CSQ Lesson 1 – Demand and Supply, Government Regulation

**Question for Discussion**

**Subsidy**

**Explain the mechanism of Subsidy**

* Subsidy is a transfer payment to the producers by the government to lower the price of the good concerned. The effect of this subsidy either raises the consumer benefit or producer benefit, depending on the value of price elasticity of demand
* Specific subsidy causes a parallel shift downwards and to the left.
* Ad valorem subsidy causes a pivoted shift in the clockwise direction.

Explain how the provision of subsidy affects the consumers and producers

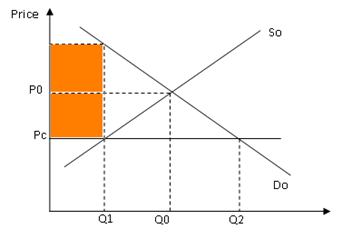
Diagram

- Description of the diagram

**1. Price Ceiling**

**1.1 Explain the mechanism of Price Ceiling**

A maximum price set artificially by the government of firms so that goods are bought and sold at that price level which is below the market equilibrium price level. The purpose in setting the price ceiling is to prevent excessive increase in price so that consumers will not pay a higher price at the market price level which may be controlled by the seller to exploit the consumer. In doing so, the government is trying to allocate goods in a more equitable approach to ensure that there is no unequal distribution of the benefits of the goods especially for scarce resources during a crisis.



As seen from the diagram, the price is lowered from Po to Pc when there is the imposition of price ceiling and this causes an increase in quantity demanded from Qo to Q2 while the quantity supplied decreases from Qo to Q2. This creates an excess demand condition between Q1 to Q2 that may lead to a rise in black market condition where the price rises from Pc to Pm at the quantity level at Q1.

**1.3 Difficulties in imposing price ceiling**

* May create an excess demand condition which cannot be resolved if there is no buffer stock.
* may give rise to black market price if the market cannot have excess supply from buffer stock to meet demand
* It contradicts the market principles which will undermine the efficiency of the economy. (shift and costless adjustment of resources)
* The price ceiling may lead to the failure of the business as the fixed price level cannot accommodate the rise in average cost of production
* It undermines the producers as there will be a loss of producer surplus but the consumers will gain as the consumer surplus becomes bigger

**Qn. The imposition of floor price on the rice market in Thailand (max 2 pages)**

1. some description of this issue by Ying Luck

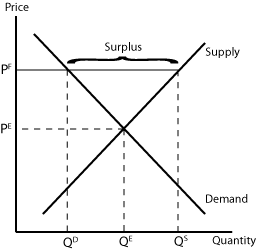
After Thailand Prime Minister Yingluck Shinawatra gained office in 2011, her government started Thailand’s Rice Pledging Scheme to buy rice from farmers, in order to boost their incomes. This raised prices for unmilled paddy rice from as low as $271 a ton to $500 a ton.

2. How Floor price works

When the Thai government sets a price floor in the rice market, it means implementing a lowest minimum price that rice can be sold for. The rice cannot be sold for a price that is any lower than the price floor. A price floor is usually implemented in agricultural markets when the equilibrium price is too low and the government wants to protect farmers. In addition, the price floor should be set above the equilibrium price, because if it is set below the equilibrium, producers would just sell their output at the equilibrium price.

2.1 mechanism

2.2 draw graph



2.3 describe graph

3. Intended impact (benefits to the Thai people)

The intended impact of this price floor policy was to protect farmers from low prices in the rice market as the prices were too low for farmers to support themselves. With the increase in price from PE to PF and quantity from QE to QS, the farmers will enjoy a higher revenue, and increase their standard of living.

4. Unexpected impact

4.1 increase cost of expenditure to government

This increased the cost of expenditure to government as it had to buy over the large surplus of rice in order to maintain the price at PF.

4.2 Feasibility of the floor price

- Other farmers will want to also enjoy this floor price

4.3 exchange rate

When the price of rice increased, the Thai rice lost its price competitiveness in the international market to other exporters of rice such as India and Vietnam. As such, demand for Thai rice fell and exports decreased. In addition, the Thai people also turned to imports of rice from other countries which were cheaper priced, increasing Thailand’s imports. Since Thailand was the world’s largest exporter and fifth largest cultivator of rice in the world, a lower demand for the Thai Baht caused the exchange rate to weaken.

4.4 corruption

There was also the issue of corruption. Millers smuggled rice in from other countries and claimed that it was Thai rice to enjoy the higher domestic price of rice. When the government sold its rice stockpiles at a price lower than the market price, rice traders bought them and then pledged this rice back to the scheme to earn profit from the difference in prices.

4.5 perishability and cost of storage of rice

Since the government had to buy up the surplus of rice, it soon accumulated rice stockpiles. It had to pay a huge amount to preserve the quality of these stockpiles. In addition, there was corruption concerning the quality of rice as well, and the stockpiles contained bad-quality rice that came from neighbouring countries. As such, Thailand was left with millions of tonnes of rotting rice.

4.6 budget strain

This policy put a massive strain on the Thai government’s fiscal budget. It had to continuously channel resources from other sectors of the economy or even dip into its fiscal budget to buy up the surplus and ensure that rice is being sold at the price floor, which left it with less revenue to spend on other sectors of the economy.

**6. The Market for cotton**

**Extract 1: Brazil's cotton growers seek to boost output as India restricts exports**

Cotton prices have soared 73% in the past year and reached a 15-year high of US$1,064 on 28 September 2010 after India, the world's second-biggest exporter after the United States, said it would limit exports. The Indian government will limit exports to 5.5 million bales in 2011, compared to 2010 when exports were 8,3 million bales. The price of cotton is expected to stay above US$1 until June 2011.

Cotton growers in Brazil, the world's fifth-largest exporter of the fibre, plan to increase output in 2011 after the rise in world prices. Planting for the 2011 harvest may rise to 1.1 million hectares from 830 000 hectares in 2010.

Brazil's government may consider increased financial support for cotton growers to encourage them to raise output in 2011, according to the Brazilian Agriculture Ministry. A four-month drought hurt the quality of the crop this year in Brazil, causing output to fall. In September the government temporarily eliminated a 10% tariff on cotton imports as domestic supplies fell short of demand.

*Source: Bloomberg, 1 October 2010*

(c) Explain the likely reason why the Brazilian government eliminated the 10% tariff on cotton imports and the Indian government restricted cotton exports. [3]

**7. Agriculture, water crisis and poverty**

**Extract 3: Madhya Pradesh farmer protests**

In June 2017, farmers in Madhya Pradesh, India, protested by demanding higher Minimum Support Prices (MSP), as well as a complete debt waiver. Farmers there had asked the central government to deliver on its promise of adjusting MSP to be cost of production plus 50 percent profit – a price that was declared impractical by the government in 2015.

After two years of drought resulting in successive crop failures farmers were finally relieved to receive abundant rainfall and a good harvest. Yet, they are still struggling to make a profit on their produce. Overproduction of food can push farmers into distress just as much as a failed harvest. A supply glut, such as the one presently faced by pulses, chili, potato, and onion cultivators in India, generally leads to a price crash, resulting in poor returns. But it is exactly for situations such as these that the MSP policy is in place in the country – to shield farmers from market volatility.

The MSP scheme forms part of India’s agricultural price policy. It is the price at which farmers’ produce in certain crops is bought by the government during the relevant seasons. When the market prices dip to a level that is below the MSP, the government agencies step up and buy over the produce in order to protect the farmers.

However, the states have either failed to procure most of the produce at MSP or are really slow in the process, forcing many farmers to sell far below the set price. There could also be exploitation by commission agents. They have been reported to have bought the farmers’ produce at much below the MSP.

*Sources: 14 June 2017, YourStory Research and 1 August 2018, Citizen Matters*

(e) Discuss the effectiveness of the minimum price support scheme (MPS) to improve the livelihood of farmers in India during a good harvest. [8]