Edexcel

A Level

Economics

(Code: WEC11 01)

Unit 03-Section 5

Government intervention

Chapter 19 – Government intervention in product markets

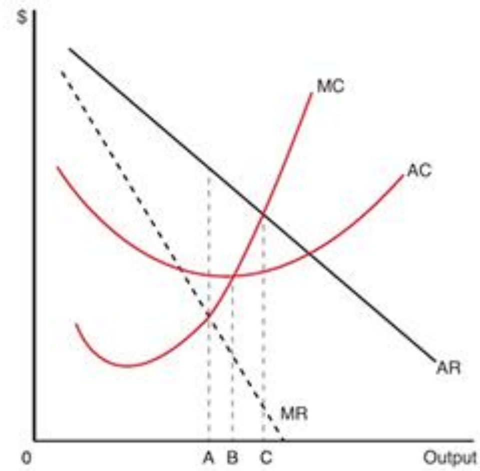
THE CASE FOR GOVERNMENT INTERVENTION

Productive efficiency would be achieved at output OB, where the firm is producing at the bottom of its average cost curve. Allocative efficiency would be achieved at output OC, where price = marginal cost. Profit maximising monopolists earn supernormal profit at the expense of their customers, reducing consumer surplus and gaining some of it as increased producer surplus. Producing below the allocatively efficient level of output also produces a **deadweight welfare loss.**

FIGURE 1

A monopoly

A profit maximising monopolist would produce at output OA. But this is below the productively efficient level of output of OB and the allocatively efficient level of output of OC.



MEASURES TO CONTROL MONOPOLIES AND MERGERS

PRICE REGULATION

Price controls can improve market efficiency by setting the maximum price a monopolist can charge equal to the marginal social cost of production. This ensures allocative efficiency, as shown in Figure 2. Without price controls, monopolists face normal downward-sloping demand and marginal revenue curves.

PROFIT REGULATION

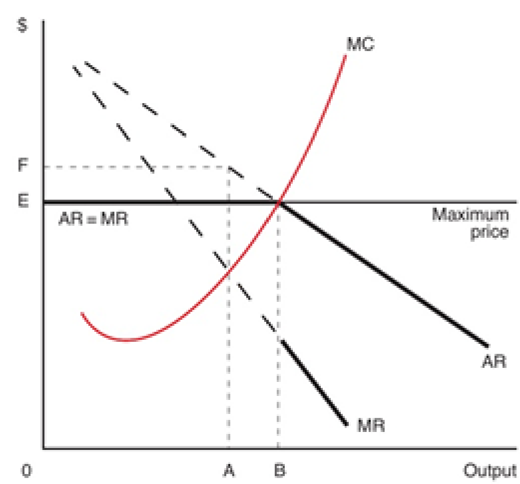
Rate of return regulation has been widely used in the USA to control utility companies such as electricity and water companies. However, there are a number of problems with this approach.

- It requires regulators to have a good understanding of costs and rates of return in the industry. The monopolist has an incentive to predict to regulators that future costs will be higher.
- Monopolists have little incentive to minimise costs. If they are allowed to cover their costs and earn a profit on capital employed, then it doesn't matter to the monopolist whether costs are $100 million or $110 million. The costs will be covered by the customer.
- Monopolists have an incentive to employ too much capital. If they are being awarded a percentage rate of return on capital, the more capital employed, the higher the amount of profit earned.

FIGURE 2

Price controls in a monopoly industry

Fixing a maximum price for a monopolist makes the average and marginal revenue curves horizontal for part of these curves. It results in higher output at OB and a lower price of OE compared to the profit maximising outcomes, of OA and OF respectively.



QUALITY STANDARDS

Monopolists focus on profit and not quality, producing high-quality products to maximize profits. Governments can intervene by setting quality standards, such as ensuring daily delivery to rural areas or preventing power cuts. Monopolists may resist quality standards by suggesting self-regulation or arguing they will provide quality standards in the future. Governments need political will and industry understanding to impose meaningful quality standards on monopolists.

PERFORMANCE TARGETS

Performance targets are government-imposed standards for various outputs, such as prices, product quality, customer choice, or production costs. Monopolists resist these targets, fearing negative publicity and regulatory fines. To increase on-timeness, they may change train timetables, adding five minutes between the last two stations. This can significantly improve the number of trains reported as on-time. However, monopolists may find ways to circumvent these targets.

REFERRAL TO REGULATORY AUTHORITIES

Monopoly laws in many countries allow governments or state authorities to investigate monopolies suspected of exploitation or anticompetitive behavior. If found guilty, the authorities can force changes or fines. Companies may avoid such referrals due to costs and negative publicity, and may also face fines.

LEGISLATION TO CONTROL MERGERS AND TAKEOVERS

Another way of controlling monopolies is to prevent their creation in the first place. All developed countries now have laws and regulations which cover the mergers and takeovers between two or more firms. Competition authorities will investigate large mergers which will significantly reduce competition in the market, and they have the power to prevent the merger from going ahead.

MEASURES TO PROMOTE COMPETITION AND CONTESTABILITY

Governments have a range of policies open to them to promote competition and contestability. Making markets more competitive and more contestable is likely to increase efficiency and make it less likely that consumers will be exploited by higher prices and less choice.

TAX INCENTIVES AND GRANTS TO PROMOTE SMALL BUSINESSES AND FDI

Governments can attempt to increase the number of small businesses in order to increase competition in the market. For example, the government can give training and grants to potential new entrepreneurs. Governments can also encourage the growth of existing small businesses by giving tax incentives or subsidies.

DEREGULATION

Deregulation is the process of removing government controls from markets and is a way of removing monopoly power. It is also, therefore, a way of increasing competition in an industry.

• The government may allow private firms to compete in a market that is currently being

supplied by a state monopoly.

• The government may lift regulations that prevent competition between private firms. For instance, the government may limit the number of premises in a local area that can be used for the sale of pharmaceutical drugs. Deregulation could end this licensing system, so any retailer could sell drugs from its premises.

• Deregulation attempts to improve economic efficiency through the promotion of competition. This, it is argued, will lower costs (leading to greater productive efficiency) while reducing prices and increasing output (increasing allocative efficiency).

PRIVATISATION

Privatisation in itself does not necessarily increase competition in a market.

COMPETITIVE TENDERING FOR PUBLIC SECTOR CONTRACTS

The government has to provide certain goods and services because they are public goods, such as defence, or services which have significant positive externalities in consumption, such as education.

They are produced by private sector firms and sold to the public sector. In theory, a government could contract out provision of all goods and services. It could employ private firms to operate everything from roads to hospitals to the army. Contracting out in itself will not necessarily increase competition in a market. If the government **contracts out** a good or service to the same firm every time, then the firm effectively becomes the monopoly supplier to the government for that good or service.

However, it can introduce competition through **competitive tendering** of contracts. This is where the government draws up a specification for the good or service and invites private sector firms to bid for the contract to deliver it. The firm offering the lowest price, subject to quality guarantees, wins the contract.

TRADE LIBERALISATION

Trade liberalisation involves reducing restrictions on the free exchange of goods and services between nations, including tariffs and non-tariff obstacles. This encourages free trade between counties, allowing efficient foreign firms to export and lower prices, and reducing local monopolies' ability to charge higher prices. This results in more contestable markets and lower prices.

MEASURES TO PROTECT SUPPLIERS AND EMPLOYEES

LOCAL SOURCING OF RAW MATERIALS AND COMPONENTS

Governments can force firms to use a minimum amount of raw materials and components that are sourced locally from domestic manufacturers. This is often when a firm is assembling products to be sold in the domestic market. This prevents the firm from using a large amount of imported raw materials or components in the products and therefore protects domestic firms.

EMPLOYMENT LEGISLATION TO PROTECT WORKERS FROM EXPLOITATION

Employees of firms are at risk of exploitation. However, it has long been recognised that workers need government protection from employers. This can be achieved in a number of different ways.

• Legal protection is extensive under EU law. This includes legislation on health and safety at work, employment contracts, maximum hours at work, redundancy procedures and the right to belong to a trade union. Firms in Europe can be prosecuted for breaking the law.

• Trade unions give their members significant protection from employers. The role of government is to create a legal framework within which trade unions can operate. For example trade unions helped to improve working conditions and wage rates for workers in South Africa.

• Government can encourage firms to draw up codes of conduct relating to employment practices. As with all voluntary codes of conduct, this is the least successful way of attempting to protect employees.

BARRIERS TO ENTRY OF FOREIGN FIRMS

Governments can force foreign firms wanting to enter the domestic market to have a percentage of the firm owned by a local person or business. This can be 51 per cent controlling interest by the local person or business or it can be more or less.

RESTRICTIONS ON THE MONOPSONY POWER OF FIRMS

Some firms have monopsony powers. They are a significant buyer or perhaps the sole buyer of products from a supplier. This means they have considerable market power to reduce the prices they pay to their supplier. To prevent exploitation of suppliers, governments have a number of possible policies.

- They can pass anti-monopsony laws which make certain practices illegal.

- They can appoint an independent regulator which has powers to force monopsonists to change their buying practices through a code of practice, possibly with the threat of large fines.
- They can encourage monopsonists to regulate themselves, drawing up their own code of practice. Self-regulation is by far the least successful of these three options. Monopsonists are likely to draw up a code of practice which allows them to continue to exploit their suppliers. Independent regulators are potentially a far better solution.

NATIONALISATION

It can be argued that private sector monopolies will always damage the interests of their customers because they charge too high prices and produce too little output. **Nationalisation**, taking private assets into state ownership, will solve this problem. A nationalised monopolist will be able to operate for the benefit of customers and not private shareholders. Prices can fall and output can increase. Costs need not rise so long as the government places the right management in charge of the nationalised company.

THE IMPACT OF GOVERNMENT INTERVENTION

Government intervention in product markets is designed to:

- Lower prices for customers
- Reduce supernormal profits of firms achieved by firms taking consumer surplus and turning it into producer surplus
- Increase productive, allocative and dynamic efficiencies
- Increase the quality of the product where quality is an issue
- Increase customer choice both of supplier and of the product.

• They can try to influence the government or specific elected representatives on issues concerning the industry.

• Some regulators are paid for by the firms they are regulating. This makes the regulator particularly at risk of threats from firms. If cases go against them, the firms can threaten to withdraw from the regulatory scheme. The staff at the regulator could then lose their jobs. So they make decisions that favour the firms.

LIMITS TO GOVERNMENT INTERVENTION

Government intervention is often less effective than is intended. There are a number of problems which limit its effectiveness.

REGULATORY CAPTURE

Regulatory capture is a government failure where regulatory agencies prioritize the interests of business or political groups over public interest. This leads to regulators becoming more sympathetic to these groups, leading to generous regulation terms. Examples include financial regulators in America allowing dangerous mortgage lending strategies. In some countries, this may involve bribing regulators, while in others, it's less obvious.

ASYMMETRIC INFORMATION/INFORMATION GAPS

Asymmetric information occurs when a regulator relies on firms' information, leading to biased decisions. Firms release the minimum amount of unfavorable information, resulting in decisions favoring firms. Firms write voluntary codes of conduct to minimize implementation costs, and if government pressures firms, they counter pressure to minimize the impact. This asymmetric information gives firms an advantage in negotiations with the government.

INADEQUATE RESOURCES

Often, insufficient resources are given to the regulators to investigate and control monopolies or promote competition. For example, in the UK, OFGEM (regulator of the whole gas and electricity industry) has 878 staff. This compares to 24,434 staff in British Gas in 2017, and 22,000 in UK National Grid in 2018.

LACK OF REGULATORY POWER

If the regulators have limited powers to enforce punishments or fines then the monopolists will carry on their anti-competitive practices. This is especially true if the monopolies will gain more profit from carrying on with the practices than they would lose by paying the fines. They will take no notice of the regulators and therefore this regulation be ineffective.

SUBJECT VOCABULARY

competitive tendering introducing competition among private sector firms which put in bids for work that has been contracted out by the public sector

contracting out getting private sector firms to produce goods and services which are then provided by the state for its citizens

deadweight welfare loss the overall loss in welfare which arises after a tariff is imposed

deregulation the process of removing government controls from markets

nationalisation the transfer of firms or assets from private sector ownership to state ownership; it is the opposite of privatisation

privatisation the transfer of organisations or assets from state ownership to private sector ownership; it is the opposite of nationalisation

regulatory capture an example of government failure, it occurs when firms in an industry are able to influence to their advantage a regulatory body which is supposed to be regulating their behaviour

Chapter 20 – Government intervention in labour markets

THE CASE FOR GOVERNMENT INTERVENTION IN LABOUR MARKETS

Government intervention in labour markets is crucial as earnings gaps widen over time, raising questions about equity and efficiency. While free market economists argue these trends are due to efficient labor markets, an opposing argument is that inequality reduces economic growth, raising the need for government intervention.

TYPES OF GOVERNMENT INTERVENTION IN LABOUR MARKETS AND THEIR EFFECTS

MAXIMUM WAGE CONTROLS

Most developed countries set **minimum wages.** However, **maximum wages** are relatively uncommon.

• More recently, some economists have suggested setting a maximum wage for chief executives of companies because their pay has been increasing much faster than that of their workers. Typically, this is set at a ratio of chief executive pay to the pay of the lowest wage rate earner in the company.

• Governments can set maximum pay limits for public sector workers in an attempt to keep down public sector spending.

Figure 1 shows the impact of a maximum wage in a competitive market. The market clearing wage rate is W_1. The imposition of a maximum wage of WMax leads to excess demand in the market of Q_1, Q3. This is because OQ_3, is now demanded by employers, while OQ_1, is supplied. In terms of chief executives, it could be argued that fewer workers will want to put themselves forward because the rewards for the job do not match the stress and responsibilities of the job. Equally, chief executives may move abroad to take posts in other countries, reducing supply.

MINIMUM WAGE CONTROLS

Many workers in the world economy work for very low wages. One way that governments can intervene to raise the wage rates of the lowest earning workers is to impose a minimum wage. Employers then have to pay a minimum wage rate per hour or risk legal and financial penalties. Economic theory suggests that minimum wages will benefit some workers but disadvantage others.

The equilibrium wage rate and employment level are OE and OB, respectively. A government imposes a minimum wage of OF, forcing industry wage rates to rise. This results in AC unemployment, with OA workers receiving higher wages but AB workers losing their jobs. Minimum wage legislation can prevent the market from clearing when unemployment increases. In a recession, a minimum wage creates AC unemployment, as demand for labor falls and wage rates fall to OE.

FIGURE 1

Maximum wages

Setting a maximum wage of W_{Max} below the free market wage of W_1 will lead to excess demand for workers. Fewer workers want to work at the lower wage rate while employers want to employ more workers.

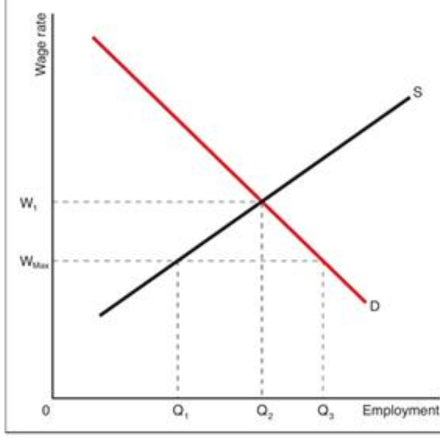


FIGURE 3

Minimum wage legislation

A minimum wage of OF will result in higher wage rates in the industry. However, AB workers will lose their existing jobs while a total of AC unemployment will be created.

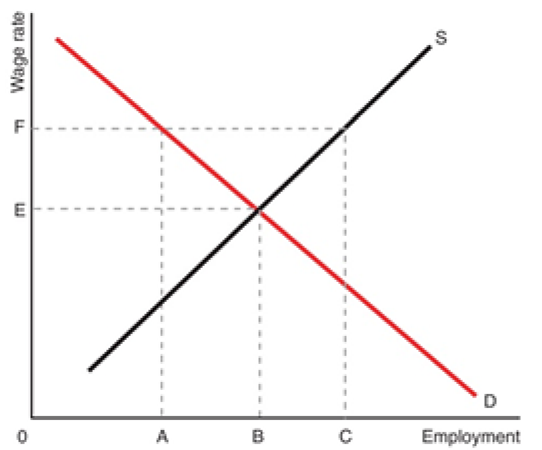
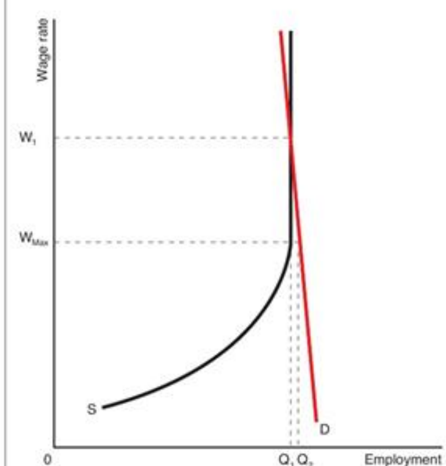


FIGURE 2

Inelastic demand and supply curves with a maximum wage

The free market wage rate is W_1 with OQ_1 being demanded and supplied. Setting a maximum wage rate of W_{Max} leads to OQ_2 equilibrium employment, barely changing the free market equilibrium employment level.



So it is argued that minimum wage legislation can cause unemployment.

The extent to which minimum wages lead to a rise in unemployment depends on three factors.

- The difference between new rights and existing free market rights is significant. A minimum wage of $12 per hour with market clearing rates of $8.25 per hour will not raise wages or create unemployment. A minimum wage of $18 with market clearing rates of $6 per hour will provide substantial benefits.
- Second, the amount of unemployment created depends on the relative elasticities of demand and supply for labour. Consider Figure 5 and compare it with Figure 3. Both diagrams relate to the introduction of a minimum wage. The market clearing wage is OE and the minimum wage set is OF. Unemployment of AC is created by the introduction of the minimum wage. In Figure 3, the demand and supply curves are relatively elastic between OE and OF.

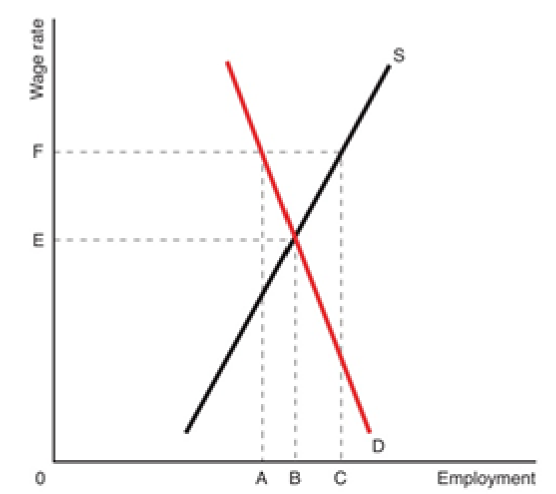
- Third, what is true for a single industry might not be true for the economy as a whole. For instance, minimum wage legislation in the restaurant industry might result in unemployment amongst waiters.

In the whole economy, minimum wages are more likely to be paid to:

- temporary workers rather than those on permanent contracts
- workers who have been in their post for less than 12 months rather than those who have been with the same employer for more than 12 months
- private sector workers than public sector workers workers employed by very small (micro) firms rather than larger firms
- workers in occupations which have low average earnings
- workers in industries where workers on average have low earnings.

FIGURE 5

Inelastic demand and supply curves for labour
The more inelastic the demand and supply curves for labour, the less unemployment is created when minimum wages are introduced.



Direct taxes

Direct taxes are collected from the person or business paying them, rather than goods or services. Examples include income tax, corporation tax, and social security tax in the US. These taxes are generally considered progressive and raise revenue for the government without harming the firm. However, higher direct taxes can lead to reduced investment, lower employment, or relocation to lower-tax countries. In the UK, National Insurance contributions are a direct tax on employing labor, providing benefits like unemployment, sickness, and pensions. In countries like the UAE, Sri Lanka, and China, these taxes are known as social security contributions or Employees' Provident Fund payments.

MEASURES TO REDUCE GEOGRAPHICAL AND OCCUPATIONAL IMMOBILITY OF LABOUR

Labour market immobility occurs when workers are not flexible enough to move from job to job according to the needs of the market. This should be distinguished from geographical immobility, which refers to factors that prevent people moving from one area to another to find work. As a result of labour market immobility, workers might find themselves:

- unemployed when employers are reporting a shortage of workers
- in temporary employment or self-employment when they would prefer to be in full-time employment with an employer
- in a job which fails to use their skills and talents. Governments can employ a variety of policies to improve labour market flexibility and reduce immobility.

These could include:

improving education and training to increase the functional flexibility of workers, allowing them to move more easily from one type of job to another

- providing specific training for workers to target skills shortages in the economy
- providing subsidies to workers who have to move house to get a job
- providing help with housing for workers who get jobs outside their local area

- increasing knowledge of job opportunities, for example by operating job centres
- subsidising employers who take on unemployed individuals from groups in the labour market who have above average unemployment rates, such as young workers or those with disabilities
- helping workers with job applications, for example by giving them training or paying travel costs for

interviews

- reforming the tax and benefits system or increasing the minimum wage to increase the ratio of take home pay in a job to the benefits received from being unemployed
- reducing discrimination in the labour market which reduces the ability of certain groups, such as women, those from ethnic minorities or those with disabilities to gain a job.

MEASURES TO REDUCE DISCRIMINATION AND EXPLOITATION

Discrimination in the labour market occurs when employers intentionally undervalue one group without considering their productive ability. This can be based on race, ethnicity, gender, or age. EU governments have passed laws to combat discrimination, but enforcement is crucial. Workers can also be exploited by low wages or poor working conditions. Minimum wages help prevent exploitation, but migrant workers are particularly vulnerable. International cooperation is needed to stop exploitation, as it often starts in the home country of the workers being recruited. International organizations investigate and highlight illegal practices, informing governments to stop them.

SUBJECT VOCABULARY

discrimination occurs in the labour market when there is an information failure leading employers to appreciate one group in society and deliberately undervalue another group

maximum wage a legal maximum wage rate per hour or total pay; employers cannot pay a higher amount than this to their workers

minimum wage a legal minimum wage rate per hour which employers must pay their workers