Chapter 6 Supply, Demand, and Government Policies

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Introduction

- In this chapter we are going to analyze several types of government policies using supply and demand.
- Policymakers often enact price controls when they believe that the market price of a good or service is too high or too low. Yet these policies can generate problems of their own.
- In the category of price controls, we examine rent-control laws and minimum-wage laws.

How Price Ceilings Affect Market Outcomes

- Price ceiling: a legal maximum on the price at which a good can be sold.
- Example: Suppose government poses a price ceiling in the market for ice cream.
- There are two possible outcomes: the price ceiling is binding; the price ceiling is not binding.

How Price Ceilings Affect Market Outcomes

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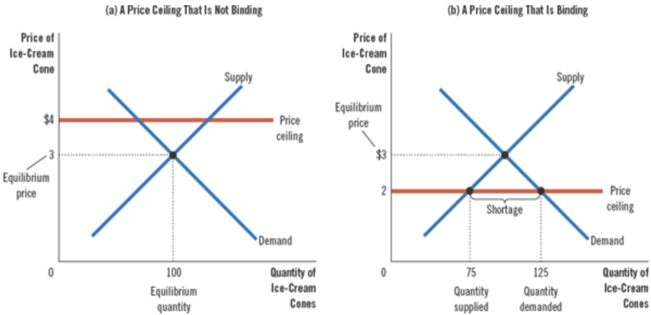

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How Price Ceilings Affect Market Outcomes

- Price ceiling is not binding:
    1. If government poses a price ceiling of \$4, because the price ceiling is higher than the market equilibrium price (\$3), the price ceiling is not binding and has no effect on the price or on the quantity sold.
- Price ceiling is binding:
    1. If government poses a price ceiling of \$2, because the price ceiling is lower than the market equilibrium price (\$3), the price ceiling is binding and will create a shortage of ice cream.

How Price Ceilings Affect Market Outcomes

- When the government imposes a binding price ceiling on a competitive market, a shortage arises, ans sellers must ration scare goods among potential buyers.
- Question: how do the consumer surplus, producer surplus, and total surplus change?

How to Create Long Lines at the Gas Pump

- In 1973, the Organization of Petroleum Exporting Countries (OPEC) reduces production of crude oil and increased its price. Because crude oil is used to make gasoline, the higher crude oil prices reduced the supply of gasoline.
- Long lines at the gas stations became common, and most people blames OPEC for this.
- Yet economists found another reason: U.S. government regulations that set a price ceiling on the price of gasoline.

How to Create Long Lines at the Gas Pump

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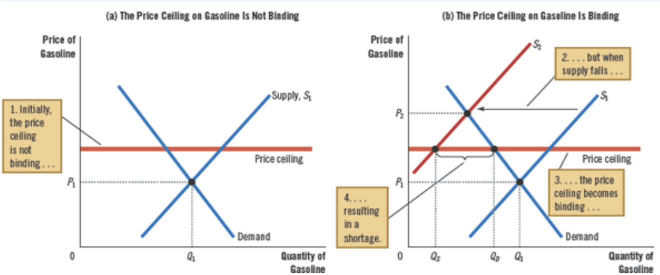

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How to Create Long Lines at the Gas Pump

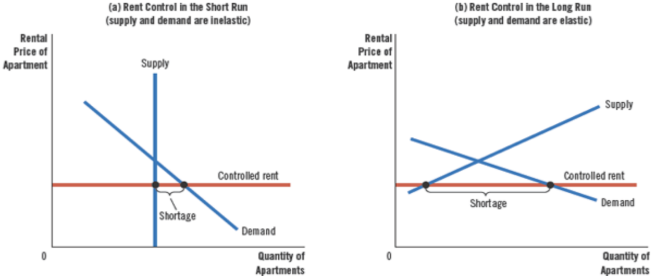
- As panel (a) shows, before OPEC raised the price of crude oil, the equilibrium price of gasoline was below the price ceiling. The price ceiling, therefore, has no effect.
- When the price of crude oil rose, however, the situation changed. The new market equilibrium price of gasoline is higher than the price ceiling, the price ceiling became binding and led to the gasoline shortage.

Why Rent Control Causes Housing Shortages, Especially in the Long Run

- Rent control is a policy aimed at helping the poor by keeping housing costs low. Yet economists often criticize rent control.
- The adverse effect of rent control may not be apparent because these effects occur over years. This is because the short-run supply and demand for housing are both relative inelastic.

Why Rent Control Causes Housing Shortages, Especially in the Long Run

- The long-run story is very different because the buyers and sellers of rental housing respond more top market conditions as time passes.
  - On the supply side, landlords respond to low rent by not building new apartments and by failing to maintain existing ones.
  - On the demand side, low rents encourage people to find their own apartments and to move to the city.



How Price Floors Affect Market Outcomes

- Price floor: a legal minimum on the price at which a good can be sold.
- Example: Suppose government poses a price floor in the market for ice cream.
- There are two possible outcomes: the price floor is binding; the price floor is not binding.

How Price Floors Affect Market Outcomes

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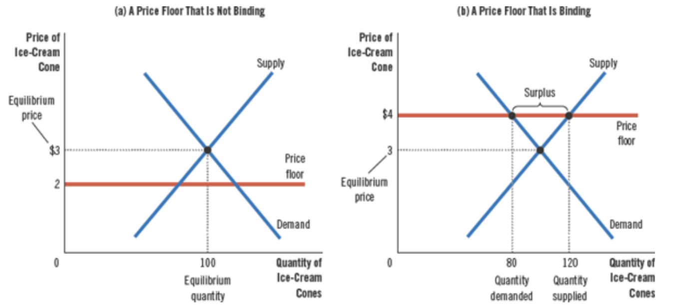

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How Price Floors Affect Market Outcomes

- Price floor is not binding:
  1. If government poses a price floor of $2, because the price floor is lower than the market equilibrium price ($3), the price floor is not binding and has no effect on the price or on the quantity sold.
- Price floor is binding:
  1. If government poses a price floor of $4, because the price floor is higher than the market equilibrium price ($3), the price floor is binding and will create a surplus of ice cream.