Chapter 3:

GOVERNMENT MICROECONOMIC INTERVENTION

3. 1. Government Intervention: Introduction.

- Market failure: where the free market does not make the best use of scarce resources.
- Regulation: various means by which governments seeks to control production and consumption.
- Taxes: charges imposed by governments on incomes, profits and some types of consumer goods and services to fund their expenditure.

The justification for intervention is usualy where there is market failure. Intervention can take a variety of forms.

* Regulation.

Governments use different methods of regulation as a means of controlling the free market.

↳ Legal and other methods are used to control the prices, quality and quantity of goods and services that are produced and consumed.

↳ Important in combating environmental problems.

↳ Regulation may also refer to prices: Eg. price controls.

* Financial Intervention: use of taxes and subsidies.

Financial tools, such as taxes and subsidies, are frequently used by governments to influence production and the prices of a wide range of goods and services in the market.

Subsidies are paid for goods and services that benefit the community and might.. that might not be provided in a free market. It can be in variety of forms.

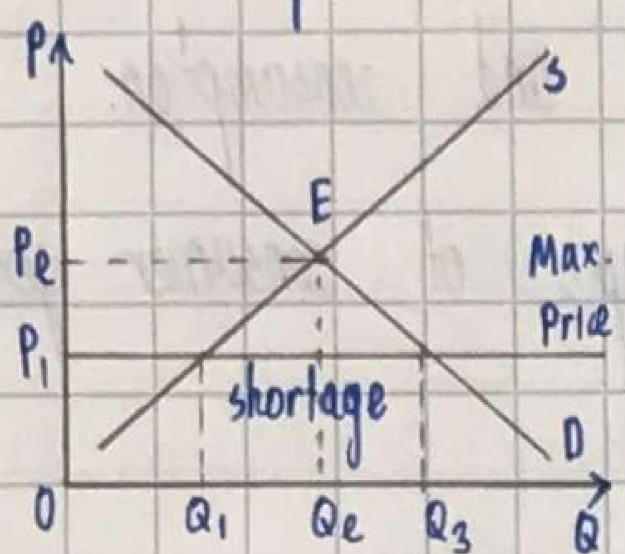
* Government provision.

It is possible for a government to take over the production of a good or service, either in whole or in part.

It is also very common to find that some goods and services are produced by both the state and the private sectors.

3.2. Maximum and minimum price controls.

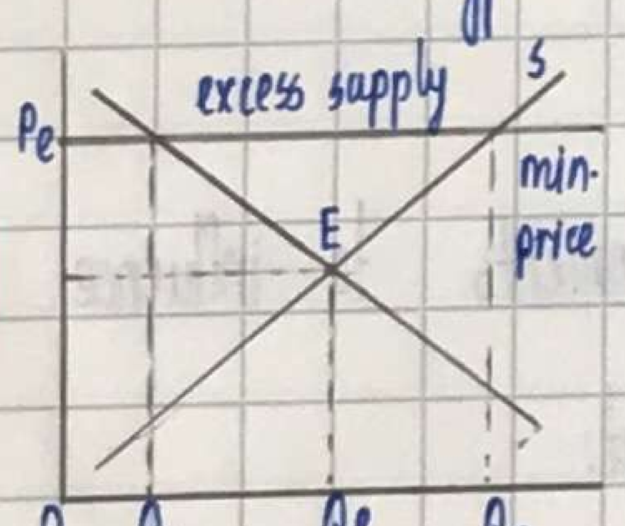
- Maximum price (price ceilings): a price that is fixed; the market price must not exceed this price, set below
  - ↳ Governments use legislation to enforce maximum prices for:
    - ↳ staple foodstuffs; e.g bread, oil (cooking) and rice.
    - ↳ rents in certain types of housing.
    - ↳ services provided by utilities, such as water, gas and electricity.
    - ↳ transport faires especially where a subsidy is p.. being paid.



→ Too few resources are being allocated. Availibity of supply has to be allocated on some other basis, most likely by queuing.

Rationing is another means of restricting demand - but this inevitably leads to an informal or underground market for the products involved, with consumers having to pay inflated prices well above the ceiling price. Such market arise when there are dissatisfied people who have not been able to buy the goods they want because not enough has been produced.

- Minimum price (price floor): a price that is fixed; the market price must not go below this price; set above
  - ↳ Governments use legislation to enforce minimum prices for:
    - ↳ Demerit goods; e.g. tobacco products and alcohol.
    - ↳ Wages in certain occupations, usually low skilled, to avoid exploitation by employers.
    - ↳ Certain types of imported goods where domestically produced close substitutes are available.



→ It is case that producers are likely to be inefficient; firms with high costs have little incentive to reduce these costs since the high-minimum price protects them from lower-cost competitors.

As with maximum price control there is risk of an informal market will develop especially for sought-after products like imported alcohols and cigarettes.

3.3. Taxes - Direct and Indirect.

Canons of taxation: A 'good' taxation must be (by Adam Smith).

- ↳ Equitible - those who can afford should pay more.
- ↳ Economic - the revenue should be greater than the costs of collection.
- ↳ Transparent - tax payers should know exactly what they are paying.
- ↳ Convenient - it should be easy to pay.

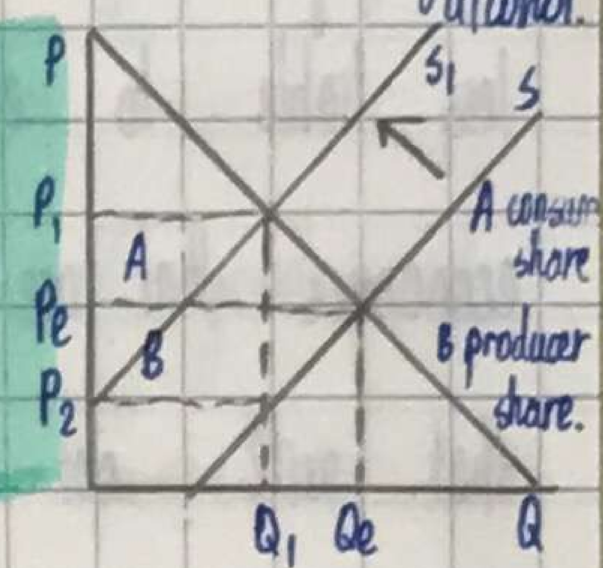
There are two main types of tax. These are:

- Direct tax: one that taxes the income of people and firms and cannot be avoided.
  - ↳ Paid directly to the government. Eg are income tax, corporation tax on the profits of businesses and national insurance contributions paid by employers and employees.
- Indirect tax: a tax that is levied on goods and services.
  - ↳ Collected for the government by retailers and local government bodies. Includes value-added tax on the retail sales of many goods and services, exise duties on fuel and alcohol and tobacco product.

In the context of indirect taxes, two main types are recognised: They are:

- Ad valorem taxes, which are a proportion or percentage of the price charged by the retailer.
- Specific taxes in the form of a fixed amount per unit purchased; widely used to tax fuel, cigas and alcohol.

Tax is represented by a shift to the left of the supply curve by the amount of the tax.



Indirect taxes are widely used to discourage the production and consumption of demerit goods such as alcholic drinks and cigarettes.

The extent to which the producer is able to pass on the tax by raising the price depends on the price elasticity of demand for the product. The more price inelastic the demand, then the easier it is for the seller to pass on the tax to the consumer in the form of higher prices. If the demand is elastic, then consumers will invariably buy less of the product as price rises, resulting in the producer having to absorb a greater part of the indirect tax.

Tax evasion is illegal. It is a major problem, particularly among companies, and one that the Pakistan government is trying to address. ↳ One line approach being pursued is to tax companies on their revenue rather than on their profits. ↳ A second approach is to tackle corruption in the disclosure of personal incomes and the evasion of salles taxes by small retail businesses.

3. 4. Other Taxation Issues.

In collecting taxes and in the development of taxation systems, governments should be very aware of the impact a tax has on the various income groups in the economy.

The average rate of taxation is defined as the average percentage of total income that is paid in taxes. Yet...

Marginal rate of taxation means the proportion of an increase in income which is paid in taxes to the government. In a progressive tax system the marginal rate will be greater than the average rate resulting in a more equal distribution of income.

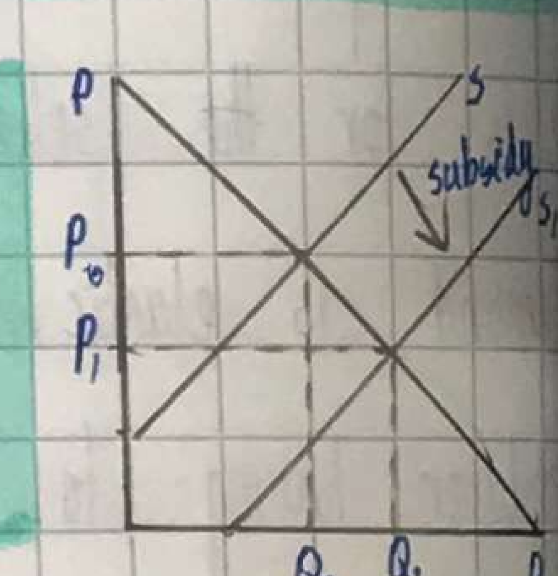
- Proportional tax: one that takes the same porportion or percentage from all who have to pay it.
- Progressive tax: a tax that makes a higher percentage from those with higher incomes.
  ↳ the average rate of taxation will therefore be lower than the marginal rate.
- Regressive tax: a tax that takes a greater percentage from those on lower incomes.
  ↳ the average and the marginal rates of taxation are falling.

Progressive tax → Income tax   Regressive tax → VAT, GST

! Balance between direct and indirect taxes is important. A trend in many economies has been to collect increasing revenues from indirect taxes on expenditure since these can usually be collected quickly, are less liable to evasion and corruption and do not interfere with the work incentive problem. Those economies that are compliant with this strategy are therefore supporting a regressive tax system, one that will not be well-liked by low- and middle-income earners. This is particularly the case in developing economies, where it is rather easier to levy indirect rather than direct taxes as a means of establishing secure tax regime.

3. 5. Subsidies.

! When paid to a producer, a subsidy has the opposite effect of an indirect tax.



↳ to keep down the market prices for essential goods.
↳ to encourage greater consumption of merit goods.
↳ to contribute to a more equitable distribution of income.
↳ to provide service that would not be provided by the free market.
↳ to raise producers' income, especially in the case of farmers.
↳ to provide an opportunity for exporters to sell more goods.
↳ to reduce dependence on imports by paying subsidies to domestic producers of close substitutes.

! Subsidy is not only interfering with the workings of the market mechanism but has opportunity cost implications.

! Another problem is that subsidies are so-called 'blanket' or lump sum payments and, unlike taxes on consumers and, unlike taxes on consumers, cannot easily be ~~lil.~~ linked to incomes and the ability to pay.

3.6. Transfer payments.

- Transfer payment: a hand-out or payment made by the government of certain members of the community.
  - ↳ Function is to provide a more equitable distribution of income.
  - ↳ The effect of it on the market is a controversial issue.

Positive ↳ Results in less poverty and a more equitable distribution of income.

Negative ↳ Can act as a disincentive to accepting work, so increasing the unemployment rate. As a consequence, output in the economy is less than it might be and there is a form of inefficiency.

3.7. Direct provision of Goods and Services.

If some important services are provided by the government it will be used equally by all citizens then they, lose., the lowest incomes gain most as a percentage of their income- thereby lowering inequality.

As with transfer payments there are substantial differences in the indirect provision of goods and services between economies.

! The direct provision of goods and services is also a controversial issue.

↳ The main cd. criticism is that the market overprovides especially where no direct charge is made.

↳ Resources are not allocated efficiently.

↳ If a charge is, made or introduced, demand is likely to fall.

↳ It can also be argued that many consumers could afford to pay a charge, so reducing the tax burden or allowing the funding saved in this way to be put to alternative use

3.8. Nationalisation and Privatisation.

- Nationalisation: When governments take over a private sector business and transfer it to the public sector.

* The Case for Nationalisation.

There are some very relevant economic arguments to support nationalisation.

↳ It makes sense for certain strategic services and activities to be in the hands of the public sector.

↳ There is also a long standing socialist view that such services are for the benefit of the public and should therefore be in the public sector.

↳ There is little sense in duplicating certain services like railways and water supplies, largely because

- the high costs of establishing that provision.
- Any profits made will be returned to the business and reinvested for the benefit of the public.
- Employees feel a sense of ownership and work hard to ensure financial viability.
- Nationalised industries will be more likely to provide loss-making services for social reasons.

* Privatisation.

- Privatisation: The sale of a state-owned public sector business to the private sector.

In modern sense, privatisation is now recognised to include:

- The direct sale of government-owned and operated activities to the private sector. The nature of the sale can be diverse.
- Deregulation through the removal of barriers to entry, which had protected the public sector from outside competition.
- Franchising to give a new private sector owner the right to operate a particular service or activity for a given length of time.
- Contracting out of services previously provided in-house by public sector organisations.

* The case of privatisation.

Some are economic, others much more concerned with political motivation.

- A deliberate commitment to reduce government involvement in the economy.
- To widen share ownership among the population and among the employees of the privatised companies.
- Benefits for consumers in the form of lower prices, wider choice and a better quality product or service.
- Privatised companies can be successful in raising capital, lowering prices and cutting out waste, they are more efficient than state-owned operations.