

## Market failure is a key concept

• Examples include :

1. externalities
2. public goods  
merit goods/ demerit goods
3. labour mobility
4. imperfect competition (syllabus 1.5 HL)  
monopoly  
oligopoly  
monopolistic

**Note:** The MSB/MSC is a **4 stakeholder** diagram. It represents the Firm, Consumer, Government and Society.

The market diagram (Supply and demand)

represents **3 stakeholders** namely the Consumer, Producer and the Government. This is the key difference between the diagrams.

Otherwise they are similar e.g. when a government indirectly taxes a market then supply shifts upwards to the left. MSC will also shift upward to the left as a result of the indirect tax.

## SYLLABUS REFERENCE 1.4<sup>1</sup>:

addressing market failure

Resource Allocation applying the concept of welfare economics: A solution to Market Failure using Social Costs +

Social Benefits

### 3 Steps to remember to draw the diagrams for market failure?

1. every time draw **MsB + MsC**. **Social optimum** is where **these lines intersect**. See black● in diagrams 1+2.
2. decide whether the third line is a benefit or cost line i.e. is the story about consumption/benefit (PMB) or production/cost (PMC)? See 3 below.
3. draw the third line using the following guidelines:
  - Is it over / under consumption or production?
  - is it over or under production/consumption?
  - is it a merit or demerit good?
  - Does society want more or less of the consumption/production?
  - E.G.If government wants more consumption then the diagram should be diagram 2 below showing 'under-consumption' or positive externalities of consumption. Markets underconsume health care e.g. public health vaccine to protect public health
  - Which triangle for welfare loss do you shade? Angle between **SmB** and **SmC** = welfare loss e.g. **abc**, see web 252

Diagram 1: SmB and SmC to show negative externalities of production

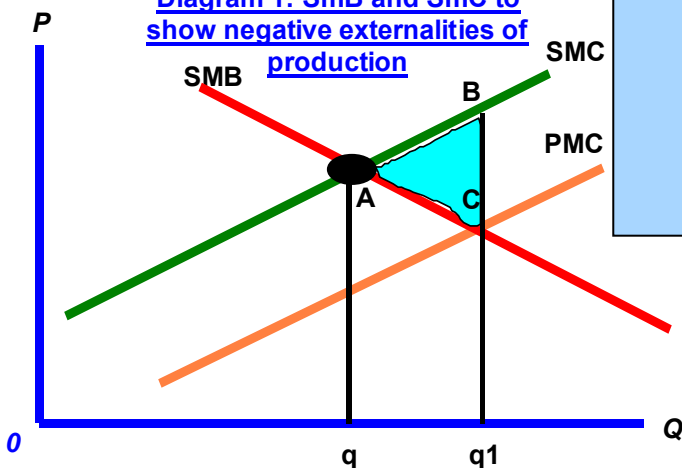
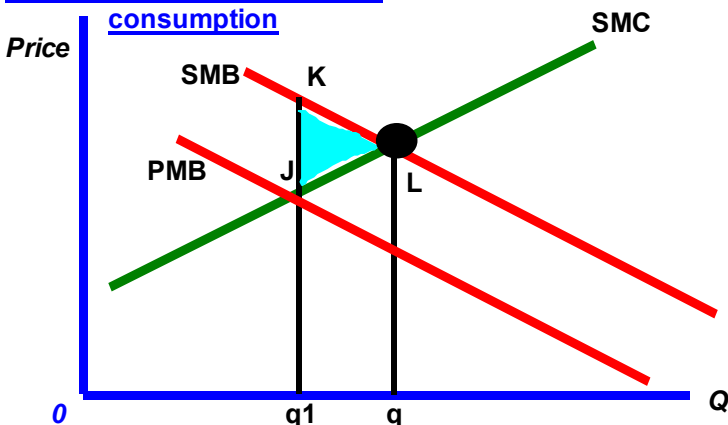


Diagram 2: SmB and SmC to show positive externalities of consumption



**Welfare loss** = a non optimal allocation of resources where MsB is not equal to MsC. This results in over/under consumption /production. MsB is not equal to MsC. (see also webnote 1493)

#### COMMENT: DIAGRAM 1

- Q is the socially efficient level of output
- Market supplies q1
- Overproduction = area abc
- This is a welfare loss or cost to society of the market failure.
- Welfare loss is a socially inefficient allocation of resources
- Social optimum is where MsC=MsB

#### COMMENT: DIAGRAM 2

- Q is the socially efficient level of output
- Market only supplies q1
- Under-consumption = area of jkl
- This is a welfare loss to society (see webnote 252 for welfare loss)

#### IB Testing Focus:

IB HL 2 paper Nov 2003: Q2 Focus is on government attempts to control tobacco  
Click on 'Assessment' in the Index and select HL 2

**Task 1: Explain the key differences between diagram 1 and diagram 2 above.**