Government microeconomic intervention (AS)

Why governments intervene in markets, the methods and effects of taxes, subsidies, price controls, regulation and direct provision, and ways of addressing income and wealth inequality.

3.1 Reasons for government intervention in markets

Markets can **fail** to allocate resources **efficiently or fairly**, so governments intervene to:

Aim	Example
Correct market failure	**externalities**, **public goods**, **merit and demerit goods**, **information failure**, **monopoly power**
Redistribute income and wealth	**reduce inequality**
Protect consumers and producers	**minimum prices** for farmers, **maximum prices** for essentials
Improve efficiency and stability	**promote competition**, stabilise **prices**
Raise revenue	**taxes** on goods and income

> **Market failure is when the free market leads to a misallocation of resources, producing too much or too little of a good, so social welfare is not maximised.**

Intervention can address the **non-provision of public goods** (the state provides them from taxes), the **over-consumption of demerit goods** (tax, ban or inform) and the **under-consumption of merit goods** (subsidise, provide directly or make compulsory).

3.2 Methods and effects of government intervention in markets

Indirect taxes

An **indirect tax** (VAT, excise duty) is levied on **spending**. A **specific** tax is a fixed **amount per unit**; an **ad valorem** tax is a **percentage**. A tax **shifts the supply curve left** (up by the tax). The **price rises**, quantity falls, and the **tax burden** is shared between consumers and producers.

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The incidence of a tax depends on elasticity. When demand is inelastic, consumers bear more of the tax; when demand is elastic, producers bear more. The government revenue is tax per unit × new quantity.

Reasons for taxing: raise **revenue**, **reduce consumption of demerit goods**, **internalise externalities**. Limits: **regressive** effects on the poor, **black markets**, difficulty setting the right rate.

Subsidies

A **subsidy** is a **payment to producers** that **lowers costs**; the **supply curve shifts right** (down by the subsidy), **price falls** and **quantity rises**. Used to **encourage merit goods** and **positive externalities**, support **new industries** and **farmers**. Costs: **opportunity cost** to the government, **may keep inefficient firms going**, hard to **withdraw**.

Price controls

Control	Effect
Maximum price (price ceiling) below equilibrium	**shortage**; may create a **black market**, **rationing**, queues. For example **rent controls**
Minimum price (price floor) above equilibrium	**surplus**; the government may **buy the excess**. For example **agricultural support prices**, **minimum wage**

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A maximum price is set below equilibrium. What happens to quantity demanded and supplied?

Quantity demanded rises and quantity supplied falls, creating **excess demand** (a shortage). **Black markets** may arise.

Other methods

- **Regulation:** laws that **ban or limit** activities (pollution limits, safety, age limits) and **competition law**. Needs **monitoring** and **enforcement**.
- **Direct provision:** the government **supplies** goods (education, healthcare, roads) funded by **taxes**; avoids **under-provision** but has **opportunity costs** and may lack **efficiency**.
- **Information provision:** campaigns, **labelling**, to correct **information failure**.
- **Tradable permits**: a **cap** on pollution; firms **buy and sell** permits.

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- **Nationalisation and privatisation**.

Evaluating intervention

Government failure occurs when intervention **worsens** the allocation: **poor information**, **unintended consequences**, **administration costs**, **political motives**, **regulatory capture**. A policy's success depends on **elasticities**, **time lags**, **costs and benefits** and **side effects**.

Buffer stock schemes stabilise the price of a **commodity** (such as wheat or coffee) whose price swings with the weather. The authority sets a **minimum (floor) price** and a **maximum (ceiling) price**: in a good harvest, when the price would fall below the floor, it **buys the surplus** and stores it; in a poor harvest, when the price would exceed the ceiling, it **sells from its stock**. This **stabilises farmers' incomes** but costs money to **store and run**, can be **hard to set the right prices** and may **encourage over-production**. **Production quotas** limit how much each producer may supply to **raise price** or **limit damage** (for example in fishing), but can lead to **cheating**, **black markets** and **higher prices** for consumers. **Excessive administrative burdens ("red tape")** are a government failure that raises firms' costs.

3.3 Addressing income and wealth inequality

Income is a **flow** received over time; **wealth** is a **stock** of assets. **Inequality** exists within and between countries. The **Lorenz curve** shows the **share of income going to each cumulative share of the population**; the **further the curve from the line of equality, the greater the inequality**. The **Gini coefficient** is the **ratio of the area between the Lorenz curve and the line of equality to the whole area under the line**: **0 = perfect equality, 1 = perfect inequality**.

Causes of inequality

Differences in skills, education and wages, **unemployment**, **ownership of assets**, **inheritance**, **discrimination**, **age**, **regional differences**, and the **tax and benefit system**.

Taxation

Type	Meaning
Progressive	the **average rate rises** with income (income tax bands)
Proportional	the **same rate** at all incomes
Regressive	the **average rate falls** as income rises (a flat tax on goods hits the poor more)

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Policies to reduce inequality

Progressive taxation, **transfer payments** (benefits, pensions), a **minimum wage**, **free or subsidised education and healthcare**, **investment in skills**, and **inheritance taxes**.

Evaluation: high taxes may **reduce incentives to work and invest**, benefits can create a **poverty trap** and cost money, and **equity** and **efficiency** may conflict. **Value judgements** affect how much inequality is acceptable. **Equity** is **fairness**; **equality** is **sameness**.

State provision of essential goods and services (education, healthcare, housing) lets **low-income households** have them regardless of ability to pay, which **narrows** inequality of **outcomes and opportunities**, but costs **taxes** and may be **inefficient**. A **negative income tax** pays **benefits** to people below an income threshold, falling as their earnings rise (rather than taxing them), which **supports the poor** while keeping an **incentive to work**.

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