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Common Error No. 5 [1]

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5. "Prices of essential goods should be controlled so that the poor can afford them."

Price caps are one of those things that sound fine in theory but are disastrous in practice. Prices are signals which tell about supply and demand, like the markings on a thermometer tell about temperature. And just as you can't control temperature by bunging up a thermometer, you can't control supply or demand by fixing prices.

When the price rises for scarce goods, it tells people to consume less and maybe switch to alternatives. It tells others to produce more of them because there are profits to be made. The combination of less consumption and greater production acts to redress the scarcity. But it only works if prices can send their signals. If they are fixed by law to shield poorer people from their effects, there is no disincentive to consume, nor any reason to switch to alternatives. Nor is there any incentive for producers to bring more of the goods to market.

If the price of bread is fixed because of rising prices in a shortage, there is no incentive for people to turn to alternatives like other grains or potatoes. Nor is there any incentive for farmers to bring more wheat to market, or for foreign merchants to bring in their wheat to take advantage of the greater returns. There is no signal telling farmers they could profit by planting more wheat next year.

All that happens when prices are fixed by law is that the supply dries up, usually because no-one can make money by selling at the fixed price. Then the state steps in again to ration the scarce goods "fairly", and passes new laws to stop black market dealing in them. We see this happen for bread, fuel, and rented accommodation. Ultimately, the outcome is clear: if you fix the price, you only succeed in choking off the supply and making the shortage even worse.

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