Edexcel (A) Economics A-level

Theme 3: Business Behaviour & the Labour Market

3.6 Government Intervention

3.6.2 The impact of government intervention

Notes

The impact of government intervention on:

Prices

Governments can prevent monopolies charging consumers excessive prices, which might result in a loss of allocative efficiency.

This can make services from utility companies, such as water, gas and electricity more affordable, which is especially beneficial to low and fixed income households.

Limiting how much a firm can increase its prices by also encourages the firm to become more efficient. This is so that they can lower their costs and increase their profit margins.

If corporation tax is high, firms might pass the extra cost onto consumers, resulting in higher prices, rather than losing their own profits.

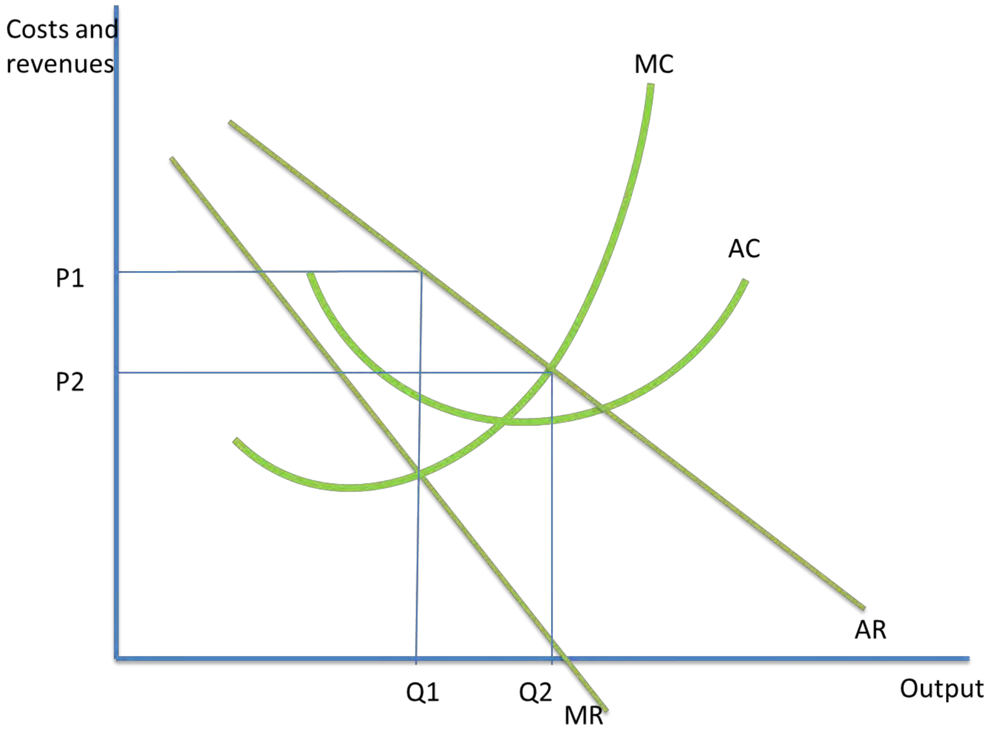
Profit

If governments impose strict price caps, investment could be limited, since the amount of profit that a firm makes is restricted.

However, the recent fall in UK corporation tax from 21% to 20% will help firms keep more profits. The size of the fall can be evaluated- is 1% a significant fall?

Efficiency

The diagram shows where public sector and private sector firms operate. Private sector firms are more likely to operate at Q1 P1, which is the profit maximising level of output and price. A public sector firm is more likely to operate at Q2 P2, which is the allocatively efficient level of output (AR=MC). Therefore, government intervention might lead to an increase in economic efficiency, since the objectives change from profit maximisation to maximising social efficiency.



However, free market economists argue that by operating in a competitive environment, firms have an incentive to become efficient. This is because they are forced to lower their average costs in order to profit maximise. This makes private sector firms more productively efficient.

They might also argue that private sector firms have to produce the goods and services that consumers want in order to keep earning profits. This might increase allocative efficiency.

Quality

Governments can ensure firms are meeting minimum targets, which ensures firms focus on increasing social welfare. For example, firms in the gas and electricity markets are regulated to ensure vulnerable groups, such as the elderly, are kept warm during colder months.

Firms which profit maximise might compromise on quality. However, if private sector firms have the expertise and knowledge which the government might not have, then they might be able to produce goods and services of a higher quality.

Choice

If governments regulate monopolies and encourage the start-up and growth of SMEs, consumer choice in the market widens, since there are more firms competing.

A stringent price ceiling might force some suppliers out of the markets, which reduces the quantity supplied and narrows choice for consumers.

If governments can reduce the price of a good or service, it could allow those on low and fixed incomes to access goods and services they previously could not afford to.

Limits to government intervention

Regulatory capture

There is the risk of regulatory capture. This is when regulators start acting in the interests of the company, due to impartial information, rather than in consumer interests. This information disadvantage is a problem for regulators.

Asymmetric information

The problem of asymmetric information can make it hard to determine what level a price cap should be imposed at.

It is hard to determine government policies when intervening where there is market failure, since the extent to which the market fails involves a value judgement. For example, it is hard to decide what the cost of pollution to society is. Different individuals will put a different value on it, depending on their own experiences with pollution, such as how polluted their home town is.

Without sufficient information, governments could make poor decisions and it could lead to a waste of scarce resources.