Quadrant II - Notes

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Module Name : Price Rationing and Price Floors

Module No : 19

PRICE RATIONING AND PRICE FLOORS

PRICE RATIONING

Meaning of Rationing

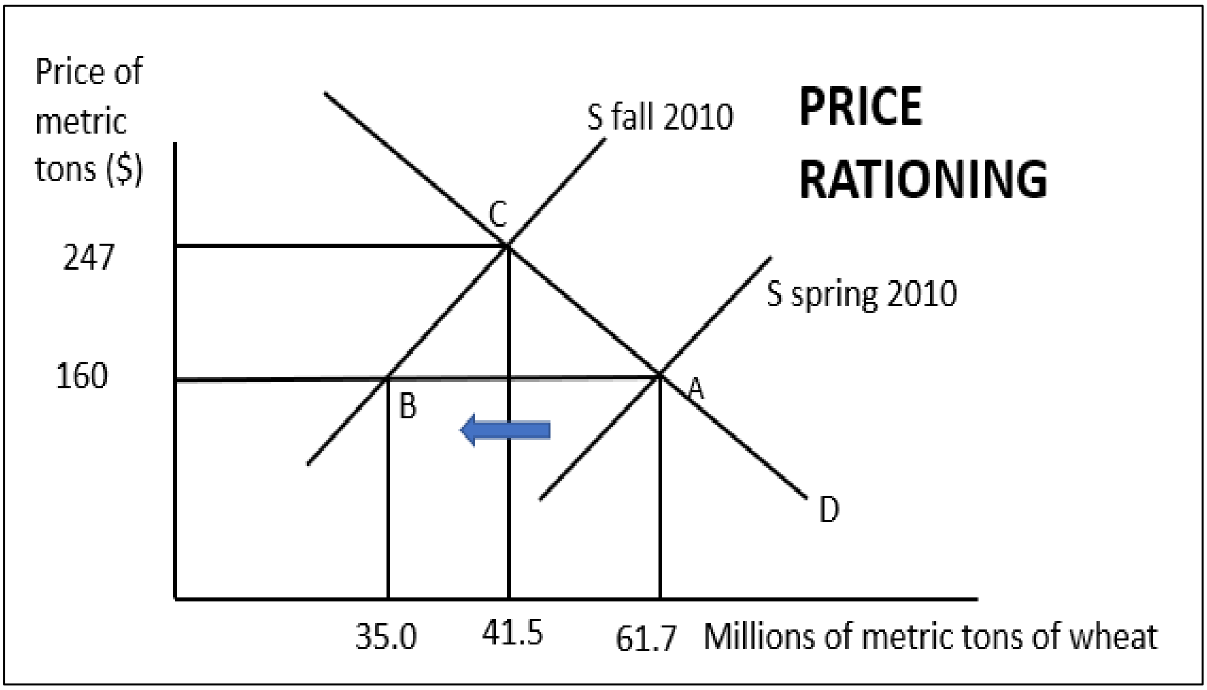
A scarce good can only be obtained by giving up something else or by paying a positive price for it. Rationing is the practice of controlling the distribution of a good or service in order to cope with scarcity. It is the limiting of goods or services that are in high demand and short supply. It can be undertaken in response to adverse weather conditions, trade or import/export restrictions, or in more extreme cases, during a recession or a war.

How Rationing Works

Rationing is often undertaken by governments as a way of mitigating the impact of scarcity and deal with economic challenges. Rationing involves the controlled distribution of a scarce good or service. Under the coupon rationing system consumers are given ration coupons just sufficient to buy the available quantity of the commodity. The number of ration coupons issued to a family may depend on the age of its members, sex, and the number of family members or on any other criterion considered desirable. The imposition of restriction on the consumption of some essential, scarce commodities, such as rice, wheat, pulses, clothes, sugar, etc., during the period of rising prices. Rationing seems to be a 'fair' way of sharing out limited supplies of essential commodities since everyone gets the same amount at a fixed price.

In figure 1, the X axis measures the quantity of wheat in millions of metric tons and the Y axis measures price in dollars. The initial equilibrium price of wheat is $160 per metric ton during the spring season of 2010 in Russia. This is determined by the intersection of demand and supply curves of wheat at Point A and 61.7 million metric tons were supplied at this price.

Fig. 1.



However, an environmental disaster strikes Russia and majority of the wheat crop gets destroyed. Hence the supply curve shifts to the left during the fall of 2010. This creates an excess demand at the original price of $160, because now only 35 million metric tons are available because of the environmental disaster. This is indicated by point B. So, at this point, quantity demanded exceeds quantity supplied, resulting in the price of wheat to rise very sharply. As the price rises, the available supply is rationed. That is, those who are willing and able to pay the most get it.

Seeing that the price has risen, farmers harvest their crops very carefully. Some wheat is taken out of storage and brought to the market. Quantity supplied increases now from 35 million metric tons to 41.5 million metric tons. A new equilibrium is established at Point C, at the price of $247 per metric ton. The market has determined who gets the wheat. The scarce supply is rationed to those who are willing and able to pay the higher price.

Purpose of Rationing

Rationing is done to ensure the proper distribution of resources without any unwanted waste. Wants and needs are unlimited, but resources are limited, available commodities must be rationed out to competing uses. Markets ration commodities by limiting the purchase only to those buyers willing and able to pay the price.

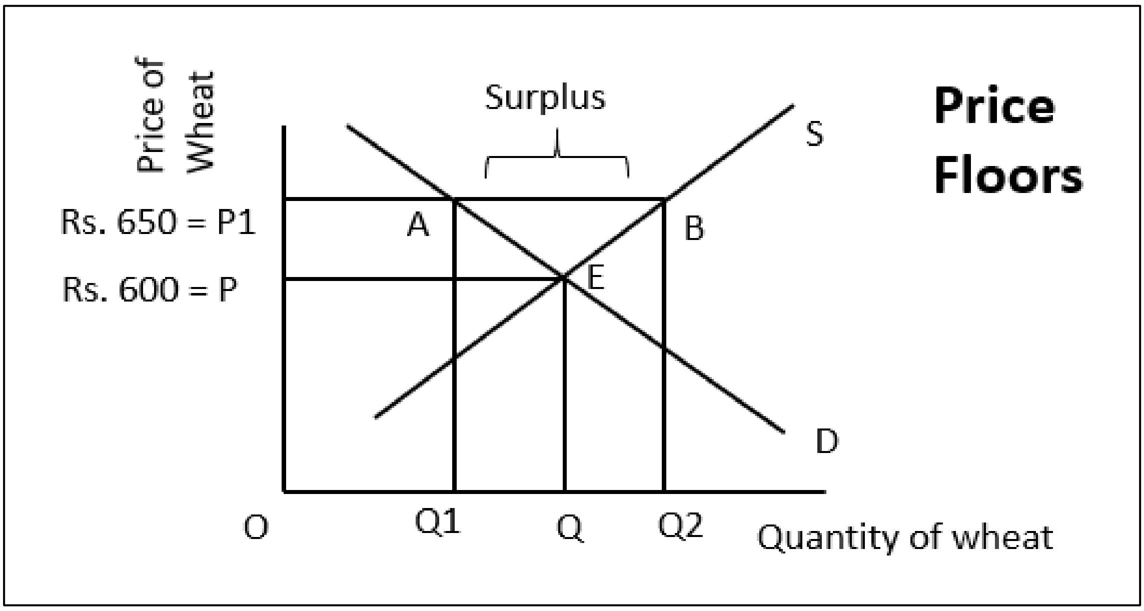
PRICE FLOORS

A price floor is the lowest legal price that can be paid in a market for goods and services, labour, or financial capital. They are also called price supports. A price floor must be higher than the equilibrium price in order to be effective. Governments use price floors to keep certain prices from going too low. Price floors are the opposite of price ceiling.

Examples of Price Floor: Minimum Wage Laws and Minimum Support Price

The government sets out the minimum rate that can be paid to labourers. The wage is the price of labour. The purpose is to prevent swings in income. The government enters the market and buys the product, thus adding to demand in order to keep prices higher than they otherwise would be.

Fig. 2.



In figure 2, the quantity of wheat is measured on the X axis in quintals and price is measured on the Y axis. The free market determined equilibrium price is OP and is equal to ₹600 per quintal, where OQ quantity of wheat is supplied at Point E. However, this price is not good enough for the farmers. It is unremunerative, i.e. it does not provide incentives to farmers to produce wheat or to expand its production.

Therefore, to promote the interests of farmers, the government intervenes and fixes a higher minimum support price OP1 at ₹650 per quintal. However, you will note that at price OP1, the quantity demanded of wheat decreases to OQ1, because the price is high for consumers so they reduce their consumption of wheat, or maybe they shift to some other commodity. But since farmers are getting a high price, they expand the production of wheat to OQ2.

Thus, at the minimum support price of OP1, the quantity of wheat supplied by farmers exceeds the quantity of wheat demanded by consumers in the market, leading to a surplus of wheat equal to AB. If the government does not purchase this surplus, it will tend to depress the price of wheat. Hence, at price OP1, farmers sell OQ1 quantity of wheat in the free market to consumers and Q1Q2 to the government. This increases the income of farmers from OPEQ to OP1BQ2.

Effects of Price floors

- Often employers hire fewer workers leading to unemployment.
- Entice more people to enter the labour market.
- Consumers reduce their purchases, switch to substitutes or drop out of the market due to higher prices.
- Suppliers find they are guaranteed a new higher price hence they increase production.