

Reflections on Price Gouging

A Google search of English language entries during the last three months turned up 1.9 million hits on *price gouging* and 1.5 million on *price controls*. *In Praise of Price Gouging* by John Stossel (townhall.com, September 7, 2005) was the top *gouging* entry and four of the top five defended it. For the most part, however, sentiment leaned toward outrage and condemnation and support for enforcement of laws against *gouging*. Politicians were universally critical with statements ranging from calls to enforce existing laws to proposals for more stringent legislation on gouging and price controls on gasoline.

President Bush was one of the more moderate voices among government officials. In an interview on ABC's Good Morning America (September 1, 2005) he reportedly said: "I think there ought to be zero tolerance of people breaking the law during an emergency such as this, whether it be looting, or price-gouging at the gasoline pump or taking advantage of charitable giving, or insurance fraud." Defenders of free markets may consider Bush's statement immoderate but his main function is to enforce the law. Of course, no federal law prohibits price gouging so he may have merely been adding his moral authority to officials charged with enforcing state and local anti-gouging laws.

The governors of most Southern states are authorized to trigger anti-gouging legislation in a state of emergency. In Georgia panic buying in response to rumors that gasoline stations would close before sundown caused prices at the pump to escalate substantially. The rumors were made credible by additional rumors that Colonial and Plantation refined product pipelines would be shut down. The latter rumors proved well founded as Colonial and Plantation pipelines were shut down due to loss of electric power at key pumping stations.

Georgia Governor Sonny Purdum responded quickly with an executive order that promised to impose heavy fines on gasoline retailers who gouge their customers. In a remarkably candid press conference called late in the day on August 31, 2005 he stated: "When you prey upon the fears and the paranoia, it is akin to looting, and it is abominable." Governors more directly affected by the hurricanes also declared states of emergency and the anti-gouging statutes.

The Georgia statute is typical of those in most other states in that the definition of gouging is based on historical and replacement costs and precisely what constitutes gouging is vague. Quoting again from the press release:

Georgia's price gouging statute prevents retailers from selling goods or services at an unreasonable or egregious price. Georgia's price gouging statute does not prevent price increases that accurately reflect an increase in the cost of the goods or services to the retailer, an increase in the cost of transporting the goods or services into the area, or an increase due to the market forces of supply and demand.

For example, a retailer may increase the price of their products as is necessary to replenish their existing daily stock at current market rates, maintaining the same markup percentage he or she applied prior to the enactment of the price gouging statute.

The focus of the gouging statute is on the behavior of retailers while consumers are thought to be passive victims. Retailers are presumed to have market power or the ability to charge prices in excess of what would prevail in a competitive market. Legislators who propose anti-gouging laws may believe competitive prices do or at least should equal average costs. Neither is true.

Competitive prices only tend toward average costs over an extended period under stable conditions. The processes that drive prices toward that level involve buyers taking less and sellers providing more when prices exceed costs. Competitive prices are not stable, may spike sharply, move cyclically over months and years, and exhibit long term trends over years and decades. In general, spiky prices occur in a time frame too short to augment supplies, or what economists call a market period. Cyclical trends occur over a period of months and years and depend on replacement costs. And secular trends are observed over years or decades.

Spiky prices serve an important purpose in short time they occur. They do not cause retailers to supply more within the short time frame they occur but do provide them with incentives to augment supplies as quickly as possible. They also cause potential buyers to think twice about how much they really need. Price spikes mitigate hoarding or unnecessary inventory accumulation. Buyers and sellers alike have incentives to stockpile less when prices are

high, which means more people are able to buy and use the goods in an emergency. Inventories are a very important if often neglected aspect of competitive markets. The behavior of buyers and sellers during hurricane Katrina provides a classic case of the competitive process, albeit impeded by the threat of prosecution under the anti-gouging statutes.

Immediately prior to the hurricane the precautionary and speculative demands for necessary commodities, especially water and gasoline, increased dramatically. Consumers built inventories to either escape or ride out the storm. Sales at grocery stores and gasoline outlets skyrocketed. Wholesale suppliers accustomed to provisioning at normal rates were called on to supply more, much more and with less ability to do so.

Fears mounted that vendors might run out of the necessary goods. Some suppliers raised their prices, in some cases a little and in others a lot. There were shortages all along supply chains at prevailing prices. As new and higher prices were announced did customers buy less? No, they bought more, fearing even higher prices later or that they would be unable to buy at all in the near future. Inventories in pantries and vehicle gasoline tanks rose. Some wholesalers and retailers may also have built inventories, fearing they would run out or could charge more in the future.

In such an environment prices might go very high indeed. Does it change behavior and the choices of sellers and buyers? Yes, no one can predict or even measure the effects precisely because markets function in real time. The end result depends on the severity of the situation and degree of uncertainty. It is certain that sellers will try to provide more and buyers will take less at higher prices. Buyers and sellers alike will accumulate fewer inventories if prices are allowed to reach market clearing levels than if they are held down by price controls. More will be available for immediate consumption, which is the correct response in an emergency and should not be impeded by public policy.

Markets adjust quickly to changed conditions when prices are allowed to perform their functions of rationing limited supplies and encouraging suppliers from nearby and remote places to step up efforts to provide more. When conditions become more normal prices recede to previous levels unless fundamental changes occur in costs or demand. With price controls all these adjustments are slower because suppliers and their customers are less willing to make the required adjustments. Suppliers are also less able to

adjust because they have less money to replace depleted supplies and repair damaged facilities. In extreme cases they may refuse to rebuild at all.

Price gouging is a pejorative term used to describe rational and often socially useful behavior of sellers in a competitive market. It should be neither encouraged nor discouraged. Sellers who want to hold prices at previous levels and run short of supplies may be praiseworthy. Sellers who want to raise their prices and run out more slowly help stabilize the market and are also performing a very useful function. Price spikes are an inherent part of competitive markets and necessary for speedy adjustments.

Criminalizing the behavior of suppliers who raise prices during an emergency like hurricanes Katrina and Rita is morally wrong. Condemning them is misguided because higher prices effectively inform buyers and sellers alike that conditions have changed. Shortages at prevailing prices are best eliminated by first making people aware they exist. Prices do this quickly and efficiently. Government officials cannot and should not be relied on to announce there are shortages nor dictate how individuals in a free society should respond to them.

Skeptics may argue that charging higher prices during an emergency is immoral because it may endanger public health and safety. The opposite is true. Any threat to life in a disaster is the shortage of the necessity itself, not its price. Hoarding scarce supplies and unwarranted inventory accumulation may threaten public health and safety but higher prices never will. In fact, the higher prices are the most effective way to allocate the scarce supplies to those who need them most.

Anti-gouging rules throttle the price mechanism and necessitate devising other mechanisms to allocate the necessities in short supply. No other rationing mechanism is as effective. Legislators need to devote more time to educating the public about the benefits of competitive markets and less to pandering. When the electorate is sufficiently informed they will demand the anti-gouging laws be rescinded. Legislators should at least amend the laws to remove criminal penalties. So-called *price gouging* is not comparable to looting, fraud and other anti-social behavior. Governors of states that have anti-gouging laws should be extremely reluctant to trigger them. But as long as they are on the books government officials will be obligated to enforce them. Anti-gouging laws to mitigate spiky prices have no place in a free society.

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