PRICES:

HOW ARE THEY FORMED? WHAT ARE THEY FOR?

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March 2015

Prices are a constant concern for policy-makers. For example, Treasury Ministers and central bankers seem very concerned with deflation. For them, deflation means a general lowering of prices, which is bad for the economy, because low prices do not incentivize entrepreneurial activity. As a result, some think that Government should act to avoid deflation by injecting more money in the economic system.

On the other side, other politicians are very concerned with possible rises of prices due to changing market structures. The telco sector has recently experienced some of these changes, both in the European Union and in the USA. So, some US Senators are very concerned that the proposed Comcast-Time Warner Cable merger could raise prices for Internet access . In Europe, the European Commission estimated that the acquisition of E-Plus by O2 (both of them mobile operators in the German market) would raise the prices for the end consumer in a 13-17%, reaching a 37%(!) for prepaid consumers . As a consequence, extensive commitments by O2 were required before authorizing an operation with such allegedly pernicious effects.

As can be seen, the relationship of politicians with prices is typically incongruous. Some of them complain if prices do not rise, others complain if they think the prices are going to rise. So, the question remains open: which is better for society, prices increasing or prices decreasing?

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The truth is that the role of prices in social welfare is clearly overstated, at least by politicians. Prices are no more than an historical record, and as such they are neither good nor bad for social welfare. They are just an indicator, a signal, nothing more… and nothing less.

A price is just the ratio at which two commodities have been interchanged by two individuals in a concrete transaction. We tend to conflate prices with offers. When we go to the supermarket, a "price" is usually set for each of the available goods. That price is actually an offer, and it will not become a price if this offer is not concreted in a transaction. So, for example, if tomorrow the "price" for apples is set on 100 Euros/kilo, it is very likely that this offer will not become an actual price, because nobody will accept the transaction at such a price. And if nobody buys apples at 100 Euros/kilo, it would be very inaccurate to say that prices for apples went up just because the salesman tried to sell them at that price.

With this in mind, let's try to answer the above question. Does social welfare improve, when prices increase or when prices decrease?

If the price of a concrete good rises, it is clear that people who own the good will be better off. Those people which have the means to produce it, be it labour or assets, will likely profit from the increase too. Conversely, people who do not own the good will be worse off, especially if they are planning to buy it in the short term.

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In the dual case, when the price of a specific good is reduced, people who own the good will be worse off, and so will those people owning means to produce it. And, equally, people who do not own the good but are planning to buy it, will be better off.

So, what is the balance for society? There is no answer. In fact, from the point of view of society, it seems indifferent that prices rise or fall. Of course, for concrete individuals in concrete moments, this is not indifferent; but from the point of view of social welfare and common interest, the point of view with which politicians are supposedly concerned, this seems completely indifferent. In sum, politicians should not care about prices moving in one or other direction.

This should be the end of the story. But of course it is not, because politicians actually care about the evolution of prices, as has been shown in the examples at the beginning of this article. And as they care, they tend to intervene in that evolution, which is something problematic for the working of the economy.

We have described prices as historical records showing concrete ratios of interchange. But they have also a fundamental role to play in the market. They are the signals by which entrepreneurs guide their decisions on investment. As such, prices are a very synthetic indicator of the relative scarcity of a good with respect to its uses.

If a price rises, this means that a concrete good is more valued by society, and conveys the signal to entrepreneurs that more resources should be deployed to the production of that good, because this is what society is currently demanding. Conversely, if a price decreases, the concrete good is losing value for society, and resources should be moved from its production to other more productive uses. This process, as explained, is not automatic, but driven by entrepreneurs using prices as signals.

What happens if prices are tampered with? Of course, the first effect will be that some individuals will lose and others will win. For example, if prices are not allowed to increase, people owning the product or the means of production, will lose wealth, while people intending to buy it will increase their own wealth. Politicians normally think that this is good for the people, because after all firms are "rich" and this action re-distributes wealth from "the rich" to the people. The fact is that it only profits the individual qua consumer; but individuals are much more than consumers: they may be shareholders of the firm, or they may have a pension plan which is invested in the firm, or they may work for the affected enterprise or for any of their providers upstream in the value chain. So, in the end, is not even easy to clarify if a concrete individual, not just the society, is better or worse off as a result of the price control.

However, this is not the gravest effect of price tampering. The actual problem is that it jams the price signal system, and thus entrepreneurs are hindered from carrying out the transferring of resources among activities in an effective way. The entrepreneurial process will go on, but the resources will be taken to the wrong places, impoverishing the society with each investment.

One other thing should be considered: entrepreneurs, being human, may make mistakes. It was said before that there are no good or bad prices for society. In the same way, there are no right or wrong prices, there are only prices. An entrepreneur may offer a good at a too high "price" and then find he is not able to sell enough units to make the investment worthwhile, being forced to bring down the price in order to increase the sales. This does not make the first price wrong and the second price right: it just means that the entrepreneur is reacting to the new information acquired after the first attempt. If further information comes along, the price may be revised again, be it up or downwards. This is the essence of the entrepreneurial process, to react to changes in the environment trying always to adapt to the new preferences shown by or anticipated in individuals.

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Conversely, an entrepreneur may offer the product at such a low price that it makes impossible for him to recover the investment, even if he thought at first that he would be able. In that case, the entrepreneur will of course try to raise the price and see if their clients cope with the increase. Again, this does not mean the first price was wrong and the second right, just that new information is being taking into account when setting the price. However, this last process will be seen as suspicious by politicians, as if lower prices were always right, as seen in the merging cases quoted above.

The good news is that the competitive entrepreneurial process tends to increase the efficiency in serving costumer needs, most of the times by investing in pursuing economies of scale. So, the natural and expected outcome of an un-intervened market would be in line with what politicians think so desirable: price reductions. But, at the same time, this reduction, being based on actual cost reductions, would be sustainable in time. There is plenty of empirical evidence showing these results: it is enough to take a look to former luxury items which are now accessible for most people (cars, computers, holidays…)

In summary:

1) There is no relationship between prices and social welfare. When the price of a good decreases, some social groups profit, but other groups are harmed; the same happen when that price increases.

2) Prices play a fundamental role in letting entrepreneurs guide the resources wherever society value them more. Tampering with prices, in consequence, makes this process harder and thus is very likely to harm social welfare.

3) Prices in un-intervened markets tend to decrease with time ceteris paribus, so there is no need for politicians to have concerns, even on this ground.

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