The Virtues of "Price Gouging"

David W. Meyer[1]

Price gouging is a term that is often used, but difficult to define. A cynic may define it as a price that is higher than a consumer wants to pay, but usually, price gouging refers to a rapid increase in prices after some type of demand or supply shock. Public outcries over the unfairness of these rapid price increases have led some states to pass laws against price gouging, and there has also been discussion of passing federal legislation banning price gouging for gasoline. The legal definitions in the laws or bills refer to "unconscionable prices" or prices that increase more than a certain amount unless justified by costs, possibly only after an official declaration of emergency. Regardless of the definition, for this type of law to be effective, it must work as a price cap. However, if there is a price cap, markets will no longer be able to allocate resources.

The Role of Prices in a Market Economy

One definition of economics is "the study of how societies use scarce resources to produce valuable commodities and distribute them among different people."[2] In a market economy, free markets determine these allocations using prices as signals of where scarce resources should be used. There are limited cases where markets may not allocate resources in a manner that society wishes, in which case properly designed regulations may improve how those resources are allocated.[3] However, price gouging laws that place limits on how much prices can increase in response to large, unanticipated changes in supply or demand, are unlikely to improve

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[1] The author is a staff economist at the Federal Trade Commission. The views expressed in this paper are those of the author and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner. In 2003-2004, he was a senior staff economist at the Council of Economic Advisers. This essay draws heavily from a text box in the 2004 *Economic Report of the President* on p. 155 titled "Market Responses to Unexpected Shortages."

[2] Samuelson, Paul A. and William D. Nordhaus, *Microeconomics* 14th Edition, p. 3 (1992).

[3] These include externalities and asymmetric information; *see* Michael R. Baye, *Managerial Economics and Business Strategy*, 5th Edition, Chapter 14 (2006).

resource allocation. These laws will remove the role that prices play in signaling how resources should be allocated.

Unexpected Changes in Supply or Demand

When there are large, unexpected increases in demand or decreases in supply for a good, a normal market response is for prices to increase by enough to restore balance between the quantity supplied and the quantity demanded. For example, there may be a large, unexpected increase in demand for flashlight batteries during the period leading up to a hurricane. Similarly, there may be a large decrease in the supply of gasoline due to the failure of a gasoline pipeline. In both examples, prices would be expected to increase. However, when such price increases occur in response to a natural disaster or a failure of supply infrastructure, consumers often accuse sellers of "price gouging."

A number of states have laws that make price gouging illegal, but even without such laws, some businesses might choose not to increase prices during an emergency for fear of a consumer backlash. If prices do not increase, however, consumers do not receive a signal to cut their consumption and suppliers do not have the proper incentives to increase supply adequately. Matters may be even worse if the fear of a shortage spurs panic buying, which in effect is a temporary large increase in demand.

Non-Price Rationing of Resources

By not allowing prices to restore the balance between the quantities supplied and demanded after the shock, non-price rationing must be implemented instead. While non-price rationing could include the use of ration coupons, in most cases that would be affected by price gouging legislation, the likely method of rationing will be queuing. For example, after a pipeline break reduced the supply of gasoline into the Phoenix, Arizona, area in August 2003, press

reports indicated that some stations ran out of gasoline, consumers waited in line for hours, and some drivers started following gasoline tanker trucks as they made their deliveries. Similar problems were reported on the East Coast in 2005 after Hurricanes Katrina and Rita knocked out the major pipelines supplying gasoline from the Gulf Coast.

Changes in demand can induce shortages a well. For example, in the days leading up to the arrival of Hurricane Isabel in the Mid-Atlantic states in September 2003, press reports indicated that many retailers sold out of flashlights and D-size batteries. The flashlights and batteries went to the first people to show up at the store, rather than to those who valued them the most. It also meant that people who were able to buy the goods might have bought more than they would have at the higher price, leaving fewer for others. Without price increases, there was no mechanism to allocate the available goods to their highest-valued uses. Had prices been allowed to rise higher, early customers may have decided not to buy new batteries for their fifth flashlight and later customers would not have been forced to sit in the dark.

Usually, when prices are not allowed to increase to a higher equilibrium where the quantity supplied equals the quantity demanded, the method of allocating resources is “first come, first served.” As a result, resources are allocated to those closest to the merchant or with the lowest opportunity cost of their time, rather than those who would value the resources the most. For example, if there is a large increase in demand for hotel rooms after a disaster, if a hotel does not increase its rate, it will quickly fill up. If a family of four arrives early and does not face higher prices, they may decide to get two rooms, but if prices were allowed to increase, only rent one. Without a market signal to conserve space, the family has no incentive to free up space for potential families who arrive later.

Potential Unintended Consequences

Price gouging legislation, like any price cap, reduces the ability of the market to send signals on how to reallocate resources. Without higher prices, potential suppliers do not have an extra incentive to increase supplies to an affected area, or to stockpile additional supplies in case they are needed. If, on average, a storm knocks out power once every three years, a merchant may stock more generators if the price is allowed to increase the next time the power goes out. These high prices during the blackout would cover his increased inventory costs in the years without a power outage, as well as the risk that the next storm does not occur for ten years. Furthermore, distant retailers (or entrepreneurs) may load up generators on trucks and deliver them to the area with the blackout. For example, a Florida man was charged with violating the Florida price gouging statute after renting a truck, driving to North Carolina to buy thirty-five generators, bringing them back to Florida and selling them for roughly twice what he paid for them.[4] The threat of large fines discourages this supply response that brings new supply into the market. Without the price increase, fewer items will be supplied, and the shortage will be worse during the next blackout. On the demand side, higher prices send a signal for consumers to use less. As mentioned above, if prices increase the people at the head of the line have an incentive not to buy the second, third or fourth unit, which allows a greater number of people to meet some of their resource needs.

The price cap also provides incentives for illegal markets to develop. Individuals may buy up batteries when the hurricane is approaching with the hope of reselling them at much higher prices once the stores run out. These individuals may also be violating the price gouging

[4] See "Miami Beach Man Sued in Generator Gouging," *North Country Gazette*, November 7, 2005, available at http://www.northcountrygazette.org/articles/110705GeneratorGouging.html. The full complaint is available at http://myfloridalegal.com/webfiles.nsf/WF/KGRG-6HTT5X/$file/Medina+Complaint.pdf. The man also did not have a business license, and failed to collect sales tax, but was charged under the price gouging laws.

laws, but they may be more difficult to identify, so that they would be more willing to take the risk of prosecution than a retailer.

Poorly defined price gouging laws have the potential to make matters even worse. The threat of large fines or criminal charges for charging prices that later may be determined to be high enough to be considered price gouging may induce firms to just close their doors until they know what prices that they will be able to charge. This is especially true if merchants do not know the maximum price that they can charge (what exactly is an "unconscionable price"?), or if the enforcement of the laws are inconsistent. For instance, one national gasoline retailer shut down its stations in Florida "because the firm could not afford to re-supply the stations without either selling gasoline at a loss or risking that it would violate the state's anti-gouging laws."[5] If this happens, the shortage becomes even worse as goods that are already in the area are no longer available for sale.

Conclusion

While allowing prices to increase substantially due to a natural disaster or a supply disruption may seem unfair, price regulation through "price gouging" laws makes matters worse because they reduce available quantities. Artificially low prices remove incentives for consumers to conserve and for suppliers to meet unfilled demand, potentially prolonging the shortage. Society must decide whether the perceived fairness resulting from regulations to hold down prices is more important than allowing the market to provide incentives for resolving the shortage as quickly as possible, while making sure that scarce resources are available for those who value them the most. There is a risk that price gouging legislation could lead to some locations running out of products such as gasoline after a natural disaster or supply disruption.

[5] See Federal Trade Commission, *Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Prices Increases*, p. 110, available at http://www.ftc.gov/ftc/oilgas/competn_reports.htm.

Furthermore, poorly written legislation may create so much confusion that firms may choose to close rather than risk fines, or even criminal sanctions as some draft legislation proposes, for selling items at too high a price.

Further Reading:

Council of Economic Advisers, "A White Paper on The Economic Consequences of Gasoline "Price Gouging" Legislation," June 20, 2007. Available at: http://www.whitehouse.gov/cea/Price_Gouging_WP_062007.html

Emmons, William and Christopher J. Neely, "Why Do Gasoline Prices React to Things That Have Not Happened?" *The Regional Economist*, July 2007. Available at: http://stlouisfed.org/publications/re/2007/c/pages/gas-prices.html