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Economics Revision Focus: 2004

AS Economics

Government Intervention in Markets – An Introduction

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Revision Focus: Government Intervention in Markets

AS Syllabus Requirements:

Candidates should understand the reasons for **government intervention** in a market economy. Candidates should be able to use basic economic models to analyse and evaluate the use of **indirect taxation, subsidies, price controls, buffer stocks, pollution permits, state provision and regulation** to correct market failure.

All governments of every political persuasion intervene in the economy to influence the allocation of scarce resources among competing uses

What are the main reasons for government intervention?

A government may choose to intervene in a market for **economic, social** and **political reasons**

The main reasons for policy intervention are:

(1) To correct for instances of **market failure**

(2) To achieve a more **equitable distribution of income and wealth**

Market failure and intervention

Market failure occurs when freely-functioning markets, fail to deliver an efficient allocation of resources. The result is a loss of economic and social welfare.

Market failure exists when the competitive outcome of markets is not efficient from the point of view of society as a whole. This is usually because the benefits that the free-market confers on individuals or businesses carrying out a particular activity diverge from the benefits to society as a whole

Markets can fail because of:

(1) **Negative externalities** (e.g. the effects of environmental pollution) causing the social cost of production to exceed the private cost

(2) **Positive externalities** (e.g. the provision of education and health care) causing the social benefit of consumption to exceed the private benefit

(3) **Imperfect information** means merit goods are under-produced while demerit goods are over-produced or over-consumed

(4) The private sector in a free-markets cannot supply **pure public goods** and quasi-public goods

(5) **Market dominance by monopolies** can lead to under-production and higher prices than would exist under conditions of competition

(6) **Factor immobility** causes unemployment hence productive inefficiency

(7) **Equity (fairness) issues**. Markets can generate an 'unacceptable' distribution of income and consequent social exclusion which the government may choose to change

Market failure and economic efficiency

Market failure results in

Productive inefficiency: Businesses are not maximising output from given factor inputs. This is a problem because the lost output from inefficient production could have been used to satisfy more wants and needs

Allocative inefficiency: Resources are misallocated and producing goods and services not wanted by consumers. This is a problem because resources can be put to a better use making products that consumers value more highly

Options for government intervention in markets

There are many ways in which intervention can take place – some examples are given below

Government Legislation and Regulation

Parliament can pass laws that for example **prohibit** the sale of cigarettes to children, or ban smoking in the workplace (Ireland, 2004). The laws of **competition policy** act against examples of price-fixing cartels or other forms of anti-competitive behaviour by firms within markets. **Employment laws** may offer some legal protection for workers by setting maximum working hours or by providing a price-floor in the labour market through the setting of a minimum wage.

The economy operates with a huge amount of regulation. The government appointed regulators who can impose **price controls** in most of the main utilities such as telecommunications, electricity, gas and rail transport.

Regulation may be used to introduce **fresh competition** into a market – for example breaking up the existing monopoly power of a service provider. A good example of this is the attempt to introduce more competition for British Telecom and also for the postal service industry. This is known as **market liberalisation**.

Direct State Provision of Goods and Services

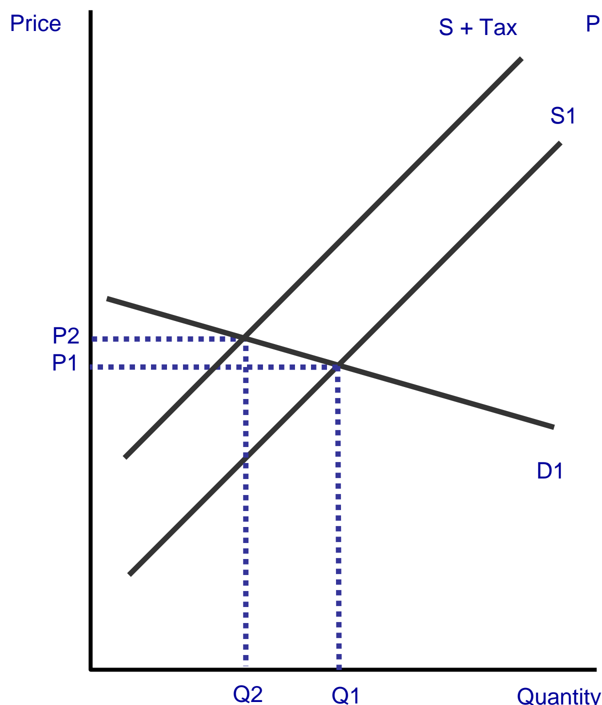
Because of privatization, the state-owned sector of the economy is much smaller than it was twenty years ago. The main state-owned businesses in the UK are the **Royal Mail** and **Network Rail.**

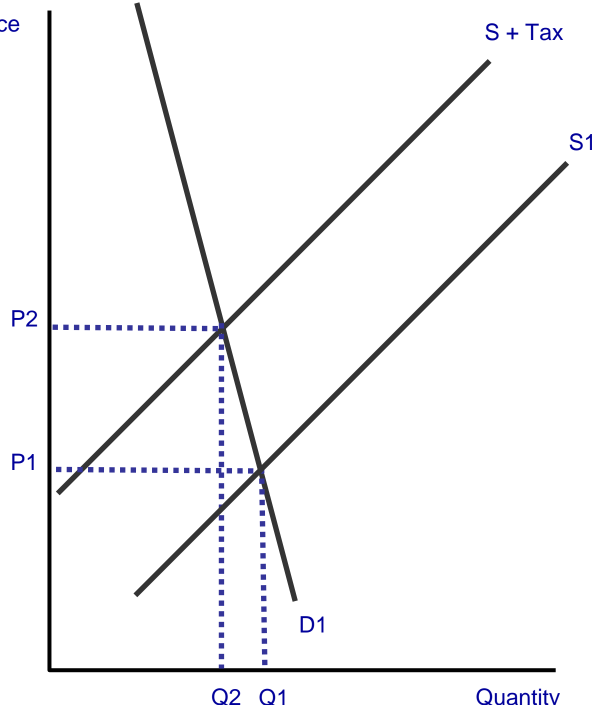
State funding can be used to provide merit goods and services and public goods directly to the population e.g. the government pays private sector health firms to carry out operations for NHS patients to reduce waiting lists or it pays private businesses to operate prisons and maintain our road network.

Fiscal Policy Intervention

Fiscal policy can be used to alter the level of demand for different products and also the pattern of demand within the economy.

(a) **Indirect taxes** can be used to raise the price of demerit goods and products with negative externalities designed to increase the opportunity cost of consumption and thereby reduce consumer demand towards a socially optimal level





(b) **Subsidies** to consumers will lower the price of merit goods (e.g. grants to students to reduce the private costs of education and subsidies to companies employing workers on the New Deal programme). They are designed to boost consumption and output of products with positive externalities – a subsidy causes an increase in market supply and leads to a lower equilibrium price (see the separate revision focus article on producer subsidies)

(c) **Tax relief:** The government may offer financial assistance such as tax credits for business investment in research and development. Or a reduction in corporation tax designed to promote investment and employment

(d) **Changes to taxation and welfare payments** can be used to influence the overall distribution of income and wealth – for example higher direct tax rates on rich households or an increase in the value of welfare benefits for the poor to make the tax and benefit system more progressive

Intervention designed to close the information gap

Often market failure results from consumers suffering from a **lack of information** about the costs and benefits of the products available in the market place. Government action can have a role in improving information to help consumers and producers value the 'true' cost and/or benefit of a good or service.

Examples might include:

(1) Compulsory labelling on cigarette packages with health warnings to reduce smoking
(2) Improved nutritional information on foods to counter the risks of growing obesity
(3) Anti speeding television advertising to reduce road accidents
(4) Advertising health screening programmes / information campaigns on the dangers of addiction

These programmes are really designed to change the "perceived" costs and benefits of consumption for the consumer. They don't have any direct effect on market prices, but they seek to influence "demand" and therefore output and consumption.

The effects of government intervention

One important point to bear in mind is that the effects of different forms of government intervention in markets are never neutral – financial support given to one set of producers rather than another will always create "winners and losers". Taxing one product more than another will similarly have different effects on different groups of consumers.

The law of unintended consequences

Government intervention does not always work in the way in which it was intended or the way in which economic theory predicts it should. Part of the fascination of studying Economics is that the "law of unintended consequences" often comes into play – events can affect a particular policy, and consumers and businesses rarely behave precisely in the way in which the government might want!

We will consider this in more detail when we consider **government failure** in another revision focus – government failure occurs when intervention to alleviate an existing market failure only serves to **deepen an existing market failure** creating more problems in its wake.

Judging the effects of intervention – a useful check list

To help your evaluation of government intervention – it may be helpful to consider these questions:

Efficiency of a policy: i.e. does a particular intervention lead to a better use of scarce resources among competing ends? E.g. does it improve allocative, productive and dynamic efficiency? For example - would introducing indirect taxes on high fat foods be an efficient way of reducing some of the external costs linked to the growing problem of obesity?

Effectiveness of a policy: i.e. which government policy is most likely to meet a specific economic or social objective? For example which policies are likely to be most effective in reducing road congestion? Which forms of intervention are most effective in improving the incentives of consumers to become active in the labour market? Which policies are more effective in preventing firms from exploiting their monopoly power and damaging consumer welfare? Evaluation can also consider which policies are likely to have an impact in the short term when a quick response from consumers and producers is desired. And which policies are likely to prove most cost-effective in the longer term?

Equity effects of intervention: i.e. is a policy thought of as fair or does one group in society gain more than another? For example it is equitable for the government to offer educational maintenance allowances for 16-18 year olds in low income households to stay on in education after GCSEs? Would it be equitable for the government to increase the top rate of income tax to 50 per cent in a bid to make the distribution of income more equal?

Sustainability of a policy: i.e. does a policy reduce the ability of future generations to engage in economic activity? Inter-generational equity is an important issue in many current policy topics for example decisions on which sources of energy we choose to rely on in future years.

There will be further revision focus articles on many of these issues