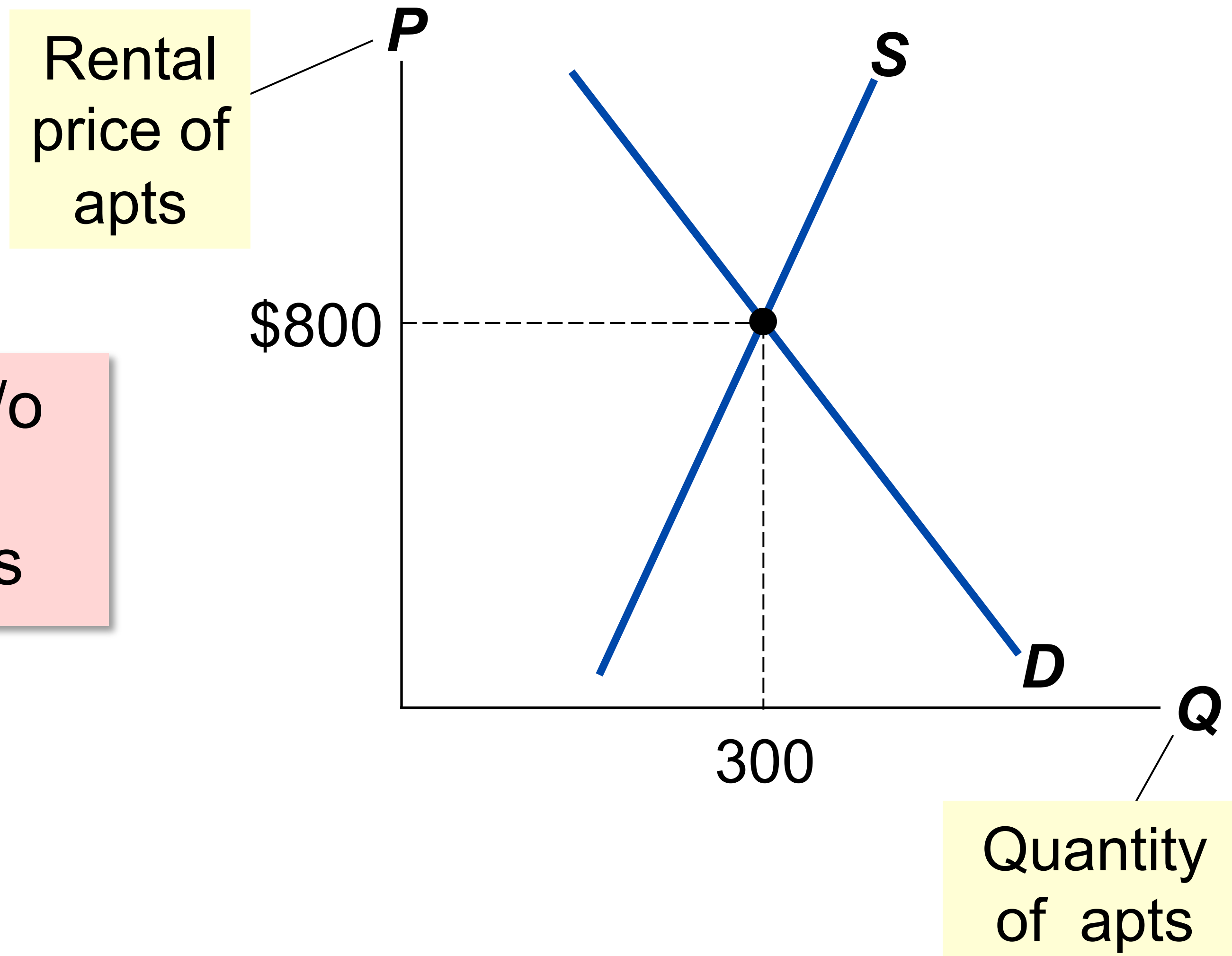
Government Policies That Alter the Private Market Outcome

- Price controls
  - **Price ceiling**: a legal maximum on the price of a good or service *Example: rent control*
  - **Price floor**: a legal minimum on the price of a good or service *Example: minimum wage*
- Taxes
  - The govt can make buyers or sellers pay a specific amount on each unit.

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).

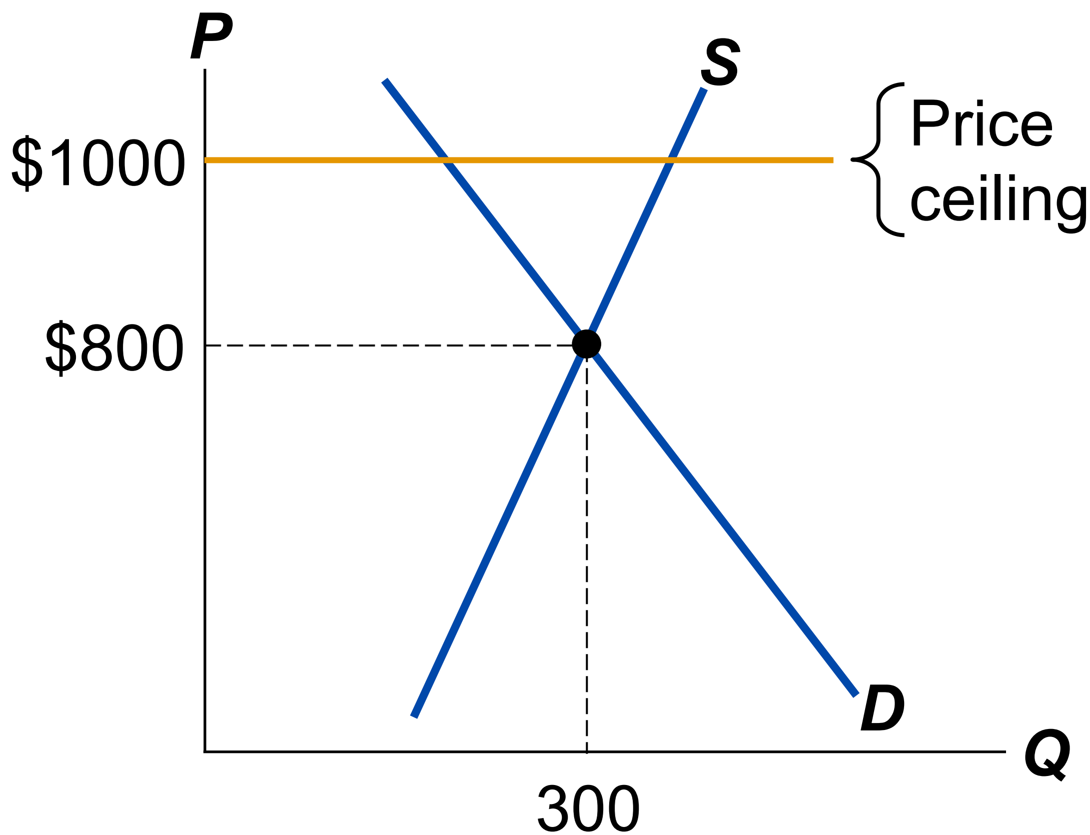
EXAMPLE 1: The Market for Apartments

Eq'm w/o price controls



How Price Ceilings Affect Market Outcomes

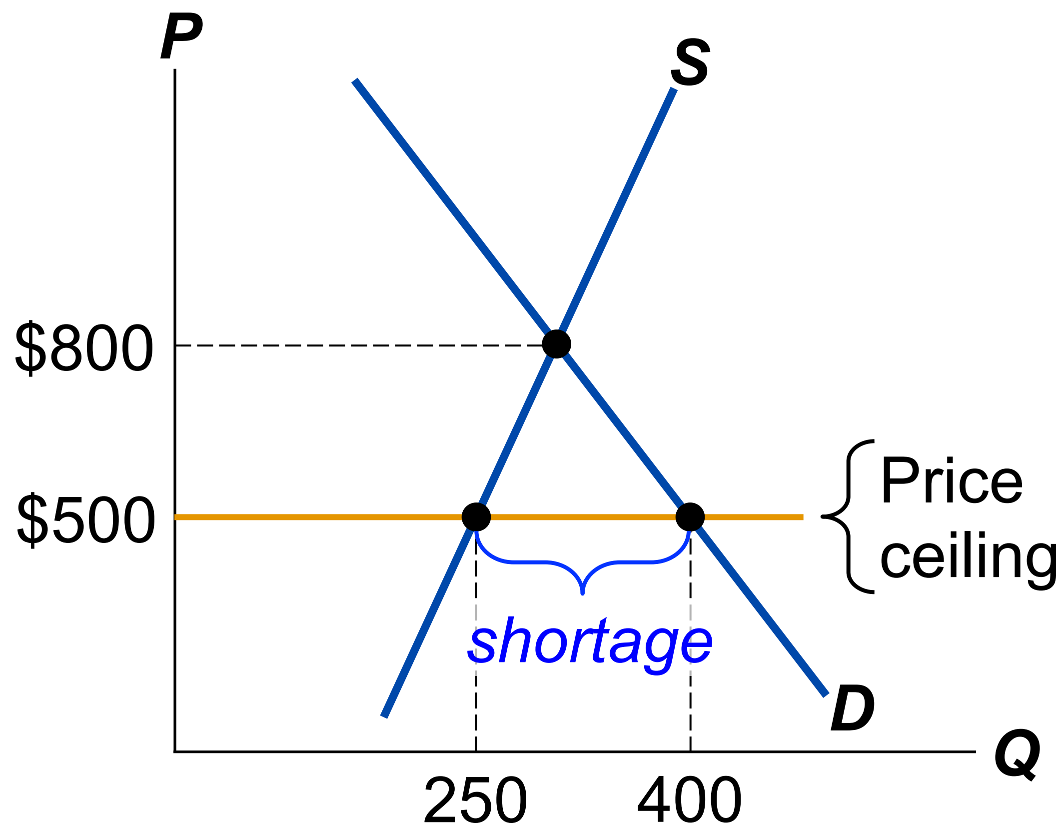
A price ceiling above the eq'm price is **not binding**—has no effect on the market outcome.



How Price Ceilings Affect Market Outcomes

The eq'm price ($800) is above the ceiling and therefore illegal.

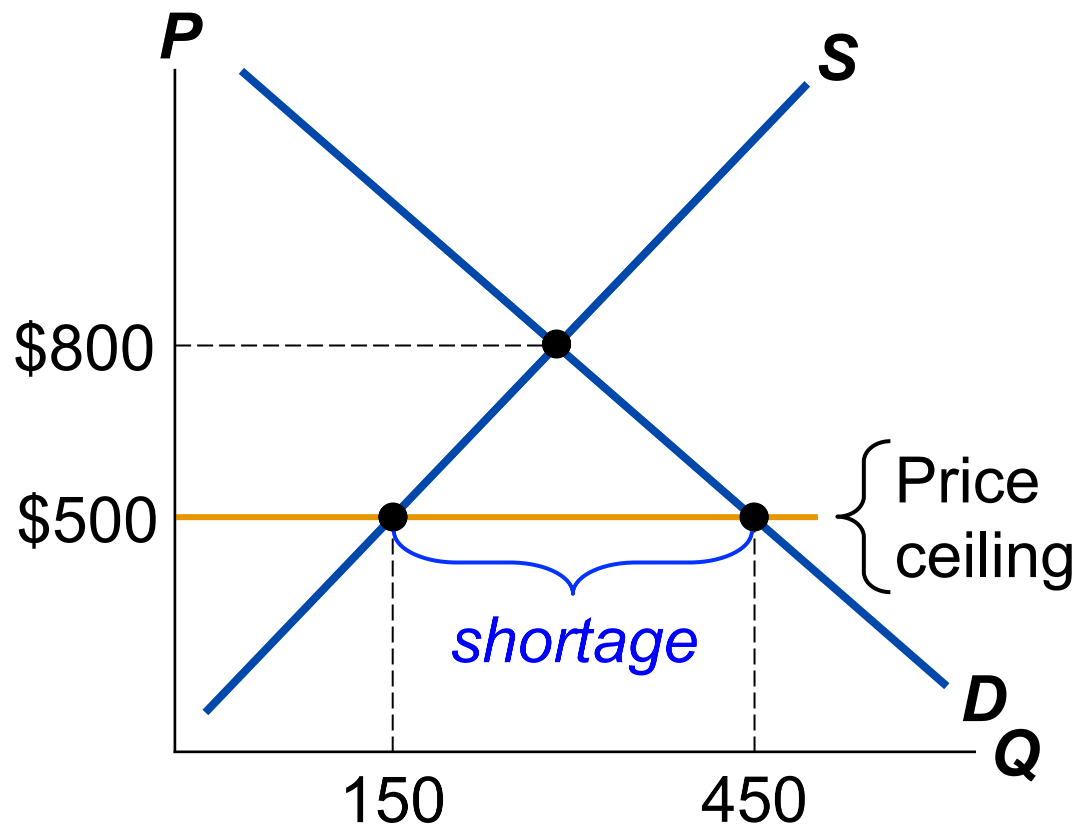
The ceiling is a **binding constraint** on the price, causes a shortage.



How Price Ceilings Affect Market Outcomes

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

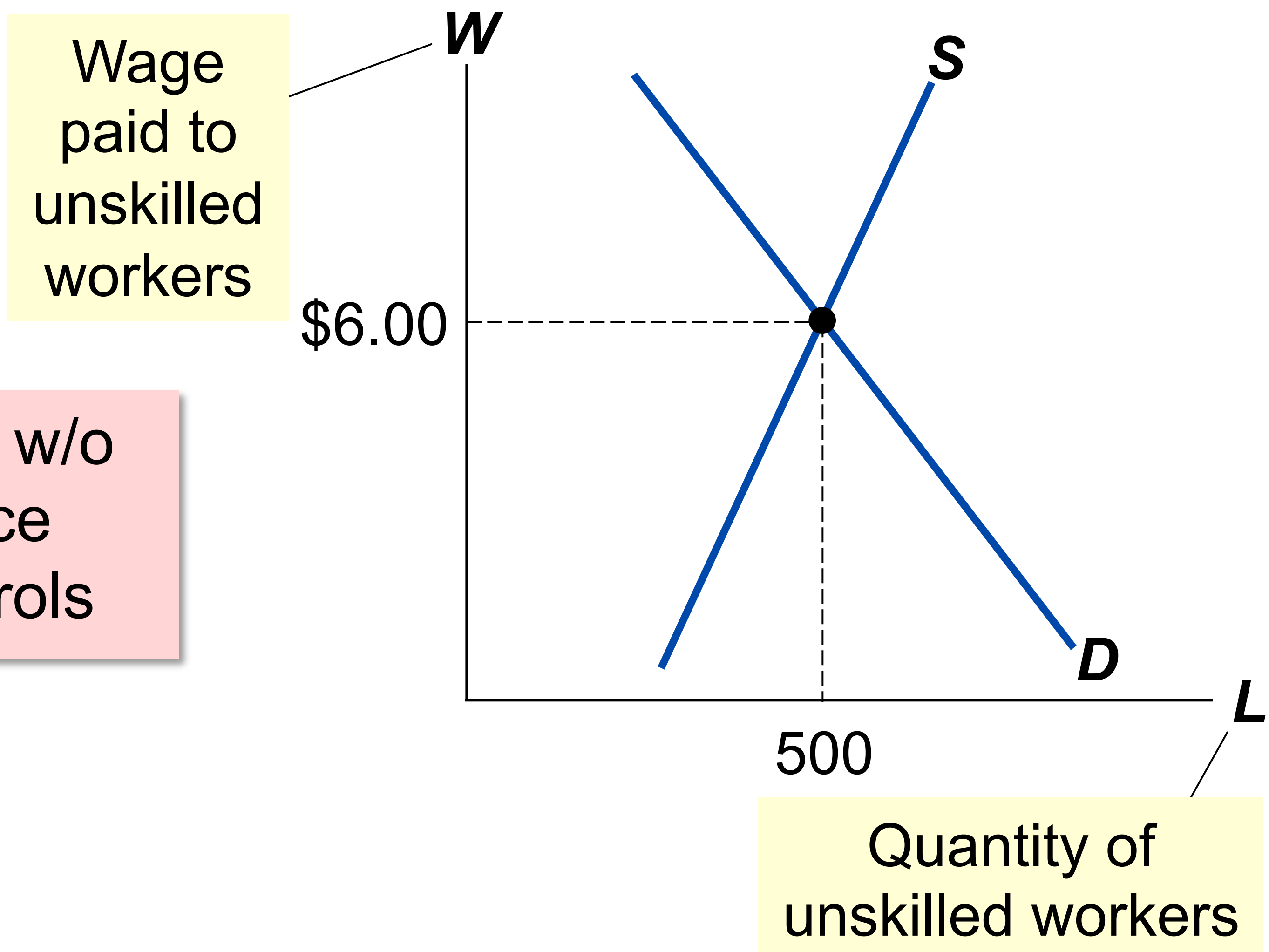
So, the shortage is larger.



Shortages and Rationing

- With a shortage, sellers must ration the goods among buyers.
- Some rationing mechanisms: (1) Long lines (2) Discrimination according to sellers' biases
- These mechanisms are often unfair, and inefficient: the goods do not necessarily go to the buyers who value them most highly.
- In contrast, when prices are not controlled, the rationing mechanism is efficient (the goods go to the buyers that value them most highly) and impersonal (and thus fair).

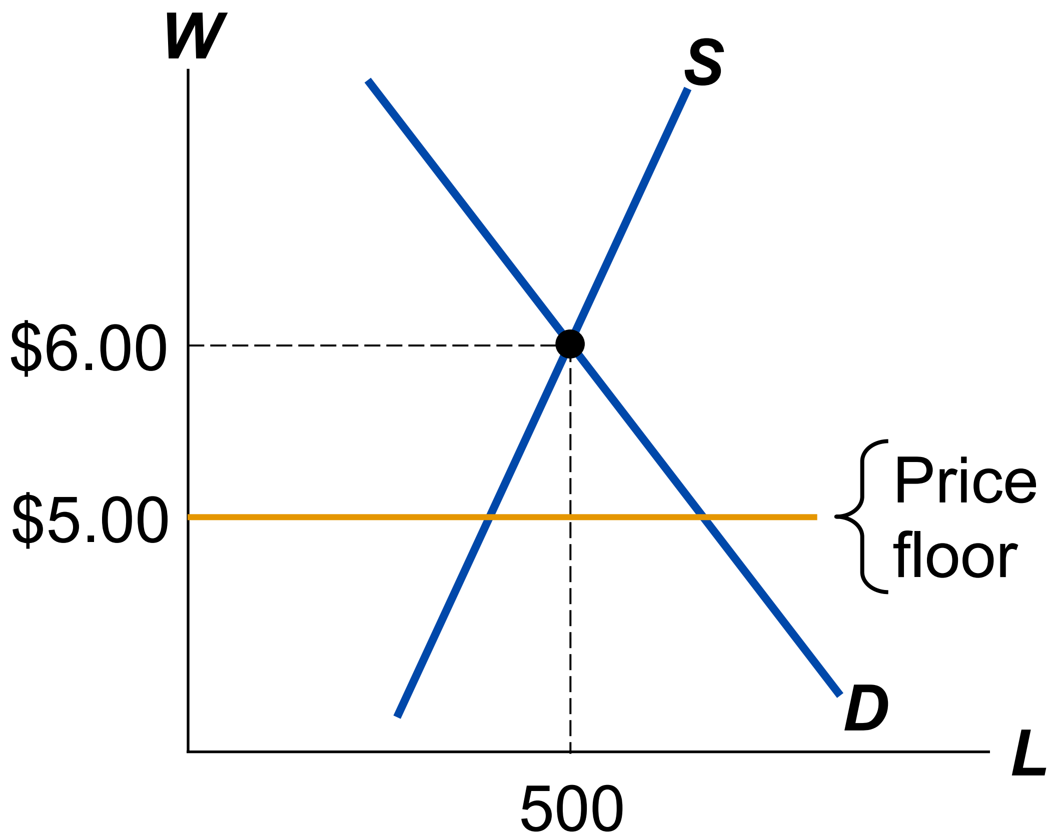
EXAMPLE 2: The Market for Unskilled Labor



Eq'm w/o price controls

How Price Floors Affect Market Outcomes

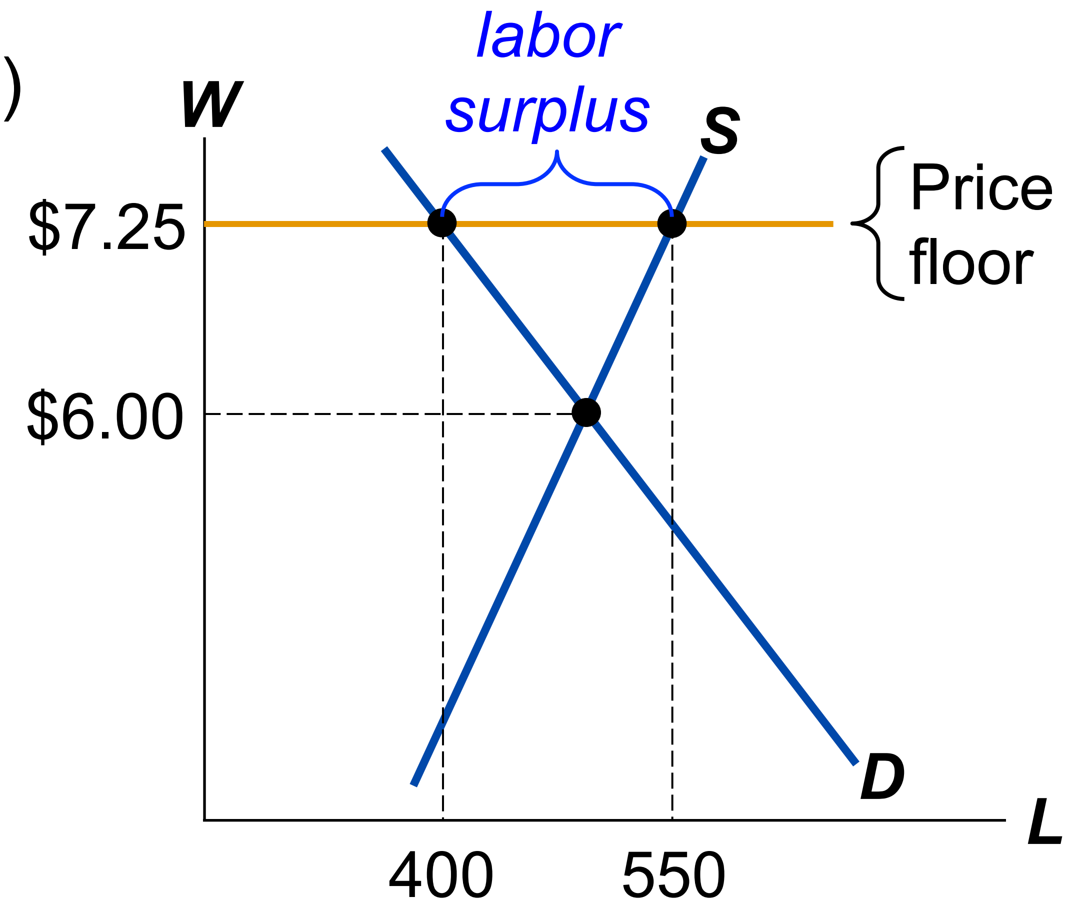
A price floor below the eq'm price is **not binding** – has no effect on the market outcome.



How Price Floors Affect Market Outcomes

The eq'm wage ($6) is below the floor and therefore illegal.

The floor is a **binding constraint** on the wage, causes a surplus (i.e., unemployment).

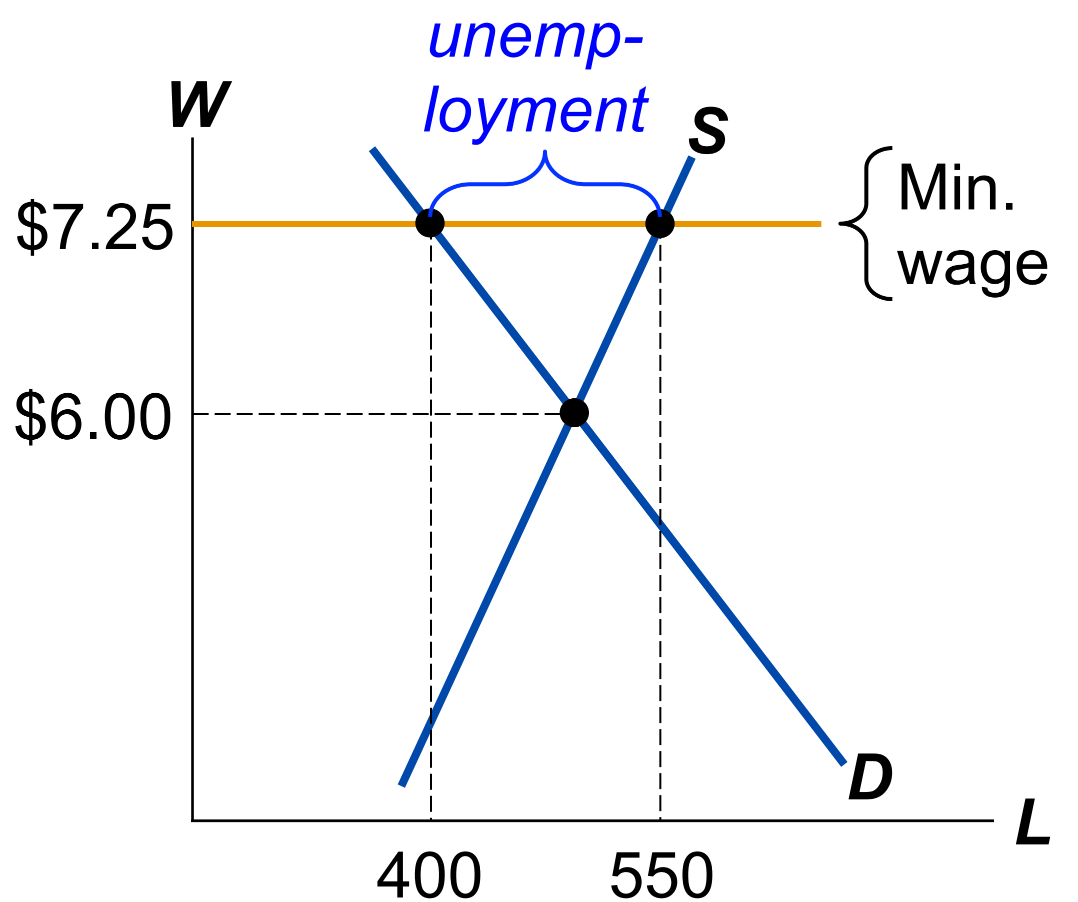


The Minimum Wage

Min wage laws do not affect highly skilled workers.

They do affect teen workers.

Studies:
A 10% increase in the min wage raises teen unemployment by 1–3%.



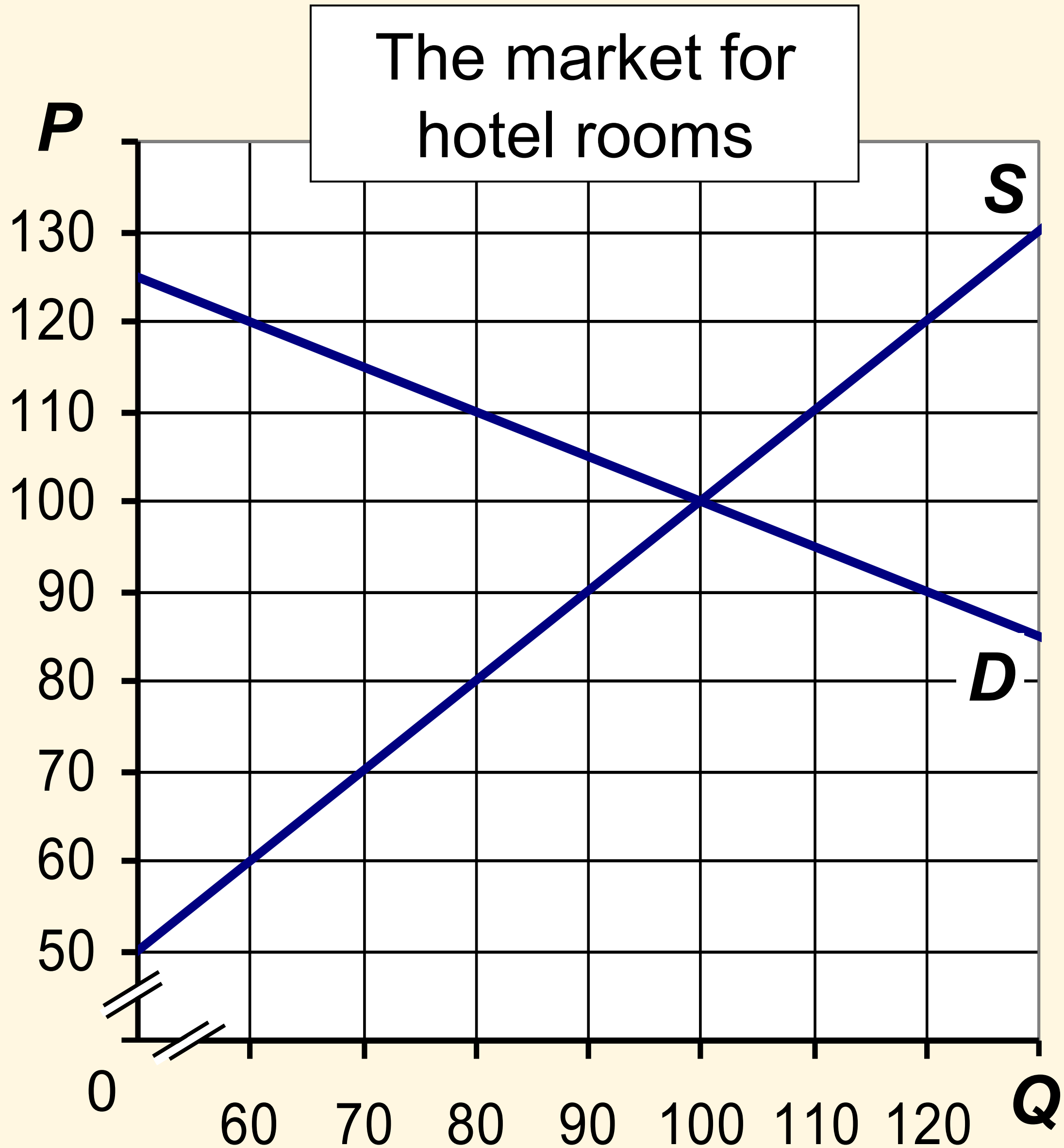
ACTIVE LEARNING 1
Price controls

Determine effects of:

A. $90 price ceiling

B. $90 price floor

C. $120 price floor

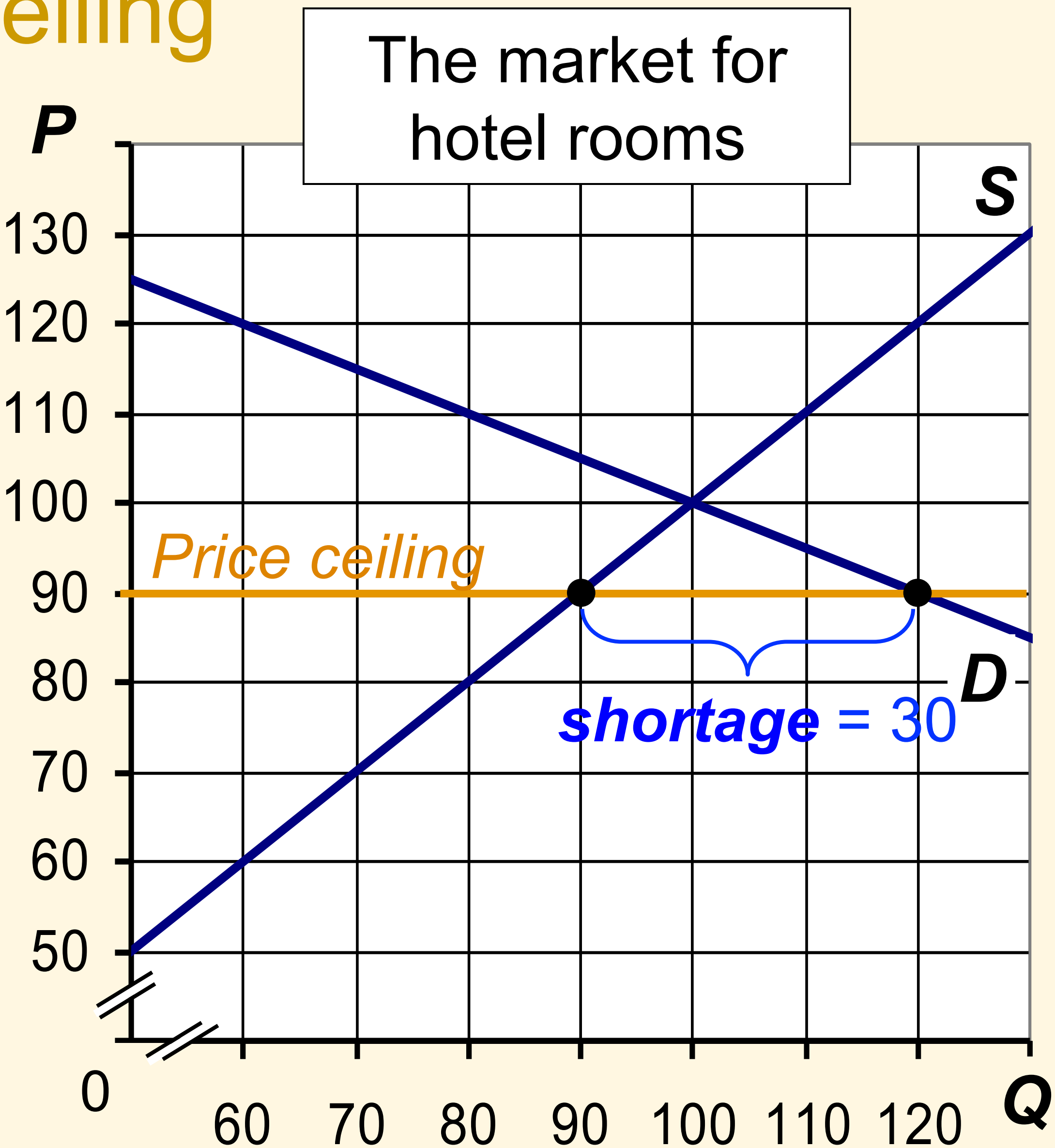


ACTIVE LEARNING 1

A. $90 price ceiling

The price falls to $90.

Buyers demand 120 rooms, sellers supply 90, leaving a shortage.

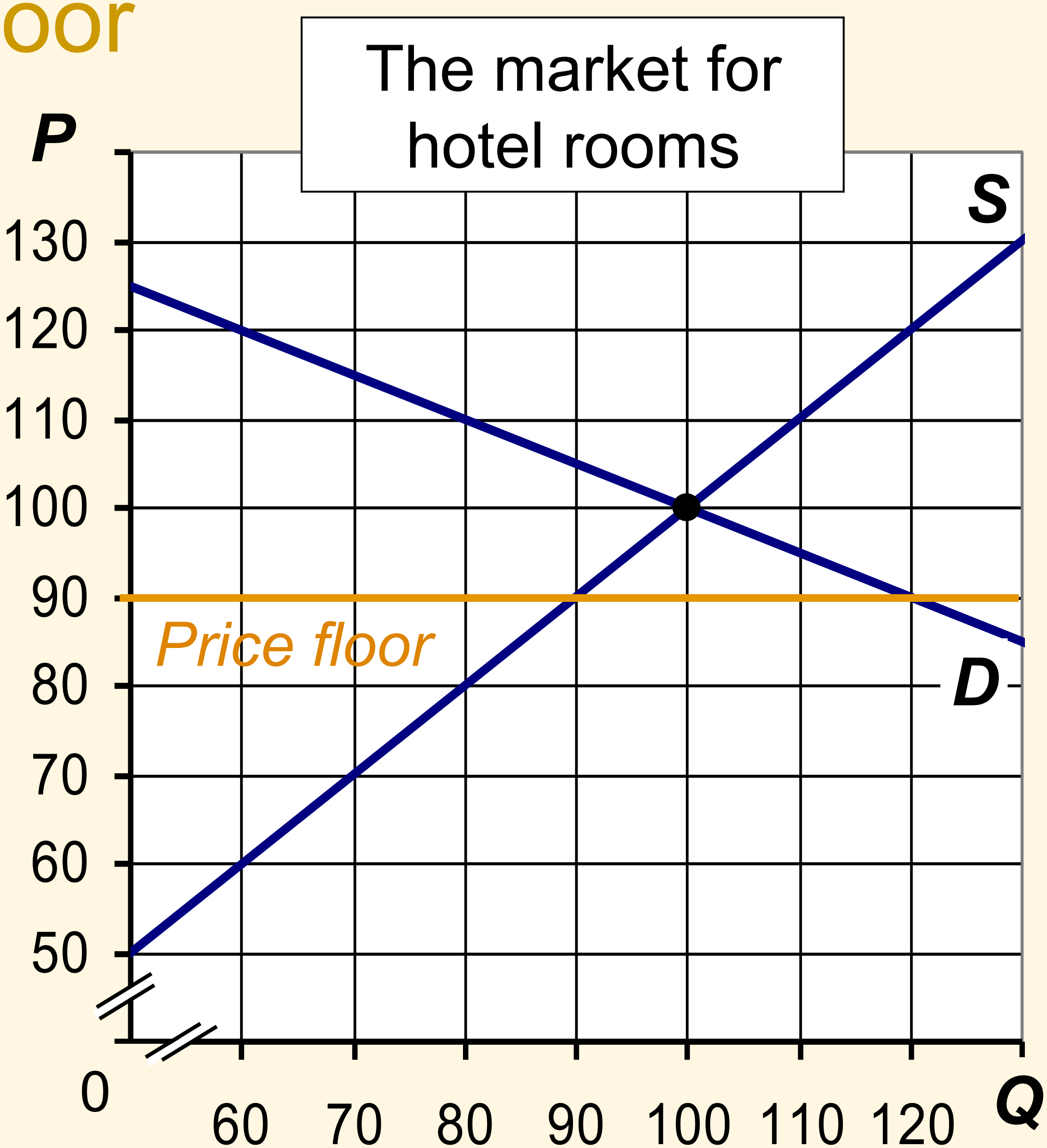


ACTIVE LEARNING 1

B. $90 price floor

Eq'm price is above the floor, so floor is not binding.

P = $100,
Q = 100 rooms.

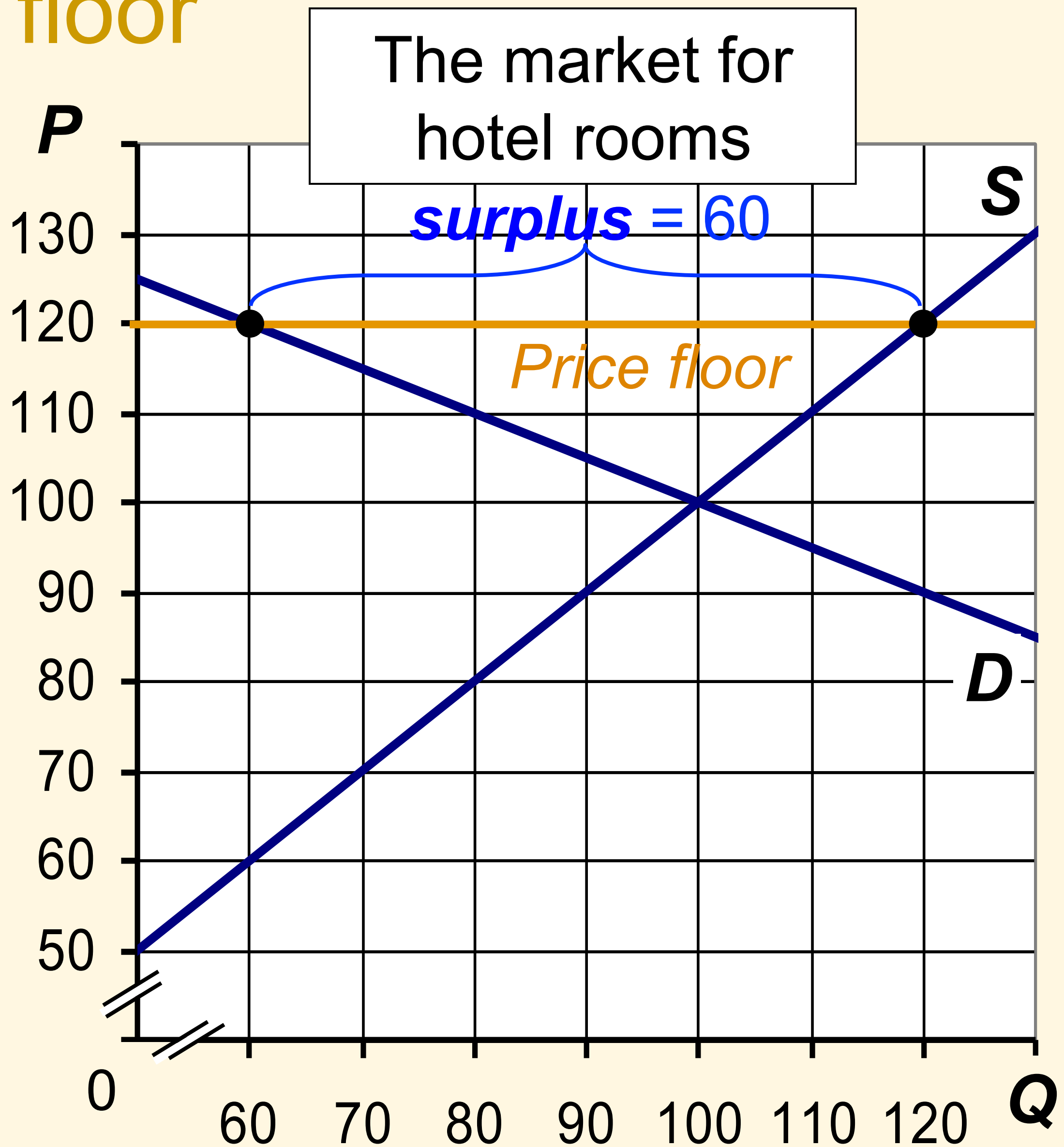


ACTIVE LEARNING 1

C. $120 price floor

The price rises to $120.

Buyers demand 60 rooms, sellers supply 120, causing a surplus.



Evaluating Price Controls

- Recall one of the Ten Principles from Chapter 1:
  Markets are usually a good way to organize economic activity.
- Prices are the signals that guide the allocation of society's resources. This allocation is altered when policymakers restrict prices.
- Price controls often intended to help the poor, but often hurt more than help.

Summary

- A price ceiling is a legal maximum on the price of a good. An example is rent control. If the price ceiling is below the eq'm price, it is binding and causes a shortage.
- A price floor is a legal minimum on the price of a good. An example is the minimum wage. If the price floor is above the eq'm price, it is binding and causes a surplus. The labor surplus caused by the minimum wage is unemployment.