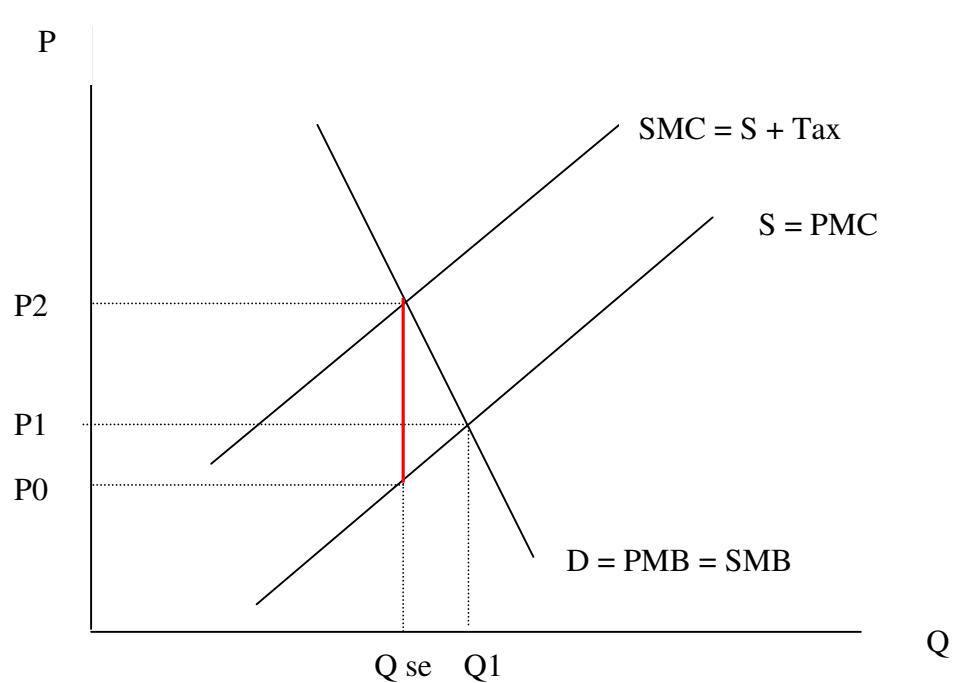


Government intervention to overcome market failure

1. Taxes

Tax on a negative externality



- Tax = $P2 - P0$: Supply curve shifts to the left
- consumers now pay the social cost SMC
- Market price increase from $P1$ to $P2$
- Output will now be Q_{se} where $SMC = SMB$

DISADVANTAGES of taxes

- i) Difficult to measure the level of negative externality e.g. what is the cost of pollution from a car?
- ii) If Demand is inelastic then higher taxes will not reduce demand much
- iii) Taxes will cause inequality
- iv) Cost of administration
- v) Possibility of evasion. E.g. with tax on disposing of rubbish there has been an increase in fly tipping (illegal dumping of rubbish)

ADVANTAGES of Taxes

- i) Provides incentives to reduce the negative externality such as pollution. E.g. cars have become more fuel efficient
- ii) Social efficiency, 1st best solution.(where $MSC = MSB$)
- iii) Taxes raise revenue for the govt, which can be spent on alternatives

Monopoly:

- This is a market structure with one dominant firm
 - Monopoly power occurs when a firm controls over 25% of the market
 - For a monopoly to occur there need to be **barriers to entry**, these are conditions which make it more difficult for a firm to enter a market: E.g.
1. **Economies of Scale.**

A new firm would find it difficult to compete because its average costs would be much higher than the incumbent who has a higher output.
 2. **Natural Barriers**

e.g. only a few countries can produce diamonds
 3. **Brand Loyalty.**

Through advertising firms can make it more difficult for new firms to enter because they would have to spend a lot of money on advertising which is a sunk cost (non recoverable)
 4. **Vertical Integration.**

By controlling supplies firms can deter entry
 5. **Legal Barriers**

e.g. patents or govt monopolies

Disadvantages of Monopolies

1. **Higher Prices.**

Consumers have only a limited choice, therefore demand is inelastic. This enables the firm to increase prices, thereby causing a fall in consumer surplus
2. **Allocative inefficiency.**

Firms don't respond to consumer needs and preferences. Therefore monopolies tend to be allocatively inefficient.
3. **Productively inefficiency.**

Because competition is limited firms have less incentive to cut costs therefore could be Productively inefficiency
4. Monopolies can pay **lower prices to suppliers**

E.g. car companies with monopoly power can pay lower prices to suppliers
5. **Diseconomies of scale.**

If a firm gets too big and unwieldy average costs will start to rise

Advantages of Monopolies

1. **Economies of Scale.**

If there are high fixed costs in the industry the firm will be able to benefit from economies of scale and lower average costs as output increases
2. **Research and Development.**

A firm can use its supernormal profits to invest in new products which will benefit the consumer. This is important for many industries such as pharmaceuticals