

ECONOMICS U\$A
PROGRAM #118

ECONOMIC EFFICIENCY: WHAT PRICE, CONTROLS?

BY JAMES CLARE

AIRSCRIPT
MAY 3, 1985

MICROECONOMICS

18. ECONOMIC EFFICIENCY: WHAT PRICE, CONTROLS?

PURPOSE:

To help viewers understand the forces that affect prices, the way prices act as signals to consumers and producers, the cost of interfering with free-market prices, and the circumstances that justify interference with the free-market.

OBJECTIVES:

1. People are motivated to buy and sell goods and labor services by their desire to improve their well-being.
 - a) Consumers purchase products and services to maximize their well-being.
 - b) Producers supply these products and services in a manner that maximizes their profits.
2. Prices are the mechanism that provides information and incentives to buyers and sellers
 - a) Prices tell producers how much they can produce at what profit.
 - b) Prices indicate to consumers how much and what they can buy with their income.
 - c) The market balance occurs at a price where the separately formed plans to buyers and sellers mesh so that the quantity demanded (at a particular price) and the quantity supplied (at that price) are the same.
 - d) This equilibrium point encourages the efficient allocation of resources.
3. Interference with the natural market forces through the imposition of price controls, rationing, quotas, etc., can lead to an inefficient allocation of resources.
4. There are circumstances in which market intervention may be justifiable.
 - a) Markets may exhibit unstable price behavior.
 - b) Market forces may hurt the economically disadvantaged.
 - c) Markets may not respond quickly enough during national emergencies.

KEY ECONOMIC CONCEPTS:

economic efficiency
allocation of resources
price controls
rent controls
productive resources

equilibrium
supply curve
demand curve
competitive price system
invisible hand

ILLUSTRATIVE EVENTS:

The concept of economic efficiency is illustrated by considering the consequences of price controls in recent U.S. history. The food price freeze of 1973 is used as an example where controls created severe problems. Controls in World War II and rent control in New York City are cited as examples where controls can be justified for national goals or equity considerations.

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TEASER

SPEAKER: “This boycott is a perfectly reasonable free enterprise tool to use when meat prices are the highest in history...and the federal government refuses to act until after the horse is out of the barn.”

DAVID SCHOUMACHER: When the cost of food threatens to jump beyond the reach of the average American family, should the government put a lid on prices? When the nation goes to war, should the government institute total controls? And what are the dangers of a well-intentional price control program once it becomes entrenched?

JOHN T. DUNLOP: “Controls...are to a politician like catnip to a cat...the politicians, in the end, have very great difficulty resisting.”

DAVID SCHOUMACHER: Economic Efficiency: What Price, Controls?...With the help of economic analyst Richard Gill, we’ll examine that question on this edition of Economics U\$A. I’m David Schoumacher...

(MUSIC PLAYS - OPENING TITLES)

(Economic Efficiency: What Price, Controls? appears on screen)

PART I

(AUDIO CLIP FROM OPEN-AIR MARKET)

DAVID SCHOUMACHER: Everyone enjoys the ritual and the “give and take? In a market like this one in Englishtown, N.J. What we’re seeing, through the eyes of an economist, is a demonstration in its purest form of the free-market pricing system. Like a well-choreographed ballet, consumers take the lead in this commercial dance. They’re looking for the best deal they can get for their limited dollars. The merchants follow their lead...the joking not quite masking the intensity. Browsers or buyers...how much are they willing to pay?...Settle for less profit or lose the sale? So what we have here is an open-air demonstration of economic efficiency. The pricing system at this level is pretty much like the merchandise on display...out in the open. However, behind the scenes, what economists call the “invisible hand” is at work, determining what is produced...how much is produced...keeping supply and demand in balance, and all with the least amount of waste. But if the “invisible hand” and the “free-market” have worked so well, why would anyone want to interfere? During the late 1960s, paying for both the Vietnam War overseas and the programs of the Great Society here at home, put a double pressure on prices. Inflation became the basic national concern during the administration of Richard Nixon.

RICHARD M. NIXON: “So what we are trying to do without, shall we say, too much managing of the economy, we’re going to have some ‘fine tuning’ of our fiscal and monetary affairs in order to control inflation.”

DAVID SCHOUMACHER: But inflation continued and “fine tuning” didn’t work. The President and his advisors felt something dramatic had to be done.

DR. HERBERT STEIN: “There we all were...all the economic officials of the government summoned up to Camp David on a weekend...told not to tell anybody where we were going, even our secretaries were not supposed to know where we were going...our wives were not supposed to know...and we were absolutely cut off from the world for two days...which is quite unusual. A lot of speculation was going on down in

the valley...in the Potomac...about what we were doing. But at least the word did not leak out that we were about to impose a wage and price freeze.”

RICHARD M. NIXON: “The time has come for decisive action...action that will break the vicious circle of spiraling prices and costs. I am today ordering a freeze on all prices and wages throughout the United States for a period of 90 days.”

DAVID SCHOUMACHER: It was August, 1971, and inflation had reached what was then considered to be a staggering 4%. President Nixon imposed temporary price controls and they worked...temporarily. But then...the controls off...prices started upwards again. It was as though the lid was off a giant pressure cooker. By 1973, there were boycotts and demonstrations against high prices...President Nixon decided he'd have to take action again.

DR. HERBERT STEIN: “The question then arose: Should we go back to the initial freeze, which the President remembered as having been so popular? And in kind of a wise guy way, I said to him, quoting Heraclitis, ‘You cannot step into the same river twice.’ And he retorted, ‘Yes, you can, if it’s frozen.’...which I think is the best joke I remember Mr. Nixon ever making, although he made others.”

RICHARD M. NIXON: “What we need is action which will stop the rise in meat prices now. And that is why I have today ordered the Cost of Living Council to impose a ceiling on prices of beef, pork and lamb.”

DAVID SCHOUMACHER: The price control gamble was based on the idea...the hope really...that all of the underlying price factors would hold still. But, in fact, experience shows the odds almost always favor change. This time the change was wheat. Huge shipments were going overseas because of the surpluses, but then a drought in the southwest destroyed much of the winter wheat crop. Throughout the spring and summer, cattlemen saw their feed prices, which were not controlled, push higher and higher...while their beef prices remained locked in a vice.

(AUDIO CLIP OF CATTLE AUCTION)

J. DAWSON AHALT: “Farmers are a pretty independent group of businessmen and one of the first things that they tried to do was to withhold their animals from markets...and that had the effect of tightening up on supplies and actually putting real pressure on the whole system. Here was the government trying to hold down prices at a time when farmers were withholding marketings...so you began getting a very difficult situation.”

FARMER: “Well, we gonna hold our cattle on the farm, definitely, rather than sell...hold ‘em.”

INTERVIEWER: Why?

FARMER: “Well, the price should come back...we don’t want to give ‘em away...Just keep ‘em and let ‘em get old if necessary. We feel like the cattle prices will come back.”

DAVID SCHOUMACHER: By the middle of the summer, beef was scarce in many areas of the country...and now it was consumers who were trapped. The price controls they had demanded had led not only to lower prices...but to lower levels of meat production.

CATTLEMAN: “Well, I don’t think I have to sell now, because the demand’s going to get greater and get us a little more profits...later on, the way I think.”

J. DAWSON AHALT: “That’s a rational thing for them to do. The problem with it, however, was that you can only do that for a short period of time. Those animals eventually had to come to market...and what happened was that they held back and when the controls were relaxed, the animals came to market and down came the price...So it had a very serious and devastating effect.”

DAVID SCHOUMACHER: The plunging prices drove many producers out of the business and consumers felt the shortages for several years. Dr. Stein evaluates his price control experience...

DR. HERBERT STEIN: “No, I think it’s something to be avoided like the plague. It did us no good at all...It probably gave us more inflation than we would have had if we hadn’t gone through this. But if you put them on in peacetime, you tend to generate those conditions in the economy which makes it very difficult to get rid of them...But you know that if they last for a long time, they’re terribly destructive.”

DAVID SCHOUMACHER: Economists now agree that price controls did not work back in 1973, and, given the same circumstances, probably would not work again. Why would it have been better to let the market set the prices? Economic analyst, Richard Gill, explains...

(MUSIC PLAYS - COMMENT AND ANALYSIS I)

(ECONOMICS U\$A LOGO appears on screen)

RICHARD GILL: In order to understand how price controls affect the economy, we have to understand a little about the price system itself. In this connection, economists usually make some assumptions about human behavior...namely, that people will generally tend to act in their own best self interest. They will try to maximize their satisfactions or welfare. Consumers might like to have all the goods they possibly could, but most of them are limited in their budgets and, therefore, they must choose. They can’t have all these goods. They must choose this good or that good. And in making these choices, they try to maximize their own welfare. The same is true of producers. In their case they try to maximize their firm’s profits. They could produce goods in old fashioned ways and produce goods that consumers didn’t want. But it will be in their own self interest...they will maximize their profits...if they use more efficient productive methods and produce those goods that consumers will, in fact buy. Let us examine the price system more closely. Suppose a new computer is introduced and priced at \$450.

Let's suppose that this is quite a low price meaning that there will be long lines of consumers wanting to buy this attractive new product. Now under the influence of the bidding of these consumers, the price, let's suppose, rises all the way to \$750. That price change will have two effects. For one thing, it will encourage other producers to come in and produce similar computers. It will also, however, discourage consumers from buying those computers, leading to an over supply of computers. Consequently, the price will come down. Let's suppose that, in fact, it comes down to \$600...a price where demand and supply are equated. Some producers have dropped out because of the lower price...Some consumers have come back into the market. Supply and demand are equated, and this is often an efficient economic situation. What do price controls do under these circumstances? The government steps in and sets a lower price, a price below equilibrium supply and demand, say, \$550. This has the effect of driving some of the producers of computers out of the market. At the same time it encourages consumers to come back into the market. And this creates a situation of over demand...lines, queues of people, trying to buy non-existent computers. The price system has gotten out of whack...as, in fact, happened in the case of certain commodities when price controls were instituted in the United States in the early 1970s.

PART II

FRANKLIN DELANO ROOSEVELT: "December 7 1941, a date which will live in infamy, the United States of America was suddenly and deliberately attacked by naval and air forces of the empire of Japan."

DAVID SCHOUMACHER: The attack on Pearl Harbor was a surprise, but planning for World War II had been underway for some time. As German armies swept across Europe, America began to build up its military and to prepare its economy for the shock of war. Many adult Americans still held vivid memories of the hardships caused by inflation during the unregulated economy of World War I. The cost of living then spiraled up more than 100%. Every worker and every resource was suddenly in precious demand. Military and civilian needs competed with no referee but the price system...and

so prices naturally shot higher. As another and potentially greater war approached American shores, President Roosevelt prepared to initiate price controls. But the job of planning and controlling the economy was anything but easy. The Roosevelt Administration chose a young economist from Canada...John Kenneth Galbraith...to be its "Price Czar".

JOHN KENNETH GALBRAITH: "We had a couple of dozen people and the task of taking charge of all the prices in the economy. And I've often thought that, in my more mature years, I would have been simply appalled. At that time I was rather of the opinion that the right man had been selected for the right job."

DAVID SCHOUMACHER: Well, how does one select "I will control this, but not that?...What was on your mind?...How were you going through that process?"

JOHN KENNETH GALBRAITH: "Well, this was the original idea...that we would control those prices where the war had brought something into very short supply...like rubber. We'd ration, and we'd let the market take care of other prices, keeping demand equal to supply. Well, that proved totally impossible and so the answer to your question is...there was no such possibility...one had to control all prices...And we did."

DAVID SCHOUMACHER: Price controls were only one weapon in the economic war. Directives relating to mobilization touched almost every branch of the economy. Scarce resources were rationed...silk, for example, was no longer available for stockings...So resourceful women found substitutes. On the production side, before industrial conversion could begin. Before these automobile assembly lines, for example, could turn out tanks and planes, there was resistance to overcome. President Roosevelt's advisors assured him that business had to make money out of the process...or business wouldn't produce...So the government ultimately determined the prices paid for war materials, with an emphasis on attractive profit incentives for producers. Between 1940 and 1944, corporate profits nearly doubled...from 6.4 billion dollars to 10.8 billion dollars. Almost every business prospered.

JOHN KENNETH GALBRAITH: “One has to remember that price control during World War II came right after the “Great Depression” where there had been a great experience with losses...great experience with limited production...idle plant capacity...and so, there was an expansion of demand, an expansion of output, an expansion of employment, all of which made people very content as they looked back on their private previous experience...even though their prices or wages might be limited.”

DAVID SCHOUMACHER: The Office of Price Administration not only had to set prices...It had to see that the men and women on the home front would go along with the regulated market. OPA wasted few opportunities to publicize the value of price controls...and for the duration of the war, it continued to provide patriotic guidance for the American public.

(SONG: “IT’S UP TO YOU”)

BEN GOLDSTEIN: “Anything that you’d put in would sell pretty rapidly, so it wasn’t a case of selling any more...it was just a case of getting the merchandise. It was really a sellers’ market rather than a buyers’ market for several years...And this became increasingly so as the war went into the third year, fourth year and fifth year.”

CHARLOTTE GOLDSTEIN: “And they restricted the amount of material that could go into a woman’s dress or skirt...And the skirts got tighter and tighter and shorter and shorter...And pretty soon we were in very tight, short skirts.”

BEN GOLDSTEIN: “The idea of a lot of barbecue parties was not to use beef, to use horsemeat and on the new barbecue thing...it didn’t work very well. I didn’t like it...and then a lot of other people didn’t. But there was a very strong feeling at the time that this was almost like a patriotic thing to do and people kidded about it, for the Saturday night barbecue so-to-speak, but they were trying to use horsemeat and other substitutes for beef.”

DAVID SCHOUMACHER: Most Americans agreed that these shortages and inconveniences were trivial compared with the national crusade to win the war. And so they cooperated with the emergency programs. They invested in war bonds and saved their money for the goods that would be available when the fighting was over. For the duration, the controlled market carried out its necessary functions...and defense goals were met.

JOHN KENNETH GALBRAITH: “Looking back on the experience, one can hardly doubt that it was a very successful experience. We have no memory of inflation in World War II...at a time when the economy doubled in output.”

DAVID SCHOUMACHER: Although they caused some problems, some imbalances...there’s general agreement that price controls played a critical role in winning the war. Richard Gill analyses why, in this instance, the government chose to intervene...

(MUSIC PLAYS - COMMENT AND ANALYSIS II)

ECONOMICS USA LOGO appears on screen)

RICHARD GILL: Most economists agree that price controls in World War II were quite successful because of the special circumstances involved. The war involved a huge transfer of resources from the civilian to the military sector of the economy. The government made tremendous demands on the economy, which, without some sort of controls, might easily have led to a rapid spiral of wages and prices, itself damaging the war effort. Also, the controls were instituted for a specific purpose...for a short period of time, and under conditions of patriotic fervor. They had some defects, but under these circumstances they worked quite well. Besides war, there are other circumstances where the market may not handle economic problems efficiently. The market may not be efficient when it comes to monopoly power...or to air and water pollution. Furthermore, we have to remember that economic efficiency is not our only economic objective. We

may want to use controls to improve the distribution of income, to aid the poor, the disadvantaged, or other groups in the society. Indeed, when it comes to rent controls, these motives were very probably paramount.

PART III

DAVID SCHOUMACHER: Economists are generally pretty careful about what they say, but it was an economist who once said that next to bombing, rent control seems to be the most efficient way to destroy cities. He was talking about New York City...and while it sounds extreme, it's pretty close to the truth. Who was it that pushed the button that caused all this destruction? The end of World War II brought a major question: Where were all these returning vets going to live? New York had a housing crisis...The returning veterans and their families badly needed an additional 200,000 housing units. Because of the shortage, big price hikes were expected. So, when the federal government removed wartime rent controls...the State of New York continued them on all existing rental housing. The goal was patriotic and understandable...to give the vets a helping hand, and it seemed to be working, after a fashion.

WILLIAM HIRAK: "I remember when I got out of the service we had our times, too. There were problems in finding homes...and if you did want a home you would approach somebody that probably would move out--a possibility--and you'd work a deal out and pay a few hundred dollars--and you would have an apartment."

ABRAHAM D. BEAME: There was a need for rent control because of the unusual shortage of housing. And, of course it also was true that there was a great deal of pressure from renters, from tenants, and obviously there are an overwhelming majority of tenants in the city as contrasted to landlords."

DAVID SCHOUMACHER: The fabric of neighborhoods and housing seemed unaffected by rent control at first. Brick and mortar do not immediately waste away and maintenance costs were stable throughout the 1950s. But the cost could not hold still

forever...inevitably the system began to crack under the stress. The steps were subtle at first...but disastrous by the end. First, landlords skimped on some repairs. Before too long, they were locked into making ends meet with deteriorating buildings. Then, balance sheets showed that costs were so high and returns so low they could no longer afford to keep their buildings. In the 1960s, first a few, then hundreds of landlords began to abandon their buildings. At the same time, private housing construction in the city came to a standstill. Rent ceilings cut into profit margins...Profits or people?...The issue was an emotional one with no neutral bystanders. But while the debate raged, investors took their money elsewhere...

FREDERICK T. ROSE: "They were much wiser in putting their money and lending it to General Electric than to lending it to a company that would build a product subject to price control. Now the net effect of that is that New York City has a declining population. There have been over 300,000 apartment units abandoned in New York City in the last 10 to 20 years. And no one abandons an apartment house unless it is uneconomical for him to continue to own it."

HOWARD DOBBS: "When we first purchased the property, I think I was paying something like 37-38 cents a gallon for fuel oil...Now I pay \$1.23 a gallon for fuel oil. If I were able to get a decent rental, and I'm not out to overdo anything, I'm only asking for what is necessary to keep the property in good order."

ABRAHAM D. BEAME: "There are times when that might be true...but there are other times when you have to subordinate the economic factor to the social factor...When you find that people of middle income or low income cannot find housing which they can afford, something has to be done to help."

FREDERICK T. ROSE: "Throughout the country, where rent controls don't apply the natural laws of supply and demand have come into play. And if there is demand for something...someone will try to supply it...and usually, oversupply it...and that will drive down the rents."

WILLIAM HIRAK: “I’ve lived in this apartment for about 28 years. To move now, to any other location without rent control, I couldn’t afford it. In other words, I’m determined to keep that I’ve got.”

DAVID SCHOUMACHER: Rent control will probably always be an emotionally charged issue in New York City. There’s not much doubt it did provide affordable housing to many in need. But there’s also not much doubt that over the long run it put a stranglehold on the quantity and quality of available housing. How rent controls upset the delicate balance of supply and demand is a question we put to economic analyst, Richard Gill...

(MUSIC PLAYS - COMMENT AND ANALYSIS III)

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RICHARD GILL: We can summarize a rent control situation through the use of one of the most famous...or perhaps I should say infamous...tools of economics...the curves of supply and demand. We measure price vertically. The higher up we go, the higher the price. We measure quantity bought or sold, horizontally. The farther to the right we go, the greater the quantity. Now as far as the supply of apartment units is concerned, the higher the price, the more of these units will be brought to market. Therefore, the supply curve slopes upwards to the northeast. As far as the demand is concerned, the lower the price, the more apartments will be demanded. And, therefore, the demand curve slope downward to the southeast. When we bring these two curves together, we have an intersection where quantity demanded and quantity supplied are equal. This is an equilibrium situation. Now when we introduce rent controls, we bring into being a lower price than this. And as the quantity demanded now exceeds the quantity supplied, there’s a housing shortage. Apartments are sought and not to be found. This is an economically inefficient situation. Economic efficiency, of course, is not our only economic objective. We may want to improve the income distribution, help the poor. Also, we know that the market place itself is not always perfectly efficient. Therefore, we cannot conclude that

any and all interferences with the price system are necessarily harmful. Almost always, however, such interferences do have some costs in terms of economic efficiency.

SALESMAN: (SHOUTING SALES PITCHES TO ATTRACT CUSTOMERS.)

DAVID SCHOUMACHER: Whether on a national scale or at a neighborhood “flea market,” there’s not much argument among economists about the effectiveness of the “invisible hand” or the efficiency of the free market. It organizes the potentially chaotic forces of supply and demand. It leads to the production of goods people really want, and does it at the lowest cost to society. We have also seen how tampering with the pricing system can lead to unwelcome results. The economic theory to be understood is that any interference with the pricing system...no matter how desirable the goal...can exact a price of its own. This is David Schoumacher for Economics U\$A...

ECONOMICS U\$A (LOGO AND MUSIC)

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