ECONOMICS TEXTBOOK REMASTERED

GOVERNMENT INTERVENTION

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Note that this is a quick revision booklet to understand the topic, for further detail we would highly recommend using the textbook.

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1. WHY DO GOVERNMENTS INTERVENE?

GOVERNMENTS MAY INTERVENE A MARKET FOR ONE OF THE FOLLOWING FIVE REASONS:

a. INFLUENCE CONSUMPTION/PROUCTION

Government implements certain policies to influence the consumption or production of certain goods and services, depending on whether they are merit or demerit goods.

b. RECTIFY MARKET FAILURE

Market failure occurs when the market fails to produce the 'socially desired quantities' of a good or service. Thus, government intervention is required to correct market failure, by implementing a set of policies.

c. PROVIDE SUPPORT TO FIRMS

In some cases, the government wishes to provide support to firms producing goods or services whose production is encouraged by the government.

d. EARN REVENUE

Indirect taxes is one of the government's sources of revenue. The government imposes taxes on goods and services as a way of earning revenue. Greater the amount of tax, greater the revenue earned.

e. TO PROMOTE EQUALITY

Governments intervene in the market to promote economic fairness. If the government thinks that the income and wealth distributions are unequal, or that those in need are not getting enough of a resource.

2. PRICE CONTROLS

a. PRICE CEILING

b. PRICE FLOOR

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a. PRICE CEILING

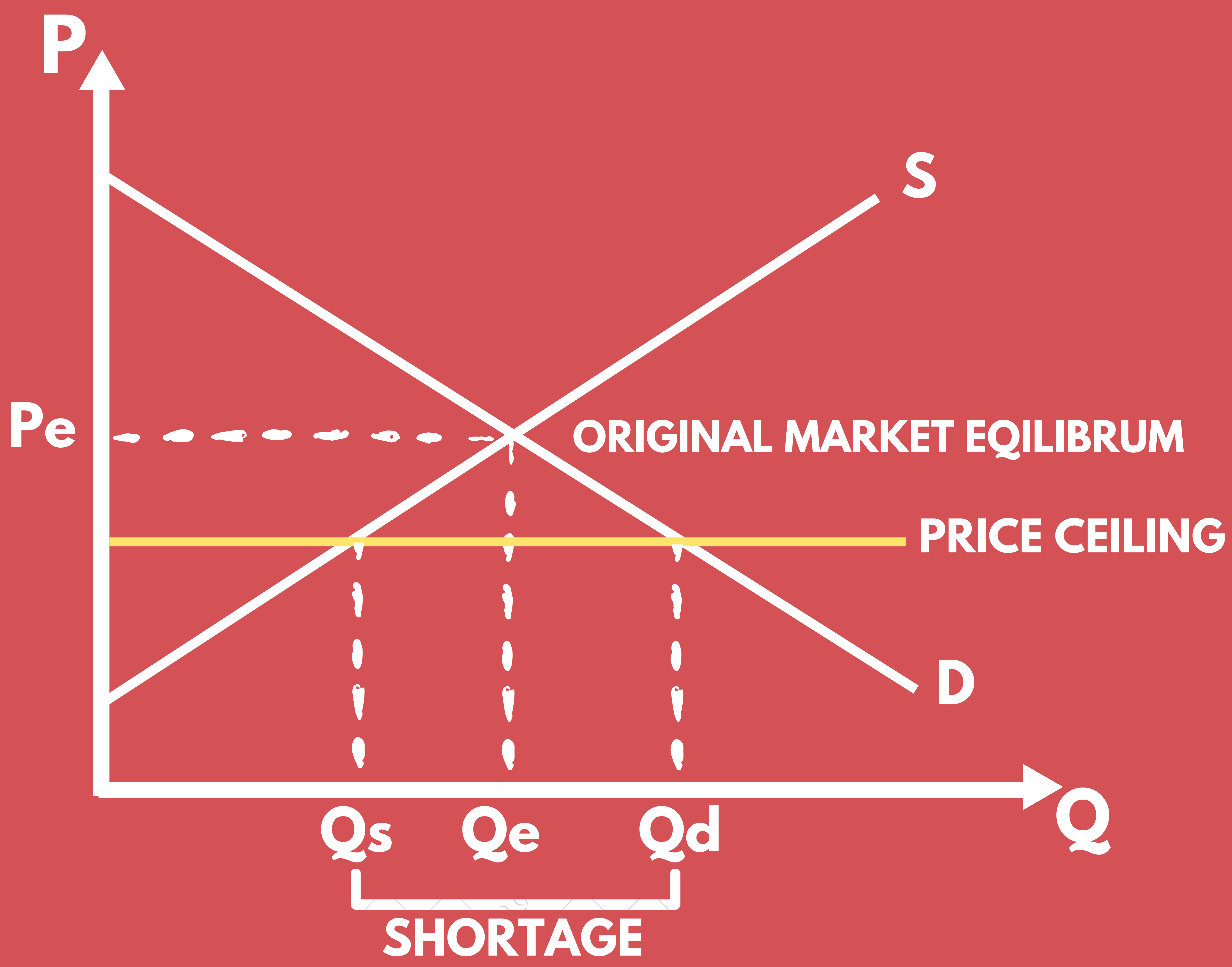
Is a type of price control wherein the government sets a maximum price set below the market equilibrium price in order to make goods more affordable for people on low incomes.

For the price ceiling to be effective, it must be set below the equilibrium price!

Price ceiling creates a shortage in the market, since;

quantity demanded > quantity supplied.

Quantity demanded increased because the price ceiling reduced the price. Quantity supplied is reduced because the drop in price makes the production of that good less profitable for the producer.



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CONSEQUENCES OF A PRICE CEILING ON STAKEHOLDERS

1. PRODUCERS

- Producers are worse off since a lesser quantity of the good is sold at a lower price, decreasing producer revenue.
- Producer surplus also decreases.

2. CONSUMERS

- Partially benefited and worse off, those who get the goods are better because they were able to buy the goods at a much cheaper price. However the rest don't even get the good because of the shortage.
- Consumer surplus more or less stays the same or increases in some cases.

3. GOVERNMENT

- The government has no specific gain or loss
- It only gains political popularity amongst the consumers who were able to buy the good in the shortage

4. WORKERS

- Worse are also worse off since the loss of output is most likely going to result in firms firing the workers.
- A price ceiling eventually gives rise to unemployment.

These consequences will be helpful when writing your evaluation and all indicate the welfare loss cause by the shortage.

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b. PRICE FLOOR

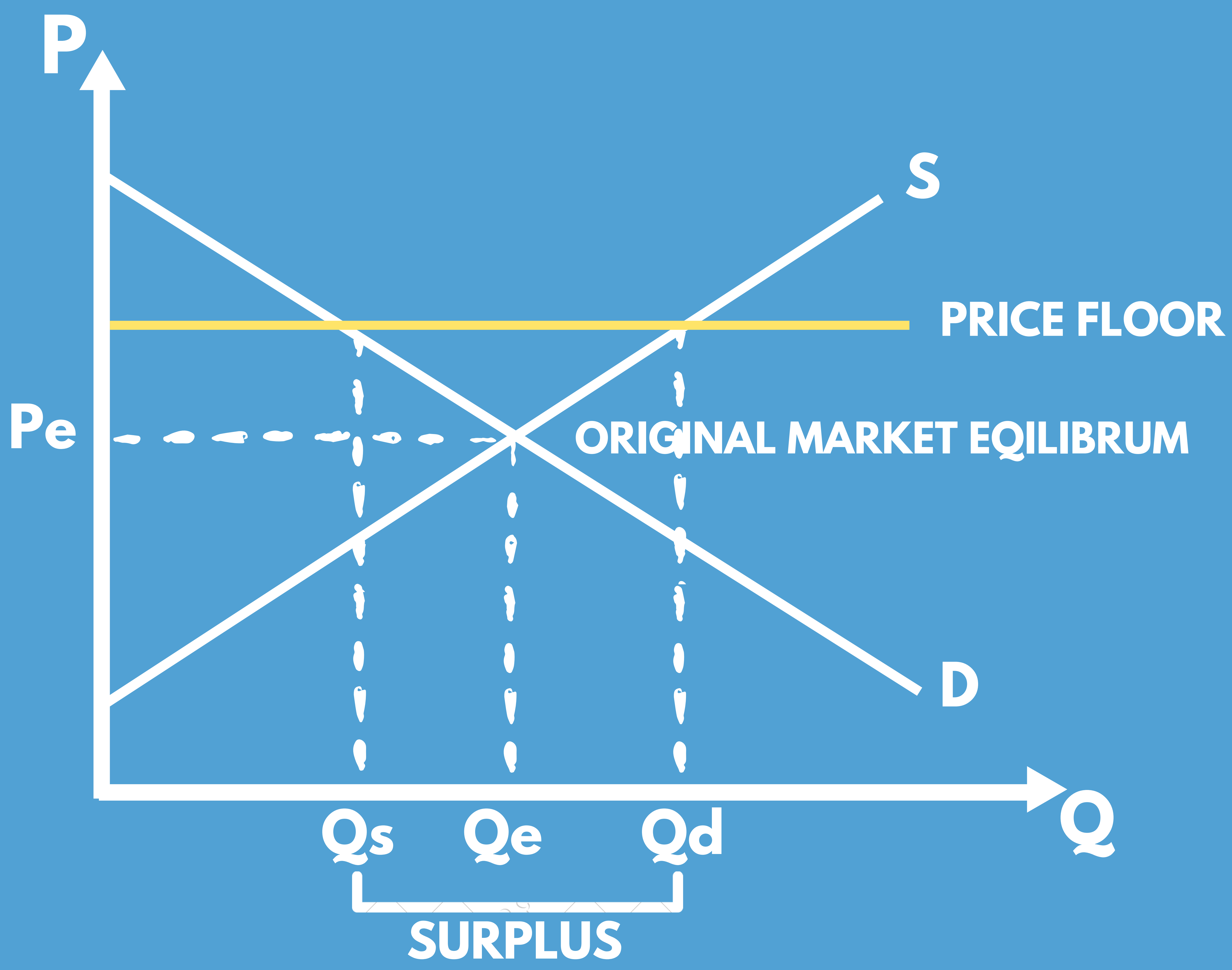
Is the second type of price control wherein a minimum price set above the market equilibrium price to help certain suppliers or, at times, increase income of people on low wages.

For a price floor to be effect it must be set above the original market price.

Price ceiling creates a SURPLUS in the market, since;

quantity SUPPLIED > quantity DEMANDED.

Quantity supplied increases because with increase in price of a good, it is more profitable for suppliers to increase output. Quantity demanded decreases because the good becomes more expensive and hence consumers opt for a cheaper alternative.



CONSEQUENCES OF A PRICE FLOOR ON STAKEHOLDERS

1. PRODUCERS

- Producers benefit since they receive higher prices and produce greater quantities of the same good. Since in most cases, the government buys the surplus, the firms' revenue increases.
- Producer surplus increases.

2. CONSUMERS

- Consumers are clearly worse off because the good becomes more expensive than before. Consumers pay a higher price whilst buying a smaller quantity.
- Consumer surplus decreases.

3. GOVERNMENT

- Since the government buys the surplus from the sellers, this acts as a burden on the government's budget, resulting in less money being spent by the government elsewhere, creating opportunity costs.
- Government expenditure increases since there are costs associated with storing and exporting the excess supply.

4. WORKERS

- Since the level of output increases, sellers are likely to hire more workers, thus increasing employment.
- Price floor fuels employment to ensure greater production of the good or service.

3. INDIRECT TAXES

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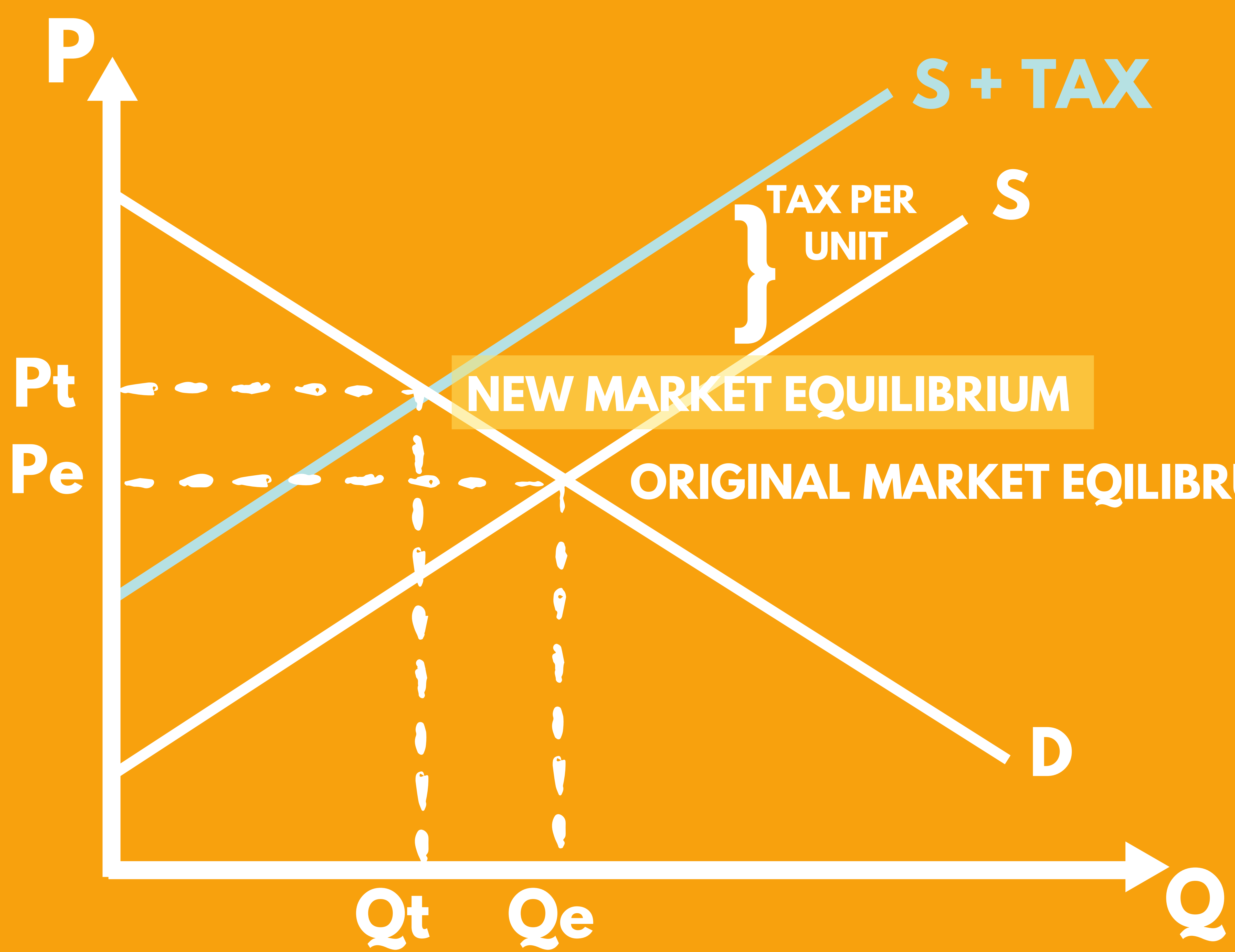
INDIRECT TAXES

Indirect taxes are paid by consumers on their spending to buy goods and services. Consumers pay indirect tax to the government through producers (thus 'indirect').

Since indirect taxes increase firms' costs of production, suppliers tend to decrease their supply. Thus, since taxes reduce supply, it causes the original market supply curve to shift to the left (or inwards).

THE DIAGRAM LOOKS LIKE SUCH:



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CONSEQUENCES ON MARKET AND STAKEHOLDERS

MARKET IMPACT

- Firms consider taxes as a cost of production, thus reducing market supply and increasing price of goods.
- Market reaches disequilibrium state since the indirect tax decreased supply, due to which equilibrium quantity is no longer being produced at equilibrium price.

1. PRODUCERS

- Revenue decreases since cost of production increases and quantity supplied decreases.
- Producer surplus decreases.

2. CONSUMERS

- Market price increases, thus making the good more expensive. Consumers buy lesser quantities at higher prices.
- Consumer surplus decreases.

3. GOVERNMENT

- Government gains through indirect taxes since it gains revenue from this intervention, increasing government revenue and budget.

4. WORKERS

- Since the level of output decreases, fewer workers would be required by firms, thus indirect taxes may lead to firms firing workers.
- Indirect taxes could create unemployment.

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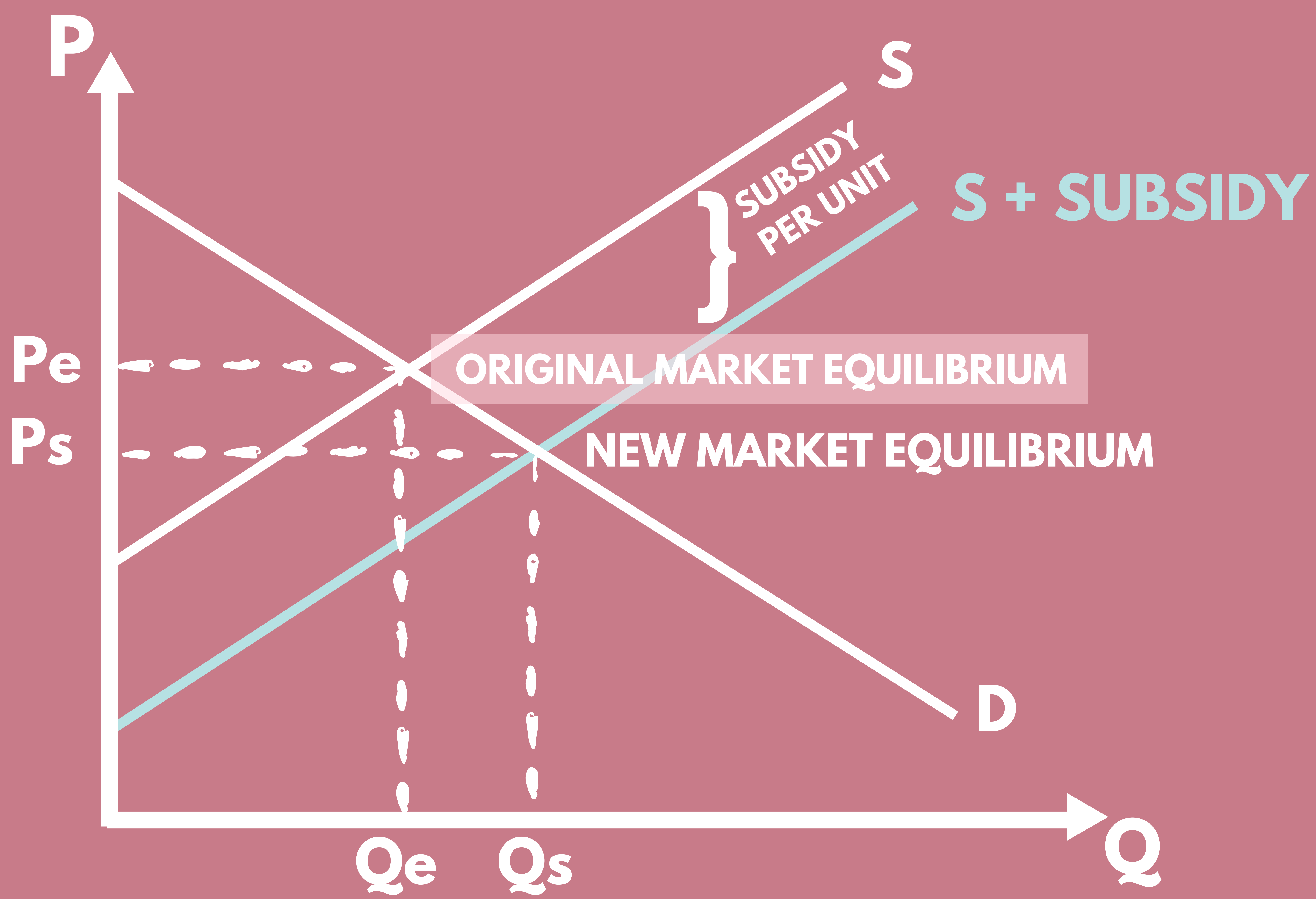
4. SUBSIDIES

SUBSIDIES

Subsidy is a form of assistance provided by the government to firms. Direct cash payments could be a form of subsidy provided by the government to support certain producers.

Since subsidies help reduce a firm's cost of production, firms are able to increase production, as a result of which the original market supply curve shifts to the right (or outwards) due to the subsidy granted.

THE DIAGRAM LOOKS LIKE SUCH:



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CONSEQUENCES ON MARKET AND STAKEHOLDERS

MARKET IMPACT

- Market price decreases since producers can produce more with the help of the subsidy. Allocation of resources changes, as subsidies decrease the price and increase the quantity, which differs from the original market equilibrium price and quantity.

1. PRODUCERS

- Producers benefit from subsidies because they receive higher prices and produce greater quantities than before, thus having their revenue increase.
- Producer surplus increases.

2. CONSUMERS

- Subsidy makes the product cheaper than before, making it more affordable for the public. Consumers benefit since they buy a greater quantity of the good at a lower price.
- Consumer surplus increases.

3. GOVERNMENT

- Since the government provides subsidy in the form of money to producers, subsidies act as a burden on the government budget. Thus, subsidies increase government expenditures whilst creating opportunity costs.

4. WORKERS

- Since output increases, firms are likely to hire more workers to increase production, making workers better off.
- Subsidies may help increase employment.