Module 6 – Taxes, Subsidies, and Market Regulations (Ch. 6)

6.1 Taxes and Subsidies

Markets and Efficiency

- In perfectly competitive markets:
  - **Marginal Benefit (MB)** = Demand curve
  - **Marginal Cost (MC)** = Supply curve
- At equilibrium (**where supply and demand intersect**):
  MB = MC, meaning the market produces the **optimal (most efficient)** quantity.
- However, markets don't always achieve efficiency:
  1. **Intervention:** Taxes, subsidies, price controls, or quotas distort the market.
  2. **Misjudged MB or MC:** Externalities cause inefficiencies (Chapter 10).
  3. **Imperfect competition:** Firms have market power (Chapters 14–17).

Taxes

- A **tax** creates a wedge between the **price buyers pay** and the **price sellers receive**.
- It **doesn't matter** whether the tax is imposed on buyers or sellers: the outcome is the same. What matter is who bears the burden:

Tax Incidence (Who Bears the Burden?)

- The **less elastic side** of the market bears the **greater tax burden**:
  - **Inelastic demand** → buyers pay more
  - **Inelastic supply** → sellers pay more
- **Intuition:** You can't avoid paying a tax on something if you can't easily change your behavior. You don't pay a tax on a good if you don't buy it.

Subsidies

- A **subsidy** is a **negative tax**: the government pays buyers or sellers to encourage production or consumption.
- It increases the quantity traded and usually lowers the price buyers pay while increasing the price sellers receive.
- Just like taxes, the **distribution of benefits** depends on elasticity.

6.2 Price and Quantity Regulations

- **Price controls** are legal restrictions on prices.
- Two main types:
  - **Price ceiling:** A **maximum** price allowed (e.g., rent control).
    - May create **shortages** ($Q_d > Q_s$).
  - **Price floor:** A **minimum** price required (e.g., minimum wage).
    - May create **surpluses** ($Q_s > Q_d$).
- A **quota** (quantity control) limits how much can be produced or sold.