

6 Revisiting market failure and government intervention in markets

Case studies

Case study 6.1

- 1 Fuel taxes should be a significant part of government policy to reduce the environmental pollution caused by vehicles burning fossil fuels, but other policies could be more significant. The problem with fuel taxes is that the demand for petrol and diesel fuel is highly price inelastic. Taxes would have to be raised to levels that might be politically impossible to impose to have any significant effect. Better policies might be regulations that require the sale by car manufacturers solely of cars which incorporate the latest environment-friendly technology — for example, electric hybrid cars — together with government encouragement of R&D in hydrogen-powered car technology.
- 2 The answer lies in the fact that road pricing is politically unpopular and that many in the general public believe that motorists have a right to drive on roads without being charged for doing so. Motorists believe that existing levels of motor taxation are already too high, and they ignore the fact that the real cost of motoring has been falling in recent years.

Case study 6.2

- 1 I believe that Lord Stern is right. Most of the greenhouse gases in the atmosphere are there because 200 years or more of industrialisation in developed countries led to the emission of these gases. The industrialisation now taking place in emerging economies such as China is responsible for the current rate of increase in greenhouse gas emissions, but it is not responsible for the previous build-up in the stock of these gases in the atmosphere.

Case study 6.3

- 1 A credit crunch is a situation in which loans are hard or impossible to get. The credit crunch which sparked the worldwide recession that began in 2008 started a year earlier in the USA, in August 2007. It then quickly spread to paralyse the financial systems of many other countries including the United Kingdom. Virtually all firms, large and small, require a reliable supply of credit or bank lending in order to remain in business. In ‘normal’ circumstances, the banking system provides this liquidity, which businesses, consumers and governments usually take for granted. Historically, the source of this liquidity stemmed from banks borrowing household savings, which they then lent on for others to spend.

However, by 2007 banks throughout the world, but particularly in the USA, were raising the funds they lent to customers by borrowing from each other rather than from households. The funds were borrowed on the inter-bank market. In the USA, much of the borrowed funds were lent in the form of mortgages to low-income customers who were bad credit risks. These loans became known as subprime mortgages (in contrast to prime mortgages, which are secured loans granted to low-risk home owners). From a bank’s point of view, a mortgage granted to a customer is an asset. For the borrower, it is a liability, since the house owner must eventually pay back the loan and pay interest in the intervening months and years. By definition, a subprime mortgage is a risky asset since there is a danger of the loan turning into a bad debt that the bank owning the loan cannot recover. In 2007, the credit crunch developed because the banks that had created subprime mortgages repackaged the risky assets and sold them on to other banks as if they were prime mortgages. In essence,

banks were buying ‘toxic debt’ from each other, without understanding that the repackaged assets were extremely risky. As banks realised that many of their so-called ‘assets’ were more or less worthless, the situation quickly deteriorated and the supply of liquidity began to freeze. Banks became unwilling to lend to each other because they distrusted each other’s creditworthiness. At the next stage, the credit crunch triggered a financial meltdown when banks either collapsed (Lehman Brothers in the USA) or were partly or completely nationalised by governments (Royal Bank of Scotland in the UK).

- 2 In the UK, the Enterprise Act of 2002 was meant to ensure that the government was largely removed from the merger control process. The Act introduced the idea that mergers should be prevented if there would be a substantial lessening of competition because rivals had joined forces. The merger in 2008 between Lloyds TSB and HBOS was certainly uncompetitive, so seemingly it should have been prevented.
- 3 The UK government still has the power to intervene in mergers that raise public-interest considerations. It used this power in 2008 by refusing to let the banking merger be referred to the competition authorities on the ground that allowing a merger that would reduce competition could be justified because it was necessary to counter systemic risk in the financial system. I believe that the Labour government in power at the time was probably right. In later years, after the end of the recession, competition in the banking industry was increased by requiring Lloyds to sell off the TSB. HBOS still exists, in the form of a wholly-owned subsidiary of Lloyds, functioning as a holding company for Bank of Scotland plc, which operates the Bank of Scotland and Halifax brands in the UK.

Case study 6.4

- 1 In 2009 National Express, which had been awarded the franchise to run the east coast mainline service from London King’s Cross to Scotland, defaulted on its contract just two years into a decade-long deal after it said it could not afford franchise payments. The Labour government in power at the time nationalised the company in order to make good a £1.4 billion hole in the rail budget. In 2015 the Conservative government reprivatised the east coast line when it sold the company to a joint venture involving Virgin and Stagecoach, which took control of train services that had been run by a public sector company, Directly Operated Railways, for more than five years.
- 2 I believe that the east coast railway service should still be part of the public sector. In its five years as East Coast, the state-run firm returned a little more than £1 billion in premiums, as well as several million in profits, to the Treasury. Detailed financial analysis from the Office of Rail Regulation shows it paid in more than it received in subsidy or indirect grants in the last two years of its existence. The TUC general secretary, Frances O’Grady, said the privatisation decision was a ‘costly mistake’. She said: ‘By taking the East Coast out of public ownership the government is passing the profits to Stagecoach and Virgin shareholders, instead of using the cash to reduce rail fares and improve services for passengers.’ I agree with this analysis.

Case study 6.5

- 1 An institutional investor is a financial services organisation such as a pension fund or an insurance company which invests pension contributions (in the case of a pension fund) or life insurance premiums (in the case of an insurance company) to build up a portfolio of financial assets which in future years will deliver the income needed to pay contributors’ pensions or insurance payouts.
- 2 £585 million of extra revenue reduces the size of the government’s budget deficit and borrowing requirement, but it is still small beer in comparison to the total sizes of the deficit and borrowing requirement. In December 2015, the Office of Budget Responsibility (OBR)

estimated that the *flow* of borrowing for the whole of the financial year 2015/16 would be £68.9 billion, which would cause the *stock* of the national debt to grow. The ONS said total public sector debt had risen to £1,536.4 billion, equivalent to 80.5% of the UK's annual economic output.

Test yourself

Test yourself 6.1

At the free-market equilibrium level of output of product W, the marginal social benefit (*MSB*) enjoyed by the whole community (£500) is less than the marginal social cost (*MSC*) incurred by the whole community (£580). There is therefore a case for reducing the level of output to a level below the free-market level, until $MSB = MSC$.

At the free-market equilibrium level of output of product Z, the marginal social benefit (*MSB*) enjoyed by the whole community (£220) exceeds the marginal social cost incurred by the whole community (£200). There is therefore a case for increasing the level of output to a level above the free-market level, until $MSB = MSC$.

Questions

- 1 Market failures resulting from inefficiency occur whenever the operation of markets leads to allocative inefficiency, for example when $P < MSB$ in the case of merit goods and positive externalities, and when $P < MSC$ in the case of demerit goods and negative externalities. By contrast, market failures which result from the inequitable functioning of markets may be caused by market forces bringing about highly unequal distributions of income and wealth.
- 2 Basic economic theory suggests that if, in the case of a merit good such as education (assumed to be provided in a private market), the government provides a subsidy to bring the price down to equal the marginal social benefit received by the community ($P = MSB$), the socially optimal level of consumption will result. This assumes that the government possesses perfect information, which would enable the government to set the subsidy at the correct level. However, in real life, the government would have to guess the size of the optimal subsidy. Its guess might be wrong and thus it might under-subsidise, in which case the price would still be too high, or it might over-subsidise, in which case too much education would be consumed. A similar argument could be applied to taxation of demerit goods. The best bet is probably for the government to see what happens when it first sets subsidies and taxes, to alter them in the light of experience, and to combine taxes and subsidies with the regulation of consumption, through compulsory consumption of education and legal controls imposed on the consumption of demerit goods.
- 3 Environmental pollution is an example of a market failure. Getting rid of government taxes and regulations, which were imposed to correct or reduce the market failure, in the hope that unfettered markets will solve the problem is a bit of an oxymoron: if the failure initially results from the operation of market forces, then eliminating methods of correcting the market failure will surely make matters worse rather than better.

However, one way in which the market mechanism can improve things is through the creation of a surrogate market in a situation in which there has been complete market failure — a ‘missing market’. The example most often quoted is the creation of a market in ‘permits to pollute’, which aims to reduce the dumping of negative production externalities, such as the atmospheric pollution resulting from the burning of fossil fuels by power stations.

- 4 Whereas market failure results from markets working badly, government failure can result from government intervention to correct market failures being either ineffective or, in the worst cases, downright damaging as a result of the creation of new and arguably worse

problems. As is often the case in economic debates, the view one takes on the question posed depends to a large extent on whether one is a pro-free-market or a Keynesian-inspired economist. Free-market economists believe that in general markets work well and that any market failures that result from the operation of market forces are fairly minor. The best course of action is to make markets more competitive, for example by making them more contestable and by so doing reducing the monopoly power which often distorts markets. Profit-seeking entrepreneurs, who stand to gain or lose by their own decisions, produce better outcomes than civil servants and planners employed by the state. By contrast, Keynesian-inspired economists argue that, through ‘smart’ intervention in the economy, market failures can be reduced or eliminated without the emergence of government failure.

5 Three possible ways are:

- Taxing monopoly profits in order to encourage monopolies to reduce prices and profits. A tax on monopoly profits attempts to punish firms for exploiting their monopoly power and making excessive profit. Monopoly taxes have not generally been used in the UK, though an example occurred in the late 1990s, when the then incoming Labour government imposed a windfall profit tax on the privatised utilities.
- Privatisation of previously state-owned monopolies. Arguably, state ownership produces particular forms of abuse, such as a general inefficiency and resistance to change, that would not be experienced if the industries were privately owned. However, privatisation has sometimes merely changed the nature of monopoly abuse from featherbedding a protected labour force to restricting output and hiking up prices in order to make monopoly profit. Privatised monopolies may be just as prone as state-owned monopolies to incurring unnecessary costs of production or X-inefficiency.
- This is why pro-free-market economists often argue that privatisation on its own is not enough. It needs to be accompanied by the removal of barriers to entry to make the market more contestable. If, when attracted by the above normal profits made by firms already in the market, new firms enter the market without incurring high entry costs, the resulting extra competition can bring prices down.

6 Privatisation involves the transfer of ownership, usually by sale, of industries and other assets from the public sector to the private sector. Free-market economists believe that by exposing firms and industries to the discipline of the market (the capital market as well as the market in which the privatised firm sells its output), privatisation improves efficiency and economic performance. Free-marketers also argue that, by extending share ownership to individuals and employees, privatisation promotes popular capitalism and an enterprise culture. Privatisation also raises revenue for the government, which reduces, at least in the short run, the government’s need to borrow.

Opponents of privatisation argue that it has encouraged short-term rather than long-term decision making. There is a danger that under private ownership, investments will not be made because company boards concentrate on the short-termism of delivering dividends to keep shareholders and financial institutions happy. However, this viewpoint is debatable. Arguably, any decisions made by government ministers with regard to nationalised industries never looked further than the next general election. Also, under public ownership, governments have starved the nationalised industries of investment funds in order to keep government borrowing down.

Opponents of privatisation also argue that if a private sector business were to sell its capital assets simply in order to raise revenue to pay for current expenditure, it would rightly incur the wrath of its shareholders. The same should be true of the government and the sale of state-owned assets. Taxpayers should not sanction the sale of capital assets owned on their behalf by the UK government to raise revenue to finance current spending on items such as wages and salaries. This has been called the ‘selling the family silver’ argument. In reply, supporters of the privatisation programme argue that, far from selling the family silver,

privatisation merely returns the family's assets to the family: that is, from the custody of the state to direct ownership by private individuals.

Opponents of privatisation also claim that state-owned assets have been sold too cheaply, encouraging the belief among first-time share buyers that there is such a thing as a free lunch. This is because the offer-price of shares in newly privatised industries was normally pitched at a level which guaranteed a risk-free capital gain or one-way bet at the taxpayer's expense. Arguably, this encourages the very opposite of an enterprise economy.