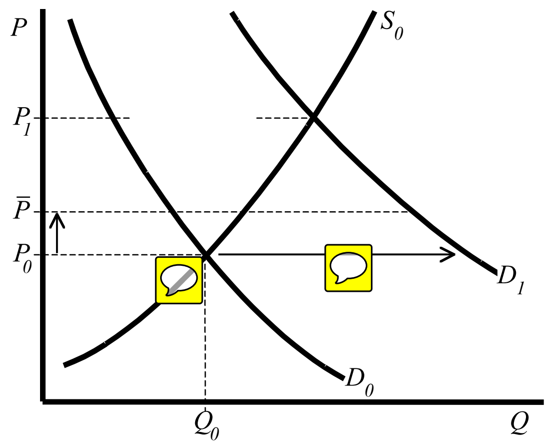
PRICE CONTROLS

Price controls – the government sets the price at some price other than the equilibrium price. It is illegal to buy and sell at a price closer to the equilibrium than the set price.

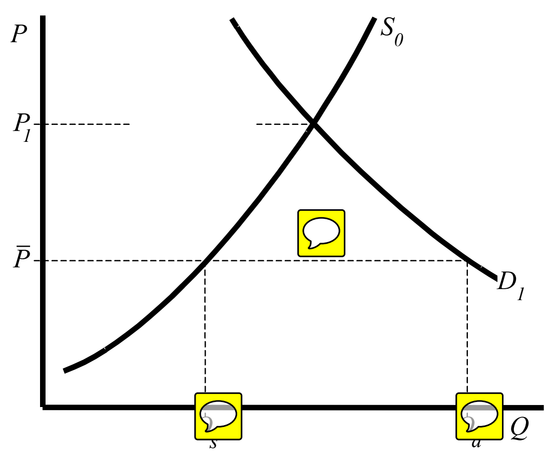
<u>Two types of price controls</u>

1) Price ceiling – the price is set below the equilibrium price. It is illegal to buy and sell at a price above the set price.
2) Price floor – the price is set above the equilibrium price. It is illegal to buy and sell at a price below the set price.

<u>HOW A PRICE CEILING USUALLY COMES ABOUT</u>



<u>THE EFFECTS OF A PRICE CEILING</u>

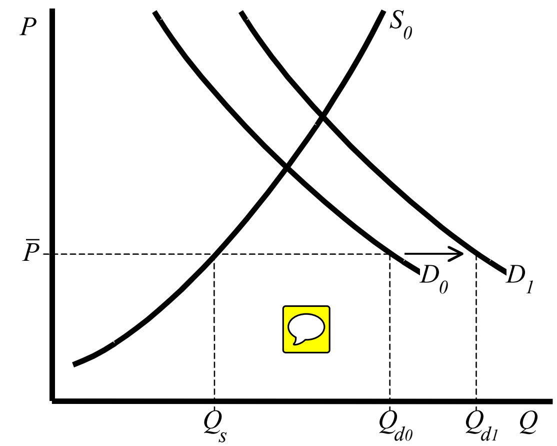


Due to <u>voluntary exchange</u>, sellers do not have to sell more than the quantity supplied. Therefore, we say that the quantity bought and sold in the market is <u>supply determined</u>.

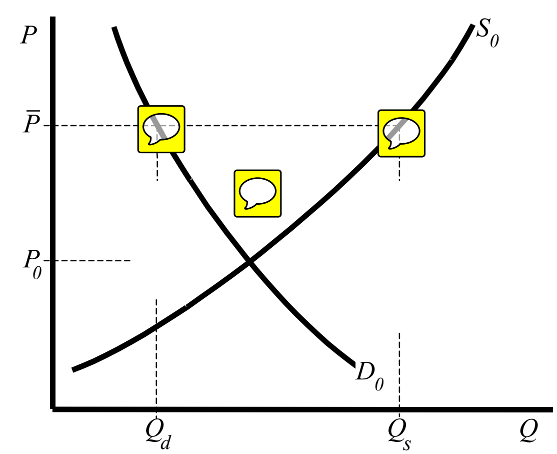
The Problems with Price Controls

1) They lead to a group of people who are willing and able to do something but cannot. example – in price ceiling case, excess demand
2) The market no longer responds to changes in the wishes of the buyers or sellers (not flexible). example – in price ceiling case, increase demand. People need more of good but market does not provide
3) People must collect extra information and/or put in extra effort in order to participate in the market – which they would not if the market was allowed to adjust.
4) They do not meet the goal for which they were designed. example – people would say that purpose of price ceiling is to get people the good at lower price – but in fact it does not do this for all people.
5) The longer they are in effect the more difficult, complex and costly they are to keep effective.

Diagram for point 2 above.



<u>THE EFFECTS OF A PRICE FLOOR</u>



Due to <u>voluntary exchange</u>, buyers do not have to buy more than the quantity demanded. Therefore, we say that the quantity bought and sold in the market is <u>demand determined</u>.