


Edexcel (B) Economics A-level
Theme 4: Making Markets Work


4.3 Market Failure across the
Economy

4.3.3 Policies to deal with market failure

Notes



 **The provision of public and merit goods, indirect taxation of demerit goods, tradable pollution permits, provision of information, legislation and regulation**

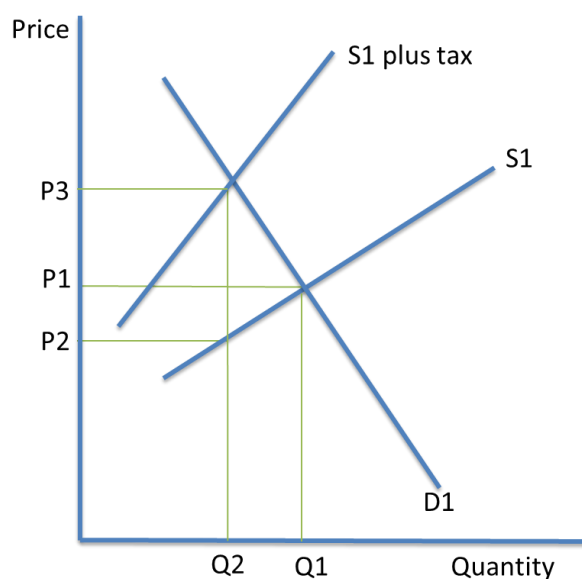
 Governments intervene in the market to correct market failure. For example, they might provide healthcare and education, which the free market would underprovide.

 **Indirect taxes:**

Indirect taxes are taxes on expenditure. They increase production costs for producers, so producers supply less. This increases market price and demand contracts. They could be used to discourage the production or consumption of a demerit good or service. For example, the government could impose a £1 tax per packet of cigarettes.

 There are two types of indirect taxes:

- **Ad valorem** taxes are percentages, such as VAT, which adds 20% of the unit price. This is the main indirect tax in the UK.

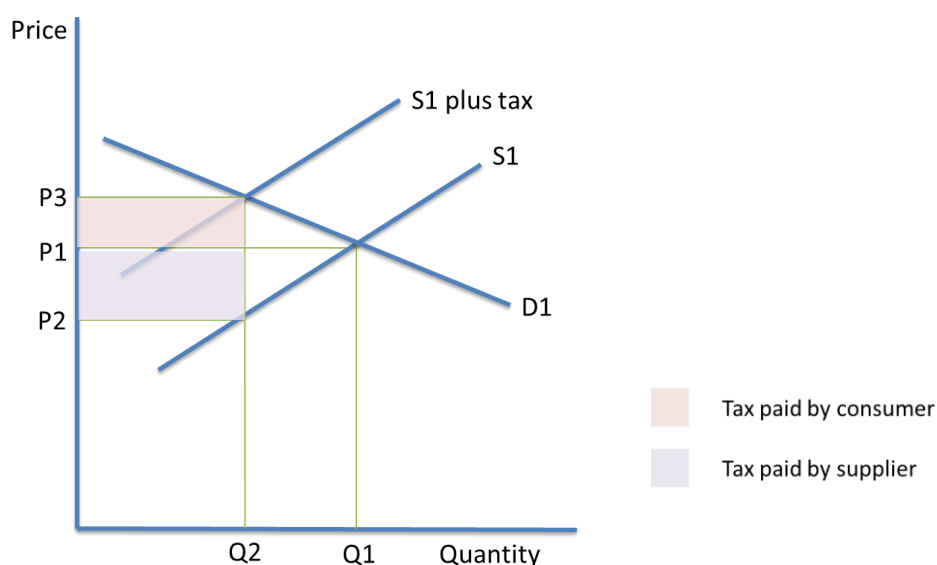


- The incidence of tax might fall differently on consumers and producers. Producers could make consumers pay the whole tax ($P_3 - P_2$), or if they feel




this would lower sales and lose them revenue, they could choose to pay part of the tax. Producers might pay $P1 - P2$, whilst consumers might pay $P3 - P1$.

- The incidence of the tax depends on the price elasticity of demand of the good. For cigarettes, since the demand is fairly price inelastic, consumers might have the larger burden of tax.
- This should, in theory, discourage consumption of the demerit good and reduce negative externalities.
- Government revenue from ad valorem taxes is larger if demand is price inelastic. This is because demand falls only slightly with the tax.
- **Specific taxes** are a set tax per unit, such as the 58p per litre fuel duty on unleaded petrol.








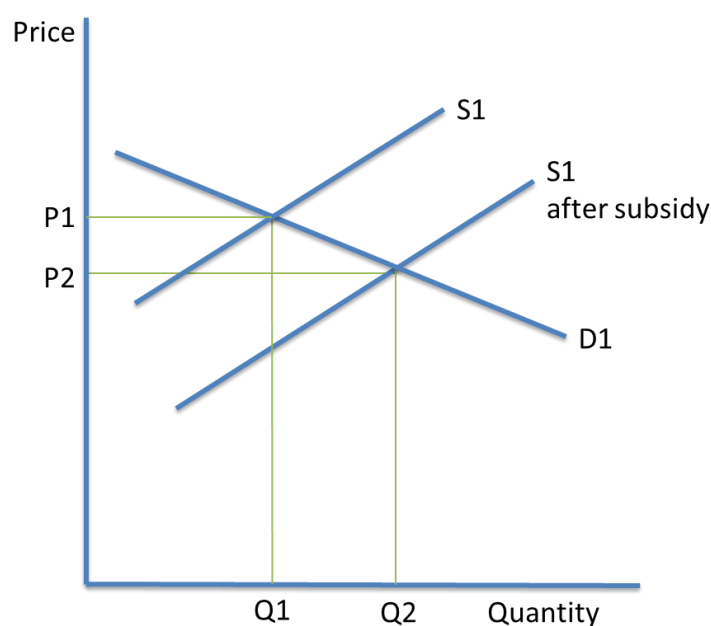
- The more inelastic the demand, the higher the tax burden for the consumer, and the lower the burden of tax for the producer.



 Indirect taxes could reduce the quantity of demerit goods consumed, by increasing the price of the good. If the tax is equal to the external cost of each unit, then the supply curve becomes MSC rather than MPC, so the free market equilibrium becomes the socially optimum equilibrium. This **internalises the externality**. In other words, the polluter pays for the damage.

 **Subsidies:**



-  A subsidy is a payment from the government to a producer to lower their costs of production and encourage them to produce more.
-  Subsidies encourage the consumption of merit goods. This includes the full social benefit in the market price of the good. Therefore, the external benefit is internalised.
-  For example, the government might subsidise recycling schemes so it is cheaper for consumers to recycle waste, which will yield positive externalities for the environment.
-  The supply curve shifts to the left. More of the merit good is produced and the price falls from P_1 to P_2 .
-  The vertical distance between the supply curves shows the value of the subsidy per unit.



-  Consumers gain more from the subsidy when demand is price inelastic, whilst producers supply more when demand is price elastic.
-  The disadvantages of subsidies include the opportunity cost to the government and potential higher taxes, the potential for firms to become inefficient if they rely on the subsidy and government failure, if they subsidise less efficient industries.

 **Tradeable pollution permits:**



- These could limit the amount of negative externalities, in the form of pollution, created in industries. Firms will be allowed to pollute up to a certain amount, and any surplus on their permit can be traded.
- This means firms can buy and sell allowances between themselves.
- For example, there could be a limit on the quantity of carbon dioxide emissions released from the steel industry.
- Advantages**
- This should benefit the environment in the long run, by encouraging firms to use green production methods.
- The government could raise revenue from the permits, because they can sell them to firms. This revenue could then be reinvested in green technology.
- If firms exceed their permit, they will have to purchase more permits from firms which did not use their whole permit. This raises revenue for greener firms, who might then invest in green production methods.
- Disadvantages**
- However, it could lead to some firms relocating to where they can pollute without limits, which will reduce their production costs.
- Firms might pass the higher costs of production onto the consumer.
- Competition could be restricted in the market, if the permits create a barrier to entry for potential firms.
- It could be expensive for governments to monitor emissions.

State provision of public goods:






- The government could provide public goods which are underprovided in the free market, such as education and healthcare. These have external benefits.
- This makes merit goods more accessible, which might increase their consumption and yield positive externalities.
- It could be expensive for governments to provide education, and the government will incur an opportunity cost of spending their revenue.

Provision of information:

- By providing information, governments can ensure there is no information failure, so consumers and firms can make informed economic decisions.
- For example, governments might make it illegal for second-hand car dealers not to reveal the entire history of a car, so consumers know exactly what they are buying.
- This could be expensive to police.

Regulation:



-  The government could use laws to ban consumers from consuming a good. They could also make it illegal not to do something. For example, the minimum school leaving age means young people have to be in school until the age of 16, and education or training until they turn 18.
-  This has positive externalities in the form of a higher skilled workforce.
-  If there was a compulsory recycling scheme, it would be difficult to police and there could be high administrative costs. Bans could be enforced for harmful goods, although they can still be consumed on the black market.
-  Firms which fail to follow regulations could face heavy fines, which acts as a disincentive to break the rule.
-  It could raise costs of firms, who might pass on the higher costs to consumers.

