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Is government intervention beneficialin a micro – economy?

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ABSTRACT

This paper studies the effects of government intervention in a micro-economy. Itincludes key, fundamental economic concepts that relate to government policies and its impact on an economy. The research has been started off by analyzing a collection of data from an online survey consisting of 6 short answer type questions, answered by 65 respondents, aimed at testing logical thinking and gaining insight from different perspectives that plays an important role in determining whether an economy benefits when the government intervenes. It has been noticed that almost 70% of the respondents feel that government intervention is beneficial in an economy since it provides resources and amenities for the growth and development of a country, and looks to achieve allocative efficiency, thus preventing any wastage of resources.

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I. INTRODUCTION

What exactly is a 'micro-economy'? A micro-economy is one in which single factors and individual decisions play an important role. In any economy, a micro-economy or macro-economy, government intervention plays a vital role. Altogether, the understanding of government intervention is a fundamental concept in the field of microeconomics. The future of an economy is more or less in the hands of the government, be it beneficial or adverse to the welfare of the economy.

Government policies influence consumer behavior, more importantly consumer spending. Consumer spending or purchasing power(GNI per capita)is the key factor on which the welfare of an economy is built. The government formulates and passes many policies which must be respected and followed by an economy, whether desired by consumers or not.

Most consumers are rational when it comes to purchasing goods and services in their economy. They are purposeful and are more probable to act consistently with their underlying tastes and preferences. For example, an individual who plays football may want to continue buying his cleats from Nike, since it is a matter of personal preference. This does not mean Adidas cleats are not good; it means consumers like to have a sense of loyalty that agrees with their tastes and motivations. Hence it is safe to say that an economy works in relation to what each consumer demands. Although, large, attractive discounts and schemes such as "Buy 2 get 1 free" make consumers irrational. Consumers will buy a good they are not very fond of, just to get another good free of cost as part of the scheme. This causes a high increase in demand which results in higher sales and leads to the betterment of the economy as a whole.

However, if the government chooses to intervene for any particular reason, the whole situation may change. For example, the government intervenes by increasing income taxes by 2%; the purchasing power of all consumers will fall, leading to lower real income values. This will result in lower demand thereby decreasing total revenue earned by the producers and retailers of the economy.

On the other hand, government intervention can prove to be beneficial through the provision of subsidies. If the government provides farmers of an economy with subsidies, their total cost of production will decrease, thus enabling them to increase their output, resulting in higher sales.

II. REVIEW OF LITERATURE

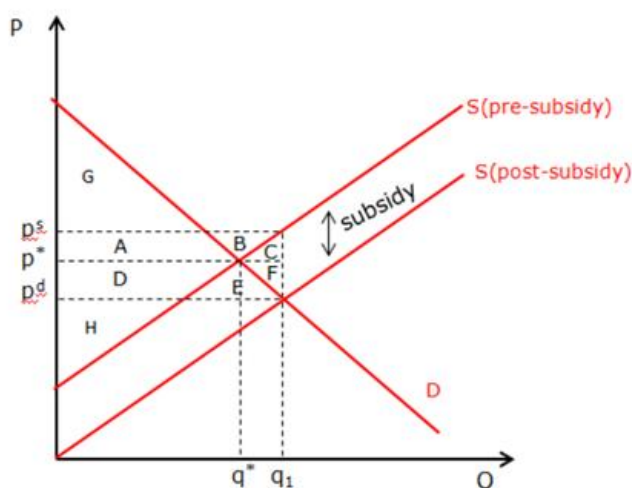
Government intervention is very common in all micro-economies around the world. Whether beneficial or adverse to the economy, in some situations, government intervention is necessary for the development of an economy. The government intervenes in an economy in 4 main aspects – Provision of subsidies, introduction or addition of taxes and to establish price floors or price ceilings when necessary.

1. Provision of subsidies: Subsidies are sums of money provided by the government to an industry or developing business to keep their costs low. This helps these firms produce more at a lower cost, thus increasing total revenue.

The government may use subsidies for a whole lot of other reasons:

- To keep the market price of essential goods low.
- To increase the demand and consumption of merit goods.

- To raise the level of the profit earned by the producer.
- To provide additional, necessary services that would otherwise not be provided by the free market.
- To provide greater opportunities for exporters all over the country to sell more goods.

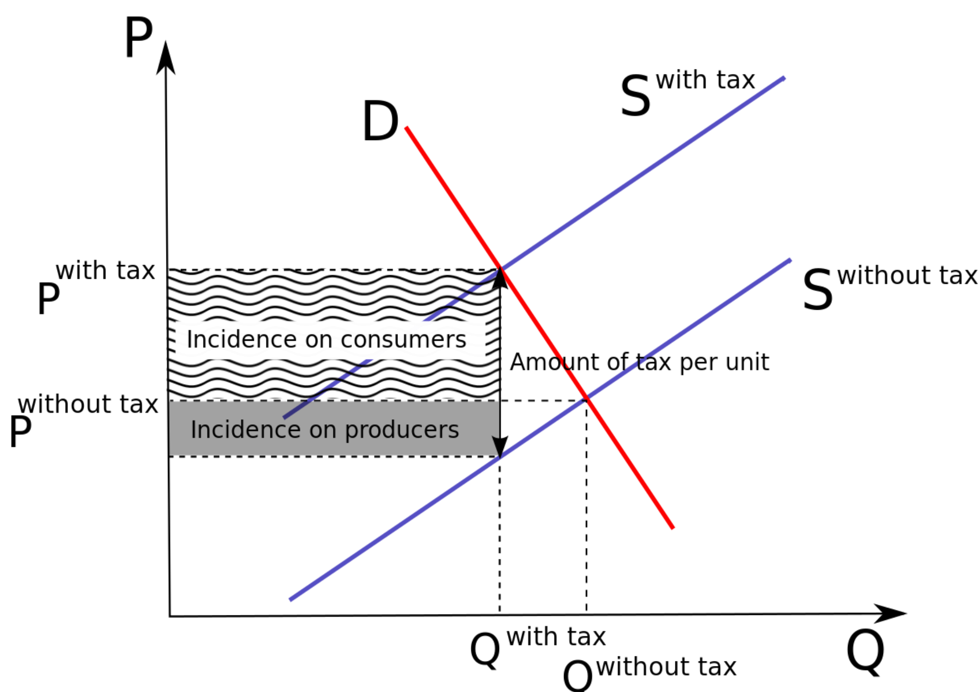


2. Introduction/Increase in taxes: Taxes are charges imposed by the government on the incomes and profits as well as some types of consumer goods and services so as to fund their expenditure. An increase in taxes reduces consumers total income and hence lowers their purchasing power, which leads to a decline in total revenue earned by the firms in the economy. Some commonly known taxes include income tax, corporate tax and service tax. There are two main types of taxes – Ad valorem taxes and specific taxes.

Ad valorem taxes are a percentage of the price charged by the seller. VAT and GST are typical examples of such taxes. The final price paid by the consumer is inclusive of these taxes.

Specific taxes are paid in the form of a fixed amount per unit of the purchased good. These are used to tax fuel, cigarettes and alcohol.

When a tax is levied on a good, the total cost of production increases and hence as a result, the supply of the good decreases. This effect is shown by a leftward shift of the supply curve, which relatively increases the price of the product.

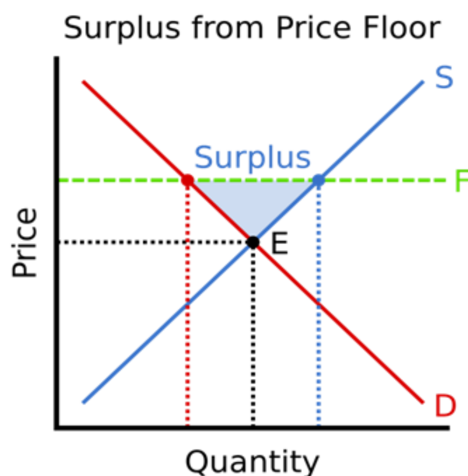


3. Price ceilings: Also known as 'maximum price', price ceilings are established by the government in case it feels the equilibrium price is too high. More importantly, price ceilings are established so as to reduce the price of staple foodstuffs such as bread and cooking oil as well as services provided by utilities, such as water, gas and electricity, thus promoting social equality. Since maximum prices are established below equilibrium, the price per quantity decreases and therefore more people are able to afford basic amenities and services, increasing the welfare of the consumers as a whole.

However, since the price decreases, demand increases by a large margin. The level of production is not enough to satisfy the needs and wants of all the consumers wanting to buy the product. Consequently, some consumers miss out on the opportunity to buy the good at such a low price. This leads to the formation of an underground market for the products involved, with consumers then having to pay inflated prices that go beyond the maximum price set by the government.

4.Price floors: Also known as 'minimum price', price floors are established by the government in case it feels the equilibrium price is too low. It is a fixed price which the market price must not go below. More importantly, price floors are established so as to reduce the consumption of demerit goods, since price floors are set above the equilibrium price, which increases the price per unit of that product. Therefore, since the price increases, demand will fall and hence less people will be consuming that particular demerit good. Another reason why price floors are enforced is to secure satisfactory wages in certain occupations, usually low skilled, to avoid exploitation by employers.

Since demand decreases drastically, excess supply is created. This leads to reduction in revenue of firms or maybe even losses, since total costs may exceed sales.



Aim
The objective of this research paper is to ascertain whether government interventionhas a positive impact on the development of an economy or a negative one.

III. METHODOLOGY

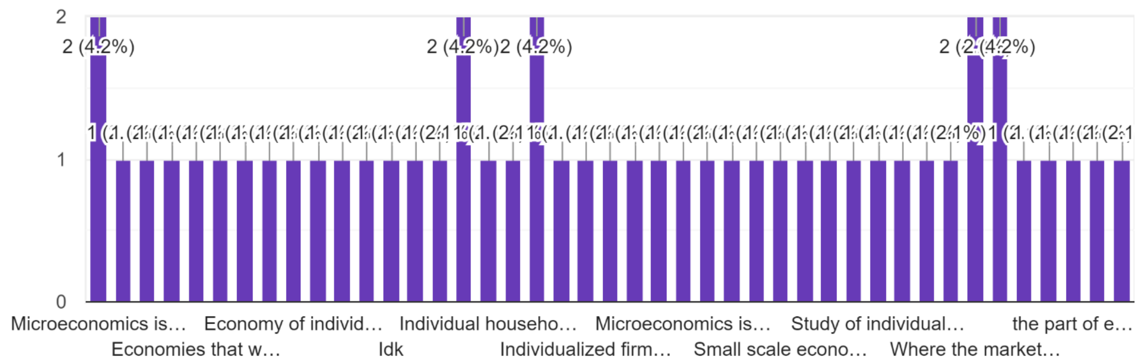
A sample of 75 grade 10, 11 and 12 economics students were chosen from the city of Mumbai to help in conducting this research. The participants had to complete an online survey, which was made using google forms. The form consisted of 2 parts. The first part contained a consent form that highlighted the key points of the survey. The second part of the form contained short answer type questions related to the topic of discussion, government intervention. After applying economic theories on basic government intervention techniques, participants were asked to share their views, whether they thought government intervention is beneficial to economies around the world or not. There were a few true or false questions as well so as to allow the participant to brush over all the key government intervention topics and concepts before stating their opinions on whether intervention in a microeconomy is positive or not.
No names were recorded for this survey, hence maintaining the anonymity of the participants.

Null Hypothesis
Government intervention is not beneficial in a micro-economy.

Alternative Hypothesis
Government intervention is beneficial in a micro-economy.

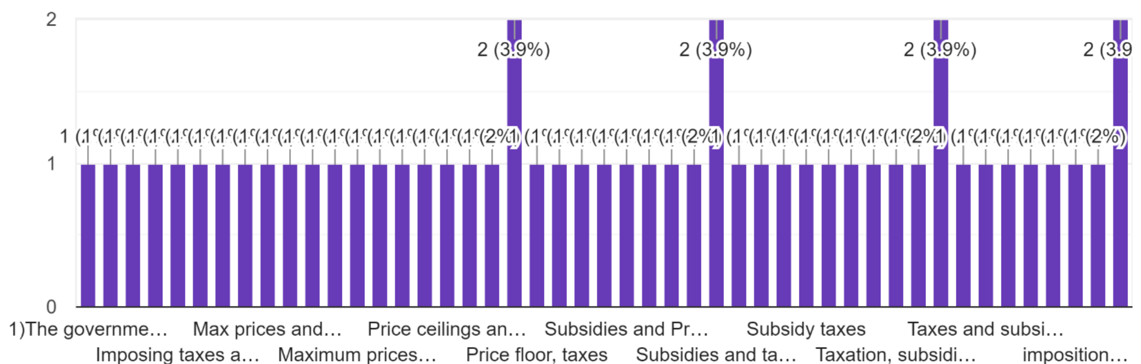
Data Analysis
The google form consisted of 6 questions on government intervention and its relation to a microeconomy. Throughout the short answer survey, there were multiple responses to each question with different perspectives, ideas and understandings.

What is a 'microeconomy'?
48 responses



Participants answered this question with similar knowledge, since it was a pretty direct question to get everyone going. A microeconomy is where individuals, enterprises as well as firms, make decisions regarding the allocation of various resources in the economy.

Mention 2 ways in which the govt intervenes in an economy.
51 responses



This question made participants think slightly more. 'Taxes' was the most common response which was expected. Fortunately, the responses covered all the main forms of government intervention that is applicable to a microeconomy – Subsidies, Price ceilings, Price floors and taxes.

To bring down the price of necessities what does the government impose – Maximum price or Minimum price?

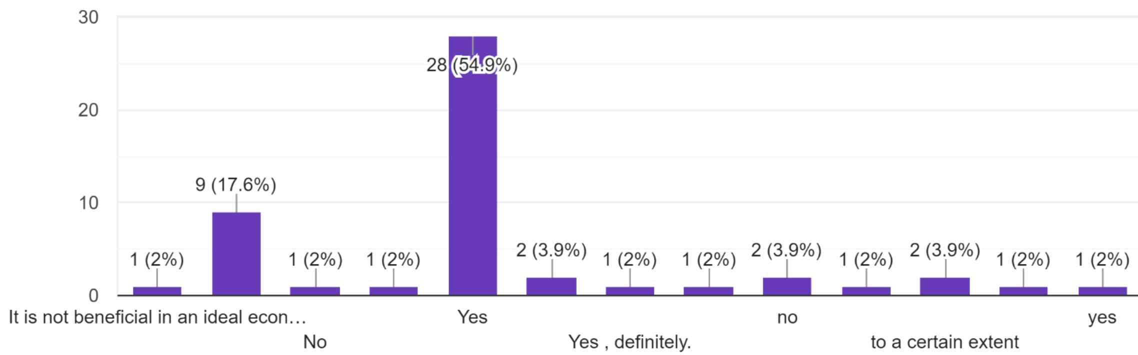
51 responses

This question was a tricky one and quite a few of the participants have gone with 'Minimum price' as their answer. However, the correct answer is Maximum Price. Let's take an example of a necessity – Rice. Rice is a crop needed by all sections of society to eat, hence a necessity. The market price of rice is the equilibrium price, where market demand and supply intersect. If the people in the economy are finding it increasingly difficult to pay for this good, the government will impose a maximum price below the equilibrium price, hence lowering the price of the necessity. This allows people in the society to comfortably consume rice.

Subsidies are a form of government intervention. They bring down the total cost of production. True or false?

52 responses

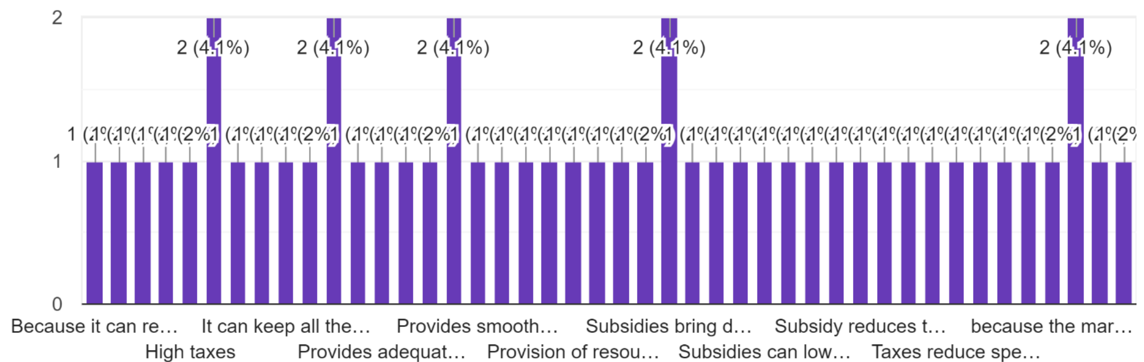
94% of the responses for this question were correct. Subsidies are a popular method of government intervention. The government often provides sun-rise industries, sun-set industries as well as certain independent businesses with subsidies which reduces their total cost of production. This enables them to supply more of their products to their desired regions.



This was the main question that addresses the purpose of the research. About 68% of the responses state that 'Yes, government intervention is beneficial in a microeconomy'. 4% of the participants have stated that it is beneficial 'to a certain extent'. The rest of the responses all state that government intervention has a negative influenceon the economy. The most agreeable choice is that which states it is beneficial 'to a certain extent'. Of course, government intervention is beneficial, but it also has a few drawbacks, hence making this the most suitable answer choice.

The government plays an instrumental role in any economy. It provides basic resources through which an economy can grow and develop. It provides assistance to those groups of people who are struggling in society, by means of transfer payments. It encourages new industries and firms to grow and helps them do so by the provision of subsidies.

However, the government may impact personal freedom on some occasions. The government may try to shift consumer behavior and may sometimes go a little overboard in trying to do so. With the influence of a maximum price, the government may benefit a few groups of the economy. However, the profit of firms producing the goods will be cut short due to the significant price decrease.



This question aims to figure the reasons behind the answers to the previous question. The participants explained their logic and reasoning to support their choice in the previous question.

The respondents who stated that they felt government intervention is beneficial to the economy have responded with many diverse answers, which enables this discussion to go on even further. The most common answer was that of provision of subsidies. Subsidies encourage small businesses to expand and perform better which improves the economy. Since subsidies cause the total cost of production to fall, suppliers can supply larger quantities of goods and distribute them throughout the country, benefitting all.

A few participants claimed government intervention is necessary for an economy to grow. They justified this statement by saying that the government provides all basic amenities and facilities so that the

economy may develop. This is a crucial part in the growth of any economy in the world. 5% of the respondents used the terms 'externalities' and 'allocative efficiency'. The main role of the government is to maintain allocative efficiency by making sure the social benefits are always greater than social costs, and to keep negative externalities to a minimum. Any disruptions in externalities will cause market failure, which tips the economy off balance.

The participants that felt the intervention by the government to be adverse in a microeconomy, also had their reasons. 75% of the respondents were unhappy with the way the government gets on with taxation. They very rightly pointed out that high taxation can reduce the spending power of an individual by a significant amount. If high taxes are charged on the incomes of the public, they will spend less money buying goods and services from suppliers in the economy. This may lead to supply exceeding demand leading to economic instability. Suppliers will make big losses as their sales will reduce by a large amount, hence decreasing total revenue.

IV. RESULTS AND DISCUSSIONS

The audience for this research was mainly confined to economic students across Mumbai, of varying ages, the most common ages being between 15-17 years old. This quality of the sample enabled the discussion and research to get a wider perspective on the topic.

Every respondent had his or her own views about government intervention and in the question – "Give a reason for your answer", each of them were able to explain and justify their decision as to why they think intervention is beneficial or not. For example, respondents claimed that the progressive tax system is leading to the downfall of an economy. The progressive tax system charges tax as a percentage of people's incomes. This simply means that people who earn bigger paychecks have to pay more tax to the government. This is affecting the economy as a whole. People are not wanting to accept higher responsibilities since they know they will have to pay more money in taxes.

On the other hand, there were so many respondents who felt that the provision of subsidies are an important factor provided by the government in a microeconomy. Subsidies sure help in generating a larger output, but there are a few drawbacks as well.

Providing subsidies to firms developing in the economy may not always result in a lower cost of domestically produced goods. The firms may not pass on the subsidies to the consumers, and instead pocket it for themselves. The payment of subsidies by the government may make firms complacent which will have a negative impact on the output the firm produces. Subsidies may also provoke retaliation as foreign governments may see them as unfair competition.

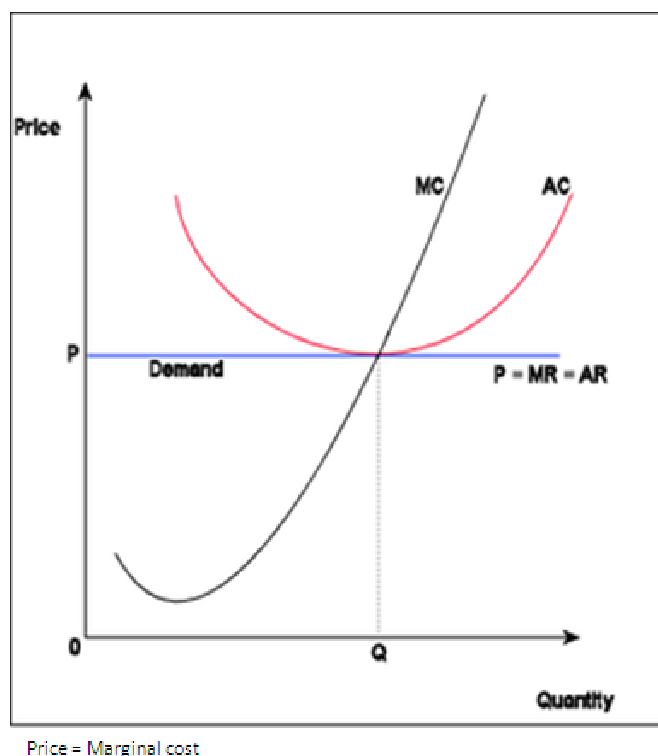
The third question was a little tricky – "To bring down the price of necessities what does the government impose – Maximum price or minimum price?" 58% of the respondents got the answer to this question correct, Maximum price. The others responses included 'price floors' and 'minimum price'.

Price floors are set above the equilibrium and hence they increase the price of a product, completely opposite compared to price ceilings (maximum prices). Price ceilings are set below market equilibrium, hence reducing the price of goods and services in an economy. Thus, if the government feels the need to reduce the price of a necessity, it imposes a maximum price on that product.

When responding to the question – "Do you think government intervention is beneficial to the economy?", 5% of the respondents used terms such as 'allocative efficiency' and 'externalities'. These two terms are key concepts in the case of government intervention, especially in a microeconomy.

All firms aim to produce their goods at the lowest possible cost so as to maximize their output and profits, but it is not enough for goods and products to be produced at the lowest possible cost. The right products and the right quantity of products must be produced to achieve economic efficiency. Allocative efficiency is all to do with allocating the correct amount of scarce resources so as to produce the right products in satisfactory quantities. Allocative efficiency looks at producing the combination of products that will yield the greatest possible level of satisfaction of consumer needs, wants and preferences.

The point of allocative efficiency exists when the price of a product is equal to its marginal cost of production. Marginal cost is the cost required to produce an additional unit of output. When the price is equal to the marginal cost of production, the price paid by the consumer will represent the true economic cost of producing the last unit of that product. This makes sure that the right amount of the product is produced.



Price = Marginal cost

Externalities are where the actions of producers or consumers give rise to side effects on third parties who are not involved in the action. An externality arises when a third party is affected by the actions of others. Externalities are of two types – Positive externalities and negative externalities.

A positive externality occurs when the externality has a positive impact and benefits third party members who are not involved in the action. A negative externality occurs when the externality has a negative or detrimental impact that gives rise to costs to third parties.

Each of these two types of externalities can be further classified into:

Positive Production Externality or Positive Consumption Externality and Negative Production Externality or Negative Consumption Externality.

Production externalities are caused due to spillover effects caused by production activities by producers. An example of a positive production externality is the discovery of a new vaccine that cures a disease. The recipients of the vaccine obviously benefit, but others in the economy also benefit since there is reduced incidence of the disease. On the other hand, an example of a negative production externality would be the dumping of unused products and wastes into nearby water bodies by large firms. This causes pollution and people who live near these water bodies will fall ill.

Consumption externalities are caused due to spillover effects caused by consumption activities. An example of a positive consumption externality is provision of merit goods by the government. This includes health facilities and education. People who receive a high level of education will have greater employment opportunities and will go on to contributing to the growth of the economy in the near future. On the other hand, an example of a negative consumption externality would be passive smoking. People who smoke in open areas cause great harm to themselves, but also cause damage to others around them, since they also inhale the smoke.

Large firms generally overlook these externalities and expect their mess to be cleaned up by the government. Hence, these firms only look at their private costs, ignoring any of the social costs they may have created in society. If a negative externality is present, the social costs are more than the private costs, hence the supply curve shifts to the left, increasing the price. The correct quantity that should be produced bears in mind the social cost, but the firm produces at a quantity where social costs are ignored, leading to overproduction and hence, misallocation of resources.

When a positive externality is present in the economy, the demand curves shifts to the right due to the presence of positive external benefits. This leads to an increase in price of the product. This takes place since the further extra benefits to society are registered, causing the shift in the demand curve. This leads to an underproduction of goods in the economy and hence, misallocation of resources.

V. CONCLUSION

Overall, the government has many roles to play in the development of an economy. It provides facilities and policies that aim to increase the welfare of people in society. However, yes, there are a few drawbacks which people are not fond of, but in my opinion these few drawbacks are worth it. Afterall, the government has a good intention and aims to make its country reach its potential. Hence, from all the data collected, the null hypothesis is disapproved and the alternative hypothesis is approved.

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