RUNNING on EMPTY

In recent months, there have been calls from many quarters to deal with the problems of stagnant standards of living by imposing price floors on wages and price ceilings on rents and energy.

But such policies have a long track record of creating shortages – in housing, power and fuel.

CHRISTOPHER J. COYNE and RACHEL L. COYNE say it's a fallacy to suggest that price controls improve living standards...

On September 25th, 2013, the *Financial Times* published an article entitled, "Labour leader Ed Miliband defends UK energy reform pledge". The article discusses Miliband's proposed reforms which include the introduction of energy price controls in the form of a 20-month freeze on gas and electricity prices. Miliband argues that his policy, if implemented, will address what he calls the "cost of living crisis" in the UK.

This ongoing debate provides an excellent opportunity to review whether price controls are an effective means to achieving the end of improving standards of living. To foreshadow our conclusion, they are not.

Price controls refer to government-imposed restrictions on how much can be charged for a good or service in the market. There are two types of price controls. A price ceiling restricts prices from exceeding a maximum price determined by government – for example, Miliband's proposed ceiling on energy prices. A price floor, in contrast, prohibits the charging of prices below a pre-determined minimum – for example, the minimum wage.

From an economic standpoint, price controls are problematic because they distort the price mechanism's ability to allocate resources to their highest valued uses. In unhampered markets, prices work to co-ordinate supply and demand and ration existing resources efficiently. By legally manipulating the market price, price controls distort this process. This distortion has both direct and indirect perverse consequences.

The direct effects of price controls

The direct effects refer to shortages created by price ceilings and surpluses created by price floors.

Consider an unhampered market in energy where supply and demand is balanced by the free-functioning price mechanism. If the government imposes a price ceiling below the market price, the quantity of energy supplied will fall, while the quantity of energy demanded will increase. The result will be a shortage of energy in that consumers who desire energy at the artificially lower price are unable to find an adequate supply.

The logic of price floors is the opposite. Suppose, for example, that the market for labour is coordinated through genuine market prices. In this case supply and demand will tend to be brought into balance. Now suppose the government imposes a minimum wage, above the equilibrium wage, with the goal of improving standards of living.

Under the artificially high price, the quantity of labour supplied will exceed the quantity of labour demanded resulting in a surplus of labour. In other words, workers who want to work at the artificially high price will be unable to find employment. There is a genuine welfare loss here. Workers who could be productive and receiving a wage will not be producing anything or receiving any wage if the minimum wage is above their level of productivity.

It is important to note that price controls do not make everyone worse off. Those who are able to secure goods at the artificially low price – in the case of a price ceiling – or those who are lucky enough to obtain a higher price for their services – in the case of a price floor – are made better off.

At the same time, those who are unable to secure the desired good, due to a shortage, or those who are unable to find a buyer for their goods, in the case of a surplus, are made worse off because of the price control.

The indirect effects of price controls

In addition to the direct effects of price controls, there are also a series of indirect negative effects emerging from government manipulation of prices.

While price controls do legally change the price, they cannot overcome the fundamental economic issue of deciding how to allocate scarce resources among an array of feasible alternatives. In the absence of the ability to use prices to ration scarce goods, alternative mechanisms emerge.

For example, shortages lead to long queues resulting from excess

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– Thomas Sowell

demand for the good or service in question. This dynamic was evident in the centrally planned economies of Eastern Europe as well as in the US in the 1970s when the government imposed price controls on petrol.

Long queues tend to lead to subsequent government interventions with rationing schemes. For example, the US government reacted to long queues for petrol by limiting consumer purchases of petrol to every second day depending on the last number of their registration plate.

The emergence of crime and black markets are other indirect negative effects of price controls. Unable to adjust prices legally, producers and buyers may move into the extra-legal market to engage in exchange. Others, desperate to obtain goods for which there is a shortage, may engage in theft.

To provide one illustration of black market activities, consider the case of farmers in the UK during World War II. Facing wartime meat rationing, many farmers would under-report animal births to the Ministry of Food and then sell the additional meat in the black market.

Yet another indirect effect of price controls is avoidance which can take on a variety of forms.

For example, facing a price ceiling, sellers may charge additional fees or tie-ins to compensate for the fact that prices are required to be artificially low. Yet another manifestation of price control evasion is deterioration in the quality of the product itself. This may include the substitution of low-quality for high-quality ingredients in the production of the good itself, poor customer service, or lower investment in maintaining or improving the provision of services: supply can be made equal to demand by changing either the price or the quantity and, if the first is illegal, the second will be used more often.

In addition to affecting customers in the short term, quality deterioration will also affect consumers in the long run. In the face of price controls, suppliers will have a disincentive to invest in expanding production of the controlled good in future periods.

For example, price controls on energy will discourage investments in increased energy production in the future. This is problematic precisely because this increased supply of energy would lower the

price of energy in the future, the very end that proponents of price controls are seeking.

Controls of energy prices have been tried before – and failed.

Returning to the present situation in the UK, what can we say about Ed Miliband's claim that price controls on energy would lower costs and improve standards of living?

It is true that the price of energy itself would be lower due to the legal mandate. But we would expect this to be offset with energy producers compensating on other margins either through additional fees or deterioration in service.

In this regard it would be wise to look at California's experience with price controls on retail energy which led to shortages, manifested in rolling power cuts throughout the state.

Most importantly, price controls would discourage energy companies from making new, long-term investments, which is precisely what is needed to increase the supply of energy and improve standards of living.

What this means is that, at best, Miliband's strategy can provide benefits in the form of lower energy bills in the short term, but with the associated cost of some form of quality deterioration both in the immediate term and long term. This is precisely the opposite of what citizens of the UK need to improve their well being.

One issue remains. Given the problems inherent with price controls, why do they continue to remain popular among politicians and much of the public?

The answer to this question lies in the important difference between the seen and unseen. Price controls are readily observable – i.e., seen – in that the public can readily observe the lower price set by government. Given the difficulty of understanding and tracing the unseen - both the direct and indirect effects of price controls – it appears to many that these controls are pure benefit with little to no cost.

But the economic way of thinking indicates this is wrong-headed. If the goal is to improve standards of living, policy must focus on incentivising improved quality and availability. Price controls do exactly the opposite and, therefore, must be dismissed as a fallacy.

In reality, price controls lower the standards of living of many while providing political gains to few•

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