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Supply, Demand, and
Government Policies

PRINCIPLES OF
ECONOMICS
FOURTH EDITION

N. GREGORY MANKIW

Premium PowerPoint® Slides
by Ron Cronovich
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In this chapter, look for the answers to these questions:

§ What are price ceilings and price floors?
What are some examples of each?

§ How do price ceilings and price floors affect market outcomes?

§ How do taxes affect market outcomes?
How does the outcome depend on whether the tax is imposed on buyers or sellers?

§ What is the incidence of a tax?
What determines the incidence?

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Government Policies That Alter the
Private Market Outcome

§ Price controls

- **Price ceiling:**
- **Price floor:**

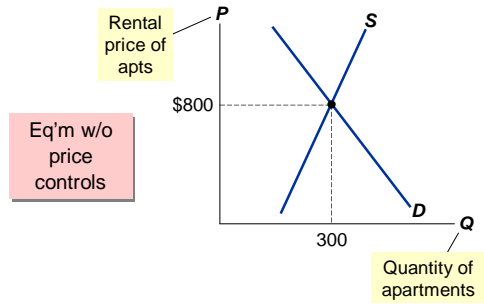
§ Taxes

- The govt can make buyers or sellers pay a specific amount on each unit bought/sold.

We will use the supply/demand model to see how each policy affects the market outcome (the price buyers pay, the price sellers receive, and eq'm quantity).

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EXAMPLE 1: The Market for Apartments

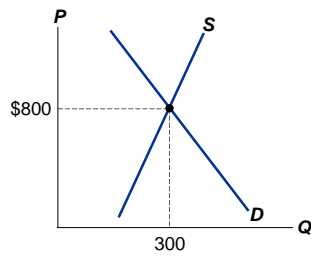


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How Price Ceilings Affect Market Outcomes

A price ceiling
above the
eq'm price



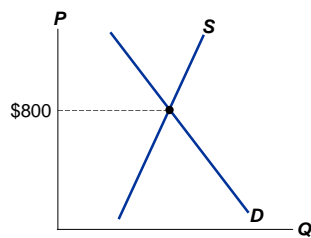
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How Price Ceilings Affect Market Outcomes

The eq'm price
(\$800) is

The ceiling
is a

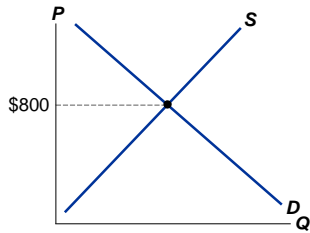


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How Price Ceilings Affect Market Outcomes

In the long run, supply and demand are more price-elastic.



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Shortages and Rationing

§ With a shortage, sellers must ration the goods among buyers.

§ Some rationing mechanisms:

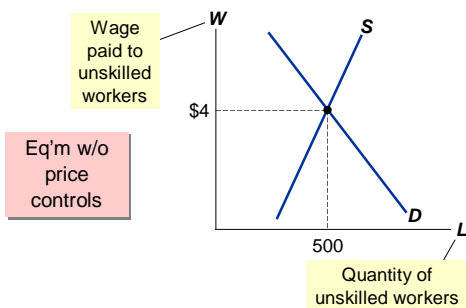
§ These mechanisms are often unfair, and inefficient:

§ In contrast, when prices are not controlled, the rationing mechanism is

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EXAMPLE 2: The Market for Unskilled Labor

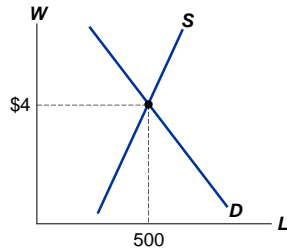


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How Price Floors Affect Market Outcomes

A price floor
below the
eq'm price

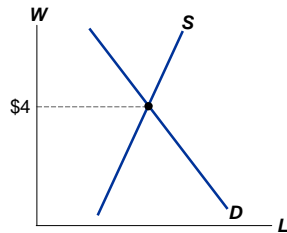


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How Price Floors Affect Market Outcomes

The eq'm wage (\$4)
is



The floor is

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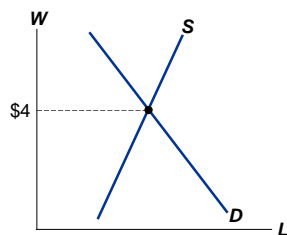
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The Minimum Wage

Min wage laws
do not affect
highly skilled
workers.

They do affect
teen workers.

Studies:



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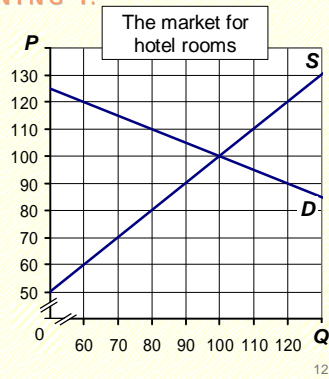
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ACTIVE LEARNING 1:

Price floors & ceilings

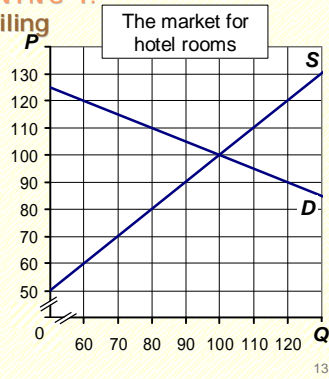
Determine
effects of:

- A. \$90 price ceiling
- B. \$90 price floor
- C. \$120 price floor



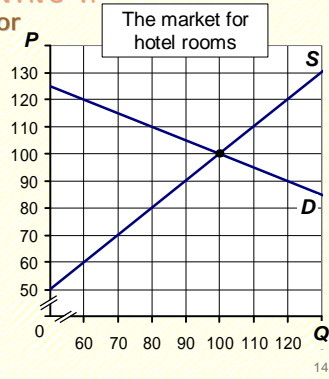
ACTIVE LEARNING 1:

A. \$90 price ceiling

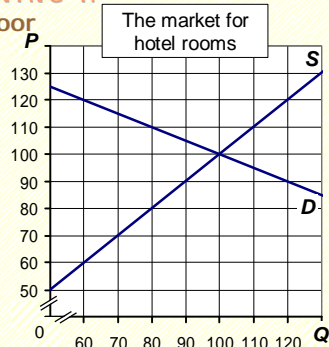


ACTIVE LEARNING 1:

B. \$90 price floor



ACTIVE LEARNING 1:
C. \$120 price floor



Evaluating Price Controls

§ Recall one of the Ten Principles:
*Markets are usually a good way
to organize economic activity.*



§

§ Price controls often intended to help the poor,
but often hurt more than help.

Taxes

§ The govt levies taxes on many goods & services
to raise revenue to pay for national defense,
public schools, etc.

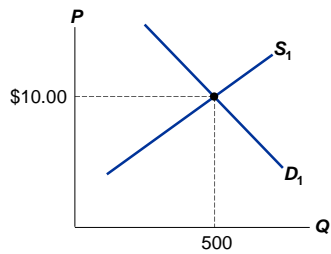
§ The govt can make buyers or sellers pay the tax.

§ The tax can be a % of the good's price,
or a specific amount for each unit sold.

- For simplicity, we analyze per-unit taxes only.

EXAMPLE 3: The Market for Pizza

Eq'm
w/o tax

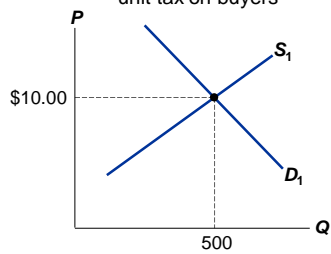


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A Tax on Buyers

Effects of a \$1.50 per
unit tax on buyers



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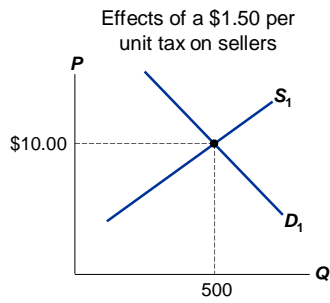
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The **Incidence** of a Tax:

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A Tax on Sellers



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The Outcome Is

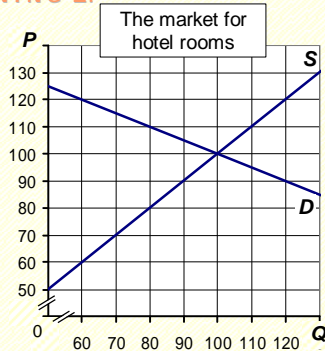
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ACTIVE LEARNING 2: Effects of a tax

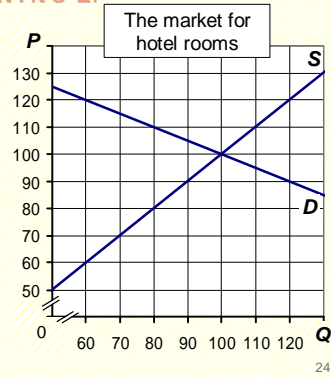
Suppose govt imposes a tax on buyers of \$30 per room.

Find new Q , P_B , P_S , and incidence of tax.



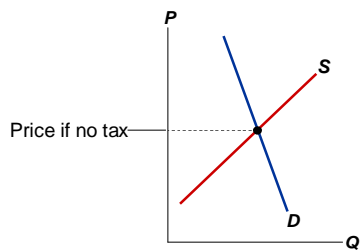
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ACTIVE LEARNING 2: Answers



Elasticity and Tax Incidence

CASE 1: Supply is more elastic than demand

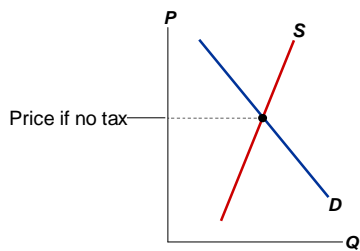


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Elasticity and Tax Incidence

CASE 2: Demand is more elastic than supply



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CASE STUDY: Who Pays the Luxury Tax?

§ 1990: Congress adopted a luxury tax on yachts, private airplanes, furs, expensive cars, etc.

§ Goal of the tax: to raise revenue from those who could most easily afford to pay – wealthy consumers.

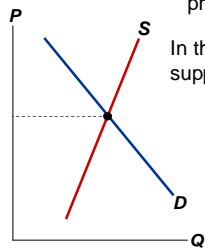
§ But who really pays this tax?

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CASE STUDY: Who Pays the Luxury Tax?

The market for yachts



Demand is price-elastic.

In the short run, supply is inelastic.

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CONCLUSION: Government Policies and the Allocation of Resources

§ Each of the policies in this chapter affects the allocation of society's resources.

§ So, it's important for policymakers to apply such policies very carefully.

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