WJEC (Eduqas) Economics AS-level

Microeconomics

Topic 5: Market Failure

5.3 The effects of government intervention

Notes

- 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.

Governments can create distortions in 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.