

Cambridge AS & A Level · Economics 9708 · Notes

Reasons for government intervention in markets

AS

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Read first: [Classification of goods and services](#), [Demand and supply curves](#), [The interaction of demand and supply](#), [Consumer and producer surplus](#)

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What you need to know

By the end of this topic you should be able to explain the three reasons the syllabus gives for a government to step into a market:

1. **To provide public goods that a market would not provide at all.** Public goods are non-rival and non-excludable, so people can free ride, firms cannot charge, and the market is missing. The government pays for them out of taxes.
2. **To correct the over-consumption of demerit goods and the under-consumption of merit goods.** Because of imperfect information, people buy more of a demerit good and less of a merit good than they would if they knew its full effects on them.
3. **To control prices in markets:** to hold a price below the market level (a maximum price) so that essentials stay affordable, or above it (a minimum price) to protect producers' incomes or cut consumption of a demerit good, and to stop prices swinging too much.

This topic is about **why** governments intervene. **How** they do it (taxes, subsidies, price controls, direct provision, information, regulation) and what those policies do is the next topic, Methods and effects of government intervention in markets. The meaning of public, merit and demerit goods is in Classification of goods and services.

Understand it

Why a market sometimes needs help

In a market economy, the price mechanism decides what is produced: firms make what people are willing and able to pay for. This works well when three things are true: firms can charge everyone who benefits, buyers know what they are buying, and the price that results is one society can accept. When any of these fails, the market gives the **wrong amount** of a good (too much, too little or none at all), and resources are **misallocated**. This is called **market failure**, and it is the case for government intervention.

A **mixed economy** is one where the market does most of the allocating and the government steps in for exactly these cases.

Reason 1: the non-provision of public goods

A public good has two features, and each one matters separately:

- **Non-excludable:** once the good is there, nobody can be stopped from benefiting, whether or not they paid. A flood barrier protects every house behind it.
- **Non-rival:** one more person benefiting does not reduce the benefit to anyone else. Protecting one more house costs nothing extra.

Non-excludability causes the free-rider problem. Each person knows they will be protected whether or not they pay, so each has a reason to wait for others to pay. A firm that built the barrier could not collect enough money from the people it protects, so it could not make a profit, so no firm builds it. The good is **not provided at all**, even though everyone values it. This is a **missing market**.

Non-rivalry means charging would be wasteful anyway. The extra cost of one more user is zero, so turning anyone away (if you could) would lose benefit for no saving.

The government solves the problem by **paying for the good out of taxation**, so everyone contributes whether they want to or not. National defence, street lighting, flood defences and lighthouses are the usual examples.

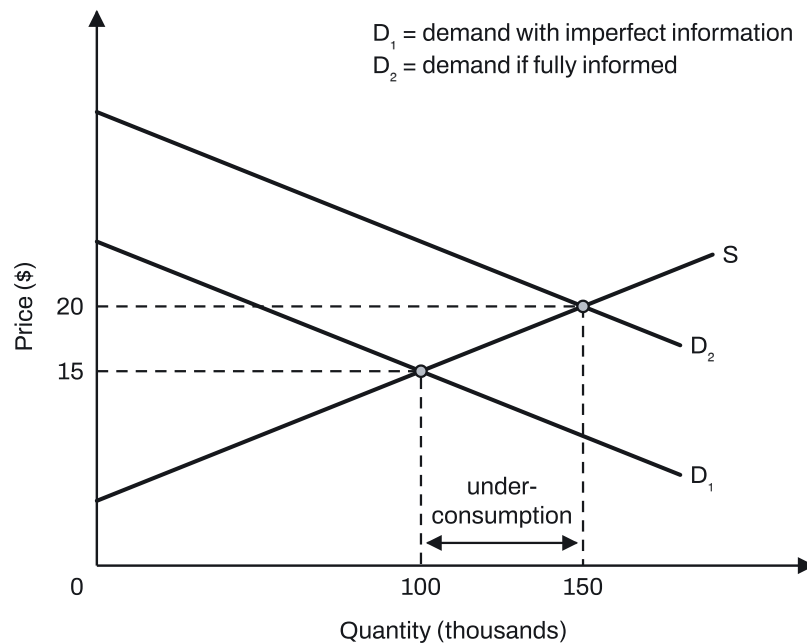
Two points that multiple-choice questions test:

- **The government must finance it, but need not make it.** A private construction firm can design, build and maintain a flood barrier under contract. What only the government can do is **pay** for it, because it can raise the money through compulsory taxes. Providing a good is not the same as producing it.
- **More public goods cost something.** They use scarce resources, so there is an **opportunity cost**, and they must be paid for, usually by **higher** taxes, not lower ones.

Reason 2: merit goods and demerit goods

Merit and demerit goods are **private goods**: they are rival and excludable, so a market **will** supply them. The problem is the **quantity**, and the cause is **imperfect information**.

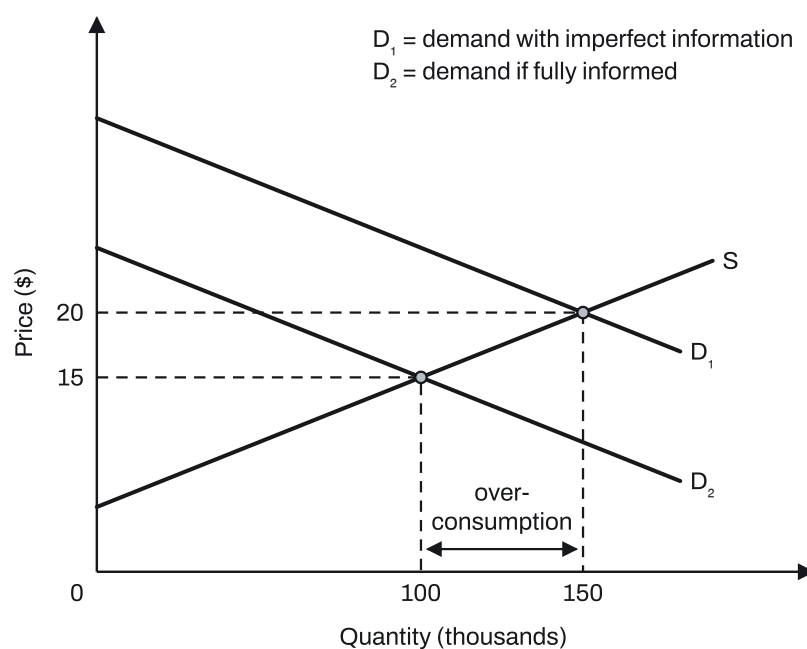
Merit goods (education, health check-ups, vaccinations, internet access for learning) are more beneficial to the consumer than the consumer realises. Many benefits come years later, or are hard to see, so people **underestimate** them. Demand is lower than it would be with full information, so the good is **under-consumed** and **under-produced**.



Here supply is $P = 5 + \frac{Q}{10}$. With imperfect information demand is $P = 25 - \frac{Q}{10}$, and the market settles at \$15 and 100 thousand check-ups a year. If people knew the full benefit, demand would be $P = 35 - \frac{Q}{10}$, and they would choose 150 thousand. The market under-consumes by $150 - 100 = 50$ thousand check-ups a year.

A high price makes this worse: people on low incomes may not be able to afford a merit good at all, however much they would gain.

Demerit goods (cigarettes, alcohol, gambling, sugary energy drinks) are more harmful to the consumer than the consumer realises. The harm is often long-term (illness, addiction), so people **underestimate** it. Demand is higher than it would be with full information, so the good is **over-consumed** and **over-produced**.



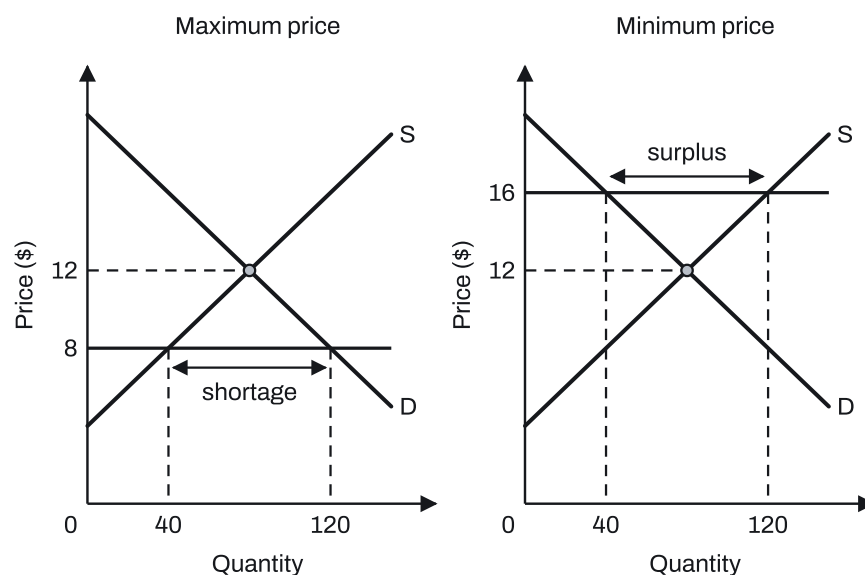
With the same supply, demand with imperfect information is $P = 35 - \frac{Q}{10}$, so 150 thousand cans a week are sold at \$20. Fully informed, demand would be $P = 25 - \frac{Q}{10}$ and people would buy 100 thousand. The market over-consumes by 50 thousand cans a week.

In both cases the **cause is the same, the direction is opposite**: imperfect information makes demand too low for merit goods and too high for demerit goods. The government intervenes to move consumption towards the fully informed level, for example by providing merit goods free, subsidising them or informing people, and by taxing, restricting or informing people about demerit goods.

Governments also care about merit goods because the benefits often spread to others (an educated worker helps the whole economy; a vaccinated child protects other children). Those wider effects make the case for intervention stronger, and questions sometimes mention them, but the syllabus definition of a merit or demerit good rests on the consumer's own **imperfect information**.

Reason 3: controlling prices

Even when a market works, the price it sets may cause problems a government wants to avoid.



Keeping a price down (a maximum price, set below equilibrium). Reasons:

- to make **necessities** (basic food, rent, fuel, medicines) affordable for households on low incomes, so that fewer people go without;
- to stop firms with market power from **exploiting** consumers with very high prices;
- to hold down the cost of living for a time when prices are rising fast.

The side effect is a **shortage**: at \$8, firms supply only 40 units but consumers want 120, so 80 units of demand are unmet. That is why maximum prices bring queues, rationing and illegal markets (the next topic covers these).

Keeping a price up (a minimum price, set above equilibrium). Reasons:

- to protect the **incomes of producers**, especially farmers, whose incomes can collapse when a large harvest pushes the price down, and so to keep them in business and secure food supply;
- to protect **workers'** incomes (a minimum wage is a minimum price for labour);
- to cut consumption of a **demerit good**, such as a minimum price per unit of alcohol.

The side effect is a **surplus**: at \$16, firms supply 120 units but consumers buy only 40.

Keeping prices stable. Prices of farm products and raw materials can swing widely from year to year because supply depends on the weather. Big swings make it hard for farmers to plan and invest, and for poor households to budget. Governments may intervene to keep prices within a range.

Why intervention is not automatically right

The reasons above explain **why** a government might intervene, not that it always should. Intervention has costs of its own: it must be paid for (an opportunity cost), the government may itself lack information about how much of a good people really need, and policies can have side effects (shortages, surpluses, illegal markets). When intervention makes the allocation of resources worse, that is **government failure**. Any "consider" or "assess" question on this topic expects you to weigh this against the reason for intervening.

Key facts and formulas

This topic has no formulas and no formula list in the exam. "Learn it" means you must remember it.

Fact	Status
Market failure: the market gives too much, too little or none of a good, so resources are misallocated	Learn it
Public good: non-rival and non-excludable, so free riders stop firms charging and the market does not provide it	Learn it
Public goods are financed by the government from taxation; private firms may still produce them under contract	Learn it
More public goods have an opportunity cost and usually need higher taxes	Learn it
Merit good: benefits underestimated through imperfect information, so under-consumed and under-produced	Learn it
Demerit good: harm underestimated through imperfect information, so over-consumed and over-produced	Learn it
Under-consumption (merit good) = quantity people would choose if fully informed – quantity bought	Learn it
Over-consumption (demerit good) = quantity bought – quantity people would choose if fully informed	Learn it

Fact	Status
Maximum price below equilibrium: keeps goods affordable, causes a shortage = quantity demanded – quantity supplied	Learn it
Minimum price above equilibrium: protects producers' incomes or cuts demerit-good use, causes a surplus = quantity supplied – quantity demanded	Learn it

How to do it

In the questions we have tagged for this topic (16 questions, 2021–2025), 15 are Paper 1 multiple choice and 1 is a Paper 2 essay question whose parts (a) and (b) are both about this topic, so the table counts 17 parts.

Question type	Questions
Multiple choice: why the government provides or finances public goods	8
Multiple choice: why the government intervenes for merit or demerit goods	6
Multiple choice: what happens if the market is left to allocate a good	1
Essay part (a), 8 marks: why a market economy does not provide public goods	1
Essay part (b), 12 marks: the consequences of imperfect information in a market and a mixed economy	1

No tagged question has yet asked about controlling prices as a reason for intervention, but it is in the syllabus: use "Reason 3" above, and the essay plans below work the same way.

Paper 2 essay parts are marked in two ways. **Part (a), 8 marks**, is point-based: up to **3** for knowledge (AO1), **3** for analysis (AO2) and **2** for evaluation (AO3, one kept for a justified conclusion). **Part (b), 12 marks**, is levels-marked: Table A gives up to **8** for knowledge and analysis (Level 3 is 6–8) and Table B up to **4** for evaluation. A one-sided answer gets **no** evaluation marks.

1. Multiple choice: why the government provides or finances public goods (8 questions)

1. **Spot the public good** in the stem: defence, flood defences, street lighting, a lighthouse, a warning system.
2. **Find the option that gives the economic reason**: it is **non-rival and non-excludable**, so **people can consume it without paying** (free riders), so the market will not supply it.
3. **Reject the tempting wrong reasons**: "private firms would charge too high a price", "the private sector's costs are higher", "one person's use leaves none for others" (that is rivalry, the opposite).

Variations you will meet:

- **"Why can't the economy rely only on market forces?"** Because public goods would not be supplied. Merit and demerit goods are still supplied, just in the wrong amounts, so "public goods will not be supplied" is the main reason.

- **"Why will some goods stay under government control in a mixed economy?"** The market fails to provide public goods.
- **"Which policy solves the free-rider problem?"** Direct provision (or financing) by the government, paid for from taxes. Advertising, price controls and taxes on other goods do nothing about free riding.
- **"Which action would only the government undertake?"** **Financing** the good. Designing, building and maintaining can all be done by private firms under contract.
- **"What is unlikely with more public goods?"** A **cut** in taxes. More provision uses resources (opportunity cost), must be paid for, and can improve the use of resources; consumers still cannot be excluded.

2. Multiple choice: why the government intervenes for merit or demerit goods (6 questions)

1. **Decide which kind of good it is:** education, health care, libraries, internet access for learning are **merit goods**; cigarettes, alcohol, gambling are **demerit goods**.
2. **Pick the reason built on information:** consumers are **not fully aware** of the benefits (merit) or the harm (demerit), so they buy too little or too much.
3. **Cross out** "it is a public good" (these goods are rival and excludable), "it would be over-consumed" for a merit good, and "private costs exceed private benefits" as a reason for providing education.

Variations you will meet:

- **A table of three columns** (consumption, production, information in a free market): a merit good is **under-consumed, under-produced**, and consumers have **too little** information. A demerit good is over-consumed, over-produced, with too little information about the harm.
- **"Why subsidise [a good]?"** where the options list a merit good, a demerit good, a public good and externalities: a subsidy that **increases provision** of something beneficial to the user points to a **merit good**.
- **"Why subsidise bicycles?"** Consumers are **not aware of the benefits** of cycling (including the benefits to others), so they cycle too little. "Can't afford them" or "fear of accidents" is not the economic reason.
- **"Why would a public body run libraries?"** Libraries are **merit goods**, not public goods: a book on loan to one person is not available to another, and members can be required to show a card.

3. Multiple choice: what happens if the market is left to allocate a good (1 question)

1. **The market always reaches an equilibrium:** price moves until quantity demanded equals quantity supplied.
2. **But market failure remains:** a merit good such as health care is still under-consumed, and poorer people may get less care. So "all consumers get better care" and "market failure is eliminated" are wrong.
3. **Health care is not a public good**, so "less of a public good" is wrong too.

4. Essay part (a), 8 marks: why a market economy does not provide public goods (1 question)

For example, "explain the difference between free goods and public goods and consider the view that public goods can never be provided in a market economy".

1. **Knowledge (AO1, 3 marks).** Define each term in the question with a correct example: a free good is not scarce, has no opportunity cost and needs no factors of production (sunlight) (1); a public good is non-excludable **and** non-rival, **each explained in its own sentence** (1); examples of both, such as fresh air and street lighting (1).
2. **Analysis (AO2, 3 marks).** One developed chain for each feature: non-excludable → people cannot be stopped from benefiting → they free ride (1); non-rival → one more user costs nothing and takes nothing from others → there is no reason to pay (1); so a firm cannot charge a price or make a profit, the market does not supply the good, and the government must finance it from taxes (1).
3. **Evaluation (AO3, 2 marks).** An "it depends" point (1): a **pure** public good will not be provided by the market unless the government pays for it; but many goods are **quasi-public** (a road can be tolled, a beach can charge for entry), and if exclusion becomes possible, for example through new technology, a firm can charge and a market can provide it. Then a justified conclusion (1): pure public goods, like defence, will not be provided by a market economy; quasi-public goods can be.

5. Essay part (b), 12 marks: the consequences of imperfect information in a market and a mixed economy (1 question)

For example, "assess the view that the consequences of imperfect information are more serious in a market economy than in a mixed economy".

1. **Knowledge:** private goods, including merit and demerit goods, are allocated by demand and supply; merit and demerit goods are defined with their cause, **imperfect information**.
2. **Analysis, market economy:** nobody corrects the information failure, so merit goods are under-consumed (education, health care), demerit goods are over-consumed, and people on low incomes may get no merit goods at all. Other private goods are allocated reasonably well by the price mechanism. Use the under- and over-consumption diagrams.
3. **Analysis, mixed economy:** the government can provide merit goods free, subsidise them, tax or restrict demerit goods and give information, moving consumption towards the fully informed level. **You must compare the two economies;** an answer that analyses only one cannot go above Level 2.
4. **Evaluation:** the market economy's problems are more serious **if** the government in the mixed economy is well informed and effective. But the government may have imperfect information too (how much education is "right"?), intervention costs money and has an opportunity cost, and policies can fail (government failure). The size of the problem depends on the good. End with a justified conclusion.

Worked examples

Example 1

A coastal town is protected by a sea wall. Which reason best explains why the sea wall is paid for by the government rather than sold by private firms?

- **A** Private firms would build the wall to a lower standard than the government.
- **B** Residents cannot be prevented from benefiting from the wall even if they refuse to pay.
- **C** The wall is used up as more people benefit from it.
- **D** The wall is a merit good whose benefits residents underestimate.

[1]

A sea wall protects every house behind it, so non-payers cannot be excluded: they would free ride, and a firm could not collect enough payment to make a profit. The answer is **B**. (1)

C describes rivalry, the opposite of a public good; D describes a merit good, which is rival and excludable; A is not an economic reason.

Example 2

Which combination describes a free market for vocational training courses, a merit good?

	Consumption	Production	Information held by consumers
A	too high	too high	too much
B	too low	too low	too little
C	too low	too high	too little
D	too high	too low	too much

[1]

Consumers underestimate the benefits because they have too little information, so demand is too low: fewer courses are bought and so fewer are produced. The answer is **B**. (1)

Example 3

With the help of a diagram, explain why a merit good is likely to be under-consumed in a free market, and consider whether this always means the government should intervene. [8]

A merit good, such as a dental check-up, is a private good that is more beneficial to the consumer than the consumer realises (AO1, 1). It is under-consumed because of imperfect information: people do not know, or underestimate, the benefits, many of which come years later (AO1, 1).

*Diagram: price and quantity axes; S , D_1 (demand with imperfect information) and D_2 (demand if fully informed) to its right; Q_1 where D_1 meets S , Q where D_2 meets S , the gap labelled "under-consumption" (AO1, 1).**

Because consumers underestimate the benefits, their demand is D_1 rather than D_2 , so the market settles at Q_1 , for example 100 thousand check-ups a year, instead of the 150 thousand they would choose if fully informed (AO2, 1). Too few resources go into the good, so it is under-produced as well as under-consumed, and resources are misallocated (AO2, 1). People on low incomes may not be able to afford it at all, so the under-consumption is greatest where the benefit could be large (AO2, 1).

However, intervention is not always justified. If the under-consumption is small, the cost of a subsidy or free provision, and the opportunity cost of that money, may be greater than the gain, and the government may not know how far D_2 lies from D_1 (AO3, 1).

So under-consumption gives a reason to intervene, but the government should do so only where the information failure is large and it can raise consumption at a reasonable cost, for example with an information campaign, which tackles the cause directly (AO3, 1, justified conclusion).

Total: $3 + 3 + 2 = 8$.

Example 4

Assess whether the non-provision of public goods is a stronger reason for government intervention in a market economy than the need to control prices. [12]

Knowledge and analysis (Table A):

A public good such as street lighting is non-excludable: once the lights are on, nobody walking in the street can be stopped from benefiting. It is also non-rival: one more person using the light does not make the street darker for anyone else. Because of non-excludability, people free ride, so a firm cannot charge or make a profit, and the market provides no street lighting at all. Without the government financing it from taxes, the good is simply missing, however much people value it.

Controlling prices is a different kind of reason. The market does provide the good, but at a price the government thinks is harmful. A maximum price below equilibrium keeps basic food or rent affordable for households on low incomes. A minimum price above equilibrium protects farmers' incomes when a large harvest pushes the price down, keeping them in business and securing future food supply. *Diagram: a maximum price below equilibrium, with the shortage marked, and a minimum price above it, with the surplus marked.* But each has a cost: a maximum price creates a shortage (quantity demanded exceeds quantity supplied), so some people cannot buy the good at all; a minimum price creates a surplus that someone must buy or store.

(Accurate definitions and developed analysis of both reasons, with the diagram explained: Level 3, 8 marks.)

Evaluation (Table B):

The non-provision of public goods is usually the stronger reason, because without the government there is **no** market at all: intervention replaces nothing and adds a good people value. With price controls, a working market already exists, and intervening can make things worse by creating shortages or surpluses, so there is a real risk of government failure. However, public goods also have costs: they must be paid for through taxes, with an opportunity cost, and the government may not know how much of the good people want. And price controls can be strongly justified when a necessity becomes unaffordable in a crisis, or when farm incomes swing so widely that farmers leave the industry. Overall, the case is stronger for public goods, because the market fails completely, while price controls are justified only in particular circumstances and for a limited time.

(A balanced judgement that answers the question, says what it depends on and reaches a conclusion: Level 2, 4 marks.)

Total: $8 + 4 = 12$.

Common mistakes

- **Calling anything the government provides a public good.** Examiners report this in almost every series. Schools, hospitals, libraries and free school meals are rival and excludable: they are merit goods (or plain private goods) that the government chooses to provide.
- **Blending "non-rival" and "non-excludable" into one phrase.** Explain each separately ("it is non-excludable because...", "it is non-rival because..."), then link non-excludability to free riding.
- **Describing merit goods as simply "good for you".** Without **under-consumption** and its cause, **imperfect information**, there is no economic analysis, and examiners give low marks. The same applies to demerit goods: say they are over-consumed because people underestimate the harm.
- **Imprecise examples.** "Food" is not a merit good and cannot be a demerit good (it is needed to live). Use education or health care; cigarettes or alcohol.
- **Writing about demerit goods when the question asks only about merit goods**, or the reverse. Examiners note time wasted this way.
- **Saying private firms "would charge too much" for a public good.** The problem is not the price: a firm cannot charge at all, because non-payers cannot be excluded. In one March paper more than a third of candidates chose this wrong reason for defence.
- **Asserting side effects of price controls without explaining them.** "A shortage will arise" earns nothing on its own; say why: at the lower price, quantity demanded rises and quantity supplied falls.
- **Answering about one economy when the question compares two.** A question on market against mixed economies needs both, or it cannot reach the top level.
- **Missing the evaluation.** In 12-mark parts, 4 of the marks (a third) are for evaluation, and examiners report many answers with little or none.

How to get the marks

- **Command words.** *Explain*: reasons linked by "because", "so", "which means". *Consider, assess, discuss*: both sides, then a judgement that answers the exact words ("never", "always", "more serious", "stronger").

- **Name the reason precisely.** Public goods: **non-provision** because of **free riding**. Merit goods: **under-consumption** because of **imperfect information**. Demerit goods: **over-consumption** because of **imperfect information**. Price controls: **affordability**, **producers' incomes**, **stability**.
- **Part (a), 8 marks: 3 + 3 + 2.** AO1: precise definitions of each term with examples. AO2: a developed chain from each characteristic to the market outcome. AO3: one "it depends" point (quasi-public goods, the cost of intervention, government failure) and a justified conclusion.
- **Part (b), 12 marks: 8 + 4.** Level 3 needs developed analysis of both sides and, when two economies or two reasons are named, of **both**. Evaluation needs a judgement with its reason; a one-sided answer gets no evaluation marks.
- **Diagrams earn marks only when explained.** Label the axes, S , D_1 and D_2 (or the maximum or minimum price), the quantities, and the gap, then say in words what the diagram shows.
- **Multiple choice:** read "most likely", "main" and "only" carefully, and check the **reason** in each option, not only the label.

Quick check

1. Why is a national system of flood warnings on the radio unlikely to be provided by a free market?
 - **A** The warnings would be over-consumed.
 - **B** People who do not pay cannot be prevented from hearing the warnings.
 - **C** Private firms would charge a price above the cost of the warnings.
 - **D** Each listener reduces the amount of warning available to others.
2. For a merit good, supply is $P = 6 + \frac{Q}{10}$ and demand with imperfect information is $P = 30 - \frac{Q}{5}$ (Q in thousands). If consumers were fully informed, demand would be $P = 36 - \frac{Q}{5}$. Find the quantity bought in the free market, the quantity people would choose if fully informed, and the under-consumption as a percentage of the fully informed level.
3. In a market for rented flats, $Q_d = 200 - 10P$ and $Q_s = 20P - 40$. Find the equilibrium rent. The government sets a maximum rent of \$6. Find the shortage, and give one reason why the government might set this maximum.
4. Explain why the free-rider problem means a public good will not be provided by the market. **[4]**
5. Explain two reasons why a government might set a minimum price for rice. **[4]**

Answers

1. **B.** The broadcast is non-excludable, so people can free ride, and no firm can collect payment. D describes rivalry, which the warnings do not have; A and C are not the reason. (1)
2. Free market: $30 - \frac{Q}{5} = 6 + \frac{Q}{10}$, so $24 = 0.3Q$ and $Q = 80$ thousand (at \$14). Fully informed: $36 - \frac{Q}{5} = 6 + \frac{Q}{10}$, so $30 = 0.3Q$ and $Q = 100$ thousand (at \$16). Under-consumption = $100 - 80 = 20$ thousand, which is $\frac{20}{100} \times 100 = 20\%$ of the fully informed level.
3. $200 - 10P = 20P - 40$, so $30P = 240$ and $P = 8$ (\$8, with 120 flats). At \$6: $Q_d = 140$ and $Q_s = 80$, a shortage of $140 - 80 = 60$ flats. Reason: to keep housing, a necessity, affordable for households on low incomes.
4. A public good is non-excludable: once it is provided, people who have not paid cannot be stopped from benefiting (1). So each person has a reason not to pay and to rely on others paying: they free ride (1). A firm therefore cannot collect enough revenue from the people who benefit to cover its costs or make a profit (1), so no firm supplies it, and the good is not provided even though people value it (1).
5. First, to protect farmers' incomes: a large harvest can push the price of rice down sharply, and a minimum price above equilibrium guarantees farmers a higher price (1), so they can stay in business and keep producing rice (1). Second, to keep rice prices stable: supply depends on the weather, so prices swing from year to year (1); a guaranteed floor lets farmers plan and invest, which protects future food supply (1).

Past questions to try

- **9708/11/O/N/24 Q14:** consumption, production and information for health care in a free market.
- **9708/13/O/N/22 Q5:** which part of providing flood defences only the government does.
- **9708/14/M/J/22 Q1:** what happens when health care is left entirely to market forces.
- **9708/12/M/J/22 Q18:** what is unlikely when more public goods are provided.