

Economic Issue of the Day

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The Janus face of price controls

In 2009, the government received mixed reactions on its move to stabilize the rapidly increasing prices of basic commodities by imposing price controls in the form of price ceiling. In August, some antihypertension and anticancer medicines were the focus of the government intervention. Toward the end of the year, price controls were set on commodities like rice and oil to curb the devastating effects of the deadly typhoons in September and October. When 2010 made its entrance, the public clamor to temper the soaring prices of sugar and cement also became strong.

While many regard price controls as a constructive move that would alleviate consumer pains, economists are skeptical about it and consider this intervention as damaging to the economy. At a mere glance, price controls appear to be the best thing government could do to protect consumers, particularly the hard-pressed, when inflation persists. But this is just seeing one side. In reality, price controls have a Janus¹ face—it has both good and bad. This *Economic Issue of the Day* explains why.

Forms of price controls

Price controls are a form of market intervention by the government on the prices of commodities and services to make them affordable. Not only basic commodities are subjected to price controls. When necessary, they are also imposed on other commodities and services that are fundamental to the survival and well-being of the population such as medicines or to the continuance of economic activities such as wages and rent.

The most common form of price control is **price ceiling** which is the highest legislated price that can be charged on a commodity. If a price ceiling is imposed on a commodity or service, the price cannot rise above that level.

Another form of price control is **price floor** or the lowest legislated price that can be charged on a commodity. If a price floor is imposed on a commodity or service, the price cannot fall below that level.

Recent examples of price ceilings include those that have been used by the government last year on oil, rice, and other basic commodities to shield consumers from inflationary prices.

Price controls such as price ceiling and price floors are artificial forms of market intervention because the prices are artificially set or controlled. They contrast against interventions wherein the market is left to adjust by itself. In a free market that is competitive and free from government regulation, the price of a certain commodity or service adjusts to the supply and demand. The price where the quantity supplied by sellers is exactly the same as the quantity demanded by buyers is the **equilibrium price**.

Price ceiling and its effect

The effect of price ceiling varies depending on whether it is set above or below the equilibrium price. Let us take, for example, the market for dressed chicken.

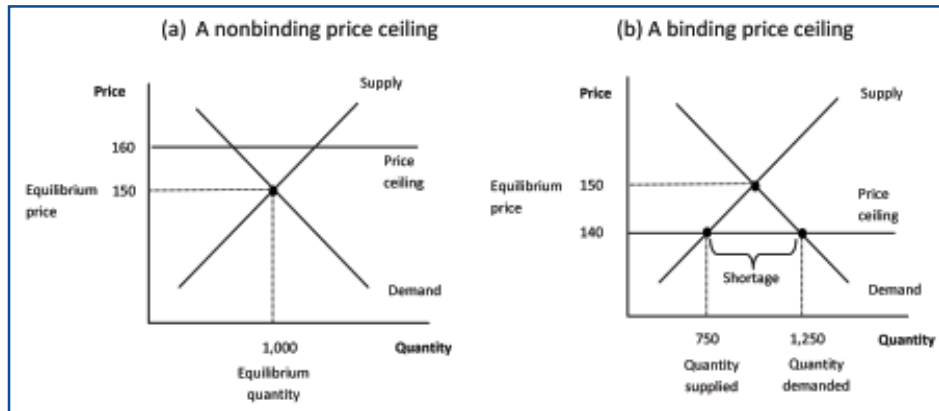
Figure 1a shows the outcome of a price ceiling that is set above the equilibrium price. Suppose the equilibrium price is at P150 per kilo given an equilibrium quantity of 1,000 units of dressed chicken. What will happen if the government imposes a price ceiling of P160 per kilo?

As can be seen in the figure, the price ceiling has no effect on the market. This type of price ceiling is therefore *not binding*. It has no effect because the price that balances supply and demand (P150) is below the ceiling. Market forces naturally adjust to the supply and demand until the equilibrium price is met but because the price ceiling is above it, it has no effect. But what if the government imposes a lower price ceiling of P140 per kilo?

Figure 1b shows the effect of a price ceiling below the equilibrium price. Unlike the former example, this type is *binding* and has an effect on the market. Because it is below the equilibrium price, buyers would want to buy more of dressed chicken, understandably due to the cheaper price. This results in an increased demand but which the market cannot meet. At a

¹ Janus in Greek methodology is the god of gates, doors, beginning and endings. He is most often depicted as having two faces looking at opposite directions (<http://en.wikipedia.org/wiki/Janus>). The term “Janus-faced” is usually used to mean having a bipolar or contrasting character, hence the connotation of being deceitful.

Figure 1. Effects of a price ceiling



Source: Derived from Mankiw et al. (2008)

price ceiling of P140 per kilo, 1,250 units of dressed chicken are demanded but only 750 units can be supplied. Therefore, there is a shortage of 500 units.

Shortage is the natural outcome of price ceiling; various mechanisms of rationing naturally develop to address it. From the buyers' side, they may decide to wait in line, or go to wet markets or supermarkets early to increase their chances of purchasing the quantity of dressed chicken that they want. This is time consuming and a waste of resources, and therefore inefficient. Others may resort to buying from the so-called 'black market' where sellers can take advantage of the situation by charging a higher price than what buyers would normally pay in an uncontrolled market where there are plenty of sellers and supply is adequate. Or buyers may adjust to the shortage of dressed chicken by simply purchasing substitute commodities like pork or beef.

From the sellers' side, they may opt to sell the quantity that they have only to a preferred group based on their personal biases, resulting in certain groups being discriminated against. For example, they may choose to sell to owners of big food businesses (like restaurants and food chains) instead of to the average buyers and collect a bigger profit out of it.

In both situations, it is clear that the policy taken by the government supposedly to protect buyers does not benefit all of them: it is beneficial to some but detrimental to others and also results in deceitful practices.

Price floor and its effect

In contrast to price ceiling, price floor is generally applied to protect the resource suppliers or producers. The effect of a price floor, as with price ceiling, depends on whether it is set above or below the equilibrium price.

A price floor which is below the equilibrium price has no effect and is therefore *not binding*. A price floor has an effect or is *binding*, however, when it is set above the equilibrium price. This may result in a surplus because the producer(s) of the commodity being controlled would

be willing to produce more considering that the price floor is higher than the equilibrium price. However, the quantity demanded by buyers becomes less than the available supply, thereby leading to an excess supply. The available quantity in the market is actually more than what buyers would actually like to purchase at the price floor resulting in a surplus. Because of the low demand, those who are holding surplus would be unable to sell. The government should take measures to absorb the excess supply of the commodity and to eliminate persistent surpluses. Possible ways could be by buying the excess supply, restricting product supply, or increasing product demand. Persistent surpluses could discourage producers to continue producing the commodity and may choose to decide withdrawing from the market. If a significant number of producers decide to do this, the supply of the commodity would be significantly reduced.

Indeed, price control—whether it is a price ceiling or a price floor—has a Janus face. It has both positive and negative effects, and unintended consequences that more often than not, hurt the ones it has originally intended to help. *

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