6.6 How Does Government Intervention Affect Markets?

On the whole, when prices are allowed to freely rise and fall to their equilibrium levels, they do an effective job of allocating scarce resources to their best uses. On occasion, however, governments intervene in the market in an attempt to influence prices. They do this by placing limits on how high or low certain prices may be. These limits are called price controls.

Why Governments Intervene in Markets
The temptation to impose price controls is, as the economist Henry Hazlitt reminds us, nothing new.

The record of price controls goes as far back as human history. They were imposed by the Pharaohs of ancient Egypt. They were decreed by Hammurabi, king of Babylon, in the eighteenth century BC. They were tried in ancient Athens.


In modern economies, governments usually impose price controls when they are persuaded that supply and demand will result in prices that are unfairly high for consumers or unfairly low for producers. For example, in the 1970s the U.S. government imposed price controls on gasoline in response to reduced shipments of foreign oil due to crises in the Middle East. This action was taken to protect consumers from price swings. The government has also imposed price controls during wars in attempts to ensure that goods are distributed fairly during periods of shortage.

Governments can control prices in two ways: by setting price floors or price ceilings. Both methods affect supply and demand.

Price Floors Lead to Excess Supply
When a government wants to keep prices from going too low, it sets a price floor. A price floor is a minimum price consumers are required to pay for a good or service. A price at or above a price floor is legal, while a price below the price floor is illegal.

Price floors are meant to push prices up, ensuring that producers receive a benefit for providing a good or service. Pressure to impose price floors usually arises when producers feel the market isn’t providing them with adequate income. Suppose, for example, that the equilibrium price of wheat were to fall so low that wheat farmers were struggling to survive. The government could intervene to establish a price floor for wheat.

The minimum wage is another type of price floor. The minimum wage is a government-imposed legal floor on the hourly wage rate, which is the price the market pays for labor. The rationale for the minimum wage is that in some low-skill job markets, where workers outnumber jobs, supply and demand would drive the equilibrium wage so low that many workers would be earning too little to live decently.

While price floors may benefit some people, the larger effect of a price floor is excess supply. To see why, consider the impact of an increase in the minimum wage on both workers and employers. As the minimum wage rises, more people apply for minimum wage jobs. The result is an increase in the supply of low-skill job seekers. At the same time, employers reduce the number of minimum wage workers they hire in an effort to keep their wage costs from rising. The result is a decrease in demand for low-skill workers.

Figure 6.6A illustrates the effect of this combined increase in supply and decrease in demand. At the equilibrium wage rate of $5.00 per hour, the quantity of workers demanded—3 million—equals the quantity supplied. At the minimum wage of $6.00 per hour, however, 4 million workers are supplied—that is, willing and able to work—but only 2 million workers are demanded—that is, hired. This leaves a surplus of 2 million unemployed people.

A price floor above the equilibrium price of wheat would have the same effect. Farmers would produce more wheat to sell, but buyers would buy less, resulting in a surplus of wheat.

Price Ceilings Lead to Excess Demand
When a government wants to keep prices from going too high, it sets a price ceiling. A price ceiling is a maximum price consumers may be required to pay for a good or service. A price at or below a price ceiling is legal. A price above the ceiling is not legal.

Governments impose price ceilings to enable consumers to buy essential goods or services they wouldn’t be able to afford at the equilibrium price. Price ceilings are usually established in response to
a crisis, such as war, natural disaster, or widespread crop failure. Such supply-shifting events can lead to price increases that may cause a financial burden for a great many people while enriching a select few.

The best-known form of price ceilings in the United States today is rent control. **Rent control** regulations make it illegal to charge more than a specified monthly amount for rental housing. In New York City, rent control was introduced during World War II to protect poor families. Over time, the regulations were eased somewhat. But a half-century later, some 2.5 million New Yorkers were still living in more than a million rent-regulated apartments.

Figure 6.6B illustrates the effect of rent control on the rental housing market in a typical city. As you might have guessed, imposing a rent ceiling that is below the equilibrium rent leads to excess demand. The artificially low rents attract young people eager to leave home and live independently or retirees hoping to reduce their expenses—in short, anyone who likes a bargain—into the rental market.

At the same time, the supply of apartments in the market decreases as landlords who are unwilling to rent at such low prices seek other ways to use their properties. Some, for example, might decide to convert their apartments to condominiums to sell.
Moreover, fewer potential landlords enter the rental market because of the difficulty of making a profit under rent control laws. The result is excess demand and a shortage of apartments.

Dealing with Excess Supply and Demand: Rationing and Black Markets

Price controls lead to surpluses and shortages because they prevent markets from reaching a market-clearing price. The excess supply and demand that arise must be addressed outside the market. This happens in various ways.

In the case of an agricultural surplus that results from price floors, the government may limit supply by restricting how much farmers are allowed to grow. Or the government may buy the crop surplus at the price floor to store for later use or to give to a developing country as foreign aid. Such aid often has the effect of undercutting farmers in countries that cannot compete with cheap American surplus grain.

When shortages occur, the government may impose rationing. Rationing is the controlled distribution of a limited supply of a good or service. For example, during the 1973 oil crisis, price ceilings on gasoline led to a severe gas shortage. The government instituted a rationing system based on license plate numbers to cope with the shortage. During World War II, the government rationed tires, gasoline, sugar, and other goods that were in short supply because they were being used for the war effort.

Rationing can be a costly means of allocating scarce goods. A giant bureaucracy, the Office of Price Administration (OPA), had to be set up during World War II to enforce the rationing regulations. Thousands of rationing boards were created, operated by 60,000 employees and 200,000 volunteers. Shortages can also give rise to black markets. A black market is an illegal market in which goods are traded at prices or in quantities higher than those set by law. There was a thriving black market during World War II for meat, sugar, and gasoline, among other products. Some people bought and sold meat through bootleg suppliers. People also made counterfeit ration coupons. In one month alone in 1944, the OPA counted 3 million counterfeit coupons.

Why Ending Price Controls Is Difficult

At this point you might be wondering why, if price controls are so harmful to markets, the government doesn’t just get rid of them. The answer to this question has more to do with politics than economics.

The political pressure on elected officials to intervene in the market when prices rise and fall rapidly can be intense. And although price controls are inefficient, many people believe that they further the goal of economic equity in such situations.

Moreover, some people—farmers, people who live in rent-controlled apartments, workers who earn minimum wage—clearly benefit from price controls. Labor unions also support minimum wage laws because such laws are believed to push all wages upward. The combined voices—and votes—of those who support price controls are enough to make most politicians reluctant to repeal them.
Most economists, as you would expect, take a dim view of price controls. When a government tries to set prices, economists warn, it is likely to set them too high or too low. The inevitable result will be shortages or surpluses. Markets, on the other hand, when left alone, will naturally gravitate to the “right” price.

This takes us back to the question we started with, How do you know when the price is “right”? The simple answer is that the price is right when the market reaches equilibrium. The process of reaching equilibrium, however, is anything but simple. It involves the individual decisions of countless producers and millions of consumers just like you. In the next chapter, you will learn more about how markets work and what happens when they work less perfectly than the model of supply and demand suggests they should.

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**Summary**

In a free market, demand and supply automatically move prices to equilibrium, the point at which quantity demanded equals quantity supplied.

**What happens when demand meets supply?** Demand and supply interact to drive prices for goods and services to the equilibrium level. On a graph, this equilibrium point is found at the intersection of the demand and supply curves. The equilibrium price, also known as the market-clearing price, may be thought of as the “right” price.

**What happens when the price isn’t “right”?** Disequilibrium occurs when prices are set above or below the equilibrium price. When prices are too low, excess demand leads to shortages. When prices are too high, excess supply leads to surpluses.

**How do shifts in supply or demand affect markets?** Many kinds of events can cause demand and supply curves to shift to the right or left. Markets adjust to such changed conditions by seeking a new equilibrium point.

**What role do prices play in a modern mixed economy?** Prices convey information to consumers and producers as to what to buy and produce. Prices motivate workers and firms to enter markets, and they help markets respond to changing conditions. They guide resources to their most efficient uses.

**How does government intervention affect markets?** Governments sometimes implement price controls when prices are considered unfairly high for consumers or unfairly low for producers. Price floors, such as minimum wage laws, prevent prices from going too low, but lead to excess supply. Price ceilings, such as rent control laws, prevent prices from going too high, but lead to shortages.