

The Nearly Invisible Invisible Hand

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Adam Smith's "invisible hand" sometimes works in such marvelously subtle ways that it remains nearly invisible even to economists. A case in point involves government efforts to control prices.

Economists have long complained that a governmentally mandated price ceiling set below the going market price causes a shortage as exemplified by the housing crisis in Paris after World War II and, more recently, in Italy and New York City. Economists have also unanimously acknowledged that a government price support established above the market clearing price causes a surplus in production. Government purchases of surplus grain in the recent past testify to the validity of that argument. However, with but a few exceptions (Working, Benedict, Johnson, and Lee¹), economists have, with a wave of their (visible) "hands", dismissed as totally irrelevant ceilings set above the current market price and floors set below it.

We want to right this nearly invisible wrong. Even price supports set below the going rate and price ceilings set above it have subtle, but real, effects on producers.

Consider the proverbial pin factory made famous by Adam Smith. Suppose the going rate today for pins is thirty cents per hundred. In a free-market economy, tomorrow's selling price may be higher or lower than thirty cents. The entrepreneur accepts this price fluctuation as a risk of doing business.

There is always the possibility that the price will fall enough to force the entrepreneur to shut down his plant and seek his fortune in another industry. And there is also a chance that tomorrow's price will rise so that the entrepreneur captures unanticipated profits.

Some of the risk may be reduced through hedging (e.g., through the futures market for pins or through long-term contracts) though the pin producer will incur a substantial cost. But the level of risk that remains for the entrepreneur after he has entered freely into all such possible contracts is

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socially efficient. Attempts to reduce risk further by legislative fiat cause misallocations of society's scarce resources.

If entry and exit into the pin industry are easy, pin producers cannot collude to limit competition. As the agricultural industry has so vividly demonstrated to the American consumer, the next best solution for a competitive industry is to develop a strong lobby to fight for its best interests. Imagine, then, that a pin lobby gets Congress to pass a law which guarantees that the price of pins cannot fall below twenty-seven cents per hundred, and that, if there is an oversupply of pins at that price, the government will serve as a purchaser of last resort—a sort of political pin cushion.

In the past the results of such laws were invisible to economists, though ever present. What economists call “downside” risk has been reduced. Firms face what is, in essence, a one-way bet. Prices can go no lower than twenty-seven cents, but higher prices, even very high future prices, are still possible. Realizing that the risk of doing business is now lower than it was before the law, existing firms will increase production and new firms will enter the industry.

Pin production will increase, forcing the price to fall towards the floor price or perhaps all the way to the floor. Because of increased production, the government may have to purchase a substantial surplus output of pins. That means taxpayers will get the sharp end once again. Society is now over-producing pins and underproducing other products. Because the price floor has acted as an insurance policy provided by the government at no cost to the pin industry, resources have been attracted to the pin industry. Since our resources are limited, that means we are producing less of something else which consumers really want even more than pins.

The analysis is symmetric with respect to a governmentally mandated price ceiling. For simplicity, assume, instead of a pin support lobby, that consumers of pins become sick and tired of greedy capitalists producing pins for a profit. Why should pin producers receive more than the pin's cost of production? Don't they realize that pins hold the economy together? Suppose government officials, in all their wisdom (and to insure their reelection), decide to do something about this sad state of affairs by mandating a maximum pin price of thirty-three cents per one hundred pins. According to conventional economic theory, if the ceiling price is above the current market price, it will have no immediate effect on the pin market. But there is an effect which has been overlooked.

The possibility of future “upside” gains to the pin producers has been reduced while the chance of downside losses has not changed. Pin production is now riskier than before the price ceiling, causing funds and resources to flow out of the pin industry. Some existing pin producers will probably convert their factories into producing safety pins or hair curling irons.

As supply is reduced, pin prices will rise. The price may even climb as high as thirty-three cents, converting a supposedly ineffective ceiling into an

effective one. As a result, society will be stuck with a shortage of pins. Scarce resources are diverted away from pins, toward the production of less desirable items, all because government imposed a "meaningless" price ceiling on the pin industry.

In summary, neoclassical economists have long viewed price ceilings set above the market price and price floors set below the market price as being costless and irrelevant. If non-binding price limits were efficient, the market would have already introduced them. Our analysis sheds some light on the actual cost of such "invisible" controls on the market and, once again, reinforces the notion that for every government action there is a corresponding market reaction that almost invariably results in economic inefficiency.

The policy implications are obvious. For example, our theory predicts that: (1) state usury laws will cause funds to flow into states where potential gains are higher, even before the ceiling lending rate is reached; (2) price supports will enhance agricultural productivity even when they are not operative; and (3) minimum wage laws will affect employment not only for workers at or below the legislated minimum, but also for workers whose salaries are above the minimum wage.

When imposing price floors or ceilings that are "non-binding," government officials must consider the market reactions described above in order to assess the true cost of such policies. Likewise, when deregulating prices, government officials must consider the benefits derived from reversing the market responses outlined above, even if the controls are currently non-binding. Failure to do so will result in erroneous policy conclusions and further cloud the welfare effects of such policy.

NOTE

1. Holbrook Working, "Price Supports and Effectiveness of Hedging," *Journal of Farm Economics* (December 1963), pp. 811-18; Murray R. Benedict, "Attempts to Restrict Competition in Agriculture: The Government Programs," *American Economic Review* (May 1954), pp. 90-106; D. Gale Johnson, "Competition in Agriculture: Fact or Fiction," *American Economic Review* (May 1954), pp. 107-115; D. R. Lee, "Price Controls, Binding Constraints, and Intertemporal Economic Decision Making," *Journal of Political Economy* (April 1978), pp. 293-301; D. R. Lee, "Price Controls on Non-Renewable Resources: An Intertemporal Analysis," *Southern Economic Journal* (July 1979), pp. 179-88. Also see R. L. Cottle and M. S. Wallace, "Effectiveness of Supposedly Ineffective Governmental Price Constraints," *Atlantic Economic Journal*, forthcoming.