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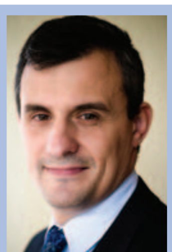
THE PERNICIOUS EFFECTS OF PRICE CONTROLS

Governments in Canada and elsewhere around the world continue to control the prices of many goods and services. These controls, aimed at helping certain producers or portions of society, result in a number of pernicious effects that damage the economy and impair wealth creation. It would be preferable to let prices play their proper role in the economy and to establish other public policies providing direct assistance to those who require such help.



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Prices set freely by the market play a crucial role in regulating the economy. They let businesses know which products and services are most highly valued by consumers and tell them which management methods, materials or technologies produce the greatest economic benefit. By holding out the prospect of profits, they give each firm an incentive to invest, to innovate and to offer products that are more highly desired.

Prices also inform consumers about the relative scarcity of resources used in producing and providing various goods or services. For example, if a product becomes more expensive, this not only indicates to producers that it would be profitable to make more but also influences consumers to use less of it and cut back on waste. In short, prices are important indicators for economic players, leading to the most efficient possible use of scarce resources.

Two types of price control

Governments can impose either of two types of controls that prevent prices from playing their proper role. They can set or maintain artificially high prices, called minimum prices or "floor prices," that purchasers must pay if they wish to have a desired good or service. These controls are intended mainly to ensure that producers' incomes will be higher than in a deregulated market. Alternatively, governments can impose artificially low prices or "ceiling prices" that suppliers are not allowed to exceed in selling products or services. These controls seek to guarantee that needy buyers or consumers can access the regulated good or service at a lower price.

The establishment of floor prices has a dual effect. First, by making products more expensive, these prices deter consumption and lead buyers to turn to substitute products. Second, they give businesses an incentive to raise production of over-priced goods, even if they risk not finding many buyers. Artificially high prices attract – or retain – more resources and more production than can be economically justified in a given sector. Without further regulation, this leads eventually to overproduction.

> *Prices are important indicators for economic players, leading to the most efficient possible use of scarce resources.*

Table 1
The economic effects of price controls

MINIMUM PRICES ("floor prices")	MAXIMUM PRICES ("ceiling prices")
Artificially high prices	Artificially low prices
Demand goes down	Demand goes up
Production and supply go up	Production and supply go down
Effect: OVERPRODUCTION	Effect: SCARCITY

Farm products

The prices of certain farm products in Canada – particularly those under supply management such as milk, eggs and poultry – are a good example of this. In these areas, marketing boards and agencies at the federal and provincial levels have the legal authority to set prices at the farm gate. For example, the Canadian Dairy Commission sets the price that serves as a benchmark for each provincial agency across Canada.

These support prices, intended to help producers, are higher than the prices that would prevail if the Canadian market were not regulated in this way. For example, OECD estimates suggest that, since 1986, milk prices at the farm gate in Canada have been two to three times higher than world reference prices at the border.[1] It is obvious that, without controls, Canadians would pay less for their milk and other dairy products, given that the raw material – milk – would be cheaper. This type of support amounts to a tax taken straight from consumers' pockets, totalling almost $40 billion between 1986 and 2003.[2]

To avoid overproduction crises caused by such support prices, regulatory authorities inevitably control production volumes as well, generally through the establishment of quotas, like in Canada. Quotas were initially awarded free of charge, but have since become very expensive, reaching about $29,000 in 2005 for the right to draw and sell the milk from a single cow in Quebec or Ontario. In the absence of price competition, producers are obliged to add to their quota if they wish to raise their production and sell more milk. This inevitably exerts upward pressure on the price of quotas.

Rather than helping producers, support prices simply end up inflating the cost of quotas, thereby preventing new producers from entering the business and penalizing the more successful producers who seek to build their volumes. Price controls not only hurt purchasers who have to pay more but also make the entire dairy industry less competitive.

Do low prices benefit consumers?

It is quite easy to comprehend how artificially high prices penalize consumers, but the damage caused by artificially low prices is less obvious. Is it not in consumers' interest to pay less for products and services?

Such price controls also have pernicious effects. First, lower prices lead consumers to buy more, thereby raising demand. But lower prices also make production and investment in regulated goods or services less lucrative. Resources and production factors are thereby likely to leave a sector, or a country, where such controls apply.

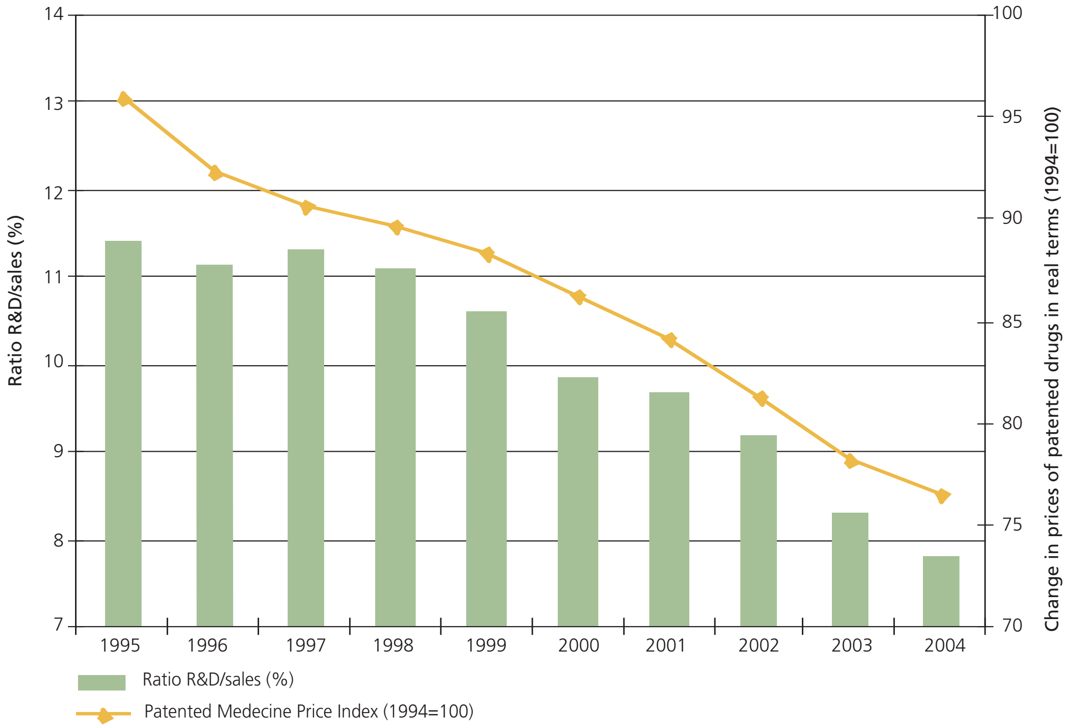
Unless other measures are imposed, such as subsidizing affected producers or investors, imposing a ceiling price will make a regulated good or service become scarce. Long lineups start to form, preventing consumers from getting as much as they want. Generally speaking, lower prices may benefit certain consumers in the short term but, by penalizing producers, they end up causing consumers damage in the long run.

Unless other measures are imposed, such as subsidizing affected producers or investors, imposing a ceiling price will make a regulated good or service become scarce.

1. See the MEI Economic Note titled "Dairy production: the costs of supply management in Canada," available at http://www.iedm.org/main/show_publications_en.php?publications_id=86.
2. See the data of the Organization for Economic Cooperation and Development, table 2.6, Milk: Market Price Support and Consumer Support Estimate, Canada, 2004, available at http://www.oecd.org/dataoecd/33/18/32360855.xls.

FIGURE 1

Changes in the prices of drugs and in the share of pharmaceutical company sales invested in R&D in Canada, 1995-2004



Sources: Patented Medicine Prices Review Board, *Annual Reports* 1995-2004; Statistics Canada, *Consumer Price Index*; calculations by the author.

The greater the number of people needing new housing, the more rent control proves harmful. For example, in New York City, known since the 1940s for the toughness of its rent controls, there is an urgent need for additional housing, but the number of housing starts is among the lowest in the United States.[4]

These pernicious effects that slow the construction of rental housing are visible in Canada as well. As noted by Pierre Desrochers, "an average of 27,000 housing units were built in Ontario in the six years preceding the introduction of rent regulation in 1974. This number plummeted to an average of 4,200 units in the following years. The production of new housing units fell even more sharply with the tightening of Ontario rental regulation in the early 1990s."[5]

Rent control

A classic example of a price ceiling is rent control, when governments regulate rents with the goal of making housing more affordable for the poor. This has a number of consequences.[3] Because their investments become less profitable, property owners have less incentive to invest in the maintenance or renovation of existing housing, or to build new rental units. Where possible, they find other uses for existing housing, converting it to condominiums or to non-residential use. The rental housing supply tends to shrink, making it harder to find a place to live, especially for the disadvantaged. Governments then seek to offset this shortage by financing the construction of public housing.

Rather than benefiting tenants, rent control ends up penalizing them by causing a reduction in the rental housing supply. On the contrary, since Ontario liberalized its rent control policies in 1998, rental housing construction has picked up and the vacancy rate for units renting under $800 a month in Toronto went from 0.9% in 1998 to 5.7% in 2005.

Price controls limit the income earned by subsidiaries of pharmaceutical companies in the Canadian market, reducing their ability to obtain research mandates from their parent companies.

3. See Walter Block, "Rent control," *The Concise Encyclopedia of Economics*, The Library of Economics and Liberty, Liberty Fund, available at http://www.econlib.org/library/Enc/RentControl.html.
4. See Pierre Desrochers, "Comment résoudre la crise du logement au Québec?," Research Paper (in French), MEI, 2002, p. 17, available at http://www.iedm.org/main/show_publications_fr.php?publications_id=39. See also William Tucker, "How rent control drives out affordable housing," *Cato Policy Analysis* No. 274, May 21, 1997, available at http://www.cato.org/pubs/pas/pa-274.html.
5. Pierre Desrochers, *op. cit.*, pp. 17-18.

Innovation in the pharmaceutical industry

Governments sometimes seek to keep prices low on innovative products to ensure that people can afford them. However, these controls directly deter future innovation and R&D investment, which tend to leave the sector or country where such controls apply. The case of price controls on drugs illustrates this eloquently.

In Canada, patented drugs are subject to dual price controls by governments. At their launch, prices are set at the federal level through the Patented Medicine Prices Review Board. Then, at the provincial level, various governments exerted, or still exert, a policy of price "freezes," as in Quebec.[6]

These dual controls result in artificially low prices for patented drugs. For example, apart from 2002, Canadian prices have been lower than median international prices since 1994. Recent data confirm that the gap between Canadian prices and those in other countries has widened again, with Canadian prices 9% below median international prices in 2004.

As well, while consumer prices rose more than 22% between 1994 and 2004, the prices of patented drugs fell by nearly 6%. The price freeze means that real prices for drugs, after taking account of inflation, have dropped continuously in recent years.

Consequently, while drugs are increasingly used to treat illness, and new drug treatments are continually sought, price controls destroy incentives for investing in R&D in Canada. This makes pharmaceutical innovation more and more difficult. Though the decision to invest in R&D in a particular country depends on many factors, price controls limit the income earned by subsidiaries of pharmaceutical companies in the Canadian market, reducing their ability to obtain research mandates from their parent companies. It comes as little surprise that R&D investment as a proportion of sales revenues in Canada fell sharply between 1995 and 2004 (see Figure 1).

This decline has costs and consequences for all areas of economic activity in Canada. For example, consulting firm Bain & Co. estimated that price controls enabled public insurance systems in Canada to "save" $7 billion in 2002. These controls, however, also led to financial losses, with research centres leaving and jobs not created by R&D-related subcontractors, not to mention less effective treatments with greater side effects, more patients sent to hospital, and so on. These losses came to more than $8 billion, meaning that regulation produced a net loss of $1 billion.[7]

Conclusion

Price controls are inefficient public policy. Artificially high prices, such as those imposed on products covered by supply management, not only penalize purchasers but end up hurting the more successful and efficient producers. If prices are too low, they result in reduced investment, less innovation and lower production of the regulated goods and services, causing losses for the entire economy and penalizing consumers in the longer term. Governments should leave prices free to play their proper role in the economy, and consider other policies, as required, to achieve their goals.

6. This freeze has been maintained since 1994, although the current government's new pharmaceutical policy – in the process of being adopted – suggests a partial "unfreezing" of drug prices.
7. Bain & Co., "The Impact on Canada of Pharmaceutical Regulations and Pricing Policies," September 2004, available at http://www.pfizer.ca/local/files/pressreleases/Narrative%20FINAL.pdf.

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