

Government Intervention

<p>Why and how governments intervene in markets</p>	<p>Explain why and how governments intervene in markets, for example, to correct market failure and reduce income inequality</p> <p>Evaluate government intervention policies</p>	<p>Governments may intervene by using policies, such as taxation (specific and ad valorem taxes), subsidies, state provision and regulation, minimum and maximum prices, use of prices, for example, road pricing and tradeable pollution permits</p> <p>Simple demand and supply diagrams should be used</p> <p>Learners should be able to link policies to the reduction of income inequality, for example, progressive taxation and the benefits system, price stabilisation and guaranteed minimum price schemes in agriculture and the national minimum wage</p>
<p>The effects of government intervention</p>	<p>Explain that, in certain cases, government intervention can create distortions in markets, for example, in agriculture, housing and labour markets</p> <p>Understand the reasons for government failure and be able to evaluate its effects</p>	<p>Learners should be aware of distortions in markets and examples of government failure</p>

Methods to correct market failure

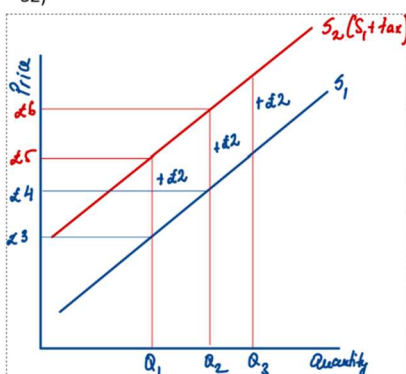
Indirect taxation:

Indirect taxation is a tax on expenditure

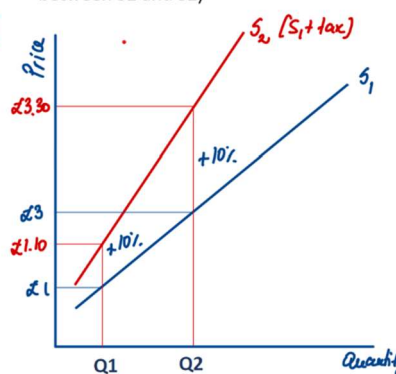
The two major indirect taxes:

- VAT (ad valorem taxes that increase in direct proportion with the price of the good – x% of the price)
- Excise duties (a specific or unit tax, where the amount of tax does not change with the price of the good but rather with the volume purchased)

A specific tax: a fixed amount is paid on each unit (e.g. £2 – amount of tax is equal to the vertical distance between S_1 and S_2)



Ad valorem tax: a percentage of the selling price is paid (e.g. 10% – amount of tax is equal to the vertical distance between S_1 and S_2)



The effect of taxation:

- Indirect taxation raises the production costs of firms and so shifts the supply curve left
- The vertical distance between the two supply curves will equal the amount of increase in tax
- This increases the price of the good and reduces the quantity produced
- The tax imposed should, in theory, equal the negative externality created by the good
- The tax should be set at the level where the tax revenues equal the cost to society of the negative externality, which internalises the negative externality

The split of the burden of the tax between the consumer and producer is known as the incidence of the tax and will vary according to the price elasticity of demand and supply of good.

- If demand for the good is price elastic or supply is price inelastic, sellers will bear most of the tax but the effect on consumption will be relatively large
- If demand for the good is price inelastic or supply is price elastic, buyers will bear most of the tax, but the effect on consumption will be relatively small
- If demand for the good is unit elastic, the incidence of the tax will be shared equally between sellers and buyers

As far as the government is concerned, tax revenue will be greater the more inelastic demand is for the goods being taxed, and vice versa.

The higher the elasticity, the larger the fall in quantity demanded and hence the lower the tax revenue received by the government.

Ad valorem taxes:

The imposition of an ad valorem tax will shift the supply curve left. However, the higher the price, the greater will be the amount of tax. Hence the shift left of the supply curve will not be parallel - it will fan out as the price rises.

The tax paid by buyers is represented by the rectangle to the left of their tax incidence. The tax paid by sellers will be the rectangle to the left of their tax incidence. The total tax revenue of the government will be these two rectangles added together.

Indirect tax analysis :

- A market-based intervention that raises marginal private cost of production to the marginal social cost of production (changing the negative externality into a private cost of production)
- Raises revenue for the government
- A market-based solution to market failure
- Internalises the negative externality into the market price and makes the producer pay the full social cost of their actions (reduces both overproduction and overconsumption)
- Leads to a more socially optimal equilibrium, a more efficient allocation of resources, and hence a welfare gain for society.

BUT

- It is hard to measure the negative externality, the amount of tax imposed, and the risk of government failure

- The precise effect on price and quantity depends on elasticities of both demand and supply (demerit goods often have price inelastic demand which can undermine the effect of indirect tax on consumption levels)
- Taxes also contribute to inflation, the reduction of international competitiveness and the destruction of jobs
- Taxes often need to be implemented internationally to be effective given the lack of incentive for individual countries to implement them unilaterally on some occasions
- Flat taxes are regressive and can be costly to police, enforce, and collect

Subsidies

A subsidy is a grant given by government to firms (producer subsidy) or to consumers (consumer subsidy) to encourage the production or consumption of a particular good

Subsidies can be used to

- Encourage increased production of merit and public goods
- To guarantee a minimum price for sellers
- To guarantee the supply of particular goods
- To enable domestic firms to compete with overseas firms
- To protect jobs and industry sectors
- To cover or reduce operating losses

Producer subsidies reduce firms' cost of production and the supply curve shifts right leading to a lower price

- Subsidies increase consumer surplus and real disposable incomes, but also increase producer surplus because although producers receive a lower price, they also receive the subsidy per unit

The price of the good falls but this will not be by the full amount of the subsidy, since some of it will be retained by the producer, which is justified by the higher costs associated with the higher output.

The incidence of the subsidy between buyers (in the form of a price reduction) and sellers will vary with the good's price elasticity of demand:

- If demand for good is price elastic or supply is price inelastic, price will fall by less than half the subsidy, but the effect on consumption will be relatively large
- If demand for good is price inelastic or supply is price elastic, price will fall by more than half the subsidy, but the effect on consumption will be relatively small
- If demand for the good is unit elastic, price will fall by half the subsidy

Subsidies analysis:

- Can create a socially optimal equilibrium with lower price and higher quantity bought and sold
- Can correct market failure associated with merit and public goods (under consumption and a missing market, respectively), creating allocative efficiency and a welfare gain for society
- Produces winners (buyers and sellers) but also losers (taxpayers, other firms not in receipt of a subsidy at home, or overseas and government)
- Can help those on low income afford to buy necessary/merit goods

However:

- They come with significant financial costs and an opportunity cost for government (they imply higher taxes)
- There is a measurement problem (measuring the positive externality)
- The precise effect on price and quantity depends on elasticities of both demand and supply (the more price inelastic demand is, the less impact subsidies will have on quantity)
- They may encourage inefficiency and dependency by insulating firms from more efficient competitors and can therefore distort markets
- There can be problems in targeting the price reduction at those in genuine need or persuade consumers to change their purchasing behaviour.
- Decisions about the level of subsidies can become 'captured' by sellers through lobbying