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Why Price Gouging Doesn't Exist

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One Sunday in 2005, soon after the double whammy of hurricanes Katrina and Rita, I took several trips to my local hardware store. En route, I noticed two gas stations gazing at each other across the road. On my first trip, one was charging $3.41 a gallon for regular, while the other was charging $3.29. There, in a nutshell, is proof that gas price "gouging" does not exist.

Price gouging is generally defined as a vendor using unusual market conditions to exploit demand and extort unreasonably higher payments from his customers. Yet, outside the black market, price gouging is unlikely to exist in practice.

My encounter with the gas stations illustrates a basic economic lesson on supply and demand in situations of scarcity. Price is not an arbitrary figure. It contains a vast amount of information from the viewpoints of both supplier and the customer. In normal circumstances, it represents a balance between the effort and risk undertaken by the supplier to provide the product and the preferences and needs of the potential consumer taken in aggregate. Each individual consumer will have different preferences and needs—one may balk at a price that another finds perfectly reasonable that yet another considers a bargain—but as a whole the price represents a signal about the balance of considerations among consumers in the market for the product.

When the product becomes scarce, however, the producer notifies the consumer through higher prices that he may not be able to supply as much of the product as his customers want. Customers can then respond to this new reality and, again taken in aggregate, the market will respond to the scarcity by reducing its demand to meet the expected supply.

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Prices = Information. Rather than "gouging," gas station owners are conveying valuable information when they raise prices. Normally, supply and demand dictate price, as when gas prices spike. However, when prices are fixed, as would be the case under an "anti-gouging" law, then demand will outstrip supply. Shortage is the inevitable result.

As experience with rent control shows, capping prices in times of scarcity has the perverse effect of reducing the quantity of the good or service supplied. In other words, capping gas prices would actually lead to less gas being sold, as suppliers reduce the amount they are willing to sell in order to avoid loss. Shortages are therefore exacerbated. By contrast, anyone who tries to "gouge" customers will find himself with unsold supply and will be forced to lower his prices to offload it.

The owner of the station charging $3.41 was presumably reacting to his own supply constraints. Yet because the other station took a lot of his business, those constraints eased. By the third time I drove past the station, he had reduced his price to $3.29 also.

Ah, but what of the hotel owner who has a captive market? Surely they are gouging people when they raise their rates for disaster evacuees? Again, the higher price actually helps people. The evacuee is generally willing to pay more for overnight accommodation than the casual traveler because the evacuee has fewer options. Therefore, a higher price actually deters those who do not really need the rooms in favor of those who do.

So, economics tells us that "gouging" simply doesn't exist in a rational market. Responsible higher prices actually ensure that as much of the good or service as possible is available for use. In an emergency, that is an important consideration.

Price Gouging: Is There Any Evidence of It? Again, the situation after hurricanes Katrina and Rita provides perhaps the best test case for whether price gouging actually occurs. The nation's energy infrastructure took a severe blow. If ever there was a situation ripe for exploitation by the unscrupulous, it was then. Congress asked the Federal Trade Commission (FTC) to investigate the market for evidence of gouging. The Commission's report, release in May 2006,[1] found

> No evidence to suggest that refiners manipulated prices through any means, including running their refineries below full productive capacity to restrict supply, altering their refinery output to produce less gasoline, or diverting gasoline from markets in the United States to less lucrative foreign markets. The evidence indicated that these firms produced as much gasoline as they economically could, using computer models to determine their most profitable slate of products.

The FTC found that the price increases seen after the hurricanes was exactly what would have been expected by the normal supply-demand model of a competitive market given a reduction in supply and typical responses from consumers.[2]

The report also warned legislators about the difficulty of drafting "price gouging" legislation. It notes that states which have price gouging legislation generally include vague, subjective terms like “unconscionable” in their statutes, which has led to difficulty in producing a consistent body of case law. Moreover, even the decision to prosecute under these laws is rarely taken. After the two hurricanes, the state of Florida received 5,260 complaints of price gouging and in the end took action against just two gas stations of the over 9,000 in the state. The report also included the following thoughts about Federal legislation:

> Consumers understandably are upset when they face dramatic price increases within very short periods of time, especially during a disaster. In a period of shortage, however B particularly with a product, like gasoline, that can be sold in many markets around the world B higher prices create incentives for suppliers to send more product into the market, while also creating incentives for consumers to use less of the product. Higher gasoline prices in the United States after Hurricanes Katrina and Rita resulted in the shipment of substantial additional supplies of gasoline to the United States from foreign locations.
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> If pricing signals are not present or are distorted by legislative or regulatory command, markets may not function efficiently and consumers may be worse off…
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> In addition, it can be very difficult to determine the extent to which price increases are greater than “necessary.” Our examination of the federal gasoline price gouging legislation that has been introduced and of state price gouging statutes and enforcement efforts indicates that the offense of price gouging is difficult to define. Moreover, throughout antitrust jurisprudence, one area into which the courts have refused to tread is the question of what constitutes a “reasonable price.” Ultimately, the lack of consensus on which conduct should be prohibited could yield a federal statute that would leave businesses with little guidance on how to comply and would run counter to consumers’ best interest.
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> For all of these reasons, the Commission cannot say that federal price gouging legislation would produce a net benefit for consumers.

If Congress were to consider anti-gouging legislation, notes the FTC, such legislation should conform to certain strict criteria:

- First, any price gouging statute should define the offense clearly.
- A price gouging bill also should account for increased costs, including anticipated costs, that businesses face in the marketplace.
- The statute also should provide for consideration of local, national, and international market conditions that may be a factor in the tight supply situation.
- Finally, any price gouging statute should attempt to account for the market-clearing price.

The report also notes that, "Holding prices too low for too long in the face of temporary supply problems risks distorting the price signal that ultimately will ameliorate the problem. If supply responses and the market-clearing price are not considered, wholesalers and retailers will run out of gasoline and consumers will be worse off."

Proposed Legislation. The Federal Price Gouging Prevemtion Act (H.R.1252), introduced by Rep. Bart Stupak (D.-Mich.), passed the House by a 284-141 vote on May 23. Here is how it stacks up against the FTC's recommendations—not well:

- FTC Recommendation: Avoid ambiguous standards. Stupak Bill: Defines gouging as "unconscionable" and "unfair." **Fail.**
- FTC Recommendation: Allow for increased costs to suppliers. Stupak Bill: Allows for increased costs, both actual and anticipated. **Pass.**
- FTC Recommendation: Avoid use of historic costs. Stupak Bill: Defines gouging by comparison with a 30-day period prior to the emergency. **Fail.**
- FTC Recommendation: Provide for consideration of local, national, and international market conditions. Stupak Bill: Allows for price rises "substantially attributable to local, regional, national, or international market conditions." **Pass.**
- FTC Recommendation: Account for the market-clearing price. Stupak Bill: Partly defines gouging as a price that "grossly exceeds the price at which the same or similar gasoline or other petroleum distillate was readily obtainable in the same area from other competing sellers during the same period." The bill attempts to account for the market-clearing price, but does so inadequately, as all suppliers might price too low from fear of triggering price-gouging legislation and therefore potentially run out of gasoline. **Fail.**

The Cost of Price-Gouging Legislation. In a recent study for the American Council for Capital Formation[3], David Montgomery of the consultancy CRA International found a total welfare loss of $1.9 billion for September-October 2005. These losses would have been concentrated most in the worst affected areas, such as Louisiana and Mississippi. He concludes, "In all, price controls would only have exacerbated the gasoline shortage during Katrina, which in turn would have disrupted the economy and added costs both immediately and in the long term." As the nation prepares for another hurricane season, lawmakers should refrain from making any such possible disruptions worse. Prices provide far more valuable information to individuals in emergency situations than can government mandates.

Notes

[1] *Federal Trade Commission Investigation of Gasoline Price Manipulation and Post-Katrina Gasoline Price Increases: A Commission Report to Congress* (Spring 2006), http://www.ftc.gov/opa/2006/05/katrinagasprices.shtm

[2] The FTC did find that there was some evidence of local gouging according to the definition of Section 632 of the Energy Policy Act 2005, but further examination showed that "other factors, such as regional or local market trends, appeared to explain the pricing of these firms in nearly all cases."

[3] David Montgomery, *Potential Effects of Proposed Price Gouging Legislation on the Cost and Severity of Supply Interruptions, Journal of Competition Law and Economics*, May 8 2007, http://www.accf.org/pdf/CRAI-Report.pdf