DP IB Economics: SL

Your notes

2.9 Market Failure: Public Goods

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2.9.1 Public Goods

Characteristics of Public Goods

- A **public good** is substantially different to a **private good**
- **Private goods** are goods which firms are able to provide to **generate profits**. They can generate profits as these goods are **excludable** and **rivalrous**
  - The firm is able to **exclude** certain customers from purchasing their goods **through the use of the price mechanism**. If customers cannot afford to buy them, then they are **excluded**
  - Customers can also **compete** for these goods which are limited in supply and this **rivalry** helps to generate profits for firms
- **Public goods** are goods that are beneficial to society (e.g. roads, parks, lighthouses, national defence) but which will not be provided by private firms due to the principles of **non-excludability** and **non-rivalry**
  - **Non-excludability** refers to the inability of private firms to exclude certain customers from using their products. In effect, the price mechanism cannot be used to exclude customers e.g. street lighting
  - **Non-rivalry** refers to the inability of the product to be used up, so there is no competitive rivalry in consumption to drive up prices and generate profits for firms
  - Therefore, governments will often provide these beneficial goods themselves, and so they are called **public goods**
- If firms decided to provide these goods anyway, it would give rise to what is called the **'free rider' problem**
  - This is a situation where customers realise that they can still **access the goods**, even **without paying** for them
  - If they are paying, they stop and continue to **enjoy the benefits**. They are **'free-riding'** on the backs of other paying customers
  - Over time, any customers who are paying for the goods will stop
  - At some point firms will cease to provide these goods and they will become **under-provided** in society

Your notes

Examiner Tips and Tricks

Make sure that you know the difference between public goods and merit goods. The key idea is that private firms will not provide public goods, so under-provision (or no provision) occurs in society.

On the other hand, private firms will provide some merit goods as they are able to make a profit from them. However, due to the profit incentive and high prices that firms charge, not all members of society will be able to afford these goods. So merit goods are also under-provided, but there is some provision for them.

Government Intervention in Response to Public Goods

- Governments have three possible responses to the **under-provision** of public goods

1. **Do nothing:** no provision is offered
2. **Provide the good/service themselves** e.g. libraries, parks
3. **Contract out:** accept bids from private companies who wish to provide the good/service, choose the lowest priced bid and pay the company to provide the good/service

- Both option 2 and 3 require the provision to be **paid for by governments**
  - There is an **opportunity cost** to any funding decision

Examiner Tips and Tricks

Government provision is an excellent way to address inequality in society. More government provision usually reduces inequality and less government provision usually increases inequality. Government provision often increases when an economy is booming and reduces when an economy is in recession or struggling.