

The Effect of Government on Markets

1. Price Ceilings

Price controls (like price ceilings and floors) are among the most invasive government interventions on markets, and are usually very inefficient.

The American Assoc. of Ice Cream Eaters wants a *Price Ceiling*, which is a maximum price that can be charged.

If a price ceiling is set too high, it is *not binding* and has no impact.

If the price ceiling is set low enough to matter, it leads to *shortages and rationing*.

- Examples: gas lines during the 1970's, many medicare services, campgrounds at our national parks, automobile insurance in New Jersey, rent control.

2. Price Floors

The National Assoc. of Ice Cream Makers wants a *Price Floor*, or a minimum price that can be charged.

If a price floor is set too low, it is *not binding* and has no effect.

If a price floor is set high enough to matter, there is a *surplus* and some sellers are rationed.

- Examples: the minimum wage, the airlines before deregulation, agricultural price supports.

Evaluating Price Controls: Minimum Wage

A binding minimum wage (price floor) has the following effects:

(i). It creates a surplus of labor, or unemployment. Some of the people targeted for help are hurt.

(ii). Those lucky enough to have jobs are better off.

(iii). Some teenagers are encouraged to drop out of school.

(iv). Not only are there fewer jobs, but the people who most benefit from the jobs may not be the ones getting them.

(v). Employers are worse off.

3. Taxes

Who should pay the \$ 0.50 tax at the ice cream celebration? Should consumers pay \$0.50 in addition to the price, should sellers pay \$0.50 out of their revenues, or does it matter?

How do we determine how much of the tax burden is *ultimately* paid by consumers and how much by firms, after the market price adjusts? *Tax Incidence*

If consumers are taxed, demand falls and the price will go down, partly offsetting the tax.

If firms are taxed, supply falls and the price will go up, partly offsetting the tax.

- Taxes discourage economic activity, since the quantity sold is smaller in the new equilibrium with imposition of a tax.
- Buyers and sellers share the burden of the tax, since buyers pay more for the good (after tax) and sellers receive less for the good (after tax).
- Surprisingly, whether buyers or sellers pay the \$0.50 tax makes no difference. If buyers pay, the price falls to \$2.80, so buyers pay \$3.30 after tax. If sellers pay, the price rises to \$3.30, and sellers receive \$2.80 after tax.

Elasticity and Tax Incidence

- Whichever side of the market is less sensitive to price changes (less elastic) will bear most of the tax burden.
- Example: The 1990 luxury tax. The demand for luxury items is fairly elastic (rich people could buy a second house instead of a yacht). The supply of luxury items is fairly inelastic in the short run (yacht building factories cannot easily be converted into other uses, and craftsmen will not readily look for new careers).
- Therefore, rather than soaking the rich, the people who supplied the luxury goods paid for most of the tax.