4.1: Why It Matters- Applications of Supply and Demand

Why evaluate the applications of supply and demand?

In the module on supply and demand, we defined a free market as one with no government intervention. In this module, we will learn about the applications of supply and demand to explore the outcomes, both anticipated and otherwise, when government *does* intervene in a market.

Economists believe there are a small number of fundamental principles that explain how economic agents respond in different situations. Two of these principles, which we have already been introduced to, are the laws of demand and supply.

Governments can pass laws affecting market outcomes, but no law can negate these economic principles. Rather, the principles will manifest themselves in sometimes unanticipated ways, which may subvert the intent of the government policy. This is one of the major conclusions of this module.

The three best examples of this are:

- Price floors–a legal minimum price in a market, e.g. the minimum wage;
- Price ceilings–a legal maximum price in a market, e.g. rent controls in certain cities;
- Tax incidence–who ends up paying a tax? For example, if the local government adds a sales tax on restaurant meals, is the tax paid by the diners or does it come out of the restaurant's profits? (We'll study more about this in the next module on elasticity.)

Understanding all the effects, both anticipated and unanticipated, of government intervention in a market is critical to determining whether the policy achieves its goal.

As you go through this module, make sure to keep in mind who is a given policy (e.g., a minimum wage) supposed to help? Only then can you evaluate whether the policy is a good one or not. Check out the following video about the minimum wage.

Watch It

The story dates from when the minimum wage was $5.15, but the issues are still relevant today as the discussion continues about further increases in the minimum wage.

A link to an interactive elements can be found at the bottom of this page.

Click through this exercise to briefly learn about two ways that government frequently interferes with a market economy and the consequences these actions have on the market.

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