

Topic 7—Government Intervention and Government Failure

Key Terms	
Government Failure	A misallocation of resources arising from government intervention that causes a divergence between marginal social benefit and marginal social cost.
Indirect tax	A tax levied on expenditure on goods or services (as opposed to a direct tax, which is a tax charged directly to an individual based on a component of income)
Internalising the Externality	An attempt to deal with an externality by bringing an external cost or benefit into the price system
NIMBY (Not in My Back Yard)	A syndrome under which people are happy to support construction of an unsightly or unsocial facility, so long as it is not in their own ar-

Government Failure
<p>Most governments see it as their responsibility to try to correct some of the failures of the markets. However some policies have unintended consequences that can make the market failure worse.</p> <p>This is largely due to a lack of information by the government which causes them to either not correct the market failure enough, or to over correct and create additional problems.</p>
<p>Sales Taxes:</p> <p>One way in which governments intervene the most in markets is through taxes in order to reduce consumption whilst also increasing government revenue. However knowing the right level of tax is very difficult which can lead to overtaxing or under taxing of a product.</p> <p>In addition taxes can have additional consequences which are not taken into consideration; it reduces the supply of the product which creates a misallocation of resources and can affect other markets. E.g. taxing petrol too much can reduce supply of petrol leading to a issues in other markets that rely heavily on petrol.</p>



Specification Link
1.4.1 Government intervention in markets
1.4.2 Government failure

Dealing with Market Failure—Pollution Permits
<p>This involves the government selling permits which allow firms to pollute up to a certain limit, any pollution past this limit will be result in the firm paying heavy fines. These permits can then be traded so efficient firms with small emissions can sell theirs to larger more polluting firms and make a profit.</p>
<p>Advantages:</p> <ul style="list-style-type: none"> • Incentive for firms to reduce emissions so that they can sell their permits for a profit • Overall level of pollution can be controlled by only allowing a certain number of permits to be available
<p>Disadvantages:</p> <ul style="list-style-type: none"> • Enforcement can be difficult especially when it must also be cost effective • Setting an appropriate level of permits can be difficult as it is not easy to measure the difference between MPC and MSC • If large firms can just buy more permits than the incentive to reduce pollution will not be there and so there may be little effect on pollution

Dealing with Market Failure—Property Rights
<p>Some externalities occur because there are no clear property rights, there is no one owner of a resource who will look after it e.g. the sea, rivers or the atmosphere.</p> <p>If the government is able to take over the property rights of the area, they can monitor and ensure that they are</p>
<p>Advantages:</p> <ul style="list-style-type: none"> • More likely that the resources will be used effectively and it will be sustainable for the future. • Property owners can charge firms that pollute the area or over use it.
<p>Disadvantages:</p> <ul style="list-style-type: none"> • It is difficult to extend property rights for areas that are not constant or are used by multiple countries • It can be difficult to trace the source of any environmental damage • Legal costs can be high which may deter legal action and so there is no incentive to stop polluting.

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Price Ceiling	A government imposed price control, limiting how much a firm can charge for a product or service. Should be below the equilibrium to have any effect
Price Floor	The lowest legal price a good or service can be sold at e.g. Minimum Wage. Should be above the equilibrium to have any effect
Prohibition	An attempt to prevent the consumption of a demerit good by declaring it illegal

Dealing with Market Failure—Price Controls

In some markets, governments have been seen to intervene to regulate prices directly e.g. wages. This can be in order to reduce market failure, possibly to help control over or under consumption.

An example of a minimum price includes a minimum price on alcohol, this has been used to reduce the amount demanded, however as it is inelastic there has been limited success in this.

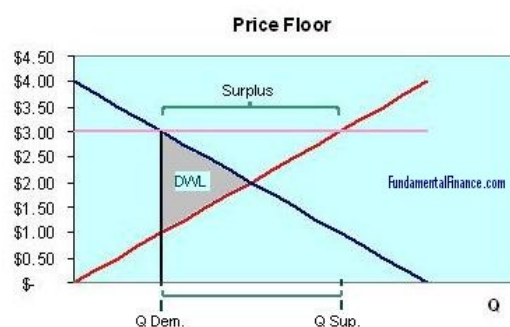
An example of a maximum price includes rent controls in which the amount of monthly rent charged cannot exceed a certain amount to ensure it remains affordable for most house-

Advantages:

- Can help stabilise volatile markets such as the agricultural market
- Can ensure that necessary goods and services remain affordable for all households
- Prevents overcharging by firms

Disadvantages:

- Can lead to an over supply or shortage of supply, resulting in a misallocation of resources, this has previously led to governments having to buy up extra goods resulting in wine lakes and butter mountains.
- Black markets may arise which will sell at the illegal price
- Price discrimination may become more common in order to try and increase profits



Dealing with Market Failure—Prohibition

An extreme form of reducing the level of consumption for demerit goods is to ban use of them altogether e.g. banning the use of recreational drugs or smoking indoors

If a product is made illegal there will be a significant reduction in supply however there is likely to continue being some suppliers willing to work beneath the law. There would also be a reduction in demand as some users will be more risk adverse than others. This is likely to lead to a very high price for the product assuming that supply is kept low through strong monitoring by the government.

- Reduces the negative effects of consuming the product significantly e.g. anti social behaviour or health effects
- Likely to lead to better productivity as individuals will be healthier and better able to do their jobs
- Hard to monitor and will need more money spent on policing
- Loss of tax revenue for the government
- Increase in the black market and crime, could also glamorise criminals if the ban is well opposed.

Dealing with Market Failure—Background Checks and Advertising

When trying to deal with information failure the best defence is to improve the information available. This could be in the form of creating background checks before selling second hand cars, health checks when giving out insurance or advertising the negative effects of demerit goods.

- Can be relatively cheap to implement
- Provides a fairer society with an allocation of resources that is closer to the social cost
- Can be intrusive to peoples privacy which may be unwanted
- Advertising requires it to be noticed and listened to, nowadays that is less likely with the ability to record and fast forward programmes.

Costs of Intervention

Some roles are critical for a government to perform if a mixed economy is going to function effectively. However some intervention creates costs:

- Admin costs for creating and monitoring policies
- Unintended costs and effects that may appear due to a policy being implemented
- Society costs of having more rules within an economy that may not all be welcome.