Case 2.8 Careful how you punish: why restricting CEOs’ pay may hurt us more than them?

Summary

This case study shows how the effect of setting maximum limits on CEOs’ pay can be studied as an example of the effect of imposing a price ceiling in a competitive market.

Suggested answers

1 An article in The Economist (2003) has described how two-thirds of New York’s two million rental apartments are subject to some form of price restraint, with a city board setting allowable rent increases for those apartments each year. It is well known that economists oppose such price controls – regarding them as the cause of reduced supply and market inefficiencies. Less known is that economists also think these policies are likely to do more harm than good for the population they are intended to help – that of low-income households.

a Why might policymakers in New York think that rent control would assist low-income households?

Where rent control imposes a price ceiling that is below the equilibrium market price that would otherwise exist, then this implies that rent control is having the effect of reducing the price that people must pay to rent an apartment. This reduction in price might be seen as a particular advantage for low-income households, who are most likely to be constrained in their ability to pay for accommodation.

b How could a policy that lowers the price of rental accommodation actually make low-income households worse off?

Under the maximum rental price policy the quantity of rental housing traded is reduced, and there is excess demand. Hence rental property owners must have a method for rationing supply. Where this involves an extra payment then it will disadvantage low-income households; alternatively, rental property owners may use household income as a method for determining who should be rented housing.

c Can you suggest a better policy for improving access to housing for low-income households?

One suggestion for a better policy would be to provide a voucher or income supplement for low-income households that can be spent on housing. This would increase the affordability of housing for low-income households but would not create the disincentives for supply of rental housing created by the maximum rental price.

2 Suppose demand for and supply of labour in Australia are:

Demand = 2000 – 50W; Supply = 1000 + 50W

(where Demand and Supply are expressed in total hours worked, and W = hourly wage rate (dollars)).

a What would be the equilibrium hourly wage rate and quantity of labour employed in the absence of any government intervention in the market?

Derive equilibrium wage and quantity of labour traded from D = S

⬄ 2000 – 50W = 1000 + 50W ⬄ W\* = 10 => L\* = 1500 hours.

b Suppose that the Australian Government imposes a minimum wage of $15 per hour for workers. What will be the effect on the market outcome? How does this relate to the argument being made by business in Australia that minimum wages reduce employment?

Minimum wage of $15 => Will be binding since it is above the market equilibrium wage of $10.

When W = $15 => Demand = 1250 hours and Supply = 1750 hours.

Market outcome is the smaller of the two quantities => L = 1250 hours.

Hence the imposition of the minimum wage reduces employment.

This fits the point about the views being expressed by business in Australia that changes to the minimum wage will affect employment in Australia.

Note: answers to 2c and 2d are on the next page.c Explain how the effect on the quantity of labour employed due to the introduction of the minimum wage will depend on whether the own-wage elasticity of demand is elastic or inelastic. How might your answer to this question be related to the argument in The Economist (2013) that the introduction of Britain’s minimum wage in 1999 had no notable impact on jobs?

How large a decrease in employment occurs as a result of an increase in the minimum wage will be determined by the wage elasticity of demand for labour. This is because – with a binding minimum wage – it is the demand for labour that determines employment. Where labour demand is wage inelastic then an increase in the minimum wage will cause a less than proportionate decrease in employment. Whereas where the demand for labour is wage elastic an increase in the minimum wage will cause a more than proportionate decrease in employment. This is shown in Figure 1.

Figure 1

Wage

minw2

Labour demand – Wage elastic

minw1

Labour demand – Wage inelastic

Qty of labour

Decrease in employment due to increase in minimum wage – size of decrease depends on degree of wage elasticity of demand for labour.

This answer does provide a potential explanation for why the minimum wage increase in Britain might have had little effect on employment. If the demand for labour is wage inelastic then it would be predicted that the introduction of a binding minimum wage would have little effect on employment.

d Are there other effects of a minimum wage that need to be taken into account to judge whether it provides a net gain to society?

A major potential benefit of the minimum wage is to increase incomes of the lowest paid workers, therefore reducing poverty. An adverse consequence would be if the minimum wage has an inflationary effect on wage-setting in Australia. While it only directly affects about 15 per cent of the Australian workforce (1.75 million workers) it is suggested that the increase granted will spill over to other workers. This could make it more difficult for macroeconomic policy makers to manage inflation and unemployment in Australia.