Maximum Prices

The government or an appointed industry regulator can set a **maximum price** in an attempt to prevent the market price from rising above a certain level. To be effective **a maximum price has to be set below the free market price**.

One example might be when shortage of foodstuffs threatens large rises in the free market price. Other examples include rent controls on properties – for example the system of rent controls still in place in Manhattan in the United States. Price capping also happens when the competition authorities judge that consumers are being exploited by businesses using their monopoly power.

A maximum price seeks to control the price – but also involves a normative judgement on behalf of the government about what that price **should** be. An example of a maximum price is shown in the next diagram. The normal equilibrium price is shown at Pe – but the government imposes a maximum price of Pmax. This price ceiling creates **excess demand** equal to quantity Q2-Q2 because the price has been held below the equilibrium.



It is worth noting that a price ceiling set above the free market equilibrium price would have no effect whatsoever on the market – because for a price floor to be effective, it must be set below the normal market-clearing price.

Maximum prices and consumer and producer welfare

How does the introduction of a price ceiling affect consumer and producer surplus. This is shown in the next diagram. At the original equilibrium price consumer surplus = triangle ABPe and producer surplus equals the triangle PeBC.

Because of the maximum price ceiling, the quantity supplied contracts to output Q2. Consumers gain from the price being set artificially lower than the equilibrium, but there is a loss of consumer welfare because of the reduction in the quantity traded. At P max the new level of consumer surplus = the trapezium ADEPmax. Producer surplus is reduced to a lower level Pmax EC. There has been a net reduction in economic welfare shown by the triangle DBE.





Black Markets

Ticket touting is nothing new, but the rise of online ticket-exchanges has expanded the market by making it much easier for sellers and buyers to find each other. Last year Britons purchased £100m worth of resold tickets; this year the market will top £250m.

Source: EconoMax, January 2008

A **black market** (or shadow market) is an illegal market in which the market price is higher than a legally imposed price ceiling. Black markets develop where there is excess demand for a commodity. Some consumers are prepared to pay higher prices in black markets in order to get the goods or services they want.

When there is a shortage, higher prices act as a rationing device.

- Good examples of black markets include tickets for major sporting events, rock concerts and black markets for children's toys and designer products that are in scarce supply.
- There is also evidence of black markets in the illegal distribution and sale of computer software products where pirated copies can often dwarf sales of legally produced software.

Rationing when there is a market shortage

Rationing when there is a maximum price might also be achieved by allocating the good on a 'first come, first served' basis – e.g. queues of consumers. Suppliers might also allocate the scarce goods by distributing only to preferred customers. Both of these ways of rationing goods might be considered as inequitable (unfair) – because it is likely that eventually those who might have the greatest need for a commodity are unlikely to have their needs met.

Another problem arising from the maintenance of a maximum price is that in the long run, suppliers might respond to a maximum price by reducing their supply – the supply curve becomes more



elastic in the long term. This is illustrated in the next diagram which looks at the effect of a maximum price for rented properties.



If landlords decide that they cannot make a satisfactory rate of return by selling rented properties in the market because of the maximum price, they might decide to withdraw some properties from the market. At the maximum rent, the long run supply curve shows a smaller quantity of rented properties available for tenants – which with a given level of market demand cause the excess demand (shortage) in the market to increase.

The **quality of rented properties** might deteriorate over time because landlords decide to cut spending on maintenance and improvements. The end result would be a loss of allocative efficiency because there are fewer properties on the market and the quality is getting worse – fewer people's needs and wants are being met at the prevailing market price.

Although maximum prices such as rent controls are still in place in many countries, in the UK, rent controls were essentially abolished in the late 1980s. And, over the last fifteen years the government has actively sought to encourage an expansion in the total supply of rented properties provided by both private sector landlords and also registered social landlords such as housing associations. The rapid growth in the buy-to-let property market has also contributed to a huge increase in the supply of properties available for letting in the majority of towns and cities in the UK.

