

## The Free Market?

Goods and services that are, or have been, illegal to buy or sell

drugs

alcohol

gambling

abortions

human body parts (for transplants)

children (for adoption)

prostitution

endangered species

yellow-dyed margarine

## Goods and services that are, or have been, regulated

gasoline, natural gas (maximum price)

apartment rent (maximum price)

interest payments

(maximum interest rate - why Citibank is based in South Dakota)

food (quality controls - e.g. utility beef)

trucking (routes set, prices regulated)

airlines (routes set, prices regulated)

telephone service (prices regulated)

automobiles (various regulations - e.g. airbags)

smoking (banned in public areas in many places)

milk (in many places, can't be shipped across county lines)

legal services (bans on advertising, other controls)

eyeglasses (ban on advertising for many years)

lawn sprinkler installation (licensed in Texas)

Warm up exercises:

Addicts who fail to buy lose ★20 if they don't buy, but gain ★30 when they consume.  
What is the most they will pay for the good?

A seller faces a cost of producing a good, and a fine. How do we account for the fine? Is a fine different than a tax?

## Experiment 4

Half the buyers are "addicts," half are recreational or casual users. Addicts lose ★20 if they fail to consume, but gain ★30 if they do consume. Recreational users value the substance at ★15.

Sellers can sell up to two units. In 4.2-4.4, sellers who attempt to sell are fined ★5.

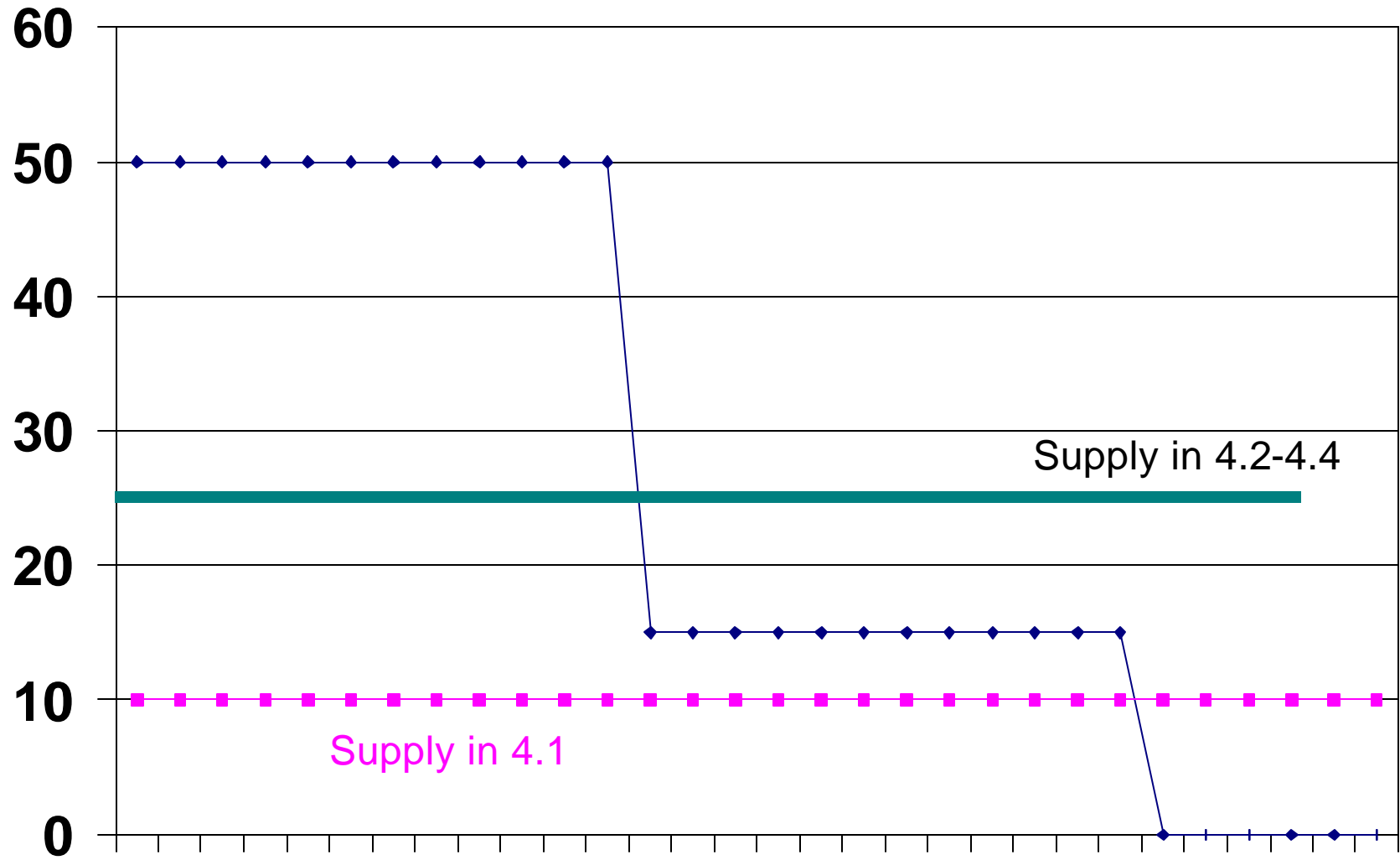
In experiment 4.1, sellers bear a fixed cost of ★20. This market works like our usual supply & demand markets with one twist: a seller can only go to the market maker once. Thus to sell two units, the seller must bring both buyers to the market manager at the same time. A seller can bring one buyer, but then pays a cost of ★20, plus a ★5 fine..

In experiments 4.2 and 4.3, police (the market manager) confiscate and destroy one unit from each transaction. Thus, if a seller brings one buyer to the market manager, the unit is confiscated, the buyer gets and pays nothing. Thus the seller makes a loss of ★25. If a seller brings two buyers to the market manager, the market manager will flip a coin, and one unit will be confiscated, but the other transaction gets through to the market. Thus the seller's cost is ★25 (cost of 2 units plus the fine).

Sellers who do not approach the market manager for a transaction lose nothing, and break even.

Experiment 4.4 is similar to experiment 4.3, except the market manager is corrupt. The market manager will attempt to sell any confiscated units to the marketplace. If time permits, we'll run a practice version of this experiment first.

What do we expect?



## Analysis

What is a seller's cost in 4.2?

★20 plus the ★5 fine, for the unit sold. Thus, a seller won't enter unless the price is at least ★25.

What is a seller's cost in 4.4?

The same.

Thus, the equilibrium in 4.4 involves half as many sellers entering, and the same price of ★25.

## **Rent Control**

Apartments are inelastically supplied in the short run, elastically supplied in the long run.

Short run effect is a transfer from landlords to tenants, with little effect on quantity.

Over decades, however, apartments are converted to condos or even abandoned (200,000 apartments were taken off the market in New York due to rent control).

Rent control also creates illegal activities (key money - bribes to circumvent the controls) and search activity (standing in line).

## **Rock Concert Tickets**

Often concert tickets and superbowl tickets are underpriced - at a much higher price they could sell all the tickets.

Creates lines - people standing in line overnight.

No one knows for sure why rock concert tickets are underpriced - the prevailing theory concerns CD sales - those willing to pay the most won't buy many CDs, so the band wants to attract low value buyers (to get higher CD sales).



## **Restaurants**

Fashionable restaurants may have lines on Friday and Saturday nights. Why don't they raise the price?

Consumer resistance to variable prices, and signalling (crowds indicate a good bargain - bringing more demand).

## Questions

Is it better to perfectly enforce a speed limit, or no parking rule, or imperfectly enforce it?

Why not tax illegal drugs, rather than ban them?

Are there legal commodities that should be prohibited?

Is it better to punish sellers or buyers? Why?

Consider the market for controlled substances (experiment 4).

- (i) Some sellers chose not to sell. Why did they do this? What was the predicted price? (Recall that half the units were confiscated, each unit cost \*10, and there was a \*5 fine for confiscation.)

*The predicted price was \*25 - the sum of the costs for two units and the fine incurred. Sellers chose not to sell because there was insufficient demand to permit all sellers to sell at this price. An additional seller would not have earned enough to make selling profitable.*

- (ii) The prices and quantity traded were roughly the same, whether the police resold confiscated units or not. Using a supply and demand diagram, illustrate why this might occur.

