Edexcel Economics (A) A-level

Theme 3: Business Behaviour and the Labour Market

3.6 Government Intervention

Summary Notes

3.6.1 Government intervention

Government intervention to control mergers:

- The Competition and Markets Authority (CMA) is the main competition regulator in the UK. The key aims for competition policy are to promote competition and ensure markets are efficient. They also protect consumer interests by keeping prices low and widening consumer choice.

- The competition authorities investigate potential mergers between two large firms, if they would dominate the market by merging.

- If the merger (or takeover) is deemed to create a larger firm with monopoly power, it is likely to be prevented.

- These are two mergers that have been in the news recently:

  Kraft shares soar on Heinz merger - BBC News

  Why mega-merger is so important for Shell - BBC News

Government intervention to control monopolies:

- Governments intervene in the market to control monopolies and prevent the abuse of monopoly power. This is because of the potential for market failure, and loss of consumer surplus, that can result from a monopoly exploiting the market.

- The transfer of wealth from consumers to producers is not necessarily considered to be an economic problem. However, the reduction in overall economic welfare that results from monopoly power is a disadvantage.

- **Price regulation**

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

  For example, they might use RPI-X, which is a form of price capping. This is usually used for privatised industries, such as the utility companies. OFGEM, which regulates the gas and electricity markets, OFWAT, which regulates the water industry, and ORR, which regulates rail services, are able to employ a price cap as part of their regulation.

The value of X is the amount in real terms that the price has to be cut by. RPI might be 5% for a particular year. If X is set at 2%, then the firm can only increase prices by 5% - 2% =3%.

In the water industry, firms are limited by RPI +/- K. K represents how much investment the firm needs to undertake.

The advantages of RPI-X include that firms could increase profits by cutting their costs by more than X. This encourages them to be more efficient, since they have an incentive to lower their costs. It also encourages competition in the market, which can prevent the firms abusing their monopoly power.

However, it is hard to determine what the value of X should be. Moreover, it could limit how much profit a firm can make, which might in turn limit how much investment they do.

There is also the risk of regulatory capture. This is when regulators start working in favour of the firm.

- **Profit regulation**

Governments can control the profits that firms earn by ensuring they are not excessive. In the UK, firms have to pay corporation on any profits they earn. The UK government reduced the rate of corporation tax from 21% to 20% in April 2015. This was with the aim of encouraging investment.

- **Quality standards**

Additionally, regulators can observe the quality of the goods and services of the firm. For example, in the gas and electricity markets, regulators ensure the elderly are treated fairly, especially in the colder months. Governments ensure minimum standards are met.

- **Performance targets**

The government sets targets on organisations, such as schools, to ensure a minimum target is being met. This aims to regulate their quality. The NHS, which has monopoly power, also has performance targets, such as reducing waiting times. It helps the firm to focus on increasing social welfare.

Government intervention to promote competition and contestability:

Enhancing competition between firms through promotion of small business

The UK government has established the 'Red Tape Challenge', which aims to simplify regulation for businesses. It is especially aimed towards small businesses. This aims to make it cheaper and easier to meet environmental targets and create new jobs.

More information on this can be found here:
http://www.redtapechallenge.cabinetoffice.gov.uk/home/index/

Small and Medium Sized Enterprises (SMEs) are important for creating a competitive market. They create jobs, stimulate innovation and investment and promote a competitive environment.

Governments aim to improve access to finance and reduce barriers to entry, which will make it easier for smaller firms to enter the market.

Schumpeter, an economist, proposed the idea of 'creative destruction'. This is the idea that new entrepreneurs are innovative, which challenges existing firms. The more productive firms then grow, whilst the least productive are forced to leave the market. This results in an expansion of the economy's productive potential.

Deregulation and privatisation

By deregulating or privatising the public sector, firms can compete in a competitive market, which should also help improve economic efficiency.

Deregulation is the act of reducing how much an industry is regulated. It reduces government power and enhances competition.

Excessive regulation is also called 'red tape'. It can limit the quantity of output that a firm produces. For example, environmental laws and taxes might result in firms only being able to produce a certain quantity before exceeding a pollution permit. Excessive taxes, such as a high rate of corporation tax, might discourage firms earning above a certain level of profit, since they do not keep as much of it. This might limit the size that a firm chooses, or is able to, grow to.

Privatisation means that assets are transferred from the public sector to the private sector. In other words, the government sells a firm so that it is no longer in their control. The firm is left to the free market and private individuals.

For example, British Airways was privatised in the UK and now operates in the competitive market.

Free market economists will argue that the private sector gives firms incentives to operate efficiently, which increases economic welfare. This is because firms operating on the free market have a profit incentive, which firms which are nationalised do not.

Since they are operating on the free market, firms also have to produces the goods and services consumers want. This increases allocative efficiency and might mean goods and services are of a higher quality. Competition might also result in lower prices. However, firms which profit maximise in a competitive market might compromise on quality.

By selling the asset to the private sector, revenue is raised for the government. However, this is only a one-off payment.

The Royal Mail was privatised in the UK. This was done by allowing the Royal Mail to float on the stock market. At the offer price, the government owned 30% of the shares.

- **Competitive tendering for government contracts**

The government provides some goods and services because they are public or merit goods, and they are underprovided in the free market. The government could contract out this provision, so that private firms operate things such as roads or hospital.

The firm which offers the lowest price and best quality of provision wins the government contract. This saves the government money, since the public sector can be bureaucratic and inefficient. The private sector has an incentive to reduce their costs, since they operate in a competitive market.

It also frees the government of maintenance, since the private sector might have the expertise and knowledge to fulfil the project and maintain the infrastructure.

This can be evaluated by considering how the private sector might not meet the specification of the contract. Moreover, the private sector firm might try and cut costs by lowering wages, and they are less likely to have social welfare as a priority.

Government intervention to protect suppliers and employees:

Restrictions on monopsony power of firms

It is the monopsony power of supermarkets that has led to many farmers losing profits. Farmers lose out to supermarket price wars, because supermarkets keep negotiating lower prices from farmers, in order to lower their own prices and compete with other supermarkets. Supplying firms are unlikely to make more than normal profit.

Governments can regulate this to ensure that farmers are receiving a fair deal. For example, farmers in the UK might receive grants and subsidies to support their production. The CMA might investigate supermarket buying power to ensure they are not abusing their monopsony power.

Nationalisation

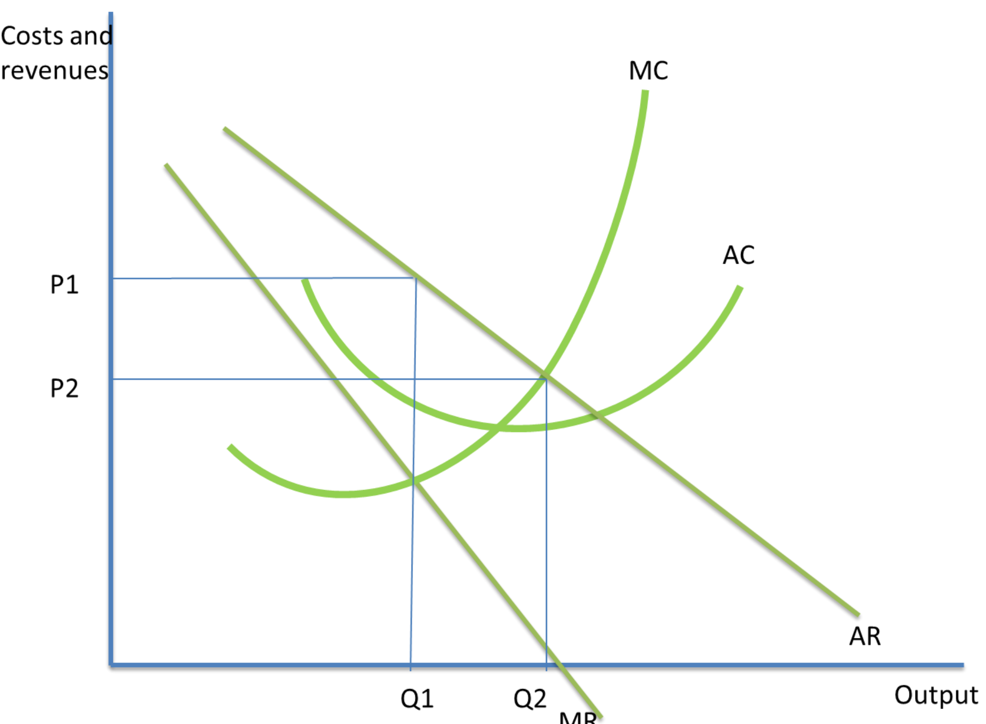
This occurs when private sector assets are sold to the public sector. In other words, the government gains control of an industry, so it is no longer in the hands of private firms.
The railway industry in the UK was nationalised after 1945.

By nationalising an industry, natural monopolies are created. This is because it is inefficient to have multiple sets of water pipes, for example. Therefore, only one firm provides water.

Some nationalised industries yield strong positive externalities. For example, by using public transport, congestion and pollution are reduced.

Nationalised industries have different objectives to privatised industries, which are mainly profit driven. Social welfare might be a priority of a nationalised industry.

The diagram shows where nationalised and privatised firms operate. Privatised firms operate at Q1 P1, which is the profit maximising level of output and price. A nationalised firm is more likely to operate at Q2 P2, which is the allocatively efficient level of output (AR=MC).


Costs and revenues
MC
AC
P1
P2
AR
Q1
Q2
MR
Output

3.6.2 The impact of government intervention

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.

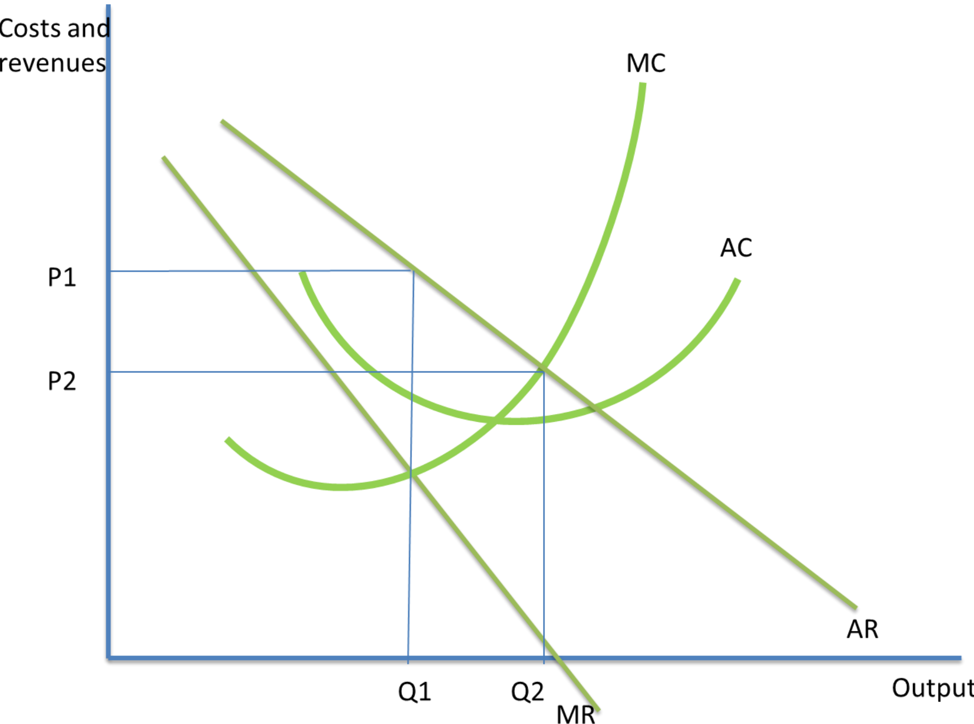
Profit

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.