**Government Failure - Notes**

*This is when government intervention results in a net welfare loss.*

Meaning that intervention either fails to eliminate the market failure entirely or makes the matter worse.

The government is intervening to compensate for market inefficiencies but creates different problems by doing so. Thus government intervention reduces economic welfare rather than increases it.

**The main causes of government failure (as outlined by the specification) are:**

* Information gaps
* Distortion of price signals
* Unintended consequences
* Excessive administrative costs

Below is an expansive look at the above four causes, including **some (but not all)** examples and application of each:

1. **Information Gaps**

In the absence of a market, there are a number of questions that might cause concern for governments (**Hayek’s argument** for why governments should not intervene):

1. What is the appropriate level of tax to set when correcting a negative externality?
2. What level of subsidy is required?
3. What is the right maximum price?
4. What is the right minimum price?
5. How much of a public good should the government provide?

The government is likely to face two problems:

* **Government may get its calculations wrong -** No reason why the government should produce a better outcome than the (failed) market.
* **Gathering of information itself incurs costs -** Time, effort, opportunity costs, bureaucracy (colloquially known as ‘red tape’) and delays.
1. **Distortion of price signals**
* Free market economists take the view that the price mechanism is the most efficient way of allocating resources, therefore intervention will **disrupt the price mechanism** and create problems.
* In some cases government creation of market failure leads to the creation of more serious market failures e.g. **Subsidies causing an over-supply of farm produce.** This surplus can be dumped on world markets at low prices causing a fall in incomes for farmers from other countries outside the EU. All of which occurs at great cost to the tax payer (as they ultimately pay for the subsidies).
* **Minimum wage causing unemployment – see lesson and the relevant diagram.**
* **Planning permission/Green Belts in the housing market –** although it prevents urban sprawl and prevents anybody from building anything, it decreases the elasticity of supply of housing. Consequently, the demand for housing has greatly outstripped the supply in recent years – resulting in a generation of people being unable to get onto the housing ladder.

**Subsidies could cause inefficiency by distorting price signals.**

If the producer (e.g. a farmer) knows they will receive a subsidy it may take away their incentive to produce efficiently.

This was Margaret Thatcher‘s argument: before she came into power, the government was heavily subsidising mining companies who were making losses. Thatcher argued that loss making pits should be shut down, as they would have no incentive to produce efficiently if they were being subsidised by the government.

This also applies to the 2008 UK Banking Crisis – having lent money to people who couldn’t afford to keep up the monthly repayments, RBS and HBOS found themselves on the brink of collapse. In order to prevent them from collapsing, the UK government ‘bailed out’ the two banks (costing £65bn). The worry is that now banks are aware that the UK government are prepared to ‘bail out’ banks that make losses, banks in the UK have no incentive to lend responsibly and produce efficiently – because they will simply be subsidised if they make a loss (or so they believe).

**Give an unfair advantage**

Where for example in agriculture, subsidies are given to farmers of the developed world it will disadvantage farmers from developing economies who don’t receive subsidies. In this way subsidies distort trade and the price level. This contradicts the theory of free trade and the law of comparative advantage (Year 13 topic – it simply means that a country can produce a certain good at a lower opportunity cost than other countries).

**Are difficult to set**

Information is not complete so it is difficult to know at what level to set the subsidy – this can be overcome by giving a subsidy which fills the gap between the equilibrium price and the guaranteed price.

1. **Unintended consequences (In the tax and benefits system):**

**Direct Taxation**

Taxation is required to fund government spending and intervention e.g. NHS but this can distort behaviour by reducing incentives e.g. increasing income tax can discourage people from working, known as the ‘welfare trap’ where they are better off on benefits.

**Indirect Taxation**

A further point concerning taxation is that it re-distributes income. Increasing indirect taxation e.g. VAT, will make the distribution of income less equal – it is a flat rate, so that regardless of your income, everybody pays the same amount.

* Introduction of VAT on domestic fuel and power can help to deal with externalities, but causes problems for poor; VAT is regressive and causes a less equal distribution of income i.e. those on lower incomes pay a greater proportion of their income in tax.
* Benefits are provided to reduce income inequality, but these can distort behaviour e.g. individuals may not seek work energetically and instead settle for unemployment and benefits. People have been known to deliberately do poorly at interviews!
* The Laffer Curve works well for most taxes – as it demonstrates falling revenue is tax is too high. People may also start to smuggle cigarettes from abroad or purchase dangerous counterfeit versions.

Reducing benefits can increase incentives but cause inequality - **A key point is to recognise that there is a contradiction between equality and incentives.**

**4. Excessive Administrative Costs**

Sometimes the administrative costs outweigh the welfare benefit from the correction of market failure e.g. cost of hiring personnel to monitor a regulation, could outweigh the social benefits created.

Government intervention can prove costly to administer and enforce. The estimated social benefits of a particular policy might be largely swamped by the administrative costs of introducing it.