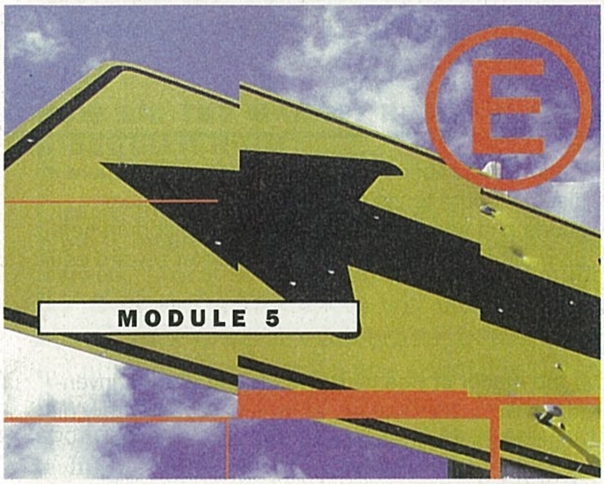


E Price Controls

- What are price controls?
- What are price ceilings?
- What are price floors?

WHAT ARE PRICE CONTROLS?

While nonequilibrium prices can crop up in the private sector, reflecting uncertainty, they seldom last for long. Governments, however, often impose nonequilibrium prices for significant time periods. **Price controls** involve the use of the power of the state to establish prices different from the equilibrium prices that would otherwise prevail. The motivations for price controls vary with the market under consideration: a maximum, or **ceiling,** price is often set for goods deemed "important," like housing, or a minimum, or **floor,** may be set on wages because wages are the primary source of income for most people.

Price controls are not always implemented by the federal government. Local governments (and, more rarely, private companies) can and do impose local price controls. One fairly well-known example is rent controls. The inflation of the late 1970s meant rapidly rising rents, and some communities, such as Santa Monica, California, decided to do something about it. In response, they limited how much landlords could charge for rental housing.

PRICE CEILINGS: RENT CONTROL

Rent control experiences can be found in many cities across the country. San Francisco, Berkeley, and New York City all have had some form of rent control. While the rules may vary from city to city and over time, generally the price (or rent) of an apartment remains fixed over the tenure of an occupant, except for allowable annual increases tied to the cost of living or some other price index. When an occupant moves out, the owner can usually, but not always, raise the rent to a near-market level for the next occupant. The controlled rents for existing occupants, however, are generally well below-market rental rates.

Results of Rent Controls

First, persons living in rent controlled apartments have a good deal, one that they would lose by moving as their family circumstances or income change. Tenants thus are reluctant to give up their governmentally granted right to a below-market rent apartment. Second, because the rents received by landlords are constrained and below market levels, the rate of return (roughly, the profit) on housing investments falls compared to that on other forms of real estate not subject to rent controls, like office rents or mortgage payments on condominiums. Hence, the incentive to construct new housing is reduced. Where rent controls are truly effective, there is generally little new construction going on and a shortage of apartments that persists and grows over time.

Third, since landlords are limited in what rent they can charge, there is little incentive to improve or upgrade

The effect of rent controls is shortages.

apartments, say, by putting in new kitchen appliances or new carpeting, in order to get more rent. In fact, there is some incentive to avoid routine maintenance, thereby lowering the cost of apartment ownership to a figure approximating the controlled rental price, although the quality of the housing stock will deteriorate over time.

A fourth impact of rent controls is that they promote housing discrimination. Where rent controls do not exist, a prejudiced landlord might willingly rent to someone he believes is undesirable, simply because the undesirable family is the only one willing to pay the requested rent (and the landlord is not willing to lower the rent substantially to get a desirable family, since this could translate into the loss of thousands of dollars in income). With rent controls, there are likely to be many families wanting to rent the controlled apartment, some desirable and some undesirable, as seen by the landlord, simply because the rent is at a below-equilibrium price. The landlord can indulge in his "taste" for discrimination without any additional financial loss beyond that required by the controls.

Consequently, he or she will be more likely to choose to rent to a desirable family, perhaps a family without children or pets, rather than an undesirable one, perhaps one with lower income and so a greater risk of non-payment.

Exhibit 1 shows the impact of rent control. If the price ceiling is set below the market price, the quantity demanded will increase to Q_D from Q^* and the quantity supplied will fall to Q_S from Q^*. The rent control policy will therefore create a shortage, the difference between Q_S and Q_D.

PRICE FLOORS: THE MINIMUM WAGE

Suppose the government decided to increase the **minimum wage rate** for workers. The argument for doing so is simple: Existing minimum wages do not allow for a very high standard of living, and a higher minimum wage will allow workers (those continuing to work, and maintaining their hours worked, anyway!) to live better than before. Ever since 1938, when the first minimum wage was established (at 25 cents per hour), the federal government has, by legislation, made it illegal to pay most workers an amount below the current legislated minimum wage.

The quantity of labor demanded, as for other goods, varies inversely with its price, because at a lower price or wage, employers find it more profitable to hire more workers. Likewise, the supply of labor varies directly with price; at higher wages, more persons have an incentive to work (and the existing workers have an incentive to work longer hours).

If the government raises the minimum wage, the quantity of labor supplied to the market grows, because more are willing to work at a higher wage rate. However, the quantity of labor demanded falls because some employers would find it unprofitable to hire low-skilled workers at the higher wage rate. Examine Exhibit 2. At $5.15 an hour, there may be a gap between the quantity of labor demanded and the quantity supplied, AB; this represents willing workers who will be unable to find jobs. However, if the wage were increased by government mandate to $10, the gap between quantity demanded and quantity

EXHIBIT 1 **RENT CONTROLS**

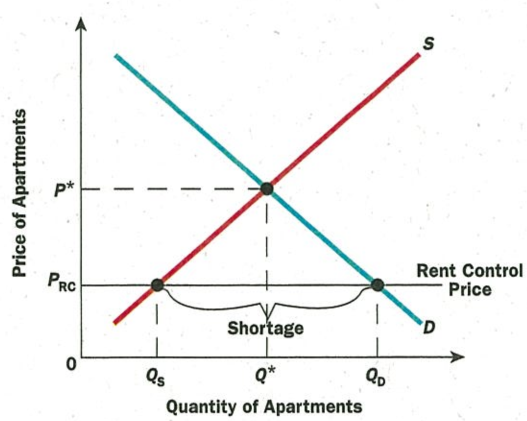
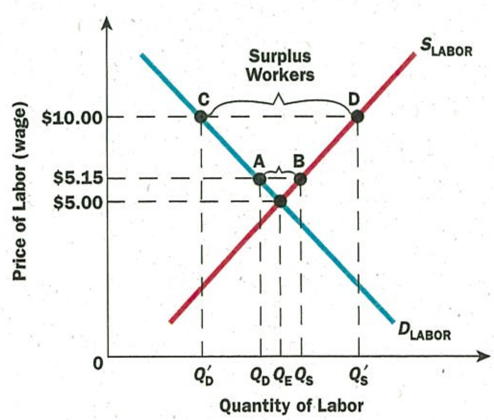
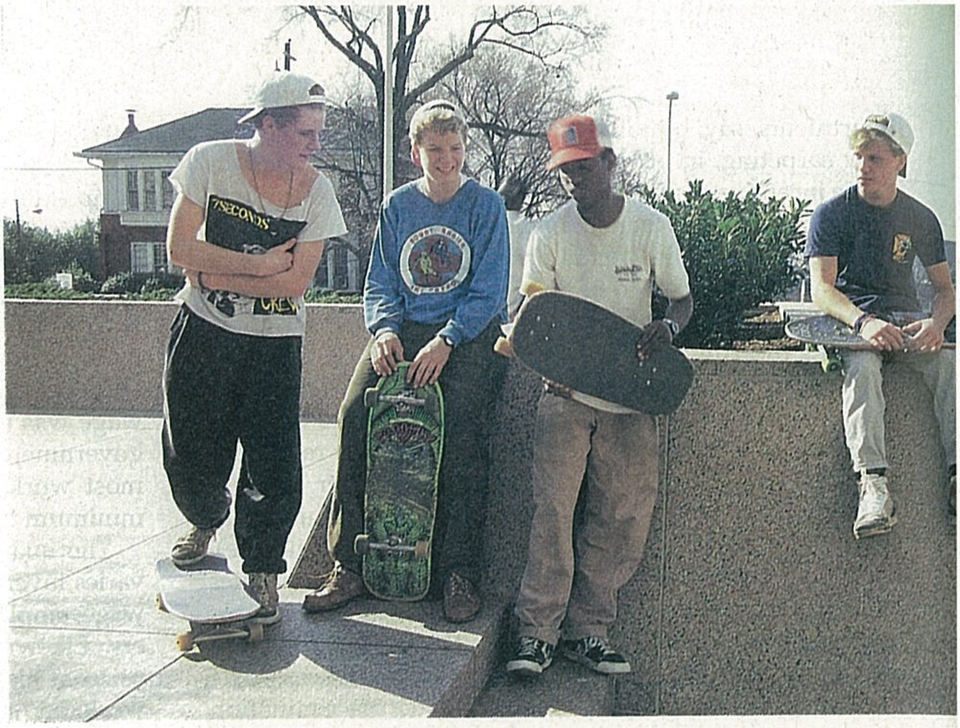


EXHIBIT 2 **THE UNEMPLOYMENT EFFECTS OF MINIMUM WAGE**



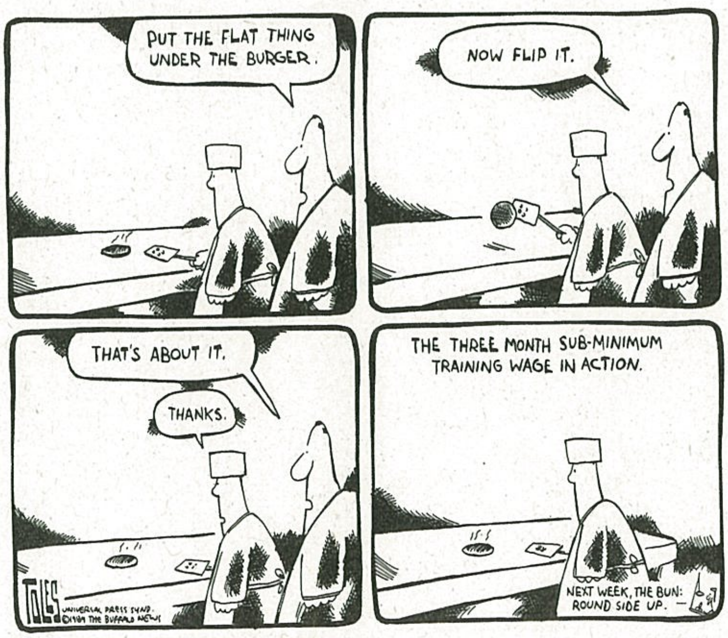


What do you think would happen to the number of unskilled workers getting jobs if we raised the minimum wage to $50 an hour? How many more people would be sitting here?

supplied, CD, would be much larger. An increase in the minimum wage would, therefore, create additional unemployment.

The additional unemployment created by higher minimum wages is not evenly distributed among various racial, demographic, and educational groups in our population. An increase in the minimum wage will not have any important impact, for example, on the unemployment rate for physicians, all of whom earn far more than $10 an hour. Rather, the impact falls mainly on the least-experienced, least-skilled persons, holding the lowest-paying jobs. A large proportion of these jobs are held by teenagers. Those who continue to hold jobs after the minimum wage is increased gain substantially, and thereby are vociferous supporters of efforts to increase the minimum. Yet another group of persons suffers tremendously more from the higher minimum wage—they lose their jobs or are unable to get them in the first place (for new labor market entrants) and suffer a decline in earnings, not a gain. Others would be frustrated when they unsuccessfully attempted to get a job at $10 an hour. Although studies disagree somewhat on the precise magnitudes, they largely agree that minimum wage laws do create some unemployment, and that the unemployment is concentrated among teenagers, blacks, and other minorities. Minimum wage laws are one reason that black and teenage unemployment rates are at least twice as high as unemployment for white adults.

The above analysis does not "prove" minimum wage laws are "bad" and should be abolished. To begin with, there is the empirical question of how much unemployment is caused by increases in minimum wages. Secondly, the cost of higher unemployment might be viewed by some as a reasonable price to pay for assuring that those with jobs get a "decent" wage. The analysis does point out, however, that there is a cost to having minimum wages, and the burden of increases in the minimum wages falls not only on employers and purchasers of products made more costly by the minimum wage but also on poor, low-income Americans who become unemployed when such increases occur.



CONCEPT CHECK

1. Price controls involve government mandates to keep prices above or below the market-determined equilibrium price.
2. Price ceilings are government-imposed maximum prices.
3. If price ceilings are set below the equilibrium price, shortages will result.
4. Price floors are government-imposed minimum prices.
5. If price floors are set above the equilibrium price, surpluses will result.

1. How is rent control an example of a price ceiling?
2. What predictable effects result from price ceilings like rent control?
3. How is the minimum wage law an example of a price floor?
4. What predictable effects result from price floors like the minimum wage?
5. What may happen to the amount of discrimination against groups such as families with children, pet owners, smokers, or students when rent control is imposed?
6. Why does rent control often lead to condominium conversions?