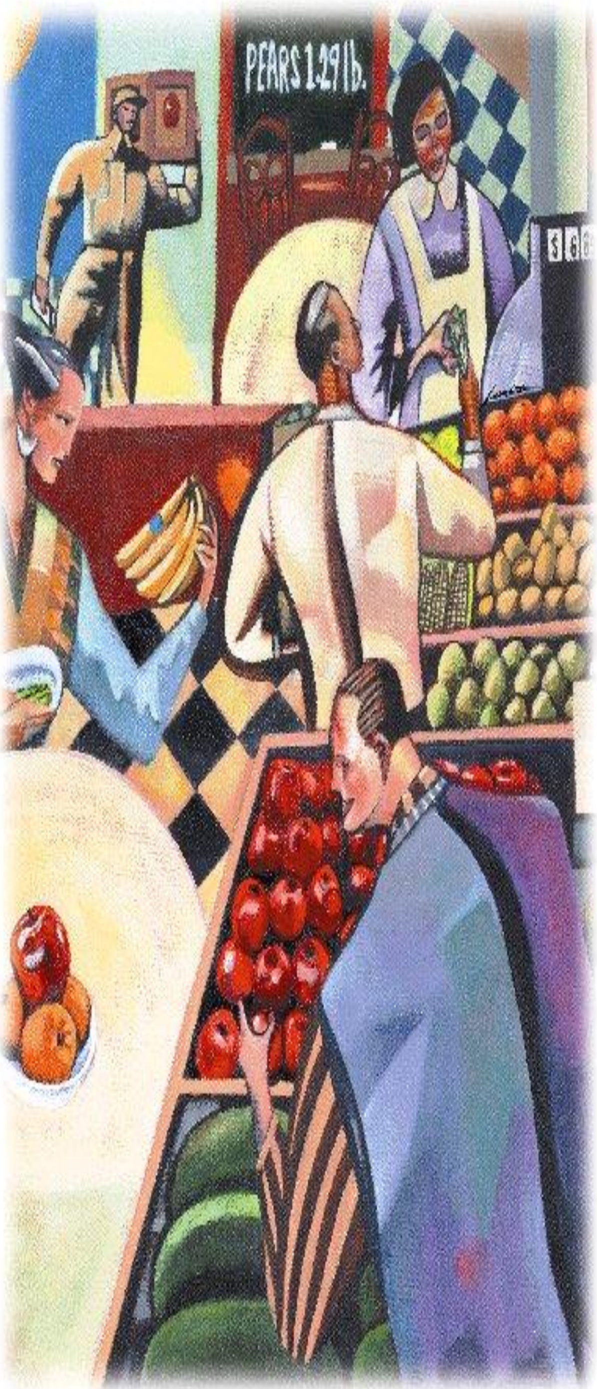


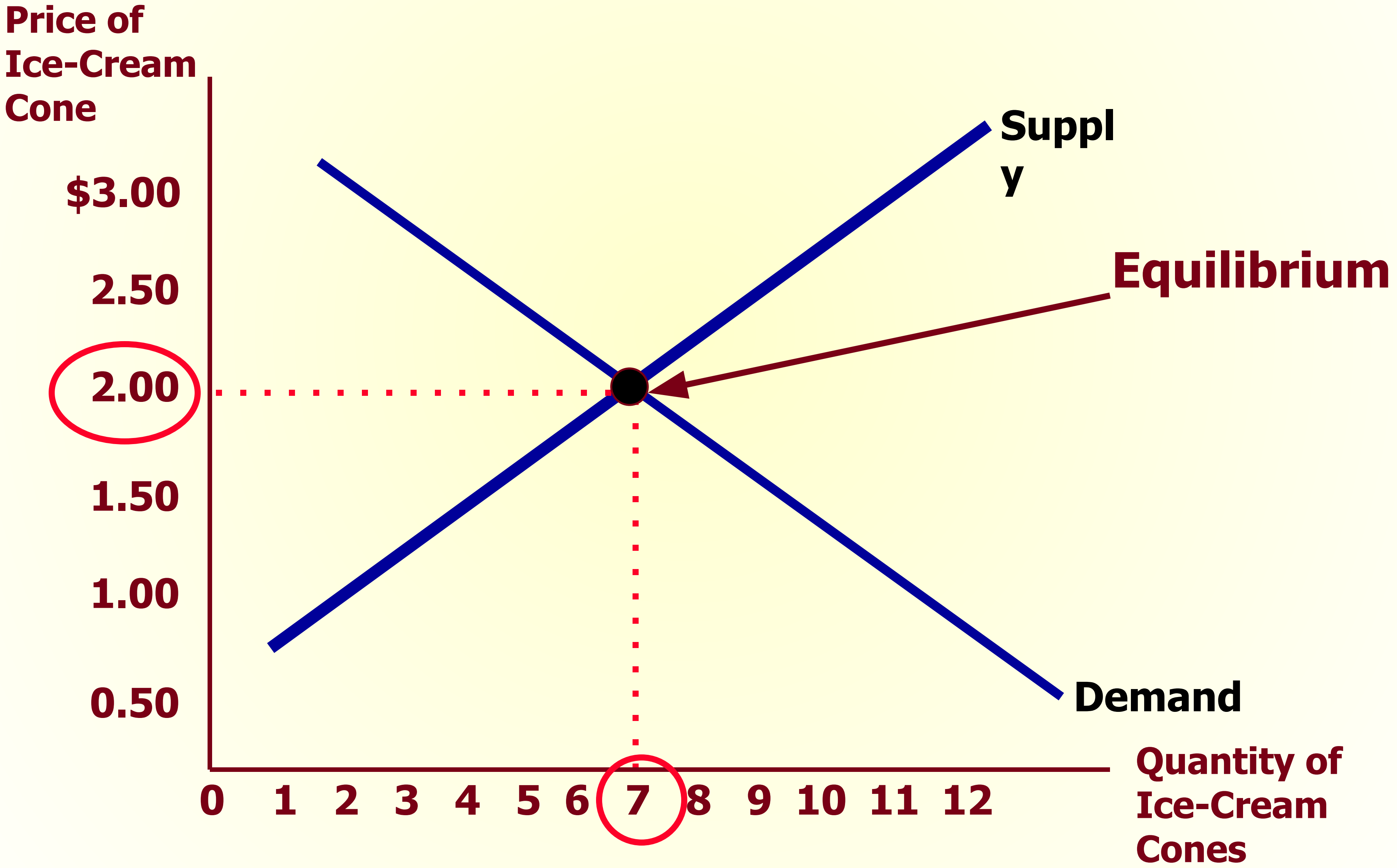
Supply, Demand and Government Policies

Chapter 6

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.**

Market Equilibrium



Price Controls...

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

Price Ceilings & Price Floors

Price Ceiling

- **A legally established <u>maximum</u> price at which a good can be sold.**

Price Floor

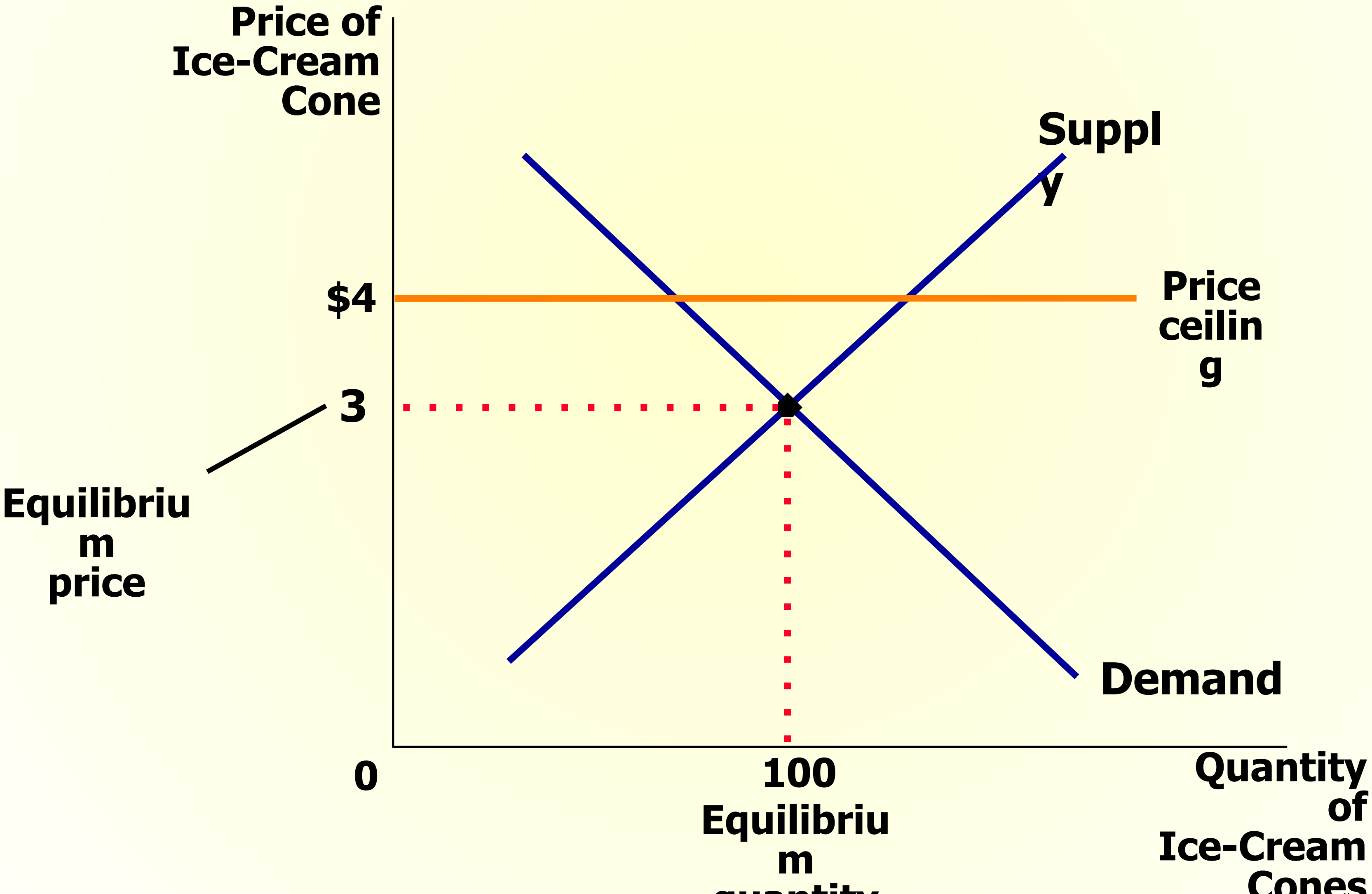
- **A legally established <u>minimum</u> price at which a good can be sold.**

Price Ceilings

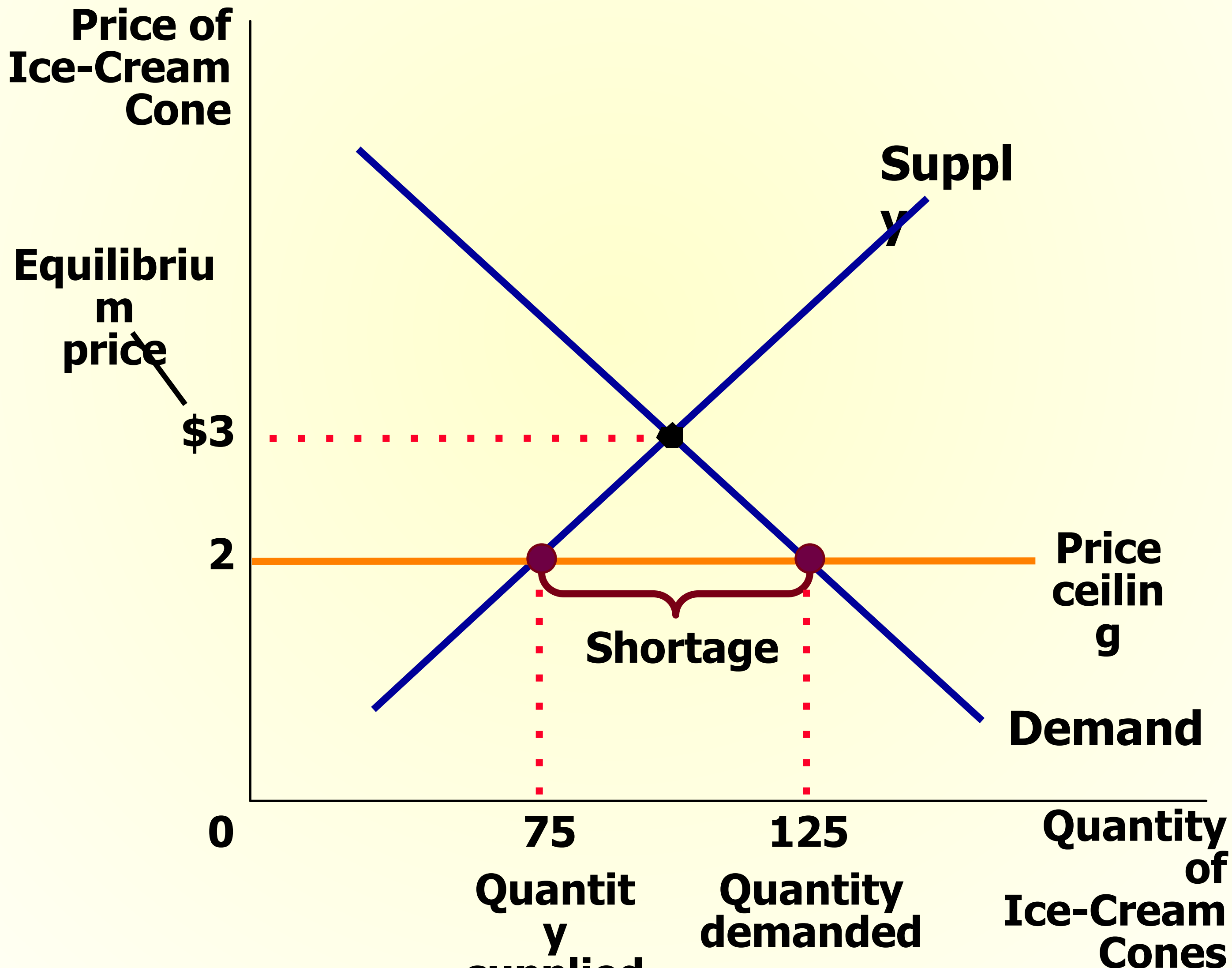
Two outcomes are possible when the government imposes a price ceiling:

- **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.**

A Price Ceiling That Is Not Binding...



A Price Ceiling That Is Binding...



Effects of Price Ceilings

A binding price ceiling creates ...

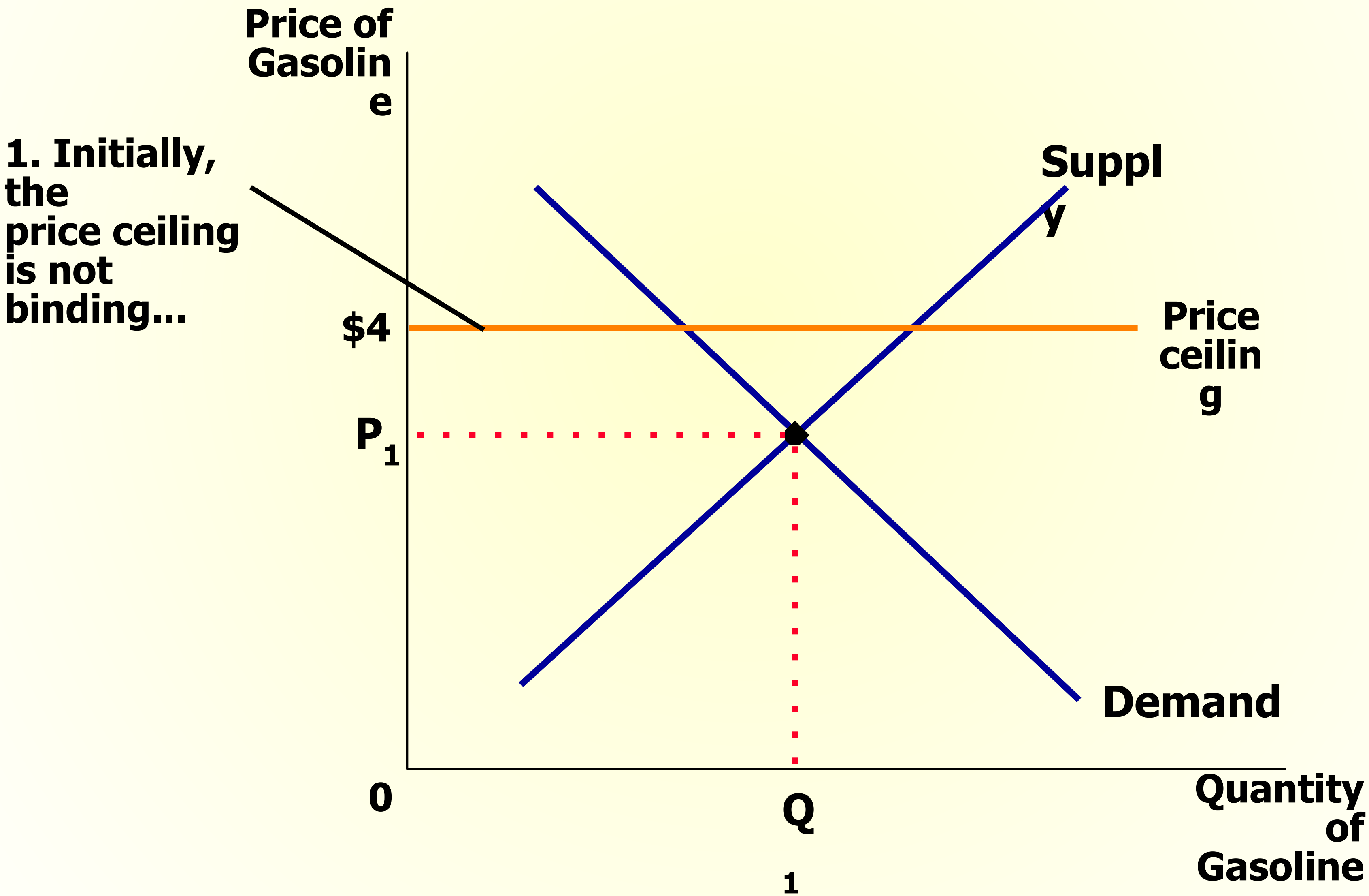
... shortages because $Q_D > Q_S$.

- Example: Gasoline shortage of the 1970s

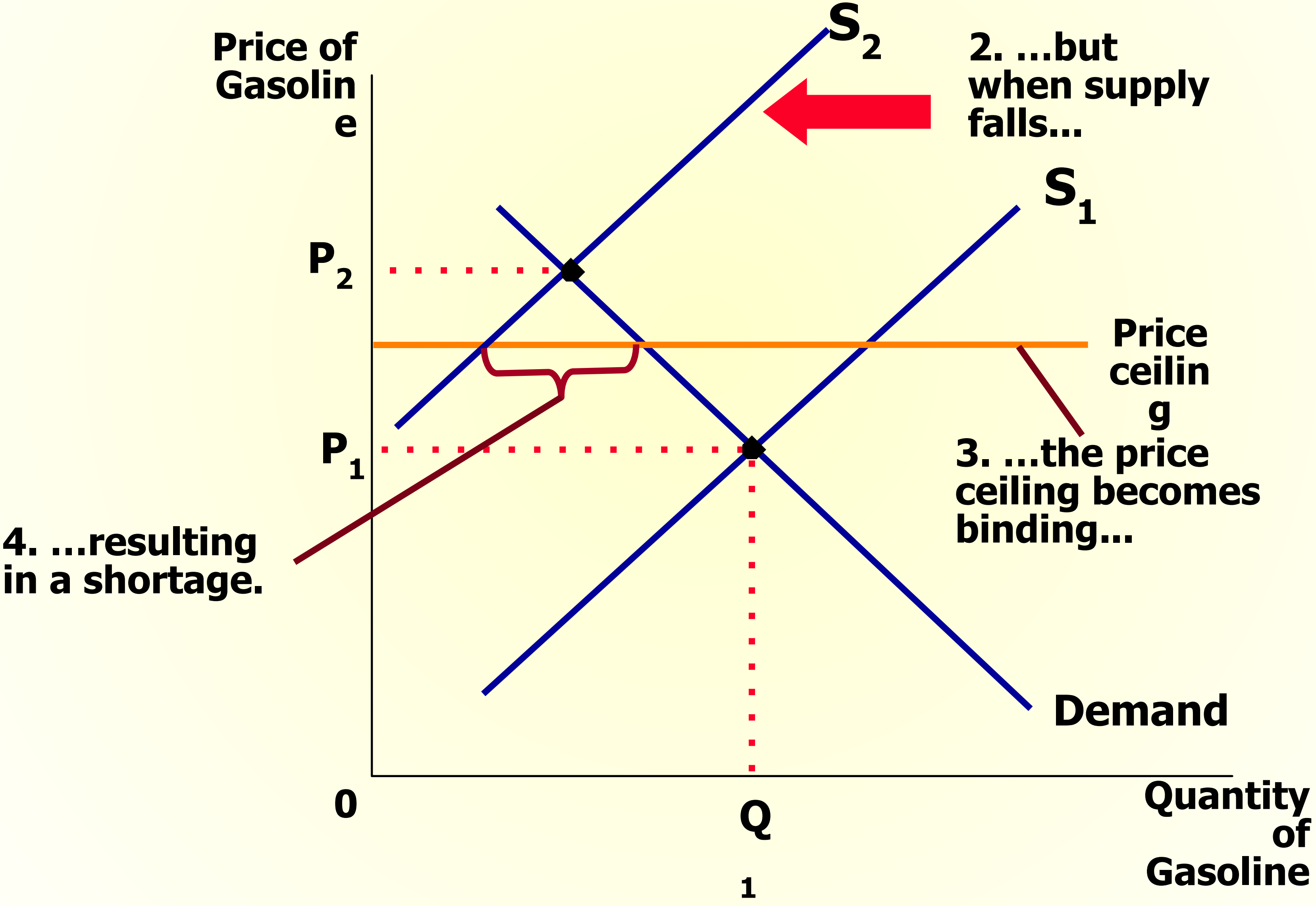
... nonprice rationing

- Examples: Long lines, Discrimination by sellers

The Price Ceiling on Gasoline Is Not Binding...



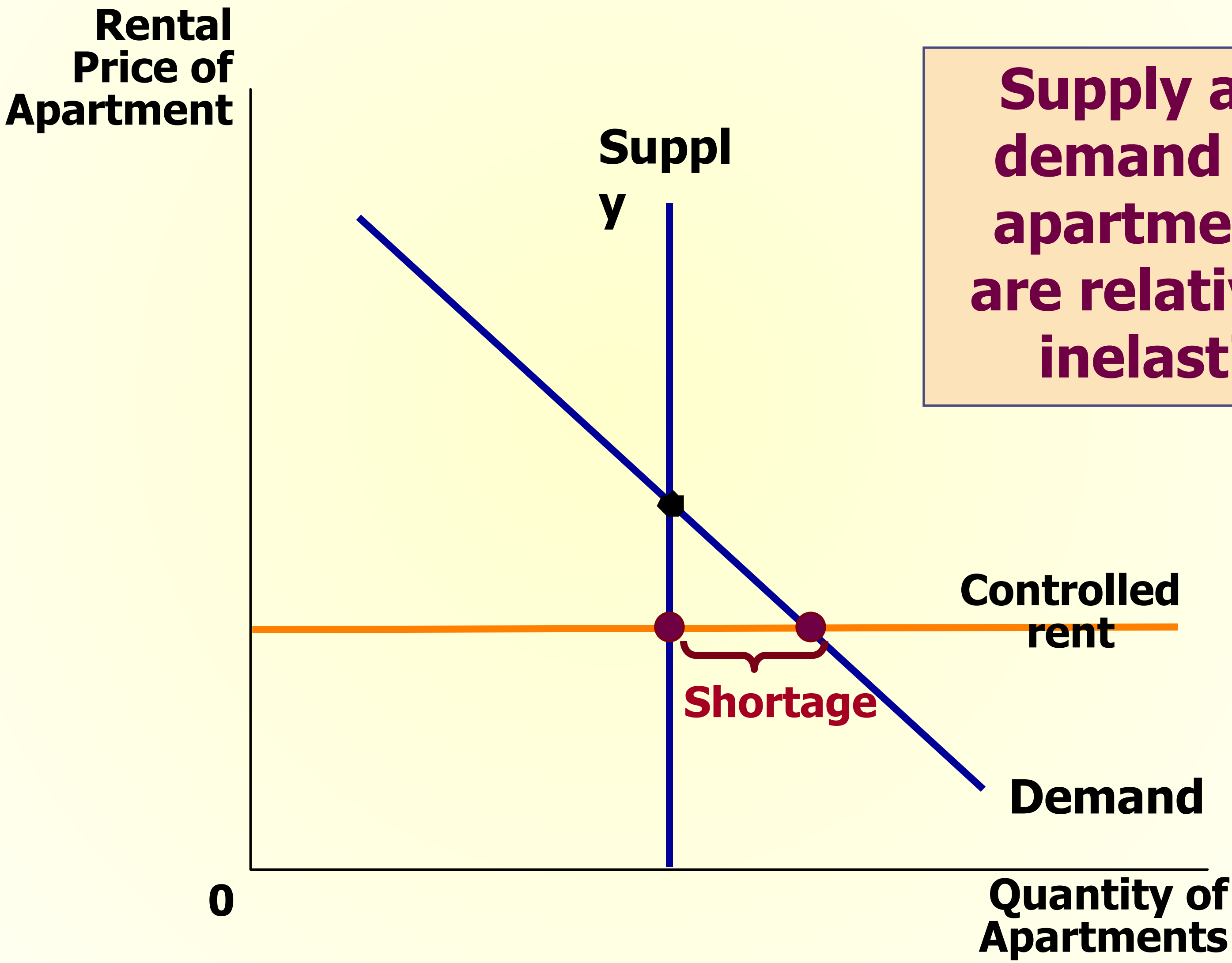
The Price Ceiling on Gasoline Is Binding...



Rent Control

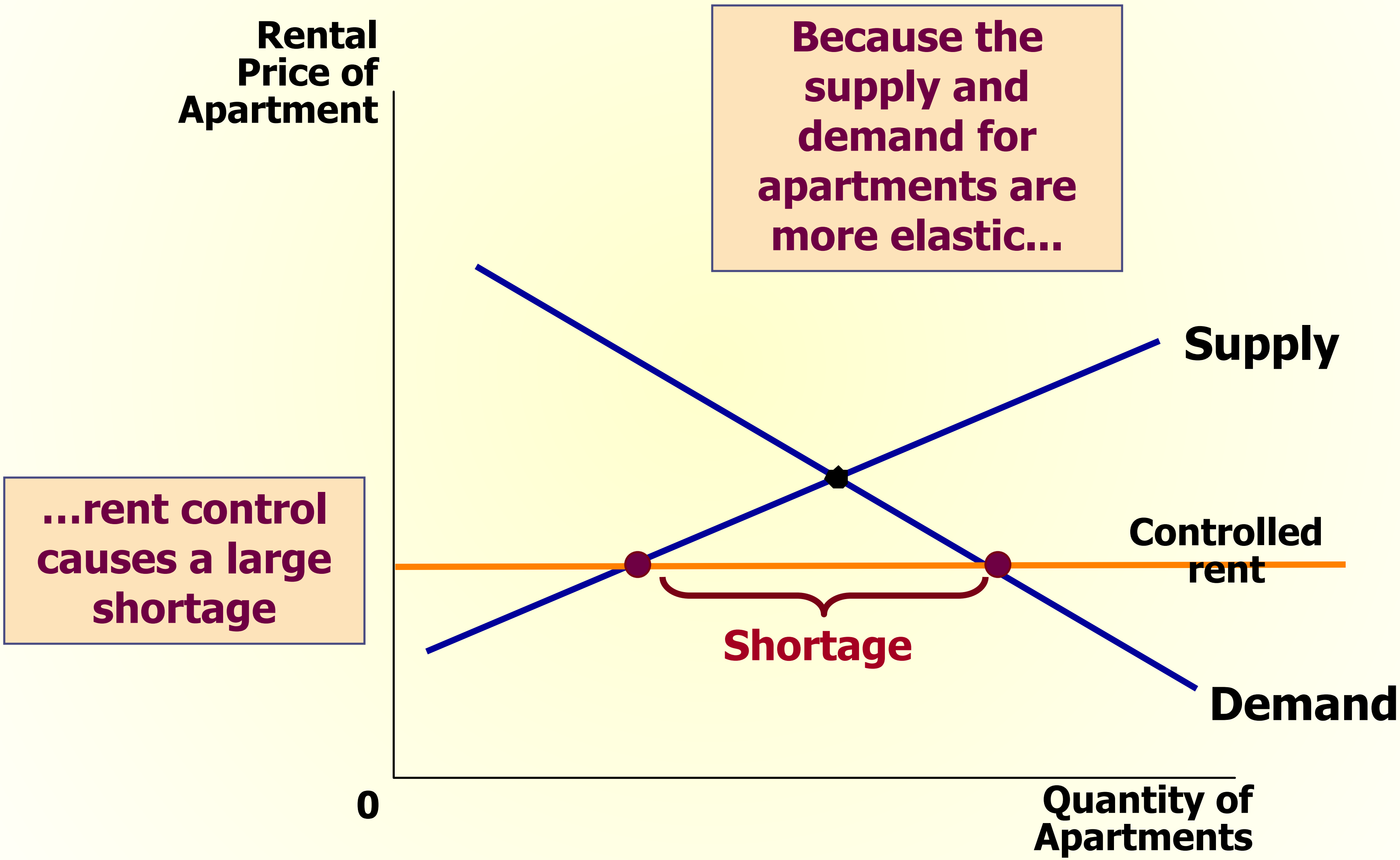
- Rent controls are ceilings placed on the rents that landlords may charge their tenants.
- The goal of rent control policy is to help the poor by making housing more affordable.
- One economist called rent control "the best way to destroy a city, other than bombing."

Rent Control in the Short Run...



Supply and demand for apartments are relatively inelastic

Rent Control in the Long Run...

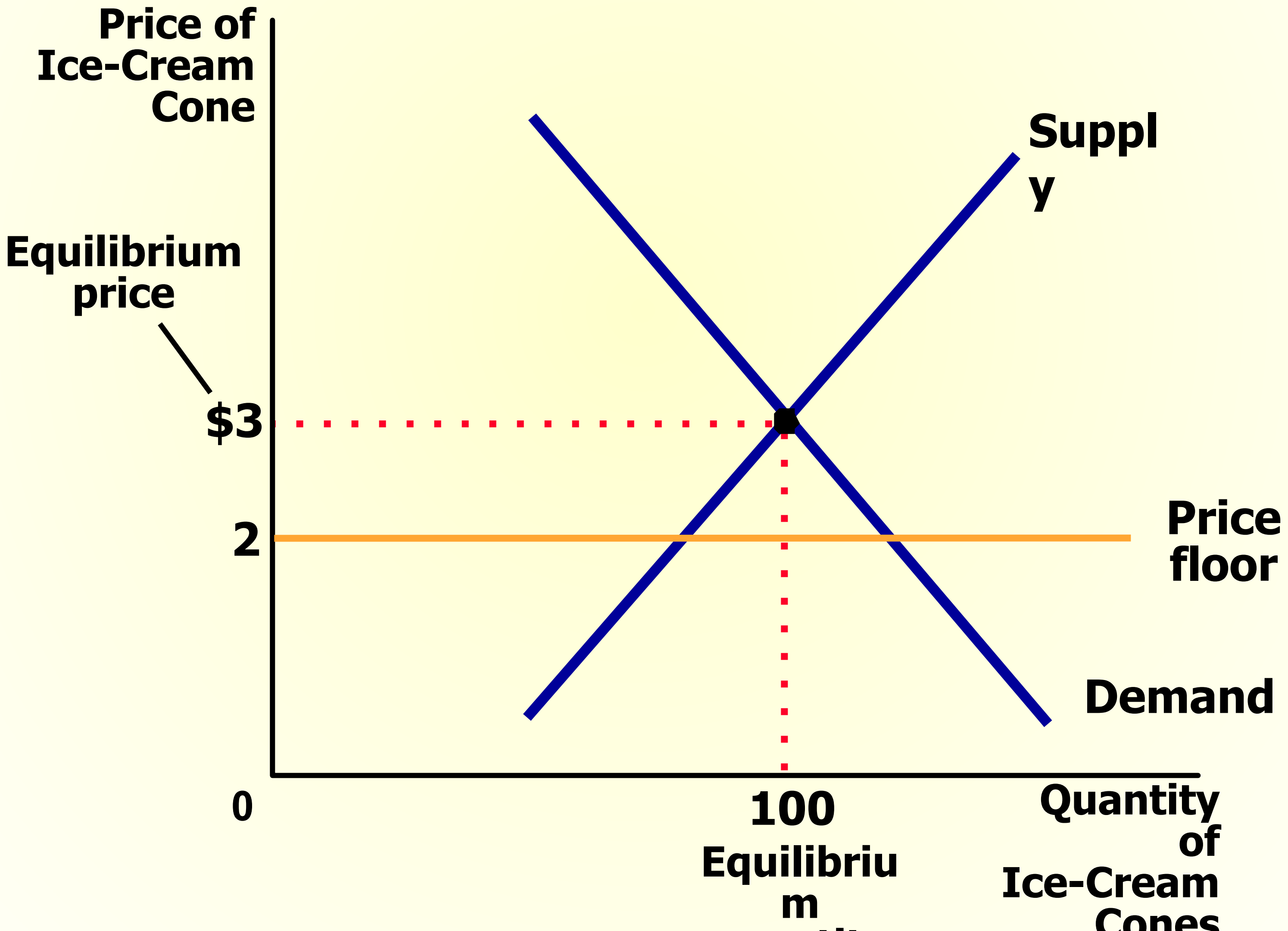


Price Floors

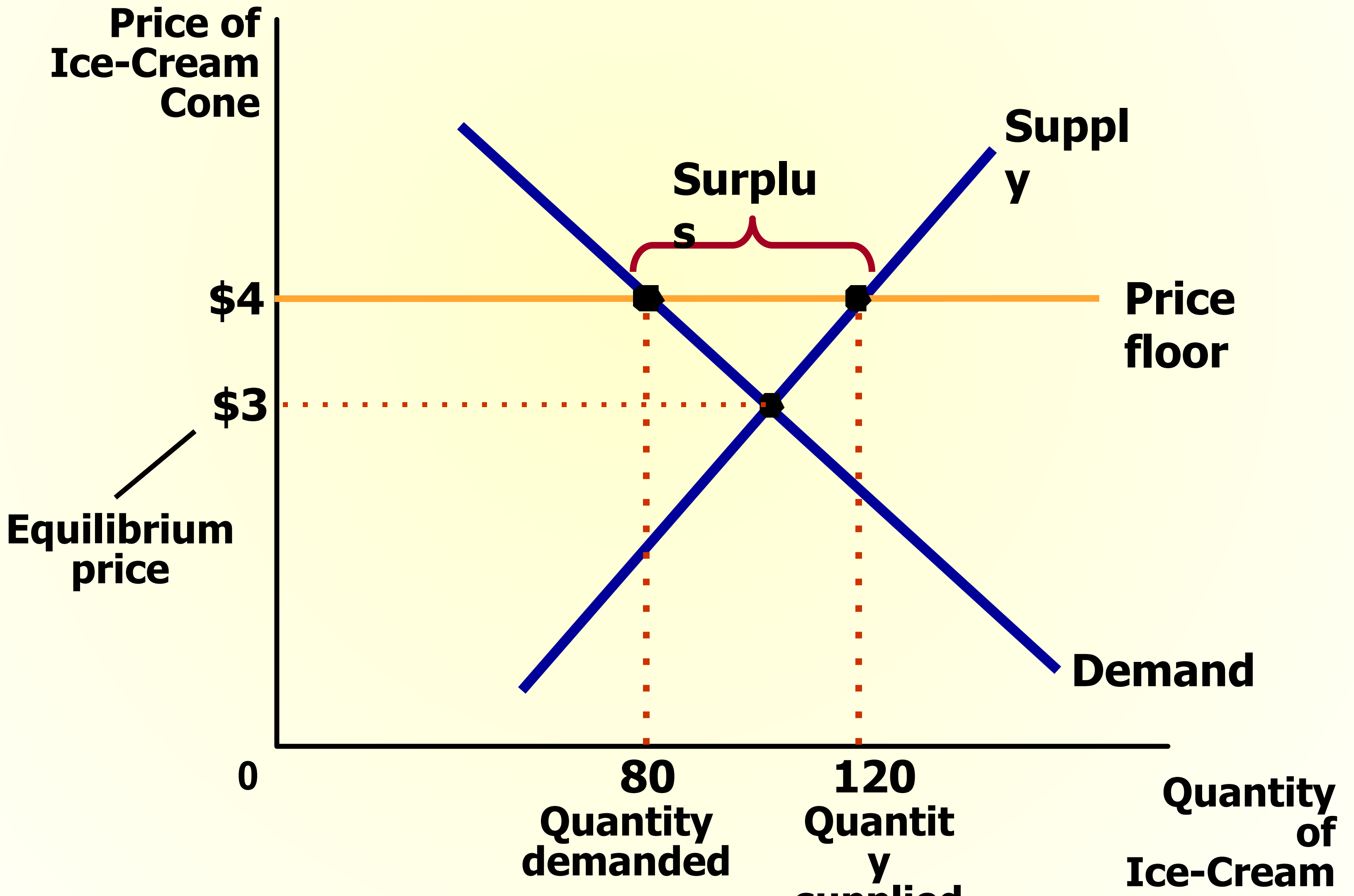
When the government imposes a price floor, two outcomes are possible.

- **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.**

A Price Floor That Is Not Binding...



A Price Floor That Is Binding...



Effects of a Price Floor

- 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.

Effects of a Price Floor

A binding price floor causes . . .

… a surplus because $Q_S > Q_D$.

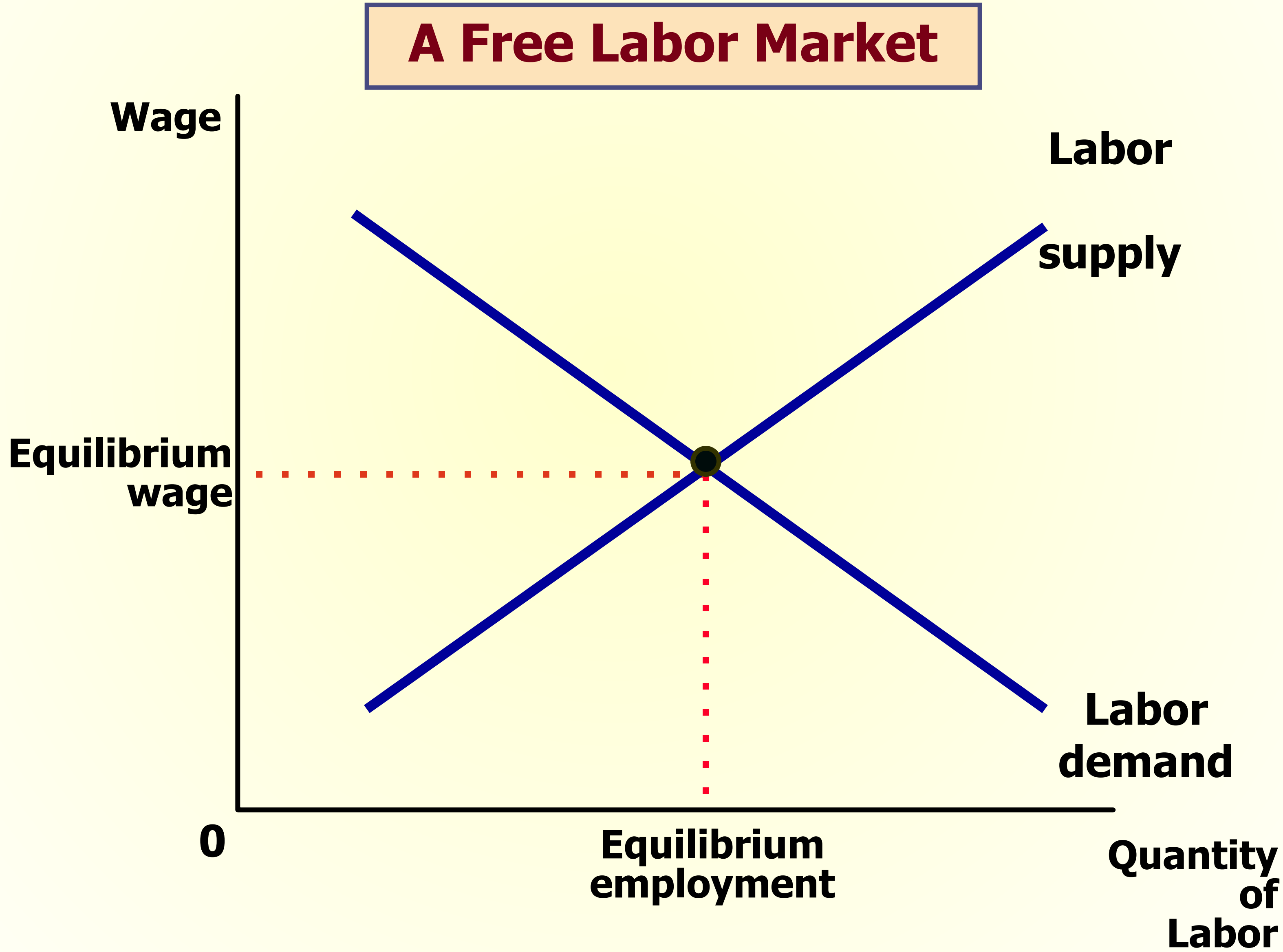
… <u>nonprice rationing</u> is an alternative mechanism for rationing the good, using discrimination criteria.

- **Examples: The minimum wage, Agricultural price supports**

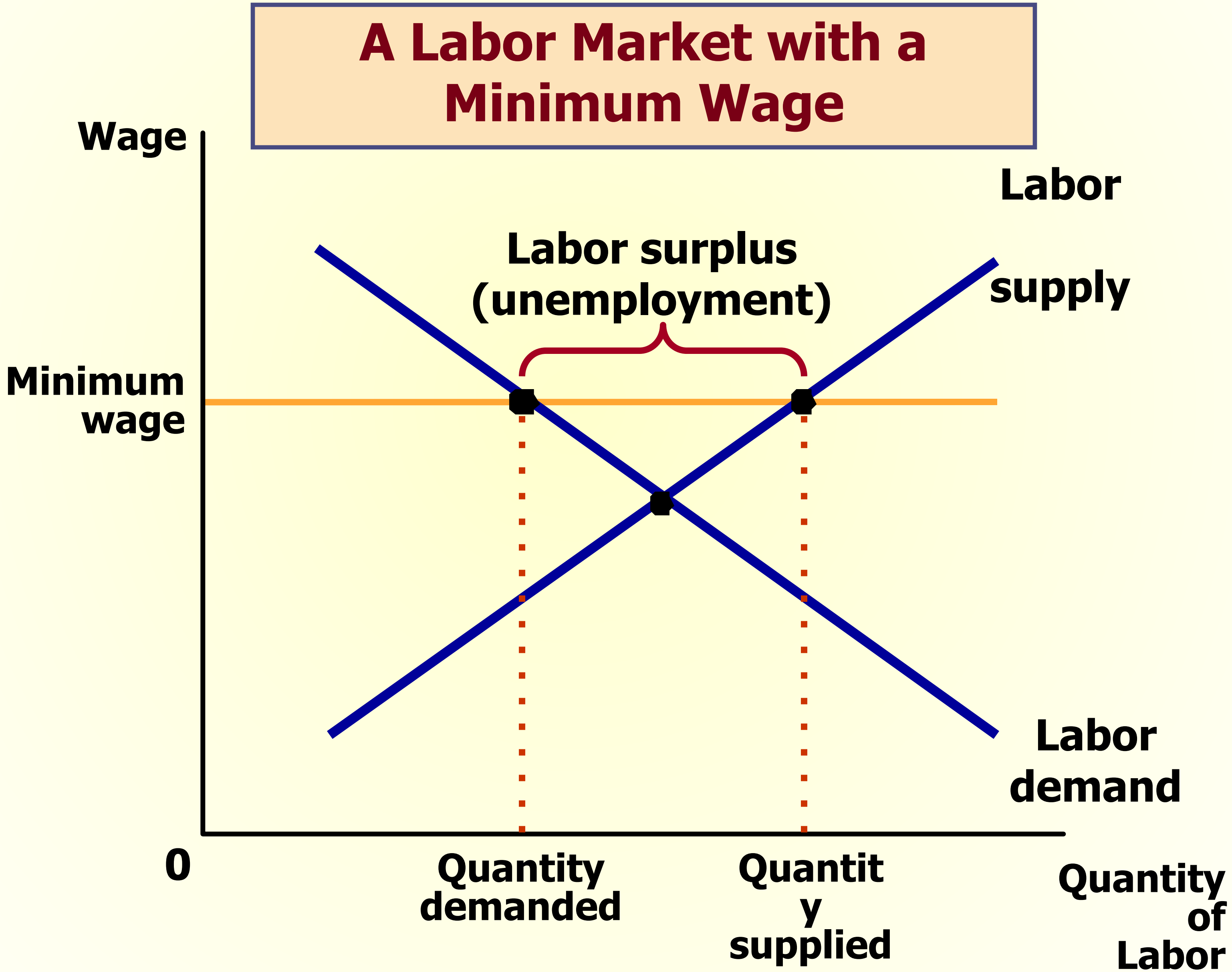
The Minimum Wage

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.

The Minimum Wage



The Minimum Wage



Taxes

Governments levy taxes to raise revenue for public projects.

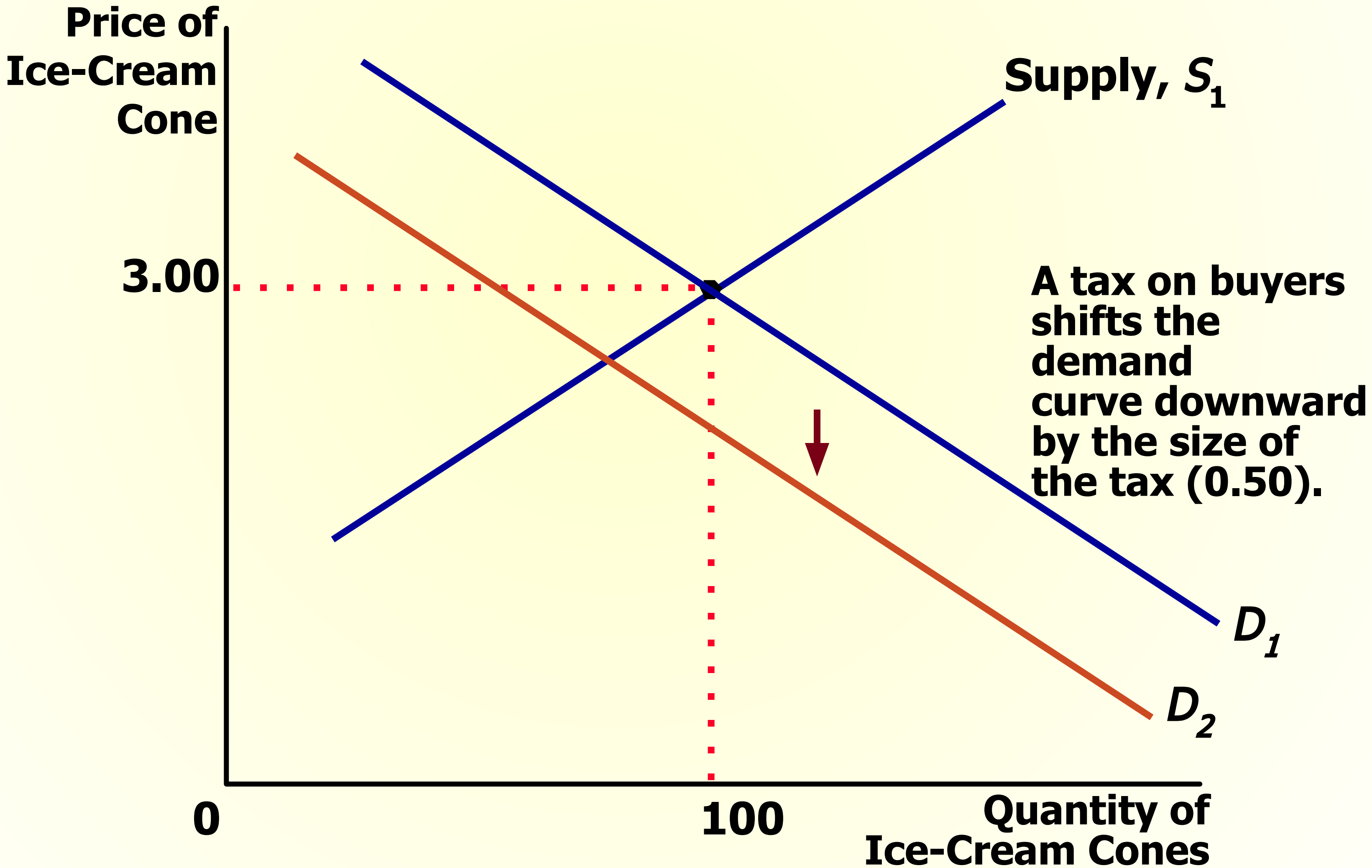
What are some potential impacts of taxes?

- Taxes discourage market activity.
- When a good is taxed, the quantity sold is smaller.
- Buyers and sellers share the tax burden.

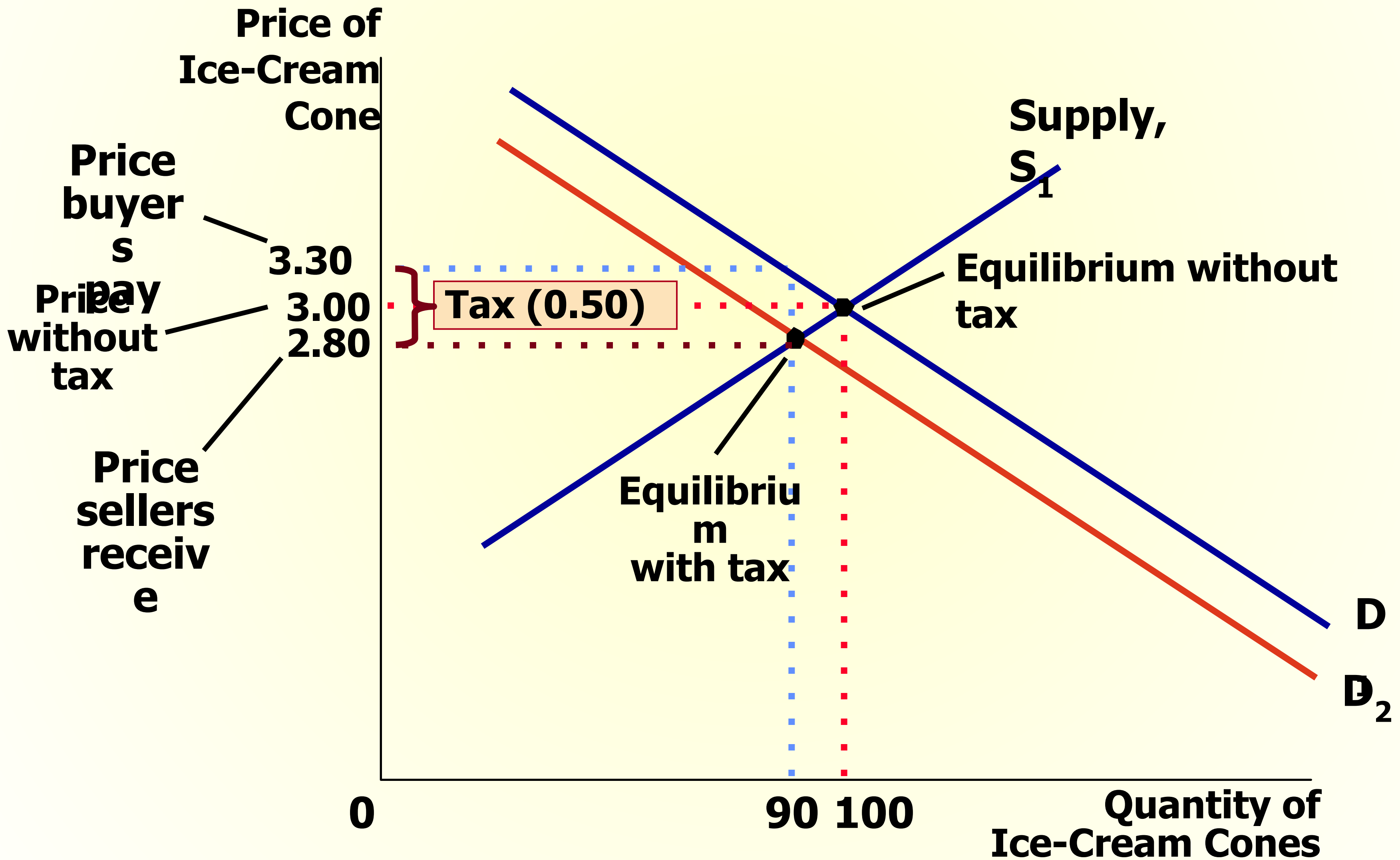
Taxes

- **Tax incidence** is the study of who bears the burden of a tax.
- Taxes result in a change in market equilibrium.
- Buyers pay more and sellers receive less, regardless of whom the tax is levied on.

Impact of a Rs0.50 Tax Levied on Buyers...



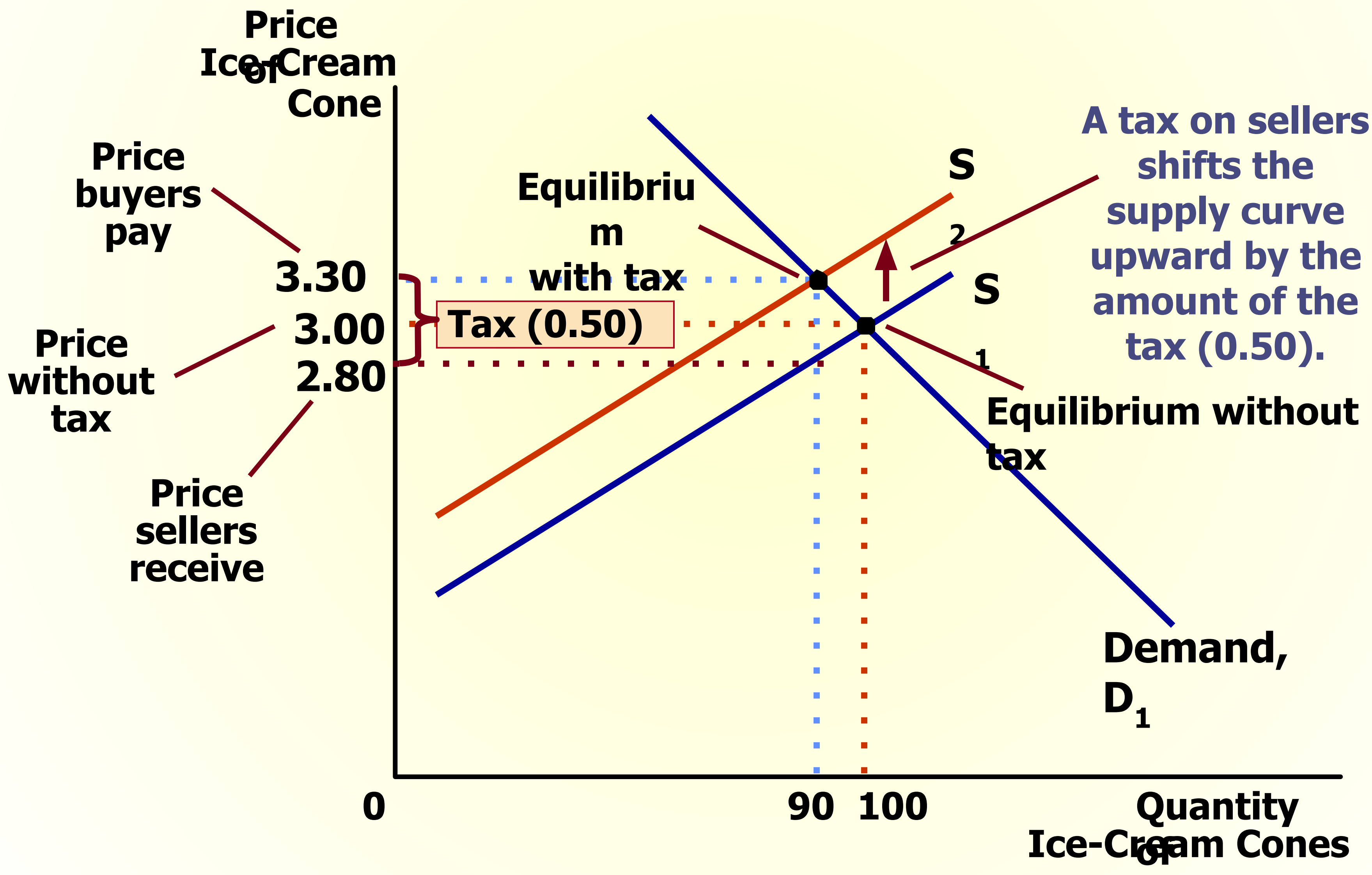
Impact of a 50 paise Tax Levied on Buyers...



What was the impact of tax?

- Taxes discourage market activity.
- When a good is taxed, the quantity sold is smaller.
- Buyers and sellers share the tax burden.

Impact of a 50 paise Tax on Sellers...

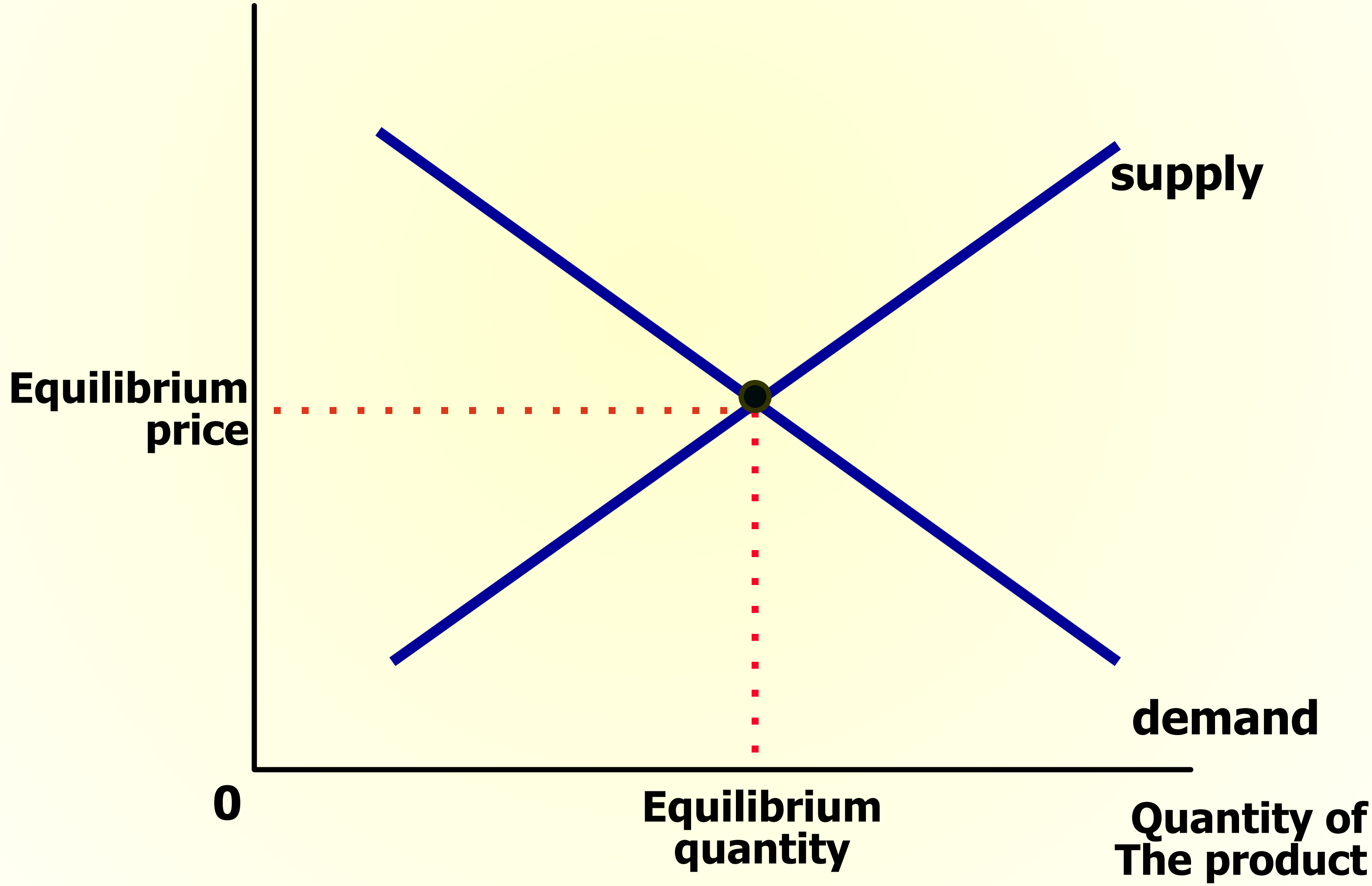


The Incidence of Tax

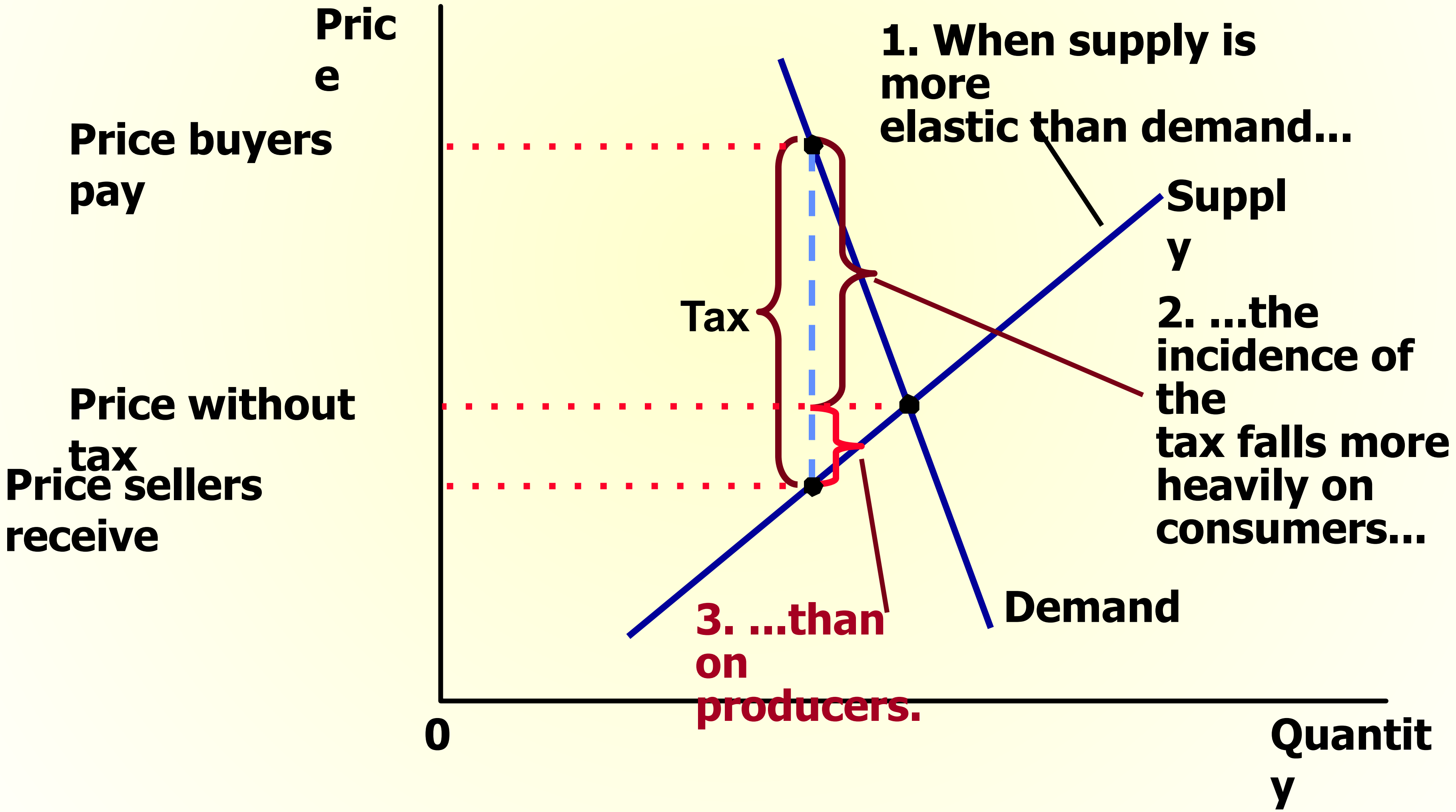
- In what proportions is the burden of the tax divided?
- How do the effects of taxes on sellers compare to those levied on buyers?

The answers to these questions depend on the elasticity of demand and the elasticity of supply.

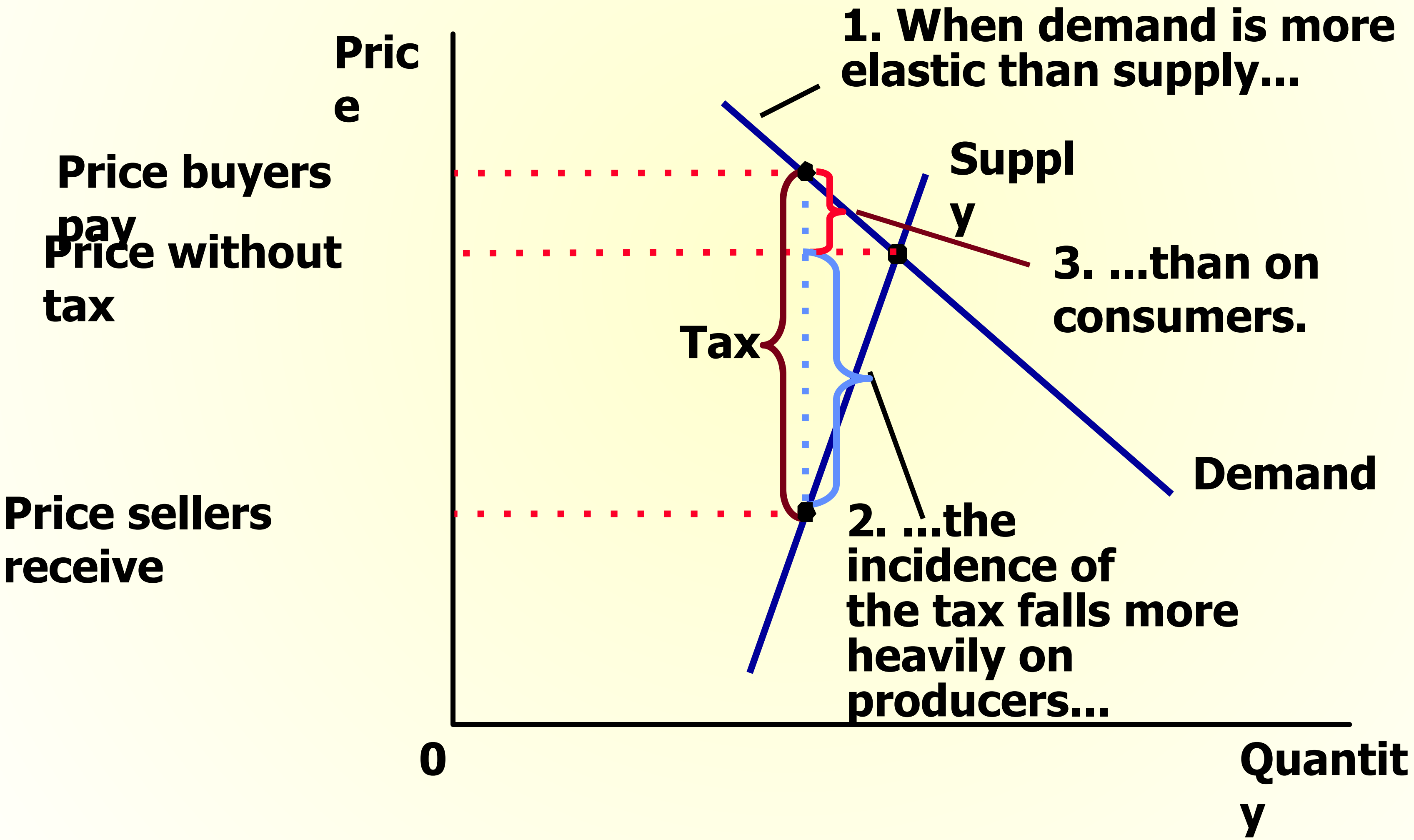
Market of a product



Elastic Supply, Inelastic Demand...



Inelastic Supply, Elastic Demand...



So, how is the burden of the tax divided?

The burden of a tax falls more heavily on the side of the market that is less elastic.

Summary

- Price controls include price ceilings and price floors.
- A price ceiling is a legal maximum on the price of a good or service. An example is rent control.
- A price floor is a legal minimum on the price of a good or a service. An example is the minimum wage.

Summary

- Taxes are used to raise revenue for public purposes.
- When the government levies a tax on a good, the equilibrium quantity of the good falls.
- A tax on a good places a wedge between the price paid by buyers and the price received by sellers.

Summary

- The incidence of a tax refers to who bears the burden of a tax.
- The incidence of a tax does not depend on whether the tax is levied on buyers or sellers.
- The incidence of the tax depends on the price elasticities of supply and demand.