diagrams, the policy instruments available to governments to address *negative production externalities*.
9. Discuss the advantages and disadvantages of market-based solutions (taxes and tradable permits) versus regulatory policies for reducing *negative production externalities*.

*The same questions apply to consumption externalities.*

1. ***Positive Production and Consumption Externalities***
2. Explain, using diagrams and examples, the concept of *positive externalities of production and consumption*.
   * Describe how positive externalities lead to a welfare loss.
3. Evaluate, using diagrams, the potential government responses, including subsidies, legislation, advertising and direct provision of goods.
4. Explain the concept of *merit goods* and why *merit goods* might arise.
5. ***Lack of Public Goods***
6. Distinguish between *private goods* and *public goods*, including examples.
7. Explain how the *free rider principle* can lead to a lack of public goods, a form of market failure.
8. Discuss the implications of the direct provision of public goods by the government.
9. Explain the meaning of *quasi-public goods*, including examples, and outline why governments generally provide *quasi-public* goods directly.
10. ***Common Access Resources and Threats to Sustainability***
11. Describe the concept of *common access resources* and identify examples.
12. Describe how the concept of *sustainability* combines economic and environmental factors.
13. Explain how the lack of price for *common access resources* leads to a market failure and a threat to sustainability.
14. Explain the difference between “pollution of affluence” and “pollution of poverty”.
15. Use an externality diagram to explain an example of “pollution of affluence”.
16. Evaluate, using diagrams, possible government responses to threats to sustainability, including legislation, carbon taxes, cap and trade schemes, and funding for clean technologies.
17. Explain, using examples, why effective responses to threats to sustainability may require international cooperation.
18. ***(HL) Asymmetric Information***
19. Explain, using examples, how market failure can occur if one party to a transaction possesses more information than the other party.
20. In what way does a market characterized by asymmetric information differ form a purely competitive market.
21. Describe the consequences of *information asymmetry* on allocational efficiency.
22. Evaluate possible government responses when sellers have more information than buyers.
23. Explain how the recent financial crisis could be an example of *moral hazard*.
24. Evaluate alternatives (by government or companies) for addressing information asymmetry in the insurance industry.