# Chapter 3
# Too Inexpensive to Be Inexpensive: How Government Censorship Increases Costs by Disguising Them

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**Abstract** Politicians often see price ceilings, subsidies and third-party payments as effective ways of reducing the amount consumers pay directly for goods and services and take credit for reducing their costs. While these policies may reduce prices, they are a form of censorship that invariably increases costs. Politically inspired interference in the communication that takes place through market prices reduces the information and discipline required to control costs. The most notable recent example of politicians trying to take credit for reducing costs with policies that increase them is found in their recommendations to reform health care. There are unfortunately a number of other examples such as price controls on apartment rents and subsidies to agriculture and education.

## 3.1 Introduction

Controlling costs requires conveying information on what costs are and then motivating people to consider them when making decisions. This is not easily accomplished and no economic system performs this task perfectly. Every decision one person makes imposes costs on countless others by using products or resources from which others could have benefited. Ideally, no one will make a decision to use something that is worth less to him than it costs-i.e., is worth to others. While no economic system achieves this ideal perfectly, market economies based on private property and voluntary exchanges are far more effective than any other process at communicating information on costs and benefits in ways that motivate appropriate responses to this information. In markets, this communication takes place through prices.

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Market prices are constantly adjusting to changing conditions and preferences to reflect the marginal costs of making goods and services available and the marginal value consumers realize from them. These prices inform consumers of the marginal cost of consuming a good, both in terms of additional production and sacrificed consumption by others. In addition, market prices motivate suppliers to expand production of goods as long as their marginal value is worth at least as much as the marginal cost of making them available. Again, no real-world market functions perfectly. When markets fail, or are seen to fail, the common response is that government policies should correct the perceived failure by altering prices with controls, subsidies or taxes. The problem is that government policies do not work perfectly either and seldom improve upon market prices at communicating dispersed information to those best able to use it in ways that keep costs as low as possible.[1]

But, no matter how well markets are controlling costs, consumers would like them to be lower. This creates opportunities for politicians to gain support by promising, if not a free lunch, a cheaper lunch with policies that give the appearance of lowering the costs of a variety of goods and services. Despite appearances, however, these policies almost always increase costs by censoring the price information that is required to keep people informed on, and sensitive to, the real costs of their decisions.[2] By concealing costs with policies that outlaw or distort the price communication that reveal those costs, politicians receive gratitude from people who, while believing they are paying less, are actually paying more.

In this paper, we consider several ways politicians consistently convince people that their costs are being reduced with policies that, by censoring communication through market prices, increase them. Price ceilings, subsidies, and third-party payments (including the problems caused by government policies on private medical insurance that are being used to justify medical-care reforms) will be examined in Sects. 3.2, 3.3, and 3.4 respectively. Concluding comments, with a brief discussion of why past health-care reforms have increased health-care costs, will be offered in Sect. 3.5.

## 3.2 Price Ceilings

Despite the long lines for gasoline caused by federal price ceilings in the 1970s and 80s, a Gallop Poll conducted during May 2008 found that a majority of Americans

[1] Given that costs are foregone benefits, keeping costs as low as possible is equivalent to increasing benefits as much as possible.

[2] Censorship is not too strong a word for government actions that alter market prices for political purposes. As we have argued in a previous article (Clark and Lee 2008), the information communicated through market prices is every bit as important to our prosperity, liberty and general wellbeing as the information communicated in written and verbal forms that is protected by the first amendment to the United States Constitution.


**Fig. 3.1** Price ceilings

favored price controls on gas because of its high cost.[3] The federal government did not impose a price ceiling on gas in 2008. In recent years, however, state governments have imposed such controls for the stated purpose of protecting consumers against the high cost of gasoline after natural disasters and price spikes. Also, a number of municipal governments have rent ceilings on apartments which are justified as necessary to keep down the cost of housing. And in the early 1970s, the federal government imposed price ceilings on literally thousands of goods and services in the name of fighting inflationary increases in the cost of living. In each of these cases, and many more, the effect of a price ceiling is the opposite of what politicians claim and the public seems to believe. As can easily be seen from demand and supply curves, price ceilings increase costs instead of reducing them.

Consider Fig. 3.1 with the demand curve $D$ and supply curve $S$ for a product. Without any restrictions on price communication, the price will reach an equilibrium given by $P_E$ and the amount demanded and supplied will be equal at the equilibrium rate given by $Q_E$. Assume, however, politicians decide the price $P_E$ is too high and promise to reduce its costs to consumers by imposing a price ceiling given by $P_C$. As seen at price $P_C$, consumers want $Q_C$ units of the product, which is where their marginal consumption value equals $P_C$, and suppliers are willing to supply only $Q_S$ units, which is where their marginal production cost is also $P_C$.[4]

[3] Fifty three percent wanted the government to impose price controls on gasoline and 45 % were opposed (Jacobe 2008).

[4] The exception to such a shortage being created by a price ceiling below the equilibrium price occurs if the good is being produced by a monopolist and the price ceiling is set at the price where that demand curve intersects the monopolists marginal cost curve. We ignore this possibility here.

Assuming that the price ceiling is strictly enforced, making it impossible for consumers to pay suppliers or for suppliers to receive from consumers a price higher than $P_C$, the marginal value of the good to consumers will increase to $P'$ (the height of the demand curve at $Q_S$). Given a marginal value of $P'$, consumers are willing to pay $P' - P_C$ more than is legal to pay with money. So, they will pay in other ways. In the case of price ceilings on gasoline, for example, the most obvious ways to pay more are by waiting in lines, driving around looking for shorter lines, or carrying full gasoline containers in the car trunk. Consumers would pursue some combination of these activities to get another gallon of gas until they are paying approximately $P' - P_C$ per gallon in terms of the opportunity cost of their time, convenience and safety. So their total cost ends up being $P'$ per gallon, which is obviously more than the $P_E$ it would cost without the price ceiling.

Price ceilings are commonly accompanied by non-price rationing schemes enforced by government. But, these schemes also lead to costly adjustments as the choices consumers would make (given their particular preferences and circumstances) are replaced by arbitrary and uniform restrictions that ignore the diversity of preferences and circumstances. In the case of price ceilings on gasoline, governments have rationed it with restrictions such as how much can be purchased at one time, how often it can be purchased (e.g., on odd or even dates, depending on the last number on ones license plates), or coupons. Coupon rationing is potentially the least costly non-price rationing approach. Gas coupons are distributed that allow a specified amount of gas to be purchased at the controlled price of $P_C$ per gallon, with the coupons restricting the total of gas consumed to the amount supplied at the price ceiling-$Q_S$ gallons in Fig. 3.1. Of course, coupon rationing also results in costly inconvenience for almost everyone, with the distribution of coupons having little to do with how much gasoline is worth to different people.[5] In the most efficient variation of coupon rationing, the coupons can be bought and sold at an unregulated price resulting in them being reallocated until all consumers realize the same marginal value from gas, which maximizes the value of the available gas (which is the same as minimizing the cost of using the available gas). Of course, the price of the coupons will be bid up to $P' - P_C$ per gallon. So even with the best government rationing approach, the price ceiling has still increased the cost of gas, or any other good subject to a price ceiling, from $P_E$ to $P'$.[6]

The increased cost caused by a price ceiling is directly related to the censorship of effective communication between consumers and suppliers. Long lines of inconvenienced and frustrated consumers do communicate to suppliers that consumers want more of the good being supplied. But, those lines do not provide infor-

[5] Some groups will be favored over others, but largely on the basis of the relative political influence of different groups. This creates incentives for groups to lobby political authorities, which is another cost associated with government interference with price communication. See the discussion on rent seeking in Sect. 3.3.

[6] In most cases, it is illegal to buy and sell rationing coupons since the price paid for the coupons makes it obvious that the price (and costs) has increased. Despite the law, however, markets for coupons invariably materialize because people benefit from exchanges by transferring the rationed good from those who value it less (at the margin) to those who value it more.

mation on consumer preferences as clearly and concisely as would market prices, and they provide no motivation for suppliers to respond to the desire for more of the good. Without the price ceiling, market prices would provide suppliers with both the information and motivation needed to expand production to $Q_E$, where consumers no longer valued another unit of the good by more than the cost of producing it.

Of course, enforcement of price ceilings is never as strict as we have assumed, and despite the penalties on those caught buying and selling at a price greater than the legal price $P_C$, illegal exchanges take place. These exchanges, by communicating price information from consumers to producers, will lower the cost of the product to consumers below $P'$, but the cost will remain higher than the market price of $P_E$. This result is shown in Fig. 3.1 with shifts in the demand and supply curves that reflect the expected penalties from buying and selling at an illegal price.

Assume that the expected marginal penalty imposed for violating the price ceiling is a constant amount for each unit bought and sold, and it is half as much for buyers as for sellers.[7] The effect is to shift the demand curve down by the buyers expected marginal penalty (from $D$ to $D_P$) and to shift the supply curve up by the sellers expected marginal penalty (from $S$ to $S_P$). The result is an illegal equilibrium at price $P_{E'}$ and quantity $Q_{E'}$. Both buyers and sellers are better off by violating the price ceiling, even with the penalties for doing so, since it results in more output with a marginal value greater than marginal cost (including the penalty cost) being made available. And, the per-unit cost to consumers has declined below $P'$, but that cost is still greater than it would be without a price ceiling. The cost is now equal to $P''$ in Fig. 3.1, which equals the price paid for the product, $P_{E'}$, plus the expected marginal penalty (given by the vertical distance between the demand curves $D$ and $D_P$).

The cost to consumers is the same no matter how the expected marginal penalty is split between buyers and sellers. For example, if the penalty were imposed entirely on buyers, the supply curve would remain at $S$ and the demand curve would have shifted down by an amount equal to the entire penalty, shown as $D_{P'}$ in Fig. 3.1. The illegal equilibrium would occur now at price $P_{E''}$ and quantity $Q_{E'}$. The new price is less than consumers were paying without the price controls, $P_E$, but the cost of the good to consumers is still $P''$ when the expected marginal penalty is added to the price $P_{E''}$.

A price ceiling that is below the free-market equilibrium price, even if imperfectly enforced, increases the cost consumers pay to acquire the good. The increased cost considered here considers only the cost of what is purchased and ignores the loss to consumers from not being able to buy as much of the good as they would like at prices that would motivate suppliers to make the additional amount available. We now consider government policies that claim to lower the cost of goods to consumers by subsidizing them. Again, the effect is contrary to the political claims, with subsidies

[7] If the same marginal penalty is imposed on sellers and buyers, the *expected* marginal penalty on sellers will typically be higher because they are easier to catch (sellers have to make information available to potential customers that can be intercepted by the police). It will be clear that our conclusion is the same for a given expected marginal penalty no matter how it is split between buyers and sellers.

increasing the cost of the goods to consumers. The difference between subsidies and price ceilings is that subsidies increase the cost of the goods by making it too easy for consumers to buy more of them.

## 3.3 Subsidies

It is not uncommon for governments to subsidize a good and claim that doing so will lower its cost and increase the amount consumed. Subsidies do increase the amount consumed, as advertised, but they increase costs to consumers. There are two general ways for government to subsidize a good: (1) subsidize its production by paying suppliers a given amount for each unit produced, and (2) subsidize its consumption by paying consumers a given amount for each unit consumed. We assume that the subsidies are given in direct money payments.[8] Although there can be political reasons from preferring subsidies to suppliers, or subsidies to consumers, or some combination of the two, for a given per-unit subsidy the effects on output, consumption and costs are the same for any split between producers and suppliers. We first consider producer subsidies, then consumer subsidies, and finally we discuss the costs of subsidizing a good in addition to those reflected in the direct cost of the subsidy.

### *3.3.1 Production Subsidies*

In Fig. 3.2, the unsubsidized demand and supply curves for a good are shown as $D$ and $S$ respectively, with the equilibrium price and quantity given by $P_E$ and $Q_E$. If it is determined through the political process that more of the product should be consumed, one way of accomplishing this is by lowering the price of the good by subsidizing its production. Assuming that producers are paid a given amount, $M$, for each unit produced, the private marginal cost of production will drop by $M$, which shifts the supply curve down by the same amount. This new supply curve is shown in Fig. 3.2 as $S_S$. The demand curve $D$ is unaffected by the production subsidy and the subsidized equilibrium is determined by the intersection of $D$ and $S_S$, and shown by price $P_S$ and quantity $Q_S$. The subsidy reduces the price consumers pay for the good, but increases its cost. The money needed to pay for the subsidy has to be paid for through some combination of current taxes, future taxes, or inflation, and it is

[8] Subsidies are often paid to producers in less obvious ways for political reasons, as when farmers in arid areas receive water from expensive water diversion projects at a small fraction of the costs, or when governments guaranty loans to producers which allow them to pay lower interest rates. Although such subsidies are more convoluted than direct cash subsidies, our analysis of the latter applies to any subsidy that lowers the private marginal cost of production.

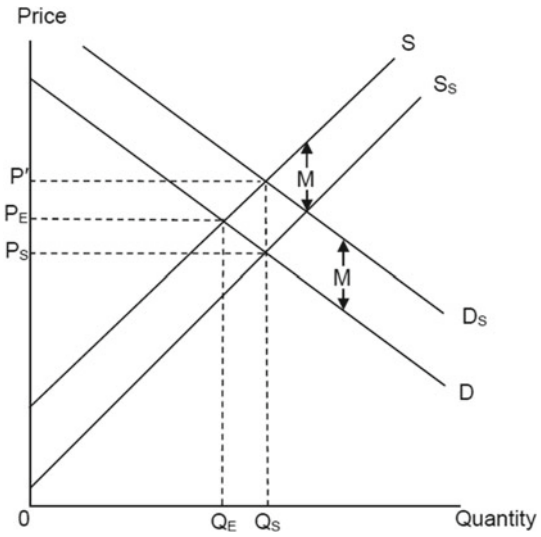


**Fig. 3.2** Subsidies

consumers (all of us) who will do the paying.[9] So the cost of each unit of the good is given by $P'$, the price $P_S$ plus $M$, the per-unit cost of subsidy-which is greater than the cost, given by $P_E$, which is the full per-unit cost without the subsidy.[10]

The political advantage from the subsidy is that its effect on supply is easily noticed and appreciated by producers, while its cost is typically ignored by consumers and has no effect on the amount demanded. There are fewer producers of a subsidized good than there are consumers of it, so the subsidy to each producer is much larger than the taxes each consumer pays to finance it. Also, few of the taxes people pay come as itemized bills. Taxpayers often have no idea if a good they are consuming is being subsidized, and almost never know the per-unit cost of the subsidy or how much of that cost they are paying with their taxes. Also, since the total amount a producer receives from the subsidy increases as he produces more, the subsidy reduces the private marginal cost of production, as seen by the downward shift in the supply from $S$ to $S_S$. It is this increase in supply that explains the decrease in price from $P_E$ to $P_S$.

[9] Another possible way to pay for the subsidy is to reduce government spending on something else. This might seem to be an attractive possibility since it would make the subsidy costless to consumers if it were paid for by reducing government spending that is wasteful already. But despite ample examples of completely wasteful government spending, eliminating such spending is not likely to be very popular to politicians. If politicians were looking for ways to eliminate wasteful spending, they would not be looking for ways to finance government subsidies that increase the cost of goods and services.

[10] It is noted that this conclusion depends on the supply, or marginal cost, curve being upward sloping at the equilibrium. This is almost always the case, although it is possible for marginal cost to be declining at the equilibrium as a result of a positive externality in production. We ignore positive production externalities in this paper, although we do consider arguments for subsidies based on a positive externality in consumption in Sect. 3.3.1.

This lower price is what consumers notice, not the cost of the subsidy they pay in higher taxes. And from each consumers perspective, it is completely rational to ignore the cost of a subsidy, even if she knows what it is, because it has effectively zero effect on the marginal cost she is paying. No consumer will see any increase in her total taxes if she buys another unit of a subsidized good. All she would accomplish by reducing her consumption of the good below the level where marginal value equals price would be to sacrifice some of her consumer's surplus to subsidize the consumption of others. This is a sacrifice few can be expected to make, which is why consumption is given by $Q_S$ in Fig. 3.2, where the marginal value of the good, as measured by the height of the demand curve, equals the good's price. Each person's consumption of the good shifts almost all of the cost of the subsidy to others. The subsidy can be thought of as an invitation for people to benefit at the expense of others.[11]

Because of the subsidy, the price of the good no longer does what market prices typically do, which is communicate to producers and consumers the real costs of consumption decisions and motivate them to take these costs into consideration. Not surprisingly, when not all costs are communicated through prices that are paid directly, producers and consumers cease to respond to those costs in ways that keep them under control.

### *3.3.2 Consumption Subsidies*

Instead of subsidizing producers for supplying a good, government can subsidize consumers for buying it. To examine this case, we first go back to demand curve $D$ and supply curve $S$ in Fig. 3.2 and the unsubsidized equilibrium price $P_E$ and quantity $Q_E$. We next consider a consumption subsidy that takes a form similar to the production subsidy just examined – a specified payment to consumers for each unit of a good they purchase. This has the effect of shifting the demand curve up by the amount of the payment since the marginal value of the good to each consumer is increased by that amount. Assuming that the per-unit subsidy is the same as the production subsidy ($M$), the new subsidized demand curve is given by $D_S$, as shown in Fig. 3.2. Since the supply curve is not affected by the subsidy, the subsidized equilibrium in this case is given by price $P'$ and quantity $Q_S$. Compared to the equilibrium with the production subsidy, the quantity produced and consumed remains the same, but the price has increased from $P_S$ to $P'$, an increase equal to the per-unit subsidy.

Although the price has increased, the marginal cost to each consumer is still given by $P_S$ because of the subsidy received on every unit purchased. But the average

[11] Although all consumers pay the same price for the product, the per-unit cost each consumer pays for the good varies. Those who pay little in taxes and consume lots of the subsidized good shift much of the per-unit cost of the subsidy to those who pay lots in taxes and consume little of the good.

amount consumers pay for each unit of the good continues to be $P'$ once the tax-cost of the subsidy is considered. As in the previous case, some consumers will pay more of the tax cost for the subsidy they receive than others. But again, the tax cost has no effect on any consumers marginal cost, and therefore no effect on the amount consumed. The subsidy remains an invitation for people to gain at the expense of each other since the price fails to motivate consumers to take all the costs of their decisions into consideration.

So whether the per-unit subsidy is paid entirely to the producer or entirely to the consumer, the effect on consumption and production is the same. And in both cases, the governments attempt to lower the cost of a good, or give consumers the impression that it is lowering the cost, actually increases the cost. It is easily shown that if the subsidy were split between producers and consumers the effect on consumption, production and cost would remain the same regardless of the relative amount given to each.

One can argue that a subsidy can be justified despite the result of our analysis. It might be that consuming the good creates a positive externality with efficiency being increased by motivating more consumption of the good with a subsidy. Education, for example, is often cited as a good that should be subsidized because education is thought to provide benefits to society in addition to those captured by the direct consumer.[12] There is nothing in our argument that denies the existence of such positive consumption externalities or the possibility that when they exist a government subsidy can, if correctly sized and targeted, add value that exceeds the additional cost that results.[13] Our point is that subsidizing a good almost always increases its costs.

### *3.3.3 Additional Costs*

The political motivation for providing subsidies is typically influenced significantly by the political influence of those receiving them, particularly when the recipients are well-organized interest groups.[14] The exercise of this influence can generate additional costs in addition to the direct tax costs discussed in the two previous

[12] See Hall (2000, 2006) for viewpoints on this argument.

[13] Unfortunately, the information necessary to know the size of a subsidy that will efficiently internalize an externality is rarely, if ever, available. And even if it were available, the political considerations that determine what goods are subsidized, and by how much, seldom have much to do with economic efficiency.

[14] In general, producers are better organized than consumers, and so producers can be expected to have more influence on the type and size of subsidies than consumers. This does not imply that political influence will favor producer over consumer subsidies. Producers can benefit from consumer subsidies as much as they do from producer subsidies and may favor the former because the benefit they receive from consumer subsidies is less direct and obvious than it is from producer subsidies.

subsections and result in a larger subsidy than warranted by any positive externality that may exist.

Political benefits seldom come free of charge. A group seeking benefits from a government subsidy has to compete for the attention and favor of politicians against many other groups who want political benefits. This "rent seeking" is costly, requiring access to key politicians and the ability to make a plausible case that the subsidy is in the public interest and a compelling case that it is in the political interest of those best able to get the necessary legislation passed.[15] The rent-seeking cost takes the form of campaign contributions, hiring well-connected lobbyists and recognized experts, generating favorable publicity and mobilizing at least the appearance of public support for the subsidy. And, much of this expense has to continue after the legislation is passed if the political support necessary to protect the subsidy against ongoing competition for government largesse is to be maintained. This rent-seeking cost is mostly a real cost-not just a transfer-since rent seeking employs resources with valuable alternative uses. The size of the per-unit subsidy may be positively related to the amount spent on rent seeking, but once the subsidy is "purchased" and the shifts in the demand and/or supply curves have taken place, the rent-seeking cost is independent of how many units of the good are produced and consumed. So the rent-seeking cost of the subsidy is a fixed (as opposed to a marginal) cost that, at least in the short-run, has no effect on production and consumption decisions.[16] It is a cost, however, that the subsidy adds to the production and consumption of the good over and above the direct tax cost. And, although it is consumers who will ultimately pay this rent-seeking cost, they completely ignore this cost in their consumption decisions.

Another cost of subsidizing a good that is invariably disregarded by consumers results from the fact that it always cost more than a dollar to raise a dollar in tax revenue. A significant portion of this extra cost is referred to by economists as the excess burden of taxation. People respond to taxes by making choices that create less value than those they would have made without taxes. For example, an employee may be willing to move to take a more productive job for the extra income her employer is willing to pay her, but not for the additional after-tax income. The net value that fails to be created is the excess burden of the income tax in this case. There have been many studies attempting to estimate the size of the excess burden of taxation. The estimates vary depending on the study and the tax being considered. In the case of the income tax, the tax that is probably the most commonly studied, it is routinely found that the excess burden of raising another dollar is $.25 (an excess burden of

[15]Tullock (1967) provided the first systematic analysis of rent seeking, although he did not use that term (Tullock 2003). The term was coined by Krueger (1974) in a paper that considered examples of the competition for political influence. Tollison (1982) surveyed the main themes and implications of the rent seeking literature.

[16]If the subsidy results in more output, and therefore profits, than anticipated, the politicians may decide to share in the unanticipated bounty of the suppliers by increasing the rent-seeking payments for maintaining the subsidy. So in the long run, the extra output might result in higher costs.

25 %) or higher.[17] There is little evidence that politicians consider the excess burden of taxation when making spending decisions. Doing so would require, for example, rejecting a project that would create $1.2 million in value and could be financed with $1 million in taxes since, with an excess burden of taxation of 25 %, the cost of the project is $1.25 million. Neither do consumers consider the excess burden of taxation when considering how much the subsidized good actually costs or how much of it to purchase. As discussed previously, none of the tax cost of a subsidy affects the marginal cost to the consumer.

Another obvious, but indirect, cost of a subsidy is the cost the government incurs to collect taxes and taxpayers incur to keep the records and prepare (or pay someone else to prepare) the forms required when paying taxes. Both of these tax-related costs are borne by taxpayers. As before, however, these costs are not seen by consumers as being connected to the total or marginal cost of a subsidized good. Consumers see the subsidy as lowering the cost of the good, but fail to see that this reduction is being more than offset by the costs of the subsidy, both direct and indirect.

## 3.4 Third-Party Payments and Insurance

Subsidizing a good with tax revenues to make consumers believe that its cost is being reduced can be thought of as an example of a third-party payment. Instead of each person paying the entire cost of his consumption directly, much of the costs are covered by taxes paid by others (third parties), with there being no relationship between the amount of the subsidy an individual pays and the amount he consumes. So the previous analysis of government subsidies is completely applicable to some third-party payments, but not all arrangements involving third-party payments are the same. For example, private medical insurance is an arrangement where the cost of medical care is not paid entirely by direct payments from the person receiving the care. The care each person receives is being subsidized in part by the payments of others-third-party payments-in the form of insurance premiums.[18] Although publicly subsidized medical care can be considered a form of insurance, and is often justified as such, there are important differences between it and privately provided medical insurance, even though both increase the cost of the care.

Consider first the similar effects both have on costs. The considerations discussed in Sect. 3.3 explain why subsidizing medical care with taxation increases the cost of that care. For some of the same reasons, privately provided medical insurance

[17] See Vedder and Gallaway (1999) for a discussion of different estimates.

[18] Of course, each person is also contributing to the care of everyone else with his own premium payment. As with government subsidies considered in Sect. 3.3, some people will end up paying more in premiums than they receive, and others will end up paying less. One can argue that it is only the latter that are being subsidized. But the important point is that everyone purchasing a good subsidized in part by insurance premiums, or taxes, will ignore the amount the subsidy is costing him when deciding how much of the good to consume. Premium payments for insurance are not marginal costs.

also increases the cost of medical care. Because the premium payments are not marginal cost, those payments are not considered in the decisions on how much care to purchase. The result is that medical care for the average consumer ends up costing more as consumption is expanded beyond the point where its marginal value is equal to its increasing marginal cost, because much of the cost is being paid for indirectly through insurance premiums. And, insurance premiums, as with the cost of taxes, are greater than the amount returned to consumers in the form of lower direct health-care payments. Much of the premium payments go to covering the cost of the personnel required by the insurance companies to collect the premiums, distribute the payments and keep track of it all. Furthermore, hospitals and doctors are also responsible for much of the cost of all this recordkeeping, and this cost also gets passed on to consumers.

Paper work is commonly required when transactions are made, but it is less than it would be otherwise when people are disciplined by spending their own money. Spending discipline is reduced when other peoples money is being spent, and restoring some of this lost discipline with cumbersome forms, regulations and aggravating red tape seems inevitable. Indeed, red tape can be justified as a way of moderating the moral hazards that result when people are able to shift the costs of their decisions onto others, as they do when not exercising proper care to avoid costs being subsidized or insured against. Moral hazards are an inherent feature of third-party payments, whether they result from public subsidies or private insurance, and provide another explanation for why subsidies and insurance increase the cost of goods by substituting non-marginal costs for marginal costs.[19]

In the case of most private insurance, the cost of moral hazards and red tape are reduced with insurance policies that require policy holders to pay a significant amount of the loss that is being insured against, with the insurance covering only large losses. This is referred to as high-deductible insurance. Fire insurance on a house is an example. Obviously, people are going to be more responsible in avoiding fire hazards (be less prone to moral hazards) if their fire insurance has a high deductible than if it has a low, or no, deductible. By keeping fire costs down and insurance premiums low, high-deductible fire insurance is more attractive than low-deductible insurance to most insurance customers, which explains why it is readily available from private insurance companies. The third-party payments that result from all insurance clearly have the effect of increasing the cost of that care. But, competition in the provision of private insurance generally moderates this effect by limiting the subsidy to unlikely, unpredictable, and relatively costly occurrences.

Interestingly, however, high-deductible medical insurance is not very popular, even though it has the same advantages as other types of high-deductible insurance. Most medical insurance is low-deductible/low-co-pay insurance, where once the medical cost reaches a relatively small threshold of a few hundred dollars (the deductible) the insurance pays most of the additional cost, leaving a small co-pay for

[19]The extra cost resulting from moral hazards is often more than justified in the case of insurance, because of the value people receive from replacing the low risk of a large and unpredictable cost with a the certain cost of small and predictable payments for insurance premiums.

the insured (commonly 20 %). This insurance is significantly more expensive than high-deductible medical insurance since it creates little incentive for the insured to make benefit-cost comparisons between different medical options, which biases decisions toward more costly choices, reduces the price competition faced by suppliers, and increases insurance premiums.[20] The question is: why is the type of medical insurance that results in higher medical cost and higher insurance premiums so popular? The answer is: government policy is disguising the cost of most medical insurance with a tax subsidy.

Most medical insurance is provided through businesses as part of employee compensation. Employees are in effect purchasing medical insurance from their employers and paying for it with lower salaries and wages than they would receive otherwise. This is an arrangement that can make both sides of the exchange better off when, as is often the case, the employer can buy group medical insurance for less than employees would pay individually, and for less than employees are willing to pay. The problem results from the fact that the value of employer-provided medical insurance is not taxed while monetary compensation is, so the more workers pay their medical bills with medical insurance premiums (which are part of their compensation, but not taxed) instead of directly in the form of copayments (which are taxed), the more they save in taxes.[21] So the limits on third-party payments that most private insurance contains are relaxed on most medical insurance because of the tax subsidy, which leads to more medical care being consumed, higher costs for medical care and for the insurance premiums that pay for much of it. As argued in Sect. 3.3, government subsidies almost always increase the cost of what is being subsidized.

The discussion in this section touches on some of the issues that are critical to any meaningful healthcare reform. The demand for reform is being driven by concern over the high cost of medical care and medical insurance, with proponents of different approaches to reform all claiming that their approach will make medical care available to more people by lowering its cost. Our prediction is that any reform legislation that satisfies the political requirements for passage will continue the trend that medical-care reform has long taken-substituting yet more subsidies and third-party payments for direct payments to give the impression that medical-care costs have been reduced, or have at least been shifted to someone else. If this prediction is correct, we are convinced that the result will be higher medical-care cost, and continued demand for reform. We are reminded of the joke: If you think medical care is costly now, just wait until its free.

[20] As reported in Cogan et al. (2005, p. 40) the average family medical insurance policy cost about $7,000 per year in the early 2000s, which reflected a high percentage of low-deductible/low-co-pay policies. At the same time, the median annual premium payment for medical insurance for a family of four with a $3,000 deductible was $2,683.

[21] This also makes providing low-deductible/low-co-pay medical insurance more attractive as a way to pay workers.

## 3.5 Conclusions

When politicians recommend policies to reduce the costs of goods, they invariably have in mind policies that censor the communication of information transmitted through market prices. This censorship reduces the coordination between suppliers and consumers needed to produce goods as cheaply as possible and supply them to the point where their marginal production cost equals their marginal value. The result is that government policies aimed at reducing costs almost always increase them.

The most blatant way governments censor price information to lower the cost of a good is by imposing a price ceiling below the equilibrium price. This has the effect of increasing cost by reducing the amount supplied and therefore increasing the amount people are willing to pay for the marginal unit. The competition between consumers for the good that follows can take many forms, but always include incurring significant costs associated with the inconvenience of dealing with an artificial shortage. This competition increases the non-price cost enough to elevate the cost of acquiring the good above what its price would be without the price ceiling. Also, government commonly steps in with restrictions to ration the goods that motivate other costly adjustments on consumers. Without being permitted to pay more than the legal price ceiling for the good, none of the costs consumers incur do anything to motivate changes in the amount supplied, which is the only thing that would reduce the price, and cost, of the good to its free-market level.

Another way governments distort price information in efforts to reduce, or appear to reduce, the costs of goods is by directly subsidizing their production or consumption with tax revenues. Once the tax-costs of the subsidies, and the related rent-seeking and excess burdens, are considered, the costs of the subsidized goods are higher than they would be without a subsidy. Consumers of publicly subsidized goods do not connect the tax they pay to support the subsidy with the goods' cost. Even if they did, the tax cost of the subsidy is ignored in consumption decisions because it does not affect the marginal cost of consumption.

The third-party payments inherent in insurance also lead to increased costs by lowering the marginal costs of choices that are subsidized by insurance premiums which each of the insured see as a fixed cost. The moral hazards that result (from government subsidies as well as from insurance) are typically moderated in the case of private insurance by high deductibles requiring direct payments on routine and predictable expenses, with the insurance reimbursing only relatively costly expenditures that are unusual and unforeseeable. But, in the case of medical insurance, a tax subsidy exists that biases all employer-provided policies toward low deductibles and low copayments which exacerbates the moral hazard and significantly increases the cost of medical care and medical insurance.

Although price ceilings increase costs by reducing the amount supplied and consumed, and public subsidies increase costs by increasing the amount supplied and consumed, there are similarities between the two. The increased costs caused by governments often result in pressures on governments to do more to reduce the costs that their cost-reducing policies have increased. In the case of price ceilings, the

response is often to increase penalties on those engaged in black market activities that are actually reducing costs. Also, price ceilings are commonly accompanied by government imposed rationing schemes that increase costs with one-size-fits-all rules that make it even more difficult to direct available goods to go to those who value them most.

In the case of public subsidies, the political response to complaints about escalating costs is typically to further reduce the amount consumers are paying directly by increasing the government subsidy. This has clearly been the history of government efforts to contain the rising cost of medical care.[22] The result is always more cost escalation caused by increased demand, and more political pressure for even larger subsidies. This process eventually leads to a government attempt to suppress the amount demanded with government rationing. This is true even though the original rational for medical-care subsidies was to increase the consumption of medical care. Elderly people are justifiably concerned that more of this reform will make it more difficult for them to receive care that could prolong their lives. As opposed to the economic stimulus plan, health-care reform might really be "shovel ready."

We do not want to leave the impression that government is always inept in its attempts to alter costs. When it sets out to increase costs, it can be depended upon to do an excellent job. Of course, politicians never brag about their ability to increase costs, or admit that is what they are doing. When enacting policies that increase cost, the claim is always that some noble purpose is being achieved such as saving American jobs (import restrictions); protecting family farms (agricultural price supports); achieving energy independence (mandated use of corn-based ethanol and tougher CAFE standards); improving education (limitations on the competition faced by public schools); or protecting the environment (mandated use of renewable energy sources). But no matter what politicians are claiming to do, when they are substituting political choices for those individuals would make in response to uncensored market information, what they are almost always doing is increasing costs.

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[22] According to Goodman and Musgrave (1992, p. 232), 51.6 % of all personal medical expenses in the U.S. in 1965 were paid directly by those receiving the care. In a recent paper, Goodman et al. (2009) reports that the amount of personal medical expenses paid directly for health care in the United States was only 13 %, while the average for OEDC countries was 20 %.

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