

# Public policies used to solve market failure economics essay



**ASSIGN  
BUSTER**

Market is defined as a group of buyers and sellers of a particular good or service. There are many different types of markets such as stock market, currency market and more. Market is efficient when the market is perfectly competitive. If a market is not perfectly competitive, the market failure will occur.

Market failure also occurs when the allocation of resources in a free market is inefficient. Market failure occurs when the market is not in perfectly competitive. There are many reasons to cause market failure. The main causes of market failure are:

#### a) Negative Externalities

Externalities are defined as the uncompensated impact of one person's actions on the well-being of a bystander. Negative externality such as the effect of environmental pollution can cause the marginal social cost(MSC) of production to exceed the marginal private cost(MPC) according to the diagram below:

In the process of production, the firms will cause the pollution of the environment. The pollution is bad for public health so that the marginal social cost(MSC) is exceed the marginal private cost(MPC). The optimum of production is at  $Q_s$ ,  $MSB$  is equal to  $MSB$ . The firms will produce goods at  $Q_p$ , where  $MPB$  is equal to  $MPC$ . The excess of production not only does not promote the public welfare but also causes more pollutions to the environment. As a result, the market will go inefficient.

#### b) Positive Externalities

The positive externalities such as the provision of education and healthcare can cause the marginal social benefit(MSB) of consumption to exceed the marginal private benefit(MPB) according to the diagram below:

In a free market, the consumption will be at  $Q_p$  where the private benefit equals to the private cost. However, this is socially inefficient because the social benefit is exceeded to the social cost. Therefore, that is under-consumption( $Q_s - Q_p$ ) of the positive externality. The social efficiency will occur at  $Q_s$  where the social cost equals social benefit.

#### c) Merit and Demerit goods

Merit good is a good that people do not realise its true benefit such as the people underestimate the benefit of education. The examples of merit goods are education and healthcare. These goods usually have positive externalities. Therefore, there will be a under-consumption of merit goods in a free market.

Demerit good is a good that people do not realise the costs of doing something such as smoking and drugs. These goods usually have negative externalities. Therefore, there will be over-consumption of demerit goods in a free market.

#### d) Public goods

The private sectors in free markets cannot profitable supply to consumers public goods that are needed to meet people's demand. So that the public goods are generally provided by government.

### e) Monopoly Power

Market that controlled by monopoly can cause under-production and higher prices than would exist under condition of competition.

### f) Factor immobility

Factor immobility will cause unemployment hence productive inefficiency.

When market fails, the market will fall into position of inefficiency. It may cause unfair distribution of income and property to the public. Many firms increase the quantity of goods supplied in order to earn more profit. It may cause the pollution in the environment as the firms are not willing to protect the environment whenever they produce goods. Besides that, unemployment will occur because of the exclusion of labor by the machines when the firms are able to improve the productivity. There will be also an undersupply of public goods. The private sectors are not willing to produce public goods as the consumers do not need to pay for these goods so that they will not earn profit from providing the public goods.

To address these public issues, the government will execute some policies to solve the market failure such as imposing taxes on negative externalities.

In the diagram above, the marginal social cost(MSC) of production will exceed to the marginal private cost(MPC). The government imposed the taxes to the sellers and the imposition of taxes will increase the production cost of the sellers. Then, the supply curve(PMC) will shift to the left. The quantity of production will decrease from  $Q_p$  to  $Q_s$  where the optimum output is and the social welfare will be maximized.

<https://assignbuster.com/public-policies-used-to-solve-market-failure-economics-essay/>

New Mexico Legislature is supposed to increase the state cigarette tax from 75 cents to \$1.66 per pack this year. The purpose of imposing the tax is to reduce the tobacco use and save lives. The increasing of tax will discourage people from smoking. Increasing the cigarette tax is one of the most effective ways to reduce smoking, especially among kids.

From the diagram above, the production of tobacco of marginal social cost(MSC) is exceed to the marginal private cost(MPC) and the output of tobacco of the sellers is at  $Q_p$ . New Mexico Legislature imposed the cigarette tax to the output of tobacco of sellers. So that, the supply curve( $S = PMC$ ) of tobacco will shift to right. The output of tobacco will decrease from  $Q_p$  to  $Q_s$  as the tobacco tax will increase the cost of production of tobacco. As a result, the supply curve of tobacco will move to left and equals to marginal social cost(MSC). At this moment, the optimum output of tobacco is at  $Q_s$ . The imposition of cigarette tax will reduce the output of tobacco and discourage people from smoking.

Taxes on negative externalities will raise the revenue for the government and reduce the pollution of environment.

The second policy that can overcome the market failure is to provide subsidy on positive externalities. The government provides subsidy to the firms to pay part of cost for them to encourage more production.

From the diagram above, the production of marginal social benefit(MSB) is exceed to the marginal private benefit(MPB). The government provided subsidy( $P_2 - P_1$ ) to the firm to decrease their cost of production. As a result,

the firm will increase the output from  $Q_p$  to  $Q_s$ . Then, the social welfare will be maximized.

For example, Malaysia government plans to provide a subsidy of RM30bil to enhance primary and secondary school education nationwide which is one of the plans of Budget 2010.

From the diagram above, when our government provides a subsidy of RM30bil on education, the operating cost of school will decrease. Then, the school will have enough capital to build more facilities and provide more educational plans from  $Q_p$  to  $Q_s$  for the students. The students will get more benefit from studying. At this moment, the social welfare will keep increasing till the marginal social benefit(MSB) equals to marginal social cost(MSC).

The third policy is to change the property right. This will happen when the government gives the property rights to certain people such as the fishermen could be given the property rights to a river. When negative externalities occurred, the owners of property could sue a company who caused damage or pollution such as the fishermen can sue a chemical factory which polluted the river. It may charge some social costs to the chemical factory. The government pursued this policy to reduce the pollution of environment so that the negative externalities could be eliminated.

In addition, the government will also impose the laws and regulation to prohibit the unhealthy behaviour of people such as legalizing the age for smoking and banning on drunk driving. The laws and regulations must be simple and easy to understand to the public. Due to a reducing in negative

externalities, the marginal social cost will decrease. So that, imposing the laws and regulations is also a policy to overcome the market failure.

For example, in New Zealand, it is illegal to sell tobaccos and cigarettes to person aged under 18. It is also illegal for a person over 18 to give a person under 18 cigarettes or tobaccos in a public place. Another example is sales of tobacco to person aged under 18 are illegal in all Australian states. The purpose of legalizing the smoking by both governments is to reduce the consumption of tobaccos. It may help to decrease the negative externalities for improving efficiency of the market.

Finally, the other policy is to give the pollution permit. The government can give a pollution permit to a firm to limit his output. The more the firm produce, the more polluted the environment is. Therefore, the marginal social cost will keep increasing and market failure will occur. The government will give the pollution permit to the firm such as limiting the firm to produce only 100 units carbon dioxide per year. As a result, there is an incentive to pollute less and the negative externalities will be eliminated.

## Conclusion

The public policies implemented by the government can successfully solve the market failure. The main causes of market failure is the externality. It can divide into negative externality and positive externality. Government will impose the tax to the firms to decrease their output as every unit of good they produce will cause the pollution of environment. The implimentation of this public policy can reduce the pollution of environment but also to eliminate the negative externalities for efficient market.

<https://assignbuster.com/public-policies-used-to-solve-market-failure-economics-essay/>

Secondly, the government will also provide subsidy to the firms. With this policy, the production cost of the firms will decrease and their output will increase. The market will be efficient as the subsidy on positive externalities forces the marginal social cost equals to the marginal social benefit. Thirdly, the government will implement the policy of changing the property rights. By giving the property rights, the owner of the property can sue a company which caused pollution to their property such as the lands. It may help to reduce the pollution of the environment and eliminate the negative externalities. So that, the market failure can be overcome.

The government will also impose the laws and regulations to prohibit people from the unhealthy behaviour such as smoking and taking drug. The implementation of this policy can effectively increase the social benefit. So that, the market failure will turn into an efficient market. Lastly, the government will also give the pollution permit to the firm. This policy can limit the output of carbon dioxide of the firm. It can reduce the negative externality of air pollution. As a result, the market will be efficient by reducing the negative externalities.

For achieving an efficient market, the government will implement the public policies when market failure occurred although the government needs to spend a high cost on them.