DOCKETED	
Docket Number:	23-OIIP-01
Project Title:	Order Instituting Informational Proceeding on Maximum Gross Gasoline Refining Margin and Penalty
TN #:	256184
Document Title:	Idemitsu Response to RFI and Attachments
Description:	N/A
Filer:	Chester Hong
Organization:	Idemitsu Apollo Corporation
Submitter Role:	Public
Submission Date:	5/6/2024 8:23:43 AM
Docketed Date:	5/3/2024

SIDLEY

SIDLEY AUSTIN LLP
350 S. GRAND AVENUE
LOS ANGELES, CA 90071
+1 213 896 6000
+1 213 896 6600 FAX

AMERICA • ASIA PACIFIC • EUROPE

+1 310 595 9644
MAUREEN.GORSEN@SIDLEY.COM

May 3, 2024

By Email

California Energy Commission
Docket Unit
Docket No. 23-OIIP-01
715 P Street, MS-4
Sacramento, CA 95814
docket@energy.ca.gov

Re: SB X1-2 CEC RFI – Maximum Gross Refining Margin and Penalty

Dear All,

Idemitsu Apollo Corporation ("Idemitsu") appreciates the opportunity to continue to work with the California Energy Commission ("CEC") to further CEC's goals of (1) increased transparency, (2) decreased price spikes, and (3) increased liquidity in the liquid transportation fuel marketplace. Idemitsu is a fuel reselling company located in Sacramento, California that buys and sells products, primarily to jobbers and independent gas stations. Resellers like Idemitsu benefit consumers by providing an alternative to refinery-direct sales, bringing additional competition to the market and ensuring that independent, non-branded gasoline retailers have ample supply.

SB X1-2 expressly prohibits CEC from adopting a margin cap and penalty if those measures will potentially hurt California's consumers more than it may benefit them. As discussed in its written comments responding to the April 11 workshop, Idemitsu believes that a maximum gross gasoline refining margin and penalty will harm consumers more than it will benefit them because (1) refining margins and penalties cannot reduce costs to the consumer when refineries are constrained in production capacity, as they are today, and (2) imports will not be able to supplement refinery capacity, especially because CEC's muddled and onerous regulation of the spot market has already contributed to a substantial decline in imports of gasoline to the State. These two considerations make a maximum gross gasoline refining margin and penalty effectively a price cap on gasoline. As Hawaii's experiment with price caps demonstrates, this approach will fail, cause tremendous disruptions, and raise prices for consumers as a result.

This view is hardly novel. For the benefit and convenience of CEC, we have collected and attached to this letter various scholarly articles, news stories, and other publications discussing the dangers of imposing a margin cap or price cap on gasoline. We hope CEC will

consider these materials, which show that the contemplated margin cap and penalty regime will ultimately harm consumers.

Attached hereto are the following materials:

- Justin-Damien Guenette, "Price Controls Good Intentions, Bad Outcomes," World Bank Prospects Group, Apr. 2020.
- Federal Trade Commission, "Gasoline Price Controls Would Likely Harm Hawaii's Consumers," Jan. 28, 2003.
- Federal Trade Commission, Testimony of Jerry Ellig, Jan. 28, 2003.
- David R. Henderson, "Price Controls: Still a Bad Idea," Hoover Institution, Jan. 20, 2022.
- Pierre Lemieux, "A Strange Ignorance of the Effect of Price Caps," Econlib, Feb. 12, 2024.
- Melissa Pavlicek, "Another Perspective – Gas Cap Has Been Costly for Consumers," Honolulu Star, Mar. 26, 2006.
- George Reisman, "Price Controls Cause Shortages," Foundation for Economic Education, Feb. 1, 1980.
- Norbert Michel, "Price Controls Do Not Work – Even in Credit Markets," Forbes Business Policy, Jul. 27, 2021.
- Vincent Geloso, "Price Controls Don't Fight Inflation: 40 Centuries of Evidence," American Institute for Economic Research, Oct. 3, 2023.
- Editorial Staff, "Why Price Controls Don't Work," Fisher Investments, June 7, 2022.
- Monica Samuel, "Price Controls: 5 Spectacular Failures," StockViz, July 1, 2013.
- Alex Horenstein et. al., "Price Controls Are Disastrous. Just Ask South America," The Dispatch, Feb. 9, 2022.
- Fundacion Civismo, "How Price Controls Fail," Jan. 24, 2020.

- Jon Miltmore, "4,000 Years of Failed Price Controls," American Institute for Economic Research, Sept. 23, 2022.
- Shanker Singham et. al., "The Unnecessary Revival of Price Controls Should Worry Us All," The Hill, June 2, 2023.
- Adrian Moore, "Price Caps Will Not Solve Electricity Problem," Reason Foundation, Apr. 19, 2001.
- Centrica, "Why Price Caps Don't Work for Customers," last accessed May 3, 2024.
- European Energy Exchange, "Price Caps on Wholesale Gas Markets Lead to Significant Negative Side Effects Without Having the Desired Results," last accessed May 3, 2024.

* * * * *

Thank you for your consideration. Idemitsu is committed to working with CEC to minimize disruptions to the California transportation fuels market to the benefit of California consumers. As always, Idemitsu would appreciate the opportunity to discuss these matters with CEC.

Regards,

Maureen F. Gorsen
Partner

Policy Research Working Paper 9212

Price Controls

Good Intentions, Bad Outcomes

Justin-Damien Guénette

WORLD BANK GROUP
Prospects Group
April 2020

Policy Research Working Paper 9212

Abstract

The use of price controls is widespread across emerging markets and developing economies, including for food and key imported and exported commodities. Although they are sometimes used as a tool for social policy, price controls can dampen investment and growth, worsen poverty outcomes, cause countries to incur heavy fiscal burdens, and complicate the effective conduct of monetary policy. Replacing price controls with expanded and better-targeted social safety nets, coupled with reforms to encourage competition and a sound regulatory environment, can be pro-poor and pro-growth. Such reforms need to be carefully communicated and sequenced to ensure political and social acceptance. Where they exist, price control regimes should be transparent and supported by well-capitalized stabilization funds or national hedging strategies to ensure fiscal sustainability.

This paper is a product of the Prospects Group. It is part of a larger effort by the World Bank to provide open access to its research and make a contribution to development policy discussions around the world. Policy Research Working Papers are also posted on the Web at http://www.worldbank.org/prwp. The author may be contacted at jguenette@worldbank.org.

Price Controls: Good Intentions, Bad Outcomes

Justin-Damien Guénette*

JEL Classification: *E62, E64, H24, H25, I38*
Keywords: *Price Control; Price Policy; Incomes Policy; Public Expenditures; Nonbusiness Subsidy; Subsidies; Safety Net; Social Welfare Programs.*

* Prospects Group of the Equitable Growth, Finance and Institutions Global Practice, World Bank; jguenette@worldbank.org. This paper benefited from valuable contributions, comments, and suggestions made by Carlos Arteta, Kevin Clinton, Ayhan Kose, Franziska Ohnsorge, and Chris Towe. Shijie Shi provided excellent research assistance. The findings, interpretations and conclusions expressed in this paper are entirely those of the author and should not be attributed to the World Bank, its Executive Directors, or the countries they represent.

1. Introduction

Price distortions are defined as instances "when prices and production are higher or lower than the level that would usually exist in a competitive market" (WTO 2019). One source of such distortions is price controls. Price controls have a long history with well documented examples stretching back to Revolutionary France (Morton 2001). In the 20th century, these policies were used extensively in several Western countries during the Second World War, culminating with widespread controls in the United States and the United Kingdom in the 1970s (Coyne and Coyne 2015). Price controls were also ubiquitous in communist countries with planned economies, such as Poland (Tarr 1994). Generalized price controls fell out of favor in the 1980s, as inflation declined, and governments pursued deregulation.[1] However, controlled pricing for certain goods and services, including rent and pharmaceuticals, remain in use to this day (Morton 2001).

Price controls can be imposed in a variety of ways. They may involve price ceilings, or price floors, imposed on selected goods and services by the authorities. Government management of prices can also occur as a by-product of other policies. For instance, preferential exchange rates for certain goods and the imposition of non-tariff barriers can all push prices away from that which would prevail in a competitive market. In emerging markets and developing economies (EMDEs), price controls on goods are often imposed to serve social and economic objectives. They may be part of government efforts to protect vulnerable consumers, by addressing market failures or subsidizing the cost of essential goods. Or they may be intended to maintain the incomes of producers, as part of a price-support program. Alternatively, they can serve the purpose of price smoothing, especially for key commodities subject to high volatility in international markets. This can lower uncertainty about households' real incomes and firms' production costs.

The modern micro-founded theory of price controls was developed in part to examine the case of commodity producers in developing countries (Stiglitz and Newbery 1979; Newbery and Stiglitz 1982). More recently, for EMDEs, price controls for petroleum products have been studied extensively, while those on food products have received less attention (Verme and Araar 2017; Kojima 2013; Devarajan 2013; Murphy et al. 2019; Shi and Sun 2017; Clements, Jung and Gupta 2007; Ghosh and Whalley 2004). The World Bank's Energy Sector Management Assistance Program (ESMAP) has conducted in-depth studies of subsidy reforms for energy markets across EMDEs (ESMAP 2019; Ore et al. 2018). The use of price controls for pharmaceutical products, wages and rent has been widely studied in advanced economies (e.g., Coyne and Coyne 2015; Nguyen et al. 1994). Studies for individual EMDEs include China, Indonesia and several MENA countries (Shi and Sun 2017; Clements, Jung and Gupta 2007; Verme and Araar 2017).

[1] The use of price controls has also often coincided with historical episodes of hyperinflation. In Brazil in the 1980s, for example, the use of price controls proved ineffective at addressing hyperinflation (Cardoso 1991). More recently, in the case of Zimbabwe, widespread shortages of goods in part due to excessively accommodative monetary policy were accompanied by extensive price controls (Munoz 2006; Coomer and Gstraunthaler 2011). Similarly, high inflation in the República Bolivariana de Venezuela was accompanied by highly restrictive price controls (Vera 2017; Contreras and Guarata 2013).

Against this backdrop, this paper seeks to determine the prevalence of price controls across EMDEs. To help answer the first question, this research contributes to the literature on price controls by presenting the findings from a new data set covering an almost complete set of EMDEs. This data set extracts the list of products subject to price controls from the latest available Trade Policy Reviews for each EMDE member country of the World Trade Organization. This list of products is compiled using existing legislation and additional material provided by country authorities. The data set provides a rough view of the prevalence of price control measures across countries. When combined with detailed information on country-level trade flows, the data set also provides an indication of imports and exports potentially subject to controls.[2] Armed with this data set, this study finds that while price controls are seldom imposed on goods in advanced economies, they are near ubiquitous in EMDEs and LICs in particular.

Second, this study seeks to enumerate the challenges that price controls impose for growth and development and government policies. While they may be introduced with the best intentions to improve social outcomes, available evidence suggests that price controls often undermine growth and development, impose fiscal burdens and can weaken the effectiveness of monetary policy. At least in part, this is because price controls cause a shift in consumption towards the subsidized good, and away from other non-subsidized goods. Moreover, when there are trend increases in international prices, or when they interact with barriers to entry, price control measures frequently morph into distortive subsidy regimes. Important social, fiscal and environmental costs are likely to follow, as well as adverse consequences for investment and employment, and productivity growth.

2. Use of price controls

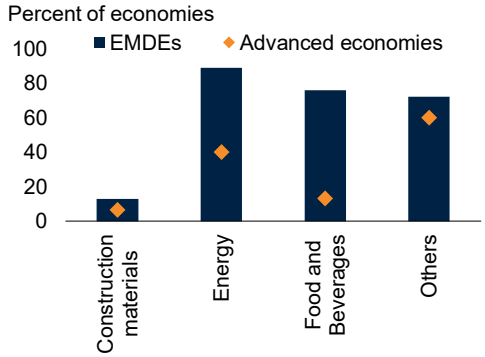
Price controls on goods and services

Price controls are widely employed across advanced economies and EMDEs. They tend to be much more pervasive in EMDEs than in advanced economies, especially so for energy and food-related goods (Figure 1.A). The relatively high prevalence of other types of price controls in advanced economies reflects the greater prevalence of controls for services such as telecommunications. While price control regimes tend to be more restrictive in EMDEs when compared to advanced economies, the extent of controls varies greatly across economies (Figure 1.B).

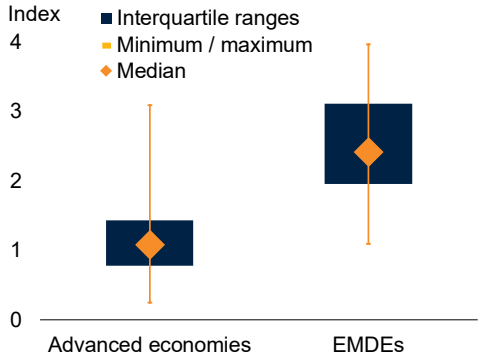
[2] Data on price controls on tradable goods combines the information on controlled prices from the World Trade Organization's Trade Policies Reviews with 4-digit HS trade values from the World Bank's World Integrated Trade Solutions database.

Figure 1. Prevalence of Price Controls: EMDEs and advanced economies

A. Price controls in EMDEs and advanced economies



B. Extent of price controls in EMDEs and advanced economies (0 least – 6 most restrictive)



Source: OECD and World Bank 2018; World Bank; World Trade Organization.

A. EMDEs = emerging markets and developing economies. Sample includes 100 EMDEs and 15 advanced economies. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication.

A. B. Unweighted averages.

B. OECD-WBG Product Market Regulation "Price controls" sub-indicator evaluating the extent and type of price controls in 8 sectors (air transport, road freight transport, retail distribution, telecommunication, electricity, gas, water, professional services).

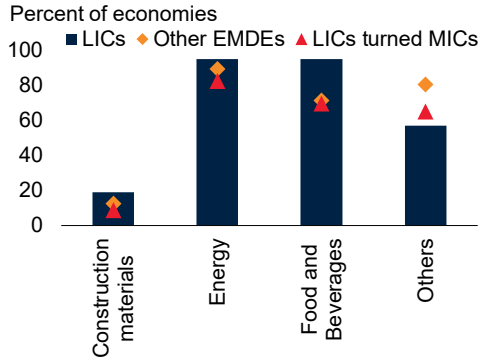
Among EMDEs, they are more prevalent in LICs (Figure 2.A). In EMDEs that have become middle-income countries (MICs) since 2001, price controls are somewhat less common than in the average EMDE, especially in goods other than energy, food, and construction materials.[3,4] Virtually all EMDEs, impose price controls on energy products. Price controls are also frequently applied to basic foodstuffs. This practice is more widespread in LICs than in other EMDEs: virtually all LICs impose price controls on some food items, compared with three-quarters of other EMDEs. Lastly, a minority of EMDEs impose price controls on construction materials. The prevalence of these controls is significantly higher in LICs thank in other EMDEs. Beyond LICs, controls on construction materials are most common in the Middle East and North Africa (MNA) and Sub-Saharan Africa (SSA; Figure 2.B).

[3] The set of LICs in 2001 that are now MICs includes Angola, Armenia, Azerbaijan, Bangladesh, Bhutan, Côte d'Ivoire, Cameroon, the Republic of Congo, the Comoros, Georgia, Ghana, Indonesia, India, Kenya, Kyrgyz Republic, Cambodia, the Lao People's Democratic Republic, Lesotho, the Republic of Moldova, Myanmar, Mongolia, Mauritania, Nigeria, Nicaragua, Pakistan, Sudan, Senegal, Solomon Islands, São Tomé and Príncipe, Turkmenistan, Ukraine, Uzbekistan, Vietnam, Zambia and Zimbabwe.

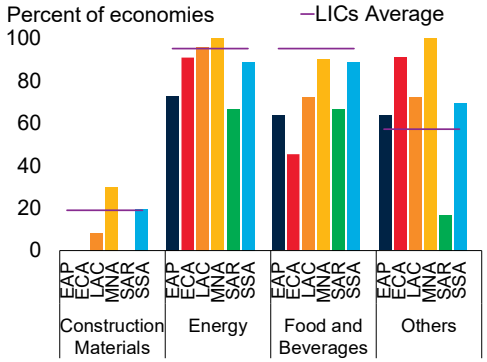
[4] Almost all LICs, including Ethiopia, Mali, Niger, Guinea and Rwanda, impose some form of price controls on petroleum products. As for food products, LICs such as Burkina Faso and the Democratic Republic of Congo impose price controls on sugar. Chad, Haiti and Guinea-Bissau impose controls on rice, and Benin, Ethiopia and Niger impose controls on bread. Burkina Faso imposes controls on cement, reinforcing bars and metal sheets. In addition to goods, price controls are also often imposed on public transportation services such as bus, train, and ship fares.

Figure 2. Prevalence of Price Controls: LICs vs Other EMDEs

A. Price controls in LICs and other EMDEs



B. Economies with price controls by sub-region

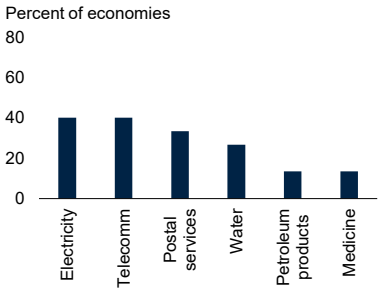


Source: World Bank; World Trade Organization.
A.B. EMDEs = emerging markets and developing economies; LICs = low-income countries. Sample includes 21 low-income countries and 79 other EMDEs, which include 23 low-income countries turned middle-income countries.
A. Unweighted averages. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication.
B. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication. Unweighted averages. EAP = East Asia and Pacific, ECA = Europe and Central Asia, LAC = Latin America and the Caribbean, MNA = Middle East and North Africa, SAR = South Asia, SSA = Sub-Saharan Africa.

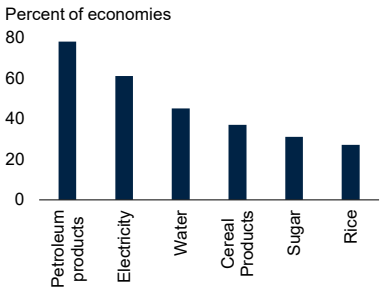
Individual goods and services most frequently subject to controls vary noticeably across advanced economies and EMDEs, but little across LICs and other EMDEs (Figure 3.A-C). Whereas controls in advanced economies are most frequently imposed on basic utilities such as electricity and water, and telecommunication and postal services, controls in EMDEs are much more frequently applied to petroleum products such as gasoline and liquified petroleum gas, as well as food products including flour, bread, sugar and rice. Less prevalent goods and services subject to controls include various pharmaceutical products, services such as the provision of medical care, public sanitation and transportation, as well as construction materials such as cement, reinforcing bars, and metal sheets.

Figure 3. Goods most frequently subject to price controls

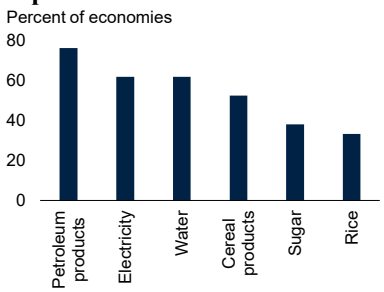
A. Goods most frequently subject to price controls in advanced economies



B. Goods most frequently subject to price controls in EMDEs other than LICs



C. Goods most frequently subject to price controls in LICs



Source: World Bank; World Trade Organization.
A.B.C. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication.

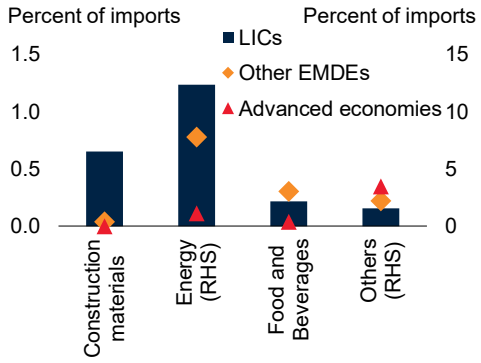
B. Sample includes 15 advanced economies.
B. Sample includes 100 emerging markets and developing economies.
C. Sample includes 21 low-income countries.

Price controls on exports and imports

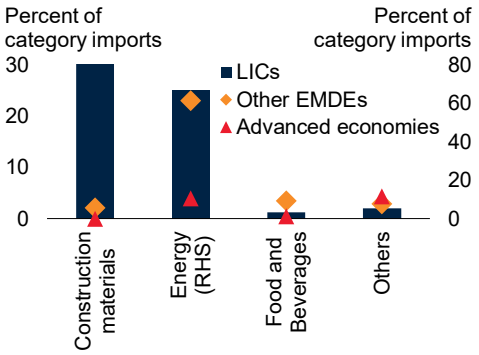
EMDEs, including LICs, apply price controls on export and import goods.[5] Governments often impose controls on the domestic prices of imports to maintain real incomes of domestic consumers, hold down costs to producers, or smooth domestic price volatility. In LICs, about 67 percent of energy imports—about 6 percentage points more than the average for other EMDEs—are potentially subject to domestic price controls (Figure 4.A-B). In both LICs and other EMDEs, only a small share of food and beverages imports are potentially subject to controls. The largest difference between LICs and other EMDEs lies in the share of construction-related imports that are potentially subject to price controls: in LICs, they amount to one-quarter of imported construction materials, compared with almost none in other EMDEs. In contrast to the case of EMDES, the amount of advanced economy imports potentially subject to controls is negligible.

Figure 4. Price controls on imported goods

A. Share of total imports subject to price controls



B. Share of 2-digit HS category imports subject to price controls



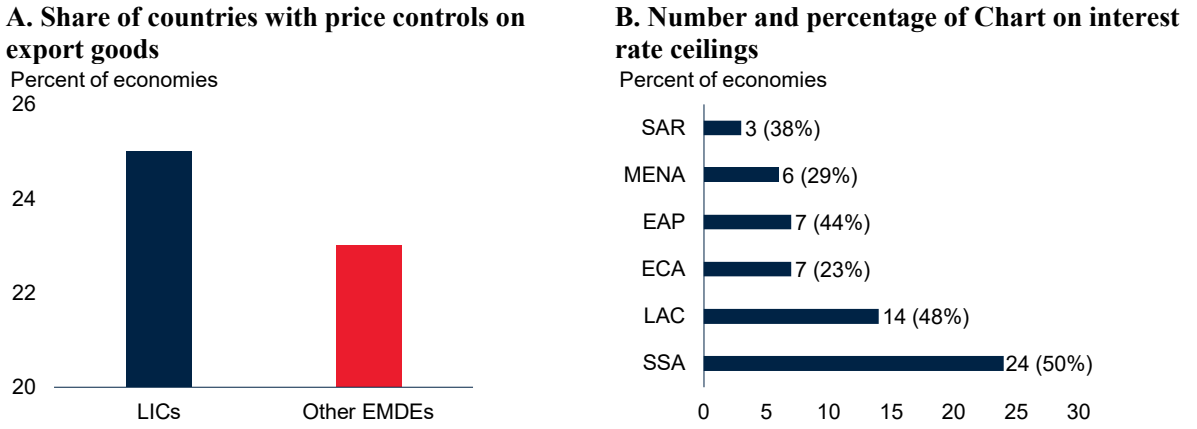
Source: World Bank; World Integrated Trade Solution (WITS); World Trade Organization
A.B. EMDEs = emerging markets and developing economies; LICs = low-income countries.
A. 2017 data. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication. Sample includes 12 low-income countries, 63 other EMDEs and 6 advanced economies.
B. 2017 data. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication. Sample includes 12 low-income countries, 63 other EMDEs and 6 advanced economies. Share of 4-digit Harmonized System (HS) category subject to controlled prices in high-level groupings of 2-digit HS categories. Construction materials aggregate includes HS68 and HS73, Energy aggregate includes HS27, Food and Beverage aggregate includes HS01 to HS22. Other aggregate includes all other imports.

EMDEs often impose price controls on exportable commodities. This may involve a monopoly marketing agency, which purchases from domestic producers at a fixed price, and resells to foreign purchasers at the world price. This arrangement implicitly taxes producers when the resale price exceeds the purchase price (Ghosh and Whalley 2004) or subsidizes producers when the resale price falls below the purchase price. About 25 percent of EMDEs that rely heavily (with more than 10 percent of goods exports) on a single export commodity group impose price controls on it

[5] Unregulated prices depend on the world price, transport costs, local monopoly power or other hurdles to the movement of goods, and harvest conditions (Aksoy and Ng 2010).

(Figure 5.A). For example, Burundi imposes controls on the price of coffee while Benin imposes controls on cashew nuts. Contrary to some EMDEs, advanced economies do not impose price controls on exportable commodities.

Figure 5. Price controls on exported goods and financial products



Source: World Bank; World Integrated Trade Solution (WITS); World Trade Organization
A. 2017 data. Listed price control policies are retrieved from the latest (2003-19) country Trade Policy Review publication. Countries that rely heavily on a single export defined as a country in which exports of one or more 4-digit HS category represents 10 percent or more of its total exports in 2017. Chart shows the share of all LICs and other EMDEs that relying heavily on a single export whose price is subject to price controls. Sample includes 12 low-income countries and 61 other EMDEs.
B. Replication of Figure 1 of Maimbo and Gallegos 2014.

While not covered in the price control data set, the financial sector is also often a target of price controls. Around 60 EMDEs have imposed ceilings on interest rates (Figure 5.B). These measures are often motivated by a desire to provide targeted support to strategic industries or to shield consumers from financial exploitation. For example, in the case of Zambia, controls were implemented from 2012 to 2015 to reduce the perceived risk of over indebtedness and broaden access to credit (Maimbo and Gallegos 2014).

3. Reforms of price control regimes

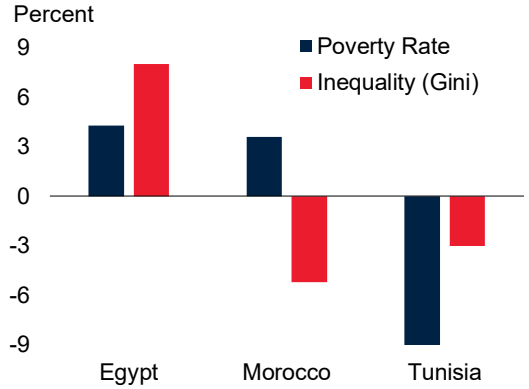
Starting in the 1980s, several EMDEs reduced the scope of price controls, opting instead to strengthen their competition policies and regulation (WTO 2000-2019). In some cases, the liberalization of prices was supported and encouraged by policy lending programs and debt relief efforts in highly indebted poor countries (HIPC). The removal of controls often become more feasible following an easing of the conditions that led to their imposition. For example, after 2011, as food prices declined from cyclical highs, some countries eliminated controls. EMDEs such as Mexico, Rwanda, and Côte d'Ivoire took advantage of the sharp decline in oil prices in 2014-16 to reduce petroleum subsidies (Baffes et al. 2018; Stocker et al. 2015).

Reforms in the Arab Republic of Egypt, Morocco, and Tunisia

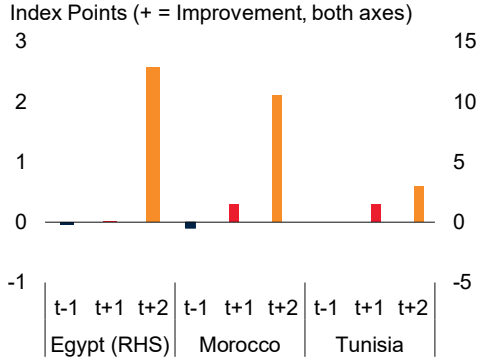
Under pressure from social tensions during the Arab Spring, some countries in the MENA region introduced or tightened food price controls in 2011 (Ianchovichina, Loening and Wood 2014). Conversely, however, high oil prices and fiscal pressures encouraged a few MENA countries, including the Arab Republic of Egypt, Morocco, and Tunisia, to reform price controls and related subsidies on energy between 2010 and 2014 (Verme and Araar 2017).[6] Some of the reforms were estimated to have reduced inequality and/or poverty rates (Figure 6.A). The reforms were also associated with improvements in the ease of doing business. Within two years of the reform, enterprises in all three countries reported easier access to electricity (Figure 6.B). The programs, however, differed substantially in their scope, and speed of implementation. They also varied with respect to compensatory transfers to disadvantaged population groups. Morocco reduced the fiscal burden of petroleum subsidies, while at the same time avoiding severe adverse consequences for poverty and inequality. Egypt, however, took a sequential, gradual, approach to reform especially for products such as liquified petroleum gas (LPG), which account for a disproportionately large expense for the poor.

Figure 6. Some impacts of price control reforms

A. Model-based estimates of impacts of reforms on poverty and inequality



B. Impact of reforms on ease of doing business (access to electricity)



Source: Verme and Araar 2017, World Bank.

A. Impacts of reforms on the poverty rate and the level of inequality estimated using SUBSIM model.

B. Chart shows the World Bank's index for ease of getting electricity in year before (t-1) and the two years after (t+1, t+2) energy subsidy reform (World Bank 2019b). Time t=0 refers to 2014 for Egypt and Morocco and 2012 for Tunisia.

In Egypt in July 2014, comprehensive reforms to fuel and electricity prices resulted in a significant rise in gasoline, natural gas, diesel, and electricity prices which contributed to a spurt of headline inflation. Initial price adjustments were followed by stepwise gradual increases to fully eliminate energy subsidies over a five-year period. While the initial price increases themselves are estimated to have raised the poverty rate and inequality, the government has put in place some mitigating

[6] Djibouti, Egypt, Jordan, Libya, Morocco, Tunisia, and the Republic of Yemen designed and implemented subsidy reform programs. These cases contrast with some other countries in the region, where social tensions during the Arab Spring caused an increased use of food price controls in 2011 (Ianchovichina, Loening, and Wood 2014).

measures for the poor, including expanding food subsidies. Moreover, the government used a share of the proceeds from the reforms to increase expenditures on health care and education provision (ESMAP 2017a). However, attempts to communicate to the affected public that they might eventually benefit from the diversion of energy subsidies to more equitable uses failed, largely because the country does not have the social security net to implement an effective system of cash compensation (Verme and Araar 2017).

Starting in 2013, the Government of Morocco first transitioned to price indexation for petroleum products, and gradually moved to fully liberalize most energy products. In August 2014, prices of household utilities jumped as part of a multiyear effort to liberalize electricity prices. The reforms were implemented without triggering social unrest despite the absence of cash transfers to households. The fiscal savings from the reform were instead used to fund other reforms.

The fiscal cost of Tunisia's energy subsidies had risen to unsustainable levels (7 percent of GDP in 2013), and in response the government gradually reduced them beginning in late 2012 in tandem with reforms to social benefits. Petroleum and electricity prices were increased over 2012-13 and an automatic price formula was introduced for gasoline in 2014. In 2016, the government agreed to further reduce subsidies as part of a reform program supported by IMF lending. Energy prices were increased several times since then, with the goal of fully eliminating energy subsidies by 2022. Over the years, measures were implemented to cushion the impact of reforms on vulnerable households, including expanded social housing and higher income tax deductions.

Reforms in Ukraine and India

In Ukraine in 2015-16, the government raised the price of natural gas, which had been heavily subsidized for decades. These reforms were coupled with a strong public communication campaign highlighting social assistance mechanisms targeted to cushion the impact on low-income households. The reforms were successful in allowing public utilities to achieve cost recovery, with the targeted support measures estimated to have reduced the poverty rate (ESMAP 2017b).

In India starting in 2012, the government reformed its subsidy regime for liquified petroleum gas (LPG). LPG subsidies to households encouraged the formation of black markets where subsidized LPG distributed to households was diverted to the commercial sector. The government gradually increased the price of LPG for households while implementing a large-scale targeted cash transfer mechanism. The program successfully eliminated distortions in the LPG market, with limited adverse consequences for the poor, and the fiscal savings obtained from the reduction in subsidies fully offset the costs of the targeted cash transfer (ESMAP 2016).

4. Challenges of price controls

While they may be introduced with the best intentions to improve social outcomes, price controls often undermine growth and development, impose fiscal burdens and can weaken the effectiveness of monetary policy. At least in part, this is because price controls cause a shift in consumption towards the subsidized good, and away from other non-subsidized goods. Moreover, when there are trend increases in international prices, or when they interact with barriers to entry, price control

measures frequently morph into distortive subsidy regimes. Important social, fiscal and environmental costs are likely to follow, as well as adverse consequences for investment and employment, and productivity growth.

Growth challenges

The use of price controls can have adverse consequences for growth for several reasons. Price ceilings can depress producer margins and discourage domestic investment and entrepreneurial activity, as in Zimbabwe's transportation sector (Newfarmer and Pierola 2015). If margins depend on subsidies to local businesses to compensate for price controls, they can discourage foreign investment in those sectors by increasing the country risk premium facing global firms (Sabal 2005). In the opposite case, where the controlled price is above that required for a competitive return to investment, its maintenance requires barriers to entry or costly government stockpiling of excess supply (a common occurrence with price support schemes in agriculture). Price-support controls can depress competition and sustain high producer margins (e.g., Rwanda's transportation sector; Teravaninthorn and Raballand 2009).

Price control regimes may also tilt the allocation of resources towards the subsidized sector. In LICs, this is often most visible in the agricultural sector where output price controls have been complemented by input (especially fertilizer) subsidies. Yet, such policies can end up reducing productivity, and worsening income inequality (Goyal and Nash 2017). They may lead to inefficient use of subsidized inputs (Jayne, Mason, Burke and Ariga 2016). They can also adversely affect incentives to adopt productivity-raising new technologies. Empirical evidence suggests that market-oriented structural reforms, including the reduction of price controls and their related subsidies, are strongly associated with improved firm-level productivity in EMDEs (Kouame and Tapsoba 2018). Conversely, in the case of petroleum products in the Middle East and North Africa, high subsidies that underpin price controls appear to be associated with lower per capita output growth (Mundaca 2017).

Moreover, price controls that distort consumption towards price-controlled goods, can cause chronic shortages of these goods, the formation of parallel markets with higher prices, and substitution towards lower-quality alternatives (Weitzman 1991; Patel and Villar 2016; Fengler 2012; Winkler 2015). Similarly, producers of price-controlled goods may turn to black markets which have elevated transaction costs and lack basic regulation (Murphy, Pierru and Smeers 2019). In addition, the situation encourages production to shift to firms in the informal sector, which avoid regulation (De Soto 2000; World Bank 2019a).

Price controls in the financial sector, such as ceilings on interest rates, can distort financial markets (Maimbo and Gallegos 2014). These measures reduce the supply of credit to safer borrowers and small and medium-sized enterprises, increase the level of non-performing loans, reduce competition and innovation in lending markets, and increase informal lending. Moreover, they can exacerbate inequality by limiting the poor's access to lending. At the same time, price controls and subsidies on energy products may heighten vulnerability to climate change and inhibit the transition to a climate-resilient, low-carbon economy.

Policy challenges

Price controls can cause significant social policy and political economy challenges. The use of price controls combined with large subsidies is an inefficient tool for redistributing domestic income (Devarajan 2013; Coyne and Coyne 2015). These policies tend to be inequitable, as wealthier segments of the population, usually urban consumers, benefit disproportionately given their greater consumption of the price-controlled good compared to rural consumers and producers. For example, subsidies and below-market prices for gasoline and liquid natural gas have proven highly regressive, with only a small share of the subsidy benefiting the poorest segments of the population (Baffes et al. 2015; IEG 2008; Coady et al. 2006).

These policies also pose mounting fiscal challenges. Price controls impose an explicit or implicit set of taxes and subsidies that varies over time, and their enforcement may require additional regulations to constrain consumption and production. Typically, a system of price controls on goods ends up as a growing burden on either the fiscal budget and public debt or the profitability of producers (Alleyne 2013; World Bank 2014a). Potential or implicit fiscal costs from price controls can be particularly high in LICs due to their more widespread use of these policies. Even in EMDEs, subsidies for products subject to price controls, such as petroleum, can be a large portion of government expenditures, in some cases exceeding 10 percent of GDP (Algeria, the Islamic Republic of Iran; World Bank 2014b).

Lastly, they also pose challenges to the effective conduct of monetary policy. In all advanced economies, and in many EMDEs, monetary policy has played a major role in reducing inflation to a low, stable rate, often in the context of an explicit inflation-targeting regime. The key has been a transparent strategy aimed at the medium and longer term. This has largely stabilized longer-run expectations of inflation, in line with central bank objectives. In these circumstances, the one-off impact on the inflation rate of the removal of price controls can be handled with the help of careful communication from policy makers as to the strategy they will employ to get inflation back on track.

In LICs, however, the monetary policy challenges go deeper. First, the wider use of price controls complicates the choice of inflation target by weakening the usefulness of the overall CPI as a measure of underlying inflation pressures (Patel and Villar 2016). In addition, volatility in headline CPI inflation is amplified by the high proportion of food in the LIC consumer basket. Food prices are liable to frequent large fluctuations from variations in local harvests, and in international supply and demand. Second, it can raise inflation because the authorities tend to respond asymmetrically when faced with cost increases, as is often the case in response to food price shocks (De Mello 2008; Ianchovichina, Loening and Wood 2012). Third, it can increase the stickiness of the inflation process as changes in controlled prices often involve a lengthy regulatory process (Springer de Freitas and Bugarin 2007). Fourth, one-off changes in controlled prices can have persistent effects on inflation in LICs, where inflation expectations are less well anchored (Ha, Kose, and Ohnsorge 2019a; BIS 2003). Lastly, price controls in the financial sector, including ceilings on interest rates, can reduce the ability of monetary policy to affect financial conditions.

LICs are also more vulnerable to the collateral damage from other countries' price controls on food and energy, because of the high share of food and energy in their consumption baskets and trade. Policies by individual countries to contain the effects of spikes in global commodity process in their local markets have been shown to have had the perverse effect of raising global prices (Laborde, Lakatos, and Martin 2019). Export restrictions in major commodity producers exacerbate global shortages, thus contributing to higher prices on the international market. In the case of the 2007-08 surge in food prices, a majority of EMDEs put in place policies to insulate domestic markets from the rise in international prices (World Bank 2009).

5. Policy implications

Price controls have been used to mitigate the impact of commodity price volatility on the most vulnerable members of society. For instance, the use of temporary stabilization funds, as introduced in Chile and Peru, or national hedging strategies, as introduced in Mexico, have been used to protect domestic consumers and firms from spikes in the prices of basic commodities on international markets (Kojima 2013; Ma and Valencia 2018). However, most governments have had difficulty designing frameworks that deliver lasting benefits. Over time, price stabilization policies often result in costly and distortionary subsidies, posing important challenges to growth, development, and macroeconomic policy, suggesting that other policy instruments may be more effective in achieving social protection objectives.

Replacing price controls with expanded and better-targeted social safety nets, coupled with structural reforms, can be both pro-poor and pro-growth. Indeed, policies to lower subsidies that underpin price controls appear to be associated with higher per capita output growth, in part because savings generated by lower subsidies can fund productivity-enhancing education and infrastructure (Mundaca 2017). The removal of price controls needs to be coupled with targeted support for those segments of the population that might be adversely affected. Despite the regressive nature of price controls and subsidies, poor households spend a higher share of their income on products subject to price controls and are liable to suffer distressful real income losses when price restrictions are lifted (World Bank 2014a). In India, for example, the removal of price controls was accompanied by targeted cash transfers and in Brazil by targeted assistance to low-income households for energy conservation (Deichmann and Zhang 2013). The different prongs of reforms, however, need to be carefully sequenced and communicated.

Improving the competitive environment can be a more effective means of lowering costs to consumers and producers than the use of price controls. Carefully-designed and properly enforced antitrust laws and consumer protection legislation are essential components of institutional frameworks that support market mechanisms. A sound legal and regulatory framework favoring competitive markets provides a more effective response to many of the problems that price controls attempt to address (Kovasic 1995). For example, the removal of price controls and barriers to entry in the transportation sector significantly increased competition and lowered transportation costs in Rwanda (Teravaninthorn and Raballand 2009). Even in the case where incumbent firms maintained outsized market shares, the presence of competition, and the potential for new entrants, significantly lowered their markups (World Bank 2006).

6. Conclusion

Price controls, although also used in advanced economies, are particularly ubiquitous in EMDEs and LICs, especially for energy commodities. While often implemented with the best social intentions in mind, these policies often distort markets and their consequences for growth, poverty reduction and government policies grow over time. Countries can replace price controls with expanded and better-targeted social safety nets, coupled with reforms to encourage competition and a sound regulatory environment. Evidence suggests that such comprehensive price control reforms can be both pro-poor and pro-growth. However, historical experience highlights the need for careful communication and sequencing of reform efforts to ensure political and social acceptance. Where they exist, authorities can ensure that price control regimes are transparent and supported by well-capitalized stabilization funds or national hedging strategies to ensure fiscal sustainability.

References

Aaron, H. 1966. "Rent Controls and Urban Development: A Case Study of Mexico City." Social and Economic Studies 15 (4): 314-328.

Aksoy, A., and F. Ng. 2010. Food Prices and Rural Poverty. Washington, DC: World Bank.

Alleyne, T. 2013. Energy Subsidy Reform in Sub-Saharan Africa: Experiences and Lessons. Washington, DC: International Monetary Fund.

Baffes, J., M. A. Kose, F. Ohnsorge, and M. Stocker. 2015. "The Great Plunge in Oil Prices: Causes, Consequences, and Policy Responses." World Bank Policy Research Note 15(01).
Bank for International Settlements (BIS). 2003. Fiscal Issues and Central Banking in Emerging Economics. BIS Paper 20, Bank for International Settlements, Basel.

Cardoso, E. 1991. "Deficit Finance and Monetary Dynamics in Brazil and Mexico." Journal of Development Economics 37 (1-2): 173-197.

Clements, B., H.-S. Jung, and S. Gupta. 2007. "Real and Distributive Effects of Petroleum Price Liberalization: The Case of Indonesia." The Developing Economies XLV (2): 220-237.

Coady, D., M. El-Said, R. Gillingham, K. Kpodar, P. Medas, and D. Newhouse. 2006. "The Magnitude and Distribution of Fuel Subsidies: Evidence from Bolivia, Ghana, Jordan, Mali, and Sri Lanka." IMF Working Paper 06/247, International Monetary Fund, Washington, DC.

Contreras, J., and N. Guarata. 2013. "Inflacion y Variacion de Precios Relativos en Venezuela." Economia 38 (36) : 85-122.

Coomer, J., and T. Gstraunthaler. 2011. "The Hyperinflation in Zimbabwe." The Quarterly Journal of Austrian Economics 14(3): 311-346.

Coyne, C. and R. Coyne, eds. 2015. Flaws and Ceilings Price Controls and the Damage They Cause. London: Institute of Economic Affairs.

De Mello. L., ed. 2008. Monetary Policies and Inflation Targeting in Emerging Economies. Paris: Organisation for Economic Co-operation and Development.

Deichmann, U., and F. Zhang. 2013. Growing Green the Economic Benefits of Climate Action. Washington, DC: World Bank.

De Soto, H.. 2000. The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else. New York: Basic Books.

Devarajan, S., and M. Giugale. 2013. "The Case for Direct Transfers of Resources Revenues in Africa". Working Paper 333, Center for Global Development, Washington, DC.

ESMAP (Energy Sector Management Assistance Program). 2017a. "Ukraine." Energy Subsidy Reform Facility Ukraine Country Brief, World Bank, Washington, DC.

———. 2017b. "Egypt." Energy Subsidy Reform Facility Ukraine Country Brief, World Bank, Washington, DC.

———. 2019. "Lifting the Burden of Electricity Subsidies, While Expanding Access." Energy Subsidy Reform Facility Rwanda Country Brief, World Bank, Washington, DC.

Fengler, W. 2012. "How Price Controls Can Lead to Higher Prices." World Bank Blogs, World Bank, Washington, DC.
Ghosh, M., and J. Whalley. 2004. "Are Price Controls Necessarily Bad? The Case of Rice in Vietnam." Journal of Development Economics 73(1): 215-232.

Goyal, A., and J. Nash. 2017. Reaping Richer Returns: Public Spending Priorities for African Agriculture Productivity Growth. Africa Development Forum. Washington, DC: World Bank.

Ha, J., M. A. Kose, and F. Ohnsorge, eds. 2019. Inflation in Emerging and Developing Economies: Evolution, Drivers, and Policies. Washington, DC: World Bank.

Ianchovichina, E., Loening, J. and Wood, C. 2012. "How Vulnerable are Arab Countries to Global Food Price Shocks?" Policy Research Working Paper 6018, World Bank, Washington, DC.

IEG (Independent Evaluation Group). 2008. "Climate Change and the World Bank Group. Phase 1—An Evaluation of World Bank Win-Win Energy Policy Reforms." World Bank, Washington, DC.

Jayne, T. S., N. M. Mason, W. J. Burke, and J. Ariga. 2016. "Agricultural Input Subsidy Programs in Africa: An Assessment of Recent Evidence." Working Paper 245892, Department of Agricultural, Food, and Resource Economics, Michigan State University.

Kojima, M. 2013. “Petroleum Product Pricing and Complementary Policies.” World Bank Policy Research Working paper 6396, World Bank, Washington, DC.

Kouame, W., and S. J.-A. Tapsoba. “Structural Reforms and Firms’ Productivity: Evidence from Developing Countries”. Policy Research Working Paper 8308, World Bank, Washington, DC.

Kovasic, W. E. 1995. “Designing and Implementing Competition and Consumer Protection Reforms in Transitional Economies: Perspectives from Mongolia, Nepal, Ukraine and Zimbabwe.” DePaul Law Review 44 (4): 1197-1224.

Laborde, D., C. Lakatos, and W. Martin. 2019. “Poverty Impact of Food Price Shocks and Policies.” Policy Research Working Paper 8724. World Bank, Washington, DC.

Ma, C., and F. Valencia. 2018. “Welfare Gains from Market insurance: The Case of Mexican Oil Price Risk.” IMF Working Paper 18/35, International Monetary Fund, Washington, DC.

Maimbo, S. M. and C. A. Henriquez Gallegos. 2014. “Interest Rate Caps around the World Still Popular, but a Blunt Instrument.” Policy Research Working Paper 7070, World Bank, Washington, DC.

Morton, F. M. S. 2001. “The Problems of Price Controls.” Regulation 24(1): 50-54.

Mpapalika, J., and C. Malikane. 2019. “The Determinants of Sovereign Risk Premium in African Countries.” Journal of Risk and Financial Management 12 (1): 29-49.
Mundaca, G. 2017. “Energy Subsidies, Public Investment and Endogenous Growth.” Energy Policy 110 (C): 693-709.

Munoz, S. 2006. “Suppressed Inflation and Money Demand in Zimbabwe.” IMF Working Paper 06/15, International Monetary Fund, Washington, DC.

Murphy, F., A. Pierru, and Y. Smeers. 2019. “Measuring the Effects of Price Controls Using Mixed Complementarity Models.” European Journal of Operational Research 275 (2): 666-676.

Newfarmer, R., and M. D. Pierola. 2015. Trade in Zimbabwe Changing Incentives to Enhance Competitiveness. Washington DC: World Bank.

Newbery, D. M. G., and J. E. Stiglitz. 1982. “Risk Aversion, Supply Response, and the Optimality of Random Prices: A Diagrammatic Analysis.” The Quarterly Journal of Economics 97 (1): 1-26.

Nguyen, A. D. M., J. Dridi, F. Unsal, and O. H. Williams. 2017. “On the Drivers of Inflation in Sub-Saharan Africa.” International Economics 151 (October): 71-84.

Ore, M. A. H., L. A. Sanchez, L. D. Sousa, and L. Tornarolli, eds. 2018. Fiscal and Welfare Impacts of Electricity Subsidies in Central America. Washington DC: World Bank.

OECD and World Bank. 2018. Markets and Competition OECD-WBG PMR Indictors for Selected Non-OECD Countries (2013-2018). Washington, DC: World Bank.

Patel, N., and A. Villar. 2016. "Measuring Inflation." BIS Paper 89, Bank of International Settlements, Basel.

Pena Nelz, M. 2016. "LPG Subsidy Reform in India Put the Right Systems in Place First." Energy Sector Management Assistance Program, World Bank, Washington, DC.

Shi, X., and S. Sun. 2017. "Energy Price, Regulatory Price Distortion and Economic Growth: A Case Study of China." Energy Economics 63 (March): 261-271.

Silveira, R., and S. Malpezzi. 1991. "Welfare analysis of rent control in Brazil: the case of Rio de Janeiro." Discussion Paper INU 83, World Bank, Washington, DC.

Springer de Freitas, P., and M. Bugarin. 2007. "A Study on Administered Prices and Optimal Monetary Policy: The Brazilian Case." Centro de Estudios Monetarios Latinoamericanos, Mexico City.

Stiglitz, J. E., and D. M. G. Newbery. 1979. "The Theory of Commodity price Stabilization Rules: Welfare Impacts and Supply Responses." The Economic Journal 89 (December): 799-817.

Stocker, M., J. Baffes, Y. M. Some, D. Vorisek, and C. M. Wheeler. 2018. "The 2014-16 Oil Price Collapse in Retrospect." World Bank Policy Research Working Paper 8419, World Bank, Washington, DC.

Tarr, D. 1994. "The Welfare Costs of Price Controls for Cars and Color Televisions in Poland: Contrasting Estimates of Rent-Seeking from Recent Experience." World Bank Economic Review 8 (3): 415-443.

Teravaninthorn, S., and G. Raballand. 2009. Transport Prices and Costs in Africa: A Review of the International Corridors. Washington, DC: World Bank.

Vera, L. 2017. "In Search of Stabilization and Recovery: Macro Policy and Reforms in Venezuela." Journal of Post Keynesian Economics 40 (1): 9-26.

Verme, P., and A. Araar, eds. 2017. The Quest for Subsidy Reforms in the Middle East and North Africa Region. Washington DC: World Bank.

Weitzman, M. 1991. "Price Distortion and Shortage Deformation, or What Happened to the Soap?". American Economic Review 81 (3): 401-414.

Winkler, R. 2015. "Feast or Famine: The Welfare Impact of Food Price Controls in Nazi Germany." Discussion Papers in Economic and Social History 136, University of Oxford.

World Bank. 2006. Review of Selected Railway Concessions in Sub-Saharan Africa. Washington, DC: World Bank.

———. 2009. Global Economic Prospects: Commodities at Crossroads. January. Washington, DC: World Bank.

———. 2014a. "Transitional Policies to Assist the Poor While Phasing Out Inefficient Fossil Fuel Subsidies that Encourage Wasteful Consumption." Contribution by the World Bank to G20 Finance Ministers and Central Bank Governors. Washington, DC: World Bank (September).

———. 2014b. MENA Economic Monitor: Corrosive Subsidies. October. Washington, DC: World Bank.

———. 2018. A New Economy for the Middle East and North Africa. MENA Economic Monitor. Washington, DC: World Bank.

———. 2019. Global Economic Prospects: Darkening Skies. January. Washington, DC: World Bank.

———. 2019b. Doing Business 2020: Sustaining the Pace of Reforms. Washington DC: World Bank.

World Trade Organization. 2000-2019. Trade Policy Review. World Trade Organization, Switzerland.

———. 2019. "Distortion." WTO Glossary. Geneva, Switzerland: World Trade Organization, Geneva.

For Release

Gasoline Price Controls Would Likely Harm Hawaii's Consumers

FTC Staff Testifies Before Hawaii Legislature on Competition in the State's Gasoline Market

January 28, 2003

Tags: Competition | Office of Policy Planning | Energy | Gasoline

Policies other than gasoline price controls provide the best options for reducing retail gasoline prices and preventing gasoline shortages in Hawaii, according to Jerry Ellig, Deputy Director of Federal Trade Commission's Office of Policy Planning (OPP). Ellig presented testimony on behal FTC staff before a joint hearing co-sponsored by six different committees of the Hawaii legislat today.

Legislation enacted by the state last year established retail and wholesale price controls on regular unleaded gasoline, to be implemented on July 1, 2004, and directed the state's Department of Business, Economic Development, and Tourism (DBEDT) to assess the impact of price controls and alternative policies to reduce gasoline prices in Hawaii.

"A significant body of research and experience suggests that price controls have a poor record of improving consumer welfare in markets where competition is possible, and may in fact cause more harm than good in the long term," Ellig noted. For this reason, he said, FTC staff believes that the Hawaii Legislature acted "with great foresight" when it included in Act 77 a provision directing DBEDT to study the potential impact of such controls and other alternative polices to reduce gas prices in Hawaii. "Substantial evidence suggests that the alternatives to price controls would

promote consumer welfare," Ellig testified, "and we urge legislators to consider this evidence when evaluating policies intended to affect gasoline prices."

The FTC staff testimony, which is available on the Commission's Web site as a link to this press release, makes the following main points:

- Several features of Hawaii's market tend to reduce retail supply and increase retail prices, including rent caps for stations operated by lessee-dealers and a law restricting marketers' ability to open new company-operated stations near existing dealer-operated stations.
- Price controls usually create shortages, reduce quality, and generate inconvenience for consumers when they are imposed in markets that could be competitive. If the price controls in Act 77 become effective and succeed in reducing gasoline prices, they likely will impose significant non-price costs on consumers, such as lines or reduced business hours at gasoline stations.
- The more consumer-friendly way of reducing gasoline prices in Hawaii would be through policies that reduce costs and/or promote competition. Policies that may deserve further consideration include repealing Hawaii's "anti-encroachment" law (which limits a refiner's or marketer's ability to establish new company-owned gas stations near existing dealer-operated stations), repealing the rent cap on gasoline stations (which may discourage refiners and marketers from establishing new dealer-operated stations), and ensuring that the Hawaii Attorney General's Office has adequate resources to review mergers that may impact competition in the state's gasoline market. If the ongoing study by the DBEDT and other evidence indicate that wholesale gasoline prices are not competitive, policy-makers may also want to consider initiatives to improve access to import terminals for new entrants.

The Commission vote authorizing staff to present the testimony before the Hawaii House-Senate joint hearing was 5-0. The testimony was given via phone before the Hawaii House Committee on Energy and Environmental Protection; Senate Committee on Energy and Environment; House Committee on Consumer Protection and Commerce; Senate Committee on Commerce, Consumer Protection, and Housing; House Committee on Transportation; and Senate Committee on Transportation, Military Affairs, and Government Operations.

Contact Information

Media Contact:

Mitchell J. Katz,

Office of Public Affairs

202-326-2161

Staff Contact:

Jerry Ellig,

Deputy Director Office of Policy Planning

202-326-3528

UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Competition and the Effects of Price Controls in Hawaii's Gasoline Market

Testimony of Jerry Ellig
Deputy Director, Office of Policy Planning
Federal Trade Commission

Before the

State of Hawaii

Joint Hearing
House Committee on Energy and Environmental Protection
Senate Committee on Energy and Environment
House Committee on Consumer Protection and Commerce
Senate Committee on Commerce, Consumer Protection, and Housing
House Committee on Transportation
Senate Committee on Transportation, Military Affairs, and Government Operations

January 28, 2003

Thank you for the opportunity to share the Federal Trade Commission staff's views on the likely effects of price controls and other policies in Hawaii's gasoline market.(1)

The Federal Trade Commission is charged by statute with preventing unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce.(2) Commission staff have had considerable experience assessing the competitive impact of regulations and business practices in the petroleum industry, including the petroleum industry in Hawaii.(3) On numerous occasions, the Commission staff have offered comments on proposed state laws covering a variety of areas, including laws that would regulate gasoline prices, ban sales of motor fuels below cost, or limit competition between refiner-owned and independent gas stations.(4)

In May 2002, Hawaii enacted Act 77, imposing wholesale and retail price controls on regular unleaded gasoline beginning on July 1, 2004. The legislation also directed Hawaii's Department of Business, Economic Development and Tourism (DBEDT) to assess the likely impact of price controls and other alternative policies to reduce gasoline prices in Hawaii. We believe that the Legislature showed great foresight when it included this provision.

During the past several months, the staff of the FTC's Office of Policy Planning, Bureau of Economics, and the Western Region (San Francisco) have engaged in extensive conversations with staff of the Hawaii Attorney General's Office and DBEDT. We have reviewed documents from the State's price-fixing lawsuit against the oil companies,(5) materials from the FTC's own investigations of oil company mergers affecting Hawaii's gasoline market, and price data collected as part of an ongoing FTC gasoline price monitoring project. Based on the evidence we have seen, we offer the following observations that may be of use to Hawaii's policymakers as you consider alternative policies affecting competition and pricing in the gasoline market:

1. Hawaii's gasoline market has two refineries and six principal retail chains. Import prices for gasoline have a significant influence on its wholesale price. Several features of Hawaii's market tend to reduce retail supply and increase retail prices, including rent caps for stations operated by lessee-dealers and a retail "anti-encroachment" law restricting marketers' ability to open new company-operated stations near existing dealer-operated stations.

2. Price controls usually create shortages, reduce quality, and generate inconvenience for consumers when they are imposed in markets that could be competitive. If the price controls in Act 77 become effective and succeed in reducing retail gasoline prices, they likely will impose significant non-price costs on consumers.

3. The more consumer-friendly way to reduce gasoline prices in Hawaii would be through policies that reduce costs and/or promote competition. Policies that may deserve further consideration include repealing Hawaii's retail anti-encroachment law, repealing the rent cap on gas stations (which may discourage refiners and marketers from establishing new dealer-operated stations), and ensuring that the Hawaii Attorney General's office has adequate resources to review mergers that may impact competition in Hawaii's gasoline market. If DBEDT's ongoing study and other evidence indicate that wholesale gas prices are not competitive, policymakers may want to consider initiatives to improve access to existing import terminals.

I will elaborate briefly on each of these points.

1. Market Structure and Costs

Hawaii's gasoline market has two refineries, owned by ChevronTexaco and Tesoro. The State's five principal marketers - ChevronTexaco, Tesoro, Shell, ConocoPhillips, and Aloha - obtain gasoline from refineries or import terminals and distribute it to retail stations. A sixth marketer, BC Oil, operated the former Texaco properties owned by United States Restaurant Properties but is now bankrupt. Retail stations can be owned and operated by marketers,(6) operated by lessee-dealers under contract with the marketer that owns the station, or owned and operated by independent retailers.

Hawaii's refiners import crude oil, and gasoline marketers can also import gasoline. Since Hawaii has only two refineries, both on Oahu, the ease or difficulty of importing gasoline can play a key role in determining the price a marketer pays for gasoline. The refineries in Hawaii normally have the capability to produce approximately enough gasoline to satisfy demand in Hawaii. These two refineries appear to be the lowest-cost source of supply.(7) Various firms occasionally have imported gasoline in the past.(8) Even if gasoline imports are rare, however, we would expect the cost of imports to influence the price that marketers pay for gasoline in Hawaii. A marketer with the ability to import gasoline likely will have a better chance of negotiating a favorable supply agreement with one of the local refineries, since the refinery likely would have to bear the cost of exporting gasoline if a competitor increased gasoline imports significantly.(9)

Act 77 was enacted shortly after settlement of the State's antitrust price-fixing suit against gasoline marketers. Antitrust laws prohibit competitors from agreeing on prices or reaching other agreements that would cause a reduction in competition. However, antitrust law does not prohibit a company from speculating about how its competitors will react to its prices and taking those expectations into account when making its own, independent pricing decisions. Parallel independent behavior, without any direct or circumstantial evidence of explicit agreement on prices or practices that may facilitate collusion, does not violate the antitrust laws.(10)

Several significant non-antitrust aspects of Hawaii's gasoline market tend to increase retailers' costs and discourage entry.(11) First, due to Hawaii's unusual land ownership regime, it is difficult to obtain fee-simple ownership to land, which may reduce the incentive to invest in station facilities sited on the land.

Second, Hawaii also has sought to enact rent cap legislation limiting the rent wholesalers could charge retail dealers who lease their stations from the wholesalers.(12) Wholesalers could respond to rent controls in two different ways, both of which likely would reduce the number and quality of dealer-operated gasoline stations. If rent controls have

the effect of reducing the total revenues that a wholesaler receives from dealers, then the wholesaler is likely to have fewer dealer-operated stations than it would in the absence of the rent control and to spend less money maintaining the stations. Alternatively, the wholesaler might try to make up for the lost lease revenues by increasing the price it charges the dealer for gasoline (assuming the wholesale price cap on gasoline is not binding). In that case, the wholesaler effectively bears more risk, because more of its revenues would come from the sale of a commodity whose price fluctuates, rather than from rents. This increased risk increases the wholesaler's cost of selling gasoline through stations operated by lessee-dealers. The wholesaler likely would respond to this cost increase by using fewer dealer-operated stations or investing less money in maintaining the stations. In short, the rent controls likely would reduce the number and quality of gasoline stations, increase gasoline prices, and cause inconvenience for consumers, who would have to travel farther to find gas stations.

Third, and perhaps most important, Hawaii's law prohibiting "encroachment" (and its predecessor "divorcement" law(13)) constrain the ability of both incumbents and new entrants to establish new stations. In 1991, Hawaii passed a divorcement law that imposed a temporary moratorium on the building of any new company-operated stations, which was extended in 1993 for two more years.(14) In 1995, Hawaii continued the moratorium but revised it slightly.(15) In 1997, Hawaii replaced divorcement with an anti-encroachment law barring oil companies as well as jobbers from opening company-operated stations within a radius of one-eighth of a mile around every dealer-operated station in an urban area and one-quarter of a mile in other areas.(16)

Published economic research demonstrates that anti-encroachment and divorcement laws tend to increase retail gasoline prices. A National Bureau of Economic Research study found that company-operated stations can be the most efficient form of management for high-volume, low-service gasoline stations.(17) Laws that limit marketers' ability to establish new company-operated stations thus force them to adopt higher-cost organizational forms, and these increased costs likely are passed through to consumers in the form of higher gasoline prices. The most comprehensive of the published economic studies, conducted by a senior FTC economist, found that state divorcement and anti-encroachment laws tend to increase retail prices by an average of 2.6 cents per gallon.(18) Another study found Maryland's divorcement law, the first in the nation, raised self-service gasoline prices by 1.4 to 1.7 cents and full-service prices by 5 to 7 cents per gallon at stations that were formerly company-operated.(19) We are aware of no study specifically estimating the effect of Hawaii's divorcement and anti-encroachment laws, but we know of no reason that these laws would not have effects in Hawaii similar to their effects in other states. Indeed, the FTC warned in 1985 that the divorcement law already under discussion in Hawaii "would unquestionably increase the costs of gasoline distribution, eliminate legitimate price competition, and raise prices for motor fuel to consumers."(20)

Legal restrictions on a marketer's ability to establish company-operated stations also may discourage new entry. There is evidence from the record of *Anzai v. Chevron*, Hawaii's now-settled lawsuit against many of the gasoline marketers, showing that Hawaii's anti-encroachment law served to stifle the efforts of BHP, former owner of the Tesoro refinery, to embark on what it hoped would be a low-priced volume retail business.(21) This constraint may especially discourage retail entry by jobbers (who purchase unbranded gasoline from refiners) or smaller oil companies, which tend to rely more heavily on company-operated stations instead of franchised dealers.(22)

2. Likely Effects of Price Controls

Most economists and antitrust experts doubt that price controls are a viable mechanism to increase consumer welfare in markets where competition is possible, and we see no reason that competition is not possible in Hawaii's gasoline market. Historical experience demonstrates that price controls tend to create shortages, reduce quality, and generate other inefficiencies.(23)

The U.S. experience with gasoline price controls in the 1970s confirms the predictions of economic reasoning. In 1971, gasoline prices were regulated as part of the Nixon Administration's two-year adoption of economy-wide wage and price controls. In 1973, the federal government prohibited refiners and marketers from charging prices that exceeded their average prices on May 15, 1973, plus adjustments for changes in costs. Though not identical to the price controls in Act 77, the federal controls were similar in two key ways: (1) they applied both to wholesale and to

retail prices, and (2) prices were adjusted based on costs.(24) A report by the Federal Trade Commission's Bureau of Economics concluded that the federal price controls led to the adoption of higher-cost production methods and sporadic shortages manifested in gasoline lines.(25)

Customers queued up at gasoline stations are perhaps the most visible example of the inefficiencies resulting from the shortages created by gasoline price controls, but myriad other examples actually occurred during this period: limited station hours, Sunday station closures, "odd-even" purchasing restrictions based on license plate numbers, and restrictions on the number of gallons the customer could purchase in a single trip to the gasoline station. Also noteworthy are the secondary effects of such inconveniences, which included efforts to hoard gasoline and, in some instances, an increased hazard of car fires because people began storing additional gasoline in containers in their trunks.(26) Some research even shows that the inconvenience and other inefficiencies associated with gasoline station lines cost consumers more than they saved as a result of regulated gas prices.(27)

The price controls in Act 77 likely would create shortages. Act 77 ties maximum retail prices in Hawaii to wholesale prices on the West Coast. Tying regulated prices in Hawaii to West Coast prices might not always create shortages. For example, when other sources of imported gasoline are cheaper than the West Coast, the price cap is less binding. The price controls could, however, create shortages when low West Coast prices coincide with a refinery outage in Hawaii. In that case, the price cap would discourage imports precisely when they are most needed.

Even in the absence of refinery problems in Hawaii, the specific formula in Act 77 has the potential to create shortages. For example, the transportation margin needs to reflect not just the out-of-pocket cost of transporting gasoline, but also the time value of money while the product is in transport, the risk that prices might change while the product is in transport, and the likelihood that prices will fall when an entire tanker-load of product enters the market. The assumed transportation margin of four cents per gallon may be below the efficient level. FTC staff have seen no evidence that transportation costs are this low, and evidence from Hawaii's lawsuit against certain of the incumbent gasoline marketers suggests that transportation costs may be substantially higher.(28)

Firms may also reduce customer convenience or quality in response to the price controls. For example, the price caps apply only to self-service regular gasoline. A retail station operator could potentially evade the price cap by offering only mid-grade, premium, or full-service. The U.S. experience with gasoline price controls reveals other ways that firms increased customer convenience or decreased quality in response to price controls. Some stations demanded "tips," while others gave customers "free" gasoline if they bought items such as rabbit's-foot keychains, will forms, or bars of soap at inflated prices. Regular customers received preferential access to gasoline. Refiners sometimes reduced octane ratings.(29)

In short, FTC staff believe that the costs of price controls to consumers would almost certainly outweigh any consumer benefits.

3. Alternative Policies to Reduce Costs and Prices

Policymakers concerned about gasoline prices in Hawaii might find it productive to assess the likely impact of several alternative policies that have the potential to reduce gasoline prices by reducing costs and/or enhancing competition. Possible options include:

- Repeal Hawaii's anti-encroachment law, so that incumbent refiners and jobbers could build additional company-operated stations in advantageous locations and new entrants would have the option of operating their own stations instead of using franchised dealers.

- Eliminate Hawaii's legislation mandating rent caps for lessee-operated gasoline stations.

- Under merger law, antitrust officials can challenge mergers or acquisitions likely to foster tacit or explicit collusion.(30) Hawaii's Attorney General should have resources sufficient to assess whether future mergers or acquisitions are likely to substantially lessen competition.(31)

The relationship between terminal access, import prices, and retail prices is another topic that may merit further consideration. Record evidence from Hawaii's lawsuit against the gasoline marketers, as well as economic logic, confirm that the greatest constraint on the pricing of the two local refiners is a marketer's credible threat to purchase gasoline from outside Hawaii.(32) If DBEDT's ongoing study and other evidence show that wholesale prices are not competitive, then policymakers may want to consider options that would improve access to existing terminals for new entrants. Hawaii has no public or private terminal that guarantees third parties nondiscriminatory access to its docks, tanks and pipelines; the State could explore innovative ideas to ensure third party access, on a nondiscriminatory basis.

4. Concluding Comments

FTC staff recognize that gasoline prices have been a highly contentious issue in Hawaii, and that legislators often face strong pressure from citizens to take action against prices that are perceived as "too high." We urge you to consider, however, that a decision to impose price controls is also, in most cases, a decision to supplant competitive forces with direct administrative intervention. A significant body of research and experience suggests that price controls have a poor record of improving consumer welfare in markets where competition is possible, and may in fact cause more harm than good in the long term.

For this reason, we believe the Hawaii Legislature acted with great foresight when it included in Act 77 the provisions delaying the implementation of price controls, so that DBEDT could study their potential impact and assess alternative policies to reduce gasoline prices in Hawaii. Substantial evidence suggests that the alternatives to price controls would best promote consumer welfare, and we urge legislators to consider this evidence when evaluating policies intended to affect gasoline prices.

Endnotes:

1. This testimony represents the views of the staffs of the Office of Policy Planning, the Bureau of Economics, the Bureau of Competition, and Western Region (San Francisco) Office of the Federal Trade Commission and does not necessarily represent the views of the Commission or any individual Commissioner. The Commission has, however, voted to authorize staff to submit this testimony. My oral responses to your questions represent my own views.

2. Federal Trade Commission Act, 15 U.S.C. § 45.

3. *Shell Oil Co., et al.*, 125 F.T.C. 769 (1998) (consent order requiring Shell and Texaco to divest certain assets on the island of Oahu as a condition of entering into a joint venture to combine certain gasoline marketing assets); *Pacific Resources, Inc.*, 111 F.T.C. 322 (1988) (consent order issued following U.S. district court's issuance of preliminary injunction to block Pacific Resources' acquisition from Shell Oil Company of certain petroleum terminaling and distribution assets and operations in the State of Hawaii).

In recent years, the Commission has investigated, among others, the mergers of Chevron and Texaco, Exxon and Mobil, and BP and Amoco. In 2001, the Commission investigated the proposed merger of petroleum refiners Valero Energy and Ultramar Diamond Shamrock. *See Valero Energy Corp.*, C-4031 (Feb. 19, 2002) (consent order); *Chevron Corp.*, C-4023 (Jan. 2, 2002) (consent order); Exxon Corp., C-3907 (Jan. 30, 2001) (consent order); *British Petroleum Company p.l.c.*, 127 F.T.C. 515 (1999) (consent order). Moreover, the *Shell Oil Co.* consent order referenced in the preceding paragraph stemmed from the planned combination of the nationwide refining and marketing businesses of Shell and Texaco.

The Commission also has conducted nonmerger investigations and workshops involving gasoline markets, and submits public comments in regulatory proceedings. In March 2001, the Commission, using the competition analysis principles in the Merger Guidelines, completed an investigation of a spike in reformulated gasoline (RFG) prices in several Midwest states in the spring and summer of 2000. Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001). Also in 2001, the Commission concluded its investigation of gasoline price increases in West Coast markets. *FTC Closes Western States Gasoline Investigation*, FTC Press Release (May 7, 2001). In addition, in August 2001, the Commission held an initial public conference to examine factors that affect prices of refined petroleum products in the United States. *FTC to Hold Public Conference/Opportunity for Comment on U.S. Gasoline Industry*, FTC Press Release (July 12, 2001). A second public conference was held in May 2002. *FTC to Hold Second Public Conference on the U.S. Oil and Gasoline Industry in May 2002*, FTC Press Release (Dec. 21, 2001). Commission staff also recently filed public comments with the Environmental Protection Agency concerning "boutique fuel" regulations. Comments of the Staff of the General Counsel, Bureaus of Competition and Economics, and the Midwest Region of the Federal Trade Commission, *Study of Unique Gasoline Fuel Blends ("Boutique Fuels"), Effects on Fuel Supply and Distribution and Potential Improvements*, EPA 420-P-01-004, Public Docket No. A-2001-20 (Jan. 30, 2002).

4. *See, e.g.*, Letter from Joseph J. Simons, Director, FTC Bureau of Competition, and R. Ted Cruz, Director, FTC Office of Policy Planning, to Gov. George E. Pataki of New York (Aug. 8, 2002) available at http://www.ftc.gov/be/v020019.pdf; Letter from Joseph J. Simons, Director, FTC Bureau of Competition, and R. Ted Cruz, Director, FTC Office of Policy Planning, to Hon. Robert F. McDonnell, Commonwealth of Virginia House of Delegates (Feb. 15, 2002) available at http://www.ftc.gov/be/V020011.htm; Letter from Ronald B. Rowe, Director for Litigation, FTC Bureau of Competition, to Hon. David Knowles, California State Assembly (May 5, 1992); Prepared Statement of Claude C. Wild III, Director, FTC Denver Regional Office, before the State, Veterans, and Military Affairs Committee of the Colorado State Senate (Apr. 22, 1992); Letter from Claude C. Wild III, Director, FTC Denver Regional Office, to Hon. Bill Morris, Kansas State Senate (Feb. 26, 1992); Letter from Claude C. Wild III, Director, FTC Denver Regional Office, to David Buhler, Executive Director, Utah Department of Commerce (Jan. 29, 1992); Letter from Thomas B. Carter, Director, FTC Dallas Regional Office, to Hon. W.D. Moore, Jr., Arkansas State Senate (Mar. 22, 1991); Letter from Jeffrey I. Zuckerman, Director, FTC Bureau of Competition, to Hon. Jennings G. McAbee, Chairman, Ways and Means Committee, Other Taxes and Revenues Subcommittee, South Carolina House of Representatives (May 12, 1989).

5. *Anzai v. Chevron Corp.*, Civ. No. 98-00792 (SPK) (D. Haw., filed Oct. 1998).

6. Marketers face significant restrictions on opening new company-operated stations; see pp. 5-7 *infra*.

7. *See, e.g.*, TOS 15961 (document filed in the Anzai litigation; estimating refinery capacity for various years); Expert Report of Dr. Jeffrey J. Leitzinger at 57 (June 23, 2000) (document filed in the Anzai litigation; estimating total volume of gasoline sales for residential consumers in Hawaii).

8. *See, e.g.*, Expert Report of Leitzinger, *supra* note 7, at 37.

9. *See, e.g.*, TXCC 0017473-77 (document filed in the *Anzai* litigation) ("Perhaps [Texaco's] biggest threat to [the two local refiners] is importing product."); SHB 015051-52 (document filed in the *Anzai* litigation) (Shell looking at importing as way to negotiate lower price from local refiner); HI 1093382-83 (document filed in the *Anzai* litigation) (Chevron, one of the local refinery owners, expresses concern internally about Texaco's ability to import "product and drive the market down").

10. *Theatre Enterprises v. Paramount Film Distributing Corp.*, 346 U.S. 537, 541 (1954) ("Circumstantial evidence of consciously parallel behavior may have made heavy inroads into the traditional judicial attitude toward conspiracy; but 'conscious parallelism' has not read conspiracy out of the Sherman Act entirely.").

11. This testimony focuses on factors that affect prices by affecting costs and competition. We are also aware that gasoline taxes directly affect retail gasoline prices, and that Hawaii's state and local gasoline taxes exceed the national average. (In 2002, combined state and local gasoline taxes in Hawaii averaged 35.1 cents per gallon, as compared with a national average of 23.6 cents.) *See* American Petroleum Institute, *Nationwide and State-by-State Motor Fuel Taxes* (July 2002). FTC staff have independently verified tax rate information reported in this publication.

12. The 1997 legislation circumscribing company-operated stations also imposed commercial rent control on rents that oil companies (refiner, marketer, or wholesaler/jobber) can charge lessee-dealers for the use of company-owned stations and prevents them from converting lessee-dealer stations to company-operated stations. The rent control aspects of this law have not been put into effect, pending litigation. Last year a federal court ruled that this aspect of the law is an unconstitutional regulatory taking, on the ground that the rent cap would not necessarily decrease retail gasoline prices and likely would increase them. *Chevron v. Cayetano*, 198 F. Supp. 2d 1182 (D. Haw. 2002). Act 77, enacted the following month, combines the rent cap with wholesale and retail price controls. The district court's decision is currently on appeal before the Ninth Circuit.

13. Anti-encroachment and divorcement laws both limit competition between refiners/marketers and lessee-dealers. Laws banning encroachment limit a refiner's and/or marketer's ability to establish new company-operated stations within a certain distance of existing dealer-operated stations. Divorcement laws either prohibit refiners and/or marketers from operating their own stations or prohibit them from opening and operating new stations.

14. Act 295 (S.B. No. 1757); Act 329 (S.B. No. 124).

15. Companies could open two new company-operated stations for every new dealer-operated station, and company-operated stations that were closed could be replaced by a new company-operated station within a one-mile radius of the closed station. Act 238 (S.B. No. 487).

16. Act 257 (H.B. No. 1451).

17. Asher A. Blass and Dennis W. Carlton, "The Choice of Organizational Form in Gasoline Retailing and the Cost of Laws that Limit that Choice," 44 *J.L. & Econ*. 511 (2001).

18. Michael G. Vita, "Regulatory Restrictions on Vertical Integration and Control: The Competitive Impact of Gasoline Divorcement Policies," 18 J. Reg. Econ. 217 (2000).

19. Furthermore, these stations reduced their operations by nine hours per week. Other stations in the locale of the divested stations also raised prices. John M. Barron and John R. Umbeck, "The Effect of Different Contractual Arrangements: The Case of Retail Gasoline Markets," 27 *J.L. & Econ*. 313 (1984).

20. Letter from Terry Calvani, Acting Chairman, Federal Trade Commission, to the Honorable Peter K. Apo (Dec. 23, 1985). The bill was Hawaii House Bill 1376.

21. *See, e.g.*, Parry (BHP's Vice President of Marketing in Hawaii) Dep. Tr. in the *Anzai* litigation, at 19-27.

22. For example, BHP sought to use company-operated stations in the early 1990s so that it would have more control over their image, operations, and pricing policies. See Dr. Sumner La Croix Dep. Tr. in the *Anzai* litigation, at 888, 897-99 and Dep. Ex. 3 at v and 63. In general, a refiner or marketer has an interest in preventing its retail stations from exploiting locational monopoly power that would enable the station operator to increase prices.

23. *See, e.g.*, N. Gregory Mankiw, *Principles of Microeconomics* 128 (2d ed. 2001) ("Economists usually oppose price ceilings and floors."); Fiona M. Scott Morton, "The Problems of Price Controls," *Regulation* at 53 (Spring 2001) ("Competition is a better tool than price controls for protecting consumers."); John E. Calfee, "Why Pharmaceutical

Price Controls are Bad for Patients," *AEI on the Issues* at 1 (March 1999) ("Almost all economists hate almost all price controls.").

24. Federal regulations allowed individual firms to raise prices by an amount equal to increases in their own production costs; Act 77 adjusts prices based on changes in estimated industry-wide average costs of product and transportation for Hawaii's gasoline marketers and retailers.

25. Scott Harvey and Calvin T. Roush, Jr., *Petroleum Product Price Regulations: Output, Efficiency, and Competitive Effects*, Staff Report of the Bureau of Economics to the Federal Trade Commission (Feb. 1981). The regulations permitted refiners and marketers to pass through increases in their own costs of production with a one-month lag. Thus, when world oil prices increased because of events like OPEC price increases or the Iranian revolution, temporary shortages would occur because companies could not immediately increase prices to reflect the higher cost of crude oil. Gasoline lines and other forms of nonprice rationing were the result. In the absence of the price controls, gasoline prices would have reflected increases in crude oil prices relatively rapidly, and most nonprice rationing would have been avoided because consumers would have reduced consumption in response to the price increase.

26. Robert L. Bradley, Jr., *Oil, Gas & Government: The U.S. Experience* 1631-34 (1996).

27. Scott Morton, *supra* note 23, at 51.

28. *See, e.g.*, THC 55 003377-79 (document filed in the *Anzai* litigation); TXU 0013405 at 0013440 (document filed in the *Anzai* litigation).

29. *Bradley, supra* note 26, at 1634-36.

30. *FTC v. H.J. Heinz Co.*, 246 F.3d 708, 716 (D.C. Cir. 2001) (merger law rests upon the theory that, where rivals are few, firms will be able to coordinate their behavior, either by overt collusion or by implicit understanding, in order to restrict output and achieve profits above competitive levels) (quoting, in part, *FTC v. PPG Indus*., 798 F.2d 1500, 1503 (D.C. Cir. 1986)).

31. The FTC and the Hawaii Attorney General's office have twice investigated proposed mergers of incumbent gasoline marketers in Hawaii. *See Pacific Resources, Inc*. and *Shell Oil Co., et al., supra* note 3.

32. See *supra* note 9.

Company logo

defining ideas

ARTICLES

Price Controls: Still A Bad Idea

A market-distorting tactic brings both short- and long-term harm.

Thursday, January 20, 2022 • 5 min read

By:
David R. Henderson

#Group_7004 .cls-7 { MyHoover font-size: 18px; } #Group_7004 .cls-8, #Group_7004 .cls-9 { fill: none; } #Group_7004 .cls-9 { stroke: #000; stroke-linecap: round; stroke-linejoin: round; stroke-width: 1.5px; }

"This is a great suppressed topic. It was absolutely mainstream from the start of World War II until the Reagan administration." This is a quote from "Price Controls Set Off Heated Debate as History Gets a

Second Look," a January 13 *New York Times* article by Ben Casselman and Jeanne Smialek. The speaker quoted is James (Jamie) K. Galbraith, a left-wing economist at the University of Texas. The "this" in the quote refers price controls, which Galbraith appears to favor. He comes by it honestly. His father, the late John Kenneth Galbraith, was a high-level official in the Office of Price Administration during World War II, and he sometimes reflected fondly on the power that he exerted over the US economy.

I disagree with Galbraith that the topic has been suppressed. We opponents of price controls have been quite willing to discuss why they're a bad idea. If he were to be more accurate, Galbraith would have to say that the idea has been rejected. Indeed, the heartening point of the *Times* article is that the vast majority of economists, including left-wing economists such as Paul Krugman, reject the idea of comprehensive government controls on prices. But sometimes it's hard for people who are losing a debate to admit that they've lost, not because the topic has been suppressed but because their idea has been analytically crushed. It's worthwhile, therefore, to say *why* they are such a bad idea. Price controls cause shortages, waste people's time in line, sometimes lead to favoritism by suppliers, and, as in the case of oil and gasoline in the 1970s, can lead to harmful regulation that lasts for decades.

Prices and the Smashed Thermometer

When University of Chicago economist Harold Demsetz gave a talk in the winter of 1970 at the University of Winnipeg, where I was an undergrad, he used an analogy that many critics of price controls still use. Demsetz told his audience that using price controls to reduce inflation is like responding to cold weather in Winnipeg by breaking the thermometer. His point was that just as thermometers respond to temperature, prices are an indicator of underlying economic phenomena, namely supply and demand. Breaking a thermometer doesn't cause the temperature to rise; controlling prices doesn't cause inflation to fall.

But it's worse than that. When you break the thermometer, you don't make the weather worse. But when a government controls prices, it makes the economy worse by causing shortages.

When I first studied microeconomics in the late 1960s, it was often called "price theory." There was a good reason for that label: the most important topic in microeconomics is how prices are determined. One thing you learn very quickly is that they are determined by supply, which reflects costs of production, and demand, which reflects consumers' preferences and incomes.

If you remember that simple fact, you are forever inoculated against the view that prices are random and also against the view, made popular by US Senator Elizabeth Warren, that prices rise because producers are greedy.

Consider, for example, the prices of used cars, which, for many models, have risen by double-digit percentages in the last year. What caused those increases? The answer is that demand has risen and supply has fallen. Both demand and supply of used cars have changed because of the reduction in the supply of new cars, which is in part due to shutdowns of production in the first few months of COVID, and due in part to a reduction in supply of a crucial part, namely semiconductor chips. The reduction in the supply of new cars caused their prices to rise. Drivers with used cars, therefore, tended to hang on to their cars longer, causing a reduction in supply; drivers who might have bought new cars responded to the higher prices of new cars by increasing their demand for used cars.

Consider another example: the price of strawberries. Why are strawberry prices higher in winter than in summer? The reason is that the domestic supply of strawberries is almost nonexistent in winter and is very high in summer. Unlike when I was a child in the 1960s, we can now get strawberries in winter by buying them from warmer climes, but the transportation cost makes them more expensive. Notice how clearly the lower supply explains the higher price.

A Word about "Greed"

What's wrong with attributing price increases to "corporate greed"? The problem with that explanation is not that corporations aren't greedy. If we take "greed" to mean "wanting to make as high a profit as possible," then yes, most corporations are greedy. But those same corporations often *cut* prices. Have you noticed that the prices of wide-screen televisions have fallen regularly over the past fifteen years? Does that mean that the corporations producing those TVs have steadily become less greedy? Unlikely. So greed is not a good explainer of price increases. A good rule for thinking, as Charles L. Hooper and I pointed out in our book, *Making Great Decisions in Business and Life*, is that to explain a change in one variable, you need to point to a change in another variable. Because greed (however defined) is relatively constant, it's not a good way to explain a change.

Price Controls Cause Shortages

When the government imposes a limit on how high a price can go, something that economists call a "price ceiling," there are two possible outcomes. If the price ceiling is above the price that would have

existed in the free market, then the price ceiling has no effect. With such a price ceiling the government is telling people that they can't charge more than the ceiling price, but that's something they didn't want to do anyway.

The more interesting case is the one that advocates of price controls want: a price ceiling that is below the free market price. At the free market price, there's a strong tendency for the amount demanded to equal the amount supplied. The reason is that if the amount demanded systematically exceeded the amount supplied, sellers would have a strong incentive to raise the price, and if the amount demanded systematically fell short of the amount supplied, sellers would have a strong incentive to cut the price in order to sell their increasing inventory.

A price ceiling below the free-market price causes buyers to demand more than they wanted at the free-market price and sellers to sell less than they wanted to sell at the free-market price. The result: a shortage.

We see the results of price controls wherever governments impose ceilings on rents. Exhibit A in the United States is New York City, where rent control was imposed as a temporary measure in World War II and still exists today. For many apartment units, the controlled rent is well below the rent that would exist in a free market and the result is a long line of potential renters for a given rent-controlled apartment.

Price Controls Change the Product

Another effect of price controls is to change the product. Imagine that you own an apartment complex on which the government imposes rent controls that force the rent below what you were planning to charge. For a given apartment, you now have more qualified tenants than you would have had with no rent control. So your incentive to maintain the property and to furnish amenities such as parking decreases. Further pushing you in that direction is the fact that you have less revenue to pay for maintenance and amenities. The product changes.

In "Price Controls," published in David R. Henderson, ed., *The Concise Encyclopedia of Economics*, Rutgers University economist Hugh Rockoff points out that because of US price controls during World War II, "fat was added to hamburger" and "candy bars were made smaller and of inferior ingredients."

We saw a major change in the product when the Nixon price controls on oil and gasoline, first imposed

on August 15, 1971, collided with the world price of oil, which OPEC raised from about $3 per barrel to about $11 per barrel during the fall of 1973. The Nixon price controls set the price of so-called “old oil” at $4.25 and later $5.25 per barrel. Gasoline prices were allowed to rise to reflect that price increase but not to reflect the world price of $11 per barrel. With the United States importing much of its oil, that was a huge problem. At the artificially low price of gasoline that resulted, there were line-ups for gasoline in the fall of 1973 and the winter and spring of 1974. I’m old enough to remember that when you pulled into a gasoline station, a gasoline station attendant washed your windshield and, if you wanted, you could get a high-quality map inside the station for free. Both of those aspects of the product disappeared over a few months.

Price Controls Waste People’s Time

Because price controls cause shortages, we consumers start competing with each other by spending time in line. That’s what happened with the gasoline shortages in the 1970s. We can waste so much time in line that the time cost plus the money cost can actually exceed what the free market price would have been. During the 1979 gasoline line-ups, one would often line up for thirty minutes to get gasoline. Imagine that you wanted to buy ten gallons. At the time the regulated price was about $1 a gallon. But a reasonable estimate of the average time value of someone in line was about $8 an hour. So the true cost of the gasoline was not the $10 in money but $10 plus $4 in time, for a total of $14. That’s $1.40 per gallon. At the time, energy economists at the newly formed Department of Energy estimated that ending the price controls would cause the price of gasoline to rise to $1.20 per gallon. With no price controls and no lineups, the time cost would have been trivial. So gasoline price controls actually made gasoline *more* expensive.

Price Controls Often Lead to Favoritism

When there are no price controls, competition is the great leveler. A seller typically cares about making money, no matter who is spending it. But when the government imposes a price ceiling, a seller, facing more demand than he can supply, has no incentive not to play favorites. A gasoline station owner, for example, might favor his neighbors and friends over strangers. A white landlord who is not fond of black people will find that the cost of discriminating against blacks will fall close to zero. Indeed, the above-mentioned Harold Demsetz, sifting through the classified ads for apartments in the World War II–era *Chicago Tribune*, found that as the wartime shortage of apartments got worse year by year, presumably because the regulated rent was further and further below the free-market rent, the percent of ads that specified either “Restricted” (meaning that blacks were not welcome) or that the tenant would have to buy the furniture (presumably at an above-market price) increased.

Price Controls Can Lead to Regulation of Our Lives

When the Nixon and Ford administrations saw the damage that price controls on oil and gasoline were doing, they could have pulled the plug and ended the damage. Instead, they regulated further. Effective on January 1, 1974, President Nixon and Congress imposed the infamous “double nickel,” a US-wide speed limit of fifty-five miles per hour, that lasted until 1987. In December 1975, Congress passed and President Ford signed the Energy Policy and Conservation Act, which, among other things, imposed fuel economy standards for cars. These standards increased over time. Congress and the president did not allow us to make our decisions about fuel economy based on actual free market prices. Even though President Reagan ended the price controls nine days after becoming president, the CAFE (Corporate Average Fuel Economy) regulations have been tightened further. President Carter imposed energy standards on various appliances and those standards are still with us today. “Temporary” measures often lead to permanent intrusive regulations.

Don’t Repeat the Mistake

The negative effects of price controls are many. By creating shortages, they often cause people to wait in line, they often cause the quality of products whose prices are controlled to fall, and they can lead to favoritism by suppliers. All those effects remain until the price controls are ended. But even after the price controls are gone, some of the regulations that came about as a result of the controls remain. Let’s not go down the price control path again.

footer-logo

With its eminent scholars and world-renowned library and archives, the Hoover Institution seeks to improve the human condition by advancing ideas that promote economic opportunity and prosperity while securing and safeguarding peace for America and all mankind.

KEY SITE SECTIONS

About Hoover

Research

Commentary

Fellows

Library & Archives

Support Hoover

Search

QUICK LINKS

Student Opportunities

News

Events

Contact Us

Hoover Daily Report

Hoover Press

Accessibility

Subscribe to receive the Hoover Daily Report.

Subscribe

Priva

A Strange Ignorance of the Effect of Price Caps

Pierre Lemieux

By Pierre Lemieux, Feb 12 2024

SHARE POST:

When a price is capped under its market equilibrium level, what happens? Few people seem to know the answer except for economists. And even some economists do as if they didn't know, perhaps distracted by their, or their bosses', ideology. The answer: price caps create **shortages**, that is, the stuff disappears from the shelves, waiting lines form, and illegal suppliers are the only recourse if you can't wait or go without. We had **many examples** of this during the Covid emergency. It is easy to see all that on a simple supply-demand graph: quantity supplied decreases while quantity demanded increases. (Understanding precisely how the demand and the supply curves are built is a bit more complicated: that's what classes in microeconomic theory are for.)

A current example: property-casualty insurance ("**Buying Home and Auto Insurance Is Becoming Impossible**," *Wall Street Journal*, January 8, 2024). In half the states, property-casualty rates require government approval, at least for the non-commercial sector (**information** for 2011; it may be worse now). Because of higher car and house values, more frequent storms and fires, and increasing reinsurance rates (which government controllers don't necessarily take into account), some property-casualty insurers have left a few states, notably California.

For the consumer, there is one thing worse than a price increase: it is to find no supplier, which is exactly what a price cap and a shortage entail. Some of the empty-handed buyers would prefer to pay more but are legally forbidden to or, what amounts to the same, their suppliers are forbidden to respond to bid-up prices.

Price caps would be a great way to nationalize an industry stealthily. Perhaps this has started for property-casualty insurance in states with "last-resort insurers," which are government bureaus or private companies backed by state governments.

There are other current examples. The Consumer Financial Protection Bureau is **proposing** to cap bank overdraft fees with the virtuous goal, the *Financial Times* tells us, of "saving consumers billions of dollars a year and stepping up US President Joe Biden's war on so-called junk fees ahead of the 2024 election" ("**US Consumer Regulator Proposes Capping Overdraft Fees**," *Financial Times*, January 17, 2014; see also Nicholas Anthony, "**CFRB Targets Overdraft Fees in Biden's War on Prices**," Cato Institute Blog, January 23, 2024). The targeted large banks will likely stop offering overdraft protection (or other services) to their more risky customers, sending them to smaller and less convenient banks —less convenient as revealed by these consumers' original choice.

Contrary to market competition, political and bureaucratic processes provide no built-in check on prices remaining higher than costs (including normal profits). As more government controls are imposed, shortages become endemic, consumers get more dissatisfied, and they cry for further controls.

On this dystopian path, nationalization under the applause of the populace would not be inconceivable. Leviathan would cap more prices and more shortages would develop. “It’s because of the supply chain.” “Is because of corporate greed.” Aren’t consumers already getting a glimpse of this future? Where is John Galt?

RELATED CONTENT By Hugh Rockoff

Price Controls

Governments have been trying to set maximum or minimum prices since ancient times. The Old Testament prohibited interest on loans to fellow Israelites; medieval governments fixed the maximum price of bread; and in recent years, governments in the United States have fixed the price of gasoline, the rent on apartments in New York City, and the wage of unskilled labor, to name a few. At times, governments go beyond fixing specific prices and try to control the general level of prices, as was done i...

READ THIS ARTICLE

RECENT POST

Feb 13 2024

LABOR MARKET

Do Wages Cause Inflation?

Scott Sumner

The answer to this question depends entirely on how one defines "cause". There's a sense in which wages do not cause inflation, and an equally plausible sense in which wages do cause inflation. I'll begin with the negative view, by responding to a recent FT story: The Fed expects the labour market to cool this year,...

READ MORE

Feb 13 2024

ECONOMIC METHODS

A Fundamental Difference between Debates in Sports...

David Henderson

I've often been involved in debates in politics in which people deny actual facts. At first, it's easy to attribute that to partisanship. But it takes more than partisanship. Consider sports. On Sunday night, I was disappointed when Patrick Mahomes threw the touchdown pass that ended the game in overtime and handed ...

READ MORE

Feb 12 2024

POLITICAL ECONOMY

A Strange Ignorance of the Effect of Price Caps

Pierre Lemieux

When a price is capped under its market equilibrium level, what happens? Few people seem to know the answer except for economists. And even some economists do as if they didn't know, perhaps distracted by their, or their bosses', ideology. The answer: price caps create shortages, that is, the stuff disappears from ...

READ MORE

Another Perspective - Gas cap has been costly for consumers

Honolulu Star - Bulletin (Hawaii)

March 26, 2006 Sunday

Section: Vol. 11; No. 85; Another Perspective

Length: 544 words

Byline: Pavlicek, Melissa

Body

THE gasoline ***price cap*** cost consumers as much as $54.9 million between September 1, (2005), through January 2006." This is the sobering conclusion of ***Hawaii***'s Department of Business Economic Development and Tourism as reported to the Legislature in a recently issued study of the effects of the state's controversial ***price-control*** law. That's an average of about $11 million out of consumers' pockets for every month since the measure took effect last September.

Other experts have pointed to increased market volatility and reported supply crunches at some ***gas*** stations as other unintended consequences of the cap.

These outcomes are consistent with the type of effects predicted by experts who evaluated the cap prior to its implementation. The state's own independent energy consultant, Stillwater Associates, warned: "The ***price caps*** are not expected to have any significant beneficial effect for ***Hawaii***'s gasoline consumers. In fact, recent analysis suggests they would increase consumer costs." Stillwater further found that "***price caps*** are likely to bring unwanted volatility and seasonality to the ***Hawaii*** market.

The irreparable flaw in the ***gas*** cap, then as now, is the fact that it fails to address the real reasons why ***gas*** prices in ***Hawaii*** are on average higher than those on the mainland. Those reasons are, according to the state's experts and other analysts:

» High taxes. ***Hawaii*** consumers pay almost the highest taxes on gasoline in the nation.

» Overall high cost of living. ***Hawaii***'s geographic isolation and relatively small population contribute to the generally higher cost of living and of doing business here, which is reflected in not just the price of gasoline but food, clothing, furniture, real estate and other necessities. The higher intrinsic costs of refining and distribution are additional factors specific to gasoline here.

» State regulations. The Federal Trade Commission has pointed to government-imposed regulations such as station rent caps and restrictions on the opening of new ***gas*** stations as anti-competitive laws that "tend to reduce retail supply and increase retail prices."

WHILE MANY states have considered some sort of ***price controls*** on gasoline over the years, none have actually adopted any -- largely because of expert testimony by the FTC and others that such laws tend to have negative effects on consumers and competition. ***Hawaii***'s experiment with the ***gas*** cap seems to validate those concerns.

The DBEDT study shows the cap has cost ***Hawaii*** consumers as much as $54.9 million already. And Automobile Club figures indicate that ***Hawaii*** consumers were typically paying the nation's highest average ***gas*** prices before the cap, and according to its data that situation appears to remain unchanged even with the cap in place.

To its credit, the Legislature studied the ***Hawaii*** gasoline market extensively while considering the ***gas*** cap as originally proposed, and based on its findings amended the law substantially before finally adopting and implementing it last year.

With the actual consequences now becoming known, the Legislature is considering repealing the ***gas*** cap and exploring other ways of monitoring and analyzing the petroleum market and prices here. Given the cap's performance thus far, this review can't come soon enough.

Load-Date: August 9, 2007

End of Document

Foundation for Economic Education

ALL COMMENTARY

FRIDAY, FEBRUARY 1, 1980

Price Controls Cause Shortages

ECONOMICS

PRICE CONTROLS

SHORTAGE

George Reisman

Dr. Reisman is Associate Professor of Economics at Pepperdine University in Los Angeles.

This article is reprinted by permission from his new book, also reviewed in this issue, The Government Against the Economy.

Price controls are advocated as a method of controlling inflation. People assume that inflation means rising prices and that it exists only when and to the extent that businessmen raise their prices. It appears to follow, on this view, that inflation would not exist if price increases were simply prohibited by price controls.

Actually, this view of inflation is utterly naive. Rising prices are merely a leading symptom of inflation, not the phenomenon itself. Inflation can exist, and, indeed, accelerate, even though this particular symptom is prevented from appearing. Inflation itself is not rising prices, but an unduly large increase in the quantity of money, caused, almost invariably, by the government. In fact, a good definition of inflation would be, simply: an increase in the quantity of money caused by the government. Rising prices as a chronic social problem are a consequence of governments overthrowing the use of gold and silver as money and putting in their place unbacked paper currencies and checking deposits whose quantity can be increased without limit and virtually without cost.

A good definition of inflation would be, simply: an increase in the quantity of money caused by the government

The imposition of price controls to deal with inflation is as illogical as would be an attempt to deal with expanding pressure in a boiler by means of manipulating the needle in the boiler's pressure gauge. It is no less self-destructive, as well. Prices are equivalent to an instrument panel on the basis of which everyone plans his economic activities and

which enables the plans of each individual to be harmoniously adjusted to the plans of all other individuals participating in the economic system.

The free market is a truly awe-inspiring complex of relationships in which the rational self-interest of individuals unites all industries, all markets, all occupations, all production, and all consumption into a harmonious, progressing system serving the well-being of all who participate in it.

All of this is what price controls destroy.

Controls Cause Shortages

The one consequence of price controls that is the most central and the most fundamental and important from the point of view of explaining all of the others is the fact that price controls cause shortages.

A shortage is an excess of the quantity of a good buyers are seeking to buy over the quantity sellers are willing and able to sell. In a shortage, there are people willing and able to pay the controlled price of a good, but they cannot obtain it. The good is simply not available to them. Experience of the gasoline shortage of the winter of 1974 should make the concept real to everyone. The drivers of the long lines of cars all had the money that was being asked for gasoline and were willing, indeed, eager, to spend it for gasoline. Their problem was that they simply could not obtain the gasoline. They were trying to buy more gasoline than was available.

The concept of a shortage is not the same thing as the concept of a scarcity. An item can be extremely scarce, like diamonds, Rembrandt paintings, and so on, and yet no shortage exist. In a free market the effect of such a scarcity is a high price. At the high price, the quantity of the good demanded is levelled down to equality with the supply available, and no shortage exists. Anyone willing and able to pay the free-market price can buy whatever part of the supply he wishes; the height of the market price guarantees it, because it eliminates his competitors. It follows that however scarce a good may be, the only thing that can explain a shortage of it is a price control, not a scarcity. It is a price control that prevents the price of a scarce good from being raised by the self-interest of the buyers and sellers to its free-market level and thus reducing the quantity of the good demanded to equality with the supply of the good available.

Of course, if a price control on something exists, and a scarcity of it develops or grows worse, the effect will be a shortage, or a worsening of the shortage. Scarcities can cause shortages, or worsen them, but only in the context of price controls. If no price control existed, the development or worsening of a scarcity would not contribute to any

shortage; it would simply send the price higher.

Shortage Amidst Abundance

It should be realized that a shortage can exist despite a great physical abundance of a good. For example, we could easily develop a severe shortage of wheat in the United States with our present, very abundant supplies, or even much larger supplies. This is because the quantity of wheat demanded depends on its price. If the government were to roll back the price of wheat sufficiently, it would create a major additional demand not only a larger export demand, but a larger demand for raising cattle and broilers, making whiskey, and perhaps for many other employments for which one does not presently think of using wheat, because of its price. In other words, no matter how much wheat we now produce or might produce in the future, we could have a shortage of wheat, because at an artificially low price we could create a demand for an even larger quantity.

To the degree that the controlled price is below the potential free-market price, buyers judge that they can afford more of the good with the same monetary wealth and income. They judge that they can carry its consumption to a point of lower marginal importance. In this way, the quantity of the good demanded comes to exceed the supply available, whether that supply is scarce or abundant.

Price controls also reduce supply, which intensifies the shortages they create.

In the case of anything that must be produced, the quantity supplied falls if a price control makes its production unprofitable or simply of less than average profitability.

Squeezing Marginal Producers

It is not necessary that a price control make production unprofitable or insufficiently profitable to all producers in a field. Production will tend to fall as soon as it becomes unprofitable or insufficiently profitable to the highest-cost or marginal producers in the field. These producers begin to go out of business or at least to operate on a smaller scale. Their place cannot be taken by the more efficient producers, because the same price control that drives them out of business restricts the profits of the more efficient produc ers and deprives them of the incentive and also the capital required for expansion. Indeed, the tendency is eventually for even the most efficient producers to be unable to maintain operations and to be driven out of business.

For example, the price controls on oil have held down the supply of oil. They have not yet totally destroyed the supply of oil, but they have discouraged the development of high-cost sources of supply, such as oil from shale rock and even from the continental shelf in some instances. They have also made the more intensive exploitation of existing oil fields unprofitable, which, it is estimated, could be made to yield from one-third to two-thirds more oil over their lives by the adoption of such methods as thermal or chemical flooding, sometimes known as “tertiary recovery.” At the same time, in restricting the profits from the lower-cost oil deposits, price controls have held down both the incentives to discover and develop new such deposits and the capital necessary to the oil companies for expanded oil operations of any type.

Rent Controls

Rent controls on housing that has already been constructed provide a similar example of the destruction of supply. As inflation drives up the operating costs of housing—namely, such costs as fuel, maintenance, and minor repairs—more and more landlords of rent-controlled buildings are forced to abandon their buildings and leave them to crumble. The reason is that once the operating costs exceed the frozen rents, continued ownership and operation of a building become a source merely of fresh losses, over and above the loss of the capital previously invested in the building itself.

This destruction of the housing supply starts with the housing of the poor and then spreads up the social ladder. It starts with the housing of the poor because the operating costs of such housing are initially so low that they leave relatively little room for further economies. For example, there are no doormen to eliminate and therefore no doormen's salaries to save. Also, the profit margins on such housing (i.e., profits as a percentage of rental revenues) are the lowest to begin with, because the land and the buildings are the least valuable and therefore the amount of profit earned is correspondingly low. As a result, the housing of the poor is abandoned first, because it provides the least buffer between rising operating costs and frozen rents.

A price control reduces supply whenever it is imposed in a local market and makes that market un-competitive with other markets. In such a case, the local market is prevented from drawing in supplies from other areas, as was the Northeast and the United States as a whole during the Arab oil embargo.

In exactly the same way, in the winter of 1977, price controls on natural gas prevented areas of the United States from suffering freezing weather from bidding for additional supplies from the producing regions in the South and Southwest. Natural gas shipped across state lines was controlled by the Federal Power Commission at a maximum of $1.42 per thousand cubic feet. Natural gas sold within the states where it was produced, and thus outside the jurisdiction of the FPC and free of price controls, was selling at $2.00 per thousand cubic feet, with lower costs of transportation besides. It was therefore much more profitable to sell natural gas in the states where it was produced, such as Texas and Louisiana, than in such states as New Jersey or Pennsylvania.

Export Policies Affected

A price control not only prevents a local market from drawing in supplies from elsewhere, but it can also cause a local market that normally exports, to export excessively. In this case, as supplies are drawn out, the price control prevents the people in the local market from bidding up the price and checking the outflow.

This phenomenon occurred in this country in 1972 and 1973. Our price controls on wheat, soybeans, and other products made possible an unchecked exportation that jeopardized domestic consumption and led to an explosion of prices each time the controls were taken off, in President Nixon's succession of on-again, off-again "phases."

In this instance, the fall in the value of the dollar in terms of foreign currencies played a critical role. When President Nixon imposed price controls in August of 1971, he also took steps to devalue the dollar by 10 percent. Over the following two years, the dollar continued to fall in terms of foreign currencies and in 1973 was formally devalued a second time. The fall in the dollar's foreign exchange value meant a lower price of dollars in terms of marks, francs, and other currencies. Since the prices of our goods were frozen, a lower price of dollars meant that all of our goods suddenly became cheaper to foreigners. As a result, they began buying in much larger quantities—especially our agricultural commodities. As they began buying, domestic buyers were prevented by price controls from outbidding them for the dwindling supplies. As a result, vast accumulated agricultural surpluses were swept out of the country, and domestic food supplies were threatened, which is why prices skyrocketed each time the controls were taken off.

The fact that price controls jeopardize supplies in markets that export leads to embargoes against further experts, as occurred in this country in the summer of 1973, when we imposed an embargo on the export of various agricultural commodities. In addition, price controls in markets that must import make such markets helpless in the face of embargoes imposed by others, as we were made helpless in the face of the Arab oil embargo. It follows that in degree that countries impose price controls, they must fear and hate each other. Each such country must fear the loss of vital supplies to others, as the result of excessive exportation, and the deprivation of vital supplies from others, as the result of their embargoes and its helplessness to cope with them. Each such country makes itself hated by its own embargoes and hates the countries that impose embargoes against it. Our embargo on agricultural products in 1973 did not endear us to the Japanese. And there was actual talk of military intervention against the Arabs. Simply put, price controls breed war. A free market is a necessary condition of peace.

Reserves Exhausted

A price control reduces supply whenever it is imposed on a commodity of the kind that must be stored for future use. The effect of a price control in such a case is to encourage a too rapid rate of consumption of the commodity and thus to reduce supplies available for the future. As we have seen, buyers are led to buy too rapidly by the artificially low price, and sellers are led to sell too rapidly, since the fixity of the controlled price does not enable them to cover storage costs and earn the going rate of profit in holding supplies for future sale.

If the buying public is unaware of the impending exhaustion of supplies, the effect of sellers placing their supplies on the market right away is to depress the current market price below the controlled price. This process tends to go on until the current market price falls far enough below the controlled price, so that once again it has sufficient room to rise in the months ahead to be able to cover storage and interest costs. The resulting structure of prices guarantees the premature exhaustion of supplies.

Under conditions such as those described above, the buying public sooner or later becomes aware of the fact that supplies will run out. At that point, demand skyrockets, as the buyers scramble for supplies. As soon as this occurs, and it may be very early, the larger supplies that sellers are encouraged to place on the market under price controls are not sufficient to depress the market price below the controlled price, because they are snapped up by the speculative buying of the public, which is aware of the shortage to come. The consequence of the speculative buying of the public is that the item disappears from the market right away; it is hoarded.

The hoarding of the buying public is not responsible for the existence of shortages. The public hoards in anticipation of shortages caused by the price controls. The public's speculative demand cannot even be blamed for hastening the appearance of a shortage. That too must be blamed on price controls, because in the absence of the controls the additional demand of the public would simply raise prices; at the higher prices, the rise in the quantity of goods demanded would be cut back; prices would rise to whatever extent necessary to level down the quantity demanded to equality with the supply available.

Speculative Influence

Speculation on the part of the suppliers of goods is likewise blameless for the existence of shortages. Contrary to popular belief, price controls do not give suppliers a motive to withhold supplies, but, as we have seen, an incentive to unload them too rapidly.

There is, of course, an important exception to the principle that price controls give sellers an incentive to sell their supplies too rapidly. This is the case in which the sellers are able to look forward to the repeal of the controls. In this case, a price control makes it relatively unprofitable to sell in the present, at the artificially low, controlled price, and more profitable to sell in the future, at the higher, free-market price. In this case, sellers do have a motive to withhold supplies for future sale.

Even in this case, however, it is still the price control that is responsible for the existence of any shortage that develops or intensifies. In this case, the price control discriminates against the market in the present in favor of the market in the future; it prevents the market in the present from competing for supplies with the market in the future. Furthermore, in the absence of a price control, any build-up of supplies for sale in the future would simply be accompanied by a rise in prices in the present, which would prevent the appearance of a shortage, as we have seen repeatedly in previous discussion.

Finally, it should be realized that the withholding of supplies in anticipation of the repeal of a price control does not imply any kind of antisocial or evil action on the part of the suppliers. Price controls, as we have seen, lead to inadequate stocks of goods; in many cases, it is probable that the build-up of stocks in anticipation of the repeal of controls merely serves to restore stocks to a more normal level. Even if the build-up of stocks does become excessive, its effect later on, when the stocks are sold, is merely to further reduce the free-market price in comparison with what that price would otherwise have been. In any event, any ill-effects that may result are entirely the consequence of price controls.

The Consumer's Interest

Sometimes, the question is raised as to what argument one could give to a consumer to convince him to be against price controls; especially what argument one could give to a tenant to convince him to be against rent controls. Our discussion of how price controls reduce supply indicates a very simple argument to give to any consumer against any price control. That is that if he wants something, he must be willing to pay the necessary price. It is a natural law—a fact of human nature—that a good or service can only be supplied if supplying it is both worthwhile to the suppliers and as worthwhile as any of the alterna tives open to them. If the price is controlled below this point, then it is equivalent to a prohibition of supply. To command, for example, that apartments be supplied at rents that do not cover the costs of construction and maintenance, and the going rate of profit, is equivalent to commanding that buildings be built out of impossible materials like air and water rather than steel and concrete. It is to command construction in contradiction of the laws of nature. In the same way, to command that oil be sold less profitably in New York than in Hamburg, say, or that natural gas be sold less profitably in Philadelphia than in Houston, is equivalent to commanding that these materials become drinkable and that water become burnable, for it is no less an act in contradiction of the nature of things.

Now it is simply absurd for a consumer who wants a good, to support a measure which makes its supply impossible. And that is what one should tell him. That is what the consumers themselves should tell the legislators who are busy enacting price-control laws for their alleged benefit. These would-be benefactors of the consumers are prohibiting the consumers from making it worthwhile for businessmen to supply them. They are destroying the businessmen. In effect, they are destroying the consumers' ability to find agents to act on their behalf. They are reducing the consumers to the point where if they want anything, they will have to produce it themselves, because price controls will make it unprofitable for anyone to supply it to them. Already, rent control has "benefitted" tenants to the point that it is becoming increasingly necessary if one wants an apartment to own it oneself: one must buy a "co-op" or a condominium. Price controls have made it increasingly difficult, and at times absolutely impossible, to buy oil or natural gas. If the legislators are to go on "benefitting" the consumers long enough with their price controls, they will benefit them all the way back to the economic self-sufficiency that was the leading characteristic of feudalism.

The ignorance that underlies the destruction of our economic system is made possible by a protective shell of envy and resentment. People take the attitude that somehow the utilities, the landlords, the oil industry, or whoever, are "already rich enough," and that they'll be damned if they'll let them get any richer. So, on with the price controls. That is the beginning and the end of their thinking on the subject, and they just don't care to think any further. They are eager to accept high nominal profits as a confirmation of their view that the industries concerned are "rich enough," and to let it go at that.

However, the simple fact is that none of these industries is rich enough, and in preventing them from becoming richer, or even staying as rich as they are, people foolishly harm themselves. None of these industries is rich enough for the simple reason that we really do not have enough power plants, enough good apartment buildings, or enough oil wells and oil refineries. Speaking for myself, as a consumer, I must say that I would like Con Edison, the landlords of New York City, the oil industry, and so on, all to be worth many more billions than they are presently worth. I would benefit from that fact. If Con Ed had more power plants, my supply of electricity would be assured. If the landlords had more and better buildings, I would have a better apartment. If the oil industry had more wells and refineries, I would have a more abundant and secure supply of oil products.

If one thinks about it, I believe, nothing could be more absurd than consumers in a capitalist economy attacking the wealth of their suppliers. That wealth serves them—they are the physical beneficiaries of it. All of the wealth of the utilities, the landlords, the oil companies—where is it? It is in power plants and power lines, apartment buildings, oil wells and oil refineries. And whom does it actually, physically, serve? It serves the consumers. It serves us all of us. We have a selfish interest in the preservation and increase of that wealth. If we deprive Con Ed of a power plant, we deprive ourselves of power. If we deprive our landlords of more and better buildings, we deprive ourselves of apartments. If we deprive the oil industry of wells and refineries, we deprive ourselves of gasoline and heating oil.

Trust the Market

There is indeed a harmony of interests between the consumer and the producer under capitalism. Because of it, even if businessmen become cowardly and do not fight for their own interests, we, as consumers, must fight for them, and thereby for ourselves. For we have a selfish interest in being able to pay prices that make it profitable for businessmen to supply us. It is to our self-interest to pay utility rates, rents, oil prices, and so on, that enable the producers in these fields to keep their facilities intact and growing, and that make them want to supply us. And I must say that we do not have to worry about being charged unfairly in a free market, because any high profits that might be made from us are simply the incentive and the means to an expanded supply, and are generally made only because of special efficiency on the part of the producers who earn them.

George Reisman

George Reisman, Ph.D., is Pepperdine University Professor Emeritus of Economics and the author of Capitalism: A Treatise on Economics.

More By George Reisman

UNCATEGORIZED

In His Youth, Ralph Raico Was My Brother

JANUARY 29, 2017 | GEORGE REISMAN

UNCATEGORIZED

The Toxicity of Environmentalism

SEPTEMBER 1, 1992 | GEORGE REISMAN

UNCATEGORIZED

Education and the Racist Road to Barbarism

OCTOBER 1, 1990 | GEORGE REISMAN

UNCATEGORIZED

Ludwig von Mises Defender of Capitalism

JULY 1, 1982 | GEORGE REISMAN

FORBESBUSINESSPOLICY

Price Controls Do Not Work – Even In Credit Markets

Norbert Michel
Contributor
I follow the evolution and devolution of monetary and financial policy

Jul 27, 2021, 02:55pm EDT

This article is more than 2 years old.

CORAL GABLES, FL - AUGUST 29: Senator (D-OR) Jeff Merkley in conversation and books signing with Dr. ... [+] MPI10/MEDIAPUNCH/IPX

Many people believe that conservative members of Congress reliably protect private markets from government intervention. History has proven otherwise, especially when it comes to credit markets.

In 2017, for instance, a Republican-controlled Congress had the chance to repeal the Durbin Amendment, but chose not to do so. Special-interest politics trumped conservatives' supposed principles even though price controls have a dismal record.

That episode makes this week's Senate hearing particularly interesting. Any Republicans who support Sen. Jeff Merkley's (D-Oreg.) new bill are essentially voting to impose interest rate caps on a large segment of the credit market.

Thursday's hearing is entitled "Protecting

Americans from Debt Traps by Extending the Military's 36% Interest Rate Cap to Everyone." As the name indicates, Merkley and several co-sponsors want to extend an interest rate cap that currently applies to active-duty service members (for some types of loans) to pretty much everyone.

To implement this broad price control, the new bill extends key features of the 2006 Military Lending Act (MLA). Specifically, it extends to all Americans the MLA provision that forbids lenders from providing *consumer credit* to active-duty service members (and their spouses and dependents) at an annual percentage rate greater than 36 percent.

MORE FROM FORBES ADVISOR

Who Is The New Platinum Card From American Express Good For?

By Eric Rosen Contributor

What To Do If You Still Haven't Received Your Child Tax Credit Payment

By Kemberley Washington Forbes Advisor Staff

Obviously, the definition of *consumer credit* is critically important here, but let's come back to that.

No matter what the hearing title suggests, this kind of policy will *not* protect high-risk

consumers from problems associated with high-cost debt. It will, in fact, harm more consumers than it will help. It's a price control, and that's what price controls do.

As this *Issue Brief* explains, interest rate caps are *price ceilings*, and just like all other price ceilings, they lead to shortages. They make it more costly to supply consumers, but they do absolutely nothing to limit consumers' demand. In this case, the rate caps will make it more costly to supply credit while doing nothing to reduce people's demand for borrowing.

People will simply develop alternate (more costly) ways to both supply and obtain credit. This will result in fewer people getting the loans that they need, and others paying more for the loans that they are able to get. (It seems obvious that many credit card companies would drop their rewards programs.)

Of course, that's not the way that the folks at the Center for Responsible Lending (CRL) see it. They support Merkley's new bill, the Veterans and Consumers Fair Credit Act. (The companion bill in the U.S. House has the identical name).

According to their website,

> Predatory, unaffordable loans are burying people in debt. They cause people to lose their cars, bank accounts, and good health. The Veterans and Consumers Fair Credit

> Act would put an end to this gross exploitation.

It is tempting to argue that, rather than merely advocate for the government to impose price ceilings in line with their own views, the people who run CRL should pool their resources and start providing credit at their preferred interest rates. The only problem is that CRL already has two affiliate organizations that can do just that. According to their website,

> Our affiliate organizations—Self-Help Credit Union and Self-Help Federal Credit Union—offer auto loans, credit cards, home equity products, debit cards, checking accounts ATMs, and convenient teller services in more than a dozen communities in North Carolina, California, Greater Chicago, and Florida.

Now let's return to that little detail from above, the definition of *consumer credit*. It turns out that the MLA, and Merkley's Veterans and Consumers Fair Credit Act, exempt residential mortgages and car loans. Section 2 of Merkley's bill also exempts loans made by federal credit unions.

The folks at CRL will surely point out that the bill does require those federal credit union loans to adhere to the usury limits implemented by the Federal Credit Union Act. On the surface, those limits appear more stringent, with a 15 percent cap "per annum on the unpaid balance inclusive of all finance charges."

Dig a little deeper, though, and one finds that the Federal Credit Union Act includes an escape clause. Section 1757(5)(A)(vi)(I) does allow credit unions to set "an interest rate ceiling exceeding such 15 per centum per annum rate, for periods not to exceed 18 months," in some cases, after consulting with "the appropriate committees of the Congress, the Department of Treasury, and the Federal financial institution regulatory agencies."

What are those special cases?

Only when it is clear that "money market interest rates have risen over the preceding six-month period and that prevailing interest rate levels threaten the safety and soundness of individual credit unions as evidenced by adverse trends in liquidity, capital, earnings, and growth."

In other words, *federal credit unions* have a work-around if market conditions make it impossible to provide credit when charging at the price cap. Everyone else will just have to deal with the negative consequences.

All of this makes it irresistible, so here goes: If the folks at CRL want to provide consumer loans at incredibly low interest rates, that's what they should do. It should be rather easy to grab market share by helping all those supposedly exploited borrowers.

If Congress imposes price controls such as those in the Veterans and Consumers Fair Credit Act, the new rate caps will essentially apply to all credit cards, deposit advance loans, overdraft lines of credit, and many different types of installment loans. This sort of policy will make it more difficult for those who most desperately need it to obtain credit — and it will ultimately raise the cost of credit for many other borrowers.

These kinds of widespread rate caps will likely even bolster the false pretense for more price controls and increasing government-provided credit. A cynic would point out that certain credit unions already provide subsidized credit, indicating that, perhaps, hurting the private lenders that they compete with while increasing people's dependency on government is exactly what they want.

If Congress really wishes to ensure that people get the credit they need, it should start removing the countless regulatory barriers – most of which Congress is responsible for creating in the first place – that are destroying the competitiveness of private credit markets.

Follow me on Twitter.

Norbert Michel

Price Controls Don’t Fight Inflation: 40 Centuries of Evidence

Vincent Geloso – October 3, 2023

Reading Time: 4 minutes

The 1970s called and they want their economic policy back. This may sound like a cheap quip against the growing popularity of attempts to control prices in the face of inflation. After all, France is implementing price controls right

now, while Canadian Prime Minister Justin Trudeau also forced grocery stores to come explain price hikes with the hint that he might start doing the same. These policies and scapegoating of businesses are the same as in the 1970s, hence the quip. But I could have quipped about any number of historical examples – the 1940s, the 1930s in Germany, the 1910s, the 1790s in France, and on and on. After all, as one aptly titled book made explicit – "forty centuries of wage and price controls" teach us exactly "how not to fight inflation."

The best way to understand why is by invoking an analogy about thermometers and temperature that Milton Friedman employed when inflation was a big issue during the 1960s and 1970s. Prices function somewhat like a thermometer inside your house. They indicate the point where the quantities that producers are willing to supply to the market match the quantities consumers demand, based on their available budget. Monetary policy for its part, is the thermostat. If the thermometer says that the temperature is going up, it's either because there are changes in the economy in general (i.e., the outside temperature) or because someone turned up the thermostat. Sometimes, it can be a mixture of both factors (i.e., loose monetary policy and supply shocks occurring simultaneously). Distinguishing between them is not an easy task. People who propose to impose price

controls are essentially trying to break the thermometer by preventing it from showing the rising temperature and claiming the problem is solved.

This approach doesn't address the underlying issue, but instead deprives us of information about its scope and progression. All it does is create noise around the price signals because the underlying fundamental factors (i.e., monetary policy, factors that affect productivity etc.) are unchanged. As such, the fact that measured prices stop increasing when the government enforces price controls doesn't mean that real prices stop rising. Something must give! With controlled prices, people must either wait in line, suffer some form of rationing, be offered lower quality goods, or be forced to engage in involuntary substitution towards less desirable goods.

Historical examples of each of these consequences of price controls abound. In my native Canada during WW II for example, the federal government imposed strict price control measures on a wide array of goods. At controlled prices, supply fell short, an issue made worse by the many thousands of Canadians who were taken out of the labor force and sent to fight. Many goods were too scarce, so rationing was necessary. Canadians were thus compelled to wait in long lines with ration books. The waiting time was a cost in

and of itself. The rationed quantities were another form of cost, such that calories consumed by civilians in Canada – which was spared the physical destruction of the war – actually fell. When too unsatisfied with the consequences of rationing, Canadians turned to the black market, where they could be ripped off with no possible recourse (food adulteration was, for example, a recurrent issue). If caught making illicit purchases, the fines were hefty. To top it all off, retailers often served lower-quality goods to the public at controlled prices while selling higher-quality goods on the black market. All of these are "real" costs that "reported prices" no longer communicated.

These kinds of costs are *very* real. In an article in *Social Science Quarterly*, Casey Pender and I estimated the true inflation in Canada during the war. Using pre-war relationships between economic activity, money supply, and inflation, we predicted what would have been the rate of inflation absent price controls. We found that the official reported increase of 28 percent in prices from 1939 to 1945 was actually 48 percent. That rate is probably too conservative. Indeed, newspapers at the time frequently discussed black markets, which led to occasional reporting of "shadow market prices" which could be compared with official prices. These suggest figures well above the 48 percent that Pender and I found (probably closer to 60 or 70 percent).

One example of involuntary substitution resulting from price controls can be found in Nazi Germany before WW II. The regime implemented strict price controls in ways that did not reflect previous consumption patterns. As such, given the prices posted, Germans could not consume what they truly desired. To illustrate, imagine that the price of beef was twice the price of pork before price controls. Yet, Germans consumed more beef than pork. Once price controls were imposed, the price of beef was set equal to that of pork. Germans should consume more beef. But rationing was still an issue – beef was simply unavailable at posted prices. They thus consumed more pork. This is involuntary substitution, and it has a cost in terms of welfare. Economic historian Robin Winkler attempted to measure the cost of this involuntary substitution by comparing some 4,000 households in 1927 (before price controls) and 1937 (after price controls), with the assumption that the former year revealed true preferences relative to the distortions in the latter year. The distortions could then be expressed as a share of income – which Winkler estimates was roughly 7 percent. Simply put, Germans would have needed 7 percent more income to compensate them for the value of the lost well-being resulting from the price controls.

I could keep going. Price controls have long

been studied by economic historians in the case of the French Revolution, many countries during and soon after World War I, the 301 AD price edict of emperor Diocletian, the Song dynasty's 13th century experiments with paper money, and the attempt to quash inflation with price controls, and even the price and wage controls of the Nixon administration. All of them point to the same thing – price controls do not stop inflation; they only make things worse. If prices are going up, it's either because monetary policy is too loose or because the economy suffered a decline in productivity. There is no way around it, and the only solutions are to tighten monetary policy or enact reforms that promote productivity growth. Everything else is a fool's errand that ends in economic pain.

Vincent Geloso

Vincent Geloso, senior fellow at AIER, is an assistant professor of economics at George

Mason University. He obtained a PhD in Economic History from the London School of Economics.

Follow him on Twitter @VincentGeloso

Get notified of new articles from Vincent Geloso and AIER.

SUBSCRIBE

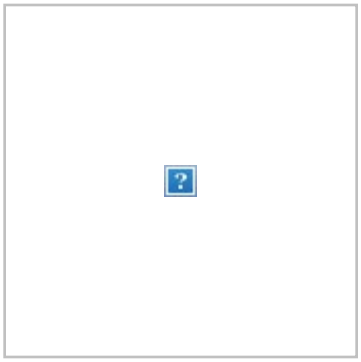
RELATED ARTICLES – ECONOMIC EDUCATION, FREE MARKETS, HISTORY, POLICY

Michael Watson –

April 24, 2024

Parity in Labor Transparency

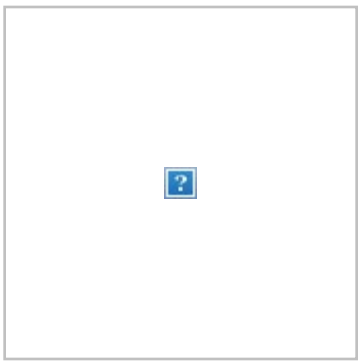
READ MORE



 Art Carden – April 23, 2024

Will Caitlin Clark Be Grossly Underpaid?

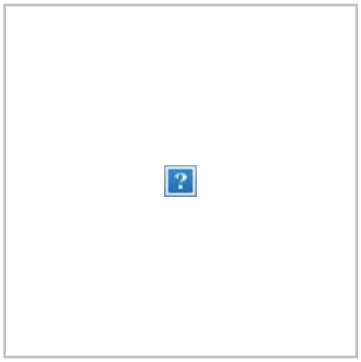
READ MORE



 Gary M. Galles – April 23, 2024

Why Even Insiders Underestimate Markets’ Power

READ MORE

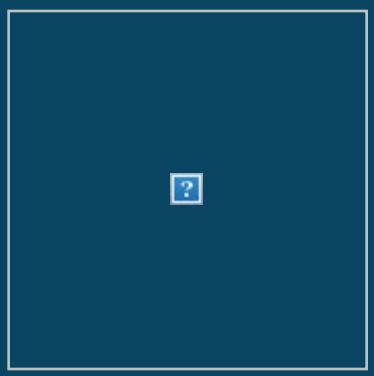


Marcus M. Witcher –

April 22, 2024

Breaking the Shackles of Socialism in Africa

READ MORE



250 Division Street |
PO Box 1000
Great Barrington, MA
01230-1000

Contact AIER
Telephone: 1-888-528-1216 |
Fax: 1-413-528-0103

Press and other media outlets contact
888-528-1216
press@aier.org

Editorial Policy

About AIER
News
Directions
Employment
Subscribe to AIER
The 1933 Club
Donate to AIER

22FC5B0B-A4EC-4985-A9EF-94269B50F21B D5AB5053-9729-48DC-BFE7-1DD0B296D2FA 7081E26A-9CE7-4FCB-BE74-A2FA6B5E1F0E 7F3372AF-C896-4062-916A-6C2C5234D09B Icon for article summary 8AB4BD7D-7AC9-49FB-BE85-2C68FA08E565 F543922C-C097-4292-BA6C-A337016C5A47 ACF32132-BE0D-485B-90C2-0A0C78C199DA C2C7D000-E097-40EC-A866-DFFAE228B1DA 5E3312C8-29BE-4690-8D0E-022F57A28720 location .Shape-location2 { fill: #165C7D; } html:lang(en-US) .Shape-location2, html:lang(en-CA) .Shape-location2, html:lang(en-AU) .Shape-location2, html:lang(ja-JP) .Shape-location2 { fill: #007952; } Phone .Path-sm-phone2 { fill: #165C7D; } html:lang(en-US) .Path-sm-phone2, html:lang(en-CA) .Path-sm-phone2, html:lang(en-AU) .Path-sm-phone2, html:lang(ja-JP) .Path-sm-phone2 { fill: #007952; } 3E0371F9-4B0C-49F2-AEE6-A78753E8DFD3 icons/24/transcript X logo B704F803-F647-470A-97EC-67D43EB1FE8F 5F584AAD-AA61-4CAC-8D0E-7A1F4A8C9338 Fisher Investments External Star Users tune-variant 93169ADC-370E-4C67-8390-3DF913F068E0 Global Icon This strategy has SRI, ESG, or Impact AUM

PERSONAL WEALTH MANAGEMENT / ECONOMICS

Why Price Controls Don't Work

They neither dampen demand nor swell supply—and have a history of hampering the latter.

By Fisher Investments Editorial Staff — 6/7/2022

Editors' note: MarketMinder is nonpartisan, neither for nor against any party, politician or policy. Though inflation has become a politically charged topic, our analysis focuses only on its—and surrounding developments'—potential impact on the economy and markets.

If rising prices are hurting so many, why not just outlaw them? It sounds so simple. But, in practice, history has proven such price controls to be highly problematic in practice. Prolonged price pressures have raised calls for government action and led to some actual legislation—e.g., windfall profits taxes in Europe. In the US, there are efforts to go further, with prospective price control bills in Congress barring "gouging." While passage doesn't seem likely, we wouldn't rule it out. We are watching their progress because, if adopted broadly, we think they could pose headwinds for the

economy and markets.

Why are price controls such a bad idea? They distort price signals, which are core to markets' functioning effectively and, not unrelatedly, economic growth. Prices balance supply and demand, coordinating production and consumption. They are signals, full stop. On the demand side, when they are high and rising, they encourage more people to cut back, substitute and economize. At the same time, high and rising prices imply greater potential profit, signaling producers to boost supply—which eventually helps keep prices in check.

But if prices can't fluctuate freely, they don't tell producers when they need to crank up output. Nor do they incentivize people to adjust consumption in order to help limited supply stretch further in the short term. As a result, you don't get the changes in behavior that help stabilize prices. Heck, price controls can even cause severe shortages if prices are set near or below producers' costs, which discourages production by destroying the profit motive—ultimately driving prices far higher still.

Price controls aren't hard permanent ceilings. Sometimes the caps reset periodically, causing prices to jump in blocky stair-steps, much as the UK is enduring with household energy prices under its retail price cap right now. Or, they lift, and shortages quickly drive prices much higher—potentially higher than they would otherwise have been. This happens regularly in Emerging Markets nations that have historically been frequent users of fuel price caps. Even if a cap is set above current market prices, they can quickly shift from ceiling to target, as producers worry they won't be able to raise prices later, if need be.

We understand and empathize: High and rising prices aren't fun. They can be excruciating. But they are crucial to incentivize more supply—and temper demand temporarily until then. Market processes aren't always quick or painless, hence the frustration and clamor for relief by other means. Without dynamic price signals to consumers and producers, though, history shows greater pain awaits.

You don't have to look back very far to see how. The Nixon administration's price controls were disastrous. Introduced in August 1971 along with scrapping dollar convertibility to gold, President Richard Nixon ordered a 90-day freeze on wages, prices and rents. Next came October 1971's dual Economic Stabilization agencies—the Pay Board and the Price Commission overseen by the Cost of Living Council—which administered wage and price controls thereafter, permitting increases by diktat. Price controls seemed to succeed at first. CPI inflation was running at 4.4% y/y in August 1971 and fell to 2.9% a year later.[i] But by January 1973, price controls started phasing out, first with "voluntary controls" and later "voluntary compliance" in August 1973. Catch-up inflation

ensued.

In April 1974, when price controls formally dissolved, CPI was at 10.1% y/y and the economy was 5 months into a recession. Gas lines, tied to 1973 – 1974's Arab oil embargo and these controls, were one result. Empty grocery store shelves were another, and the two became the face of America's malaise. Without profit, ranchers stopped bringing their cattle to market. Farmers drowned their chickens—perverse and sad, but it is what occurs when governments interfere with price signals. We think it is clear Nixon's heavy-handed interventions—and the uncertainty surrounding them—helped *cause* the 1970s' high inflation. They didn't control it. Moreover, they helped contribute to the deep mid-1970s recession as a result.

So, price controls are generally something to watch out for. If enacted broadly, they would be a negative. But even short of that, just their increasing likelihood would probably add to headline fears already weighing on sentiment. That could roil markets short term, especially since price controls risk interfering with the forces that are already working to tame inflation, which stems predominantly from supply disruptions. Take oil, cars, homes and semiconductors—in all cases, unit production is ramping up, hitting or approaching record highs. As Economics 101 teaches, there are two ways to tame inflation: either curb demand or build supply. Only the latter spurs growth. But price controls do neither. Relieving supply bottlenecks takes time and may not provide immediate respite, but it gets the job done eventually.

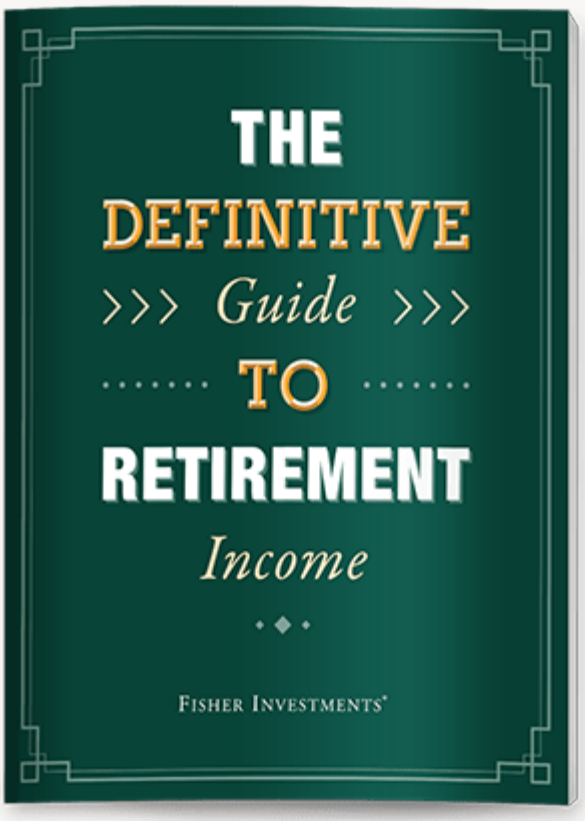
Positively, the risk Congress implements price controls appears remote, as there aren't the votes for it. The Democratic Party's current edge in the House is among its smallest majorities in history, and they are fractured on the issue. The Senate is evenly divided, and we are only about five months from midterm elections that, if history is an indication, are likely to flip control of one or both chambers, dividing nominal party control of government. If that happens, price control legislation stands little to no chance.

Actually, those midterms may somewhat explain the push to act on prices: It is an effort to show politicians are "doing something" about inflation, a stance perhaps aimed at turning out the base at midterms. A windfall profits tax may stand more of a chance, yet that isn't very likely, either, considering politically centrist red-state Democratic Senators and Representatives are against the idea and facing fraught battles to keep their seats. So even if there is movement on this front generating headlines, it isn't likely to sail through Congress anytime soon. In the unlikely event anything passes, it would probably have to be greatly watered down for approval.

[i] Source: Federal Reserve Bank of St. Louis, as of 6/6/2022. CPI, August 1971 – August 1972.

If you would like to contact the editors responsible for this article, please message MarketMinder directly.

**The content contained in this article represents only the opinions and viewpoints of the Fisher Investments editorial staff.*



See Our Investment Guides

The world of investing can seem like a giant maze. Fisher Investments has developed several informational and educational guides tackling a variety of investing topics.

See All Guides

SHARE THIS MEDIA

Share on Facebook **Share on X** **Share on Linkedin**

Related Resources

PODCASTS

Ken Fisher Answers Questions on Inflation, When to Buy and Emerging Markets Opportunities Beyond Chin... 2024

4/24/2024 12:00:00 AM

POLITICS

Disunity: The Divides Waylaying Europe’s ‘Capital Markets Union’

4/23/2024 12:00:00 AM

WEEKLY WRAP-UP

Fisher Investments Reviews: Last Week in Markets—April 15 - April 19

4/22/2024 12:00:00 AM

IN THE NEWS

Ken Fisher: It's a bull market, enjoy it

4/22/2024 12:00:00 AM

Learn More

Learn why 150,000 clients* trust us to manage their money and how we may be able to help you achieve your financial goals.

*As of 3/31/2024

New to Fisher? Call Us.

(888) 823-9566

Contact Us Today

Connect With Us

Call us at (888) 823-9566

Find Fisher Investments on social media.

twitter Instagram Icon TikTok Icon

Get the Fisher App

Available for US customers only.

Get the app on Apple App Store

StockViz

Invest Without Emotions

Price Controls: 5 spectacular failures

MONICA SAMUEL | JULY 1, 2013 | 0

Every since the creation of civil society, governments have tried to influence economic and social trends by prescribing minimum or maximum price limits for commodities. And in almost every instance, price controls have done more damage than good.

Understanding price control

Price control is when governments pass a law to control the minimum or maximum cost of a product or service. Usually, it is a short-term measure that can get extended for political reasons. Price controls are meant to control inflation or offer short-term relief to citizens. These laws are usually implemented after or during emergencies such as natural disasters, wars or in situations where common people are deprived of basic amenities because of soaring costs or scarce supply. Unfortunately, price controls usually backfire, worsening the situation and crippling the economy in the long run.

How does that happen? During an emergency, essential goods become scarce because retailers, shops, and warehouses get gutted and the regular supply chain is disrupted. Since providers now need to get products from unusual channels or through extraordinary efforts, they charge more. This certainly angers people and affects them but at least the products are made available. When a price cap is imposed on the sale of products, providers are unable to sustain the supply chain and forced to close shop, creating greater shortage. Cheaper prices also attract greedy people wanting to capitalize on the opportunity to hoard.

Here are a few examples of how price control laws end up hurting the very people they intend to help. It's the same story all over the world.

India drug price controls, 1995

India has a long history of drug price controls that go back to 1955. As per the provision of Drugs (Prices Control) Order, 1995, drug manufacturers had to abide with ceiling prices fixed by National Pharmaceutical Pricing Authority (NPPA) for scheduled category of drugs.

NPPA studies show that the law restricted many manufacturers from producing all the essential bulk drugs. In fact, only 47 of the 74 notified bulk drugs in the First Schedule of the DPCO, 1995 were produced. Furthermore, price control led to production loss and competition in the Indian ingredients supply which hurt the clinical trial sector.

Price controls intended to cub malpractice by pharmaceutical companies created imbalances between medicine affordability and availability and the growth of the industry. The price control law for drugs is still a point of debate and has undergone multiple revisions since.

US wage controls, 1971

In 1971, President Nixon implemented wage price controls to mollify the public in view of the 1972 elections, decrease unemployment and contain inflation. After a 90 day trial period during which the controls seemed to be working though unemployment did not reduce, inflation picked up again as the dollar weakened with increasing price of imported goods and other global factors. Under political pressure, Nixon reinforced wage controls but to no good – ranchers stopped selling cattle, farmers drowned their chickens, and supermarket shelves emptied. The system was finally abolished in April 1974, 17 months after Nixon's triumphant reelection victory.

US gas and oil controls, 1970s

President Nixon sanctioned oil and gas price control during his term. These were continued by other presidents till 1981 when President Reagan entered office and immediately abolished what remained of oil and gas price controls.

In the previous decade, the oil price control system created several tiers of oil prices. With a clamp on prices for domestic production, producers were forced to subsidize imported oil and provide additional incentives to import oil into the United States. An elaborate and confusing system of price controls, entitlements, and allocations led to long angry lines at the

pump. By the time the Iranian oil crisis hit in 1979, President Carter had waived most of the controls on oil and gas prices to make more fuel available.

The resulting price hike created new problems: double digit inflation that put the Federal Reserve in crisis mode, forcing it to make its largest ever increase in interest rates in October 1979, plunging the economy into a deep recession.

Pennsylvania commodity control, 1770s

Post war, Pennsylvania imposed price controls on "those commodities needed for use by the army" to support George Washington's revolutionary army. This created severe shortages of just about everything needed by the army, almost starving them to death in the field.

The Continental Congress thankfully passed a anti-price control resolution on June 4, 1778 that read: "Whereas it hath been found by experience that limitations upon the prices of commodities are not only ineffectual for the purpose proposed, but likewise productive of very evil consequences—resolved, that it be recommended to the several states to repeal or suspend all laws limiting, regulating or restraining the Price of any Article."

By the fall of 1778 the army was fairly well provided for as a direct result of this change in policy.

French Revolution, 1793

During the French Revolution (1789-1799), politicians put into place the "Law of the Maximum" that imposed price controls on grain and later, on other items. The resulting situation is described as "in some [French] towns, the people were so badly fed that they were collapsing in the streets from lack of nourishment." A delegation from various provinces appealed to the government in Paris stating that markets were supplied before the new price control law. As soon as the price of wheat and rye was fixed, those grains became scarce. Other grains not subject to the maximum law were the only ones brought in.

The French government finally repealed the price control law after the death of thousands.

Price controls are like short-term palliatives that do nothing to fix the root cause of problems. Yet, governments continue to implement price control laws to appease the public and attract vote banks. While the greater good of a nation is sacrificed at the altar of political agendas,

the core issues for which price controls are implemented only grow worse, building up to almost irrecoverable situations. Instead of price controls laws, we need a law to ban price control.

Related articles

Venezuela's Price Control Enforcer to Speculators: "The Fun is Over"

Economic SNAFU in Argentina

Gas pricing: Get govt out of the way

New drug policy welcome move for consumers: Pharma cos

Simple models and the macroeconomics of price controls

. Your Money

Monthly Recap

Gold: The New Normal

Comments are closed, but trackbacks and pingbacks are open.

Dispatch logo

Price Controls Are Disastrous. Just Ask South America.

The failure of price controls to stop inflation and allow more access to goods has been well-documented.

By Alex Horenstein and Noah Williams

Feb 9, 2022

38

As inflation in the United States has spiked to levels not seen in forty years, some progressive voices have become increasingly bold in their calls reform. Reasoning that inflation is, after all, due to firms raising their prices, these commentators have directly attacked businesses: complaining about price gouging and what they call corporate greed, threatening antirust legislation, and even calling for price controls. While limiting price increases seems like a straightforward remedy for inflation, a look at how price controls have worked in South America shows why such measures bring more problems than solutions.

"We consulted with the president in view that the shelves were empty and people were demanding food," Francisco Arias Cárdenas, a Venezuelan provincial governor told a reporter in the fall of 2016 amid unrest in the country. In response, President Nicolás Maduro allowed some provinces to relax the price controls that were driving chronic food shortages. While the easing of price controls led to a jump in prices, the shortages were alleviated. "At least I can come in and buy, even if at high cost," Ana Atencio, a nurse, told

the *Wall Street Journal*. “Before, I wouldn’t even dream of it because of the line and people fighting.” Unfortunately, Maduro did not learn the lesson from this local experiment, as price controls remained in place nationwide in Venezuela for years afterward. When the price controls were finally relaxed, Venezuela’s economy was hit with hyperinflation and mass hunger, and endured possibly the worst peacetime economic collapse in history.

The Venezuelan experience with price controls was not unique. The failure of price controls to achieve their aims of stopping inflation and allowing for broad access to goods has been documented time after time. Many of these episodes were described back in 1979 in a book whose title, *Forty Centuries of Wage and Price Controls: How Not to Fight Inflation*, summarizes the history. And yet, it seems, all bad ideas come back around.

It is rare to have a policy with such a long history of failure be proposed as “new” idea. But over the past few months, that’s exactly what we’ve seen. The new progressive commentators argue that price controls are a popular means of arresting corporate power, that “strategic” price controls can arrest inflation by cutting into profit margins, and that “democratic control over price levels” can limit the impact of supply shocks. This last referenced piece was commended by a member of President Biden’s Council of Economic Advisers, which suggests these ideas are being seriously considered by policymakers in the United States.

Importantly, while these contemporary commentators make reference to the wartime price controls in the U.S., none makes the case that price controls are a successful long-term strategy. Price controls can indeed reduce measured inflation, at least temporarily. For goods already on the shelf or in production, suppliers and retailers have limited options beyond selling at the capped price. But the supply soon dries up and before long, many types of leakages occur as buyers and sellers try to evade the controls: a black market arises in off-book transactions, buyers and sellers substitute away from goods whose prices are controlled, and policymakers may introduce quantity controls to deal with limited supply and shortages. When price controls are finally relaxed or lifted, the economies typically experience a burst of inflation and spiraling costs for consumers.

Argentina gives us another window to observe the impact of applying price controls. They have been the preferred policy in the country on multiple occasions when inflation has picked up, and have been used by democratically elected governments as well as

dictatorships for more than 70 years. The price controls have always failed.

The recent history in Argentina also illustrates the failure of the limited or "strategic" price controls favored in some of the recent commentary. Since 2013, the most recent Argentinian administrations have resorted to price controls once again with a policy called "Precios Cuidados", where some products have price controls while others do not. The end result is often a dramatic difference in quality between the products with price controls and those without. There are also shortages for products under price controls, while producers always find creative ways to avoid the government regulations, such as changing the labeling or the size of the product. To take just one example, the price of a 500 gram box of Kellogg's Frosted Flakes ("Zucaritas") is on the list of controlled prices. On a recent trip to a grocery store, buyers found signs on the shelf apologizing that the cereal was out of stock due to delivery problems from the supplier. Amazingly, the shelves were full of Frosted Flakes in 510 gram boxes, the price of which was not controlled.

In addition to the distortions they introduce, price controls are costly to implement. To enforce price controls, the government has an army of employees whose job is to check

prices around the country. This is consistent with U.S. experience where, “at the peak of price control efforts in World War II, the government employed 160,000 price regulators.” The costs of enforcing price controls are paid by the taxpayers whom the policy is supposed to protect. Despite price controls, inflation in Argentina is still above 50 percent annually, according to official statistics.

Price control policies have the implicit assumption that government officials know the cost structure and market conditions better than the companies operating in them, a heroic assumption considering the historic performance of centralized economies. (Recall Friedrich Hayek’s justly famous formulation showing how markets make use of dispersed and partial information in “The Use of Knowledge in Society”.) In addition, price controls foster corruption that can benefit those with ties to the government. After all, government officials are given the power to decide who will make profits and how much (or who will endure losses and for how long).

When implementing price controls on strategic goods markets like energy, a large component of the price index, the result is lack of investment and the necessity of large government subsidies to keep companies afloat. These subsidies add to one of the main problems driving inflation, which is a large government deficit. After all, inflation is just the symptom of the problem, not the cause.

While price controls have sometimes tamed inflation momentarily in Argentina, lack of long-term effectiveness, shortages, and other induced distortions have forced governments to move away from the policy. Once price controls are removed, high inflation resumes. Once high inflation resumes, price controls resume, only to fail again. The history has repeated itself intermittently since the 1940s. Price controls have led to scarcity, scarcity has many times led to quantity controls (as people are allowed to buy only a limited quantity of goods), and all these problems too often have made black markets flourish. Economic growth in Argentina in the last 70 years has been subpar compared to the rest of the world. Price controls have exacerbated the economic problems, not solved them. It is well-documented that the primary source of Argentina’s inflation problem in the 1970s and 1980s was the government deficit. It still is.

Unable to address the long history of failure of price controls, the contemporary commentators effectively argue that this time is different. They suggest that growing

concentration has led to increased market power by large companies, who use this power to restrict production and extract exorbitant prices. In competitive markets, price controls lead to shortages as demand exceeds supply at the controlled, below-market price. With monopoly power, firms restrict production below efficient levels, and in theory a well-chosen price control can improve welfare.

But while there is evidence in the recent economics literature documenting increased concentration, there is much less evidence that these are leading to distortions which affect consumers, particularly on a local level. (Leena Rudanko, an economist with the Federal Reserve Bank of Philadelphia, provides a summary.) With their focus on monopoly power, advocates of price controls echo many of the same arguments of the "New Brandeis" antitrust school. Abandoning the consumer welfare standard—by which courts evaluate business practices on whether they harm consumers—they instead focus directly on regulating the size of companies and concentration of industries.

Whatever its merits as an approach to antitrust policy (and we are skeptical), the idea that policymakers could effectively limit monopoly power and control inflation through the use of price controls seems fanciful. Many before have tried the same approach and failed. Attacking the symptoms of the problem does not solve it, and in the long run, may only make matters worse. When Latin American countries successfully tamed inflation, they did so by adjusting their fiscal and monetary policy. Price controls have never succeeded in this task. If monopoly power truly is a problem, then antitrust policy may be the solution. If government spending and expansionary monetary policy is a problem, the solution is adjusting the fiscal and monetary policies.

Policymakers already have the tools to address the inflationary problems we face. Using a policy with a proven record of failing around the world and across history does not seem to be the best course of action. Rather than embarking on an experiment by introducing price controls in the U.S., policymakers should learn from the experience of Latin America. Millions of hungry Venezuelans and Argentineans would suggest an alternative approach.

Alex Horenstein is an associate professor of economics at Miami Herbert Business School, University of Miami.

Noah Williams is the Curt and Sue Culver professor of economics at the University of

Wisconsin-Madison and adjunct fellow at the Manhattan Institute.

38

By Alex Horenstein and Noah Williams

Comments (38)

Join The Dispatch to participate in the comments.

Sort by: Newest to Oldest

Pingback: ขึ้นทะเบียน อย
Pingback: dating site
Pingback: buy weed online
Pingback: https://ellen-hempel.de/wp-includes/js/codemirror/index.html
Pingback: สล็อต ฝากถอน true wallet เว็บตรง 888pg
Pingback: bonanza178

Ben Connelly 2 years ago

I can’t believe the Biden administration is considering price controls. Did they pass high school economics? This is elementary.

Collapse

Jason Gibson 2 years ago

Is the Biden administration really considering this course? I thought at least in this country there was a bipartisan recognition that that’s a bad idea

Collapse

Tmcke 2 years ago

Can someone tell me the names of "Progressive commentators" who are talking up price controls? Of course there are laws against price gouging but... really is this a thing? Or do conservatives have to create a progressive bogeyman?

Collapse

Peter S. 2 years ago

I confess I am baffled at how this is still a debate. I mean, talk about your "settled science."

Collapse

Ben Connelly 2 years ago

Seriously was thinking the same thing.

Collapse

Jason Gibson 2 years ago

No kidding

Collapse

LOAD MORE

Worth Your Time

Apr 24, 2024

Gaslighting in Defense of Bigotry

Jonah Goldberg

Apr 22, 2024

The Cass Review Won't Fade Away

Jesse Singal

Apr 24, 2024

Menace and Cringe

Nick Catoggio

Apr 22, 2024

Pinching Pennies for Putin

Kevin D. Williamson

FREE COMPETITION | REGULATION | TRADE

How price controls fail

24 DE ENERO DE 2020

POR FUNDACIÓN CIVISMO

Price controls have always been a theme for debate and confrontation between economists, politicians and political commentators in the media. In most developed countries, price controls were abandoned as a public economic policy some decades ago, due to the great variety and diversity of goods and services, supplied at various price ranges and accessible to more people each time, thanks in great part to the process of globalization. Recently, the debate about price controls in developed economies was brought back into light with house prices and rent controls all around Europe. This is an issue I already commented about in a previous post, so I won't analyse it again in this one. What surprised me this week and incentivized me to write this post was a fact I read at the World Bank "Global

of developing countries meddle with the price of construction components and materials, as various metals. Even though price controls have repeatedly demonstrated to be a failure, according to empirical evidence (which I'll analyse throughout this post), many politicians continue to implement, because politically it is a cheap and easy measure to introduce, easily sellable to voters and attractive in the short term for those suffering from a high inflationary pressure. One clear example of this was Mauricio Macri's price control policy. When he arrived at the *Casa Rosada*, he promised that he would gradually eliminate price controls and allow markets adjust following what he predicted that would be higher economic growth and lower inflation. At the end, he didn't only not end up with the *precios cuidados* (food and basic products price controls), but even introduced price controls for 60 other goods. Price controls therefore, have shown to be a very politically profitable policy, but a complete economic disaster. Let's analyse some empirical evidence showing its effects.

First of all, price controls can be imposed in two different ways: price floors or price ceilings. Price floors are introduced with a goal of guaranteeing a minimum revenue for producers, as has been the case for price floors for agricultural products in many European countries throughout the last decade, as one of the main points of the European Common Agricultural Policy (CAP). The other type of price control are price ceilings which are implemented with the goal of benefiting consumers by lowering prices below the market equilibrium, but which tend to lead to excess of demand and scarcity. The vast majority of economist, independently of their political positioning, are against price controls, arguing that they have a dysfunctional effect on markets and end up by causing excess of stock (price floors) or scarcity (price ceilings). In the same World Bank dataset, we can find an astonishing fact, making reference to how food price controls were responsible for nearly 40% of the increase in the price of wheat in the period between 2010-2011.

Prices do not only reflect how much money you have to pay for something. Prices are signals the market sends to consumers and producers, which at the same time help to coordinate market forces and reach dynamic market equilibrium. In other words, prices show the relative scarcity of a product of service, allocating those goods and services to consumers which can and are willing to buy at that price. So, when price controls are imposed, price signals are distorted and not valid any more for that good or service, which is why market imbalances as excess demand or supply occur. Price ceilings, which fix a price below the one set by the market can cause firms to reduce their profit margin and disincentivize many of them from investing in a certain country or region, leading to underinvestment, a reduction of investment in innovation and lower productivity rates, being all of these some of the negative effects of price controls

analysed by the economists D. Dhananjay, K.Gode and S. Sunder in their paper *Double auction dynamics: structural effects of non-binding price controls.*

Small price increases prompted by a certain government action can ignite a social revolution

---

But price controls do not only have effects on the short term… once they are implemented, their effects will last for many years, and even decades, depending on the case. This doesn't relate only to the vast disrupting effects they can have on a country's economy, but also on the longevity of price controls throughout History, due to the extreme political difficulties of removing them. Small price increases prompted by a certain government action can ignite a social revolution, and it won't be the first time it happens. A simple example, of a government regulated price change which started a revolution was the small change in the Chilean metro fare last year in Santiago. The metro ticket fare was increased by a mere 3.5% ($0.04, or 30 pesos), and caused more than two months of political and social unrest, brought the army to the streets to control violent protesters, and caused 29 deaths of various causes. Obviously, protesters didn't only argue about the politically-controlled metro fare, but about a wide array of issues, ranging from inequality to poverty, passing through social mobility. But it was this small change in a government regulated price which ignited the flame. Another example was Iran recently. In November the Iranian government decided to rise fuel prices (another government-controlled price), and protesters went furiously to the streets, starting another social revolution. Other governments as Mexico or Rwanda were able in the past to lift price controls on fuel, by profiting from market slumps in 2014, and compensating the worse-off citizens with subsidies and greater spending on health and education, but overall, publicizing all these compensatory public policies to prevent a social upheaval.

Admittedly, it's true that some prices in many countries around the world may be excessively high for many consumers to be able to access those goods and services. Form renting a house in the main European city centres, to being able to buy enough food for a whole family in the Cuban communist regime. I'm not saying we don't need to find a solution to all these problems, and of course policymakers should propose solutions that could be studied, analysed and implemented. But price controls, as evidence gas shown are just a long lasting economic failure, by causing severe market dysfunctions and being extremely difficult to remove. Price controls are the seed of future socio-political instability.

The market as a natural and spontaneously-formed institution has several solutions for the problems previously presented, and which have tended to be tackled by

governments with price controls. In a free-market production will oscillate to where it is more profitable to be done, in a global sphere, so if for a European entrepreneur, producing a certain good or service is not profitable anymore, due for example to globalization, he or she might need to focus in producing other goods in which he or she presents a relative advantage, or even generate that advantage through innovation. Schumpeter's theory of creative destruction, in action! On the other hand, for those prices which are excessively high for certain consumers, and paradoxically cause at the same time an excess of demand (as occurs right now with the residential markets in many Spanish cities), due mainly to government restrictions to supply (caps on land uses and building)… well the solution might come from deregulating those markets and allowing a greater supply, causing a lowering of prices, more accessibility to those products and services, and greater allocative efficiency. Price controls are the problem. Free markets, the solution.

Publicaciones relacionadas

Desde dentro

Abr 23, 2024

L

Florentino Portero, investigador senior de Civismo, entrevistado en Canal 24h de RTVE sobre la tensión en Oriente Medio

Abr 22, 2024

L

Florentino Portero, investigador senior de Civismo, entrevistado en «Cara a cara con Gabi Sanz» de Vózpopuli

Abr 22, 2024

L

Civismo es un think tank, o catalizador de ideas, que trabaja en la defensa de la libertad personal bajo los principios del liberalismo clásico.

ÚNETE A NOSOTROS

ÚNETE

HAZ UN DONATIVO

CONTACTO

Paseo de la Castellana 114, esc.1, 5º 1, 28046 Madrid (España)

+34 914 02 30 95

info@civismo.org

SUSCRÍBETE A LA NEWSLETTER

Nombre y apellidos*

Email*

Suscribirse

4,000 Years of Failed Price Controls

Jon Miltimore – September 23, 2022

Reading Time: 5 minutes

Reprinted from the Foundation for Economic Education

In 1892 the French archaeologist Henri Pognon made a historic discovery a few dozen miles northeast of Baghdad: a massive tell that held the ruins of the ancient city-state Eshnunna.

Though it was not excavated until decades later by another archaeological team led by Dutch Egyptologist Henri Frankfort, the tell was one

of the great finds of the century, revealing secrets of a Mesopotamian city that had been hidden for millennia.

Among the secrets discovered on cuneiform tablets was that Eshnunna used price controls, a discovery notable in that it appears to be the oldest historical record of humans fixing prices. (I've attempted to verify this fact with economic historians, and will let you know if I get a response.)

> *1 kor of barley [she'um] is (priced) at [ana] 1 shekel of silver;*
>
> *3 qa of "best oil" are (priced) at 1 shekel of silver;*
>
> *1 seah (and) 2 qa of sesame oil are (priced) at 1 shekel of silver. . . . The hire for a wagon together with its oxen and its driveris 1 massiktum (and) 4 seah of barley. If it is (paid in) silver, the hire is one third of a shekel. He shall drive it the whole day.*

Eshnunna's price controls edge out by a couple centuries the Code of Hammurabi (1755–1750 BC), a more famous record from ancient Babylon that was a "maze of price control regulations," as the historian Thomas DiLorenzo put it.

This might explain why the First Babylonian Empire fizzled nearly a thousand years before the Greek poet Homer told the story of the

Trojan War. Price controls *don't work*, and an abundance of history (as well as basic economics) proves it.

A Brief History of Price Controls

The Ancient Greeks may have given us Homer and his wonderful stories, but they suffered from the same economic ignorance as the rulers of Eshnunna when it came to price fixing.

In 388 B.C., grain prices in Athens were out of control—largely because Athenian rulers had an incredibly complex set of regulations on agriculture production and commerce, which included "an army of grain inspectors appointed for the purpose of setting the price of grain at a level the Athenian government thought to be just." The penalty for evading these price controls was death, and many grain traders soon found themselves on trial facing such a punishment when it was discovered they were "hoarding" grain during a (man-made) shortage.

The Athenian Empire was history by the time Rome attempted its own price control scheme seven hundred years later on a much larger scale. In 301 A.D. the Emperor Diocletian passed his Edict on Maximum Prices, which set a fixed rate on everything from eggs and grain to beef and clothing and beyond, as well as the wages of laborers who produced these items. The penalty for anyone caught violating these edicts was—you guessed it—death. Traders

responded exactly as one would expect to these regulations.

"The people brought provisions no more to market, since they could not get a reasonable price for them," one historian wrote. Not coincidentally, Rome's empire soon went the same way as that of the Athenians (though the eastern half would survive another thousand years).

And then there's the British colony of Bengal, located in northeast India. Few people today remember the Bengal Famine of 1770, which is astonishing considering an estimated 10 million people died, roughly a third of its population. What's even more astonishing is how little attention the event attracted at the time, at least in the London press. While many attributed the famine to the monsoons and drought that plagued the region in 1768 and 1769, Adam Smith, writing in *The Wealth of Nations*, correctly observed that it was the price controls that came afterwards that likely turned a scarcity of food into a full blown famine.

> "The drought in Bengal, a few years ago, might probably have occasioned a very great dearth. Some improper regulations, some injudicious restraints, imposed by the servants of the East India Company upon the rice trade, contributed, perhaps, to turn that dearth into a famine.

> When the government, in order to remedy the inconveniencies of a dearth, orders all the dealers to sell their corn at what it supposes a reasonable price, it either hinders them from bringing it to market, which may sometimes produce a famine even in the beginning of the season; or, if they bring it thither, it enables the people, and thereby encourages them to consume it so fast as must necessarily produce a famine before the end of the season."

And let us not forget the French Revolution, where in 1793 leaders paused their head-lopping to pass the Law of the General Maximum, a set of price controls passed to limit "price gouging." (Henry Hazlitt had it right when he called the law "a desperate attempt to offset the consequences of [the leaders'] own reckless overissue of paper money.")

The American historian Andrew Dickson White (1832-1918), a cofounder of Cornell University, explained the consequences of the policy.

"The first result of the Maximum [price law] was that every means was taken to evade the fixed price imposed, and the farmers brought in as little produce as they possibly could," White wrote. "This increased the scarcity, and the people of the large cities were put on an allowance."

Important Market Signals

Fortunately, today we have the advantage of not just history but the science of economics to show us that price controls don't work.

Basic economics teaches that prices are important market signals. High prices might be an aggravation for consumers, but they signal to producers the opportunity for profit, which leads to more production and investment. They also signal to consumers that the good is scarce, which encourages people to use less of it.

Take gasoline. When prices are $7.50 a gallon, people drive less than they would if the price were $1, $3, or $5 per gallon. Meanwhile, the high price also signals to producers an opportunity for profit, which encourages investment and production, which ultimately leads to lower gasoline prices. As economists will sometimes say, the solution to high prices is high prices.

Putting an artificially low price on gasoline sends the wrong signals to both consumers and producers. The low price discourages producers from bringing fuel to market, and it also encourages consumers to use more fuel because it's artificially inexpensive—which is a recipe for a gas shortage.

This is precisely what happened in the 1970s after President Nixon announced price controls on gasoline, resulting in a sustained national

shortage and massive gas lines. (For what it's worth, Nixon knew his price controls would be a disaster, but passed them anyway because it would signal to voters he "meant business.")

> Gas lines from the 1970s after Nixon passed price controls. pic.twitter.com/VjylWfTO74
>
> — Jon Miltimore (@miltimore79) September 9, 2022

Price Controls Are Back

Today nearly all economists agree that price controls are harmful—yet this has not stopped the specter of them from rising once again during our current global economic turmoil.

As *Axios* recently reported, price controls are back and are no longer a relic of the 70s. Facing an energy crisis, G-7 countries are seeking to form a buyers cartel that would effectively put a price cap on Russian crude oil.

The scheme, like all price control schemes, is likely to backfire. An abundance of evidence shows price fixing produces little beyond scarcity, black markets, and—in worst case scenarios—death and famine.

The people of ancient Eshnunna can be forgiven for not understanding why setting the price of a kor of barley at a shekel of silver was a harmful policy.

Today's policymakers, who have the benefit of history and economics, have no excuse.

Print

READ MORE

Jon Miltimore

Jonathan Miltimore is the Managing Editor of FEE.org and a Senior Writer at AIER. His writing/reporting has been the subject of articles in TIME magazine, The Wall Street Journal, CNN, Forbes, Fox News, and the Star Tribune.

Get notified of new articles from Jon Miltimore and AIER.

SUBSCRIBE

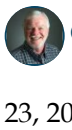
RELATED ARTICLES – ECONOMIC HISTORY, GOVERNMENT, REGULATION

Michael Watson –

April 24, 2024

Parity in Labor Transparency

READ MORE

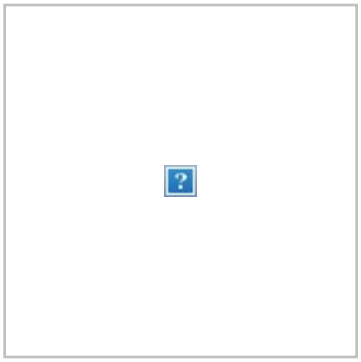


Gary M. Galles – April

23, 2024

Why Even Insiders Underestimate Markets' Power

READ MORE

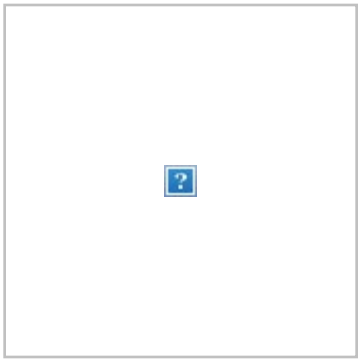


 Michael Munger –

April 22, 2024

Competition Can't Be Perfect

READ MORE

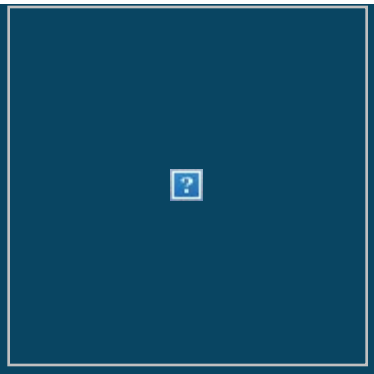


 Paul Mueller – April

18, 2024

ESG Puppeteers

READ MORE



250 Division Street |
PO Box 1000
Great Barrington, MA
01230-1000

Contact AIER
Telephone: 1-888-528-1216 |
Fax: 1-413-528-0103

Press and other media outlets contact
888-528-1216
press@aier.org

Editorial Policy

About AIER
News
Directions
Employment
Subscribe to AIER
The 1933 Club
Donate to AIER

AIS is a fully owned subsidiary of AIER

AIS American Investment Services, Inc.
Disciplined, Diversified, & Cost Effective

OPINION > FINANCE

THE VIEWS EXPRESSED BY CONTRIBUTORS ARE THEIR OWN AND NOT THE VIEW OF THE HILL

The unnecessary revival of price controls should worry us all

BY SHANKER SINGHAM AND ALDEN ABBOTT, OPINION CONTRIBUTORS - 06/02/23 7:30 AM ET

Sen. Roger Marshall, R-Kan., speaks during the Senate Health, Education, Labor, and Pensions Committee hearing on Capitol Hill in Washington, Wednesday, May 10, 2023, to examine the need to make insulin affordable for all Americans. (AP Photo/Carolyn Kaster)

Government price caps are again in the news again. The U.S. government is in the process of imposing them on key drugs as authorized by the Inflation Reduction Act. Across the Atlantic, the British

government suggests their use not just for energy but now also for food retail.

These are not new reactions to inflation and escalating costs. They are in line with the natural knee-jerk reaction of politicians to impose price controls as a mistaken cure for rising prices. For example, in the 1970s both British Prime Minister Edward Heath and U.S. President Richard Nixon experimented with price caps of one sort or another. These experiments sparked shortages and sparked inflation after the caps were lifted, severely harming the British and American economies.

Price caps have a long and sordid history, dating back to at least 301 A.D. when the Roman Emperor Diocletian imposed maximum prices on key products and services. Diocletian's "Decree on Maximum Prices" failed miserably. It generated a massive shortage of all goods and was quickly lifted.

In short, price controls have never actually succeeded in combatting inflation. Instead, they have sown the seeds of dangerously anti-competitive markets and structural impediments to economic growth in the medium and long term. As economist Pierre Lemieux explains, price caps cause shortages, increasing the quantity demanded of a good while reducing its supply. As a result, sellers invest less in the production of the good, leading to an inefficient undersupply of the product in the future, to the detriment of consumers.

In the case of energy, where the United Kingdom regrettably still operates a price cap — one which has often acted as a price floor rather than a ceiling — maintaining price regulation will cause energy producers to exit markets and thereby lessen competition. This will drive up inefficiency, increasing the ultimate costs of energy production which the taxpayer eventually has to pay.

An energy price cap invariably harms the economy, yielding higher prices and lower production. The fact that a U.K. price cap is now being openly talked about in the context of food and supermarkets is very troubling.

As for U.S. drug price controls, these can be expected to deter innovation and the future supply of new drugs, denying innovative new life-saving medicines to patients. Specifically, the U.S. Chamber of Commerce recently reported that in light of the Department of Health and Human Services Department price control plans, research and development into important blood cancer and eye disease treatments is being dropped. Furthermore, important R&D in the fields of RNA and radioligands may also be discouraged.

More generally, the Congressional Budget Office points out that "proposed regulation of some drug prices would affect the sales volumes of existing drugs and, as a result, expected returns on R&D on future drugs; in turn, lower expected returns would result in fewer new drugs."

In a similar vein, an Americans for Prosperity analysis finds that "drug price controls result in drug shortages, lower research and development spending by pharmaceutical companies, fewer drugs reaching the market, and longer wait times for drugs that do."

Government price cap regimes are a textbook case of what we have called "anti-competitive market distortions." These distortions lead to increased costs and more inefficiency and ultimately must be paid for by taxpayers. There is a reason that reliance on free markets — which enable human beings to meet each other's needs in voluntary exchange — has been the most efficient and cost-effective way of uniting consumer demand with supply.

The cost of food is not high because of any type of market failure in the sector. It is especially high in the U.K. because of massive energy cost increases caused by a price cap for consumers in that sector and through a lack of sufficient generation of power.

High drug prices are a function of the very risky and massive R&D needed to produce new drugs. Only a small proportion of drug R&D projects actually result in new drugs being marketed.

The lesson is clear: Government price controls that ignore the diverse market factors that affect the pricing of different goods and services are a recipe for harmful market failure, not economic betterment.

Governments need to start addressing the real reasons for inflationary pressures. They could start by curbing the massive deficit spending and excessive money supply increases that lie at the heart of inflation. They should not apply infected band-aids in the form of price cap regulations that make the patient worse, not better. Let us hope that politicians and government officials pay heed to this economic reality and act accordingly.

Shanker Singham is an academic fellow with the Institute of Economic Affairs, CEO of Competere Ltd, and a former advisor to the United States Trade Representative and U.K. Trade Secretary. Alden Abbott is a senior research fellow with the Mercatus Center at George Mason University and a former general counsel with the Federal Trade Commission. They are co-authors of a new book, "Trade, Competition and Domestic Regulatory Policy."

TAGS CAUSES OF INFLATION DRUG PRICES INFLATION REDUCTION ACT POLITICS OF THE UNITED STATES PRICE CONTROLS RICHARD NIXON

More Finance News

Lawmakers push Wall Street giveaway disguised as increased worker security

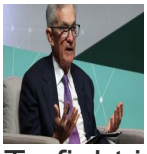
OPINION / 22 HOURS AGO

The bipartisan tax bill contains a critical fix to spur American innovation

FINANCE / 2 DAYS AGO

Conservatives are misguided in embracing big government industrial policy

FINANCE / 2 DAYS AGO



To fight inflation, we should look for ways beyond the Fed's policies

OPINION / 3 DAYS AGO

See All

Video/Hill.TV

Rising: April 24, 2024

RISING / 24 HOURS AGO

Rising: April 23, 2024

RISING / 2 DAYS AGO

Rising: April 22, 2024

RISING / 3 DAYS AGO

See all Hill.TV

See all Video

Top Stories

Supreme Court debates whether coup, assassination would be official acts: Live updates

COURT BATTLES / 3 HOURS AGO

See All

Most Popular

1. **Texas Gov. Abbott faces backlash after mass arrest at UT Austin pro-Palestine ...**
2. **Supreme Court debates whether coup, assassination would be official acts: Live ...**
3. **Female Supreme Court justices push back most strongly on Idaho abortion ban**
4. **FTC votes to ban noncompete agreements**
5. **Conservatives aim their fire at Texas Republican after 'scumbags' comment**

Resources

THE HILL APPS

PEOPLE

RSS

Other Areas

GALLERIES

THE HILL JOBS

NATIONAL JOBS

Contributors

SUBMIT OPINION CONTENT

Follow Us On

Visit our Facebook page

Visit our X profile

Get the App

GET IT ON Google Play

Download on the App Store

THE HILL 1625 K STREET, NW SUITE 900 WASHINGTON DC 20006 | 202-628-8500 TEL | 202-628-8503 FAX

COMMENTARY

Price Caps Will Not Solve Electricity Problem

Price controls distort market

Adrian Moore
Vice President of Policy

Lynne Kiesling

April 19, 2001

The drumbeat is again sounding for a return to wholesale price caps in California's electricity market. While well intentioned, such a move would be a grave mistake.

Price controls have a history of distorting markets where competitive prices are possible, leading to shortages of supply, inadequate investment, over-consumption, and a myriad of other problems. In the case of California's electricity crunch, a return to price caps would only increase the threat of blackouts, as the

supply of electricity would not keep pace with California's appetite for power. Unfortunately, state leaders pushing for price caps ignore history's lessons and seem destined to repeat past mistakes.

California already experimented with price caps and it was a dismal failure. As California's wholesale power prices rose rapidly in the spring of 2000, the state Independent System Operator (ISO) quickly imposed a price cap. As a result, the amount of power supplied to the state decreased as suppliers pursued more lucrative opportunities elsewhere, selling their power in states without price caps. In fact, imported electricity declined 33 percent in 2000 from the previous year.

Consumer prices in two-thirds of the state were not affected and consumers did not reduce demand. Scarcity turned into outright shortages. ISO staffers spent much of their time rounding up power to keep the lights on hour by hour rather than tending to the needs of the grid. As supplies continued to fall, the ISO eventually lifted the caps to avert blackouts.

When a similar situation occurred across the Midwest in 1998, policy-makers pursued a dramatically different course which resulted in a dramatically different outcome. Policy-makers let market prices rise to attract both power and investment to the region, and now new power plants are being built.

So, if price caps are not the solution, what is?

California must choose between two directions for its electricity market to move out of its current dysfunctional state: a state takeover of the market, which is the direction Gov. Gray Davis' policies are leading, or a transition to a deregulated market with real choices for customers. Given the success of deregulating electricity generation in states like Pennsylvania and Texas,

California should pursue the latter course. But the transition will not be easy.

First and foremost, California must articulate a vision of moving toward competition that will encourage new suppliers to enter the market. Too many state leaders are offering isolated policy ideas and conflicting proposals that do not inform the market in what direction policy is moving and what end state is sought. In other cases, the state is hanging a "business not welcome" sign on the door by scaring off would-be suppliers with high-pitched rhetoric and threats of state takeovers.

Once a clear vision is laid out, California will need to move toward a system where consumers pay market prices for electricity, as this is the only way to ensure that demand does not outpace supply. But this move will inevitably cause some transition pains. Laying out a clear plan for this transition will make it easier for the public to deal with.

The state also can encourage utilities to implement real-time pricing and metering so consumers can adjust their use of electricity as prices change. Again, by providing more information, customers are better able to manage this transition.

But the state should ensure that utilities do not simply pass all of their previous losses onto consumers through increased prices. The utilities helped contribute to the problem and must shoulder some of the costs.

Finally, if the state is going to move to a truly competitive market, utilities must be free to purchase power competitively. Rather than trying to oversee every transaction through a central pool, the state should encourage a voluntary, independent competitive exchange and develop bidding rules that attract both buyers and

sellers, and enable utilities to purchase long-term contracts at lower prices.

Granted, the electricity crisis is no simple problem that the state can solve with the stroke of a pen or public speech about the need for conservation. Without a doubt, it is going to cause some pain.

But beyond the short-term difficulties, California can still emerge with a robust, reliable power supply that encourages new investment, empowers consumers to choose providers of their choice, and lowers the cost of the fuel our state's high-tech economy runs on. A return to price caps would all but eliminate that prospect and shatter California's track record as a forward-looking source of new ideas.

Adrian Moore is Vice President of Reason Foundation.

Lynne Kiesling is director of applied energy research at the International Foundation for Research in Experimental Economics and an adjunct scholar at the Reason Foundation.

ADRIAN MOORE, Ph.D., is vice president of policy at Reason Foundation.
LYNNE KIESLING is Director of Economic Policy at Reason Public Policy Institute. She is also Visiting Associate Professor of Economics at Northwestern University. Her previous positions include Assistant Professor of Economics at the College of William and Mary, and Manager in the Transfer Pricing Economics group at PriceWaterhouseCoopers LLP. She has a Ph.D. in economics from Northwestern University, and has published extensively in academic journals.

MORE FROM ELECTRICITY

The 2021 Texas Power Crisis: What Happened and What Can Be Done to Avoid Another One?

This report focuses on ERCOT and the electric power system because the power outages were the proximate cause of many hardships suffered during the failures.

By Michael Giberson
April 22, 2021

How To Prevent Another Texas Power Failure

The severity of the failures, the lives lost to the cold, and the significant costs imposed on the state demand a careful look at the range of possible alternatives.

By Michael Giberson
April 22, 2021

Nevada Ballot Initiative Analysis: Question 6 (2020)

Nevada's Question 6 would double the state's renewable portfolio standard to 50 percent by 2030.

By Geoffrey Lawrence
September 28, 2020

FOLLOW

- Facebook

1630 Connecticut Ave
NW
Suite 600
Washington, DC 20009
(202) 986-0916

Privacy Policy
Accessibility

centrica

Why price caps don't **work for customers**

The Government has promised to introduce a price cap on UK household energy bills and the regulator is taking steps to implement that policy. They argue that it will mean lower prices. But we believe that the cap won't work and will have harmful consequences for customers.

We're not alone. The Government's own competition watchdog thinks that a retail energy price cap will be bad for customers. The Competition & Markets Authority says that a cap on all default tariffs would "run excessive risks of undermining the competitive process, likely resulting in worse outcomes for customers in the long run".

What are energy price caps, and what are they for?

A price cap is a type of restriction on the amount that energy retailers can charge customers for their energy. There are different sorts of retail price caps:

- They can apply to all customers; or to a subset of customers.
- They can be absolute (e.g. no more than £X per unit of energy consumed); or relative (e.g. no more than X% difference between tariff A and tariff B).
- They can be set in advance by regulators (known as "ex ante"); or set by suppliers and monitored by regulators ("ex post").
- They can apply to all constituent parts of the bill (total price); or just one part of it (e.g. a limit on profit margins).

There are different sorts of retail price caps because they have different objectives. The most common reason for having retail price control is to manage the transition from a nationalised industry to a fully competitive market, known as liberalisation. As liberalisation progresses, more customers engage in the market and more suppliers enter. As competition keeps prices down, price caps are withdrawn. It is very unusual for price caps to be reintroduced to competitive markets after they have been withdrawn.

Why price caps don't work in competitive markets

Retail energy price caps are very difficult to set, because they need to strike a balance between competing objectives. In practice, no regulator has ever got the balance perfectly right because it is an impossible task. Customers want prices that are as low as possible. But companies need to be able to recover their costs, to invest and to make a fair margin.

Setting price caps at a low level seems attractive. But companies can't recover their costs when the cap is set too low. Recent history is littered with examples of the disastrous consequences. Here are just two:

- In 2001 in California, retail prices were capped at levels that ended up being below the wholesale cost of energy. As a result, the main energy retailers found themselves US$20 billion in debt and one of them went bankrupt. They could not buy electricity on the wholesale market, so the state (i.e. the taxpayer) had to step in.
- In Spain, the "tariff deficit" (the difference between retail price caps and actual costs) reached €29 billion or 3% of GDP. The deficit sits as an unconditional liability on the Spanish Government's balance sheet (i.e. it is guaranteed by taxpayers).

Competition is squeezed out when the cap is set too low, which means that customers lose out:

- Prices bunch around the cap. This happened with tuition fees in the UK, with the majority of universities charging maximum rates.
- It has also happened with the pre-payment meter (PPM) price cap. On average, prices are now within £15 of each other and they have bunched around the cap, with quite a few of them going up, not down. Suppliers appear to be following the energy buying strategy that the PPM cap assumes, so their wholesale energy costs will be similar. PPM customer switching is also slowing relative to other customer groups.
- Customers have little incentive to engage in the market and search for the best deal, because there isn't much money to be saved from switching. In France's more regulated market, electricity switching recently reached a peak equivalent to 8% on an annualised basis in 2017. In the UK switching is nearly 17%.
- Suppliers can't afford to invest or innovate to attract customers, because they won't be able to make reasonable returns on their investment.
- Customer service quality suffers, as suppliers seek to make savings. Indeed, some companies may try to avoid supplying certain groups of customers altogether, as some currently do with customers on pre-payment meters.
- The market isn't attractive for potential new entrants, and can lead some existing players to leave the market.

Price caps that are set too low can also have damaging implications for Government policies, for example, suppliers might not have enough money to invest in infrastructure, such as smart meters and energy efficiency measures.

Price caps are not always disastrous, but they are not a model to follow. In Belgium, for example, where the price cap appears to have become permanent, retail energy prices are higher than in the UK and there are fewer suppliers.

But in markets where competition is allowed to flourish freely, without a price cap, the benefits to customers in terms of choice and affordability are clear. In Texas, for example, there are now 116 energy suppliers and 34% of customers switched suppliers in 2016.

We do not support price caps on retail energy prices as a way of reducing bills and we believe they are counterproductive. Where caps are introduced it is vital that they are limited in scope and duration. Setting a cap at a level where suppliers cannot recover their costs would be disastrous.

Price caps on wholesale gas markets lead to significant negative side effects without having the desired results

The role of gas prices:

- On spot markets, gas prices reflect the fundamental physical situation. They are essential for short-term adjustment.
- On futures markets, gas prices reflect the expection of the future physical situation. They are essential for hedging price risks and guiding investment decisions.
- Market prices are the core of the allocation function of the market. When determined under transparent conditions, like on an exchange market, they connect sellers and buyers.

Why caution before intervention is warranted:

A **gas price cap[1] undermines the basic economic principle of price signals** and leads to significant unintended negative side effects such as:

1. Move towards less transparent trading: OTC-transactions could be concluded at a different price than on the exchange. A shadow gas market with shadow gas prices might arise.
2. Impair the negotiating position of European actors: A wholesale gas price cap would make EU-destinations less attractive for very price-sensitive LNG.
3. Distortion of the short-term price signal and the market as allocation mechanism: It would bring inefficient distribution of physical/financial resources, distorted incentive for energy efficient consumption behaviour, loss of efficient allocation mechanism.
4. Negative impact on long-term gas price signal and hedging function: Traders would not be able to transparently hedge against price and counterparty risk.
5. Disincentivise decarbonisation: Renewable energy, including renewable gases, needs high-price periods to improve their competitiveness.
6. Uncertainty around execution of contracts already entered into: Capping prices undermines forward contract conditions leading to an increase of political risk.

What needs to be done:

- Prioritize short- to medium-term framework conditions to diversify supply and ensure an adequate level of stored gas and;
- Support vulnerable households to cope with the situation on the retail-level.

Until there is an actual physical shortage of gas, the market is the most efficient and effective allocation mechanism based on flexible market price signals. Capping wholesale market prices may even lead to physical supply shortage.

[1] In the frame of this position paper, gas price caps are understood as a fixed, politically-set limit to wholesale gas market prices stable over the medium to long term.

Price caps on wholesale gas markets lead to significant negative side effects without having the desired results

In recent months, various factors on the physical supply and demand side of the natural gas markets brought the gas prices worldwide to new highs. Geopolitical tension, low storage levels and the Russian invasion of Ukraine have further contributed to increased prices and volatility. Rightly so, corresponding political intervention is sought to limit the negative effects on those companies or households who cannot bear the costs.

However, this does not mean that the wholesale gas markets or their design are malfunctioning: gas prices reflect the physical fundamental situation and the expectation of it. Doing so, supply and demand have been covered at any time.

Price intervention in form of a gas price cap undermines the basic economic principle of price signals and leads to significant unintended negative side effects. High-price periods on energy markets provide important incentives to increase supply or for investments in alternative energy sources and energy effienciency. Without this, necessary investments might not materialize or supply might shrink with negative consequences for security of supply.

Price caps may harm or even destroy the allocation and transparency function of the gas market. In a worst case, supply and demand are unable to meet each other (figure 1). In practice, it is to be expected that in particular tense situations, markets dry out over time, with less and less companies supplying gas and buyers being unable to cover demand at any time.

Further, a price cap creates intransparency about the actual market situation. However, when a market comes under stress and reaches price levels under which the price cap would kick in if implemented, this is exactly when transparency is needed most.[2]

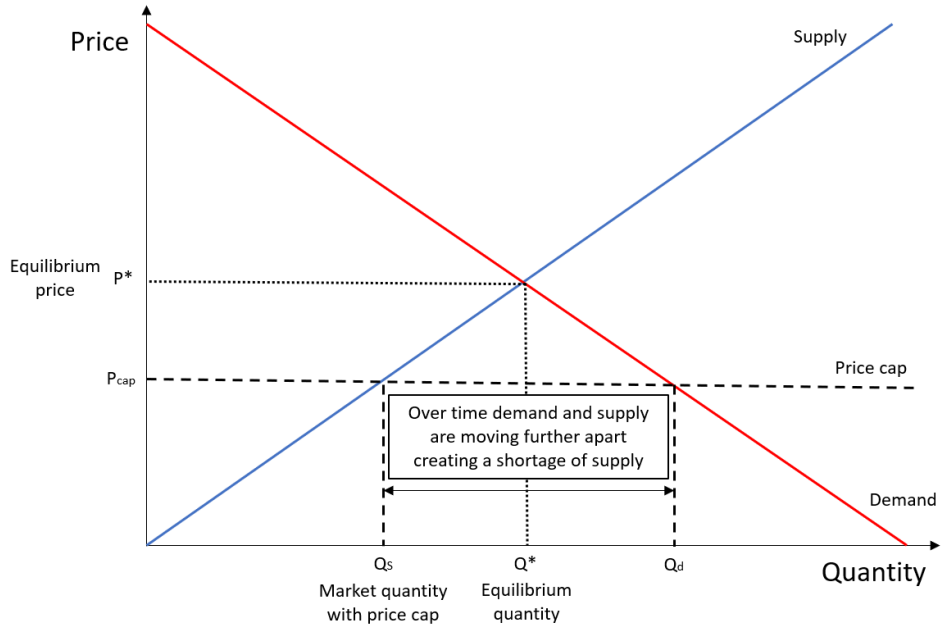


Figure 1: Supply and demand curves with price caps

[2] Also refer to "The importance of keeping energy markets open in times of turmoil", EEX, 3 October 2022

The critical role of wholesale gas markets

On cleared **wholesale gas markets**, market participants such as gas suppliers or industrial consumers can cover their demand or supply. Dependening on their goals, they trade short-term contracts on the spot market or longer-term contracts on the futures market.

The **gas spot markets** help traders to adjust their gas supply or purchase very short term. Among the trading participants are gas grid operators and/or market area managers[3] using the spot market to keep the grid stable and reliable at any time. Executing their activities on regulated exchanges enables them to trade under transparent conditions and to be protected against defaulting counterparties.

On the **gas futures market,** market participants trade up to years in advance and by doing so receive protection against future price changes and the risk of counterparty defaults.

The **gas prices** resulting from these actions serve multiple purposes. At any time, they are the valuation of gas according to available supply and demand. It includes the actual physical situation as well as an anticipation or interpretation of the impact of potential political action such as an embargo on Russian gas. Especially in the past weeks, uncertainty on the latter translated into high volatility. Market prices on future markets are also used to assess the financial viability of investments in low-carbon projects and are thus key for the energy transition.

The importance of picking the right policy tool

The European Commission's communication from 8 March 2022[4] calls for a rapid diversification of physical natural gas sources and the greatest possible independence from Russian gas imports. The Commission aims at accelerating the expansion of renewable energy and energy efficiency, a switch to alternative gas sources and mandatory minimum filling levels for gas storage facilities. These come on top of the immediate short term actions highlighted in **the Commission's October 2021 toolbox[5]** on how to support vulnerable consumers on a national level.

All these measures help either in the short or in the medium run and leave energy markets mainly intact: Price formation and the allocation function of markets are not severely distorted.

This is different from wholesale gas price caps. They harm the allocation function of the wholesale gas market once the price level of the cap has been reached. They lead to significant uncertainty on the legal and, most critically, practical implementation. Especially in the gas sector, with its possibilities for intertemporal shifting, a price cap would immediately lead to a demand surplus on the wholesale market and may even deteriorate supply of natural gas. As a result, supply and demand could no longer be brought into balance and market clearing would become eventually impossible. In such a scenario, and having lost the important information and coordination function of the price mechanism, gas rationing executed by a public authority together with a highly complex prioritization process would be necessary. Consequently, the scarce resource – gas – will likely not to be allocated according to the areas of its highest economic value.

[3] Market Area Managers are market actors providing important services for the stability of the gas grid, e.g. including the purchase of gas for the purpose of keeping the pressure in the grid stable. In many EU-Member States gas grid operators are also market area managers.
[4] REPowerEU: Joint European Action for more affordable, secure and sustainable energy.
[5] Link: Tackling rising energy prices: a toolbox for action and support.

Specifically, the negative effects of wholesale price caps can include the following:

1. **Move towards less transparent trading**

   Where possible, market participants would seek their counterparties in the less transparent market segments. Then, over-the-counter (OTC) -transactions could be concluded at a different price than on the regulated exchange.[6] This would lead to a situation where no clear price reference would be available.

   Prices are more difficult to be capped or controlled in the environment of the OTC market. And crucially, risks are not mitigated by a central clearinghouse. If no control on the gas price cap is done within the OTC-market, a shadow gas market with shadow gas prices might arise.

2. **Impair the negotiating position of European actors**

   Natural gas is a globally traded and transported commodity. Specifically liquefied natural gas (LNG) is very price-sensitive. Following the ambition to diversify the supply sources for natural gas, LNG will become more important for European market participants. A wholesale price cap would make EU-destinations less attractive.

3. **Distortion of the short-term gas price signal and the gas market as allocation mechanism**

   A wholesale gas price cap will lead to an inefficient distribution of physical and financial resources as the actual market situation becomes impossible to know.

   In particularly tense situations when the price level of the cap would be reached, the market as allocation mechanism would not function fully. Gas distribution companies and consumers would not be able to conclude transactions at any time because suppliers would cease their market activity. Also network operators and/or market area managers being active on the market to balance the grid would not be able to buy or sell gas on the exchange.

   On the demand side, a gas price cap would restrict the exposure of demand to the price signal. This diminishes incentives to reduce gas demand. In expectation of the price cap being reached and a potential supply shortage this could lead to anticipatory activities e.g. gas hoarding.

   In the worst case, alternative allocation mechanism, e.g. centrally controlled through public institutions would have to take this task to ensure security of supply.

4. **Negative impact on long-term gas price signal and risk management function**

   In the case a gas price cap would only be introduced on the short term spot markets, market participants would not be able to manage their risks to anticipate the volatile and tense periods. Also long-term markets would be affected since futures are based on the underlying spot market.

   If long-term gas prices were capped instead of short-term prices, market participants would be unable to manage their future risks in case the supply and demand situation causes high prices. In essence, future markets would become like a flood insurance that does not pay out when the house is flooded.

5. **Disincentivise decarbonisation**

   Through artificially cheapening gas costs and thereby harming the gas price signal, consumers would lose their incentive to increase energy efficiency or to invest in the use of renewable gas. In a situation where energy saving is particularly necessary, some of the most important solutions to counter the current tense context would be put in harm´s way. As a result, the role of fossil power gerneration would be cemented and incentives for alternative approaches to resolve scarcity such as storage, load flexibility and renewables weakened.

[6] Under normal circumstances, there are no big gaps between exchange and OTC-prices.

Renewable gases benefit from high-price periods to become cost-competitive. Today, because of the high prices, we see particularly biomethane or biogas producers can market their production on multilateral markets without subsidies.

6. **Uncertainty around execution of contracts already entered into**

   The majority of gas trades happen on a forward basis, with delivery at a future point in time, sometimes with a long delivery period. Capping gas prices would undermine the contract conditions of many of those contracts which are already agreed upon.

   On the other side, potential new contract partners such as from the LNG-ecosystem would perceive a gas price cap as an increase of political risk when concluding transactions with partners in the EU. They would thus likely refrain from entering into long-term delivery contracts.

Concluding remarks

Capping gas market prices is like capping a thermometer: Even if the display is capped at a maximum, the temperature may nevertheless rise in the background without anyone noticing.

It would have **serious consequences** for the efficiency and effectiveness of the gas market as allocation mechanism, raise numerous questions and lead to unintended and severe side-effects.

Putting in place the right short-term to medium-term framework conditions to calm down the gas prices should be prioritised. This includes the quick diversification of gas supply and a market-based procurement of gas to fill Europe´s storage capacity. Vulnerable households should be supported to cope with the situation on the retail-level.

Should the gas market dry out because of a shortage in physical supply of gas in Europe, other mechanisms would kick in. These include for example the cut off of single gas consumers to protect the most vulverable ones and the allocation of gas through the government or national regulatory authorities. **A gas price cap can not prevent this from happening. It could however speed up such a situation unintendedly.**

When there is no physical gas supply shortage, the gas market remains the most efficient and effective allocation mechanism.

Contact

Daniel Wragge
Director Political & Regulatory Affairs
daniel.wragge@eex.com

Miriam Brandes
Senior Political & Regulatory Affairs Officer
miriam.brandes@eex.com

Jan Eustachi
Political & Regulatory Affairs Officer
jan.eustachi@eex.com

Annex: Background on the interaction between physical and financial gas market layers

On many energy exchanges, the clearing house does not only handle financial settlement and securitization, but also **physical settlement**.
In the case of EEX Group, the clearing house ECC ensures the physical settlement of all respective transactions. Physical settlement does not mean that ECC stores physical gas in its premises, but they conclude so-called **balancing group bookings** with one of the European grid or transmission system operator. This is comparable with an energy account booking. For any activity on a European gas market, market participants need to possess of at least one balancing group. With this respect, ECC closely cooperates with European grid operators or TSOs and Hub Operators or Market Area Managers for power and natural gas.

The European natural gas and power markets are divided into:

- the **physical flow layer**, where physical entries respectively production and consumption volumes are managed by the grid operator having own balancing measures and
- the commercial rights layer on the so-called **Virtual Trading Points (VTPs)**.

Power and natural gas transactions cleared by ECC are related to Virtual Trading Points. Balancing groups need to be in balance at any time (i.d. sales and purchase need to be in an equilibrium as these translate into demand for physical gas and supply of physical gas).

If any imbalance on the commercial side occurs, the relevant and individual rules and costs of each TSO or hub operator will apply. In case of an imbalance on the physical layer, TSO, Hub Operators or Market Area Managers become active and purchase or sell energy.