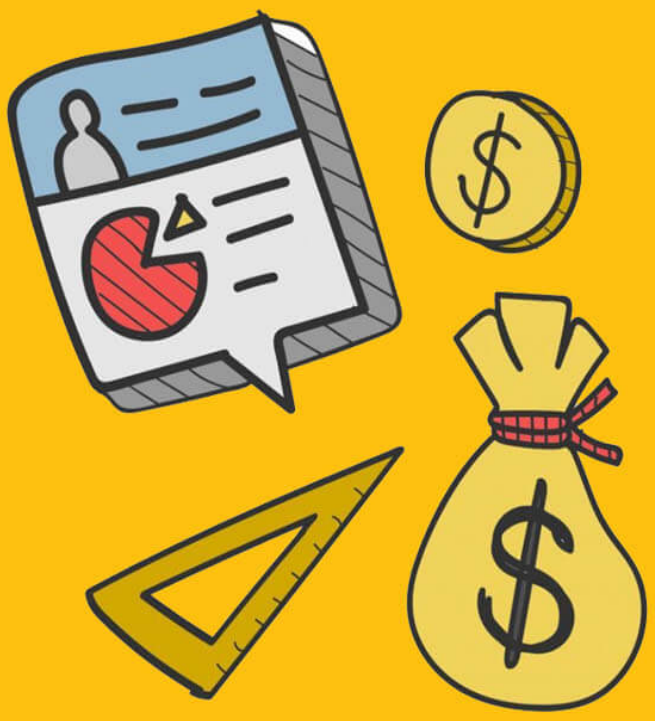
Exam Papers Practice

The Meaning of Market Failure



AQA A Level Economics Revision Notes

www.exampaperspractice.co.uk

- Market failure occurs whenever a market leads to a misallocation of resources.

- A misallocation of resources is when resources are not allocated to the best interests of society. There could be more output in the form of goods and services if the resources were used in a different way.
- Economic and social welfare is not maximised where there is market failure.

Types of market failure:

- **Externalities**
  An externality is the cost or benefit a third party receives from an economic transaction outside of the market mechanism. In other words, it is the spill-over effect of the production or consumption of a good or service. Negative externalities are caused by the consumption of demerit goods, such as cigarettes, and positive externalities are caused by the consumption of merit goods, such as recycling schemes.

- **The under-provision of public goods**
  Public goods are non-excludable and non-rival, and they are underprovided in a free market because of the free-rider problem.

- **Information gaps**
  It is assumed that consumers and producers have perfect information when making economic decisions. However, this is rarely the case, and this imperfect information leads to a misallocation of resources.

- **Monopolies**
  Since the consumer has very little choice where to buy the goods and services offered by a monopoly, they are often overcharged. This leads to the under-consumption of the good or service, and therefore there is a misallocation of resources, since consumer needs and wants are not fully met.

- **Inequalities in the distribution of income and wealth**
  There is an unequitable distribution in income and wealth. Income refers to a flow of money, whilst wealth refers to a stock of assets. This can lead to negative externalities, such as social unrest.

Complete and partial market failure:

- Complete market failure occurs when there is a missing market. The market does not supply the products at all.

- Partial market failure occurs when the market produces a good, but it is the wrong quantity or the wrong price. Resources are misallocated where there is partial
market failure.