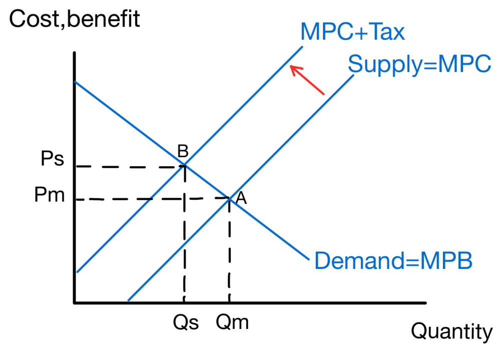
Government intervention in markets

a) The purpose of government intervention, including reference to market failure.

Government can help to improve allocative efficiency.

b) Methods of intervention:

1. Indirect taxation (*ad valorem* and specific)

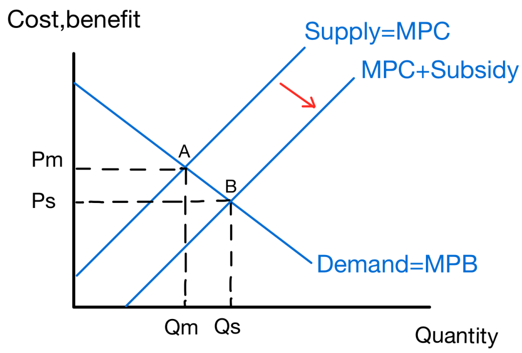


- Government can impose tax on production and consumption which generate external cost. Tax imposed equals to external cost (EC).
- It is to internalise external cost (EC) into private cost (PC).
- Indirect tax increases cost to firms, causing MPC to increase and shift to MPC+Tax
- Finally, price rises and quantity of output falls to socially optimal level of output.
- Government also gain tax revenue.

Evaluation

1. It is difficult to measure external cost (EC) in terms of money, then it is hard to identify the proper level of tax on pollution or tax on demerit goods.
2. Producers may pass on tax to consumers rather than reducing pollution.

2. Subsidies



- Government gives subsidy which equal to external benefit (EB).
- It reduces cost to firms, then marginal private cost(MPC) falls.
- Then, socially optimal level of production/consumption can be achieved

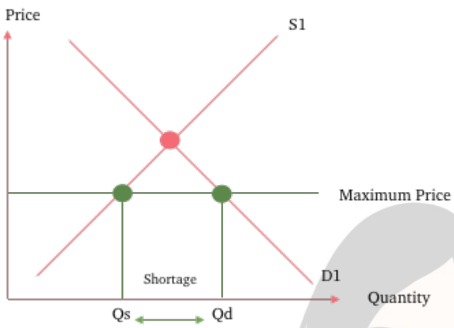
Evaluation

1. It has an opportunity cost to government.
2. It increases tax burden to next generation and it creates government debt.

3. Maximum and minimum (guaranteed) prices.

3.1 Maximum prices

- Maximum price : products cannot be legally sold above this price level.
- Maximum price is to prevent too high price for essential goods and merit goods in order to enable poor people to afford.
- Effective maximum price must be set below market price.



=> Effective maximum price is set below market price.

=> It causes contraction in supply and extension in demand.

=> At maximum price, quantity of demand = Qd

quantity of supply = Qs

there is shortage = Qd - Qs

=> New equilibrium is at maximum price and quantity of trade is at Qs

Problems:

1. Shortage or excess demand (Disequilibrium) = Qd-Qs

↳ At max price producers will only supply at Qs

↳ Consumers who are able to buy the product at Qd are better off

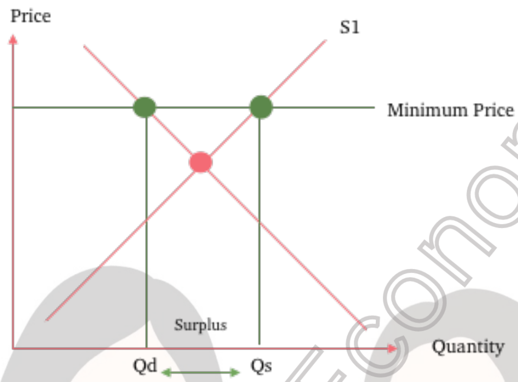
↳ Those consumers who want to buy Qd-Qs are worse off because the goods are not enough for them.

2. Maximum prices can lead to black market

↳ Some producers may illegally sell the product in the black market at very high price.

3.2 Minimum prices

- Minimum price : products cannot be legally sold below this price level.
- Minimum price is to prevent too low price of demerit goods, and to stabilize price of agriculture products to farmers.
- Effective minimum price must be set above market price.



=> Government would like to increase the price of the products, and effective minimum price must be set above market price.

=> At minimum price there is a contraction of demand and an extension of supply

=> At minimum price, quantity of demand = Qd

quantity of supply = Qs

there is excess supply or surplus = Qs - Qd

=> New equilibrium is at minimum price and quantity of trade is at Qd.

Problems:

1. There will be excess supply or surplus (Qs - Qd)
2. It needs government help to buy surplus. (Qs - Qd)

4. Tradeable pollution permits

- Pollution permits; a form of license given by you that allows a firms to pollute up to a given level.
- Price of permit : permits are market based solution and they can be bought and sold (unlike tax & regulation)

Problems:

1. It is difficult to identify proper level of permit

↳ If supply of permit rises, the price of permit will fall.

↳ If price of permit is too low it cannot make incentive to reduce pollution

2. it has high administrative cost and monitoring cost.

5. Extension of property rights

- Where owners have a right to decide how their assets may be used.
- If people affected by externality are assigned property rights, then polluting firm will be charged for compensation.

Problems:

1. it is difficult to identify who should get property right.

6. **State provision**

- Government can directly provide public goods such as road and street light.
- Government can directly provide merit goods such as education state-funded education compulsory up to a certain age

Problems:

1. It has opportunity cost from government spending.

7. **Regulation**

- A wide range of legal and other restrictions by government in order to influence people and business behaviours. It can impose large fines as well.
- For example, prohibit smoking in some public areas

Problems:

1. It depends on ability to monitor.

8. Provision of information

- Government provides information which helps people to make decision rationally
- For example, warning and photographs are placed on package of tobacco's product