Microeconomics Activity: How Price Ceilings Affect Incentives?

The following microeconomics activity is taken from the Instructor's Manual to Accompany "Teaching Tools for Microeconomics from John Stossel -- College edition" by James Gwartney, John Morton, Mark Schug, and Joseph Calhoun. The accompanying Stossel DVDs may be purchased at: AbcNewstore.com

Common Sense Economics
Part I: Key 9

Key Economic Words and Concepts: Incentives, Price Signals, Price Ceilings and Shortages

Prices send signals and provide incentives for buyers and sellers. When supply and demand change, market price changes which, in turn, changes incentives for buyers and sellers. Higher prices encourage production and discourage consumption. Lower prices stimulate consumption and discourage production. In an unregulated market, supply and demand result in a market price that incorporates a vast amount of information from buyers and sellers.

But what happens if government interferes with market prices as several people in the video advocate? Politicians are often tempted to reduce prices by creating price ceilings in order to please the voters.

Graphs can often help students understand price ceilings. Draw a supply and demand diagram for prescription drugs. Show the equilibrium price. Then insert a price ceiling below that equilibrium. Discuss the role of incentives with students. The lower price is an incentive for consumers to use more prescription drugs and an incentive for sellers to provide less. The result is a shortage of prescription drugs.

Now have the students answer the following questions.

1. Why will drug companies produce more pharmaceuticals at higher prices?

2. Why will consumers buy more pharmaceuticals at lower prices?

3. What happens to the price if a price ceiling (maximum legal price) is imposed?

4. Does a price ceiling create a surplus or a shortage? Why?

5. Does a price ceiling cause greater shortages in the short run or in the long run? Why?