Problem Set 6 - Question 2

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Question 2

True, False or Uncertain: In a city with rent control - a law that puts a maximum on what landlords can charge for housing - an increase in resident's incomes would exacerbate the housing shortage rather than increasing the quantity of housing.

Suggested Solution

- General Tip 1: Refer to the key concepts from class, and discuss how they apply in the context of the question.
- Uncertain. Depends on whether living in the city is a normal or inferior good. Demand would generally increase if it is a normal good (causing shortage), but would decrease if it is an inferior good.
- Normality of a good may be heterogeneous across consumers. For instance, it may depending on overall wealth distribution of the residents who received such income shock.
- Also depends on the elasticity of supply in the housing market. If it is elastic, then increase in demand would increase the quantity of housing. If inelastic, housing shortage may be exacerbated as rent control starts to bind.
- We usually think of housing supply as inelastic in the short-run, but more elastic in the long-run.

Suggested Solution

- General Tip 2: When it's not straightforward to refer back to the concepts learned in class, try to think of real-life/creative examples.
- Even with negligible income effects, a city with high-income residents usually have better infrastructures or amenities and lower crime rates. Such positive externality may attract people from other cities (even if they didn't receive any income shocks) and cause housing shortage.
- With higher income, landlords may lobby to remove or relax the regulation which would alleviate the housing shortage. Tricky for higher-income tenants, since they would prefer low rents but may suffer from shortage.
- General Tip 3: Try to avoid making assumptions that make the question too uninteresting (unless the alternative is to leave it blank).
- Example: Assuming that the rent control was set with an unrealistically high price, so that it never binds.