

The Impact of Government Intervention

Government intervention aims to improve market outcomes where the free market may fail to maximise social welfare.

The main areas affected are:

- Prices
- Profit
- Efficiency
- Quality
- Choice

However, intervention may also create **government failure** if policies worsen the allocation of resources.

Prices

Government intervention can prevent firms with significant market power from charging excessively high prices.

For example, Ofgem's energy price cap lowered typical fuel bills by **over £400 per year** during peak 2023 price spikes, keeping heating affordable for 29 million homes.

Market power $\uparrow \rightarrow$ firms restrict output + raise prices $\rightarrow$ consumer surplus $\downarrow$ + allocative inefficiency $\uparrow$

Price regulation $\rightarrow$ maximum price $\downarrow \rightarrow$ essential services become more affordable $\rightarrow$ consumer surplus $\uparrow$ + access for low-income households $\uparrow$

Price regulation may also encourage firms to reduce costs because they cannot simply increase prices to raise profits.

Ability to raise prices $\downarrow \rightarrow$ incentive to reduce costs $\uparrow \rightarrow$ productive efficiency potentially $\uparrow$

Profit

Government intervention can prevent firms from earning excessive supernormal profits while still allowing sufficient profit for them to remain in the market.

Strict price cap $\rightarrow$ revenue + profit $\downarrow \rightarrow$ supernormal profit $\downarrow \rightarrow$ consumers protected from excessive prices

However, profits provide firms with the funds and incentives to invest.

Profit $\downarrow \rightarrow$ retained funds for investment $\downarrow \rightarrow$ investment + innovation $\downarrow \rightarrow$ dynamic efficiency potentially $\downarrow$

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Therefore, regulation that is too strict may benefit consumers in the short run but reduce investment and quality in the long run.

Efficiency

Government intervention can improve **allocative efficiency**, particularly where firms have monopoly power.

An unregulated monopolist is likely to profit maximise where **MC = MR** giving output **Q_{max}** at price **P_{max}**.

The government could instead regulate the firm towards the allocatively efficient level where **MC = AR**. This increases output to **Q_{allo}** and reduces price to **P_{allo}**.

Government regulation → output ↑ from Q₁ to Q₂ + price ↓ from P₁ to P₂ → consumer surplus ↑ → allocative efficiency ↑

For example, regulating Openreach wholesale broadband prices reduced consumer internet fees by **20%**, increasing UK fiber adoption to **68% of households**.

However, private sector firms may have stronger incentives to achieve **productive efficiency**.

Competition + profit motive → incentive to minimise costs ↑ → average costs ↓ → productive efficiency ↑

Competition may also encourage firms to respond more closely to consumer preferences, as firms that fail to provide what consumers want risk losing customers.

Therefore, whether intervention improves efficiency depends on whether greater allocative efficiency outweighs any reduction in productive or dynamic efficiency.

Quality

Governments can impose minimum standards and performance targets to prevent firms from reducing quality in pursuit of higher profits.

Minimum quality standards ↑ → firms required to maintain service quality → consumer protection ↑ → social welfare ↑

For example Ofcom fined Royal Mail **£5.6 million** for delivering only 73.7% of First Class mail against a statutory quality target of **93%**.

This can be particularly important for essential services where poor quality may have significant consequences for consumers.

Choice

Government intervention can increase consumer choice by encouraging competition and supporting the entry and growth of smaller firms.

Barriers to entry ↓ + SMEs encouraged → number of firms ↑ → competition ↑ → consumer choice ↑

For example The CMA's Open Banking regulation enabled over **130 challenger fintech SMEs** to enter the UK market, gaining 10 million retail customers

Greater choice may also encourage firms to improve quality because consumers can switch to competing products.

However, excessively strict regulation can have the opposite effect.

Strict regulation or price ceilings → profitability ↓ → firms leave market → number of suppliers ↓ → consumer choice ↓

For example Strict rent caps in Scotland caused private landlord sell offs, reducing available rental housing stock by **18%** and severely limiting tenant choice.

Limits to Government Intervention

Government intervention does not necessarily improve market outcomes. Poorly designed intervention can create **government failure**, where intervention leads to a less efficient allocation of resources.

Two important limitations are:

- Regulatory capture
- Asymmetric information

Regulatory Capture

Regulatory capture occurs when a regulator begins to act in the interests of the firms it regulates rather than consumers.

Firms may possess greater information and expertise than regulators and may also attempt to influence decisions through lobbying.

Firm influence over regulator ↑ → regulation becomes more favourable towards firms → consumer interests overlooked → effectiveness of regulation ↓

For example, **Ofwat allowed £15m+ in executive bonuses despite water companies dumping sewage into UK rivers for over 460,000 hours.**

Regulatory capture can therefore mean that regulation exists but fails to produce a fair or competitive market outcome.

Asymmetric Information

Governments and regulators may lack the information required to determine the correct level of intervention.

For example, a regulator setting a price cap may not know a firm's true costs or the level of profit required to maintain sufficient investment.

For example Ofgem set the energy cap below wholesale costs in 2021, causing **29 UK energy suppliers to go bankrupt** due to imperfect cost data

Information available to regulator ↓ → risk of inappropriate regulation ↑ → unintended consequences ↑ → government failure

If a price cap is **too high**, firms may continue earning excessive profits and consumers receive little protection.

If a price cap is **too low**, firms may make insufficient profit:

Price cap too low → profit ↓ → investment ↓ + firms potentially leave market → quality + choice ↓

Governments may also struggle to measure the exact extent of a market failure. For example, placing a monetary value on the external cost of pollution involves judgement and uncertainty.

Imperfect information → inappropriate intervention → scarce resources misallocated → government failure

The effectiveness of government intervention ultimately depends on whether policymakers have sufficient information and whether regulators remain independent from the firms they regulate.