Demerit goods

Obesity – is it a case of market failure?

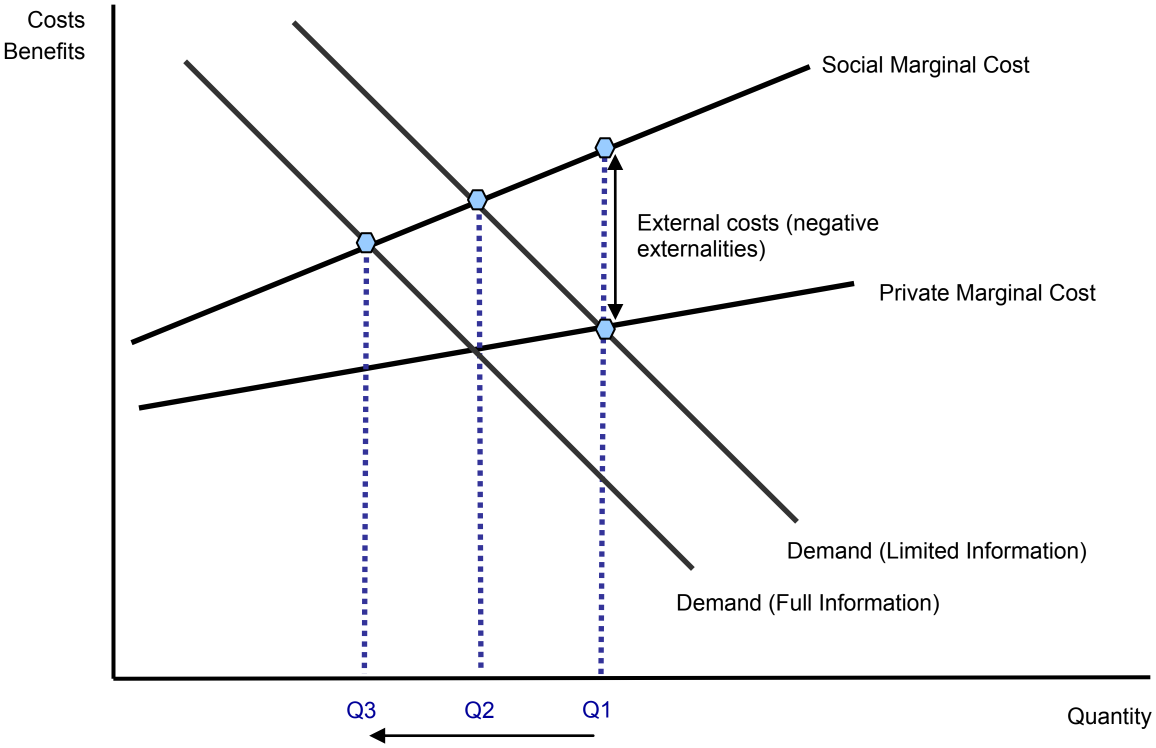
Healthcare costs related to obesity-linked illnesses such as diabetes, heart disease and high cholesterol are soaring. Should the government intervene in the market in order to combat the growing costs of obesity?

The City of Detroit in the USA has considered a fast-food tax to combat some of the external costs of obesity

De-merit goods are thought to be 'bad' for you. Examples include the costs arising from consumption of alcohol, cigarettes and drugs together with the social effects of addiction to gambling. The consumption of de-merit goods can lead to **negative externalities**.

Consumers may be unaware of the negative externalities that these goods create – they have **imperfect information** about long-term damage to their own health.

The government may decide to **intervene in the market** for de-merit goods and impose taxes on producers or consumers. Higher taxes cause prices to rise and should lead to a fall in demand. But many economists argue that taxation is an **ineffective** and **inequitable** way of curbing the consumption of drugs and gambling particularly for those affected by addiction. Banning consumption through regulation may reduce demand, but risks creating secondary (illegal) or underground markets in the product.



The social optimal level of consumption would be Q3 – an output that takes into account the information failure of consumers and also the negative externalities.

Market failure with demerit goods

The free market may fail to take into account the negative externalities of consumption (because the social cost > private cost). Consumers too may experience imperfect information about the long term costs to themselves of consuming products deemed to be de-merit goods

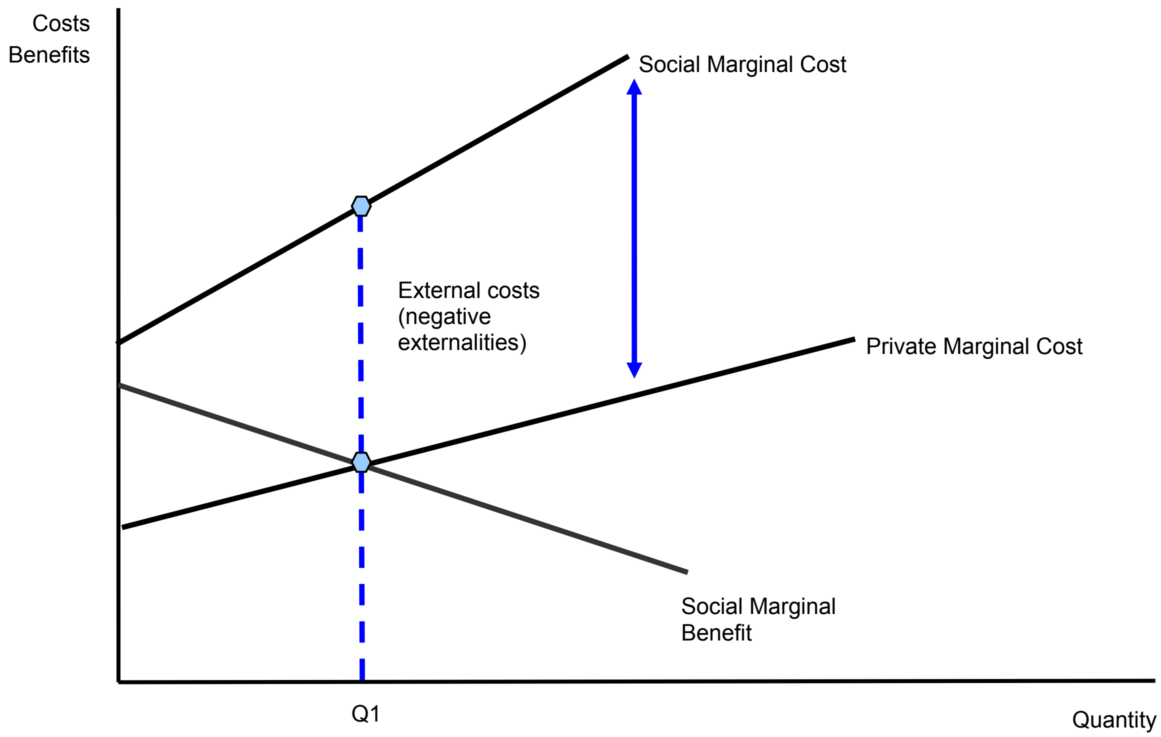
Obesity – a time bomb

There is a huge debate at the moment about the root causes of obesity and the social costs that arise from increasing levels of obesity. A report published in June 2007 said that obesity could be a factor that bankrupted the National Health Service in the years to come. Obesity is also an international problem.

What of harder drugs?

Should hard drugs be prohibited at all costs by the government in a bid to control demand by restricting supply? Regulation has been the route chosen by most governments in developed countries over recent years – but economists are once again divided on the issue. Some believe that legalisation and taxation of harder class drugs is a more appropriate policy to pursue, arguing that regulation is both ineffective and also costly. Another approach would be to divert resources away from regulation towards giving **better information** to drug users about the longer term health implications of their consumption decisions.

The case for a complete ban



The case for a complete ban on de-merit goods such as class A narcotics could be justified on the ground that the social marginal cost of consumption is always higher than the social marginal benefit. In the diagram above there is no output where the social benefit equals the social cost and welfare would be best protected by trying to enforce a total ban on the product.

Food additives – a de-merit good?

The use of food additives has long been a subject of controversy. Examples include the preservatives used in products from soft drinks to barbecue sauce – designed mainly to lengthen the shelf life of products available for sale in supermarkets.

Research published in 2007 by the Food Standards Agency (FSA) claimed a link between food additives and hyperactive behaviour in children leading to losses of concentration and a worsening in classroom behaviour ands they want a number of food colourings to be banned.

Gambling – economic and social effects

From betting on the results of general elections, the Grand National, the number of corners that England win in one of their World Cup matches or the temperature in London on Christmas Day, we seem to have an almost insatiable desire for gambling on the outcomes of virtually every sporting, political, meteorological event.

Inevitably the rapid expansion of this industry raises important questions about **the external costs and benefits of gambling.** Some researchers point to the employment and tourism benefits that flow from the growth in demand for gambling services especially if businesses are established in some of the UK's poorest towns and cities. There is also a fiscal dividend from this booming industry with a predicted £3bn per year of extra tax revenues flowing into the Treasury's coffers.

But gambling also creates external costs. Over 350,000 people in the UK are thought to be addicted to betting and their problem gambling can contribute to crises including personal debt or bankruptcy, loss of employment and the breakdown of families. The dangers of addiction are greatest for the young and the vulnerable susceptible to advertising and marketing strategies.

The usual approach to de-merit goods is to tax consumption, so that the private cost of consumption is increased and demand contracts. But the government has actually got rid of betting & gaming duty (it was abolished in 2001) to be replaced with a tax on the profits of gaming companies. The Gambling Act of 2005 deregulates the industry and allows the creation of more casinos in the UK.

Suggestions for further reading on de-merit goods and market failure

These articles have been selected because they are relevant to the ideas in this chapter on de-merit goods and – in some cases – the related question of government intervention to influence behaviour.

Alcohol sales under scrutiny (BBC news, July 2008)

Australia in thrall of gambling mania (BBC news, January 2007)

Bid to remove food additives (BBC news, April 2008)

Call for better NHS gambling help (BBC news, January 2007)

'Casino social costs outweigh benefits' (BBC news, September 2006)

Doctors attack gambling policies (BBC news, April 2007)

Estonia to raise tax on alcohol (BBC news, August 2007)

Minimum age for buying cigarettes to be raised to 18 (BBC news, July 2007)

Smokers kick habit after ban (BBC news, January 2008)

Surge in alcohol related hospital admissions (Telegraph, July 2008)