Exercise walk-through

Government policies to achieve efficient resource allocation and correct market failure ▪ 8.1

eXercise

You must be able to

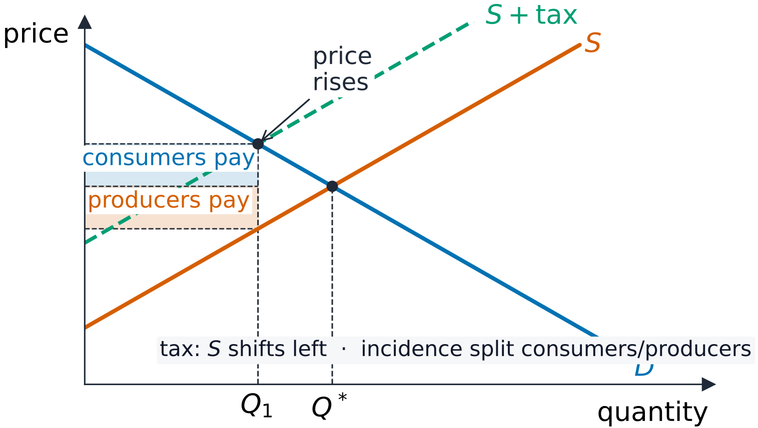
- describe the policy tools used to correct market failure
- explain competition policy and tradable permits
- analyse government failure

Method — Policy tools

- **Tax** on a negative externality; **subsidy** on a positive externality.
- **Tradable permits 可交易许可证**: cap total pollution, firms trade the right to pollute.
- **Competition policy 竞争政策**: block harmful mergers, ban price-fixing, fine abuse of **monopoly power 垄断势力**.
- **Government failure 政府失灵**: intervention worsens resource use (poor information, lags, a black market).

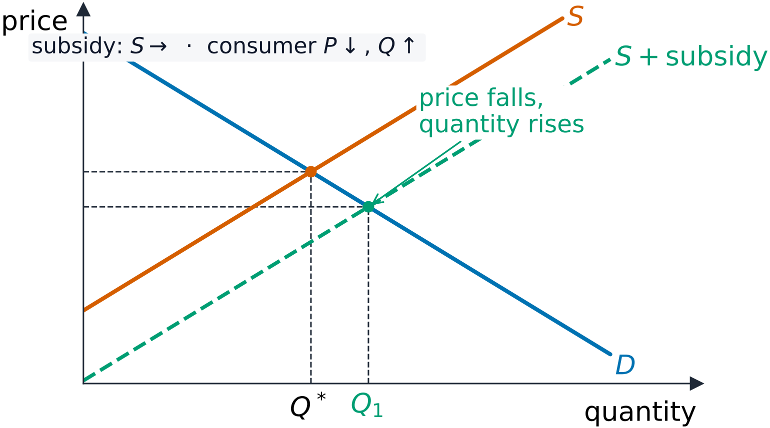
Answer shapes: an **Explain [up to 8]** answer may use a diagram (AO3); **Discuss [12]** adds a judgement (AO4).

Method — Policy tools



An indirect tax shifts supply up, raising price and cutting the quantity

Method — Policy tools



A subsidy shifts supply right, lowering price and raising the quantity

Practice 2.1 ▪ 2 marks

Define the term *tradable permit*.

Solution 2.1

Worked steps

a permit allowing a firm to emit a set amount of pollution, which can be bought from or sold to other firms (2 for a clear definition; 1 for a partial idea).

Practice 2.2 ▪ 1 mark

State one aim of competition policy.

Solution 2.2

Method: Policy tools

Worked steps

any one of: protect competition; block harmful mergers; ban price-fixing; stop the abuse of monopoly power (1).

Practice 2.3 ▪ 2 marks

Define the term *government failure*.

Solution 2.3

Method: Policy tools

Worked steps

when government action leads to a worse allocation of resources than the market outcome it replaced (2 for a clear definition; 1 for a partial idea).

Exam-style 3.1 ▪ 1 mark

Tradable pollution permits reduce total pollution by:

- **A** banning all pollution
- **B** capping total pollution and letting firms trade the right to pollute
- **C** subsidising polluting firms
- **D** taxing every unit of output equally

Solution 3.1

Method: Policy tools

A banning all pollution

B capping total pollution and letting firms trade the right to pollute ✓

C subsidising polluting firms

D taxing every unit of output equally

Worked steps

B. Permits cap total pollution and let firms trade the right to pollute.

Exam-style 3.2 ▪ 6 marks

Explain how a system of tradable permits can reduce pollution at the lowest cost.

Solution 3.2

Method: Policy tools

Worked steps

[6] AO1 1 + AO3 up to 5 — the government caps total pollution and issues permits → firms that can cut pollution cheaply do so and sell their spare permits → firms for whom cutting is expensive buy permits instead → the cap is met, but the cuts happen where they cost least → pollution falls at the lowest total cost.

Exam-style 3.3 ▪ 12 marks

Discuss whether government intervention always improves the allocation of resources.

Solution 3.3

Method: Policy tools

Worked steps

[12] AO1/AO2/AO3 up to 8 + AO4 up to 4. **For:** taxes, subsidies, regulation and permits can correct externalities, provide public goods and curb monopoly power. **Against:** government failure — poor information leads to the wrong tax/subsidy, policies are costly and slow, and price controls can create black markets. Judgement: well-designed intervention usually improves allocation, but it can fail — so the gain depends on the quality of information and design.