Government Intervention

AQA A-Level Economics

Taxes · Subsidies · Price Controls · Buffer Stocks · Regulation · Competition Policy · Government Failure

Why Do Governments Intervene?

Governments intervene in markets to correct market failure and to achieve social and economic objectives:

Correct Externalities

Tax activities with external costs and subsidise those with external benefits, moving output towards Q*.

e.g. Fuel duty, landfill tax, subsidies for heat pumps.

Provide Public Goods

The free market fails to provide non-rival, non-excludable goods due to the free-rider problem.

e.g. Defence, street lighting, flood defences.

Merit & Demerit Goods

Encourage consumption of merit goods and discourage demerit goods, where information failure exists.

e.g. Free NHS care; high tobacco and alcohol duties.

Control Monopoly Power

Prevent firms abusing market power through high prices, low output or anti-competitive behaviour.

e.g. The CMA blocks harmful mergers; Ofgem caps energy prices.

Reduce Inequality

Redistribute income through progressive taxes, benefits and minimum wages.

e.g. Universal Credit; the National Living Wage.

Stabilise Prices & Incomes

Reduce volatile prices in markets such as agriculture, protecting producers' incomes and consumers.

e.g. Buffer stock schemes; guaranteed minimum prices for farmers.

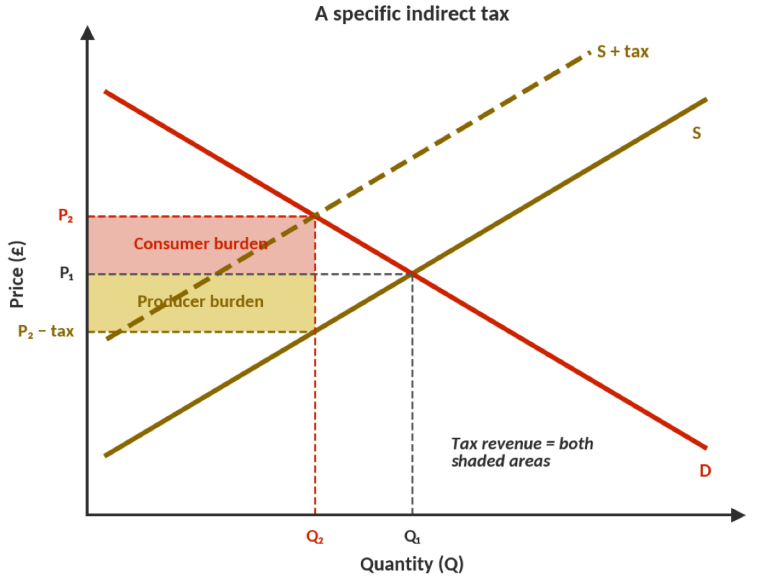
Indirect Taxes

Definition:
A tax on spending on goods and services, collected from producers. It raises costs, shifting the supply curve left (upwards) by the amount of the tax.

Two types:
Specific (unit) tax: a fixed amount per unit — e.g. fuel duty per litre (parallel shift). Ad valorem tax: a percentage of the price — e.g. VAT at 20% (the curves diverge).

Incidence of the tax:
Consumers pay the rise in price ($P_1 \rightarrow P_2$); producers bear the rest. The more price inelastic demand is, the more of the tax falls on consumers.

Evaluation:
Raises revenue and can correct negative externalities. ✗ Regressive — takes a larger share of poorer people's income. ✗ Little effect if demand is inelastic. ✗ May encourage smuggling.



Real-World Example

VAT is the UK's third-largest tax, raising around £170bn a year at a standard rate of 20% — with reduced or zero rates on essentials such as food and children's clothes.

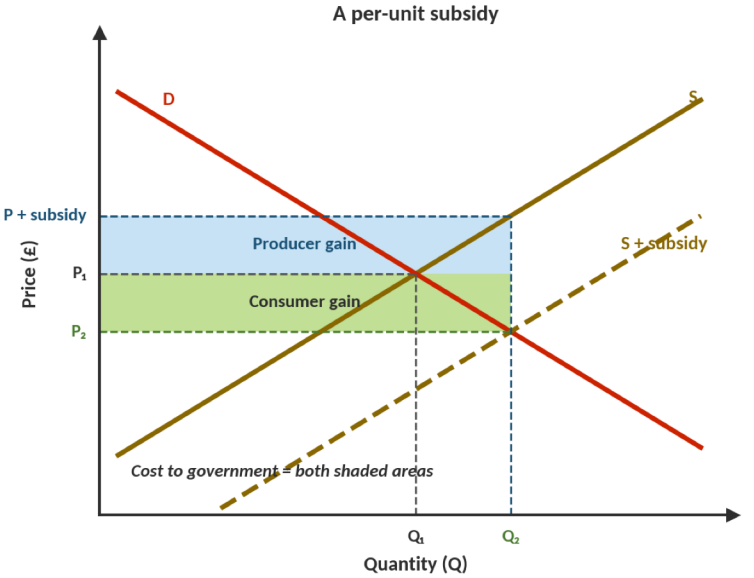
Subsidies

Definition:
A payment from the government to producers to reduce their costs, shifting the supply curve right (downwards) by the amount of the subsidy.

Effects:
Price falls ($P_1 \rightarrow P_2$) and output rises ($Q_1 \rightarrow Q_2$). Consumers gain from lower prices; producers gain from a higher price received per unit (P + subsidy).

Why subsidise?
Increase consumption of merit goods and goods with positive externalities; keep prices low for essentials; support strategic industries and jobs; encourage exports.

Evaluation:
Increases output of beneficial goods. ✗ Opportunity cost — funded by taxes or borrowing. ✗ Firms may become inefficient and dependent. ✗ Hard to remove once in place.



Real-World Example

Bus fares in England were capped at £2 a single from 2023, with the government subsidising operators. The cap rose to £3 in 2025 as the cost of the scheme grew.

Maximum Prices (Price Ceilings)

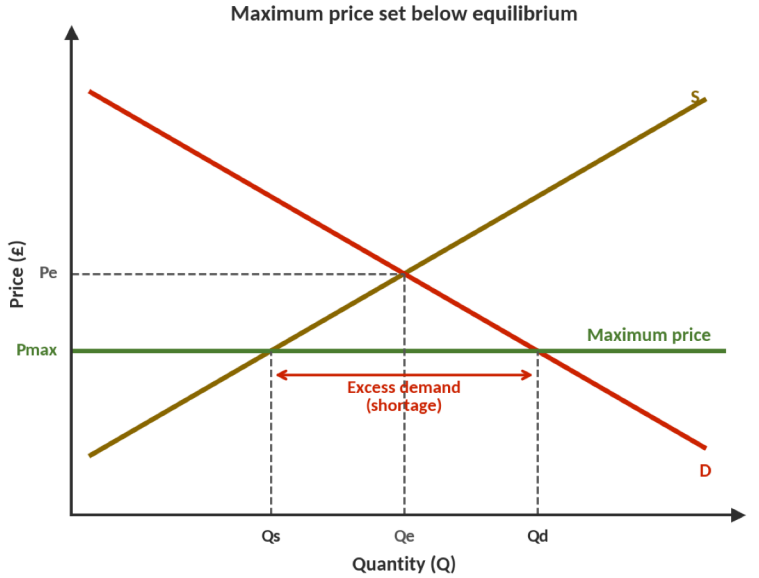
Definition:
A legal upper limit on the price of a good, set below the equilibrium price to make it more affordable.

Effects:
At Pmax, quantity demanded (Qd) exceeds quantity supplied (Qs) — a shortage. Fewer units are sold than at equilibrium (Qs < Qe).

Problems:
Rationing is needed — queues, waiting lists, or first come first served. Black markets develop where goods are resold at higher prices. Producers may cut quality.

Examples:
Rent controls; energy price caps; food price controls in wartime or developing economies.

Eval: helps consumers who can buy the good — but some consumers get nothing at all.



Real-World Example

Scotland froze most private rents in 2022, then capped rises at 3%. Landlords reported reducing supply, and rents on new lets rose sharply — a classic ceiling effect.

Minimum Prices (Price Floors)

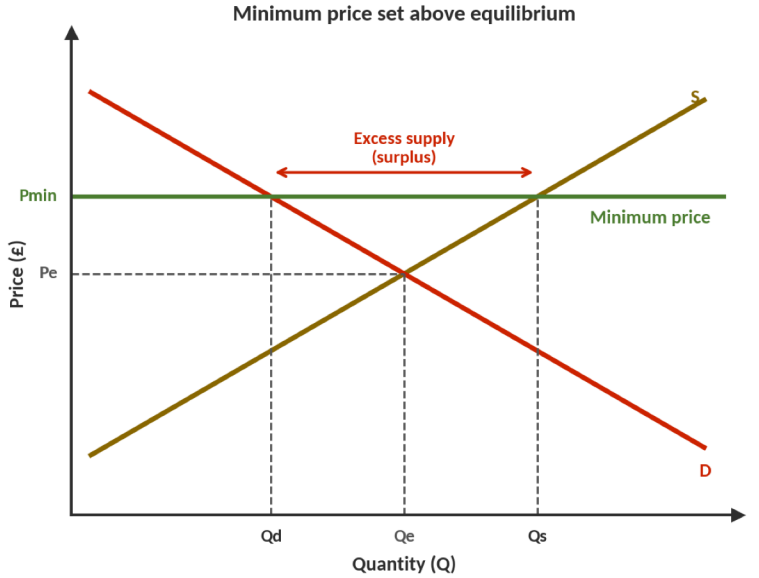
Definition:
A legal lower limit on the price of a good, set above the equilibrium price — usually to protect producers' incomes or discourage consumption.

Effects:
At Pmin, quantity supplied (Qs) exceeds quantity demanded (Qd) — a surplus. Consumers pay more and buy less.

Dealing with the surplus:
The government may buy up the surplus and store or destroy it — which is costly. Or it may be exported cheaply ('dumped'), harming farmers in other countries.

Examples:
Guaranteed prices for farmers; alcohol minimum unit pricing; the National Minimum Wage (a floor in the labour market).

Eval: protects producers' incomes — but causes inefficiency and higher consumer prices.



Real-World Example

The EU's Common Agricultural Policy guaranteed high minimum prices in the 1970s–80s, creating huge surpluses — 'butter mountains' and 'wine lakes'.

Buffer Stock Schemes

Purpose:
To stabilise the prices of commodities (e.g. cocoa, coffee, wheat) whose supply varies with the weather — protecting producers' incomes and consumers from volatile prices.

How they work:
An agency sets a target price band. In good harvests, when prices fall towards the floor, it buys up surplus stock. In bad harvests, when prices rise towards the ceiling, it sells from its stock.

Evaluation:
Stabilises incomes and prices, encouraging investment. ✗ Storage costs are high and some goods are perishable. ✗ If the floor is set too high, stocks build up and the agency runs out of money. ✗ Can encourage overproduction.

Good Harvest

Supply rises → prices fall → agency buys surplus, keeping price above the floor.

Poor Harvest

Supply falls → prices rise → agency sells stock, keeping price below the ceiling.

Real-World Example

The International Tin Council ran a buffer stock scheme until 1985, when it ran out of funds trying to support the tin price — the scheme collapsed and tin prices crashed.

Regulation & Competition Policy

Competition policy aims to protect consumers by promoting competition and controlling market power:

Merger Control

The CMA can investigate and block mergers that would substantially lessen competition.

e.g. The CMA blocked the Sainsbury's–Asda merger in 2019.

Cartels & Collusion

Price-fixing and market-sharing agreements are illegal under the Competition Act 1998.

Eval: collusion is hard to detect — leniency schemes reward whistleblowers.

Abuse of Dominance

Firms with market power must not use predatory pricing or exclude rivals unfairly.

e.g. Fines of up to 10% of global turnover.

Price Regulation (RPI – X)

Regulators cap price rises of privatised utilities below inflation, forcing efficiency gains.

Eval: X must be set carefully — too high cuts investment, too low allows excess profit.

Performance Targets

Regulators set quality standards — e.g. punctuality, leakage, customer service — with fines for failure.

e.g. Ofwat fines water firms that miss leakage and pollution targets.

Market Investigations

The CMA studies whole markets where competition seems weak, and can impose remedies.

e.g. Reviews of road fuel, vets and groceries after price rises.

Privatisation, Nationalisation & Deregulation

Ownership and control:
Governments can change who owns an industry, or how tightly it is regulated.

The UK privatised most state-owned industries in the 1980s–90s — some are now returning to state control

Three approaches:

Privatisation

Selling state-owned firms to the private sector. Aims: greater efficiency through the profit motive, competition, lower costs and revenue for the government.

e.g. BT (1984), British Gas (1986), water (1989), rail (1990s). Critics point to high prices, underinvestment and large dividends.

Nationalisation

Taking private firms into state ownership. Aims: protect essential services, invest for the long term and put the public interest before profit.

e.g. Rail franchises are returning to public ownership under Great British Railways from 2025.

Deregulation

Removing rules and barriers to entry, to increase competition and reduce costs.

e.g. Bus deregulation (1986) and the opening of the energy supply market. Risk: weak rules can harm quality and safety.

Government Failure

Government failure occurs when intervention leads to a net welfare loss — making the allocation of resources worse:

Inadequate Information

Governments cannot measure external costs, public good demand or the right tax rate accurately.

e.g. Setting carbon permit caps too high made the early EU ETS ineffective.

Unintended Consequences

Policies change behaviour in unexpected ways — black markets, smuggling or tax avoidance.

e.g. High tobacco duties have encouraged illegal cigarette sales.

Distortion of Price Signals

Taxes, subsidies and price controls stop prices reflecting scarcity, misallocating resources.

e.g. The CAP's guaranteed prices caused massive food surpluses.

Administrative Costs

Running, monitoring and enforcing policies can cost more than the benefits they bring.

e.g. Complex benefit systems are costly to administer and hard to navigate.

Political Short-Termism

Politicians may favour policies that win votes before elections rather than long-term solutions.

e.g. Fuel duty frozen since 2011 despite its environmental costs.

Regulatory Capture

Regulators come to act in the interests of the firms they regulate, not consumers.

e.g. Criticism of Ofwat over sewage spills and water company debt.

★ Bonus: Public Choice Theory & Regulatory Capture

Public choice theory:
Economists such as James Buchanan argued that politicians and officials are self-interested, like everyone else. They act to win votes, gain power or expand budgets — not always in the public interest.

Implications:
Interest groups with a lot at stake (e.g. an industry lobby) have more influence than the general public, whose costs are spread thinly. Policy may favour them.

Regulatory capture:
Over time, regulators rely on industry for information and staff, and may come to share its views — weakening regulation.

Evaluation:
Explains why well-meant intervention can fail. ✗ Many officials are motivated by public service, and transparency can limit capture.

The Revolving Door

Staff move between regulators and the firms they regulate — creating close ties and possible conflicts of interest.

Solutions

Independent regulators, transparency, fixed-term appointments and strong parliamentary scrutiny.

Real-World Example

In 2025, after years of criticism over sewage spills, bills and debt, the government announced that Ofwat would be abolished and replaced by a new single water regulator.

Summary: Key Terms & Relationships

Key Term	Meaning
Indirect tax	A tax on spending, collected from producers. Specific (per unit) or ad valorem (%).
Tax incidence	How the tax burden is shared between consumers and producers — depends on PED and PES.
Subsidy	A government payment to producers that lowers costs and shifts supply right.
Maximum price	A legal price ceiling below equilibrium → shortages, rationing, black markets.
Minimum price	A legal price floor above equilibrium → surpluses that may need to be bought up.
Buffer stock scheme	Buying in good harvests and selling in bad ones to stabilise commodity prices.
Competition policy	Rules and bodies (CMA) that promote competition and control market power.
RPI − X	Price cap regulation: prices can rise by inflation minus an efficiency factor X.
Privatisation	Transferring state-owned firms to the private sector.
Nationalisation	Taking private firms into state ownership.
Deregulation	Removing rules and barriers to entry to increase competition.
Government failure	Intervention that leads to a net welfare loss — a worse allocation of resources.
Regulatory capture	Regulators act in the interests of the firms they regulate, not consumers.