Government Intervention in the Market

Laissez faire economics

In a **free market system**, governments take the view that markets are best suited to allocating scarce resources and allow the market forces of supply and demand to set prices. The role of the government is to protect property rights, uphold the rule of law and maintain the value of the currency. Competitive markets often deliver improvements in allocative, productive and dynamic efficiency – but there are occasions when they fail – providing a case for intervention.

Intervention in the market

The main reasons for policy intervention are:

(1) To correct for **market failure**

(2) To achieve a more **equitable distribution of income and wealth**

(3) To improve the **performance of the economy**

There are many ways in which intervention can take place – some examples are given below

Government Legislation and Regulation

Examples include:

- Laws on minimum ages for buying cigarettes and alcohol
- The Competition Act which penalizes businesses found guilty of price fixing cartels
- Statutory national minimum wage
- A new law in Scotland banning under-18s from using sun-beds
- Equal Pay Act and acts preventing other forms of discrimination
- Changes in the law on cannabis
- Maximum CO2 emissions for new vehicles, laws which restrict flight times at night
- Government appointed utility regulators who may impose price controls on privatized monopolists e.g. telecommunications, the water industry

The economy operates with a huge and growing amount of regulation. The government appointed regulators who can impose **price controls** in most of the main utilities such as telecommunications, electricity, gas and rail transport. **Free market economists** criticize the scale of regulation in the economy arguing that it creates an unnecessary burden of costs for businesses – with a huge amount of "red tape" damaging the competitiveness of businesses.

Regulation may be used to introduce **fresh competition** into a market – for example breaking up the existing monopoly power of a service provider. A good example of this is the attempt to introduce more competition for British Telecom. This is known as **market liberalization**.

Direct State Provision of Goods and Services

What is best provided by the market? And what might be more appropriately provided by the government sector of the economy? Privatisation has radically changed the public or government sector of the economy although since the current Labour government came to power, there has been a huge rise in total public sector employment, in part the result of a large rise in government spending on the national health services. The following businesses remain part of the public sector:

a. British Nuclear Fuels plc - an international company, owned by the British government, concerned with nuclear power.

b. Network Rail - Network Rail is a "not for dividend" company that owns the fixed assets of the UK railway system that formerly belonged to British Rail, the now-defunct British state-owned railway operator. Network Rail owns the infrastructure itself, railway tracks, signals, tunnels, bridges, level crossings and most stations, but not the rolling stock. Network Rail took over ownership by buying Railtrack plc, which was in "Railway Administration", for £500 million from Railtrack Group plc.

c. **East Coast Rail Line**. In June 2009 the government announced that it was nationalising the East Coast rail line previously operated by National Express.

d. The Royal Mail - Royal Mail has been a state-owned company since 1969 and remains a public limited company wholly owned by the UK government. The Royal Maul is regulated by PostComm which has the power to grant licences to new competitors entering the deregulated market for household and business mail services. The market was opened up to full competition in January 2006. The Royal Mail retains a universal service commitment.

e. **The Tote** – a betting business that remains in state ownership and has done since it was created by an act of parliament in 1928. The government has announced plans to privatise the business but this has not yet been completed in part because of difficult stock market conditions following the credit crunch and the recession.

f. Northern Rock - In the autumn of 2007 the government announced the nationalisation of Northern Rock - all shares in the business were handed over to the Treasury. The main justification for the decision was that Northern Rock's business model had failed but that the economic and social consequences of allowing the business to go bust were too severe - hence the need for government intervention. Weeks earlier Northern Rock ran into a financial crisis which led to the first run on a major UK bank since the nineteenth century. It was forced to ask the Bank of England for emergency funding. With nationalisation, the debts of the bank were taken onto the public sector finances. These loans and guarantees were estimated to be worth more than £50bn. In the months since the nationalisation, Northern Rock has been downsizing its activities, reducing the size of its mortgage loans book and making several thousand employees redundant.

g. **Bradford and Bingley** - In September 2008 the UK government nationalised Bradford and Bingley - it took control of the bank's £50bn mortgages and loans, while B&B's £20bn savings unit and branches was bought by Spain's Santander.

h. **Royal Bank of Scotland**: On the 13 October 2008 the UK government announced its plan to save the Royal Bank of Scotland from failing. It agreed a bail out of the bank in return for taking a seventy per cent stake in the business. The government also has a 43 per cent stake in **Lloyds Banking Group**.

State funding can also be used to provide merit goods and services and public goods directly to the population e.g. the government pays private sector firms to carry out operations for NHS patients to reduce waiting lists or it pays private businesses to operate prisons and maintain our road network.

Fiscal Policy Intervention

Fiscal policy can be used to alter the **level of demand** for different products and also the **pattern of demand** within the economy.

- **Indirect taxes** can be used to raise the price of de-merit goods and products with negative externalities designed to increase the opportunity cost of consumption and thereby reduce consumer demand towards a socially optimal level
- **Subsidies** to consumers will lower the price of merit goods. They are designed to boost consumption and output of products with positive externalities – remember that a subsidy causes an increase in market supply and leads to a lower equilibrium price
- **Tax relief:** The government may offer financial assistance such as **tax credits** for business investment in research and development. Or a reduction in **corporation tax** (a tax on company profits) designed to promote new capital investment and extra employment
- **Changes to taxation and welfare payments** can be used to influence the overall distribution of income and wealth – for example higher direct tax rates on rich households or an increase in the value of welfare benefits for the poor to make the tax and benefit system more progressive

Intervention designed to close the information gap

Often market failure results from consumers suffering from a **lack of information** about the costs and benefits of the products available in the market place. Government action can have a role in **improving information** to help consumers and producers value the 'true' cost and/or benefit of a good or service. Examples might include:

(1) Compulsory **labelling** on cigarette packages with health warnings to reduce smoking
(2) Improved **nutritional information** on foods to counter the risks of growing obesity
(3) Anti-speeding television advertising to reduce road accidents and advertising campaigns to raise awareness of the risks of drink-driving
(4) Information campaigns on the dangers of addiction and binge-drinking
(5) Home Information Packs for home-buyers

These programmes are really designed to change the **"perceived" costs and benefits** of consumption for the consumer. They don't have any direct effect on market prices, but they seek to influence "demand" and therefore output and consumption in the long run. Increasingly adverts are becoming more hard-hitting in a bid to have an effect on consumers.

Intervention and Stakeholders

As an economist, whenever you are required to discuss the costs and benefits of an example of government intervention it is worth asking yourself "who are the major stakeholders in this issue?"

A **stakeholder** is any person or organization that has a legitimate interest in a specific project or policy decision.

The decisions of government, businesses and other non-governmental organisations inevitably affect different groups within society. Increasingly, many businesses are taking into account the effects of their actions not just on the value that such decisions create for shareholders – but also to a broader range of stakeholder groups.

Typically stakeholder issues come into play on major infrastructural projects where a cost benefit analysis might be undertaken to assess the likely social costs and benefits – it is important to bring as many stakeholders into the picture as possible – many people might be affected,

Examples of stakeholders you might think of bringing into a discussion

1. Employees of a business / organisation (who may / may not be members of a union)
2. Communities where a business is located or affected *directly* by a decision
3. Suppliers to a particular business (e.g. back down the supply chain)
4. Shareholders and other investors / financiers
5. Creditors (people owed money)
6. Government (and through them – taxpayers)
7. Trade unions (and the workers they represent)
8. Professional associations
9. NGOs and other advocacy groups (i.e. World Bank, IMF, Pressure Groups)
10. Prospective employees
11. Prospective customers
12. Local communities
13. National communities
14. International community
15. Competitors within a market

Topical issues where the stakeholder concept might be considered important

Stakeholders affected by all kinds of issues including the following:

1. Increasing the national minimum wage
2. Rise in the London Congestion charge and expansion of the congestion charge zone
3. The building and opening of Heathrow Terminal 5
4. Government investment in wind farm technology
5. Reforms to the EU's common agricultural policy
6. Possible introduction of a tax on aviation fuel for flights inside the EU
7. Key decisions on developing new towns to help meet the demand for housing
8. Food export bans and export taxes (e.g. India increasing the tax on exported rice)
9. Decisions to lower import tariffs on goods and services coming into the UK
10. Changes to rules on mortgage lending as a result of the credit crunch
11. Removing the 10% starting rate of income tax
12. Higher tuition fees for UK students at English universities

Intervention in Action – The UK Housing Shortage

The elasticity of housing supply in the UK is low – one of the lowest in Europe – current policy is focused on improving the elasticity of supply so that house building is more responsive to changes in market demand.

1. **A loosening of planning restrictions**: Relaxation of planning constraints for new housing – including relaxation of the greenbelt restrictions. There is no shortage of land in the UK, merely a shortage of land on which it is possible to build new homes.
2. **Building homes on brown-field sites**: Financial incentives for construction companies to build on brown-field sites (e.g. previously developed land).
3. **Encouraging self-build schemes**: Self-build homes work out cheaper in the long run and they give people the satisfaction of building a home to their own specification and design.
4. **Build more social housing**: Allowing each local authority (council) greater freedom to borrow money to fund the construction and supply of social housing may help to reverse the collapse in the building of council properties over the last ten to twenty years. Increased funding for the 1,400 housing associations responsible for building and maintaining nearly 3 million homes in the UK is also an option.
5. **Increased innovation and productivity in house-building industry**: Encouraging more innovation in the building industry – for example innovations that make it possible to build new homes attractively at higher densities (i.e. more properties per square acre).
6. **Reducing the number of empty homes** – There are several options for this including compulsory purchase orders if owners of properties allow their properties to remain empty and unused for 6 months or more – these properties could then be made available to people on housing waiting lists at sub-market rents.
7. **Tax breaks** for investors willing to make rented properties available at affordable rents.

Evaluation on the effects of [government intervention](#)

a) **Value judgements:** Be aware of the use of 'value judgements' in discussions about government intervention – many people want a particular intervention because of their own vested interests.

b) **Changing prices to change incentives and behaviour:** Many interventions work though the price mechanism by changing the relative prices / relative costs of day-to-day decisions
    a. E.g. raising the price of fuel to curb consumption
    b. Offering a subsidy to bio-fuel producers
    c. Using tariffs to change the relative prices of imports in a domestic economy

c) **Social science:** Economics is a social science and the effects of intervention cannot be calibrated / forecast with great accuracy – people's behaviour is subject to change – remember the 'law of unintended consequences'!

d) **Combinations of policies**: One single intervention is unlikely to produce a solution to deep-rooted economic and social problems – try to build a variety of policy options into your discussion e.g. policies that work on market demand and market supply

e) **The power of markets**: Is government intervention always necessary? Market forces can be really powerful in finding profitable solutions to problems – don't underestimate the importance of innovation and invention – government's rarely have all of the answers and the new economics of mass collaboration offers powerful insights into the impact that collusive behaviour can have e.g. in fast-tracking ideas linked to reducing carbon emissions

f) **Costs and benefits**: You cannot go far wrong in an evaluation question by trying to identify and then discuss the costs and benefits of government intervention – some of which only become apparent over long time periods

g) **The 'law of unintended consequences'**: Government intervention does not always work in the way in which it was intended or the way in which economic theory predicts it should. Part of the fascination of studying Economics is that the "law of unintended consequences" often comes into play – events can affect a particular policy, and consumers and businesses rarely behave precisely in the way in which the government might want!

Judging the effects of intervention – a useful check list

To help your evaluation of government intervention – it may be helpful to consider these questions:

1. **Efficiency of a policy**: i.e. does a particular intervention lead to a better use of scarce resources? E.g. does it improve allocative, productive and dynamic efficiency? For example - would introducing indirect taxes on high fat foods be an efficient way of reducing some of the external costs linked to the growing problem of obesity?
2. **Effectiveness of a policy**: i.e. which policy is most likely to meet a specific economic or social objective? For example which policies are likely to be effective in reducing road congestion?
3. **Equity effects of intervention:** i.e. is a policy thought of as fair or does one group in society gain more than another? For example, would it be equitable for the government to increase the top rate of income tax to 50 per cent in to make the distribution of income more equal?
4. **Sustainability of a policy**: i.e. does a policy reduce the ability of future generations to engage in economic activity? Inter-generational equity is an important issue in many current policy topics for example decisions on which sources of energy we rely on in future years.

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