# Price Controls


## *Hugh Rockoff*

***Hugh has written extensively on a wide range of economic topics***


Governments have been trying to set maximum or minimum prices since ancient times. The Old Testament prohibited interest on loans, 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 minimum wage, to name a few. At times governments go beyond fixing specific prices and try to control the general level of prices, as was done in the United States during both world wars, during the Korean War, and by the Nixon administration from 1971 to 1973.

The appeal of price controls is easy to divine. Even though they fail to protect many consumers and hurt others, controls hold out the promise of protecting groups of consumers who are particularly hard-pressed to meet price increases. Thus the prohibition against usury—charging high interest on loans—was intended to protect someone forced to borrow by desperation; the maximum price for bread was supposed to protect the poor, who depended on bread to survive; and rent controls were supposed to protect those who rented at a time when demand for apartments appeared to exceed the supply and landlords were able to "gouge" tenants.

But despite the frequent use of price controls, and despite the superficial logic of their appeal, economists are generally opposed to them, except perhaps for very brief periods during emergencies. The reason is that controls on prices distort the allocation of resources. To paraphrase a remark by Milton Friedman, economists may not know much, but they do know how to produce a surplus or shortage. Price ceilings, which prevent prices from exceeding a certain maximum, cause shortages. Price floors, which prohibit prices below a certain minimum, cause surpluses. Suppose that the supply and demand for automobile tires are balanced at the current price, and that the government then fixes a lower ceiling price. The number of tires supplied will be reduced, but the number demanded will increase. The result will be excess demand and empty shelves. Although some consumers will be lucky enough to purchase tires at the lower price, others will be forced to do without.

Because controls prevent the price system from rationing the supply to those who demand it, some other mechanism will take its place. A queue or lineup, once a familiar sight in the controlled economies of Eastern Europe, is one possibility. When the U.S. government set maximum prices for gasoline in 1973 and 1979, dealers sold gas on a first-come-first-served basis, and drivers got a little taste of what life was like for people in the Soviet Union: they had to wait in long lines to buy gas. The true price of gas, which included both the cash paid and the time spent waiting in line, was often higher than if prices were not controlled at all. At one time in 1979, for example, the U.S. government fixed the price of gasoline at about $1.00 per gallon. If the market price would have been $1.20, a driver who bought ten gallons apparently saved $.20 per gallon, or $2.00. But if the driver had to line up for thirty minutes to buy gas, and if her time was worth $8.00 per hour, the real cost to her was $10.00 for the gas and $4.00 for the time, an overall cost of $1.40 per gallon. Some gas, of course, was held for friends, long-time customers, the politically well-connected, or those who were willing to pay a little cash on the side.

The incentives to evade controls are ever present, and the forms that evasion can take are limitless. The precise form depends on the nature of the good or service, the organization of the industry, the degree of government enforcement, and so on. One of the simplest forms of evasion is quality deterioration. In the United States during World War II, fat was added to hamburger, candy bars were made smaller and of inferior ingredients, and landlords reduced their maintenance of rent-controlled apartments. The government can attack quality deterioration by issuing specific product standards (hamburger must contain so much lean meat, apartments must be painted once a year, and so on) and by government oversight and enforcement. But this means that the government bureaucracy controlling prices tends to get bigger, more intrusive, and more expensive.

Sometimes more subtle forms of evasion arise. One is the tie-in sale. During World War I, for example, in order to buy wheat flour at the official price, consumers were often required to purchase unwanted quantities of rye or potato flour. Forced up-trading is another. Consider a manufacturer that produces a lower-quality, lower-priced line sold in large volumes at a small markup, and a higher-priced, higher-quality line sold in small quantities at a high markup. When the government introduces price ceilings and causes a shortage of both lines, the manufacturer may discontinue the lower-priced line, forcing the consumer to "trade up" to the higher-priced line. In World War II, for this reason, the government made numerous attempts to force clothing manufacturers to continue lower-priced lines. Under the controls imposed by President Nixon in the early seventies, steel manufacturers eliminated a middle grade of steel sheet, allegedly with the intention of inducing buyers to purchase a more expensive grade.

Not only do producers have an incentive to raise prices, but at least some consumers have an incentive to pay them. The result may be payments on the side to distributors (a bribe for the superintendent of a rent-controlled building, for example) or it may be a full-fledged black market in which goods are bought and sold clandestinely. Prices in black markets may be above not only the official price, but even the price that would prevail in a free market, because the buyers are unusually desperate and because both buyers and sellers face penalties if their transactions are detected.

The obvious costs of queuing, evasion, and black markets often lead governments to impose some form of rationing. The simplest is a coupon issued to consumers entitling them to buy a fixed quantity of the controlled good. For example, each motorist might receive a coupon permitting the purchase of one set of new tires. Rationing solves some of the shortage problems created by controls. Producers no longer find it easy to divert supplies to the black market since they must have ration tickets to match their production; distributors no longer have as much incentive to accept bribes or demand tie-in purchases; consumers no longer have as much incentive to pay excessive prices since they are assured a minimum amount.

But rationing creates its own problems. The government must undertake the difficult job of adjusting rations to reflect fluctuating supplies and demands and the needs of individual consumers. While an equal ration for each consumer makes sense in a few cases—bread in a city under siege is the classic example—most rationing programs must face the problem that consumer needs vary widely. Some motorists drive a lot and buy a lot of gasoline, and others drive very little.

One solution is to tailor the ration to the needs of individual consumers. Physicians or salesmen can be given extra rations of gasoline. In World War II, community boards in the United States had the power to issue extra rations to particularly needy individuals. The danger of favoritism and corruption in such a scheme, particularly if continued after the spirit of patriotism has begun to erode, is obvious. One way of ameliorating some of the problems created by rationing is to permit a free market in ration tickets. The free exchange of ration tickets has the advantage of providing additional income for consumers who sell their extra tickets and also improves the well-being of those who buy. But the white market does nothing to encourage additional supplies, an end that can be accomplished only by removing price controls.

With all of the problems generated by controls, we can well ask why are they ever imposed, and why are they sometimes maintained for so long. The answer, in part, is that the public does not always see the links between controls and the problems they create. The elimination of lower-priced lines of merchandise may be interpreted simply as callous disregard for the poor rather than a consequence of controls. But price controls almost always benefit some subset of consumers, who may have a particular claim to public sympathy and who, in any case, have a strong interest in lobbying for controls. Minimum wage laws may create unemployment among the unskilled, but they do raise the income of poor workers who remain employed; rent controls make it difficult for young people to find an apartment, but they do hold down the price of rent for those who already have an apartment when controls are instituted (see Rent Control).

General price controls—controls on prices of many goods—are often imposed when the public becomes alarmed that inflation is out of control. In the twentieth century, war has frequently been the reason for general price controls. Here, the case can be made that controls have a positive psychological benefit that outweighs, at least in the short run, the costs of shortages, bureaucracy, black markets, and rationing. Surging inflation may lead to panic buying, strikes, animosity toward racial or ethnic minorities that are perceived as benefiting from inflation, and so on. Price controls may make a positive contribution by calming these fears, particularly if patriotism can be counted on to limit evasion. However, such benefits are not likely to outlive the wartime emergency.

Moreover, most inflation, even in wartime, is due to inflationary monetary and fiscal policies rather than to panic buying. To the extent that wartime controls suppress price increases produced by monetary and fiscal policy, controls only postpone the day of reckoning, converting what would have been a steady inflation into a period of slow inflation followed by more rapid inflation. Also, part of the apparent stability of the price indices under wartime controls is an illusion. All of the problems with price controls—queuing, evasion, black markets, and rationing—raise the real price of goods to consumers, and these effects are only partly taken into account when the price indices are computed. When controls are removed, the hidden inflation is unveiled. During World War II, for example, measured inflation remained comparatively modest. But after controls were lifted the consumer price index jumped 18 percent between December 1945 and December 1946, the biggest one-year increase in this century.

Inflation is extremely difficult to contain through general controls, in part because some prices are inevitably left uncontrolled. At times the decision to leave some prices out is deliberate. The reason for controlling only some prices—those, say, of steel, wheat, and oil—is that these goods are strategic in the sense that controlling their prices is sufficient to control the whole price level. But demand tends to shift from the controlled to the uncontrolled sector, with the result that prices in the latter rise even faster than before. Resources follow prices, and supplies tend to rise in the uncontrolled sector at the expense of supplies in the controlled sector. Because the controlled sector was originally chosen to include goods thought to be crucial inputs for many production processes, the reduction in the amount of these inputs is particularly galling. Thus, if controls are kept in place for a long time, a government that begins by controlling prices on selected goods tends to replace them with across-the-board controls. This is what happened in the United States in World War II.

A second problem that afflicts general controls is the trade-off between the need to have a simple program generally perceived as fair and the need for sufficient flexibility to maintain a semblance of efficiency. Simplicity requires holding most prices constant, but efficiency requires making frequent changes. Adjustments of relative prices, however, subject the bureaucracy administering controls to a barrage of lobbying and complaints of unfairness. This conflict was brought out sharply by the American experience in World War II. At first, relative prices were changed frequently on the advice of economists who maintained that this was necessary to eliminate potential shortages and other distortions in specific markets. But mounting complaints that the program was unfair and was not stopping inflation led to President Roosevelt's famous "hold-the-line" order, issued in April 1943, that froze most prices. Whatever its defects as economic policy, the hold-the-line order was easy to explain and to sell to the public.

The case for imposing general controls in peacetime turns on the possibility that controls can ease the transition from high to low inflation. If, after a long period of inflation, a tight money policy is introduced to reduce inflation, some prices may continue to rise for a time at the old higher rate. Wages, in particular, may continue to rise because of long-term contracts or because workers fail to appreciate the extent of the change in policy. That, in turn, leads to high unemployment and reduced output. Price controls may limit these costs of disinflation by prohibiting wage increases that are out of line with the new trends in demand and prices. From this viewpoint restrictive monetary policy is the operation that cures inflation, and price and wage controls are the anesthesia that suppresses the pain.

While the logic is acceptable, the result often is not. In the eyes of the public, price controls free the monetary authority—the Federal Reserve in the United States—from responsibility for inflation. As a result the pressures on the Fed to avoid recession may lead to a continuation or even acceleration of excessive growth in the money supply. The painkiller is mistaken for the cure. Something very like this happened in the United States under the controls imposed by President Nixon in 1971. Although controls were justified on the grounds that they were being used to "buy time" while more fundamental cures for inflation were put in place, monetary policy continued to be expansionary, perhaps even more so than before.

The study of price controls teaches important lessons about free competitive markets. By examining cases in which controls have prevented the price mechanism from working, we gain a better appreciation of its usual elegance and efficiency. This does not mean that there are no circumstances in which temporary controls may be effective. But a fair reading of economic history shows just how rare those circumstances are.

### About the Author

Hugh Rockoff is a professor of economics at Rutgers University in New Brunswick, New Jersey, and a research associate of the National Bureau of Economic Research.

### Further Reading

Blinder, Alan S. *Economic Policy and the Great Stagflation.* 1979.
Clinard, Marshall Barron. *The Black Market: A Study in White Collar Crime.* 1952.
Galbraith, John Kenneth. *A Theory of Price Control.* 1952.
Grayson, C. Jackson. *Confessions of a Price Controller.* 1974.
Jonung, Lars. *The Political Economy of Price Controls: The Swedish Experience 1970-1987.* 1990.
Rockoff, Hugh. *Drastic Measures: A History of Wage and Price Controls in the United States.* 1984.
Schultz, George P., and Robert Z. Aliber, eds. *Guidelines: Informal Controls and the Market Place.* 1966.
Taussig, Frank W. "Price-Fixing as Seen by a Price-Fixer." *Quarterly Journal of Economics* 33 (1919): 205-41.