1.4 Government intervention

Why do governments intervene in markets?

- ➔ If there is an overconsumption of demerit goods (e.g. due to a lack of information).
- ➔ If there is an underconsumption of merit goods.
- ➔ Irrationality.
- ➔ To meet people's basic needs (especially if they're on low incomes).

- **Tax** = a compulsory financial contribution to state revenue.
- **Direct taxes** are paid directly to the government by the taxpayer (e.g. income tax) whilst **indirect taxes** are taxes levied on the expenditure of goods or services (e.g. VAT).
- Indirect taxes occur when goods have significant external costs - e.g. cigarettes, alcohol and petrol.
- The burden of direct taxes cannot be passed on, whilst producers can pass on the cost of indirect taxes to the consumer (in whole or in part - depending on PED/PES).
- 2 types of indirect tax - **ad valorem tax** (which is taken as a percentage of the value of a product, like VAT = 20%) and **specific tax** (a fixed rate per unit, like the tax on a pint of beer is 41.5p).
- **Deadweight loss** = the loss of welfare to society because taxes are introduced.
- **Subsidy** = a grant provided by the government to encourage the production and consumption of a particular good or service.
- **Incidence of tax** = the distribution of the tax paid between consumers and producers.

Specific tax diagram