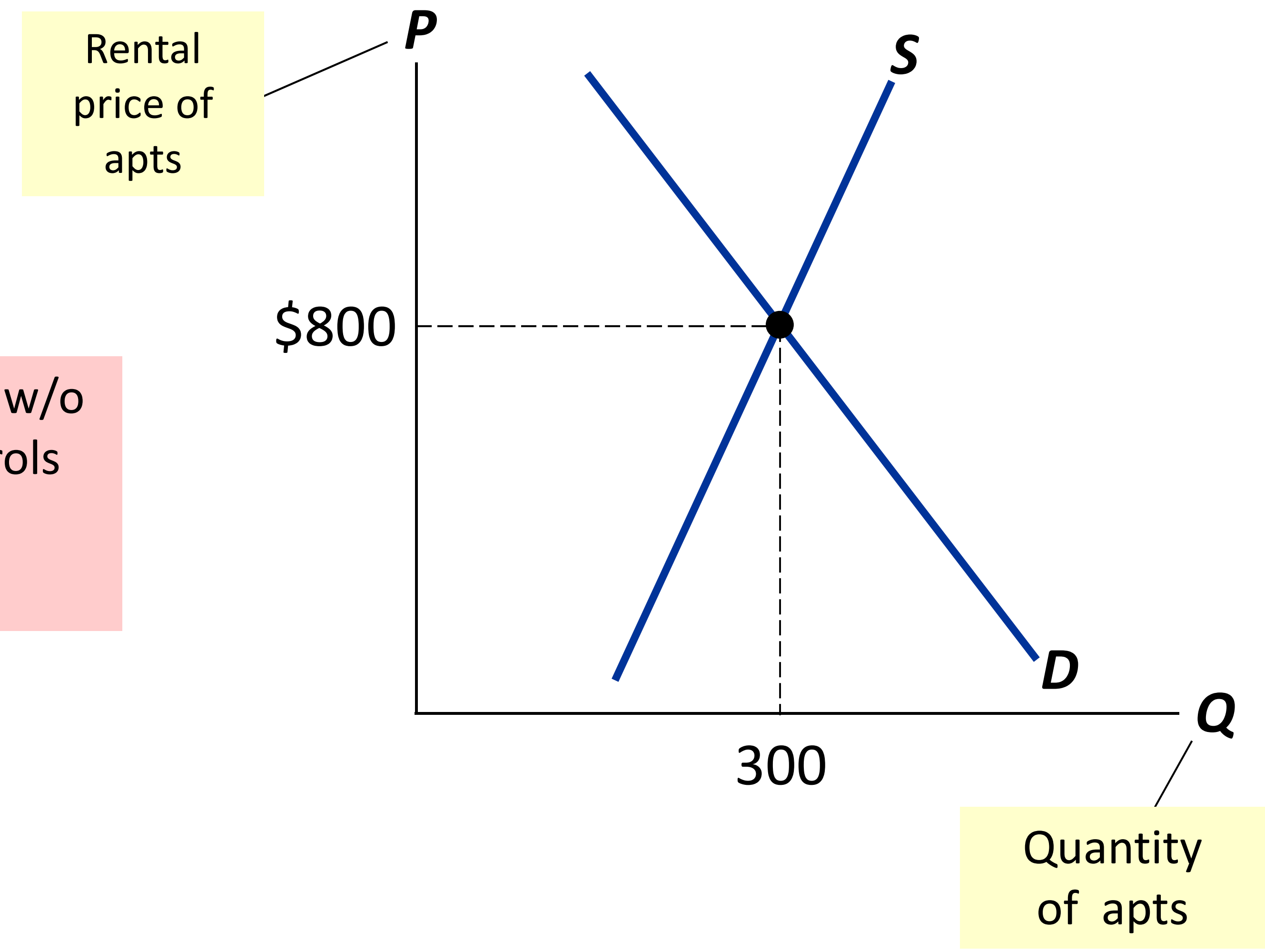
Price ceiling

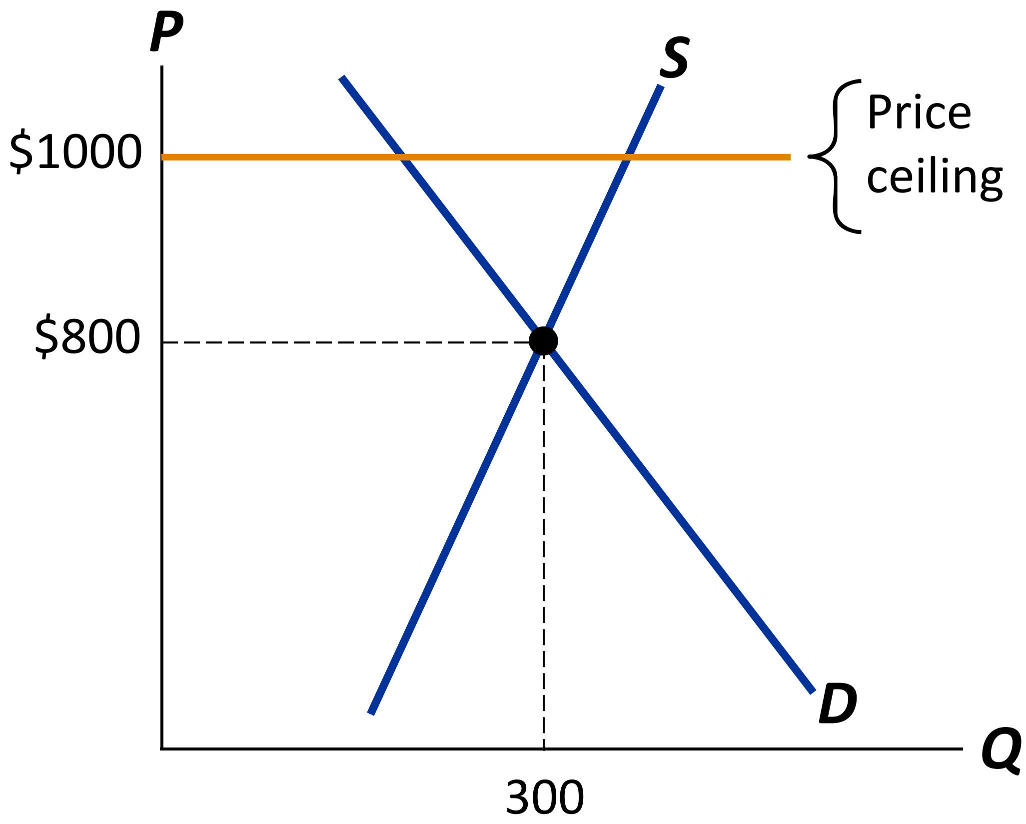
EXAMPLE 1: The Market for Apartments



Equilibrium w/o price controls

How Price Ceilings Affect Market Outcomes

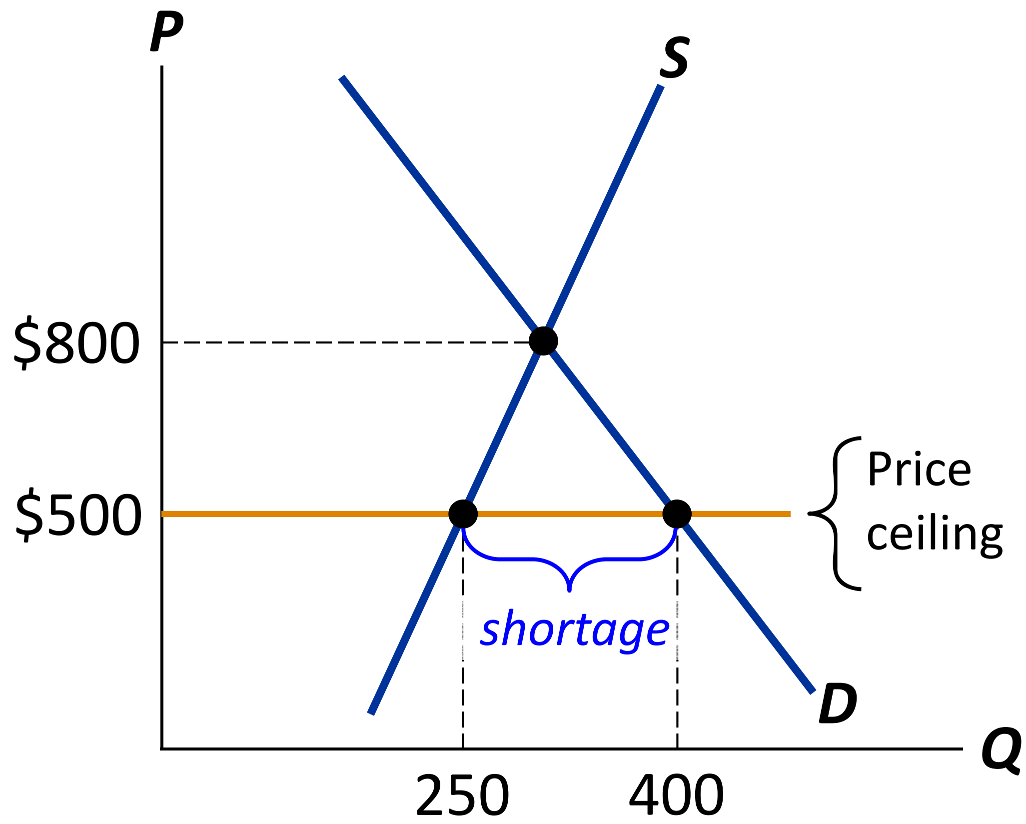
A price ceiling above the equilibrium price is **not binding**— has no effect on the market outcome.



How Price Ceilings Affect Market Outcomes

The equilibrium price ($800) is above the ceiling and therefore illegal.

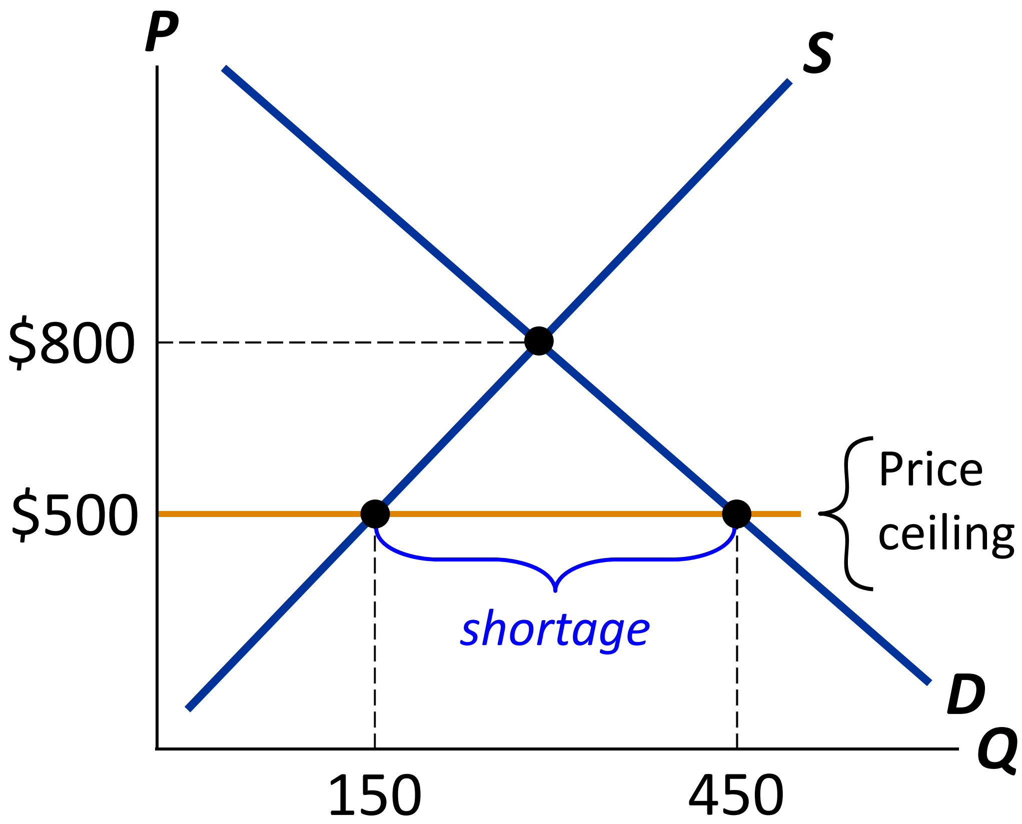
The ceiling is a **binding constraint** on the price, causes a shortage.



How Price Ceilings Affect Market Outcomes

In the long run, supply and demand are more price-elastic.

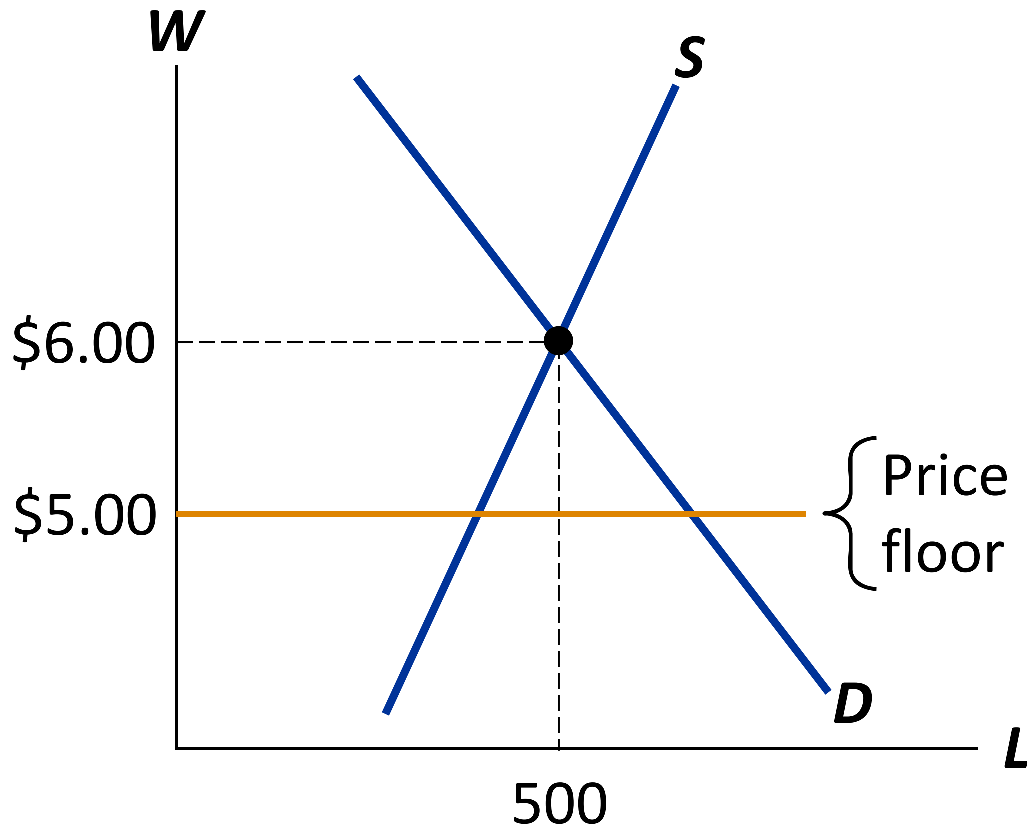
So, the shortage is larger.



Price Floor

How Price Floors Affect Market Outcomes

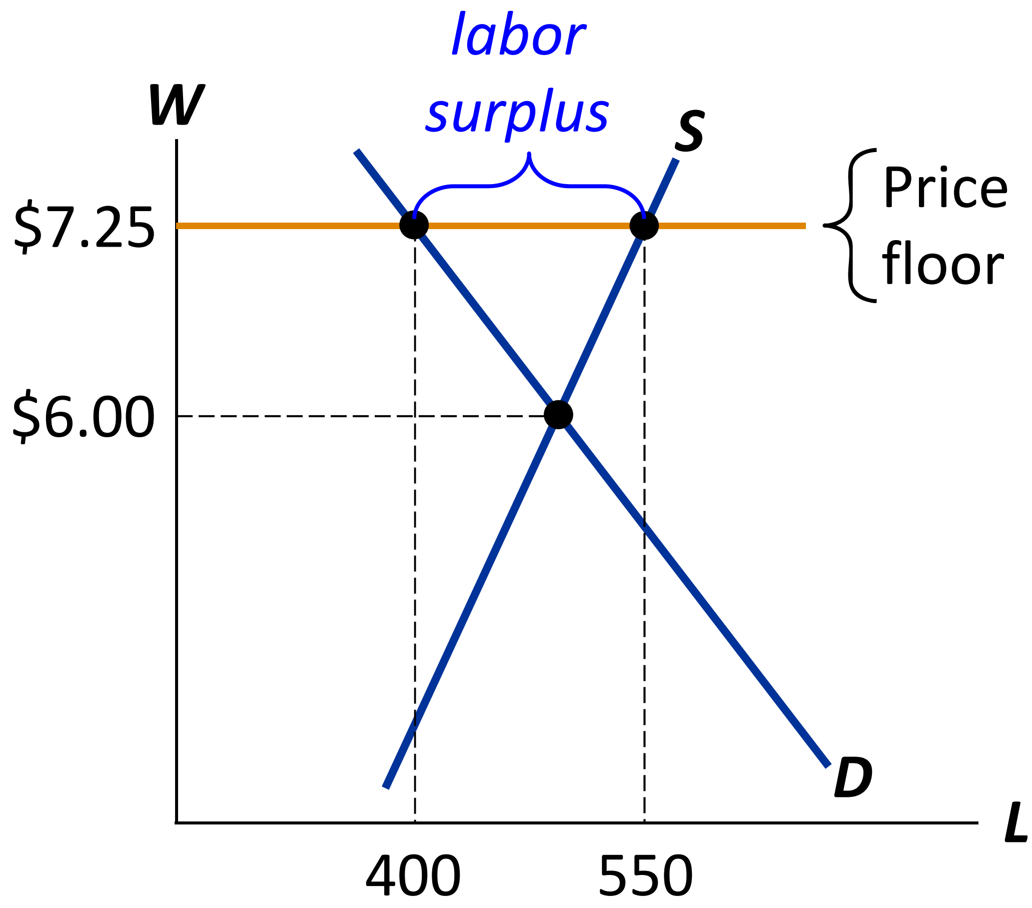
A price floor below the equilibrium price is **not binding** – has no effect on the market outcome.



How Price Floors Affect Market Outcomes

The equilibium wage ($6) is below the floor and therefore illegal.

The floor is a **binding constraint** on the wage, causes a surplus (i.e., unemployment).

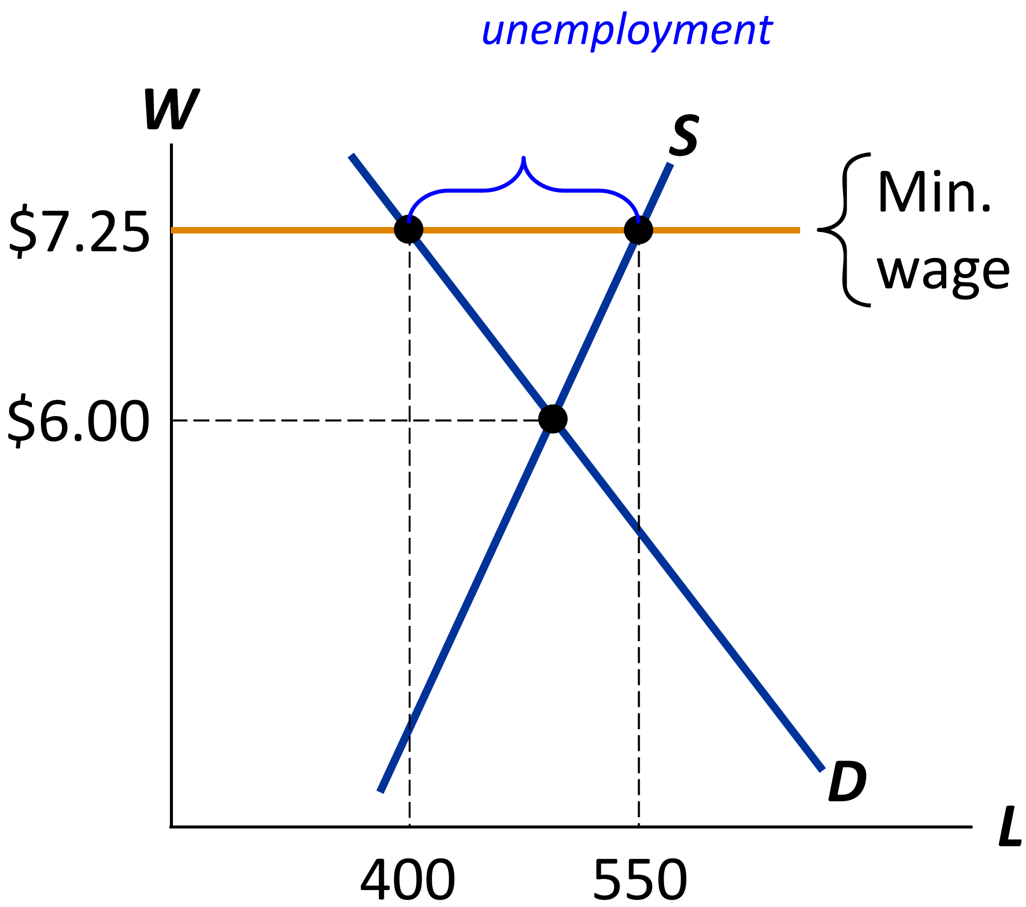


The Minimum Wage

Min wage laws
do not affect
highly skilled workers.

They do affect teen workers.

Studies:
A 10% increase in the min wage raises teen unemployment by 1–3%.



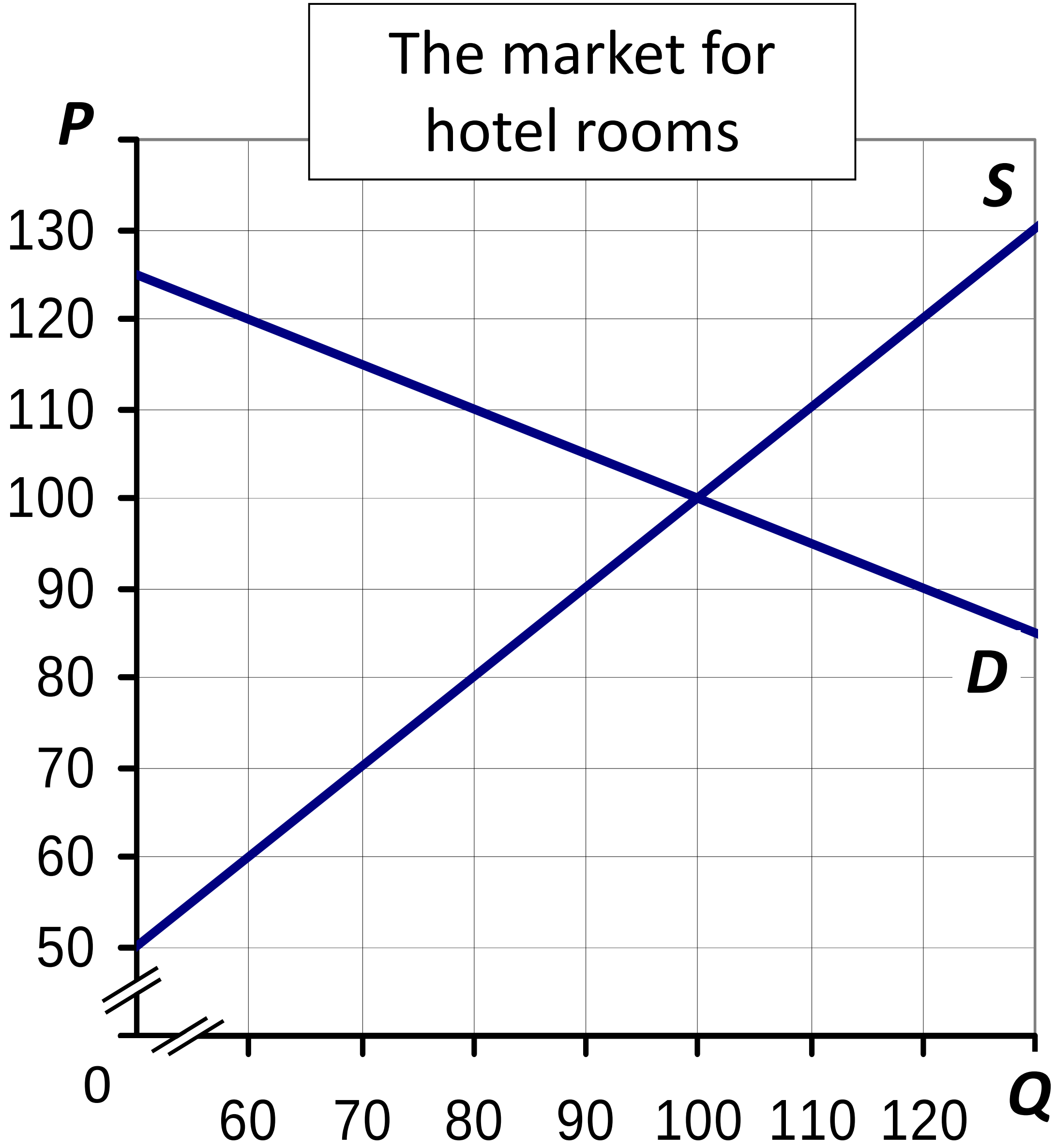
Practice I
Price controls

Determine effects of:

A. $90 price ceiling

B. $90 price floor

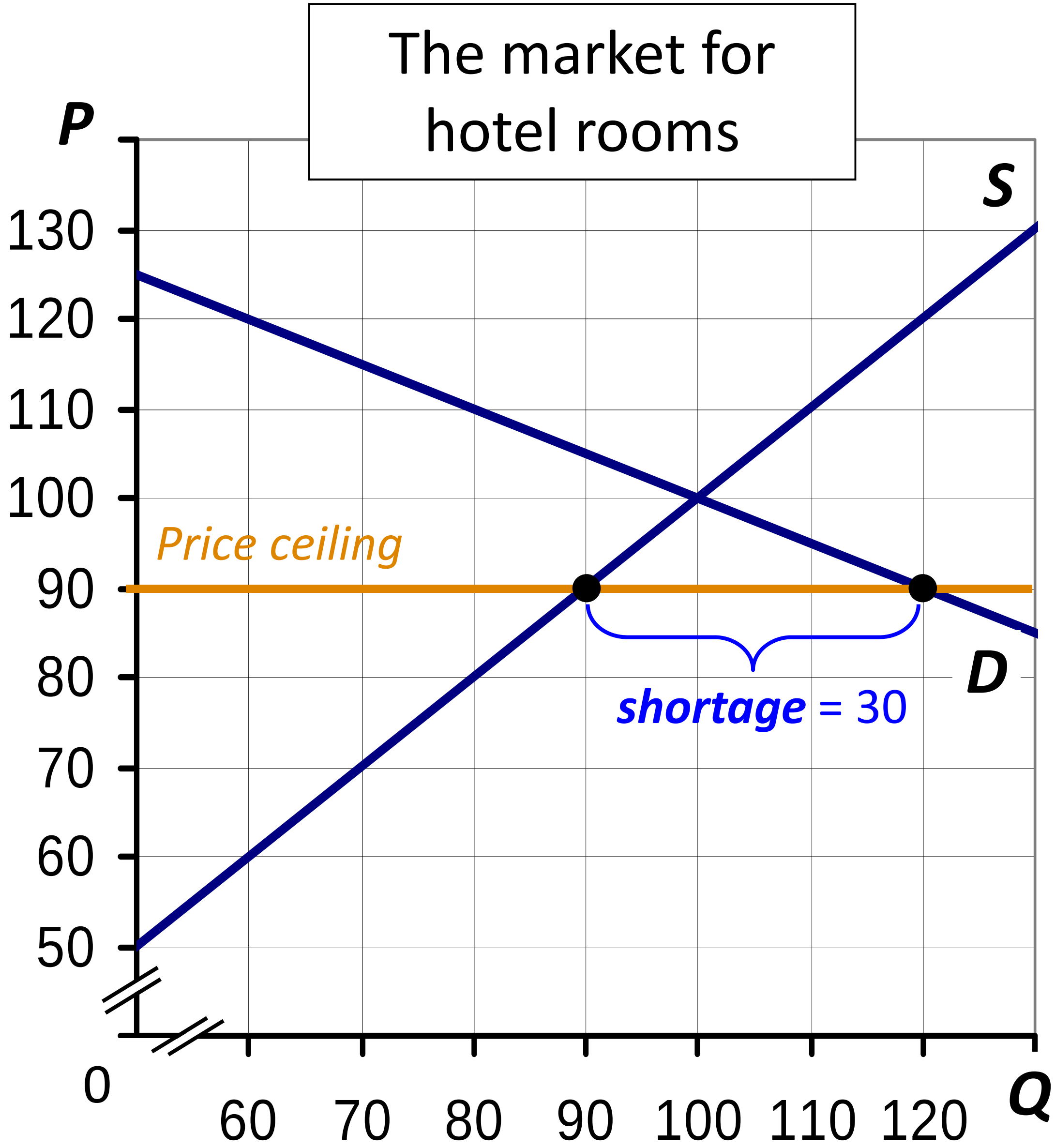
C. $120 price floor



A. $90 price ceiling

The price falls to $90.

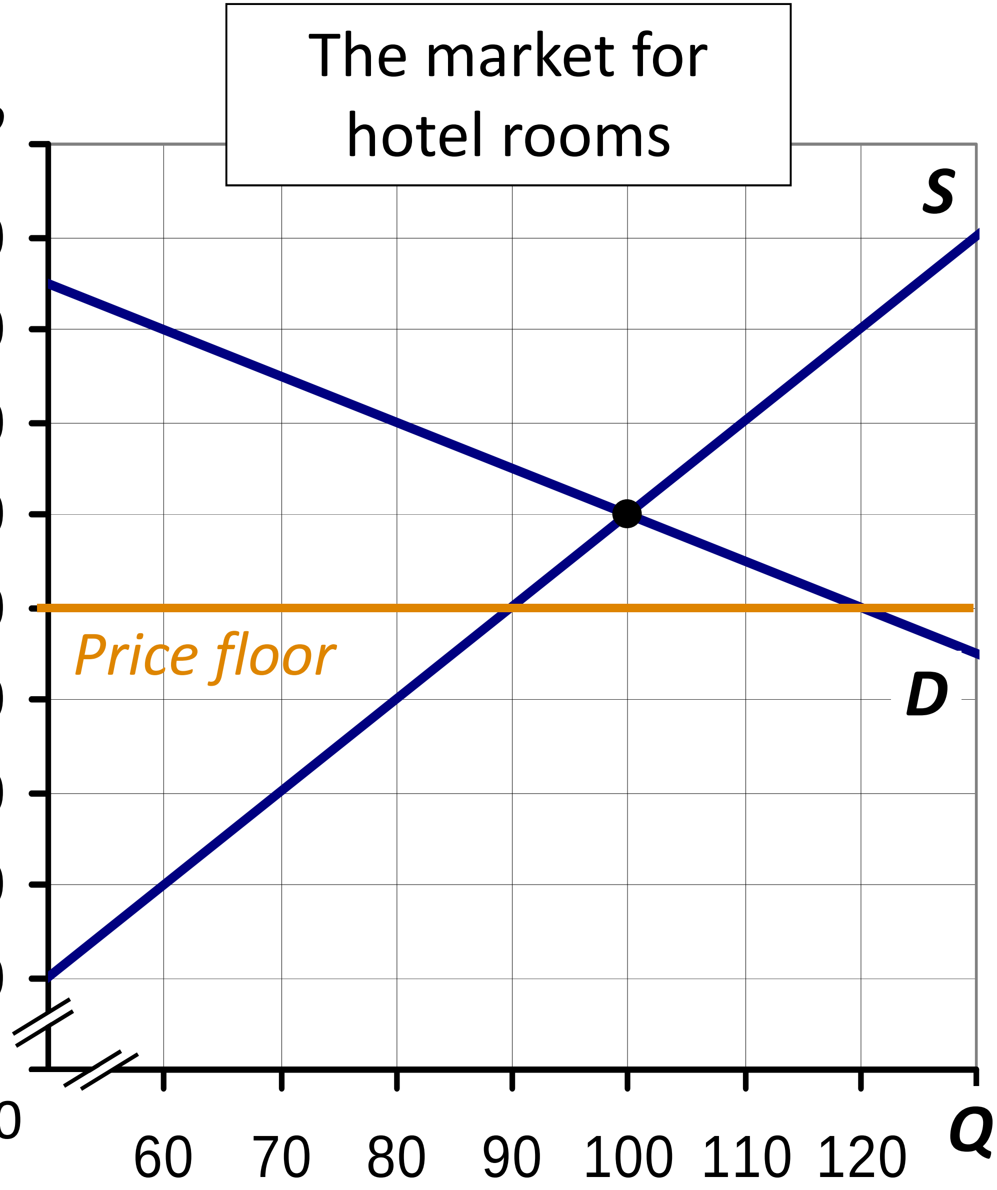
Buyers demand 120 rooms, sellers supply 90, leaving a shortage.



B. $90 price floor

Eq'm price is above the floor, so floor is not binding.

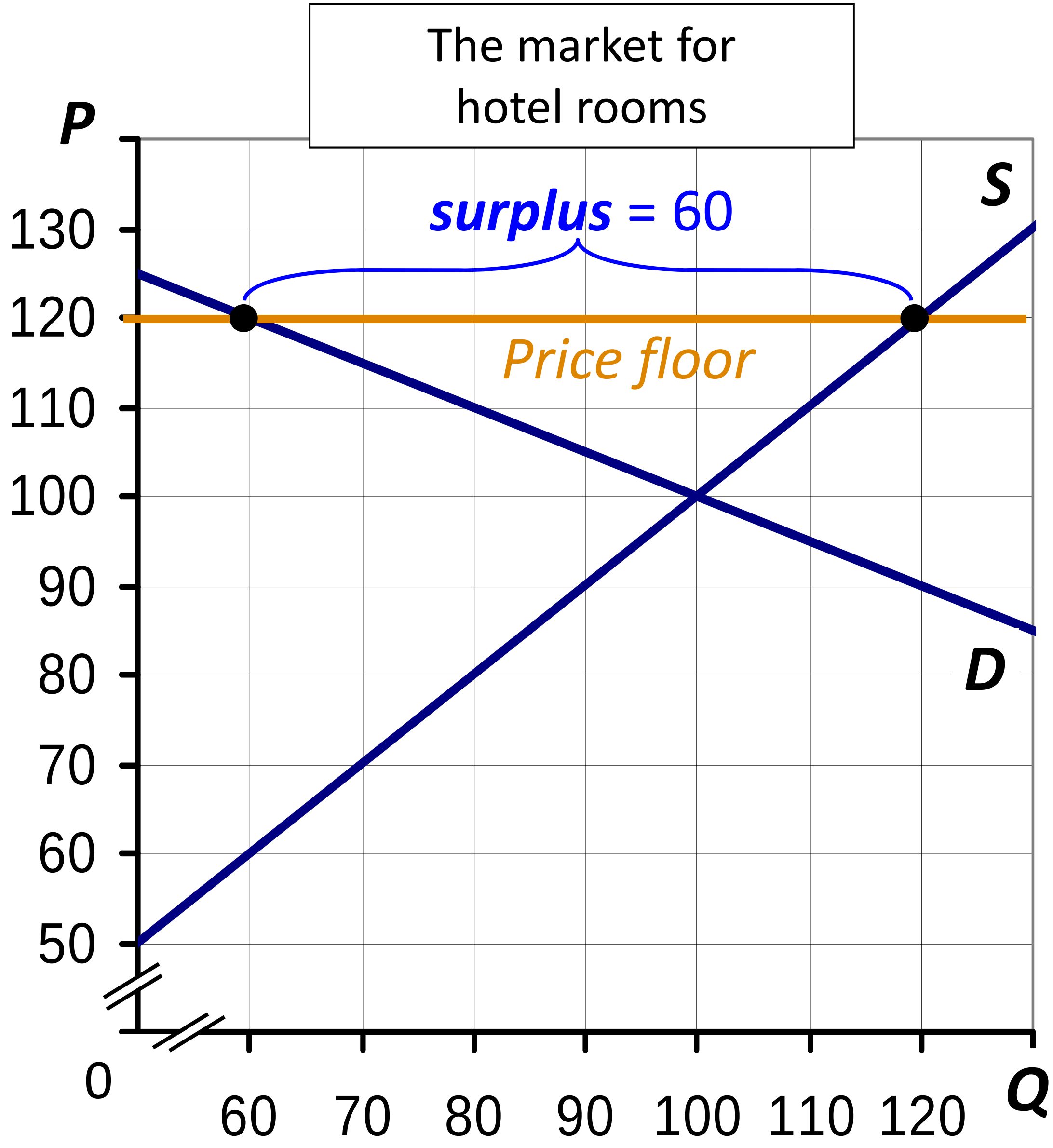
P = $100,
Q = 100 rooms.



C. $120 price floor

The price rises to $120.

Buyers demand 60 rooms, sellers supply 120, causing a surplus.



Practice II

In the late eighteenth century, the price of bread in New York City was controlled, set at predetermined price above the market price

a) Draw a diagram showing the effect of the policy. Did the policy act as a price ceiling or price floor?

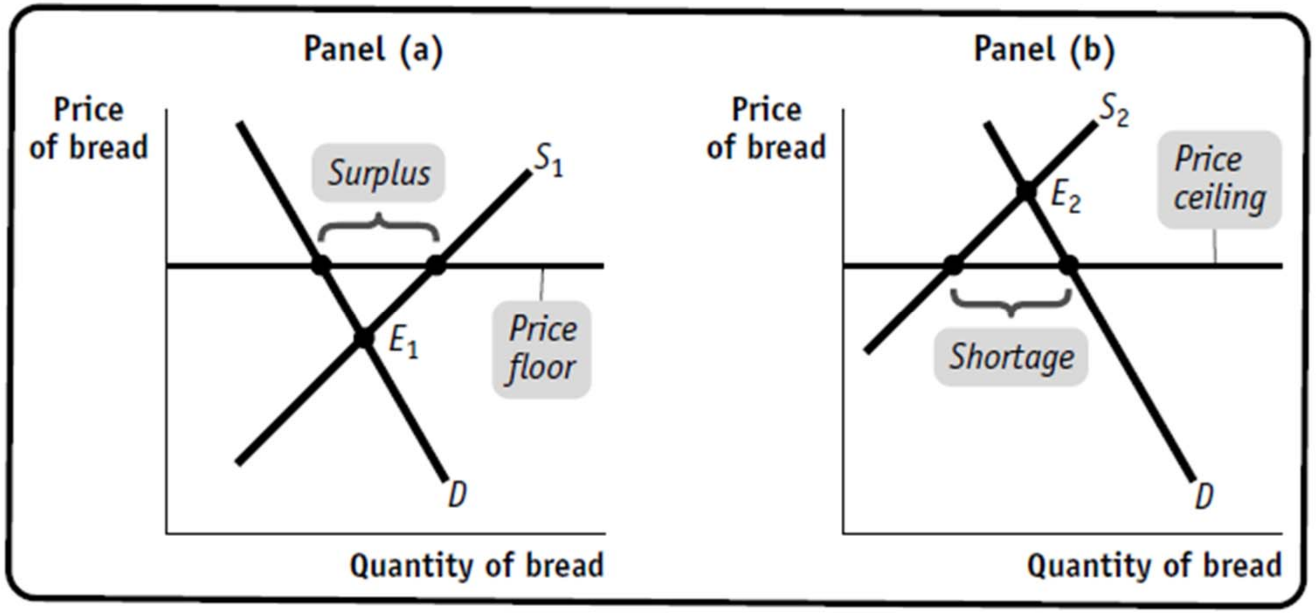
b) What kinds of inefficiencies were likely to have arisen when the controlled price of bread was above the market price? Explain in detail.

One year during this period, a poor wheat harvest caused a leftward shift in the supply of bread and therefore an increase in its market price. New York bakers found that the controlled price of bread in New York was below the market price

c) Draw a diagram showing the effect of the price control on the market for bread during this one-year period. Did the policy act as a price ceiling or a price floor?

d) What kinds of inefficiencies do you think occurred during this period? Explain in detail.

Practice II answers



a) Panel (a) illustrates the effect of this policy. Since the price is set above the market equilibrium price, this policy acts as a price floor: it raises the price artificially above the equilibrium. As a result, too much bread is produced: there is a surplus

b) As with all price floors above the equilibrium price, there are several associated inefficiencies.

- There is deadweight loss from inefficiently low quantity
- There is inefficient allocation of sales among bakers
- Wasted resources from surplus production of bread that must be given or thrown away
- There is inefficient high quality as bakers produce bread of high quality than consumers want. Consumers would instead prefer a lower price

c) Panel (b) illustrates the effect of the fixed price if the market equilibrium is above that price. The set price now acts like a price ceiling, preventing the price from rising to the equilibrium. There is a shortage, as occurs with every price ceiling below the equilibrium price

d) As with all price ceiling below the equilibrium price, there are several associated inefficiencies

- Deadweight loss from inefficiently low quantity
- There is Inefficient allocation to consumers ,as some who want bread very much are not able to find any, while those who value bread less are able to purchase some
- Wasted resources as consumers expend resources to find bread
- Inefficiently low quality of bread that is offered for sale