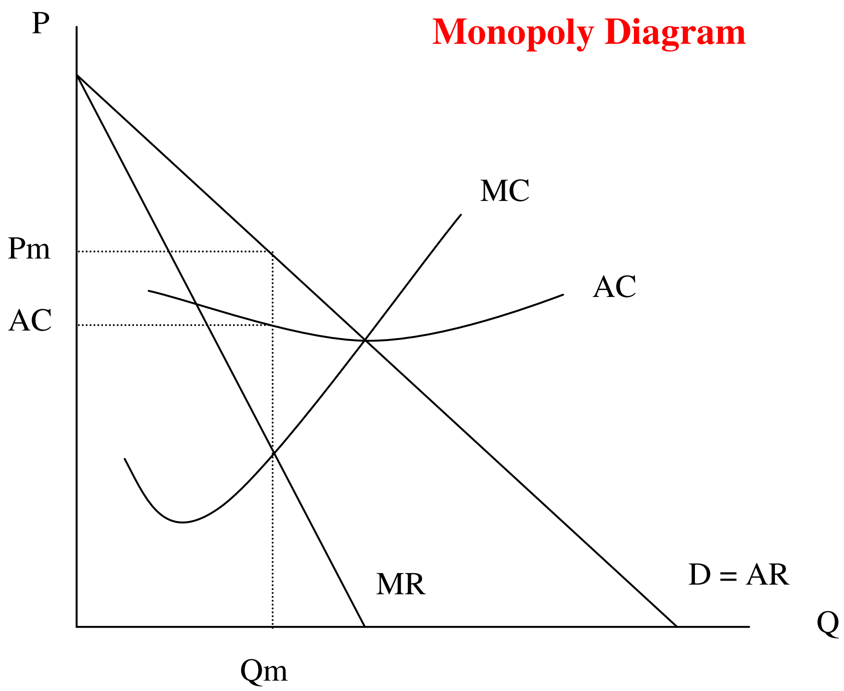
14. In some European Countries, price controls are imposed upon pharmaceutical companies. Discuss the case for government intervention to control market prices (15) Based on AQA Jan '04

The first argument for government price controls is the idea of monopoly power. If firms have monopoly power in a market, they are in a position to increase prices. As the diagram below shows, this monopoly power enables firms to set prices above marginal cost, which is allocatively inefficient.



In an ideal world, the government would be able to increase competition. But, in some markets, competition is not practical. In the case of Pharmaceutical companies they may get a pure monopoly because of their patent. In the example, of tap water, very high fixed costs mean competition is not practical. Therefore, monopoly power is inevitable and price controls are the only realistic way to prevent abuse of monopoly power and prevent allocative inefficiency.

There are also issues of equity. In the case of drugs, it could be argued they should not be too expensive otherwise people cannot afford them. It is also the same with gas and water supplies. As an essential public service it is important that they remain in reach of all income groups. Also some goods like medicinal drugs may be paid for by the government. Capping prices on medicinal drugs will help to limit the government's health care budget and therefore lead to lower taxes.

However, there are arguments against price controls. If governments limit price, firms may not make sufficient profit to encourage more research and development. To develop new drugs is quite risky with no guarantee of success, therefore, it is essential to give firms sufficient incentive to develop them. This could decrease dynamic efficiency. Also allocative efficiency may be an inappropriate measure given that the marginal cost of producing a drug is very low, but, fixed costs are very high.

There is also an element of potential government failure. For example, the government may not have sufficient information about the state of the industry to make an appropriate decision on price. Government could set prices which are too low and cause firms to leave the market