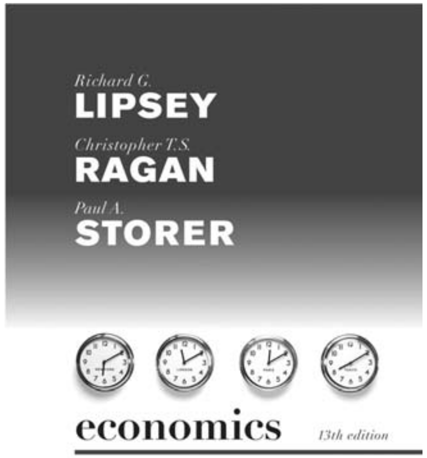
Chapter 5

Markets in Action



In this chapter you will learn to

1. Explain why changes in one market typically have repercussions in other markets.
2. Describe the operation of a market in the presence of price ceilings or price floors.
3. Describe how legislated rent controls affect the housing market in the short run and in the long run.
4. Explain why government interventions that cause prices to deviate from their market-clearing levels are inefficient for society as a whole.

Equilibrium Analysis

<u>Partial-equilibrium analysis</u> examines a single market in isolation and ignores <u>feedback effects</u> from other markets.

In general, this is appropriate when the specific market is quite small relative to the entire economy.

Most of microeconomics uses partial-equilibrium analysis.

When economists study all markets together, they use <u>general-equilibrium analysis</u>.

General-Equilibrium Analysis

General-equilibrium analysis is more complicated because it involves the analysis of all of the economy's markets simultaneously.

Economists must consider how all the markets function together, taking into account the feedback effects between individual markets.

Government-Controlled Prices

Disequilibrium Prices

If price is set above equilibrium, some sellers will be unable to find buyers.

Conversely, if price is set below equilibrium, some buyers will be unable to find sellers.

With administered prices, the quantity is determined by the lesser of quantity demanded and supplied.

Figure 5.1 The Determination of Quantity Exchanged in Disequilibrium

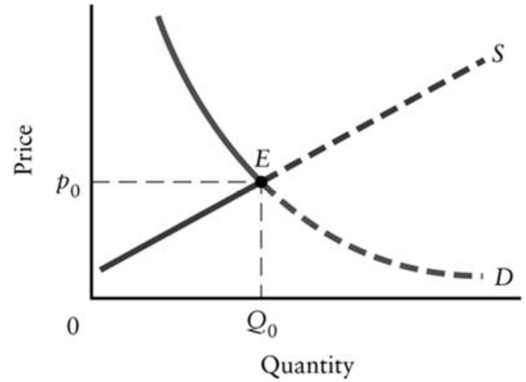
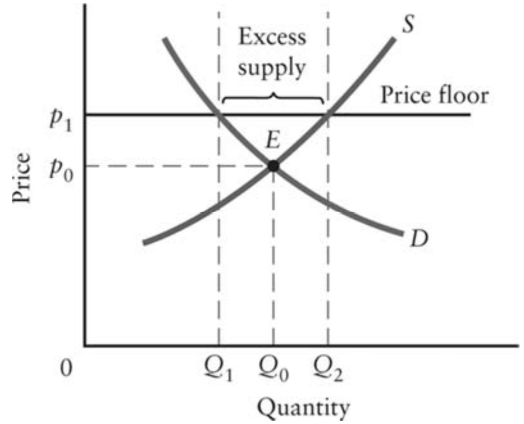


Figure 5.2 A Binding Price Floor



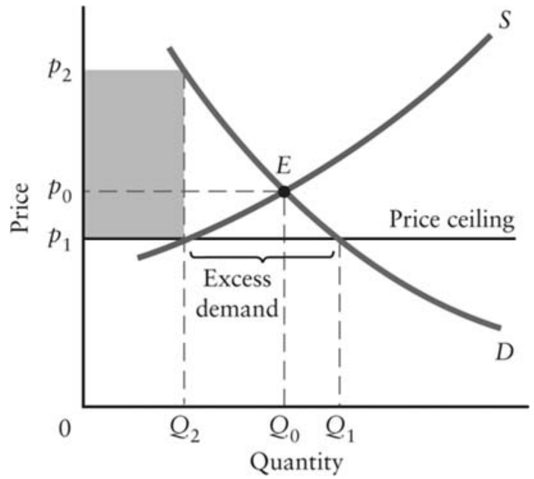
Example of a Price Floor

A common example of a price floor is the legislated minimum wage. Do minimum wages lead to unemployment?

APPLYING ECONOMIC CONCEPTS 5.1

Minimum Wages and Unemployment

Figure 5.3 A Price Ceiling and Black-Market Pricing



Why Price Controls?

Typically, a government has one (or more) of three main objectives in imposing a price ceiling:

- to restrict production
- to keep specific prices down
- to satisfy notions of equity in consumption

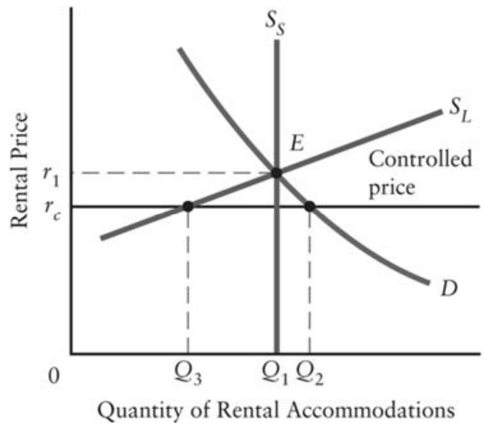
Rent controls: A Case Study of Price Ceilings

The Predicted Effects of Rent Controls

Binding rent controls are a specific form of price ceiling. We can use the previous diagram to predict the effects:

- a housing shortage
- alternative allocation schemes in black markets
- illegal schemes like “entrance fees”

Figure 5.4 The Short-Run and Long-Run Effects of Rent Controls



Recent control causes housing shortages to worsen in the long run (S_L as supposed to S_S)

Who Gains and Who Loses?

Existing tenants in rent-controlled apartments win.

Landlords lose.

Potential future tenants also suffer.

Policy Alternatives

Housing shortages can be reduced if the government (at taxpayers' expense) either subsidizes housing production or produces public housing directly.

The government may also provide lower-income households with income assistance.

But no policy is "free" -- every policy involves a resource cost.

An Introduction to Market Efficiency

Legislated minimum wages make firms and some workers worse off, but benefits those workers who retain their jobs.

Rent controls make some tenants better off at the expense of landlords (and harm other tenants).

But how about the overall effect on society? Economists use the concept of market efficiency.

Demand as "Value" and Supply as "Cost"

Price corresponding to a specific quantity demanded is the highest price consumers are willing to pay

– as shown by the height of the demand curve.

Price corresponding to a specific quantity supplied is the lowest price producers are willing to accept

– as shown by the height of the supply curve.

Figure 5.5 Reinterpreting the Demand and Supply Curves in the Pizza Market

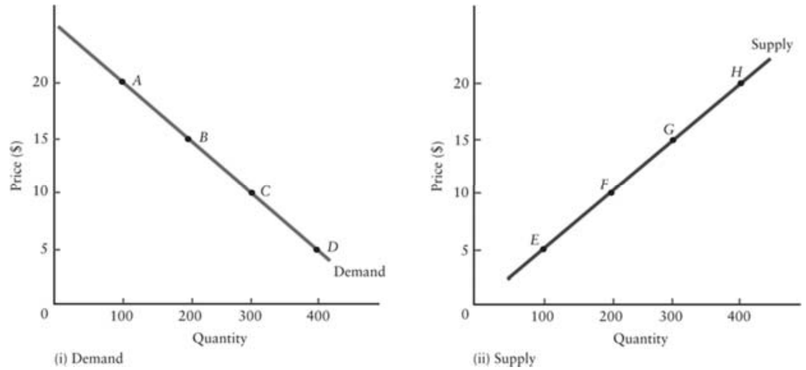


Figure 5.6 Economic Surplus in the Pizza Market

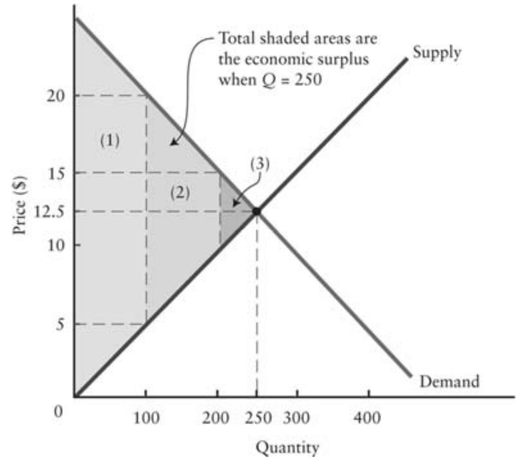


Figure 5.7 Market Inefficiency with Price Controls

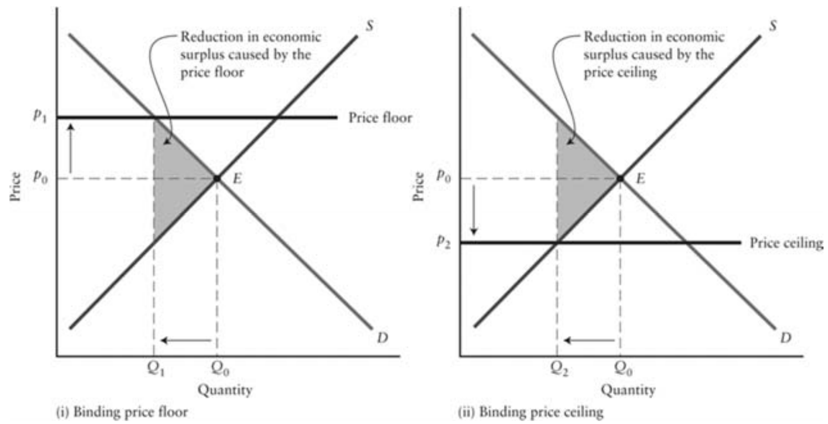
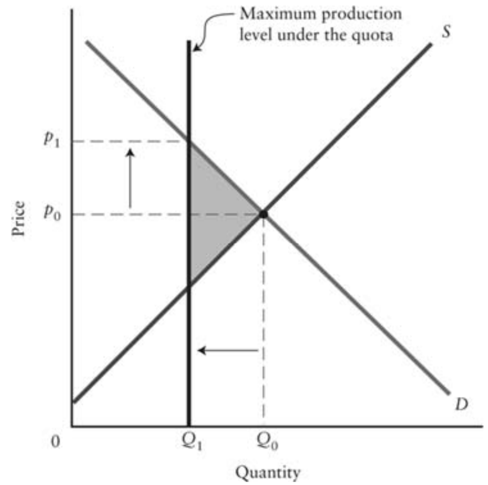


Figure 5.8 The Inefficiency of Output Quotas



A Cautionary Word

Government intervention in competitive markets redistributes surplus between buyers and sellers, but often creates overall losses. So why do it?

Government policy is often motivated by a desire to help a specific group (e.g., increase incomes of farmers).

Economists must carefully analyze the effects of such policies to determine the actual effects rather than what is desirable for political reasons.