

On Price Gouging

BY DONALD J. BOUDREAUX



The immediate aftermath of a natural disaster inevitably brings much higher prices for staple goods, such as lumber, batteries, fuel, and bottled water. Just as inevitably, these higher prices are roundly decried as unjust and inexcusable.

Such price hikes are slapped with the derisive name “price gouging.” And even people who typically endorse markets often call for it to be outlawed.

A recent example comes from *Times of India* columnist Swaminathan Aiyar, who describes himself as a market liberal. In his January 9 column, Aiyar condemned the price hikes that followed the tsunamis, referring to them as an additional tragedy visited upon already-suffering victims.

This interpretation of the price hikes is as unfortunate as it is mistaken. Let’s review here some basic economics of “price gouging.”

Prices are not set arbitrarily. They are what they are for a variety of reasons. These reasons are summarized by the two words “supply” and “demand.” Prices reflect existing conditions of supply and demand. If the price of bottled water rises, it does so either because supplies have fallen or because people’s demand has risen. In the wake of natural disasters, both of these effects kick in strongly.

A natural disaster destroys inventories, vehicles, and infrastructure (including water-treatment plants and roads). Existing stocks of bottled water and of close substitutes, such as tap water, are reduced. Also reduced is the flow of supplies of water. Many of the roads and vehicles ordinarily used to carry bottled water to market are now destroyed. Less bottled water makes it to market in the devastated region. In short, supply falls significantly.

At the same time, demand for bottled water rises, principally because tap water is now less available and more dangerous. This fall in supply combined with rise in demand means that the value of each available

bottle of water rises. People are willing to pay more for each bottle.

The higher price per bottle reflects the underlying reality; it reflects the fact that bottled-water supply is lower and bottled-water demand is higher. In short, it reflects the fact that bottled water is now more valuable than it was before the disaster.

Therefore, the fact that is unfortunate is not the higher price; it’s the underlying reality reflected by the higher price. That a natural disaster destroyed supplies and supply lines is indeed unfortunate. But this is the reality. Because, as Thomas Sowell reminds us, reality is not optional, we ought to deal with it as best as we can.

Dealing Honestly with Reality

And how best to deal with this unfortunate reality? To begin, never pretend that reality is other than what it is. Face reality squarely, fully, and soberly. If this advice sounds trite, understand that government-imposed prohibitions on “price gouging” mask the underlying reality, shielding people from the truth of it.

If the market value of a bottle of water is \$25, preventing merchants from charging a price higher than \$5 shields consumers from the fact that potable water is now more precious than it was pre-disaster. The price cap also shields suppliers from this same truth.

The inevitable consequences of this hoax only add to the problems caused by the natural disaster. With the price artificially kept low—at its pre-disaster level—consumers will try to use this now-more-precious commodity today with no more care than they used it yesterday.

But they can only try, for they’ll not succeed in using bottled water with the same nonchalance as they did pre-disaster. Misled by the counterfeit low price,

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consumers initially will do nothing to use water more carefully. But as fast as you can say “tsunami,” other signals will alert them to water’s now-greater preciousness. Long queues to buy water will emerge, as will empty shelves, black markets, and reports of neighbors hoarding bottled water in their basements.

Not only will most people who want bottled water be unable to buy all they want at the counterfeit price, many will spend valuable time waiting in queues (often to no avail). Some will drive over obstructed roads to buy water in distant towns, while others will use their personal or political connections to obtain water. Time and resources that could be better spent cleaning up and launching the rebuilding effort are diverted to frequently futile efforts to obtain bottled water.

These consequences are avoidable misfortunes compounding the pain of the natural disaster. Note several regrettable facts.

Fact one: capping the price does not keep the cost of bottled water low. Time spent waiting, time and fuel spent driving to distant towns where supplies are greater, and the anxiety unleashed by the inability to obtain water are all costs. The fact that these costs are not revealed in the price of bottled water does not render them less significant or real.

Fact two: while a higher market price *both* prompts consumers *voluntarily* to economize more diligently on water’s use *and* increases the quantity of water supplied (by giving incentives to suppliers to bring more water to this market), the queues and empty shelves generated by the price cap *force* consumers to economize, but do nothing to inspire suppliers to bring more water to market.

Fact three: the economization forced on consumers by price caps is ugly and arbitrary. Those obliged to do without are the unlucky ones who couldn’t get into the queue early enough and who have no political or business connections. These unlucky consumers are also typically too poor to pay the high prices demanded on the black market. A fact always missed by proponents of price caps is that black-market prices are higher than the unregulated market prices would be. The reason is that unregulated market prices—being visible and legal—will stimulate a larger inflow of supplies than will black-market prices.

There’s no denying that people dislike the higher

prices. What is deniable is that the higher prices are the problem. They are not the problem; they reflect the problem. Because the problem itself is unfortunate, its undistorted reflection will reveal this misfortune. But only by revealing this misfortune as accurately as possible to everyone who can help to minimize its effects will reality be returned as quickly as possible to normal.

Shouldn’t Merchants Be More Charitable?

Still, why must merchants profit from other people’s misfortune? Surely sellers can and should choose to sell their inventories at pre-disaster prices? Such questions reveal a deep and persistent objection to post-disaster price hikes—namely, it’s simply unfair for merchants to profit from disasters.

Of course, merchants can voluntarily keep their prices below market levels. But to do so would be not only harmful but also unfair! If a grocer refuses to raise the price he charges for bottled water up to the market level, he will find his store besieged by consumers. Only consumers near the front of the line will be lucky enough to get the water; those closer to the rear will go home empty-handed. Is queuing a fair means of deciding who gets the water?

Also, by not raising the price, the grocer will mute the price signal sent to the global market that bottled water is especially needed in this locale. Muting this signal will reduce how much or the speed with which additional, much-needed supplies of bottled water are shipped from where they are valued less to the disaster area where they are desired more.

A better way for the merchant to extend a helping hand would be to charge market prices and, out of the profits he earns, to make cash contributions to cash-strapped victims of the disaster. Those contributions will enable victims to better express on the market their need for bottled water and other supplies—thus communicating to suppliers worldwide just how desperately they need things to help rebuild their lives—without diluting the incentives of all consumers to economize on the now-much-scarcer goods or the incentives of suppliers to turn their supplies to where they are now needed most urgently.

Thwarting market forces only worsens calamities and is therefore most unfair.

