

CHAPTER 6

Supply, Demand, and Government Policies

PRINCIPLES OF
Economics
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 do the effects depend on whether the tax is imposed on buyers or sellers?
- § What is the incidence of a tax?
What determines the incidence?

1

Government Policies That Alter the Private Market Outcome

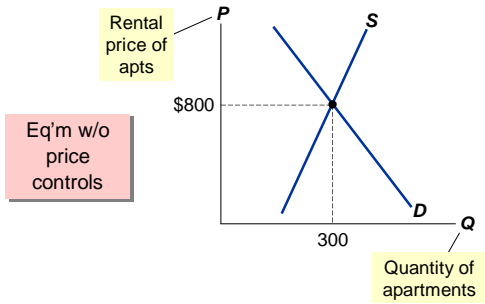
- § Price controls
 - § **Price ceiling:**
 - § **Price floor:**
- § Taxes
 - § The govt can make buyers or sellers pay a specific amount on each unit bought/sold.

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

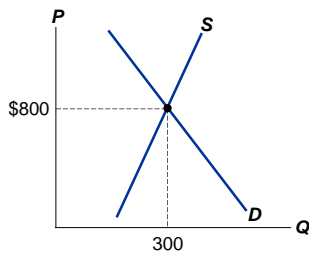


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How Price Ceilings Affect Market Outcomes

A price ceiling above the eq'm price



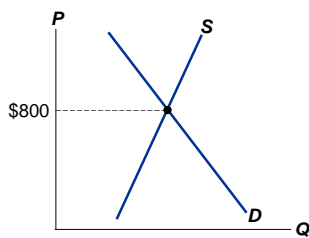
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How Price Ceilings Affect Market Outcomes

The eq'm price (\$800) is

The ceiling is a

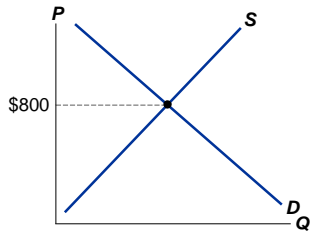


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How Price Ceilings Affect Market Outcomes

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:

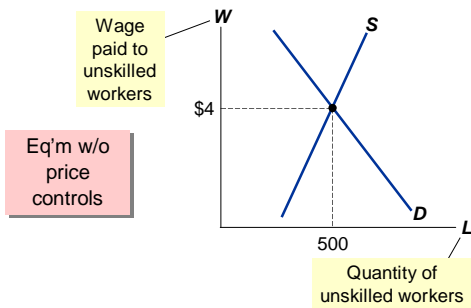
§ These mechanisms are often unfair, and inefficient:

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

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EXAMPLE 2: The Market for Unskilled Labor

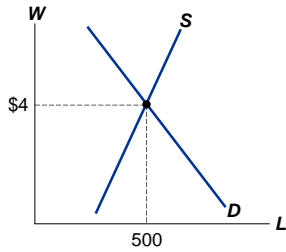


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How Price Floors Affect Market Outcomes

A price floor below the eq'm price

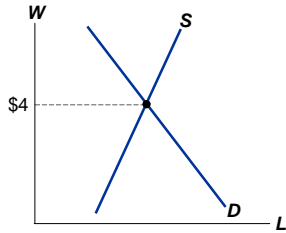


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How Price Floors Affect Market Outcomes

The eq'm wage (\$4) is



The floor is

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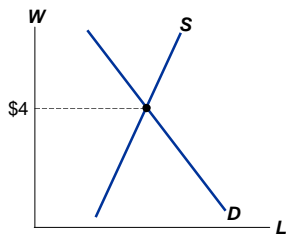
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The Minimum Wage

Min wage laws do not affect highly skilled workers.

They do affect teen workers.

Studies:



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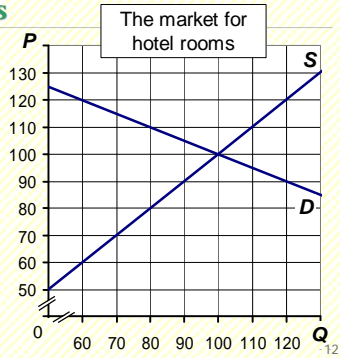
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ACTIVE LEARNING 1

Price controls

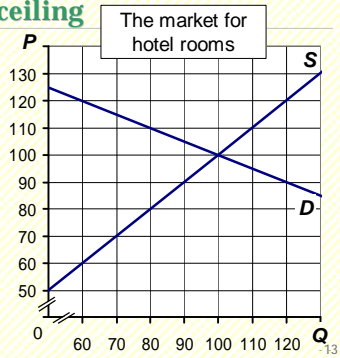
Determine effects of:

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



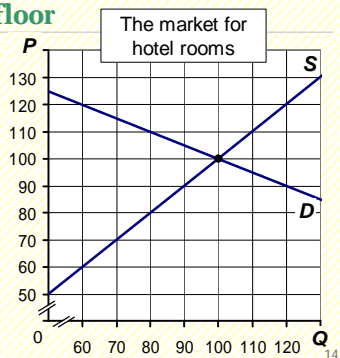
ACTIVE LEARNING 1

A. \$90 price ceiling

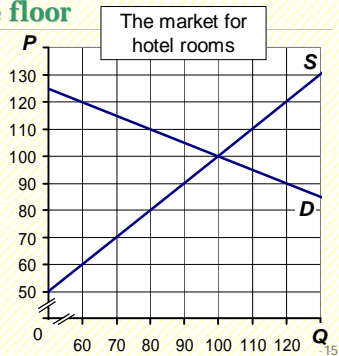


ACTIVE LEARNING 1

B. \$90 price floor



ACTIVE LEARNING 1
C. \$120 price floor



Evaluating Price Controls

§ Recall one of the Ten Principles from Chapter 1:
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.

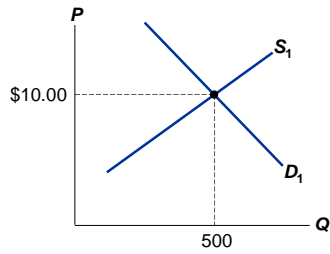
§ The govt can make buyers or sellers pay the tax.

§ 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



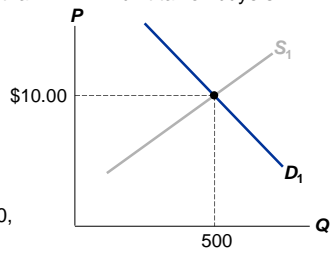
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A Tax on Buyers

The price buyers pay is now \$1.50 higher than the market price P .

Effects of a \$1.50 per unit tax on buyers



E.g., if P falls from \$10.00 to \$8.50, buyers still willing to purchase 500 pizzas.

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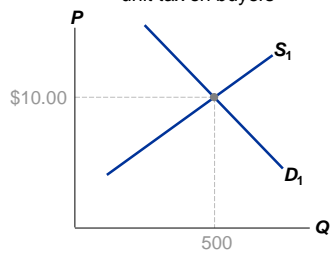
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A Tax on Buyers

New eq'm:

$Q =$

Effects of a \$1.50 per unit tax on buyers



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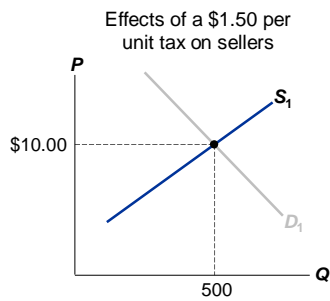
The **Incidence** of a Tax:

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A Tax on Sellers

Sellers will supply
500 pizzas
only if



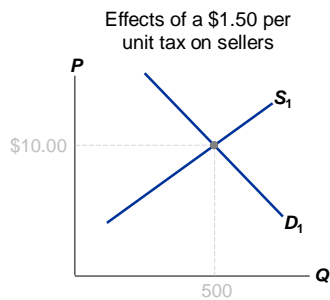
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A Tax on Sellers

New eq'm:

Q =



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The Outcome

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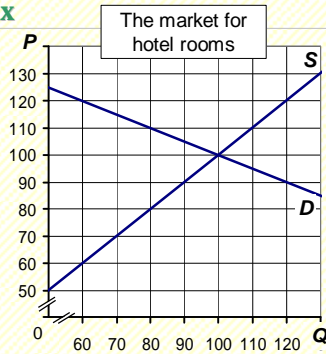
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ACTIVE LEARNING 2

Effects of a tax

Suppose gov't imposes a tax on buyers of \$30 per room.

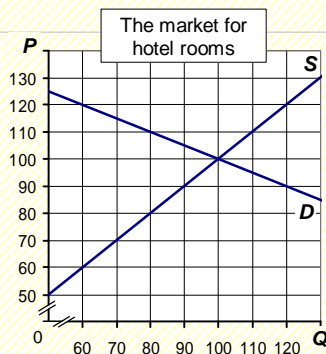
Find new Q , P_B , P_S , and incidence of tax.



ACTIVE LEARNING 2

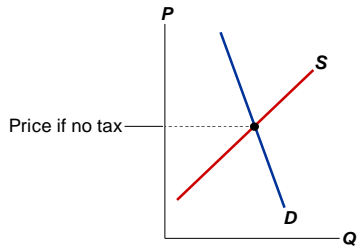
Answers

Incidence



Elasticity and Tax Incidence

CASE 1: Supply is more elastic than demand

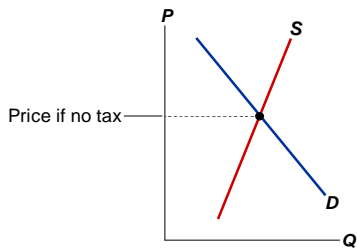


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Elasticity and Tax Incidence

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: raise revenue from those who could most easily afford to pay – wealthy consumers.

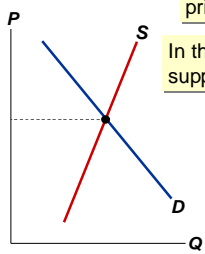
§ But who really pays this tax?

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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.

§ *Example 1:* A tax on pizza

§ *Example 2:* A binding minimum wage causes

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

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