

Government Failure

Government failure happens when government intervention in a market leads to a net welfare loss. Put simply, when government intervention makes the allocation of resources even worse than before.

Causes of Government Failure

Distortion of Price Mechanism

Government intervention can distort price signals, which weakens the price mechanism. When prices cannot adjust freely, markets may not clear and shortages or surpluses can appear.

This can lead to:

- Surpluses from minimum prices
- Shortages from maximum prices

Maximum Prices

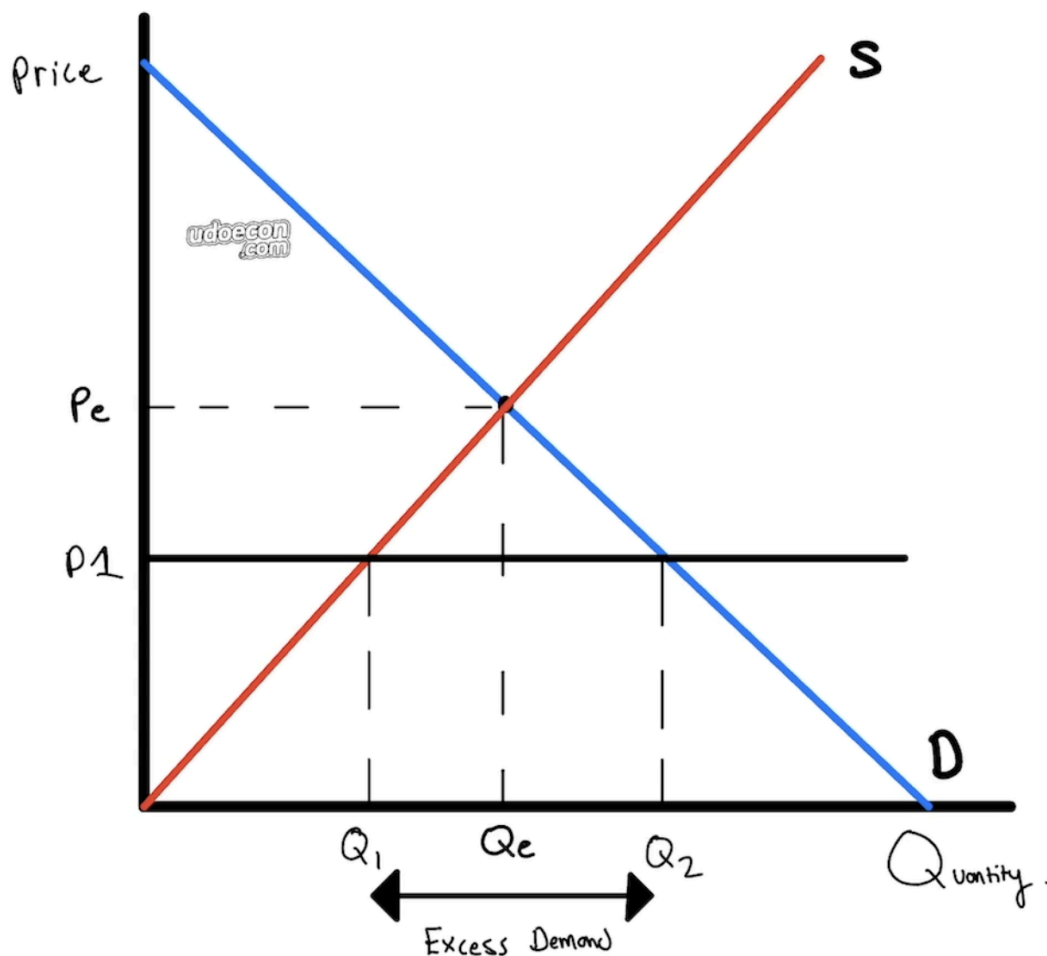
An example is a maximum price for **petrol** (a fuel price cap).

A maximum price **P1** is set **below** the free market equilibrium price **Pe** in the diagram.

At **P1**, firms are less willing/able to supply, so quantity supplied falls to **Q1**, while consumers want more at the lower price, so quantity demanded rises to **Q2**. This creates **excess demand (a shortage) of $Q2 - Q1$** , as shown on the diagram.

In this case, “excess demand” could mean **queues at petrol stations**, rationing per customer, and some consumers being unable to buy fuel even though they’re willing to pay **P1**. Without the maximum price, the **price mechanism** would push prices up toward **Pe**, which would **reduce quantity demanded** and **increase quantity supplied**, helping the market move back toward **Qe**. However, the maximum price prevents the price mechanism

from functioning to clear the shortage.



Minimum Prices

If a minimum price is set above the equilibrium price, supply becomes greater than demand. This creates excess supply because the price cannot fall to remove the surplus.

For example, agricultural minimum prices can lead to wasted food when surplus output cannot be sold - as seen in the **EU's Common Agricultural Policy (CAP)** "**wine lakes and butter mountains**"

Unintended Consequences

Examples

The British government in colonial Delhi wanted to **reduce dangerous cobras**, so they **paid** people for every dead snake handed in.

Instead of reducing numbers, locals started **breeding cobras** to earn **money**.

When the bounty was **cancelled**, breeders **released the snakes**, leaving the city with more cobras than before

Unintended Effects of Maximum Prices and Subsidies

Rent Controls

Rent controls (maximum price on rent) can reduce landlords' incentives to maintain properties. This means the landlord's incentive to maintain and improve properties falls, leading to falling quality e.g damp/mould. As a result, although the policy is meant to improve access to housing, it can **worsen quality and reduce availability** therefore meaning the government has intervened in the market and made the allocation of resources worse than before thus representing govt failure.

Administrative Costs

These administrative costs can be large and get out of control thus meaning they can exceed the benefit of government intervention thus leading to government failure.

Example: UK Dog Licence (Scrapped 1987)

For over a century, dog owners in Great Britain had to buy a dog licence.

The aim: raise revenue

The problem: by the 1980s, the fee was still stuck at **37p**

Why it backfired: issuing each licence cost the govt around **£4** in admin (processing, paper, postage), but it only brought in **37p**.

That meant the government was **losing around £3.60 per licence**. So a tax which was meant to raise revenue became a policy that **burnt money**.

Information Gaps

Governments do not have perfect information when setting policy. This makes it difficult to choose the correct level of tax, subsidy, or regulation.

This may cause:

- Taxes set too high or too low
- Subsidies misjudged
- Regulation too strict or too weak

Some Extra Real World Examples

UK Energy Market

Ofgem raised the price cap by 53%. Some pensioners used buses to stay warm due to higher heating costs.

British Gas made £948m profit during this period.

NHS IT Programme

Over £10bn was spent on the programme. It was eventually abandoned and did not work properly.