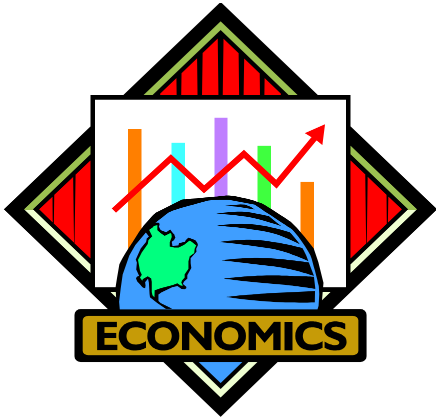
CHAPTER 6
Prices and Decision Making

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ADVANTAGES OF PRICES

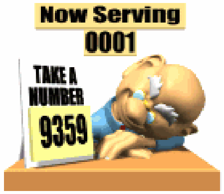
- **Prices are neutral because they do not favor the buyer or the consumer. They are the result of competition.**
- **Prices are flexible, allowing for the "shocks" of unforeseen events and changes in the market.**

ADVANTAGES OF PRICES (continued)

- **Prices have no administration costs.**

- **Prices are familiar and easily understood.**

Representative Jeff Duncan
Third Congressional District of South Carolina



ALLOCATIONS WITHOUT PRICES

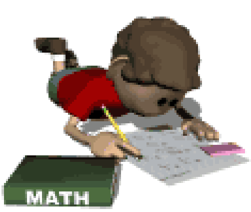
- **Rationing, or the system where the government decides everyone's "fair" share, leads to the question of fairness.**

ALLOCATIONS WITHOUT PRICES (continued)

- **Rationing leads to high administration costs.**
- **Rationing leads to fewer incentives to work and produce.**

PRICES AS A SYSTEM

- **Together, prices comprise a system that helps buyers and sellers allocate resources between markets, linking all markets in the economy.**



THE PRICE ADJUSTMENT PROCESS

- **Price adjustments help a competitive market reach market equilibrium, with fairly equal supply and demand.**

John Roberts

Chief Justice of the Supreme Court

THE PRICE ADJUSTMENT PROCESS (continued)

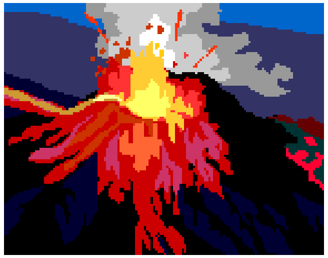
- ***Surpluses*** **occur when supply exceeds demand.**
- ***Shortages*** **occur when demand exceeds supply.**
- **The *equilibrium price* is the price at which supply meets demand.**

Senator Lindsey Graham

EXPLAINING AND PREDICTING PRICES

- **A change in price is normally the result of a change in supply, a change in demand, or both.**

THE COMPETITIVE PRICE THEORY



- **The theory of competitive pricing represents a set of ideal conditions and outcomes.**

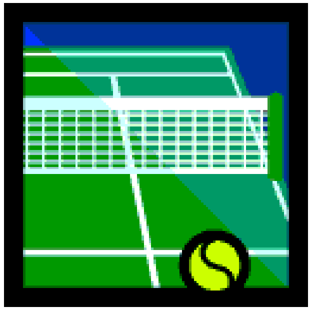
THE COMPETITIVE PRICE THEORY (continued)

- **It serves as a model to measure market performance.**



THE COMPETITIVE PRICE THEORY (continued)

- **In theory, a competitive market allocates resources efficiently.**



THE COMPETITIVE PRICE THEORY (continued)

- **To be competitive, sellers are forced to lower prices, which makes them find ways to keep their costs down.**

THE COMPETITIVE PRICE THEORY (continued)

- **Competition among buyers keeps prices from falling too far.**

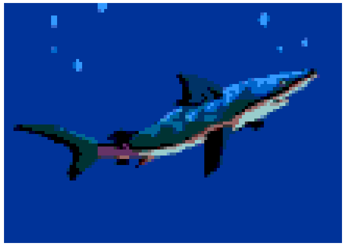
Senator Timothy Scott

DISTORTING MARKET OUTCOMES

- **Achieving *equity* and *security* usually requires policies that distort market outcomes.**

DISTORTING MARKET OUTCOMES (continued)

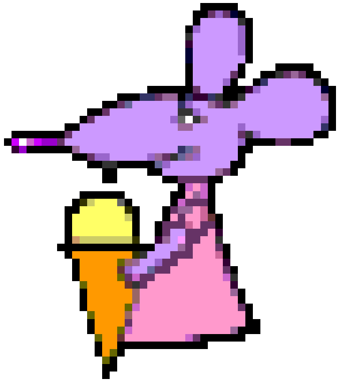
- **One way to achieve these goals is to set "socially desirable" prices, which interferes with the pricing system.**



<u>DISTORTING MARKET OUTCOMES</u> (<u>continued</u>)

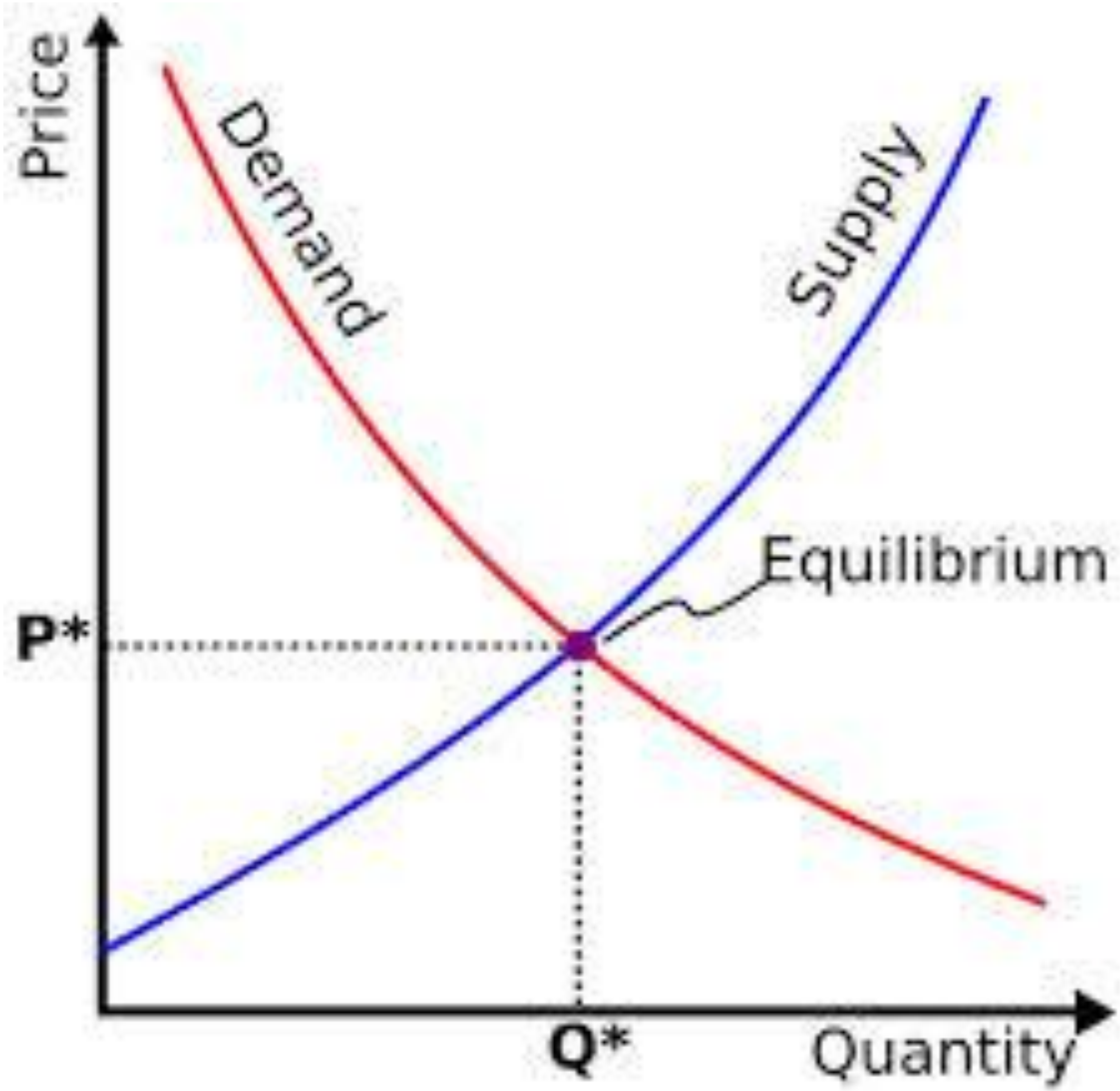
- **Setting *<u>price ceilings</u>* affects the allocation of resources.**

<u>DISTORTING MARKET OUTCOMES</u> (<u>continued</u>)



- **The <u>*minimum wage*</u> is an example of a <u>*price floor*</u>.**

EQUILIBRIUM PRICE



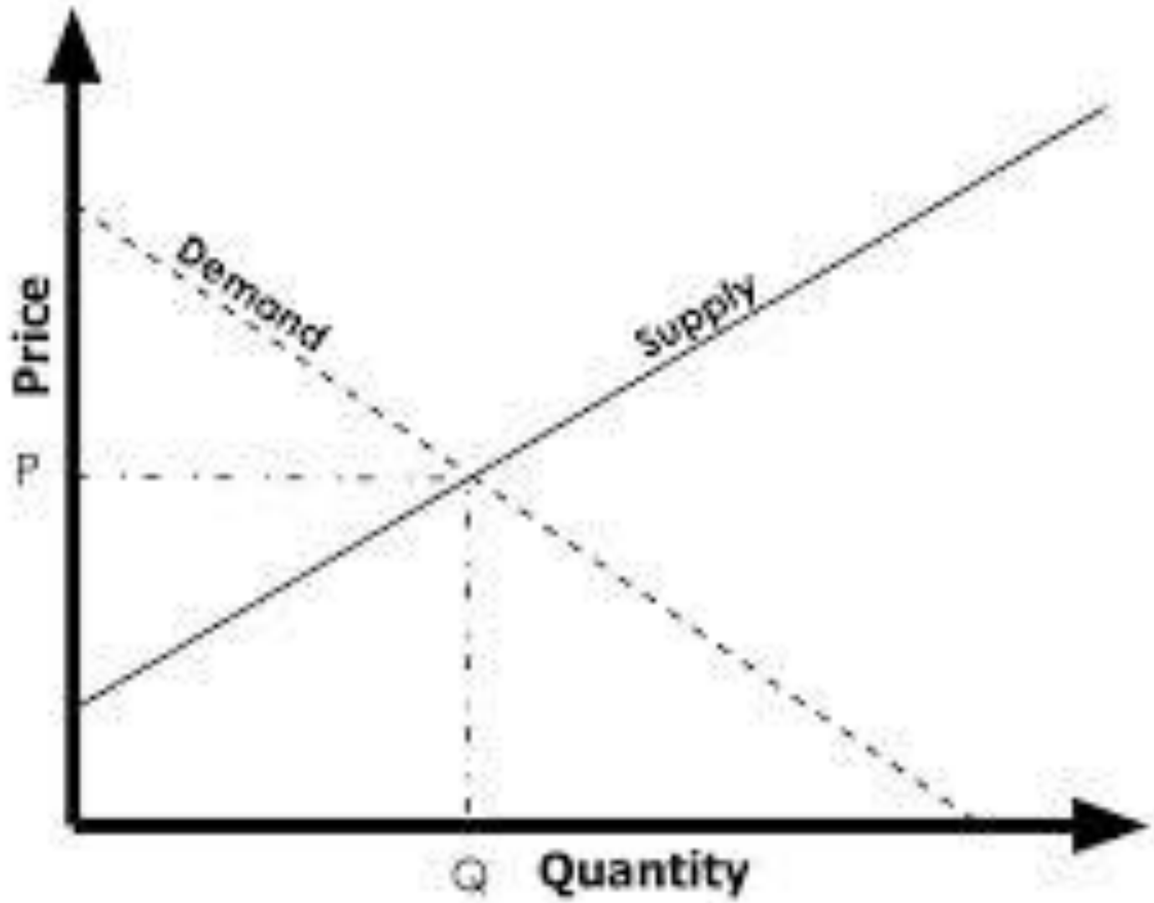
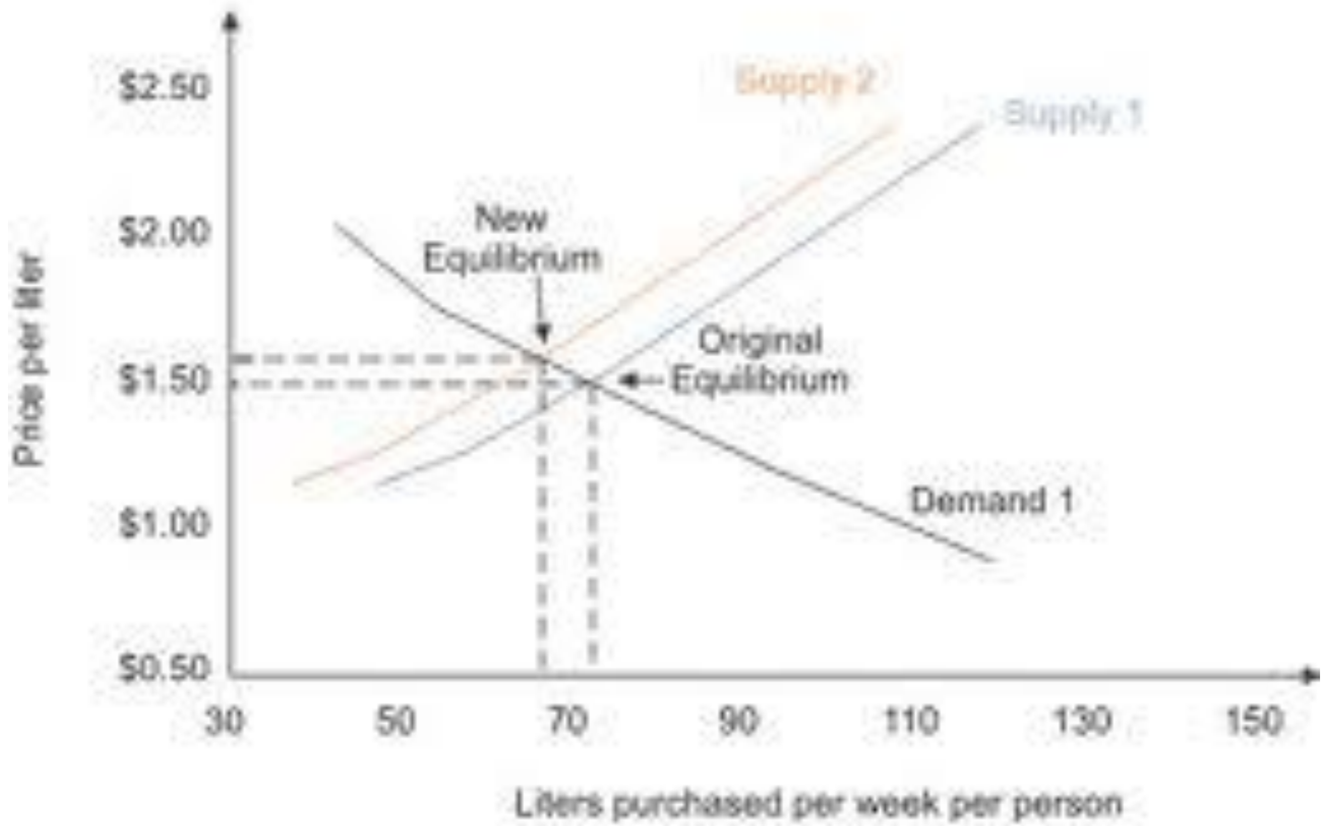
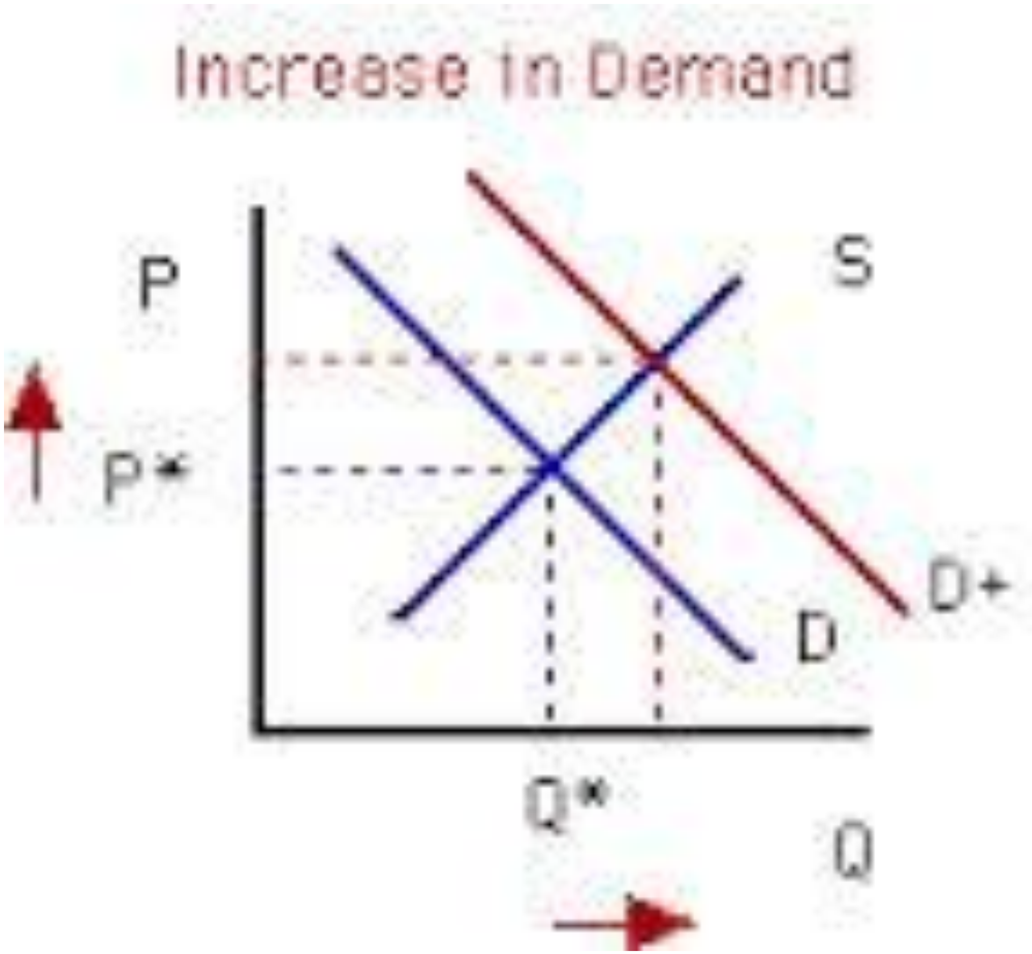
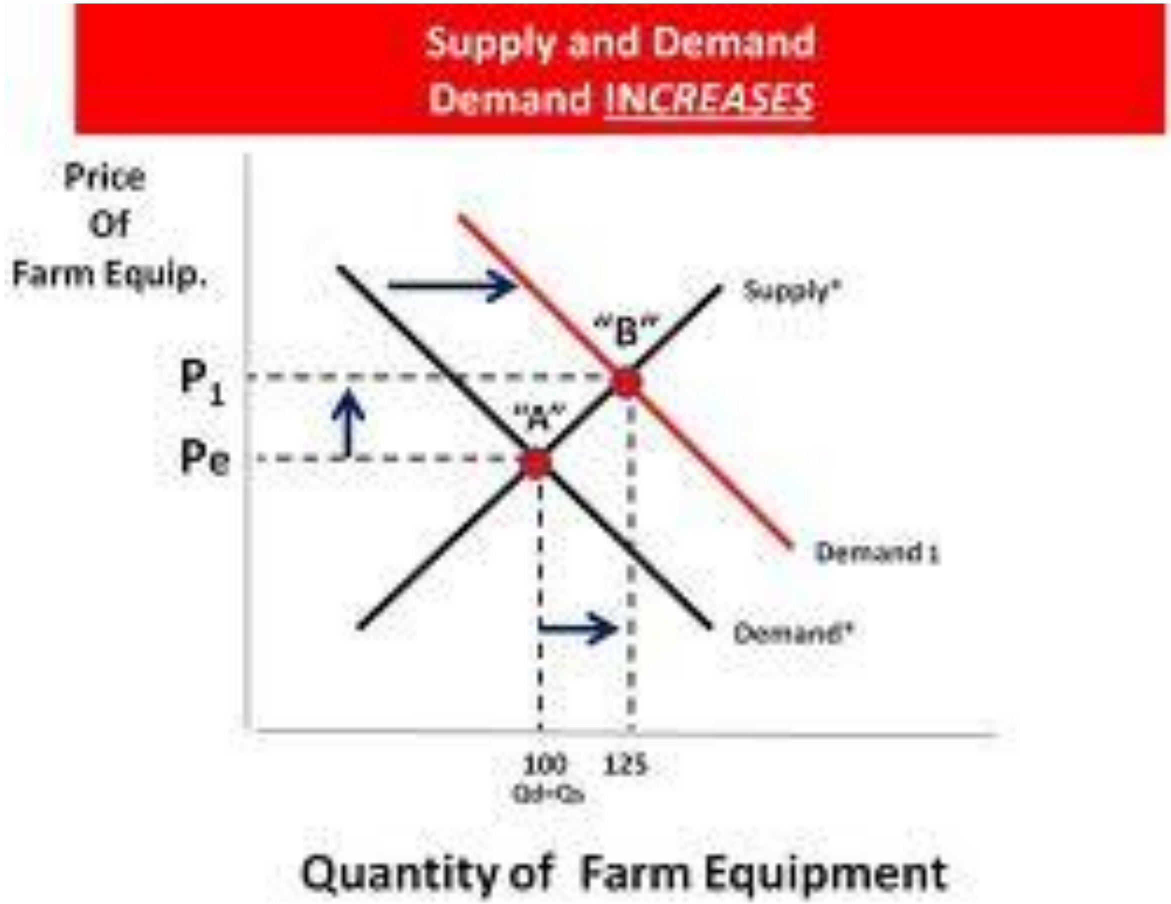

Price
P
Demand
Supply
Q
Quantity

Figure 6: Market Equilibrium




Supply and Demand
Demand
Supply
Surplus
Equilibrium
Shortage
PRICE
QUANTITY
P*
Q*
0
10
20
30
40
50
60
1
2
3
4
5
6


Increase in Demand
P
P*
S
D+
D
Q*
Q



Supply and Demand
Demand INCREASES
Price
Of
Farm Equip.
Supply*
"B"
P_1
"A"
Pe
Demand 1
Demand*
100
125
Quantity of Farm Equipment