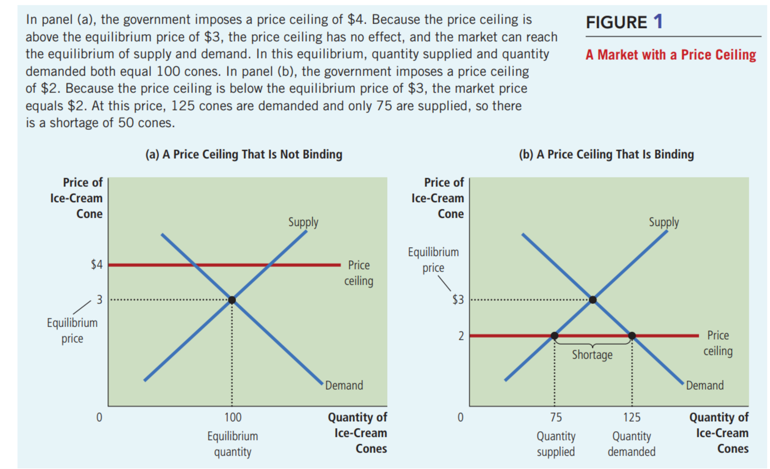
Chap 6 Supply, Demand, and Government Policies

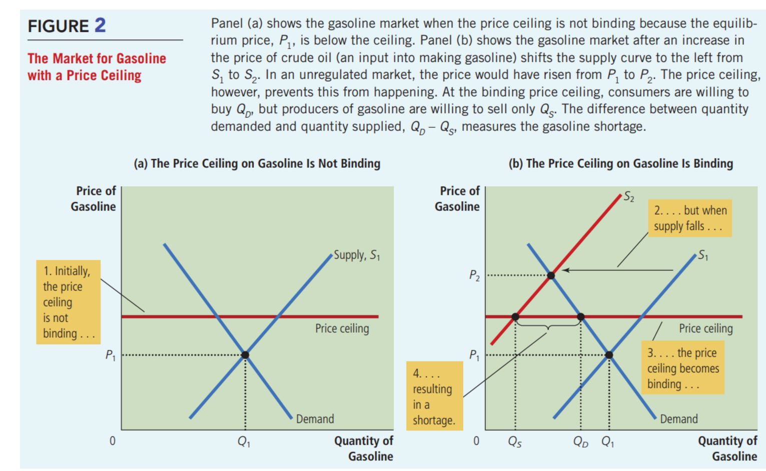
Controls on Prices

- 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

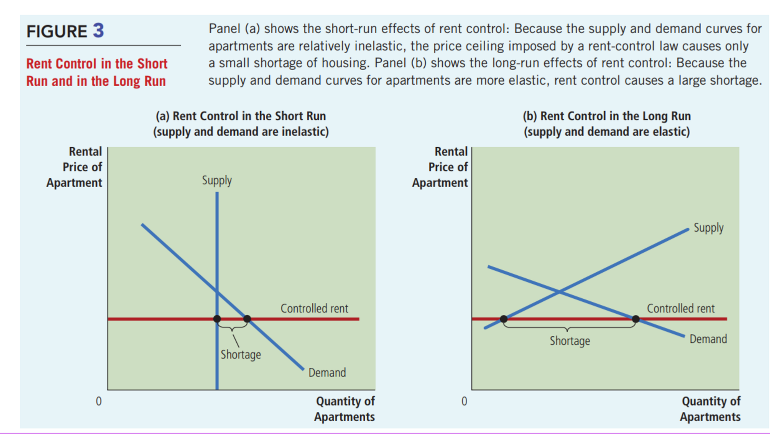
How Price Ceilings Affect Market Outcomes



When the government imposes a binding price ceiling on a competitive market, a shortage of the good arises, and sellers must ration the scare goods among the large number of potential buyers.

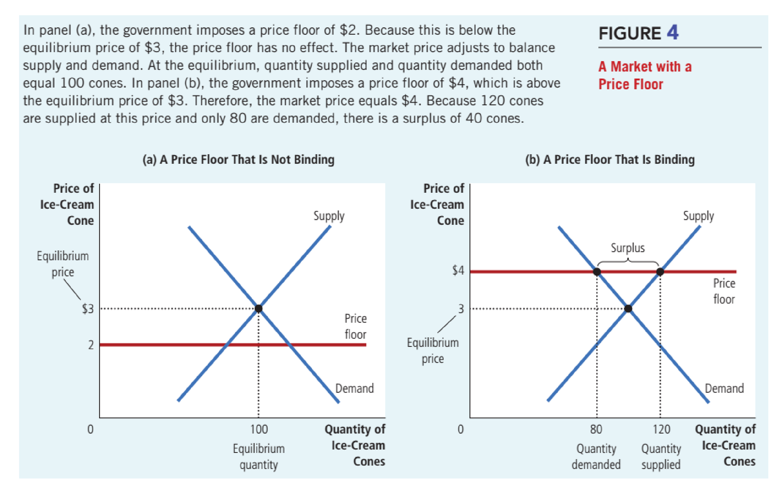


Eventually, the laws regulating the price of gasoline were repealed. Lawmakers came to understand that they were partly responsible for the many hours Americans lost waiting in line to buy gasoline. Today, when the price of gasoline changes, the price of gasoline can adjust to bring supply and demand into equilibrium.



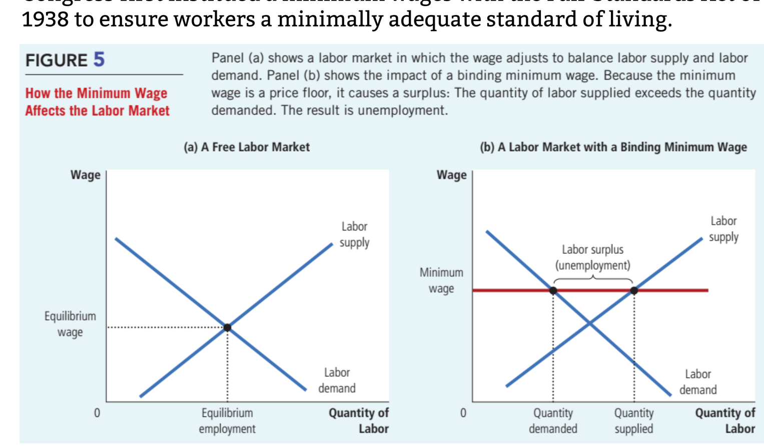
- In cities with rent control, landlords use various methanisms to ration housing. Some landlords keep long waiting lists. Others give preference to tenants without children. Still others discriminate on the basis of race. Sometimes apartments are allocated to those willing to offer under-the-table payments to building superintendents. In essence, these bribes bring the total price of an apartment closer to the equilibrium price.
- In free markets, landlords try to keep their buildings clean and safe bacause desirable apartments command higher prices. By contrast, when rent control creates shortages and waiting lists, landlords lose their incentive to respond to rentants' concerns. Why should a landlord spend money to maintain and improve the property when people are waiting to move in as it is? In the end, tentants get lower rents, but they also get lower-quality housing.

How Price Floors Affect Market Outcomes



The minimum wage

Congress first instituted a minimum wages with the Fair Standards Act of 1938 to ensure workers a minimally adequate standard of living.



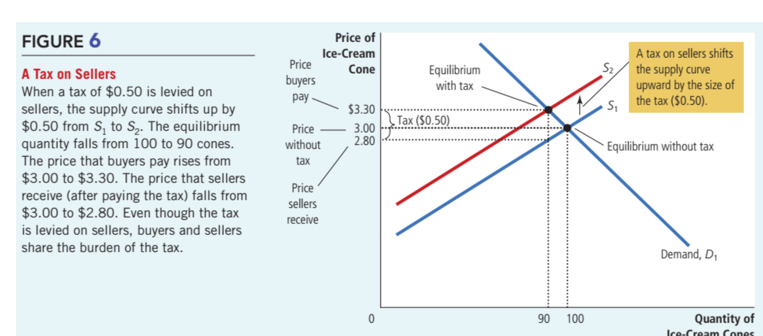
- The minimum wage has its greatest impact on the market for teenage labor. The equilibrium wages of teenagers are low because teenagers are amone the least skilled and least experienced members of the labor force. In addition, teenagers are often willing to accept a lower wage in exchange for on-the-job training.
- A 10 percent increase in the minimum wage depresses teenage employment by 1 to 3 percent. In interpreting this estimate, note that a 10 percent increase in the minimum wage does not raise the average eage of teenagers by 10 percent. A change in the law does not directly affect those teenagers who are already paid well above the minimum, and enforcement of minimum-wage laws is not perfect.
- Because the minimum wage raises the wage that teenagers can earn, it increases the number of teenagers who choose to look for jobs. With more people vying for the available jobs, some of these new dropouts displace other teenagers who had already dropped out of school and now become unemployed.
- Not all minimum-wage workers are heads of households trying to help their families escape poverty. In fact, less than a third of minimum-wage earners are in families with imcomes below the poverty line. Many are teenagers from middle-class homes working at part-time jobs for extra spending money.

Evaluating Price Controls

Taxes

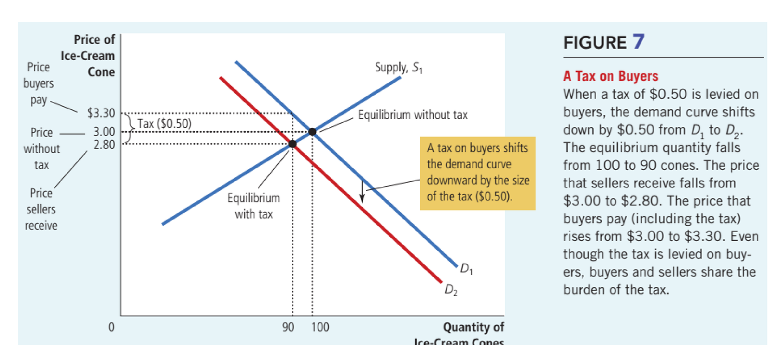
- tax incidence: the manner in which the burden of a tax is shared among participants in a market

How Taxes on Sellers Affect Market Outcomes



- Taxes discourage market activity. When a good is taxed, the quantity of the good sold is smaller in the new equilibrium.
- Buyers and sellers share the burden of taxes. In the new equilibrium, buyers pay more for the good, and sellers receive less.

How Taxes on Buyers Affect Market Outcomes



- Taxes levied on sellers and taxes levied on buyers are equivalent.
- Whether the $0.5 goes directly from the buyer's pocket into the bowl, or indirectly from the buyer's pocket into the seller's hand and then into the bowl, does not matter. Once the market reaches its new equilibrium, buyers and sellers share the burden, regardless of how the tax is levied.

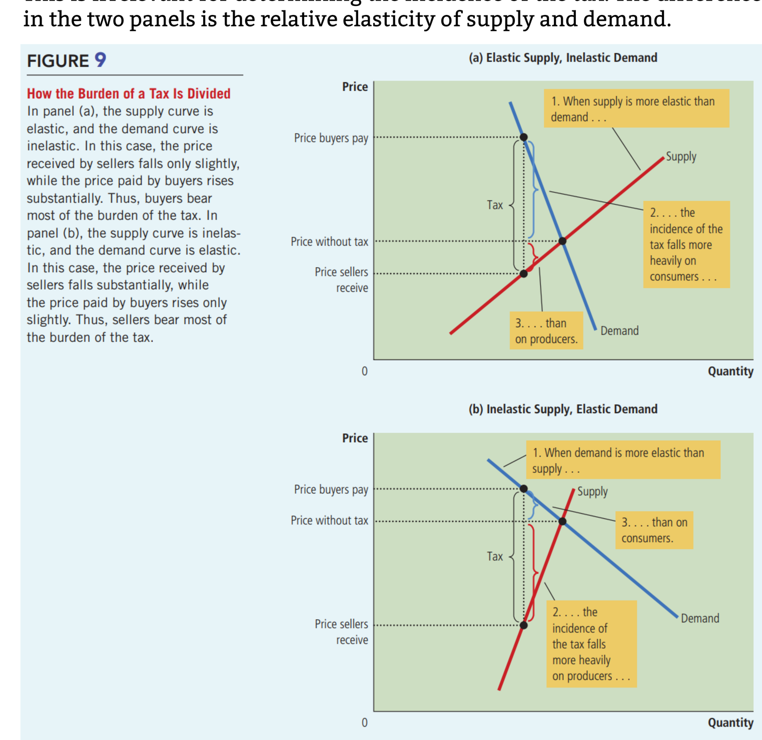
Can congress distribute the burden of a payroll tax?

Lawmakers can decide whether a tax comes from the buyer's pocket or from the seller's, but they cannot legislate the true burden of a tax. Rather, tax incidence depends on the forces of supply and demand.

Elasticity and Tax Incidence

When a good is taxed, buyers and sellers of the good share the burden of the tax. But how exactly is the tax burden divided?

This is irrelevant for determining the incidence of the tax. The difference in the two panels is the relative elasticity of supply and demand.



- A tax burden falls more heavily on the side of the market that is less elastic. In essence, the elasticity measures the willingness of buyers or sellers to leave the market when conditions become unfavorable.
- When the good is taxed, the side of the market with ferwer good alternatives is less willing to leave the market and, therefore, bears more of the burden of the tax.
- Most labor economists believe that the supply of labor is much less elastic than most demand. This means that workers, rather than firms, bear most of the burden of the payroll tax. In other words, the distribution of the tax burden is far from the fifty-fifty split that lawmakers intended.