6

Supply, Demand, and Government Policies

Supply, Demand, and Government Policies

- In a free, unregulated market system, market forces establish equilibrium prices and exchange quantities.
- While equilibrium conditions may be efficient, it may be true that not everyone is satisfied.
- One of the roles of economists is to use their theories to assist in the development of policies.

CONTROLS ON PRICES

- Are usually enacted when policymakers believe the market price is unfair to buyers or sellers.
- Result in government-created price ceilings and floors.

CONTROLS ON PRICES

- *Price Ceiling*
  - A legal *maximum* on the price at which a good can be sold.
- *Price Floor*
  - A legal *minimum* on the price at which a good can be sold.

How Price Ceilings Affect Market Outcomes

- Two outcomes are possible when the government imposes a price ceiling:
  - The price ceiling is not binding if set above the equilibrium price.
  - The price ceiling is binding if set below the equilibrium price, leading to a shortage.

Figure 1 A Market with a Price Ceiling

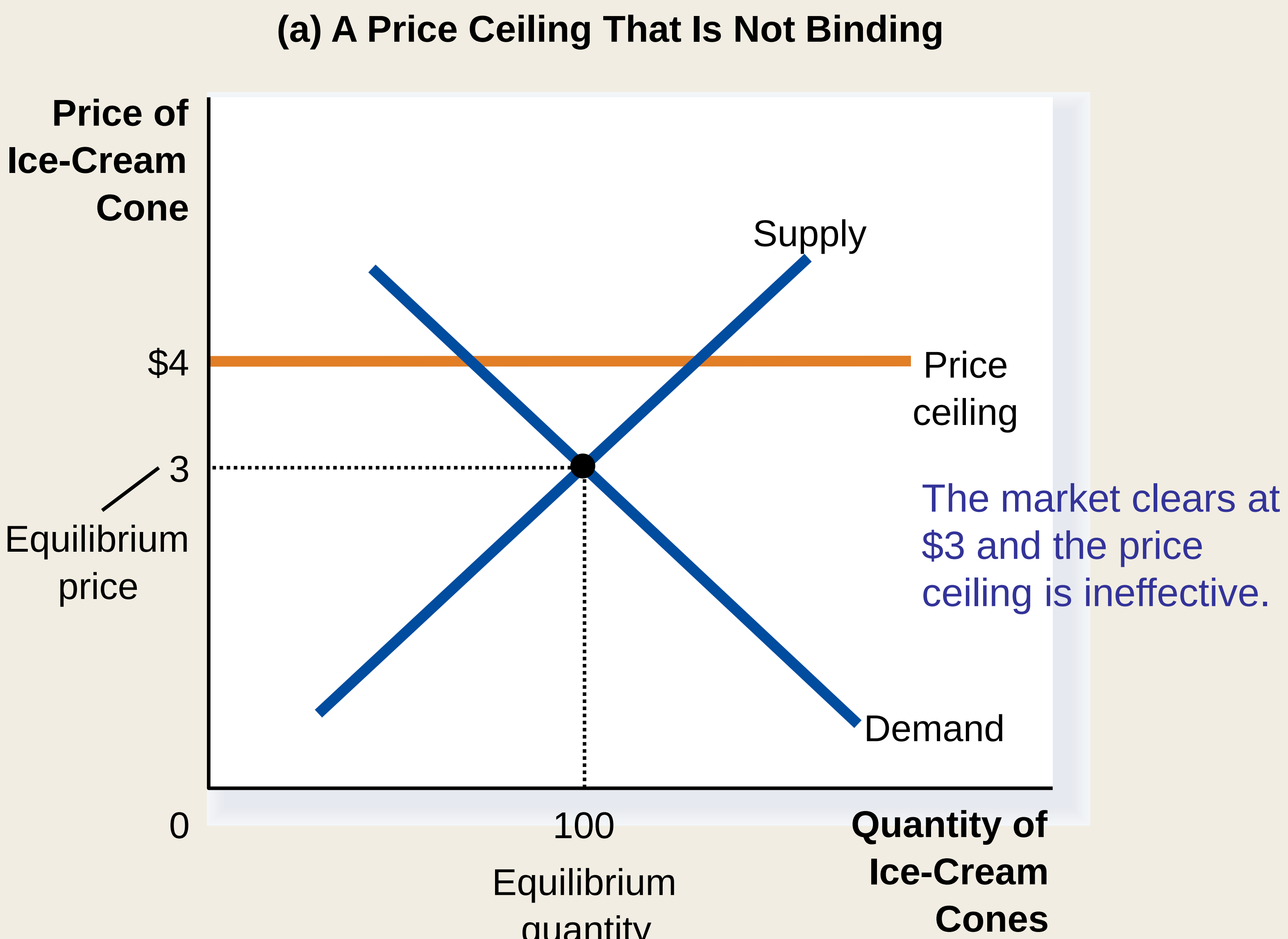
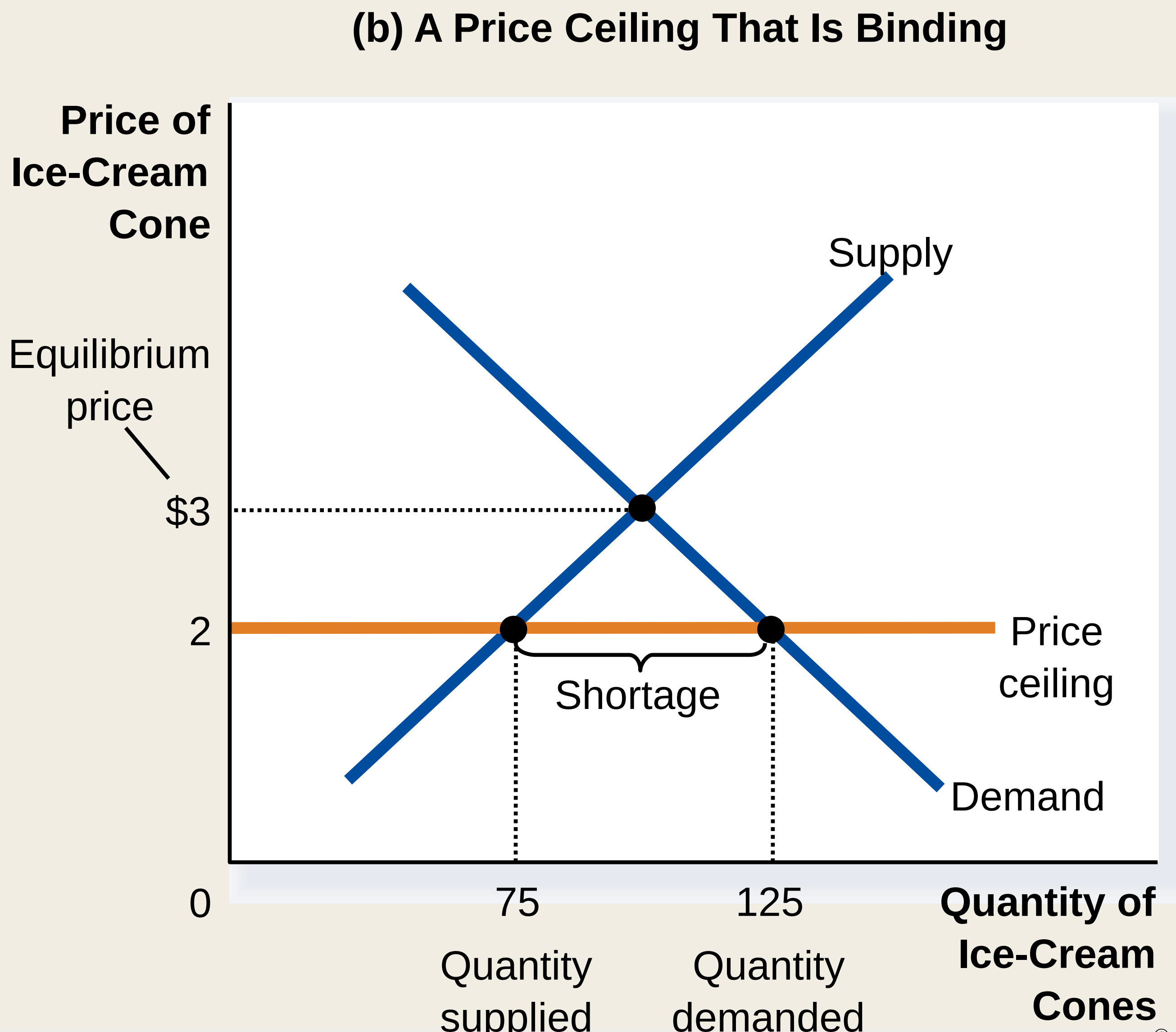


Figure 1 A Market with a Price Ceiling



How Price Ceilings Affect Market Outcomes

- Effects of Price Ceilings
- A binding price ceiling creates
  - Shortages because $Q_D > Q_S$.
    - Example: Gasoline shortage of the 1970s
  - Nonprice rationing
    - Examples: Long lines, discrimination by sellers

CASE STUDY: Rent Control in the Short Run and Long Run

- Rent controls are ceilings placed on the rents that landlords may charge their tenants.

- The goal of rent control policy is to help the poor by making housing more affordable.

Figure 3 Rent Control in the Short Run and in the Long Run

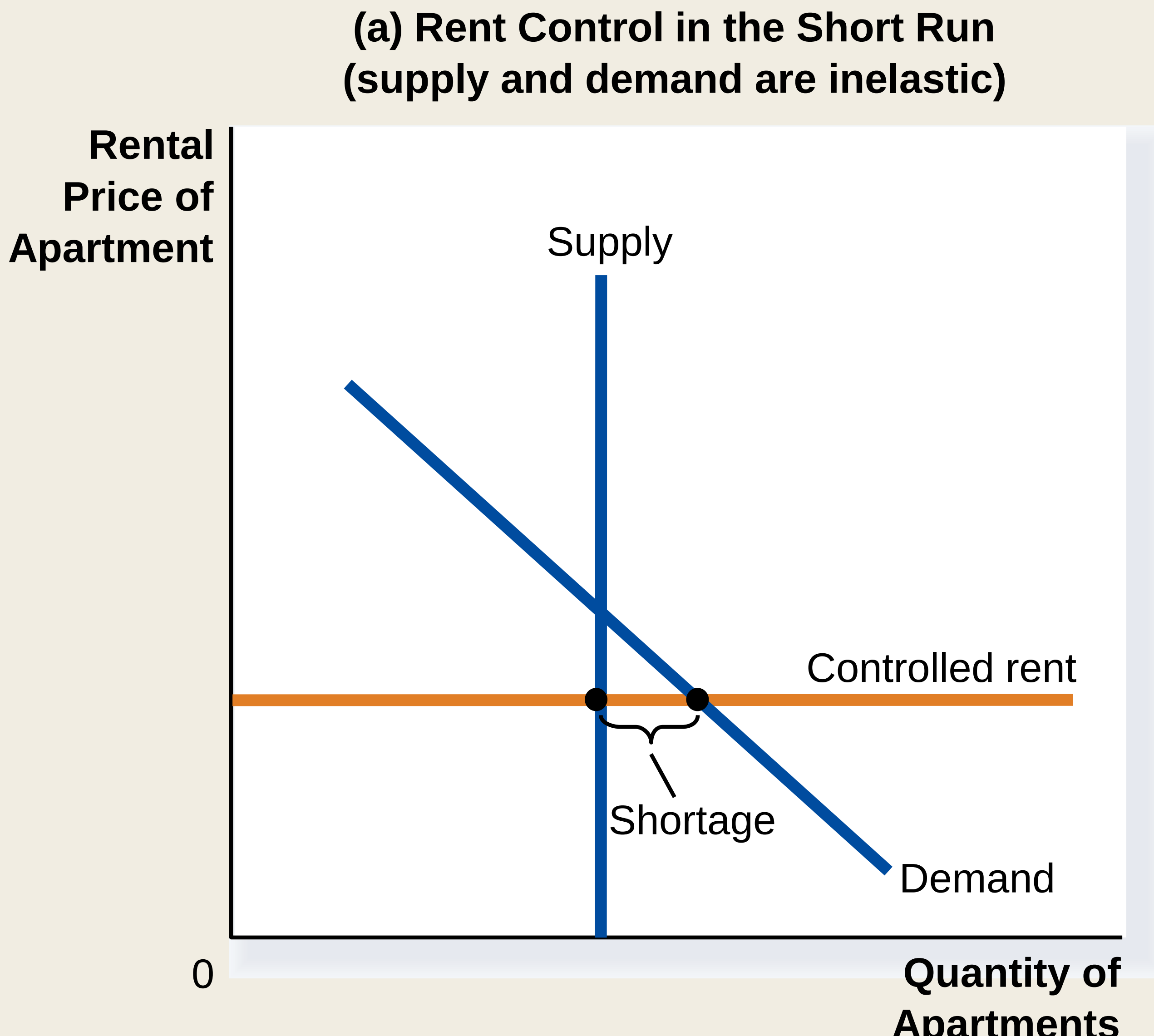
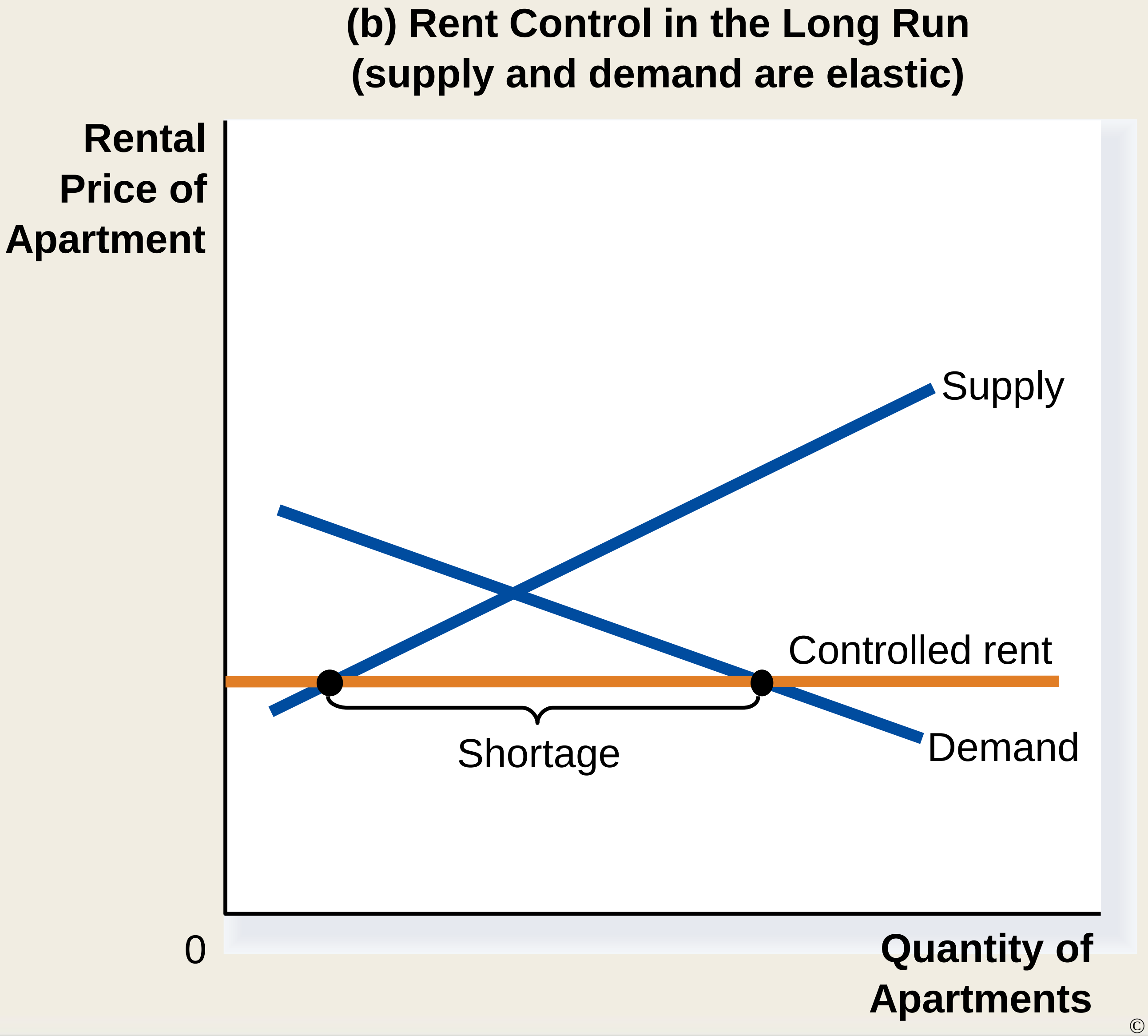


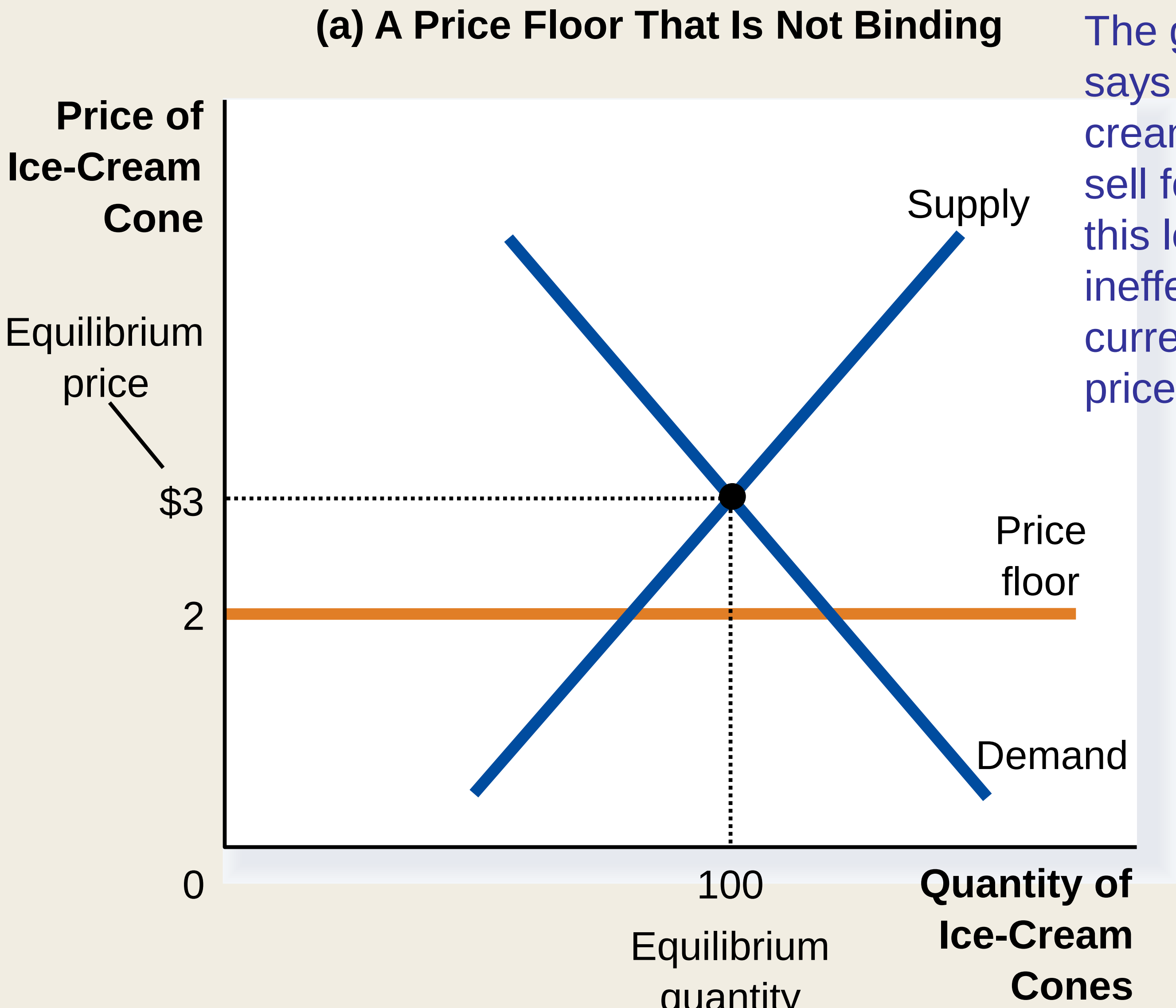
Figure 3 Rent Control in the Short Run and in the Long Run



How Price Floors Affect Market Outcomes

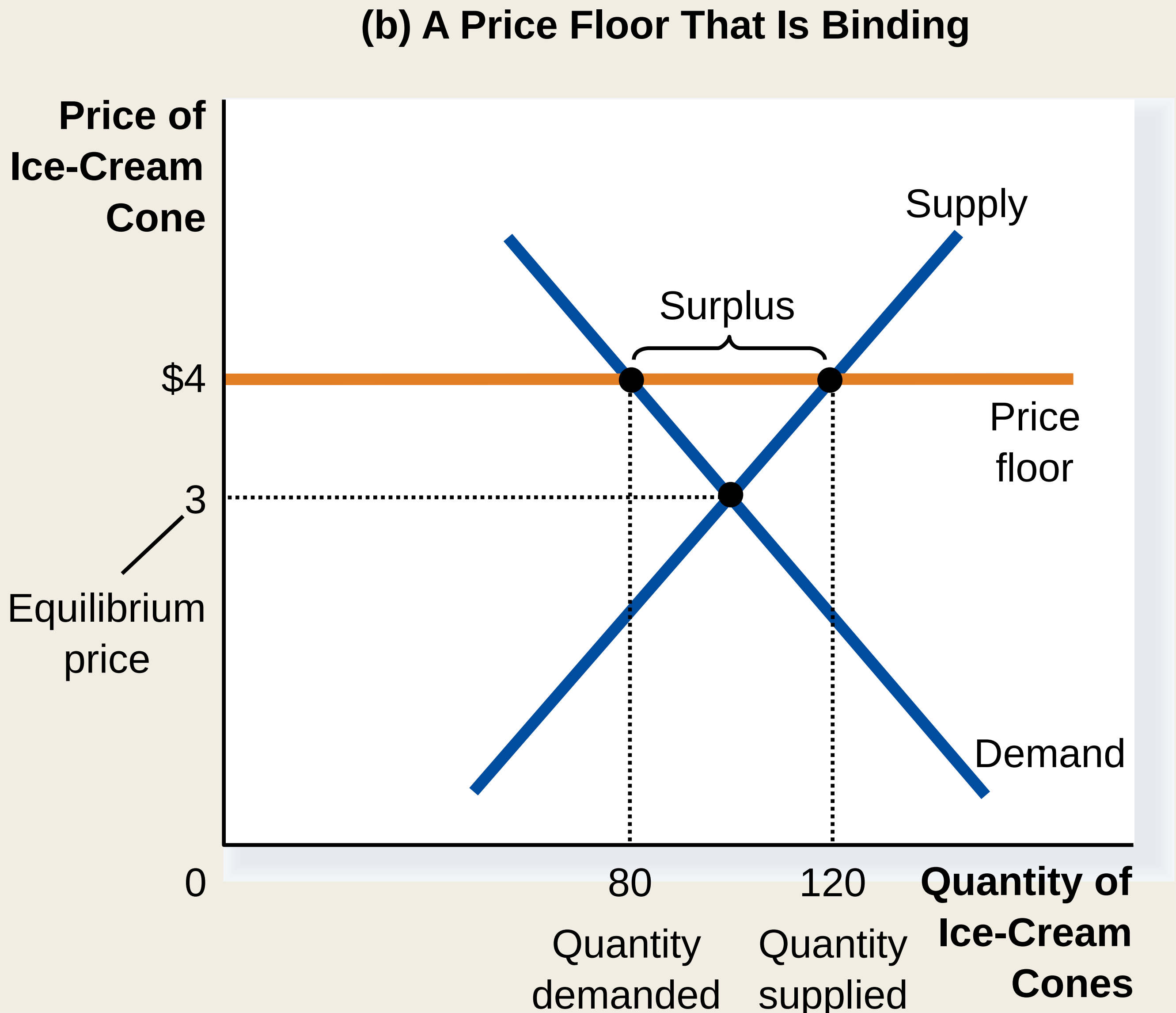
- When the government imposes a price floor, two outcomes are possible.
  - The price floor is not binding if set below the equilibrium price.
  - The price floor is binding if set above the equilibrium price, leading to a surplus.

Figure 4 A Market with a Price Floor



The government says that ice-cream cones must sell for at least $2; this legislation is ineffective at the current market price.

Figure 4 A Market with a Price Floor



How Price Floors Affect Market Outcomes

- A price floor prevents supply and demand from moving toward the equilibrium price and quantity.
- When the market price hits the floor, it can fall no further, and the market price equals the floor price.

CASE STUDY: The Minimum Wage

- An important example of a price floor is the minimum wage.
- Minimum wage laws dictate the lowest price possible for labor that any employer may pay.

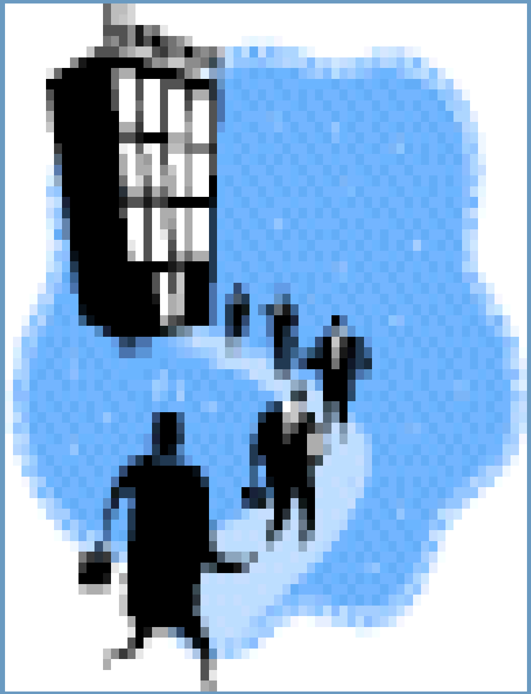


Figure 5 How the Minimum Wage Affects the Labor Market

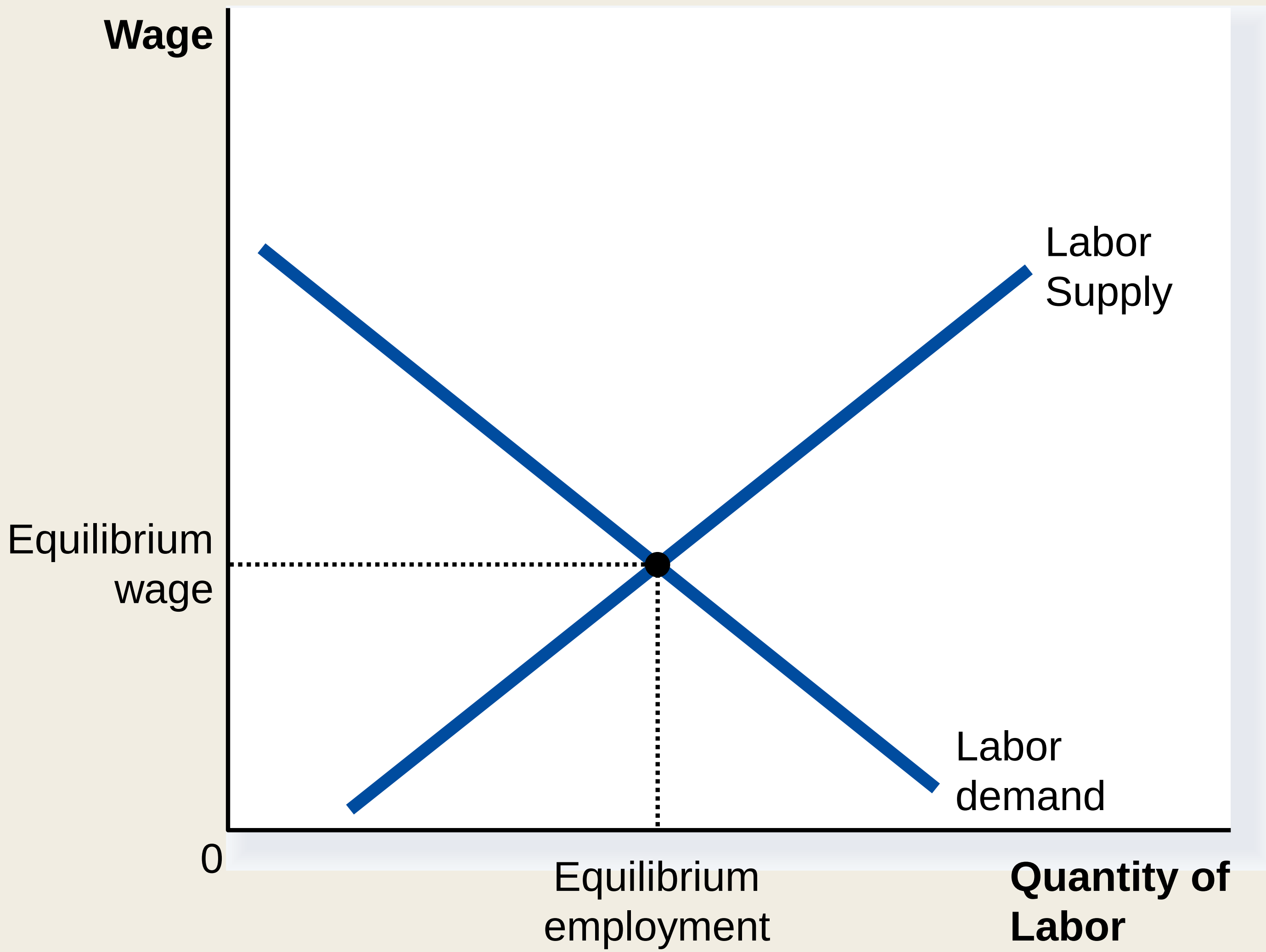


Figure 5 How the Minimum Wage Affects the Labor Market