Market Incentives, Substitutes, and Complements

By Cindy Grigg

Supply is how much of any product that sellers offer for sale. Products are not only objects like clothing, books, or computers. Products people buy can also be experiences. When you buy a ticket to ride a roller coaster, you expect to get a few minutes of thrills. When you go to a movie, take a vacation, or rent shoes and a lane at the bowling alley, you're buying an experience. Another kind of product is service. You can buy raw food in the grocery store, or you can buy a prepared meal at a restaurant. The restaurant has supplied a service - they have cooked the food for you. Babysitting is a service. Other services include paying someone to mow your lawn, wash your windows, or clean your house.

Demand is the buyer's willingness and ability to pay for a product or service. The MCP, or market clearing price, is the highest price that a seller can charge and still sell all of his or her products. It clears the seller of his or her supply. Under the MCP, the supply perfectly satisfied the demand. Markets are simply where suppliers offer their goods and services for sale to demanders.

Markets never hold still. Prices rise and fall, demand climbs and drops, and supply grows and shrinks. Generally speaking, a rise in demand causes the price and the supply to rise. The rise in supply causes the price to fall. The fall in price causes demand to rise. When supply and demand change, market prices adjust. These affect the incentives of both buyers and sellers. Markets and people respond predictably to incentives.

What are incentives? Incentives are something that motivates people to act. An incentive is usually some type of reward; with buyers and sellers, an incentive is usually money. An incentive for buyers is the reward of saving money. An incentive for sellers is an increase in profit or sales.

Prices send signals to buyers. Low prices are an incentive to buyers to spend their money now. Higher prices are an incentive to sellers to increase production to make more goods. But the biggest incentive for sellers is knowing that when prices rise, their profits will probably rise, too.

Sometimes when the supply is low, smart sellers offer substitutes. A substitute product can pull demand away from the original product. Producers know this fact well. They also know that when demand for a supplier's product rises, competing suppliers make substitutes for that product. For example, when personal computers first became popular and the demand for them rose, the makers of other office machines noticed. They created similar machines to compete in the market.

Why do consumers buy substitute products? Sometimes there isn't enough supply of the original products. Usually though, there is enough supply of the originals, but the substitutes are sold at a lower price. The lower price will raise the demand for the substitutes. It is common to see "knockoff" products of popular items flooding the market after a new product becomes popular. But beware - often a lower price also means lower quality. There are substitutes for almost every product if the consumer is willing to accept them. If you see plenty of substitutes for a product, expect the demand for the original product to fall.

Suppose there's a new candy bar on the market that has been heavily advertised. Suddenly, everyone wants this new candy bar. Supply is low; demand is high. Suppliers will try to create demand for the candy bars they already have in stock. They may lower the prices on the other candy bars and raise prices on the new candy bars, if they still have any in stock. They may advertise the other candy bars to drive up the demand for them. Many different factors can influence demand. Some of these are taste, preference, price, and availability of substitutes. If the old candy bars taste better than the new one, you can bet demand will fall quickly for the new candy.

Complements are products that fit together so well that when the demand for one of the products rises, the demand for the other product usually rises, too. They're called complements because when they're put together, they form a complete package. Some examples of complements are hot dogs and buns. When the demand for hot dogs rises, the demand for buns rises, too. Often stores will stock complements together. For example, you might see hot fudge sauce stocked right beside the ice cream. You might not have thought of buying the hot fudge sauce and only wanted ice cream. Suppliers try to tempt you to buy complements to increase their sales by increasing demand.
Sellers' incentive to make more profits causes them to try to manipulate demand. Demand drives prices, and prices determine whether sellers will make a profit. Some things that sellers offer to manipulate demand are offering substitutes and complementary products.

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Questions

1. What is the market clearing price?
   A. the highest price that a seller can charge and still sell all of his supply of goods
   B. the price at which the supply perfectly satisfies the demand
   C. the price that clears the seller of his entire supply
   D. all of the above

2. Markets are static; that is to say that there is little change in prices, supply, and demand.
   A. true
   B. false

3. What is a buyer's incentive?
   A. to be the biggest spender
   B. to spend more money
   C. to get a cheaper-quality product
   D. to save more money

4. What is a seller's incentive?
   A. to make more profits
   B. to charge the lowest price
   C. to have fewer customers
   D. to save money on the raw materials needed to make products

5. What happens to the demand when substitutes are offered for a product?
   A. Demand has nothing to do with substitutes.
   B. Demand stays the same.
   C. Demand usually falls.
   D. Demand usually increases.

6. What are complements?
   A. two products that go together to make a complete package
   B. when supply and demand are perfectly balanced
   C. substitutes for other products
   D. when someone tells you that you look nice today

7. Why do sellers offer complements and substitutes?
   A. to try to drive up demand
   B. to try to drive up prices
   C. to try to make more profits
   D. all of the above
8. What is the main thing that drives supply and demand?

Suppose there's a cool new video game system coming out on the market. Would you accept a substitute for it, or would you pay full price right away? Please explain.

Without the incentive of making a profit, do you think many people would start a business for themselves? Please explain.
Make a flow chart showing how a change in price, supply, or demand affects the others.