3.8 Limitations to markets

Key Words

Externality	An effect of an economic activity on a third party
Positive externality	Beneficial effect of an economic activity on a third party, also known as external benefit
Negative externality	Harmful effect of an economic activity on a third party, also known as external cost
Indirect Tax	A tax on spending. Often defined as a tax on goods and services.
Subsidy	An amount of money that the government gives directly to firms to encourage production and consumption
Regulation	Rules, directives or government orders to control the way people and organisations behave.
Legislation	Laws to control the way people and organisations behave.
Information provision	The government provides information to encourage people (especially consumers) and organisations to change their behaviour
State Provision	Goods and services provided directly by the government. E.g. Health and education

Government policies to correct positive and negative externalities

The government tries to reduce negative externalities and increase consumption and production of goods with positive externalities. The policies used are:

- Taxation
- Subsidies
- State provision
- Legislation and regulation
- Information provision

Taxation

Governments increase taxes to reduce negative externalities e.g green tax/sugar tax. Taxes increase prices causing consumption to fall. Where there are positive externalities, the government may place low or no tax on the good or service e.g. no VAT on food or medicine

Use and impact:

- Impact of tax will depend on the price elasticity of demand. When demand is very inelastic, the use of taxes is not very effective at reducing quantity demanded e.g. cigarettes

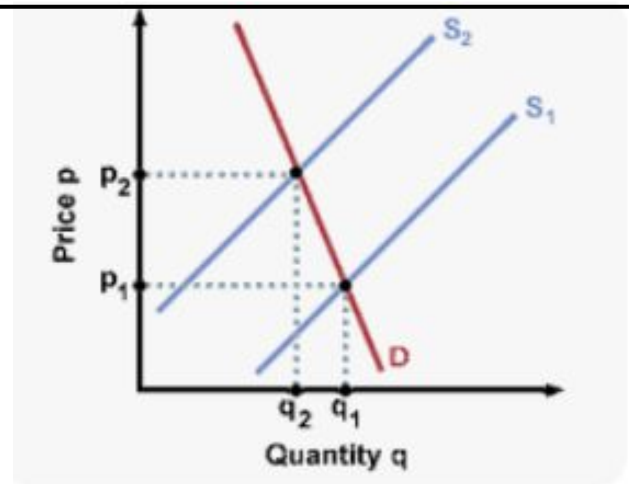
Costs:

- Indirect taxes have a disproportionate impact on those on lower incomes. This conflicts with the government aim to reduce inequality
- Can lead to unofficial “black” markets.e.g. In the UK tobacco market, cigarettes smuggled into the country lose the government tax revenue. In addition policing those markets has an opportunity cost.

Benefits:

- Revenue for government, as demand is inelastic a rise in tax leads to a rise in revenue
- Reduction in quantity traded, depending on PED.

When PED is inelastic, a left shift in supply leads to a small drop in quantity demanded and a large rise in price.



Legislation and Regulation

Use of laws to eliminate or reduce negative externalities. E.g illegal drugs, licenses for pubs/clubs.
Use of laws to encourage positive externalities e.g. compulsory education.

Use and impact:
Making production and consumption illegal can be very effective - such as firearms in the UK. However it does not necessarily mean consumption will fall to zero. Effective policing is also required.
Regulation can change attitudes - banning smoking in public places, quickly became the norm.

Costs:

- Illegal markets
- Money spent on policing markets

Benefit:

- Safer society

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State provision

The government provides some goods that cause positive externalities for the benefit of society as a whole. This includes health and education

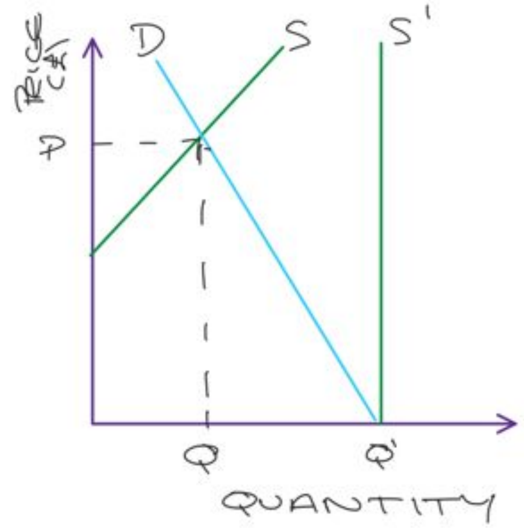
Use and impact:

- If the government provides goods and services at zero cost to the consumer then they may not provide enough to satisfy demand e.g. healthcare - this means that some consumers may not be able to get healthcare when they demand it - long waiting lists.

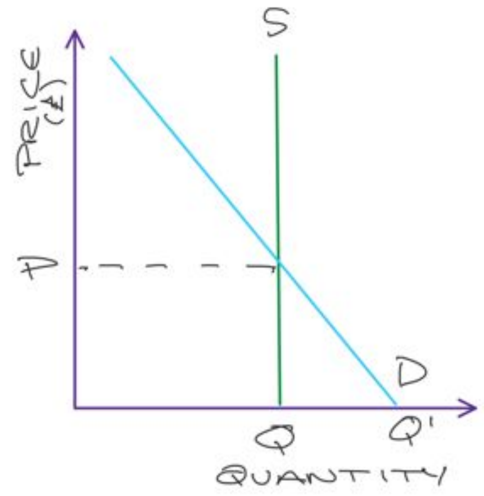
Costs and benefits:

- Pressure is put on the government to increase supply e.g. reduce waiting lists. - each time the government chooses to spend money on one area there is an opportunity cost - the money could be spent elsewhere.
- Demand may rise at a faster rate than supply e.g. ageing population, so demand for operations for knees, hips etc. has increased and waiting times have increased.

The effect of state provision on education:



The effect of state under-provision of healthcare:



Information Provision

Programmes of education and information e.g. smoking being harmful to health. If this is successful demand for goods with negative externalities should fall.

Governments can encourage the use of products with positive externalities through publicity campaigns e.g. 5 a day, use of trains. This aims to change consumer preferences so that demand rises.

Use and impact:

- It can be difficult to judge the effectiveness of these campaigns, however is demand rises after a campaign promoting train use then it can be assumed the campaign had a positive effect.
- The extent to which demand will fall may be affected by the good - particularly when it is addictive such as tobacco. This might have a more significant long term impact.

Costs:

- Can be ineffective, particularly for addictive products.

Benefits:

- Less costly than other methods of discouraging/encouraging consumption.

Subsidies

Governments give subsidies to encourage the production or consumption of goods and services with positive externalities, which may replace the production or consumption of products with negative externalities.

Use and Impact:

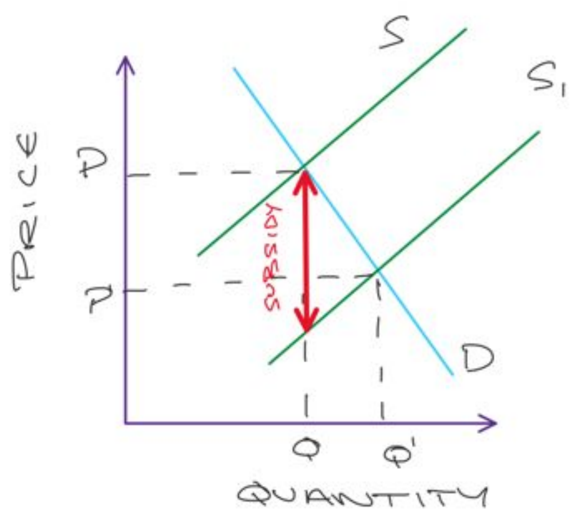
- Subsidies cause the supply to rise, price to fall and quantity bought to rise
- The extent to which the quantity bought rises depends on elasticity of demand. Subsidies will be particularly successful if the good has a price elastic demand and less successful if it is inelastic.

Costs and benefits:

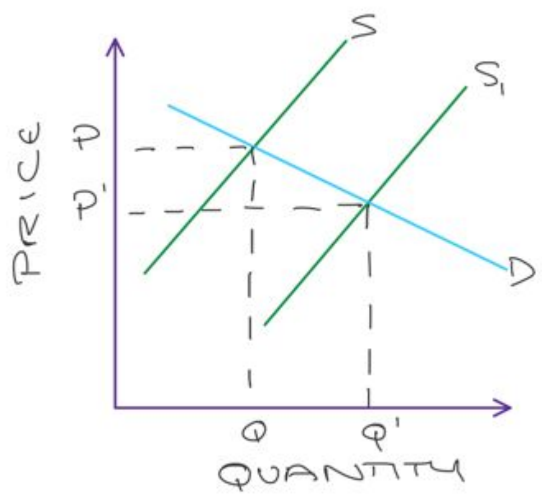
Benefit - increase in consumption of goods with positive externalites

Costs - Opportunity cost, the money could be used elsewhere. Subsidies given to train company operators could be spent on education.

The effect of a subsidy on public transport:



The effect of a subsidy on a product with elastic PED.



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