Edexcel (B) Economics A-level

Theme 1: Markets, Consumers and Firms

1.5 Market Failure and Government Intervention

1.5.2 Government intervention and failure

Notes

Purposes of intervention with reference to market failure in various contexts

- The existence of market failure, in its various forms, provides an argument for government intervention in markets.
- Governments intervene in the market to correct market failure. For example, they might provide healthcare and education, which the free market would underprovide.

Methods of government intervention:

Regulation and legislation

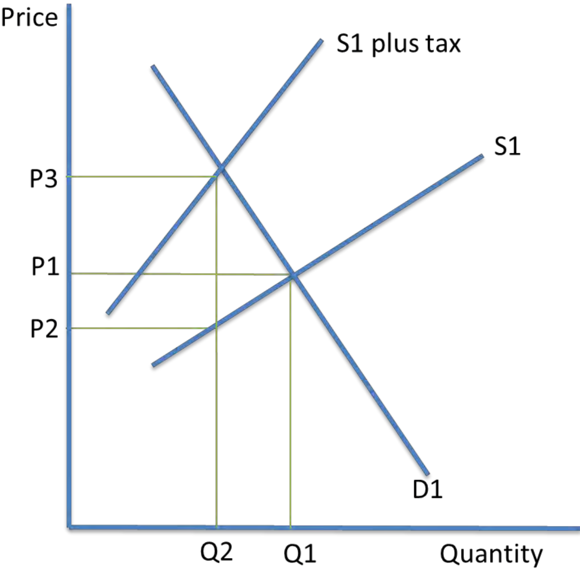
- The government could use laws to ban consumers from consuming a good. They could also make it illegal not to do something. For example, the minimum school leaving age means young people have to be in school until the age of 16, and education or training until they turn 18.
- This has positive externalities 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.

Indirect taxation

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.

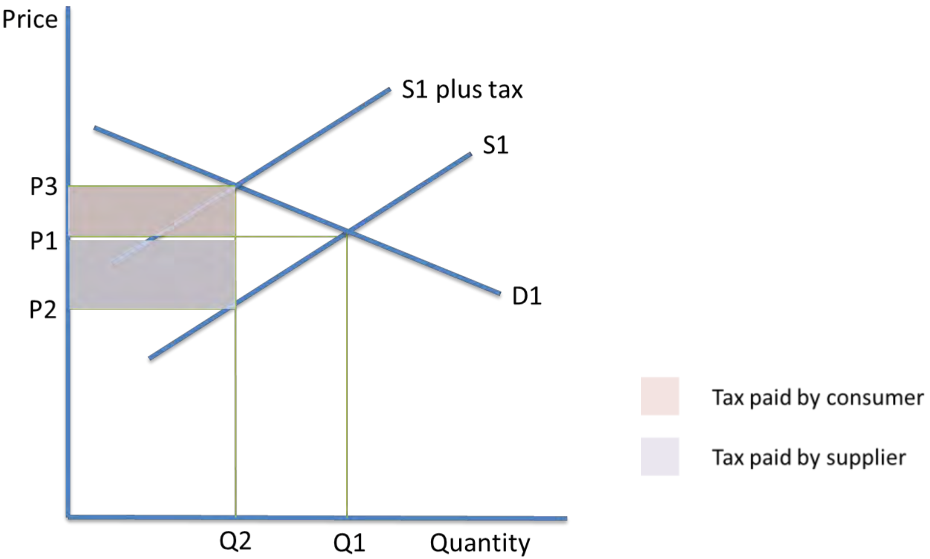
- There are two types of indirect taxes:

- **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.

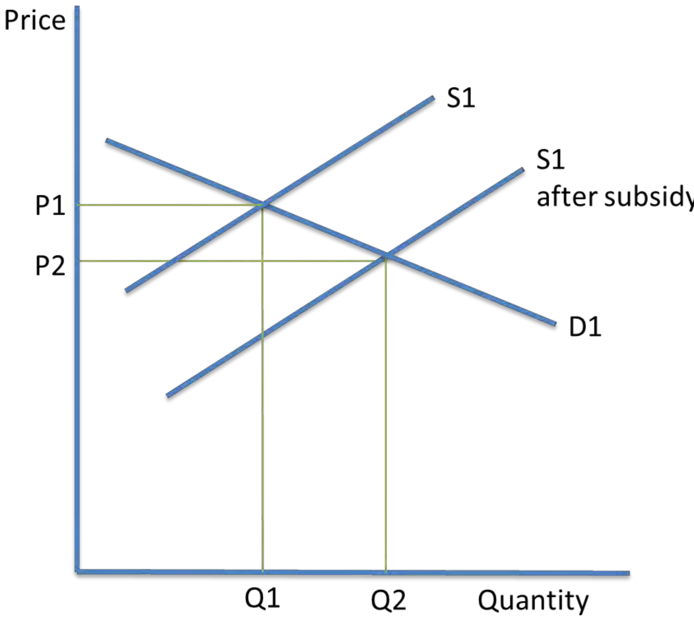
- Indirect taxes could reduce the quantity of demerit goods consumed, by increasing the price of the good. If the tax is equal to the external cost of each unit, then the supply curve becomes MSC rather than MPC, so the free market equilibrium becomes the socially optimum equilibrium. This **internalises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

Grants and 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.

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.

Government failure in various markets

- In the agriculture market, governments might intervene with a buffer stock system to reduce price volatility. However, historically, these have been unsuccessful.
- Governments buy up harvests during surpluses, then sell the goods onto the market when supplies are low.
- **Advantages:**
  Farmer incomes remain stable, because fluctuations in the market are reduced.
  This will be particularly beneficial in rural areas, where farming is a main source of income.
  It also increases consumer welfare by ensuring prices are not in excess.
- **Disadvantages:**
  Governments might not have the financial resources to buy up the stock.
  By guaranteeing farmers a minimum price, they might overproduce. This could be expensive and damaging to the environment.
  Storage is difficult and expensive, since agricultural goods do not last long, and there are administrative costs.

- In the housing market, house prices are important because they make up most of consumer wealth in the UK.
- This means that changes in house prices can significantly affect the rest of the UK economy, due to the wealth effect and changes in interest rates.
- If house prices increase, the ratio of the market value of the house to the mortgage increases, and consumers experience an increase in equity.
- Due to the **wealth effect**, there is a rise in consumer spending and a shift to the right of the demand curve.
- In the long run, house prices increase, but in the short run they are volatile.
- This can make using supply and demand diagrams less effective.
- In the UK housing market, there is failure due to the housing shortage, which means resources are not being allocated efficiently.
- This shortage affects the mobility of labour.
- It is partially caused by information asymmetry, where sellers know more than buyers.

- In the labour market, market failure is caused by immobility, skills gaps and discrimination within the market. The government might intervene by implementing a National Minimum Wage or having an Equal Pay Act. There is also a minimum school leaving age, to ensure workers have a sufficient basic education.
- The NMW could lead to government failure if instead of raising living standards, people become unemployed. However, there has been no evidence of this in the UK.