What Goes Wrong When the Government Mandates Prices

Featured Scholars:
John Cochrane, Richard Epstein, Milton Friedman, Daniel Heil, Lee Ohanian, Russ Roberts, and Thomas Sowell

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This Hoover Institution ebook examines how government price mandates—across housing, health care, and essential goods—undermine market signals and worsen economic outcomes. Featuring insights from leading economists, it reveals how rent control, anti–price gouging laws, and cross-subsidies distort incentives, create shortages, and drive up costs. Discover why interfering with prices can backfire—and how embracing market signals can lead to greater prosperity.

PRICES ARE A FACT OF LIFE, AND SO IS COMPLAINING about them. You probably prefer lower prices on just about everything, but especially when buying a house or paying for college, and you wish for higher prices when it comes time to sell that house or negotiate your salary. Complaints aside, however, prices are actually the key to widespread prosperity.

Prices contain vital information. They show us how scarce resources are. They indicate what consumers want. Entrepreneurs and innovators rely on prices to decide what to make and how to make it. But not all prices are meaningful. Too often, governments interfere. In an attempt to protect consumers, politicians mandate lower prices. Other times, governments push prices up to benefit certain industries. These efforts might be well intentioned, but they distort the information that prices convey and tend to make us poorer.

Why are prices so important, and what happens when policy makers forget this lesson?

PART 1: WHY PRICES?

The economy looks chaotic. Each day millions of people are independently making billions of decisions. From cups of coffee to new cars, consumers are making countless purchases. Innovators are busy developing new products. And entrepreneurs are investing in new equipment, processes, and buildings. Somehow, though, the result isn't chaos; it is widespread prosperity.

In "It's a Wonderful Loaf", economist—and poet—Russ Roberts shows how, without any central planning, the economy delivers orderly outcomes.

This order, Roberts notes, is a consequence of prices and competition. Price signals help create order where chaos seems more likely. Higher prices encourage consumers to conserve or to buy other products. Likewise, prices show innovators where they should commit their time and effort. They help entrepreneurs decide where they should invest their money.

> Explore how spontaneous order emerges in the economy through poetry—read **"IT'S A WONDERFUL LOAF"** by Russ Roberts. Read here: https://www.policyed.org/its-wonderful-loaf-0/its-wonderful-loaf/read-poem

But prices are effective only when they reflect actual economic conditions. They should rise and fall as consumer preferences change or when inputs become more or less scarce. When prices don't reflect these changes, the result will be shortages or excess. In the case of shortages, the cost to make more of the good is less than its value to society, yet no one has the incentive to produce more. Conversely, an excess supply means resources are wasted on goods that cost more to make than their value to society. Whether it is a shortage or an excess, the outcome is that society gets less of what it wants.

Usually, a sudden increase in demand causes prices to rise.

The COVID pandemic served as a tragic example of the consequences of government price mandates. As demand rose for masks, personal protection equipment, and toilet paper, prices should have risen too. But, as the story below explains, that is not what happened. Anti-price-gouging laws prevented prices from rising. With the prices remaining largely fixed, businesses had little incentive to increase production and consumers bought more than they needed. Dangerous shortages followed. Hoarders bought up supplies, while doctors and nurses couldn't get masks.

When the coronavirus struck, there were shortages of masks to protect doctors and nurses from infection.

Usually, a sudden increase in demand causes prices to rise.

Higher prices encourage manufacturers to add shifts, hire more workers, and increase production.

If prices rise enough, companies that make other things may find it profitable to start making masks too.

If laws against so-called price gouging stop prices from rising, the financial incentive to increase production disappears, and there won't be nearly enough masks to go around.

It may seem cruel and heartless to ask hospitals or people to pay higher prices for masks when they are desperately needed to save lives. But the alternative—a world where prices do not rise, and doctors and nurses go without masks—is cruel and heartless, too.

Higher prices discourage hoarding and buying masks just in case. That means more masks for people who desperately need them now. Buyers of masks pay a premium, but there are a lot more masks to go around and the incentive to expand production will reduce that premium over time.

Instead of letting prices drive private choices, governments around the world stepped in to buy masks and distribute them centrally. Yet in the US, Spain, Germany, and the United Kingdom, the number of masks available was woefully inadequate. Doctors and nurses died for lack of protection. Even in a crisis, it is better to use prices. [1]

Government-mandated price controls are a problem not just during pandemics. In nearly every part of our economy—from housing to health care—there are regulations that prevent prices from adjusting as economic conditions change. These rules distort the signals prices send and result in less prosperity.

PART 2: WHAT ABOUT HOUSING MARKETS?

In housing, governments often enact policies to push prices upward. In other cases, they create policies to keep housing costs from rising. And occasionally, they support policies that aim to raise and lower housing costs simultaneously.

Rent control is a classic example of a government-engendered price distortion. No one likes to pay more for rent, so politicians often resort to laws that simply prevent rents from rising. Advocates of these rules argue that landlords do little to deserve higher rent payments. In the San Francisco Bay Area, for example, landlords have been able to increase rents due to a booming job market. Why, rent control supporters ask, should these landlords collect higher rents when they just happened to buy a property at the right time?

Rent-control laws, however, distort incentives for renters and landlords. Those who don't value the space have little reason to move to smaller accommodations, while would-be renters who need more space, such as families with children, can't find adequate living spaces. The large family who needs more space would be willing to pay more, but rent-control laws mean there is no way for them to outbid those who don't value the extra space.

Landlords have little incentive to maintain and invest in their properties. With rent so low, they can easily find renters, so why would they make any improvements? Other landlords may choose to stop renting. They turn their properties into condos or other types of units that are not subject to rent-control laws. Developers and prospective landlords, meanwhile, have no incentive to build additional rental units. Thus, as explained below, rent-control laws lead to housing shortages and reduce the quality of existing units.

Whenever rental prices are considered unaffordable, many see rent control as the answer to make housing more attainable.

Rent control is a system where the government restricts how much a landlord can increase rent. And the thinking goes, if the government has the ability to regulate rental prices, shouldn't they? Well, maybe not.

The problem with rent control is that it ultimately manipulates supply and demand, and ends up creating a self-destructive chain reaction in the rental market. Whenever the government caps rental prices, demand skyrockets. After all, artificially low prices attract more renters, so the newly rent-controlled units get snatched up quickly.

Where the problem begins is that by restricting rental prices, landlords inevitably decide it isn't financially feasible to rent units under rent control. Because of this, many landlords will convert their rental units into sellable condos, and other landlords will stop building new rental properties. This causes the rental supply to actually decline, and apartments that ARE NOT rent controlled become even more expensive. Which was the problem in the first place. Basically, the only people who benefit from rent control are the lucky few who get in early, and stay in. And because landlords have no incentive to improve or even maintain rent controlled units, the lucky few may not be lucky for very long.

At the end of the day, rent control is a band-aid that only temporarily addresses the symptoms of the problem

At the end of the day, rent control is a band-aid that only temporarily addresses the symptoms of the problem – and only for a small number of people. But it fails to address the root of the high-cost problem - a lack of supply - and ultimately makes the problem worse by increasing the demand.

Surprisingly, many places with rent control also have rules in place that lead to increased housing prices. Economist Lee Ohanian explains how strict land-use rules lead to large housing shortages that increase costs:

Many communities in the United States are struggling with a housing crisis. Home prices and rent payments are growing much faster than incomes. In California, for instance, over a quarter of renters devote half their household income to rent. In expensive areas, people are living in garages, vans, or on the streets.

The reason for the crisis is simple: well-intentioned housing policies have made it expensive and often impossible to build enough homes to meet rising demand.

Many of these regulations were created for perfectly good reasons. Zoning laws were written to maintain nice-looking neighborhoods, limit congestion, and prevent public nuisances. Environmental rules were written to protect wildlife habitats; preserve open spaces and public access to nature; and protect against flooding and soil erosion.

But unfortunately, these policies have been implemented too broadly. Strict zoning rules no longer promote safe and appropriate construction projects. Instead, the regulations are used to stop all new construction. Environmental laws have resulted in long procedural delays and have given lawyers the power to file countless frivolous lawsuits that stifle development.

The result is that in some states and communities few construction projects are initiated, and even fewer are completed. In California, there are examples of zoning laws and environmental lawsuits forcing developers to wait 25 years or longer before beginning construction.

The beneficiaries of these prohibitive rules are current homeowners: their property values rise dramatically as housing demand outpaces new housing supply. But these rules hurt low and middle-income families who are priced out of the housing market. They cannot afford to buy a home or, in some cases, even rent one.

Beyond the impact these policies have on families, these rules weaken the nation's economy. By artificially constraining the housing stock, we have discouraged workers from seeking better opportunities in other geographical areas. When we look at the data, we see a declining share of Americans moving from states with few job openings to states with many available positions. That weakens the economy by keeping workers from jobs where they would earn more and be more productive. I have found relaxing land-use rules could add trillions of dollars to the US economy. That would mean higher wages, more job opportunities, and higher standards of living for Americans.

Fortunately, we can create land-use policies that meet today's housing demands while still protecting our communities and environment.

First, we can stop frivolous environmental lawsuits. We could ban duplicative suits where litigants file the same claim several times. We could also require those who file these lawsuits to pay all legal fees if they lose. We should also demand transparency among those who are financing these lawsuits.

Next, governments should change zoning rules to encourage more multiuse buildings and multifamily housing. And we should make it easier to retrofit existing buildings to add to the housing stock.

And finally, we should rewrite land-use rules to make it easier to build new cities. New cities would not only alleviate the house shortage, they would avoid the political challenges of trying to build in the heart of populated cities. These new cities could embrace the latest technologies for water, transportation, and energy use.

Meeting today's housing demand will remain a challenge, but fixing the way we regulate will help create more economic opportunities for American families and a growing economy for all.

The people who benefit from these rules are current homeowners who see their home values rise. The artificially high prices, however, hurt families who can't find housing or have to pay higher rents. Moreover, because restrictive land-use policies discourage workers from moving to areas with plentiful job opportunities, workers remain in jobs where they are less productive. This, of course, hurts these workers, but it also harms the entire economy.

PART 3: HOW DOES THE GOVERNMENT INTERFERE WITH PRICES IN HEALTHCARE?

It is not just housing. Politicians are eager to enact laws that will lower health care costs and increase insurance coverage. Sometimes these laws directly subsidize care, but this comes at a high price. Between Medicare, Medicaid, and other programs, the federal government spends more than a trillion dollars on health care programs each year. Lawmakers must raise taxes or borrow money to pay for these programs. Politicians, of course, prefer to avoid making these tough political decisions. They favor policies that appear to lower costs or increase coverage without increasing government spending. One attractive option is simply to mandate lower prices.

The Affordable Care Act (ACA), for example, created rules that prohibit insurance companies from charging higher premiums to individuals with costly health conditions. Congress hoped these restrictions would make health insurance more affordable. And, indeed, insurance companies lowered premiums for high-cost enrollees. But the insurers didn't stop there. To pay for the premium reductions, insurers raised premiums on young and healthy individuals. In short, Congress didn't lower health costs when it passed the ACA; it just shifted costs from one group to another. This cost shifting is called a cross subsidy. Economist John Cochrane explains how these cross subsidies corrupt the US health care system:

> Lawmakers do not want to be seen taxing and spending, so they hide transfers in cross-subsidies. They require emergency rooms to treat everyone who comes along, and then hospitals must overcharge everybody else. Medicare and Medicaid do not pay the full amount their services cost. Hospitals then overcharge private insurance and the few remaining cash customers. [2]

These cross-subsidies do not merely affect who pays. They distort the health market in ways that harm our health in the long term. Cochrane writes:

> Over the long term, cross-subsidies are far more inefficient than forthright taxing and spending. If the hospital is going to overcharge private insurance and paying customers to cross-subsidize the poor, the uninsured, Medicare, Medicaid and, increasingly, victims of limited exchange policies, then the hospital must be protected from competition. If competitors can come in and offer services to the paying customers, the scheme unravels. [2]

No competition means no pressure to innovate for better service and lower costs. Soon everybody pays more than they would in a competitive free market. The damage takes time, though. Cross-subsidies are a tempting way to hide tax and spend in the short run, but they are harmful over years and decades.

Cochrane describes the harm of cross-subsidies:

Why is paying for health care such a mess in America? And why is it so hard to fix? Cross-subsides are a root cause of the problem: The government wants to help a group of people, so it forces businesses – doctors, hospitals, health insurers – to undercharge those people. To make up the lost money, the government allows those businesses to overcharge someone else.

But, in order for this scheme to work, the government can't let other or new health providers and insurers offer better or cheaper care to the people who are overcharged. So the government has to enforce monopolies and stifle competition.

Stifling competition in any market removes the pressure to innovate, to lower costs, or to improve service for consumers. And soon everybody, even the people getting the subsidy, pays more than they would in a competitive market.

The government wants to help the elderly and the poor pay for health care. But lawmakers do not want to be seen taxing and spending, so they force doctors, hospitals, and insurers to do it.

Medicare and Medicaid programs pay hospitals and doctors less than the cost of treatment. The government mandates that hospitals provide emergency care to everyone, regardless of whether they pay. Health care providers make up the difference by overcharging people with private insurance, or cash-paying customers. In return, the government makes it hard or impossible to start new hospitals or insurance companies that cater to young, healthy, and cash-paying customers.

This is an old game. The federal government used to require that telephone companies provide landlines at low cost, especially to rural areas. So it forced a cross-subsidy from overpriced long-distance calls. The government enforced telephone monopolies to keep new phone companies out and long-distance prices up. When telephone service was deregulated, costs for everyone plummeted, and the quality and quality of service grew enormously. Now we take cell phones for granted.

Much like the phone companies of the 1960s, continued reliance on cross-subsidies in the U.S. health care system will only drive up costs and reduce efficiency. We talk about competition and transparency, forcing hospitals to disclose prices for example, but the government cannot allow competition and transparency as long as it insists on funding care for some people by overcharging others.

If the government wants to subsidize health care and insurance for the poor, elderly, and other groups, it should do so directly and on-budget. And raise the money for it honestly and forthrightly through taxes. It should then leave markets free to compete ruthlessly for the rest of our business. There is no fundamental reason that in order to help people in need, your and my health care and health insurance must be so thoroughly screwed up.

Taxing and spending is not good for the economy, but it's better than cross-subsidization.

Taxing and spending is not good for the economy, but it's better than cross-subsidization. It allows most people's heath care and insurance to be provided by an unfettered competitive innovative market. It ensures voters can see where their money is going, and decide if they want to be more or less generous and to who. The taxes would be unpopular, but our health bills would go down far more than our taxes would go up, and the quality and efficiency of our health care would skyrocket.

There are other ways prices are distorted in health care. For example, employer-provided health insurance premiums are tax deductible, which encourages workers to select insurance plans with high premiums and low out-of-pocket expenses. Research from Milton Friedman explains how this tax deduction arose:

Whether it is a world war or a pandemic, authorities are quick to enact policies during a crisis to protect the public from harm. These policies are enacted with the best of intentions, but they often have long-term consequences that far outlast the crisis.

For example, during World War II, the government instituted wage and price controls to help with the war effort. But there was a problem. Businesses couldn't recruit enough workers without offering higher wages. To sidestep these restrictions, employers started paying for their employees' health insurance as a new benefit.

Businesses and workers then successfully lobbied Congress not to count health insurance as income, effectively making it tax free.

Wage and price controls were lifted after World War II, but the tax-free status of employer-paid medical care remained in place.

Today, the government is still subsidizing expensive employer-paid insurance. These plans give patients fewer reasons to consider the cost of their healthcare choices, encouraging them to use more care than they really need. Ultimately, this drives up medical costs and healthcare premiums for all.

If not for a temporary decision made in the midst of a world war, today's health care system would offer Americans more options and lower prices.

When a crisis happens, we expect our policymakers to respond. But we should remember that policies that sound good in the short term can have bad long-term consequences.

When an insured person visits a doctor or chooses to undergo a health care procedure, they don't face the full cost of their decision. Because the price they pay is far below the cost, people tend to consume more health care than they would if they had to pay for treatments directly. That might seem like a good tradeoff. It ensures patients don't have to worry about the cost when making decisions about their health. The excessive consumption, however, pushes premiums upward, making health insurance less affordable for all.

PART 4: CONCLUSION

In the twenty-first century, fewer people are living in poverty and more needs are being met. Remarkably, this progress has come with little central planning. Most economic decisions are left in the hands of individuals. Their choices are guided only by their own preferences and by market prices. As we have seen, when politicians interfere with prices, they obscure and distort the guideposts that are integral to prosperity and ultimately weaken the delicate economic order that benefits so many.

ENDNOTES

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2 John H. Cochrane, Single Payer Sympathy, blog post, accessed May 30, 2025, https://johnhcochrane.blogspot.com/2018/07/single-payer-sympathy.html

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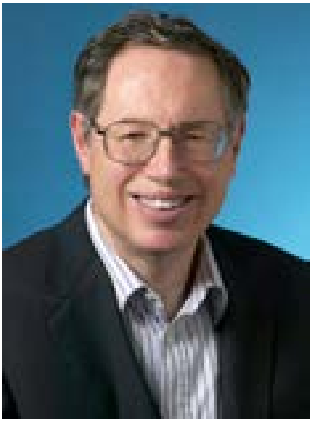

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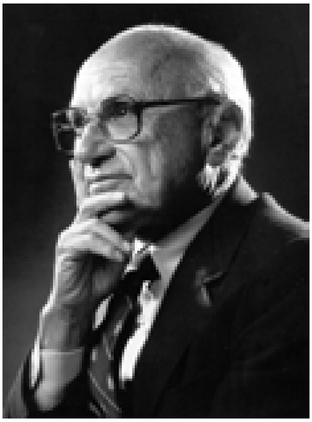

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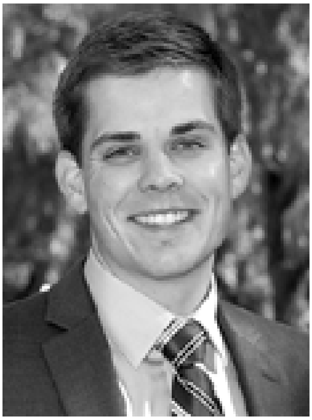

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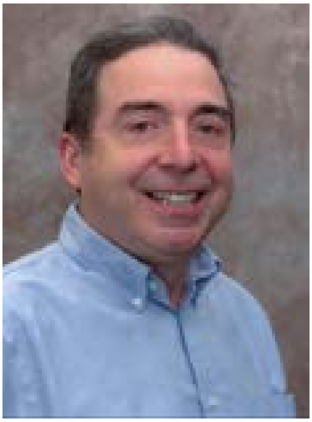

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