Price floor and price ceiling

Business

In a free market system, the prices of commodities are determined by the market forces of demand and supply. The level of demand for products will influence the price at which suppliers will offer goods in order to clear the market (Boyes & Melvin, 2011). However, there are circumstances in which the government influences commodity prices by setting their minimum or maximum limits. On the one hand, a price ceiling is defined as the maximum price set by the government that suppliers can sell their commodities for. Suppliers can place their products at a lower price so long as it does not exceed the set ceiling price (Boyes & Melvin, 2011).

On the other hand, a price floor is the minimum price at which products can be sold in the stock market. When a price floor is set, suppliers would be penalized for selling their commodities below the price floor. A price ceiling may be set by the government when the suppliers charge exorbitantly for basic commodities such as food products. This is often characterized by increased demand for the commodities that allow suppliers to raise their prices. If the ceiling is set above the market price, there will be no significant effect since sellers will continue selling at the market price and even increase their prices further. When a price ceiling is set, there will be an artificial shortage of commodities in the market (Boyes & Melvin, 2011).

If the price is set at a lower price than the stock exchange equilibrium price, it will stimulate more demand for products than there would have been at the equilibrium price. There will also be decrease in supply as opposed to the equilibrium quantity supplied. Overall, this mechanism will lead to inefficiency in the market. At the ceiling quantity supplied, the marginal benefits exceed the marginal cost. The total magnitude of the inefficiency thus equals the deadweight welfare loss.