

## **Price Controls do not Reduce Inflation**

J. S. RYAN

### **INTRODUCTION**

The “What” of what I want to say today is already pretty clear from the title of my paper. However, I should explain to you the “Why” of the paper: why in the first place I want to bring to your attention the fact that price controls do not reduce inflation.

We probably all agree that Pakistan has more inflation than it needs and we share the popular desire to lower inflation or at least to keep it from rising. Unfortunately, fear of inflation seems to dominate Pakistan’s discussion of many economic policies that have little to do with inflation or the cost of living. For example, both the public debate and the political debate over what prices the government should set for its agencies’ sales of wheat and fuels is dominated by a widespread belief that raising these prices, or using a flexible market-determined pricing policy, would be inflationary. Tax reforms and export development are also constrained in Pakistan by the popular fear that they would be inflationary.

In my view, none of these fears of inflation is justified. However, false fears of inflation exist, and the longer we let them distort policy, the more we delay many of the important steps Pakistan needs to take to increase both the national rate of private investment and the level of government spending on social programmes for the worst-off groups in the population.

In this paper, I will very briefly explain why some of these widespread fears of inflation are unfounded. I will also suggest some non-technical arguments that economists can use, not in scholarly debate, but in the *popular* and *political* debate over economic policy to bring home some of these points.

### **PRICE CONTROLS**

Price controls are potent policy measures that can have important impacts on production and personal incomes, although in practice it is extremely difficult to identify these impacts. For example, although lower electricity prices may

reduce what a household pays for the electricity it receives, they also reduce the amount of investment in electrical generating capacity and thus reduce the quantity of electricity that that same household receives through load shedding. Furthermore, this household loses because of higher taxes and higher interest rates that result from the alternative means used to finance power sector spending that might otherwise have been paid for by full-cost electricity tariffs. Perhaps the total tax burden would have been the same even if electricity rates had been higher, but then the tax revenues would have been spent on something else, say schools. In this case, the household might have faced lower marginal costs of education if electricity tariffs had covered full costs.

The net effect of price control's various possible impacts on a particular household's welfare is thus extremely difficult, if not impossible, to evaluate. The point of my paper on this subject, therefore, is not to debate price controls in all their ramifications. The point is, however, that, in thinking about all these possible issues, the public should at least be free of the misconceptions about price control's inflationary effects, because price controls just happen not to lower the price level or the rate of inflation.

The whole idea of price controls is based on the observation that the common man in Pakistan is poor and cannot afford all he needs or wants. In these conditions, it should be clear that if the common man in Pakistan saves some money as a result of the government's controlling a price, he is going to use this money to try to buy more goods, rather than just hold on to cash. Presumably, this is the policy-makers' hope. How else would the common man be better off if he did not use the savings from lower, controlled prices to buy more goods?

How does this shifting of the common man's spending from the controlled commodity to other goods affect the overall price level, the average price at which total nominal spending power is translated into purchases of real goods? To start with, the controlled price will be lower, and the extra cash spent on uncontrolled goods will push those goods' prices higher. However, these are *relative* price changes, not changes in the price level.

To determine the effect on the overall price level, one has to determine how the control of a single price affects total nominal spending power and the total sales of real goods.

Starting with the effect on total nominal spending, it is clear that the common man's total spending does not change. On the other hand, the shift of sales revenues from the controlled commodity to other commodities may affect spend-

ing. If the seller of the controlled good is a governmental agency, the government's nominal spending may have to rise to subsidize the seller for the sales revenues it lost under price control. Alternatively, the seller of the controlled good could be a private firm, in which case the government might intend that the loss be absorbed by the firm instead of being subsidized. In this case, the owners of the firm will either have to divert their personal resources to meet the firm's losses, or the owners will receive less profits, and in either case the owners will have to reduce personal spending.

The case is symmetrical with the owners of other private goods on which the common man spends his savings. This offsets any effect on changes in spending in the controlled good's industry. However, if the common man tries to shift spending to other controlled-price commodities sold by government agencies, the agencies will not receive more revenues since their prices are controlled. (Quantity changes are considered below.) Therefore, subsidies, if any, will not be reduced.

Thus the expected impact on total spending of controlling a price (i.e., imposing a control that reduces the price) would be either zero, or in the case that subsidies must be raised, positive. This possible increase in total spending depends, however, on how the government would finance the increase in subsidy payments. If government spending is simply diverted from some other heading, then there would be no change in total spending. Similarly, if private spending power is diverted to the government by increased taxation or borrowing, total spending would not be affected. Only if spending is financed by the monetary authority (money creation) is the higher subsidy clearly an increase in total spending.

In fact, most of these shifts of spending power from agent to agent are only shifts and not changes in the aggregate. As will be familiar to the members of the intended audience for this paper, the impact on aggregate nominal spending must come from (or be balanced by) a combination of two sources: changes in "idle balances" in a short-term Keynesian framework or changes in the money supply in a longer-term framework, Keynesian or classical.

Changes in the money supply are not an effect of price controls, but independent policy decisions. So, the best chance for price controls to have an independent effect on the price level is for private loan financing of increased government subsidies to come partly out of idle balances.

Thus, we can fairly conclude that the effect of a price control on total spending is either to leave it unchanged or (under Keynesian assumptions that

many economists do not wholly accept) to increase it as an indirect result of the governmental fiscal problems it may cause.

Moving to the impact of price control on total production, we may short-cut an equally tortuous (and conventional) discussion of micro-level shifts to come to the overall conclusion that the aggregate effect depends on the availability of productive resources (which is exogenous, like the money supply) and short-term variations in employment of those resources (which, like variations in idle balances, are usually thought to depend on expectational disequilibria).

Putting the two strands of analysis together, we arrive at the familiar Keynesian conclusion that there is no long-term effect of price control on the overall price level, but that it is at least conceivable, although controversial, that extra governmental spending on subsidies occasioned by price control could lead to short-term and temporary increases in the price level, output, or both. Even this conclusion depends on the assumption that overall government spending passively follows the subsidy bill up and down. If the government holds to a firm outlay target and substitutes other spending for subsidy outlays as needed, then this avenue for a price controls to affect the overall price level is closed also. (This in effect makes a price control identical to expansionary fiscal policy.)

In no case, however, do we arrive at the conclusion that a price control *lowers* the aggregate price level. (The exception to this rule is the Soviet-style system where *all* prices are effectively controlled and people have forced savings in the form of money balances they cannot spend—the famous problem of “monetary overhang”.)

Another way to approach this question is a proof by negation. Suppose that a price control could indeed reduce the overall price level; what conclusions can one draw? Anyone who believes that the price level *will* fall and that the common man will buy more goods and live better should explain where price control should stop. After all, if price controls *do* lower the price level and raise total consumption, then why not lower prices yet further and expand consumption even more? Indeed, by controlling prices at levels near to zero, the common man in Pakistan could be made as rich as an oil sheikh.

If this conclusion seems unlikely, then there must be a problem with the argument that price control lowers the price level. Clearly, at some point the resource constraints for both total nominal spending and total real production make themselves felt. Most economists feel that we do not have to cut all controlled prices by half to make these constraints felt, but that they are with us all the time, and that in effect, “There is no free lunch”.

Besides administrative price controls, there are also some other related policies about which the public debate is burdened by a false connection with inflation. Export controls and taxes subsidies are good examples.

### EXPORT RESTRICTIONS

In this section I will take a different tack. Rather than to go through lengthy substitution arguments as I did above (e.g., that adding imports to the supply of goods reduces the price level by as much or more than taking exports out of the supply of goods increases it), consider instead some empirical evidence.

Take a look at the data in Tables 1 ("Basic Data" for inflation rates) and 9 ("Structure of Demand" for export's share in GDP) of the *World Development Report*. Low- and middle-income countries with more exports as a share of their output have, on the average, lower inflation rates. Those countries whose exports rose more relative to GDP between the 1960s and the 1980s also had lower average inflation rates in the 1980s. In fact, if you look at countries whose exports as a portion of GDP rose by 1 percentage point more than their neighbours' between 1965 and 1987, you find that on the average their inflation rates fell by 2 percentage points relative to their neighbours'.

It is important to emphasize that this is not the result of a causal relation between exports and inflation. Rather, it was due to other variables that pushed exports and inflation in opposite directions. As a whole, the factors that increased exports also reduced inflation.

I would hypothesize that one of these strategic factors would be openness to trade with the high-income countries, where inflation is generally low. The low- and middle-income countries who were relatively open to trade with the low-inflation countries essentially "imported" price stability.

I think that you would also find that relatively heavy reliance on price controls was *not* the common characteristic of those low- and medium-income countries that had lower inflation and more exports.

### TAXATION

Tax reform is perhaps the most pressing economic policy step needed in Pakistan. However, income taxation seems almost to be ruled out of discussion and the public views any increase in commodity tax rates as inflationary. Even a programme to equalize taxation of internal and international transactions is handicapped by charges of being inflationary, despite the fact that this programme

involves *lowering* international trade taxes while it raises internal taxes.

This is perhaps the clearest case of the public and economists holding opposite points of view, since economists generally believe that financing government outlays through tax revenues contributes less to inflationary pressure than borrowing does. Where the government's tax or sales revenues substitute for borrowing, they reduce pressure on credit markets. Since monetary authorities tend to relate monetary policy to "credit conditions", they are likely to react to reduced pressure on credit markets by expanding aggregate credit *less*, thus tending to reduce future inflation. This would not be the case if monetary authorities worked like strict quantity theorists, but strict quantity theory is a luxury that even monetary authorities can rarely afford.

### WHAT IS THE RIGHT THING TO SAY TO THE PUBLIC?

I personally am not at all sure how to explain to the common man points like those I have been making above. Relative to the effects of price controls, exports, and taxation on inflation, probably the best approach is bring to people's attention the tendency for price controls to be tougher, exports to be less, and taxation to be lighter when inflation is faster. Statistics like those cited from the *World Development Report* above might help. This would probably make people start to ask themselves why reductions in administered prices, exports, and tax rates are not effective in reducing the price level. On the other hand, constantly publicizing monetary growth rates alongside the inflation rate would probably also gradually result in people making the right correlation in their own low-tech way.

The public should be reminded often that economists' deflationary approach succeeded in Pakistan quite well as recently as 1989: inflation was reduced at the same time that the sales tax was extended to new goods and controlled prices were adjusted to cover more of government companies' operating costs.

People should also be reassured that the everyday consumption items of the common man in Pakistan are not actually in heavy demand in export markets. Tastes differ and high-income markets demand product quality that common consumption articles do not meet at present in Pakistan. If an export strategy succeeds, output of new products targeted to export markets will grow rapidly, *supplementing* production for local markets rather than draining it.

Ultimately, we economists need to move on to arguments that are not just for damage-control, but that positively move us in the right direction. The public

needs to learn to support higher national savings rates, including specifically higher (less negative) public-sector saving, which means tax revenues. The public needs to learn to demand freer access to world markets, which means eliminating non-tax barriers and equalizing the tax burden between international and domestic transactions. The public needs to learn to insist that government subsidies not be universal, but be positively targeted to manageably small segments of the population with special needs.

In all of the areas, the key task for economists is to translate unpopular but correct insights into prescriptions that can compete successfully in the newspapers with absurd but formidable bogeymen like how exports create inflation.

## CONCLUSION

I conclude by saying that I recognize that what I am urging economists to do is a little different than the usual cutting-edge technical economic research. It involves an effort to simplify and to find the argument that will enlist wide support, rather than to become more esoteric and divisive.

By taking a wider public as our partner or opponent in dialogue, however, we economists will certainly not abolish disagreement and debate. We will not cut off the need for research. But we will be more effective in the public policy arena. For the economics profession as a whole, as well as for the general public, the pie will get bigger.

**Comments on  
“Price Control do not Reduce Inflation”**

Following the proposition that one’s favourite policy prescription is intimately related to one’s favourite theory, the title of Ryan’s paper suggests that the author is trying to reassert that inflation is a monetary phenomenon and stabilization policies in the form of price and wage controls cannot effectively reduce the rate of inflation. However, a deeper look into the paper reveals that the paper cannot simply be categorized as one belonging to the set of papers that profess the “rules vs. discretion” belief. In fact, the discussion of price controls forms only a part of the entire paper. The remainder of the paper deals with alternative policy prescriptions to reduce inflation like increasing the openness of the economy and tax reform.

Coming to specific comments on the price control-inflation argument Ryan’s paper makes the statement that government intervention in the form of controlled prices (price ceilings) which is aimed at the provision of certain goods at below equilibrium prices ends up by raising the price level of other consumption goods, thereby defeating the purpose. Now even if we believe that this is the case, it still does not overrule the fact that the primary objective of price controls is the provision of certain basic commodities at below market-clearing prices and controlling the rise in the general price level is only a secondary outcome that is hoped to emerge from this policy measure. However, in the wake of deregulation in Pakistan, the issue of price controls raised by Ryan in this paper is a very relevant one.

The effectiveness of export-promotion policies and tax reform in controlling inflation is basically an empirical one and as such, nothing can be said definitively as to which of these policies if any, can ensure a stable price level.

**Aliya H. Khan**

Quaid-i-Azam University,  
Islamabad.