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The Price is Right—Or Better Be!
Lessons on the Folly of Political Price Regulation

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On the popular television game show "The Price Is Right," players guess prices on various items. The most accurate guessers win valuable prizes, and everyone—winners, losers, and the audience—has a good laugh. In reality, however, accurate prices are no laughing matter.

We assume ours is a market economy, with prices set by forces of supply and demand—yet it's surprising how often prices reflect political rather than economic decisions. Yes, some left-leaning economists allege that private firms collude to "fix prices." But in the true marketplace—an arena of voluntary competition and cooperation—coordinated pricing policies can actually enhance efficiency, benefiting consumers. In contrast, government price-setting policies—in industries ranging from electricity to highways to telecommunications—invariably lead to misallocation, waste, and stifling of innovation. Indeed, the pricing folly we face is regulators' refusal to let the market "fix" prices.

There is considerably more pricing regulation than most Americans realize; policy makers should address the disconnect between existing pricing policies and real market pricing in a number of economic sectors.

Prices are important mechanisms for signaling the scarcity and productivity of both inputs and outputs of the production process. Indeed, many economists argue that the Soviet Union collapsed largely because it could never get prices right. In market economies, the right amounts of pizza, beer, and umbrellas tend to be produced because price signals impart real time, valuable information. If a locality produces too little pizza, excess demand will lift prices, making pizza production more profitable. Those profits in

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turn entice both existing pizza producers and new entrants seeking profits to supply more. A new price level becomes established, only to be disturbed by changing consumer incomes or tastes, or by supply-side factors such as new costs for tomatoes and cheese. The process repeats itself continuously, and does so for all marketable goods and services.

In the Soviet Union, prices set by bureaucrats were essentially phony. Pizza might have been priced according to cost, but the costs of dough, cheese, mushrooms, etc. were artificial, placed on items arbitrarily by officials. By contrast, at a humble capitalist yard sale, demand is king—prices on unsold items are reduced as the afternoon progresses. Soviet price determination was a very complex process, and once completed, bureaucrats were loath to repeat the effort. Prices remained frozen for years, despite changing consumer preferences or production costs. Goods "underpriced" relative to demand disappeared from the marketplace, while "overpriced" items sat on shelves for years. In short, Soviet prices were artificial, conveying little useful information about productivity or scarcity. This made it impossible to effectively produce the right quantities at least cost—so the system finally fell apart.

For market economies to effectively allocate goods and services, prices must also be "right." When they are not, costly errors and inefficiencies result, as the relatively recent California energy crisis reminded us.

Despite bouts of supposed "deregulation," there is disturbing evidence that the disconnect between actual prices in American markets and "true" prices is far greater than generally perceived. Indeed, for some critical commodities prices are highly inaccurate—as a few examples easily illustrate.

Water Everywhere—But Pricing Is All Wet. Let's start with water. Prior to the wet winter of 2002-2003, the East Coast endured a five-year drought. For example, in August 2002, Maryland's governor asked state residents to voluntarily reduce their water use by 10 percent, while all businesses were mandated to do so. The city of Frederick prohibited watering lawns, washing paved surfaces, and home washing of cars, trailers, and boats. More than half of neighboring Virginia was in drought; one critically impacted town closed public toilets and replaced them with portable ones. In New York City during the summer of 2002, "Save Water" signs were ubiquitous. Alas, such exhortations and limitations have consistently failed, hence growing water crisis outbreaks. While the relative abundance of rain over the past 18 months has greatly alleviated America's water scarcities, this is a temporary blip. Continuing water crises are as inevitable as death and taxes, if current pricing policies continue.

Throughout the country water prices have been kept artificially low—or distorted in other ways—by government utilities, price regulators courting popularity, and politically inspired federal water contract arrangements. But cheap water invariably brings waste and inefficiency—and droughts make these problems painfully apparent. In place of truthful prices, lawmakers and regulators habitually invoke equally distortionary usage restrictions, which consistently fail. In the early 1990s California's state reservoirs fell to one-third of their capacity; and the Midwest's Ogallala aquifer, America's largest, is being depleted more than 10 times faster than its natural replenishment.[1] Given current pricing practices, water availability and quality will continue to degrade in many areas.

Such blindness is nothing new. In July 1965, a *Wall Street Journal* column on New York City's water crises noted the failure of traditional attempts to restrain consumption by usage limitations, such as restrictions on watering lawns and washing cars.[2] Yet only a few years earlier city leaders were so concerned about water shortages that they built a plant to purify Hudson River water, only to tear it down later after a few good rains filled the reservoirs. Forty years later the same issues persist. It would be both foolish and costly to let recent above normal rains lull us into a false sense of security. Ending water subsidies, disguised and overt, and charging realistic market prices are essential actions that need to begin soon.

Water pricing problems, of course, are not restricted to the U.S. According to estimates from the World Bank, over one billion people around the world lack access to fresh water. In the Middle East, where, of all places, water is often supplied free of charge or at low cost, water is egregiously wasted and few households bother to repair minor pipe leaks. And Mexico City could experience several water crises over the coming decade.[3]

Highways. Few, if any, Americans are untouched by failures in road pricing. Ever sit in a traffic snarl, angrily glancing at your watch as time dragged on? With gasoline price distortions and zero-priced roads, this painful national pastime is inevitable and ubiquitous. Yet the remedy for congestion is not simply more highways, but better pricing. We have been building highways for decades, but "free" roads attract more vehicles, so the problem never goes away. With modern technologies like E-Z Pass "smart cards," tolls today can be collected with minimal costs and minimal disruption of traffic flows, as a step toward highway privatization.

Not surprisingly, zero-priced roads have lessened the demand for private mass transit options, which proper pricing could make into an efficient and minimally polluting means of transportation. A recent study[4] found that congestion in America costs 5.7 billion gallons of wasted fuel annually and 3.5 billion hours of lost productivity, putting the 2001 tab for congestion at $69 billion. Congestion costs are significant and growing.

Road congestion charges have helped reduce congestion in Singapore and Norway; the city of London, where travel delay costs were estimated from $2.5 million to $10.2 million per working day, instituted them recently, with positive results.[5] America needs to get smart. Reduced congestion would lower both pollution and oil consumption, while the increased productivity associated with less congestion will lower production costs, assist in job creation, and promote export competitiveness.

Airport Congestion. Who hasn't endured the unpleasant experience of waiting around in an airport because planes are delayed? As with road pricing, better pricing for aircraft landing rights would greatly alleviate airport congestion and associated delays.

Farm Prices. The most recently passed farm bill hikes government agricultural spending by over $80 billion over the next decade. While the "right" price of heavily subsidized commodities like corn, soybeans, and cotton is now impossibly obscured, we do know that tax proceeds, transferred to farmers as subsidies—to the tune of almost $46 billion in 2003—comprise roughly 20 percent of all farm receipts.[6] Farm subsidies thus send a signal of artificially high demand to farmers, who in turn overproduce massively.

There is absolutely no reason to subsidize agriculture in the name of food security—the area that is now the U.S. has experienced not one food shortage in 400 years. Price-distorting subsidies also hurt the poor, since they artificially deflate prices for struggling agricultural producers in developing countries. Indeed, the World Trade Organization's 2003 ministerial trade talks in Cancún collapsed due to developing world anger over American and European agricultural policies, which raise prices for domestic consumers, but lower global prices, thus distorting world production.

Pricing Even More Critical in Today's Information Economy. Pricing problems persist, especially in declining marginal cost industries like electricity and telecommunications, where the price of serving the next individual might be low, but startup costs high. Price regulation can take new, damaging forms in today's information-based, networked economy.

For example, communications service providers are moving toward providing consumers with all-inclusive billing—for cable, phone, and Internet—but this innovation is threatened by demands for cable "a la carte" pricing. Yet price bundling is good for consumers. Travel agencies may offer hotel, auto rental, and airfare packages—but not the pricing of the individual elements, since disclosure would undermine competition with other vendors by revealing pricing strategies, ultimately hurting consumers.

Conclusion. Markets, not government, should determine prices. The market is the combination of *all* voluntary agreements—prices and contractual. While the regulatory underbrush from the progressive era is still causing real damage, the improved allocation of resources will benefit everyone via the efficiencies and cost reductions they generate. Americans love a good price, but it will serve us far better if we learn to love truthful prices even more.

Notes

[1] Terry Anderson and Pamela Snyder, *Water Markets: Priming the Invisible Pump* (Washington: Cato Institute, 1997), pp. 3, 5, 1611-163. See also Maude Barlow and Tony Clarke, *Blue Gold: The Fight to Stop the Corporate Theft of the World's Water* (New York: The New Press), 2002, pp.15, 16, 34, 44.
[2] Vermont Royster, "Thinking Things Over," *The Wall Street Journal*, July 26, 1965, p. 7.
[3] Melissa Master, "Just Another Commodity?" *Across the Board*, July-August, 2002, p. 19.
[4] Tim Lomax and David Schrank, *2004 Urban Mobility Report*, Texas A&M University, September, 2004, p. 1.
[5] Oxford Economic Forecasting Ltd. Study for the Corporation of the City of London. 2003, for the lower estimate and "Londoners Can Be Congestion Winners," Transport 2000, January 23,2003 news release (http://www.transport2000.org) for the higher one.
[6] See Michael R. Pakko, "Aid, Trade, and Agriculture," *International Economic Trends*, Federal Reserve Bank of St. Louis, February, 2003.