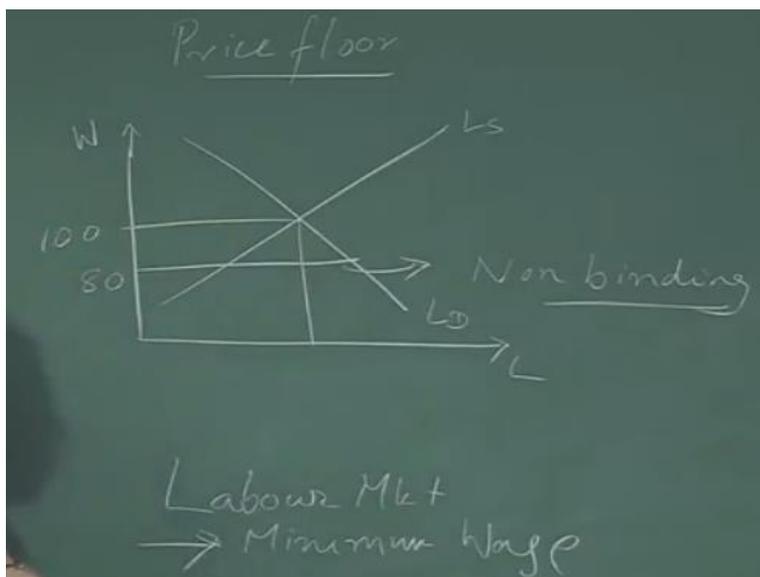


Foundation Course in Managerial Economics
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Lecture - 11
Demand Supply & Government Policies (Contd.)

Welcome back we are now going to discuss about price floors. We ended our discussion on price ceilings and we are going to talk about now price floors. So the example that I gave in the earlier section on price floor was I talked about minimum wage. So and price floor can happen in case of agriculture products also. So let me take the example of minimum wage and let me just show what it does to the labour market.

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So this is an example of price floor and I am taking the example of a labour market where a minimum wage is imposed by the government. So as I said so this is the labour supply and this is the labour demand and this is the amount of labour. This is wage. So it is basically the same framework of prices, price of labour is nothing but wage and quantity of labour is nothing but number of people working or number of hours worked in a day etc. So it can be in any unit.

So we have on the x axis we have the labour supply or demand and this is the supply curve of labour. This is the demand curve of labour. Now as I said in the earlier class that it is possible that the economy has whole lot of people who are looking for job basically very unskilled people

and with poor unskilled people who are who would like to work for a very low amount level of wage.

So they are all there in the market and it is a highly populated market with a huge workforce. In that case it is easy to imagine that the market is probably going to clear at a wage which is say quite low which is it is possible that the market clears say right like today in India the minimum wage is rupees 160 per day. So it is 160 per day.

So say the market clears at 100. So the market clears at 100 and the government says that see 100 is not a decent wage. It is not sufficient for a person to maintain a subsistence level of consumption at this very low wage so every employer has to pay a wage which is at least 160.

So what happens if the government decides that the wage is going to be, price floor is going to be 80, nothing. This is not a binding constraint.

So this is not this is not binding. So this price floor of 80 would be non-binding and so if the government imposes a minimum wage which is 80 and below the market clearing wage then this minimum wage is non-binding and does not disturb the equilibrium in the market. Nothing happens in the market. The market just clears at 100 because any wage above that above 80 is acceptable to the government.

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So we are not interested in this case and we are going to just stick to the above equilibrium level of prices. We are going to just stick to the above equilibrium level of prices. So this is equilibrium and let me just this is W_e and the government now imposes a price floor at W_f and

the government says tells all employers that you cannot pay a wage which is lower than W_f . Now what happens in such a situation?

It will probably it will be easier this time since we have already discussed about price ceiling so you might have already figured out that what happens in this case. Now since the wage has the market wage that can be offered has gone up this is the minimum wage. At this wage along the supply curve this many people L_1 number of people or labourers would like to supply their labour. They would be very happy to work at this higher wage. So all this people now enter the job market. They are all looking for now job.

But what happens to demand, the people who are employing these people? For them the cost of employing the people have gone up. So now they have to pay a higher wage than the equilibrium they have to pay a higher wage and they are going to demand people or they are going to demand employees depending on what how much wage they have to pay.

So when they see that they have to pay W_f is the minimum that they can pay so they are going to demand L_1 dash or L_1 prime amount of labour. They are basically reducing their labour demand. So earlier they were demanding L_e . Now they are demanding L_1 prime amount of people to work for them.

So what is happening? So basically if the market was left to itself. Market would have cleared at a lower wage and L_e number of people would be employed but now since the government has imposed a price floor or it has imposed a minimum wage at a level which is above the equilibrium wage what has happened is the employability of people or the people looking for employees the producers looking for employees they are going to demand less number of people to work for them and on the other hand more and more people have entered the job market.

So firstly the government has created this amount of unemployment because these people could have been employed in the economy and now basically the employers are no longer employing this L_1 prime L_e amount of people but there is also additional unemployment in the economy because now L_e L_1 amount of people have entered the labour market have entered the job market looking for jobs.

So as a result of this minimum wage unemployment has increased in the economy. Unemployment has increased in the economy because now because the producers the producers or now because the employers have to pay a higher wage they are employing less number of people so the first level of unemployment is created over here. The second level of

unemployment is created because the minimum wage has gone up more people have entered the job market looking for jobs.

So they also end up being jobless and so the amount of unemployment goes up in the economy. So this is what happens so basically what is this? This is basically surplus. This is a surplus that has been created in the market. The same way that the price ceiling created a shortage in the market, price floor has created a surplus in the market. Price floor has created a surplus in the market.

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Price Floor

- Example – Minimum wage or minimum price of agricultural produce, say wheat
- Minimum wage does not affect highly skilled workers
- Price controls disrupt the role of prices as signals for both buyers and sellers
- Policies intended to help the society often end up hurting them

Now so coming back to the slides. So we started with example of minimum wage or minimum price of agricultural produce say wheat and we showed the impact we showed what happens in case of a price floor with the labour market and what is the how does actually labour market impact the people who are looking for jobs.

Minimum wage does not affect the highly skilled workers because highly skilled workers are probably getting a wage which is much higher than the minimum wage. So basically who are the people who lose their jobs? They are probably the people who work around who were accepting a wage level which is lower than W_f .

So these are the people who are actually losing the jobs which is not a good thing because the minimum wage was probably imposed in the first place to protect this poor people who were getting a low level low amount of wage and these people are in any case many of these people are losing job because of this minimum wage requirement.

Okay and another thing that another impact of a price floor could be say for example there is a price floor on wheat say there is a price floor on wheat and the government basically is trying to protect the farmers and says that the amount of that the price of the wheat cannot be lower than a certain level.

So what happens in that case? Since there is a price floor on wheat the many more farmers would be willing to supply this product because now there is a the price cannot go down any further. The price cannot go down and many farmers would like to supply. So the same way it is if we imagine this diagram for say wheat market so since the price has gone up of wheat so all these people wheat producers they will enter the market and start supplying wheat in the market.

But then what happens? When the market when the government says that I would like to protect the farmers and you can go for because of technology etc the farmers are producing huge amount of wheat and in normal circumstance unless and until of course of there is a some you know some drought or something so in such circumstance maybe supply has contracted but in normal circumstance if there is a price floor because there is bumper production many of the farmers are willing to sell their product at a higher price and who is going to who is going to buy the products because there are no takers in the market. The demand is here.

Since the price is higher these people are people are not interested in buying more wheat. So who buys the wheat? The government's this policy will fail if the wheat is not sold because at the end of the day that is what the government is trying to do. The government is trying to protect the farmers. So what does the government do?

Government buys up this amount of surplus. So to make the policy more effective of imposing a price floor on wheat what the government has to do is it says that okay fine I am going to buy up this surplus wheat that the farmers have brought into the market but does it end there? No. So once the government purchases this wheat then this wheat has to be stored, it has to be transported, it has to be distributed.

So that also incurs a lot of cost to the government and where is that cost or where is that money going to come from for the government. So the so where is that going to come from? It is going to come from the taxes that the government raise from the people. So then it is a double problem. It is a so on the first place in the first place the government has increased the price of wheat so people are paying a higher price of wheat and secondly now the people are having to pay higher taxes to support the government to support this price floor that the government has imposed.

So basically the price control disrupts the role of prices as signals for both buyers and sellers. Now we saw in the last class that if the market is left to itself and if there is by due to whatever reason if the price if the supply is too much what happens? If there is a surplus the suppliers know that to sell this product we have to reduce the price. So they start reducing the price and as they reduce the price more and more people are buyers get interested they enter the market and they start buying.

So prices basically go down till they reach the equilibrium till they reach the equilibrium. But in case of price floor and price ceiling what is happening is the price cannot adjust in the market price cannot adjust in the market no matter there could be a shortage in the market prices are not going to go up. There could be surplus in the market prices are not going to go down and the price does not signal properly.

So basically in the long run instead of the problem resolving itself the problem becomes bigger because in the long run say in the case of the price ceiling people have adjusted the demand. They since electricity is cheaper they would now like to consume more and more electricity. So they have adjusted their habits so that they can use more and more electrical gadgets because that is the cheaper of the fuels and in the long run on the other hand to the suppliers it is less attractive to produce.

So they have shifted. They have changed their plans. They do not increase capacity because they have to sell the produce at a low price decided by the government. So the problem becomes even bigger in the long run. Unlike the free market where the prices adjust price acts as a signal and the equilibrium is reached in the long run in this case the problem actually aggravates in the long run.

So minimum wage can cause job losses and rent control similarly rent control. It can reduce the quantity or quality of affordable housing. What happens is government has introduced the policy with the very good intention of making housing affordable and accessible to people but what is happening is it does not have direct control on the suppliers.

So the suppliers lose interest and they leave the market and so the quality and quantity of housing in the market goes down and on the other hand the low prices or the low rents is a false signal to the people looking for a housing. It is a false signal to the people that housing is cheap. So they are all adjusting their consumption habits and they are all entering the market looking for houses to rent.

So basically prices price controls they disrupt the role of prices as signals for both buyers and sellers. So basically what we are seeing is policies intended to help the society often end up hurting them. So policies intended to help the society often end up hurting them like it is people are losing jobs in case of a minimum wage and in case of surplus when there is a price floor it is the government has to incur a huge cost of for it.

However this is not this discussion is that the scope of this discussion is limited to the demand supply framework that I have introduced and we have discussed this policy in the context of this very simple demand supply framework. That is not to say that price controls or government intervention or taxes are summarily bad. No. I am not saying that.

All that I am trying to say here is given this framework demand supply framework any disruption in the market can create some amount of inefficiency in the market but sometimes the objective of creating that inefficiency far surpasses these the inefficiency the end goal that is achieved sometimes the benefit is much higher than the cost that is we are seeing here in this very simple framework and coming back to this framework basically this teaches us how to use this framework to see how the efficiency how efficiency is arrived at in a market if it is left to itself and how prices act as a signal and help the market to come back into equilibrium. Thank you.