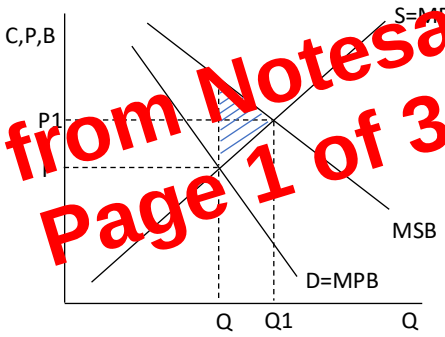
Evaluate the extent to which a subsidy given to producers might encourage an increase in the consumption of a product such as pu'er tea which generates positive externalities. [25]

A market failure is the economic situation defined by an inefficient distribution of goods or services in the free market. A market failure could be the under consumption of a good with positive externalities. Positive externalities occur when the consumption or production of a good imposes an external benefit on third parties for which they didn't pay. This market failure can be fixed through a subsidy, which is a grant given by the government to producers to encourage the production of a good or service.

Pu'er tea generates positive externalities in consumption, as it claims to reduce cholesterol and aid weight loss, therefore creating a potentially healthier lifestyle for consumers. This would benefit healthcare systems as there may have a reduced number of cases of heart disease, therefore reducing the strain on the health service. However, Pu'er tea is under consumed, under consumption occurs because the social benefit is greater than the private benefit, as shown in the graph below. The current free market equilibrium is P,Q, this is where the marginal private benefit (D=MPB) meets the marginal social cost (S=MPC=MSC). This is different to the social optimum of P1,Q1 where the marginal social benefit (MSB) meets the marginal social cost (S=MPC=MSC). At the free market equilibrium (P,Q) there is too low consumption at a too high price resulting in underconsumption.



This market failure can be corrected using a subsidy. Subsidies are given to produces to decrease their cost of production, thus increasing producer's incentive to supply the good, making them more willing and able to sell at a given price and time. An increase in supply, shifts the S=MPC=MSC curve to the right creating the S+Subsidy curve as shown on the graph below. This decreases the price from P to P2, a cheaper price means consumers are more willing and able to buy at this given price and time. Leading to an increase in quantity from Q to Q2 making quantity consumed greater. This would improve economic welfare from ABC to BDE, and then increasing allocative efficiency. This helps correct the market failure of underconsumption as an increase in quantity from Q to Q2 moves the free market equilibrium closer to the social optimum.