Revision – Government intervention

Maximum (ceiling) price: A price set below the equilibrium price, preventing producers from raising the price above it.

Minimum (floor) price: A price set above the equilibrium price, preventing producers from reducing the price below it.

Commodity agreement: The situation where different countries work together to operate a buffer stock scheme for a particular commodity.

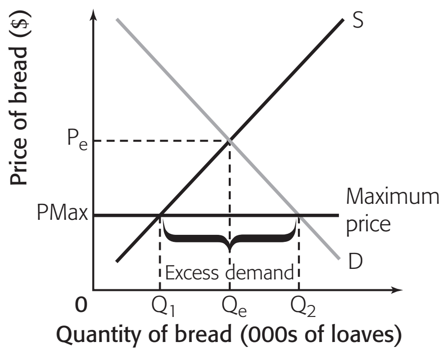
Indirect tax: A tax imposed upon expenditure, e.g. VAT, sales tax or merversteuer.

Subsidy: An amount paid by the government to a firm per unit of output.

Price controls – maximum and minimum prices

Maximum price – the government may set a **maximum price**, below the equilibrium price, which then prevents producers from raising the price above it. This is sometimes known as the **ceiling price**.

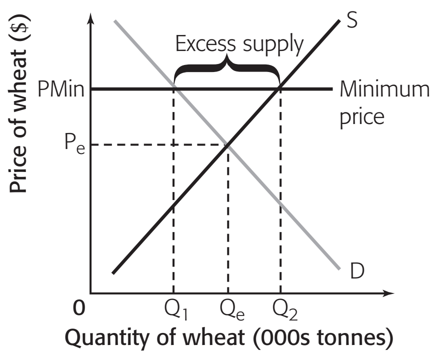
Maximum prices are usually set to protect consumers and they are normally imposed in markets where the product in question is a necessity and/or a merit good. For example, governments may set maximum prices in agricultural and food markets during times of food shortages to ensure low-cost food for the poor or they may set maximum prices on rented accommodation to attempt to get affordable accommodation for those on low incomes. Maximum prices will, however, lead to excess demand.



The excess demand creates problems. The shortages may lead to the emergence of a black market, (an illegal market) and queues developing in the shops. Thus, governments have to act. Essentially, they have two options. First, attempt to shift the demand curve to the left, until equilibrium is reached at the maximum price, but this would limit the consumption of the product, which goes against the point of imposing the maximum price.

Second, attempt to shift the supply curve to the right, until equilibrium is reached at the maximum price, with more being supplied and demanded. There are a number of ways of doing this.

- The government could offer subsidies to the firms in the industry to encourage them to produce more.
- The government could start to produce the product itself, thus increasing the supply.
- If the government had previously stored some of the product (see buffer stocks), then they could release some of the stocks (stored goods) onto the market.



Minimum price – the government may set a **minimum price**, above the equilibrium price, which then prevents producers from reducing the price below it. This is sometimes known as the **floor price**.

Minimum prices are mostly set for one of two reasons: either to attempt to raise incomes for producers of goods and services that the government thinks are important, such as agricultural products; or to protect workers by setting a minimum wage, to ensure that workers earn enough to lead a reasonable existence. Minimum prices will, however, lead to excess supply.

The excess supply creates problems. Producers will find that they have surpluses and will be tempted to try to get around the price controls and sell their excess supply for a lower price. Thus, the government has to intervene. The government would normally eliminate the excess supply by buying up the surplus products, at the minimum price, thus shifting the demand curve to the right and creating a new equilibrium. The government could then store the surplus, destroy it or attempt to sell it abroad.

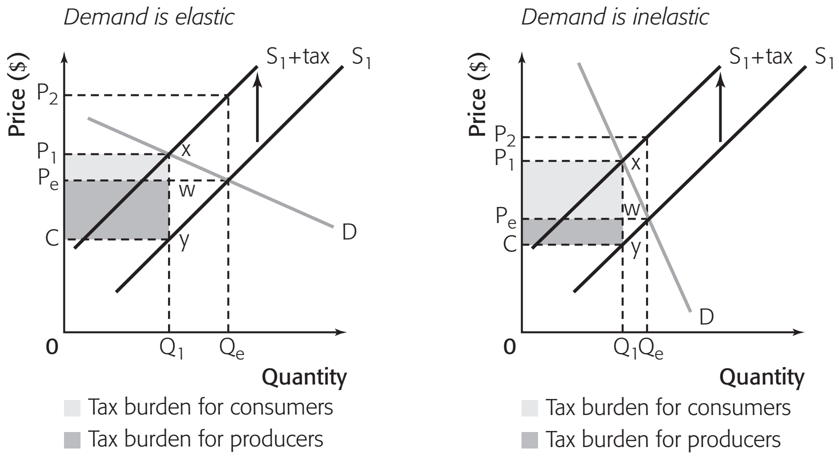
There are two other ways that the minimum price can be maintained. First, producers could be limited by quotas, restricting supply. This would keep price at P_{Min}, but would mean that only a limited number of producers would receive it. Second, the government could attempt to increase demand for the product by advertising or, if appropriate, by restricting supplies of the product that are being imported, through protectionist policies, thus increasing demand for domestic products.

If governments do protect firms by guaranteeing minimum prices, there are problems that are likely to occur. Firms may think that they do not have to be as cost-conscious as they should be and this may lead to inefficiency and a waste of resources. It may also lead to firms producing more of the protected product than they should and less of other products that they could produce more efficiently.

Indirect taxes

An indirect tax is a tax imposed upon expenditure. It is a tax that is placed upon the selling price of a product, so it raises the firm's costs and thus shifts the supply curve for the product vertically upwards by the amount of the tax. Less will be supplied at every price because of this. Producers and consumers will, between them, bear the burden of any tax that is put on. The amount that each pays will depend upon the elasticity of demand.

1. If price elasticity of demand (PED) is greater than price elasticity of supply (PES), then the producer will pay more of the tax.
2. If PED is less than PES, then the consumer will pay most of the tax.
3. If demand is elastic, then the producer will pay more of the tax wy > wx
4. If demand is inelastic, then the consumer will pay most of the tax wx > wy



This is why governments tend to place indirect taxes on products that have relatively inelastic demand, such as alcohol and cigarettes. By doing this, the government will gain high revenue and yet not cause a large fall in employment, because demand changes by a proportionately smaller amount than the change in price.

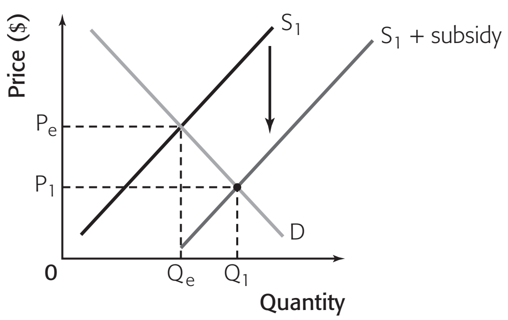
Subsidies

A subsidy is an amount of money paid by the government to a firm, per unit of output. The main reasons for subsidy are:

- to lower the price of essential goods, such as milk, to consumers, so consumption of the product will be increased
- to guarantee the supply of products that the government think are necessary for the economy, such as a basic food supply
- to enable producers to compete with overseas trade, thus protecting the home industry.

If a subsidy is granted to a firm, then the supply curve for the product will shift vertically downwards by the amount of the subsidy, because it reduces the costs of production for the firm, and more will be supplied at every price.

The price paid by the consumer falls from P_e to P_1



The amount paid by the government to the subsidy is the shaded area. (The amount of the subsidy multiplied by the quantity sold).