Edexcel Economics (A) A-level

Theme 1: Introduction to Markets and Market Failure

1.4 Government Intervention

Summary Notes

1.4.1 Government Intervention in Markets

Government intervention to target market failure:

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.
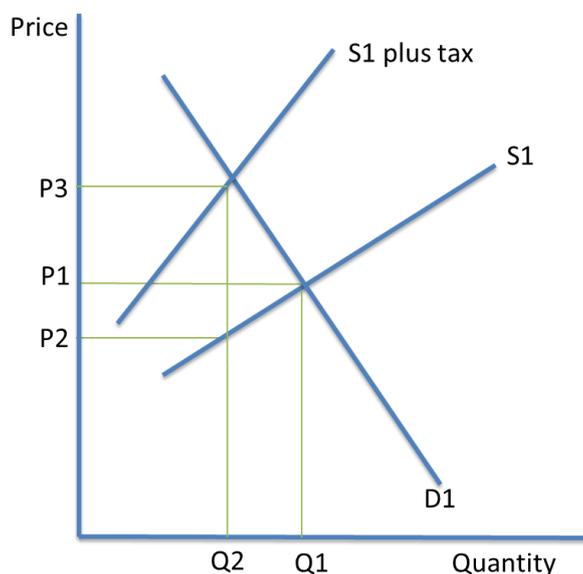
- The incidence of tax might fall differently on consumers and producers. Producers could make consumers pay the whole tax (P3 – P2), or if they feel this would lower sales and lose them revenue, they could choose to pay part of the tax. Producers might pay P1 – P2, whilst consumers might pay P3 – P1.

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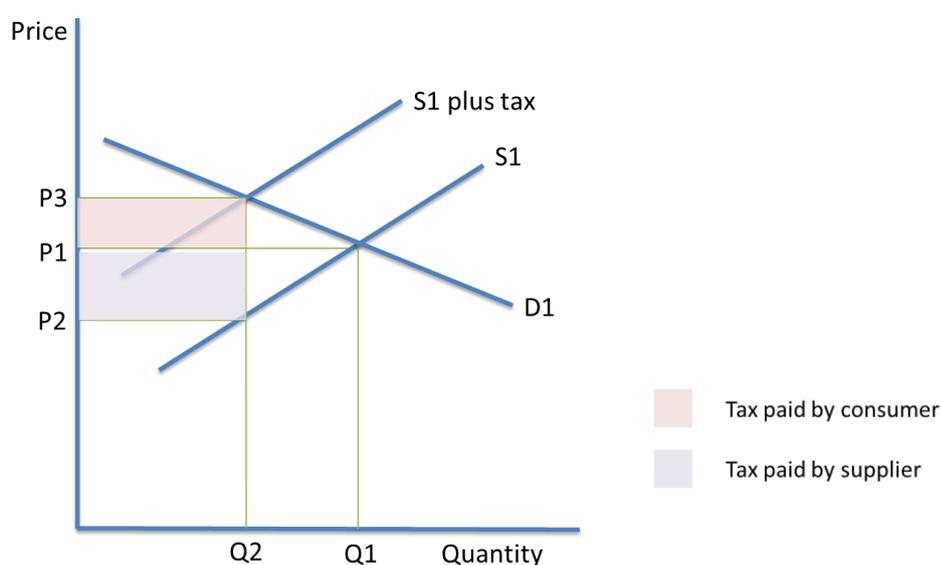
○ The more inelastic the demand, the higher the tax burden for the consumer, and the lower the burden of tax for the producer.

◻ 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 P1 to P2.

- The vertical distance between the supply curves shows the value of the subsidy per unit.
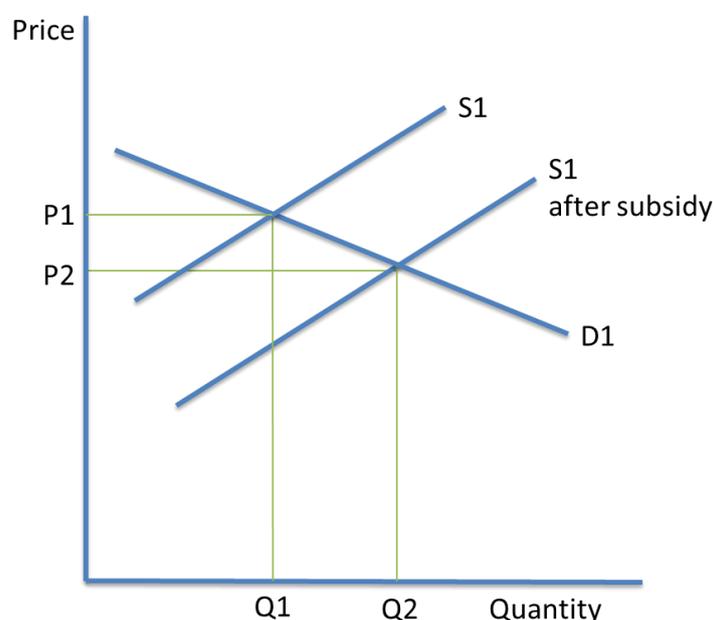
- Consumers gain more from the subsidy when demand is price inelastic, whilst producers supply more when demand is price elastic.

- 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.
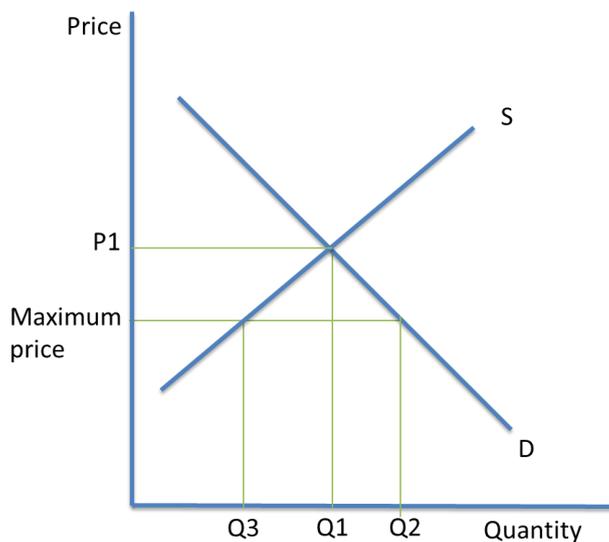
Maximum and Minimum Prices:
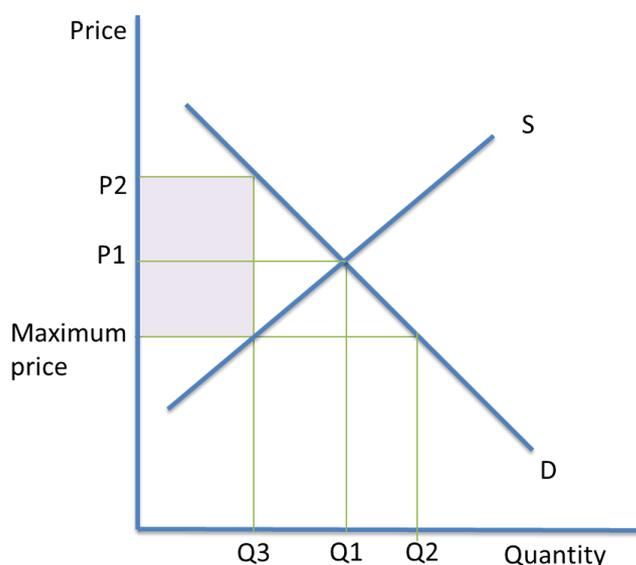
Maximum price

- The government might set a **maximum price** where the consumption or production of a good is to be encouraged. This is so the good does not become too expensive to produce or consume.

- Maximum prices **have to be set below the free market price,** otherwise they would be ineffective.

Price

S

P1

Maximum
price

D

Q3   Q1   Q2   Quantity

- The free market equilibrium is at P1, Q1.

Price

S

P2

P1

Maximum
price

D

Q3   Q1   Q2   Quantity

- If suppliers only produced at Q3, some consumers would be willing to pay P2. The shaded area shows the consumer surplus producers can take with the higher price.
- A quantity of Q3 would require rationing or auctioning, since quantity demanded is Q2.
- They prevent monopolies exploiting consumers. For example, in the EU, price caps on roaming charges are in place to make sure it is not too expensive for consumers to use their mobile phones abroad.
- Maximum prices control the market price, but this could lead to government failure if they misjudge where the optimum market price should be.

- Maximum prices could lead to welfare gains for consumers by keeping prices low, and they could increase efficiency in firms, since they have an incentive to keep their costs low to maintain their profit level.
- However, it could reduce a firm's profits, which could lead to less investment in the long run. Moreover, firms might raise the prices of other goods, so consumers might have no net gain.
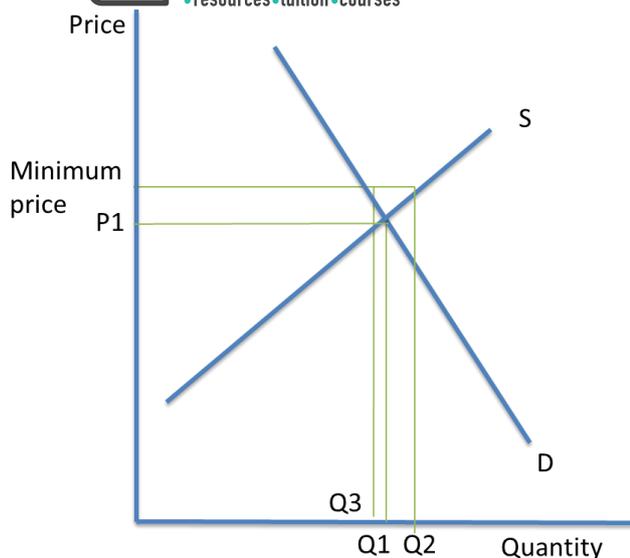
- **Minimum price**

- The government might set a **minimum price** where the consumption or production of a good is to be discouraged. This ensures the good never falls below a certain price.
- For example, the government might impose a minimum price on alcohol, so it is less affordable to buy it. The **National Minimum Wage** is an example of a minimum price.
- Minimum prices would reduce the negative externalities from consuming a demerit good, such as alcohol.
- Minimum prices **have to be set above the free market price,** otherwise they would be ineffective.
- The minimum wage could be used as an example.
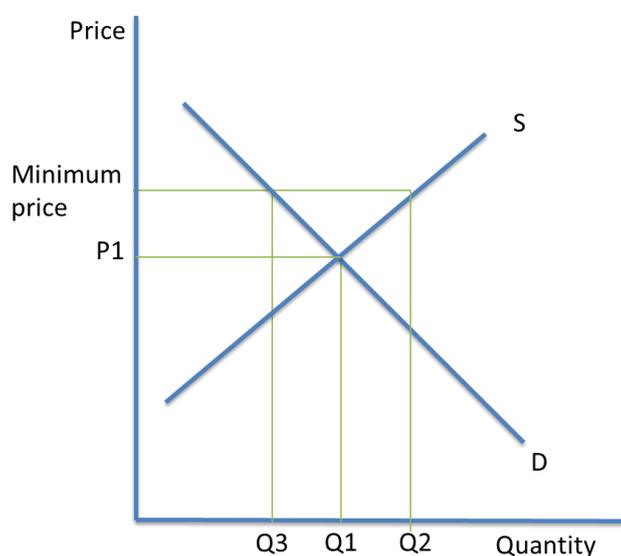
- The diagram suggests that a minimum wage leads to a fall in the employment rate (Q1 – Q3). It depends on what level the wage is set, though. An inelastic labour demand will mean there is only a small contraction in demand for labour (Q1 – Q3).

S

P1

D

Q3

Q1 Q2   Quantity

- This minimum price will yield the positive externalities of a decent wage, which will increase the standard of living of the poorest, and provide an incentive for people to work.

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.

- Governments can fail when they intervene in markets. They could worsen the market failure already present or a new failure might occur.
- This results in a **net welfare loss** to society.
- The loss could be from having ineffective intervention or when harm is caused.

Causes of government failure:

Distortion of price signals

- Government subsidies could distort price signals by distorting the free market mechanism. A free market economist would argue that this could lead to government failure. There could be an inefficient allocation of resources because the market mechanism is not able to act freely.
- For example, the government might end up subsidising an industry which is failing or has few prospects.

Unintended consequences

- This is when the actions of producers and consumers have unexpected, or unintended, consequences.
- With government policies, consumers react in unexpected ways. A policy could be undermined, which could make government policies expensive to implement, since it is harder to achieve their original goals.

Excessive administrative costs

- The social benefits of a policy might not be worth the financial cost of administering the policy. It might cost more than the government anticipated. The government has to consider whether the policy is good value for money.

Information gaps

- Some policies might be decided without perfect information. This might require a full cost-benefit analysis, and it could be time-consuming and expensive.
- For example, government housing policies are long term, and have failed several times in the past.
- However, it is impractical for governments to gain every bit of information they need, so assumptions are made.