AS ECONOMICS
Knowledge Organisers

AS Micro Economics

3.1.1. ECONOMIC METHODOLOGY & THE ECONOMIC PROBLEM

3.1.1. ECONOMIC METHODOLOGY & THE ECONOMIC PROBLEM

3.1.1.1 ECONOMIC METHODOLOGY

WHY IS ECONOMICS A SOCIAL SCIENCE?	It uses **scientific** methods to build theories that can help explain the behaviour of individuals, groups and organisations. **Economics** attempts to explain **economic** behaviour, which arises when scarce resources are exchanged.
WHAT ABOUT EMPIRICAL EVIDENCE?	**Economic** theory is to be judged by its predictive power supported by **empirical** regularity. Only factual or **empirical evidence** can make a theory go from a "meaningless" hypotheses to part of man's accumulated knowledge.
SIMILARITIES TO NATURAL SCIENCES	Economics shares the combination of qualitative and quantitative elements common to all social sciences.
DIFFERENCES TO NATURAL SCIENCES	Some critics of the field argue that economics falls short of the definition of a science for a number of reasons, including a lack of testable hypotheses, lack of consensus, and inherent political overtones. Despite these arguments,
POSITIVE ECONOMIC STATEMENTS	Objective and fact-based where the statements are precise, descriptive, and clearly measurable. E.g. GDP rose by 2.5% in 2021.
NORMATIVE ECONOMIC STATEMENTS	These are opinions or value judgements which are not based on real economic data.
USE OF VALUE JUDGEMENTS IN ECONOMICS	Economists often demonstrate a lack of consensus and inherent political overtones.
THE INFLUENCE ON PEOPLE'S MORAL & POLITICAL JUDGEMENTS	The first rule of economics is scarcity. The first rule of politics is to ignore the first rule of economics. As such politics has a profound impact upon economic policy.

THE CENTRAL PURPOSE	The production of goods & services to satisfy needs and wants
KEY ECONOMIC DECISIONS	• What to produce? • How to produce? • Who is to benefit?

3.1.1.3. ECONOMIC RESOURCES

FACTORS OF PRODUCTION	These are the key economic resources of Land, labour, capital, enterprise.
LAND	Land includes all **natural physical resources**. Some nations are richly endowed with natural resources and then specialise in the their extraction and production. Other countries such as Japan are heavily reliant on importing these resources.
LABOUR	**Labour** is the **human input** into production e.g. the supply of workers available and their productivity. An increase in the size and the quality of the labour force is vital if a country wants to achieve **growth**. In recent years the issue of the **migration of labour** has become important. Can migrant workers help to solve labour shortages? What are the long-term effects on the countries who suffer a drain or loss of workers through migration?
CAPITAL	**CAPITAL GOODS** are used to produce other consumer goods and services in the future **Fixed capital** includes machinery, equipment, new technology, factories and other buildings New items of capital machinery or technology are used to boost the **productivity** of labour.
ENTERPRISE	Regarded by some as a specialised form of labour input An **entrepreneur** is an individual who supplies products to a market to make a profit Entrepreneurs will usually invest their own **financial capital** in a business and take on the risks. Their main reward is the **profit** made from running the business.

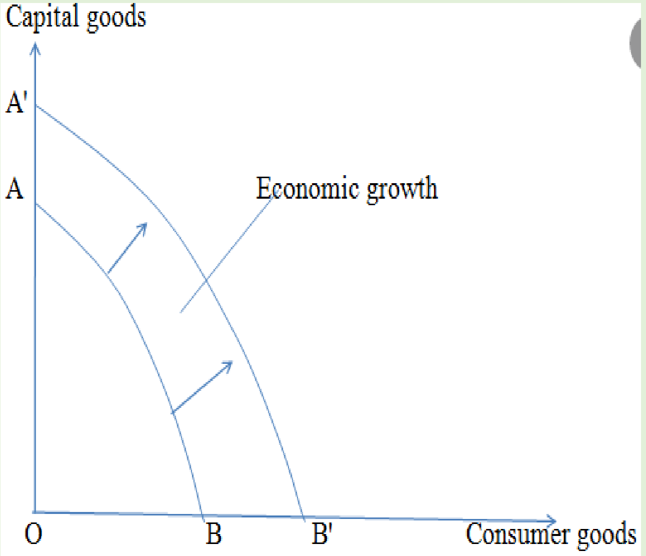
SCARCITY, CHOICE & THE ALLOCATION OF RESOURCES

FUNDAMENTAL ECONOMIC PROBLEM	Limited resources and unlimited wants.
SCARCITY & CHOICE	Choices must be made about how scarce resources are allocated between different uses.
CHOICES & OPPORTUNITY COST	Choices have an opportunity cost.
OPPORTUNITY COST	The next best alternative foregone.

3.1.1.5. PRODUCTION POSSIBILITY DIAGRAMS	
PRODUCTION POSSIBILITY DIAGRAMS	Illustrates the possible combinations of two goods that can be produced with existing resources, such that more of one good could be produced only by diverting resources from the other good, resulting in less production of it.
Why does it slope downwards?	Because resources are **LIMITED**.
Why does it bow outwards?	This is due to the fact that some resources will be better suited to the production of good X & some good Y. eg. Guns & butter. **DECREASING RETURNS TO SCALE**.
Why is it a straight line?	Because resources are equally well-suited to the production of both goods X & Y. **CONSTANT RETURNS TO SCALE**
Why does it bow inwards?	Because resources are focused upon SPECIALISATION which generates **ECONOMIES OF SCALE**. Or **INCREASING RETURNS TO SCALE.**
How does it illustrate efficiency?	Any point achieved on the PPC is **PRODUCTIVELY EFFICIENT**. Yet not all points are allocatively efficient as this is determined by supply & demand.

A common PPF: increasing opportunity cost
A straight line PPF: constant opportunity cost
An inverted PPF: decreasing opportunity cost

SPECIALISATION & DIVISION OF LABOUR	
ADVANTAGES	Will lead to an increase in labour productivity and firms will be able to benefit from **ECONOMIES OF SCALE** (lower average costs with increased output) and increased efficiency.
DISADVANTAGE	However, workers do specific tasks which may become boring and their productivity may fall as a result. High levels of specialisation could lead to possible **DISCECONOMIES OF SCALE.**



3.1.2. PRICE DETERMINATION IN A COMPETITIVE MARKET

3.1.2.1. THE DETERMINANTS OF THE DEMAND FOR GOODS & SERVICES

EFFECTIVE DEMAND	The level of demand that represents a real intention to purchase by people with the means to pay.
JOINT DEMAND	When the **demand** for one product is directly and positively related to market **demand** for a related good or service. e.g. with 2 complements.
COMPOSITE DEMAND	When goods or services have more than one use so that an increase in the demand for one product leads to a fall in supply of the other.
FACTORS DERTERMINING DEMAND	Price Income Tastes & Trends Expectations Complementary goods
THE DEMAND CURVE	a graphical representation of the relationship between the price of a good or service and the quantity demanded for a given period of time.
FACTORS THAT CAN SHIFT DEMAND	W - Weather I – Income & Interest rates F - Fashion C – Complementary goods & Credit A – Advertising (Promotion) PS – Price of Substitutes

3.1.1.2 THE NATURE & PURPOSE OF ECONOMIC ACTIVITY

THE CENTRAL PURPOSE	The production of goods & services to satisfy needs and wants
KEY ECONOMIC DECISIONS	• What to produce? • How to produce? • Who is to benefit?

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3.1.1.4 SCARCITY, CHOICE & THE ALLOCATION OF RESOURCES

FUNDAMENTAL ECONOMIC PROBLEM	Limited resources and unlimited wants.
SCARCITY & CHOICE	Choices must be made about how scarce resources are allocated between different uses.
CHOICES & OPPORTUNITY COST	Choices have an opportunity cost.
OPPORTUNITY COST	The next best alternative foregone.

Stretch and Challenge Activities
Additional Reading
Extension Activities

3.1.2.2. PRICE ELASTICITY OF DEMAND (PED)

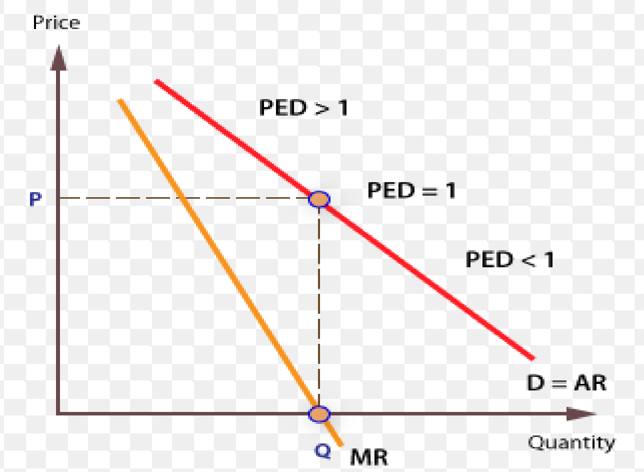
Measures the responsiveness of demand following a change in price. INVERSE relationship means NEGATIVE PED.
Measured by the % change in QD / % change in price.

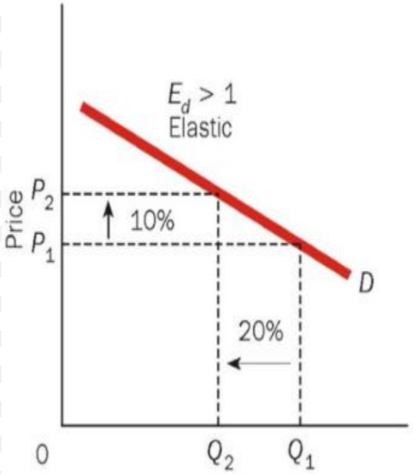
CO EFFICIENT VALUES	> -1 means **price elastic** (sensitive). A small change in price causes a large change in QD. 0 to -1 means **price inelastic** (insensitive). A change in prices causes a smaller impact on QD.
IMPACT ON DEMAND	PRICE CHANGES CAUSE **A MOVEMENT ALONG** THE DEMAND CURVE
DETERMINANTS OF PED - SPLAT	1. The number of close substitutes for a good 2. The % of a consumer's income allocated to spending on the good 3. The degree of necessity or whether the good is a luxury 4. Whether the good is addictive 5. The time period allowed following a price change 6. Peak and off-peak demand 7. The cost of switching between products.
BUSINESS USE OF PED	• The effect of a change in price on the total revenue & expenditure on a product • The effect of a **change in an indirect tax (e.g VAT, fuel or other duties)** on price and quantity demanded and also whether the business is able to pass on some or all of the tax onto the consumer. • Information on the PED can be used by a business as part of a policy of **price discrimination**. This is where a business decides to charge different prices for the same product to different segments of the market e.g. peak and off peak rail travel. • To estimate the impact of price discounts on given products

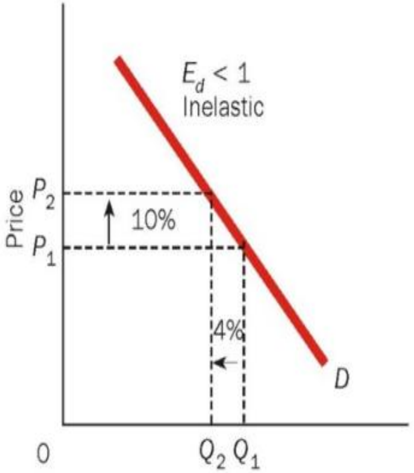
3.1.2.2. INCOME ELASTICITY OF DEMAND (YED)

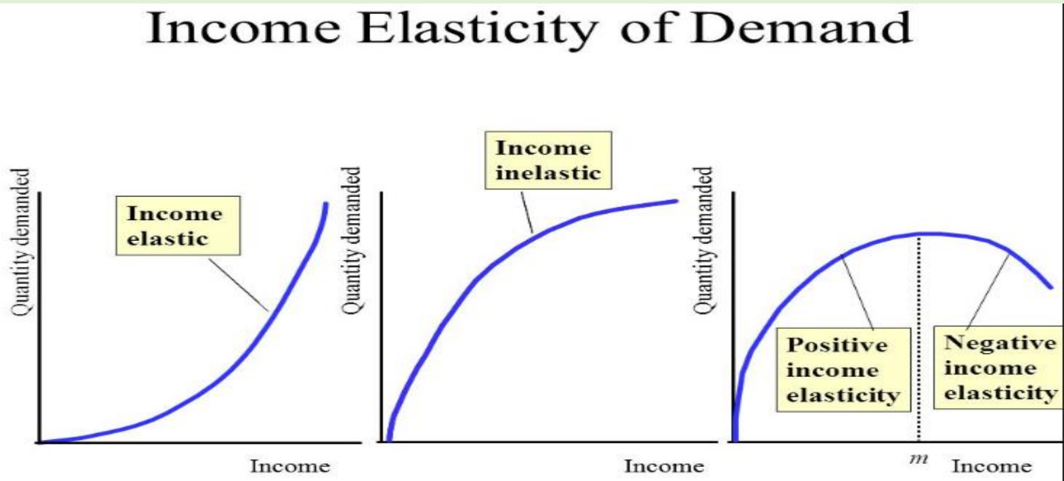
Measures the responsiveness of demand following a change in income.
Measured by the % change in QD / % change in income.

CO EFFICIENT VALUES	• **POSITIVE YED** represents NORMAL GOODS. E.g. Branded consumer goods. So as consumers' income rises more is demanded at each price i.e. there is an outward shift of the demand curve • **NEGATIVE YED** represents INFERIOR GOODS. Here, demand falls as income rises. E.g. Value brand products. • A YED value between **0** & **+1** is likely to mean necessity products e.g. fuel.
IMPACT ON DEMAND	An increase or decrease in income will lead to **A SHIFT IN DEMAND**
LUXURY GOODS & YED	The income elasticity of demand is usually strongly positive for luxury goods such as Fine wines and spirits, high quality chocolates and luxury holidays overseas. Sports cars, Consumer durables - audio visual equipment, smart-phones Sports and leisure facilities (including gym membership and exclusive sports clubs).
NESCESSITY GOODS & YED	In contrast, income elasticity of demand is lower for Staple food products such as bread, vegetables and frozen foods, Mass transport (bus and rail), Beer and takeaway pizza!
INFERIOR GOODS	Income elasticity of demand is negative (inferior) for cigarettes and urban bus services.
BUSINESS USE OF YED	• Helps firms predict the effect of an economic cycle on sales. **Luxury products** with high income elasticity see greater sales volatility over the business cycle than **necessities** where demand from consumers is less sensitive to changes in the cycle. • They could also choose to locate in areas of high or low incomes depending upon whether they sell LUXURY or INFERIOR GOODS or expand their product range to cater for a different consumer group e.g. Lidl Deluxe.









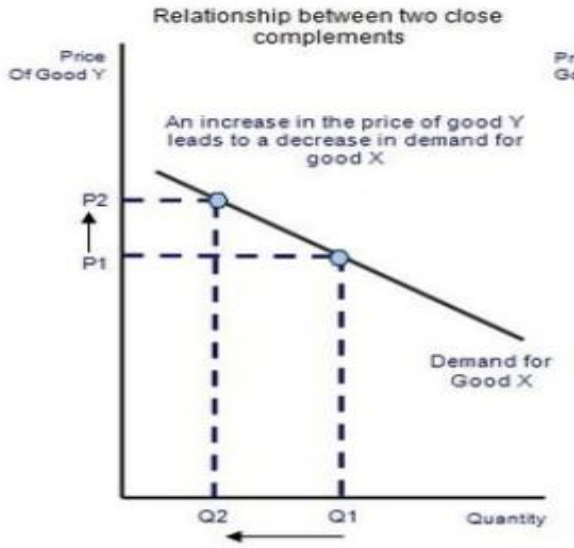
3.1.2.2. CROSS PRICE ELASTICITY OF DEMAND (XED)

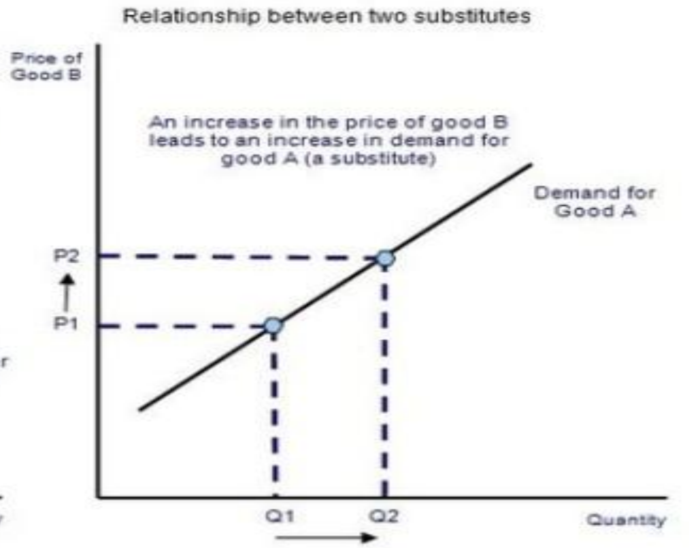
Measures the responsiveness of demand for good A following a change in price of good B.
Measured by the % change in QD A / % change in price B.

SUBSTITUTES & XED	POSITIVE VALUE means the products are SUBSTITUTES. If the price of one product goes up the QD of another will fall e.g. Beef & lamb. >1 means close substitutes, <1 weak substitutes.
COMPLEMENTS & XED	NEGATIVE VALUE means the products are COMPLEMENTS. If the price of one product goes up the demand for the other falls e.g. Tennis racquets & tennis balls.
IMPACT ON DEMAND	A price change of a **substitute** or **complement** will lead to a **SHIFT IN DEMAND.**
BUSINESS USE OF XED	• When setting prices firms will have to look at what alternatives the consumer has, if there are no close substitutes they will be able to increase the price. Therefore, firms spend a lot of money on advertising to differentiate their products and reduce XED. • A firm may offer a loss leader to attract complementary sales. E.g, a firm may offer a printer, at a low price, because it knows this will lead to increased sales for the highly profitable ink cartridges.

EVALUATION OF COMMERCIAL APPLICATION OF ELASTICITIES

- Do firms really know their Elasticities? Who uses them effectively?
- Different Elasticities are of use for different firm related decisions.
- Elasticities vary dramatically across consumer groups/ regions/ even time of day etc. Difficult to calculate!
- Elasticities & rational behaviour. Irrational consumption may mean more inelastic demand.





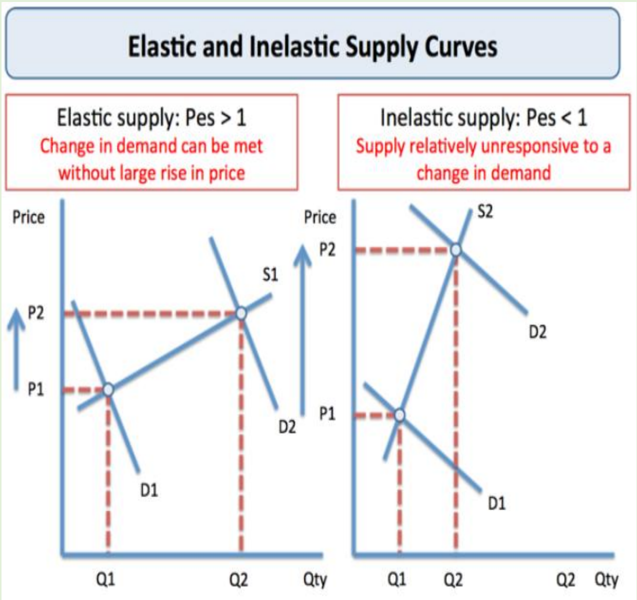
3.1.2.3. SUPPLY

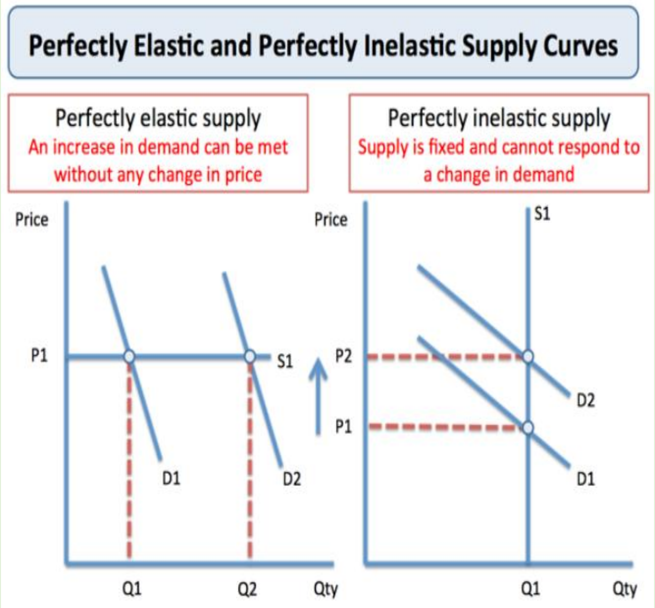
SUPPLY	Output is provided by businesses in the pursuit of profits. Higher profits mean greater incentives to increase supply.
SUPPLY CURVE	A graphic representation of the correlation between the cost of a good or service and the quantity supplied for a given period.
FACTORS CAUSING A SHIFT IN SUPPLY	S - Subsidies P - Productivity Gains E - Efficiency N - Number of firms T - Technology

3.1.2.4. PRICE ELASTICITY OF SUPPLY (PES)

Measures the responsiveness of supply to a change in price. POSITIVE RELATIONSHIP = POSITIVE PES
Measured by the % change in QS / % change in Price.

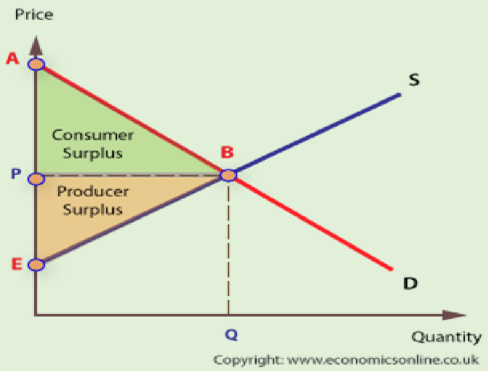
CO EFFICIENT VALUES	>1 Price elastic (sensitive). A small change in price causes a large change in QS. <1 means Price inelastic (insensitive). A change in prices causes a smaller impact on QS.
IMPACT ON SUPPLY CURVE	Price changes cause **A MOVEMENT ALONG** A SUPPLY CURVE.
DETERMINANTS OF PES	1. **Production lag:** Supply is more price elastic the longer the **time period** that a firm is allowed to adjust its production levels. 2. **Stocks of finished products and components:** If stocks of raw materials and finished products are at a high level then a firm is able to respond to a change in demand - supply will be elastic. Conversely when stocks are low, dwindling supplies force prices higher. 3. **Spare production capacity:** If there is plenty of **spare capacity** then a business can increase output without a rise in costs and supply will be elastic in response to a change in demand. Therefore, supply of goods and services is most elastic during a recession. 4. **The ease and cost of factor substitution/mobility:** If both capital & labour are **occupationally mobile** then the elasticity of supply for a product is higher than if capital and labour cannot easily be switched. E.g. a printing press which can switch easily between printing magazines and greetings cards. 5. **Time lag-** In some agricultural markets the **momentary supply** is fixed and is determined mainly by planting decisions made months before, and also climatic conditions, which affect the production yield. In contrast the supply of milk is price elastic because of a short time span from cows producing milk and products reaching the market place.

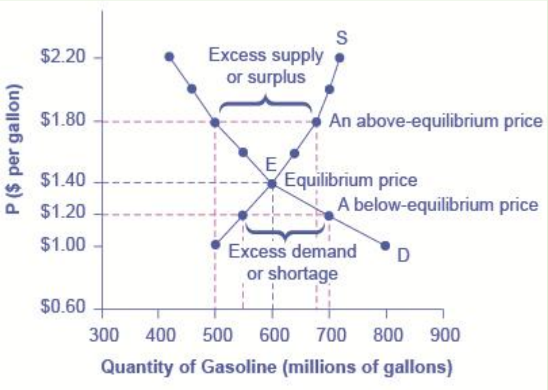




3.1.2.5 & 6 PRICE DETERMINATION & THE INTERRELATIONSHIP OF MARKETS

3.1.2.1. THE DETERMINATION OF EQUILIBIRUM MARKET PRICES	
THE PRICE MECHANISM	The manner in which the prices of goods affect the demand & supply of goods & services. There are four functions: **1. Allocating. 2. Rationing. 3. Signalling. 4. Incentivising.**
CONSUMER SURPLUS	is an economic measurement of **consumer** benefits. A **consumer surplus** happens when the price that **consumers** pay for a product or service is less than the price they're willing to pay.
PRODUCER SURPLUS	is the total amount that a **producer** benefits from producing and selling a quantity of a good at the market price. The total revenue that a **producer** receives from selling their goods minus the total cost of production equals the **producer surplus**.
MARKET EQUILIBIRUM	Economic equilibrium is a situation in which economic forces such as supply and demand are balanced and in the absence of external influences the values of economic variables will not change.
MARKET DISEQUILIBRIUM	**Disequilibrium** is a situation where internal and/or external forces prevent **market** equilibrium from being reached or cause the **market** to fall out of balance. This can be a short-term byproduct of a change in variable factors or a result of long-term structural imbalances.
EXCESS DEMAND	occurs when the Price of a good is lower than the Equilibrium Price, meaning more consumers will want to buy the good than suppliers are willing to sell. The difference between the Quantity Demanded (QD) and the Quantity Supplied (QS) is the **Excess Demand**.
EXCESS SUPPLY	an excess supply, economic surplus market surplus or briefly surply is a situation in which the quantity of a good or service supplied is more than the quantity demanded, and the price is above the equilibrium level determined by supply and demand





3.1.2.6. THE INTERRELATIONSHIP BETWEEN MARKETS	
INTERDEPENDENCE	The dependence of two or more people or things on each other.
MARKETS ARE OFTEN INTERDEPENDENT	For example, the availability of timber from the lumber industry will affect the housing market.
FIRMS ARE OFTEN INTERDEPENDENT	For example, the decisions of airbus will have a direct impact upon the results of Boeing.
JOINT DEMAND	When the **demand** for one product is directly and positively related to market **demand** for a related good or service. e.g. with 2 complements.
DEMAND FOR SUBSTITUTES	**Substitutes** are goods where you can consume one in place of the other. The prices of complementary or **substitute goods** also shift the **demand** curve. ... When the price of a substitute good decreases, the quantity demanded for that good increases, but the **demand** for the good that it is being substituted for decreases.
COMPOSITE DEMAND	When goods or services have more than one use so that an increase in the demand for one product leads to a fall in supply of the other.
DERIVED DEMAND	Refers to the **demand** for any goods or services, which is **derived** from any related goods, services, or intermediate goods or services. In the case of **derived demand**, a market can exist for both intermediate and related goods or services.
EFFECTIVE DEMAND	The level of demand that represents a real intention to purchase by people with the means to pay.
JOINT SUPPLY	Is an economic term referring to a product or process that can yield two or more outputs. Common examples occur within the livestock industry: cows can be utilized for milk, beef, and hide.

3.1.5. THE MARKET MECHANISM, MARKET FAILURE & GOVERNMENT INTERVENTION

3.1.2.1. THE DETERMINATION OF EQUILIBIRUM MARKET PRICES	
THE PRICE MECHANISM	The manner in which the prices of goods affect the demand & supply of goods & services. There are four functions: **1. Allocating. 2. Rationing. 3. Signalling. 4. Incentivising.**

EFFICIENCY DEFINITIONS	
ALLOCATIVE EFFICIENCY	Where DEMAND = SUPPLY maximising society surplus.
PRODUCTIVE EFFICIENCY	Maximising output at the lowest possible average cost.
DYNAMIC EFFICIENCY	Re-investment of SNP into innovation, R&D & new technology to improve future products & lower LRAC. **LONG RUN EFFICIENCY**.

3.1.5.2. THE MEANING OF MARKET FAILURE	
DEFINITION	A situation in which the allocation of goods and services is not **ALLOCATIVELY EFFICIENT. Thus, a misallocation of resources takes place.**
EXPLANATION	A misallocation of resources takes place.
COMPLETE MARKET FAILURE – A MISSING MARKET	The absence of a **market** on which to trade a good. It is not possible to trade the full range of future and contingent commodities, and **markets** are **missing** for many externalities.
PARTIAL MARKET FAILURE	Occurs when the **market** does actually function but it produces either the wrong quantity of a product or at the wrong price. This leads to resource misallocation.

MARKET FAILURE EXAMPLES	
PUBLIC GOODS	A good that is both **non-excludable** and **non-rivalrous** in that individuals cannot be effectively excluded from use and where use by one individual does not reduce availability to others. May also be **non-rejectable** e.g National defence.
EXTERNALITIES	Are third party effects arising from production and consumption of goods and services for which no appropriate compensation is paid. They arise due to a divergence between private social costs & benefits.
MONOPOLY	Sole provider of a good or resource. They will often restrict output to gain a higher price.
INEQUALITY OF INCOME & WEALTH	The phenomenon of unequal and/or unjust distribution of resources and opportunities among members of a given society.
FACTOR IMMOBILITY	Occurs when it is difficult for **factors** of production (e.g. labour and capital) to move between different areas of the economy.

MARGINAL ANALYSIS DEFINITIONS	
MARGINAL BENEFIT	The additional satisfaction or utility that a person receives from consuming an additional unit of a good or service.
MARGINAL COST	The cost added by producing one additional unit of a product or service.
DEADWEIGHT WELFARE LOSS	A loss of economic efficiency that can occur when equilibrium for a good or service is not achieved or is not achievable.

3.1.5.3. PUBLIC GOODS, PRIVATE GOODS & QUASI-PUBLIC GOODS	
PURE PUBLIC GOODS	A good that is both **non-excludable** and **non-rivalrous** in that individuals cannot be effectively excluded from use and where use by one individual does not reduce availability to others. May also be **non-rejectable** e.g National defence.
PRIVATE GOOD	Private goods are those whose ownership is restricted to the group or individual that purchased the good for their own consumption. It is rivalrous and excludable in its consumption.
QUASI-PUBLIC GOODS	A near-public good. It has some of the characteristics of a public good especially when it becomes rival in consumption at peak times.
FREE RIDER PROBLEM	A person who receives **PUBLIC GOODS** benefits that others have paid for without contributing payment themselves.
Susan Collins	*"The first obligation of government is to protect its citizens".*

3.1.5.4. POSITIVE & NEGATIVE EXTERNALITIES

EXTERNALITIES	Are third party effects arising from production and consumption of goods and services for which no appropriate compensation is paid. They arise due to a divergence between private social costs & benefits.
NEGATIVE PRODUCTION EXTERNALITIES	Production of goods/ services which impose a cost on a third party. **Social Cost > Private Cost**. E.g. air pollution from a factory.
NEGATIVE CONSUMPTION EXTERNALITIES	Consumption of **DEMERIT GOODS** which impose a cost upon a third party. **Private Benefit > Social Benefit**
POSITIVE CONSUMPTION EXTERNALITY	Consumption of **MERIT GOODS** which give benefit a to a third party e.g. cycling to work may mean less congestion. **Social Benefit > Private Benefit**
POSITIVE PRODUCTION EXTERNALITY	Provision of **MERIT GOODS** which give benefit to a third party e.g. Training programmes & apprenticeships which may benefit future employers. **Private Cost > Social Cost**
NEGATIVE EXTERNALITIES RESULT IN OVER PRODUCTION	The **overproduction** of goods with **negative externalities** occurs because the price of the good to the buyer **does** not cover all of the costs of producing or consuming the good. If all costs were accounted for, the prices of these goods **would** be higher and people **would** consume less of them.
POSITIVE EXTERNALITIES RESULT IN UNDER PRODUCTION	The **underproduction** of goods with **positive externalities** occurs because the producers of the goods **do** not capture the extra value the goods create for others in the price they receive for their goods.

3.1.5.5. MERIT & DEMERIT GOODS

CLASSIFICATION OF MERIT & DEMERIT GOODS	This depends upon a normative value judgement – one man's meat is another man's poison.
PUBLIC GOODS	A good that is both **non-excludable** and **non-rivalrous** in that individuals cannot be effectively excluded from use and where use by one individual does not reduce availability to others. May also be **non-rejectable** e.g National defence.
QUASI PUBLIC GOODS	A near-public good. It has some of the characteristics of a public good especially when it becomes rival in consumption at peak times.
MERIT GOODS	May have two characteristics: a). People do not realise the true benefit. E.g. people underestimate the benefit of education or vaccinations. b). Usually these goods have **POSITIVE EXTERNALITIES**.
DEMERIT GOODS	A good which can have a negative impact on the consumer – but these damaging effects may be unknown or ignored by the consumer. They also usually have **NEGATIVE EXTERNALITIES**– where consumption causes a harmful effect to a third party.
FREE RIDER	A person who receives **PUBLIC GOODS** benefits that others have paid for without contributing payment themselves.
SUSAN COLLINS	*"The first obligation of government is to protect its citizens".*

3.1.5.6. MARKET IMPERFECTIONS

TRAGEDY OF THE COMMONS	A situation within a shared-resource system where individual users acting independently according to their own self-interest behave contrary to the common good of all users by depleting or spoiling that resource through their collective action.
ASSYMMETRIC INFORMATION -	**ASSYMETRIC INFORMATION** occurs when somebody knows more than somebody else in the market. This may lead to under-provision or under consumption of merit goods and over-provision of
INFORMATION FAILURE	Where individuals or firms have a lack of information about economic decisions.
AGRICULTURE	MF may occur due to the following: Volatile Prices / volatile supply, Low and volatile income for farmers, Environmental costs of intensive farming (negative externalities), Agriculture key component of rural life (positive externalities), Monopsony power of food purchasers.
PRINCIPAL-AGENT PROBLEM	Occurs when a principal delegates an action to another individual (agent), but the principal does not have full information about how the agent will behave. Secondly, the interests of the principal diverge from that of the agent, meaning that the outcome is less desirable than the principal expects.
MONOPOLY	A pure monopoly is defined as a single seller of a product, i.e. 100% of market share. In the UK a firm is said to have monopoly power if it has more than 25% of the market share. Restricts output to charge a high price.
MONOPOLISTS & MARKET FAILURE	The firm will set a specific price for a good that is available to all consumers. The quantity of the good will be less and the price will be higher (this is what makes the good a commodity). The monopoly pricing creates a deadweight loss because the firm forgoes transactions with the consumers. The deadweight loss is the potential gains that did not go to the producer or the consumer. As a result of the deadweight loss, the combined surplus (wealth) of the monopoly and the consumers is less than that obtained by consumers in a competitive market. A monopoly is less efficient in total gains from trade than a competitive market.
FACTOR IMMOBILITY	The free **market** can fail to provide an efficient allocation of resources because of the geographical and **occupational** immobilities. **Factor immobility** can lead to increased inequality.

GOVERNMENT INTERVENTION	**Government intervention** is regulatory action taken by **government** that seek to change the decisions made by individuals, groups and organisations about social and economic matters.
AIMS OF GOVERNMENT INTERVENTION	• Governments may also intervene in markets to promote general economic fairness. • Governments may sometimes intervene in markets to promote other goals, such as national unity, advancement and tackle inequality.

REASONS FOR GOVERNMENT INTERVENTION

- To correct **NEGATIVE & POSITIVE EXTERNALITIES**
- To provide **PUBLIC & MERIT** goods.
- To correct **FACTOR IMMBILITY**
- To improve **UNEQUAL DISTRIBUTION OF INCOME**
- To correct **MONOPOLY ABUSE**
- To correct **TRAGEDY OF THE COMMONS**
- To resolve **ASSYMERTIC INFORMATION**
- To support **AGRICULTURE**
- To resolve the **PRINCIPAL-AGENT PROBLEM**.
- To protect industries of **STRATEGIC IMPORTANCE**.

ARGUMENTS AGAINST GOVERNMENT INTERVENTION	Government failure – when the government creates further inefficiency. This could distort incentives, increase bureaucracy, increase political interference, administrative costs, moral hazard, regulatory capture & unintended consequences.

Taxation, indirect taxation, subsidies, welfare provision, direct state provision, regulation, price controls.

MIXED ECONOMIES	Allow private enterprise to run most business. Then the governments intervene in certain areas of the economy, such as regulation, and public services – public goods & merit goods.

INTERVENTION METHODS TO CORRECT NEGATIVE EXTERNALITIES

	DEFINITION	ADVANTAGE	DISADVANTAGE
INDIRECT TAXATION	Taxes on **NEGATIVE EXTERNALITIES** are intended to make consumers / producers pay the full social cost of the good. This reduces consumption and creates a more socially efficient outcome.	1. Changes in indirect taxes can change the pattern of demand by varying prices 2. Indirect taxes can be used as a means of making the polluter pay and "internalizing the external costs" of production and consumption 3. Indirect taxes can be charged more easily than direct taxes. 4. Earns TAX REVENUE	1. Difficulty in setting the right value – IMPERFECT INFORMATION 2. REGRESSIVE 3. Little impact when demand is INELASTIC 4. May create a **BLACK MARKET** 5. Misuse of Government Tax Revenue 6. Impact on firms & jobs?
REGULATION	To overcome **NEGATIVE EXTERNALITIES**, the government may place laws and regulations which prohibit certain behaviour and actions.	1. Simple and easy to understand. 2. When the danger is great it may be better to ban it all together, e.g. heroin. 3. When a decision needs to be taken quickly, a tax may be too cumbersome. 4. A legal ban sends a clear signal that it is wrong (e.g. drinking alcohol in city centre) 5. It is fairer than taxes – not REGRESSIVE.	1. Difficulty in setting the right value – **IMPERFECT INFORMATION** 2. Firms may shut down/ leave the market– jobs? 3. Cost of **REGULATION** 4. Enforcement issues. 5. May create a **BLACK MARKET**.
EXTEND PROPERTY RIGHTS	A way of **internalising the externality**. By ensuring firm's pay for pollution to eg. air, water in surrounding areas.	1. Incentivises private agents to act in a responsible manner & not pollute. 2. May result in more equitable decisions.	1. Is it possible to exclude people? 2. Cost 3. Enforcement 4. Equitable Concerns
POLLUTION PERMITS	Involve giving firms a legal right to pollute a certain amount e.g. 100 units of Carbon Dioxide per year	1. If the firm produces less pollution it can sell its pollution permits to other firms. 2. However if it produces more pollution it has to buy permits off other firms. 3. Therefore there will be a market for pollution permits. 4. Therefore there is an incentive for firms to cut pollution & sell permits.	1. Setting the right cap 2. Cost 3. Enforcement 4. Global agreement needed 5. May concentrate pollution in areas.
INFORMATIO N PROVISION	**Assymmetric info** occurs when somebody knows more than somebody else in the market. Information campaigns can help reduce NEG CONs EXTERN.	1. Markets are at their most efficient, when knowledge is perfect and is evenly shared by all the parties in a transaction. 2. Consumers are now less likely to be exploited.	1. Quality of provision 2. Targeted at who? 3. Costly 4. Long term – difficult to assess impact 5. No guarantee of success.

METHODS TO CORRECT POSITIVE EXTERNALITIES & PROVIDE PUBLIC & MERIT GOODS	DEFINITION	ADVANTAGE	DISADVANTAGE
SUBSIDY	A sum of money granted by the government to help an industry or business keep the price of a commodity or service low.	1. Enables greater social efficiency. Consumers end up paying the socially efficient price which includes the external benefit. 2. Lower price encourages greater consumption.	1. Setting the right value – imperfect information 2. Cost 3. Promotes inefficiency 4. Inelastic demand 5. Misuse of subsidy
DIRECT STATE PROVISION	Direct provision of **PUBLIC & MERIT GOODS** by the government. E.g. NHS & state schools.	1. More productively efficient due to economies of scale & natural monopolies; 2. Better Management!? Which tries to maximise net social benefit; 3. Maximise net social benefit not private profit. 4. A fairer distribution of resources.	1. Setting the right level – imperfect information 2. Cost 3. Excess demand 4. Necessary? 5. X-inefficiency – failure to be dynamically efficient. 6. Quality arguments.
INFORMATION PROVISION	Information campaigns can resolve **ASSYMETRIES OF INFORMATION**.	1. Markets are at their most efficient, when knowledge is perfect and is evenly shared by all the parties in a transaction. 2. Consumers are now less likely to be exploited.	1. Quality of provision 2. Targeted at who? 3. Costly 4. Long term – difficult to assess impact 5. No guarantee of success.
PRIVATE FINANCE INITIATIVE	Creates "public–private partnerships" by funding public projects with private capital.	1. The belief that the private sector can be more productively & dynamically efficient through better management.	1. Debt at higher interest burden. 2. Inflexibility & poor value for money.

3.1.5.9. GOVERNMENT FAILURE, THE LAW OF UNINTENDED CONSEQUENCES

Where government intervention in the economy to correct a market failure creates inefficiency and leads to a misallocation of scarce resources.

REASONS FOR GOVERNMENT FAILURE	**1. Lack of incentives**: In the public sector, there is limited or no profit motive. For example, the public sector may be more prone to over-staffing. **2. Poor Information**: politicians may have poor information about their intervention. Politicians will not be experts in their department, but concentrate on their political ideology. **3. Political interference & conflicting objectives** e.g. politicians may take the short term view rather than considering long term effects. **4. Administration costs** of government bureaucracy in running public services **5. Moral hazard**. The government may offer a guarantee to all bank deposits to protect financial system, but this could encourage banks to take risks – because they know they can be bailed out by the government. **6. UNINTENDED CONSEQUENCES:** Markets are DYNAMIC & intervention can distort existing incentives, signals & result in misallocation of resources.
OVERCOMING GOV'T FAILURE	1. Give performance targets / profit incentives 2. Competitive tendering – where public sector bodies face competition from the private sector for the right to run a public service. 3. Employing outside private sector consultants to make decisions about how to cut costs.
LAW OF UNINTENDED CONSEQUENCES	The law of unintended consequences refers to how economic decisions may have effects that are unexpected. Usually this refers to an economic law which distorts consumer or producer behaviour in a way that is not expected.
EXAMPLES OF UNINTENDED CONSEQUENCES	- After Exxon Valdes oil Spill many US coastal state enacted a law of placing unlimited liability on tanker spills. This led to many big oil companies sub contracting the delivery of oil to other companies. Oil specialists worried that these smaller companies may have lower standards and poorer insurance than the big companies, so the risk increased. - A maximum price for renting accommodation. A government may respond to public pressure and impose maximum rent levels for accommodation in London. But, a maximum price which lowers the price could lead to less incentive for landlords to supply accommodation. Therefore, there is less supply and more people struggle to get accommodation.