Ch.4
Applications of Supply and Demand

The economics of price controls

Price controls are government mandated prices. They can either be higher or lower than the market equilibrium price.

Price ceiling – a price ceiling sets a maximum price that a producer can sell at. This price is generally set below the equilibrium price.

Shortages result when price ceilings are set. This means that there is more demand for a product than there is supply of the product.

Rent control is the typical example of a price ceiling. A low price is set on the amount of rent a landlord can charge for an apartment. This in turn drives demand for the apartment higher. However, the landlord cannot increase the price of the apartment because of the government restriction.

Price floors – a price floor sets a minimum price that consumers must buy at. This price is generally set above the equilibrium price.

Surpluses result when price floors are set. This means that there is more supply of a product than there is demand for a product.

The dairy articles on the web-site deal with price floors. The price of dairy products is set above the equilibrium price so dairy farmers will profit. Without this price floor, dairy farmers will not profit and they will go out of business and we will no longer have dairy products (This is not necessarily true but it is what the dairy farmers would like us to believe that the price floor is there for. The price floor was actually imposed years ago to ensure that people who lived in non-dairy producing regions would receive drinkable milk. Today's dairy farmers would like to keep the price floor because they are earning more profits by keeping the price floor than they would if they let the market regulate the price.)

***Note that price floors are set above the equilibrium price and price ceilings are set below the equilibrium price. If you are looking at a graph a price ceiling will be on the bottom of the graph while a price floor will be on the top.

Black markets

Black markets are markets that operate outside the legal framework.

There are three characteristics that distinguish black markets from those that operate inside the legal framework.

1. Higher chance of defective products
    a. There is no regulation of black market products which could lead to inferior products
2. Higher profit rates
    a. If you do not get caught in participating in a black market you can make higher profits than by participating in a legal market because people who buy black market products do not have a good choice of substitutes
    b. Following from the fact that black market products can be inferior, people can sell cheap products at high prices because the consumer may not be able to gather information on the seller and his products. The consumer must then buy the product to see the quality.
3. There is a greater chance of violence
    a. There is no legal recourse in a black market – you cannot go to court because somebody sold you a defective product on the black market because you are not supposed to be buying that product
    b. Violence becomes the mean of protecting property rights, not the government

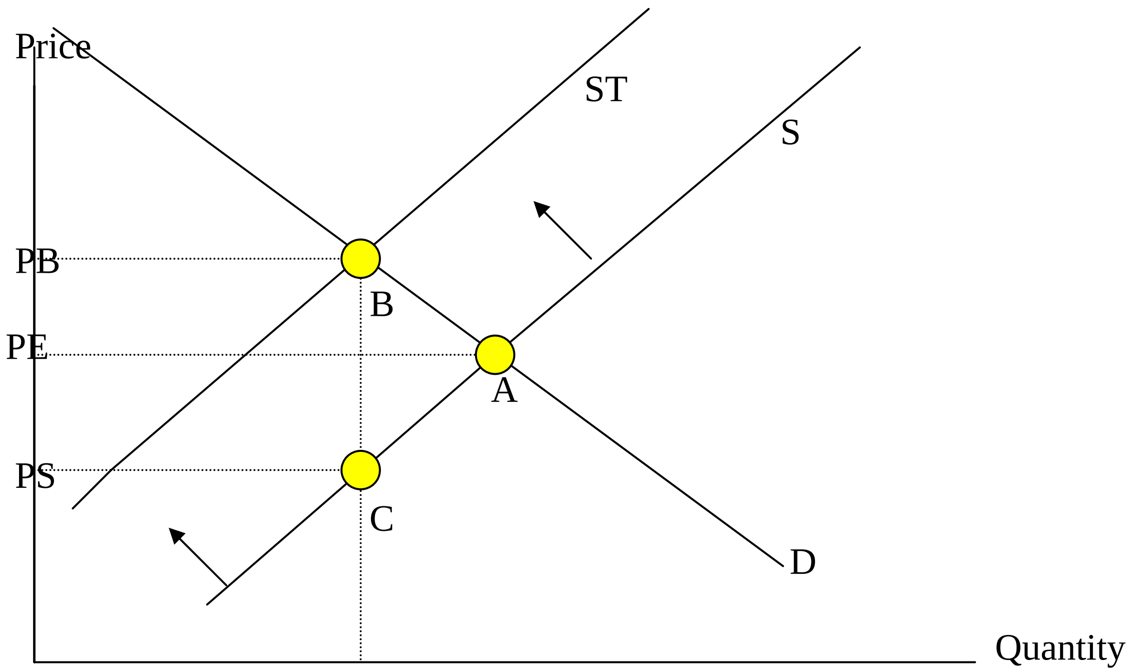
Ch.4 tax section

How do taxes affect the way the market operates?
Who bears the burden of taxation?

Statutory tax incidence – who is legally responsible for the tax
Actual tax incidence – the party who ends up paying for the tax

It does not matter where the tax is placed statutorily; the market will determine who bears the burden of taxation.

For example, a tax may be placed on the selling of cigarettes, in which the seller is the party responsible for the tax. However, the seller may pass the tax on to the buyers. So the actual tax incidence falls upon the buyers of cigarettes.



Above is a graph of what happens when a tax is placed on suppliers.
ST = the supply curve when it is taxed
S = the supply curve without the tax
D= the demand curve
PS = the price the seller receives
PE = the equilibrium price
PB = the price that the buyer pays
The welfare loss is given by the triangle ABC – remember that the welfare loss is lost gains from trade – nobody receives this portion of the gains from trade because trading does not occur.

The government revenue is given by the square PB B C PS. This is the portion of the gains from trade that the government receives as a result of the tax.

Producer surplus now lies below the dotted line from PS to C.

Consumer surplus now lies above the dotted line from PB to B.