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In Defense of Price Gouging

Joseph W. Trefzger

When the Los Angeles area was rocked by a major earthquake on January 17 of this year, the waves measured on the Richter scale were not the only shocks felt. As typically happens when natural disasters occur, resulting shocks to production and distribution networks reduced the readily available supplies of some essential goods and services. While vendors' reactions were not uniform, a commonly observed means of coping was the raising of prices to levels much higher than had prevailed prior to the quake.

The idea of charging high prices to better allocate scarce supplies of simple commodities is hardly a new one. History tells of those who accepted years of indentured servitude in exchange for the limited berths on ships bound for the New World, and of unequipped "Forty Niners" who paid dearly to obtain scarce mining tools from early California entrepreneurs. More recently, we recall the aftermath of a 1992 hurricane, when news broadcasters offered reports of beleaguered Floridians paying $5 per bag for a scarce commodity: ice.

A common thread of all these reports, both historical and recent, is that people who use the price mechanism to allocate scarce resources are viewed as *price gougers*, acting unconscionably, or even dishonestly, toward buyers. Yet in allowing prices to rise, our product markets do the best possible job of channeling scarce resources to their highest-valued uses. Because other means of distributing goods in times of shortage are bound to lead to outcomes that are unfair and inefficient, it seems that there is a need to defend price gouging.

How Prices Are Determined

To survive in the long run, a producer must charge a price that covers the costs of all factors of production. These costs include the payments made to suppliers of raw materials, utilities, real estate services, and debt financing; wages paid to workers; and a fair profit. Profit is the return to the financing provided by the owner of the enterprise. If profits are too low (with respect to what could be earned on other investments that carried similar risks), then the owner withdraws his money from the business. The owner may withdraw money voluntarily by selling some or all of the assets, or may withdraw it involuntarily through bankruptcy. An owner who withdraws money voluntarily redirects it to other activities, just as the workers would redirect their labor to other enterprises if their compensation were inadequate.

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UI Team Completes IDRC Study

Two University of Illinois researchers received a grant from the Industrial Development Research Council (IDRC) to study financial aspects of corporate headquarters development projects. The researchers are **Peter Colwell**, ORER Professor of Real Estate in the U of I Department of Finance and the University's Director of Real Estate Research; and **Edward Pierzak**, a Ph.D. student in Finance.

The pair created a method for using recently-developed computer software in analyzing uncertain investment situations. They based their study on a detailed survey of eight firms that had built new headquarters in recent years. They found that corporate headquarters typically are overbuilt and overly specialized facilities that prove to be poor financial investments. A primary recommendation was that firms should build headquarters to standards more like those of typical office buildings, in order to hold costs in line and to provide for easier resale. Colwell and Pierzak presented their results at a May IDRC conference in Dearborn, MI.

The U of I grant was the first awarded through the IDRC Internship Program. The Council established the Program to build a stronger link between industry and the academic community. IDRC is a nationwide association of professionals who deal with corporate real estate resources. The chair of the Internship Committee is **Ronald Pollina**, a University of Illinois graduate. Dr. Pollina is President of Pollina Corporate Real Estate in Chicago and publisher of the quarterly *Pollina Corporate Report.*

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Commentary

If profit is higher than is warranted by the risk of the activity, then other entrepreneurs are attracted to the industry in numbers such that competition causes excess profits to disappear; indeed, the expectation of excess returns becomes a self-defeating prophecy. Thus, a producer who charged more than his costs (including a reasonable profit) would go out of business as a result of losing market share to those with more competitive prices. On the other hand, a producer that charged less than the amount sufficient to cover costs would sell a large quantity of goods, but would go out of business as a result of losing money on each item sold.

How Shortages Are Handled Without Price Gouging

When a shortage of a specified simple commodity seems imminent (more complex commodities, such as housing services, are addressed in "A Fresh Look At Rent Control," page 4), a governmental body may decide to intervene in the market and prevent the price mechanism from filling its crucial allocative role. This intervention may be observed in the form of rationing. Rationing has not been imposed in the U.S. on a nationwide scale since World War II, although 1970s news reports indicated that federal gasoline rationing coupons were printed and ready for distribution, and some local areas did impose gasoline rationing systems based on even vs. odd license plate numbers.

Another governmental action might involve restricting the price that a seller can charge to a figure below the market-clearing level. The regulatory authority might attempt to deal with the resulting supply/demand imbalance by imposing rationing; government might, on the other hand, impose price controls but allow each consumer to buy whatever quantity he or she could find.

Who Wins, Who Loses?

Some serious problems accompany the imposition of regulatory controls. The most obvious problem is that if prices are held artificially low, then owners of productive facilities are induced to redirect their assets to other uses. Shortages are created when producers are not permitted to charge prices that cover their costs (including risk).

What may be less obvious is that prices do, in fact, rise despite official controls. Consider a case in which price controls are imposed on a simple good, but quantities are not rationed. One method by which consumers would cope is *queuing*, or standing in line (1980s commentators quipped that consumers in the controlled Communist economies of Eastern Europe had perfected queuing to an art form). Queuing imposes an added price in the form of lost time, and we must recognize that the ability to spend time waiting is not distributed with more fairness than is wealth. For example, the opportunity cost of time is very low for a well-to-do retiree, whereas time is very costly for a low-income worker who must miss work in order to wait in line to buy essential goods. If queuing serves as the allocative device, then the initial recipients of goods are likely to be not those who value the goods the most, but rather those who value their time the least.

Another possibility involves price controls accompanied by rationing. In this situation, each person could obtain, from legitimate suppliers, the restricted quantity of the simple commodity at the prescribed price without substantial waiting time. (Queuing could become necessary because the restricted price would reduce the quantity supplied, so that even those with rationing coupons would not be assured of receiving the restricted goods, but such an outcome is ignored in this example.) Under these circumstances, it is likely that a formal or informal black market would develop and that prices would rise to (or perhaps even above) the price that would prevail in an unrestricted market. Anyone who did not need the allotted quantity could buy at a low controlled price and sell at a profit (this activity could also occur in the case of queuing without price controls). The problem that ensues, from a fairness standpoint, is that a party pocketing a profit born only of government rationing has done nothing to earn it. An efficiency problem also arises, in that the party receiving the profit is not in a position to take action to alleviate the shortage.

Consider the situation in which $5 per bag is the price that clears the market for ice after a natural disaster causes severe power outages. If the government

would try to control the price (perhaps at the $1 per bag level that had been observed prior to the disaster) and ration the quantity that any purchaser could buy, then a black market could arise; those who truly needed the ice would pay $5 per bag to each person who valued the product at an amount less than $5. The head of a large household, or someone with a health condition that required chilled medicine, would pay $5 per bag to a young, healthy, unmarried individual with no need to preserve milk or medication. (Declaring such profiteering illegal would be pointless, in that the activity would be impossible to police.) Yet the recipient would have done nothing to deserve a $4 profit, and would be unable to produce more ice to alleviate the crisis.

On the other hand, if producers were able legitimately to charge a price that (temporarily) exceeded their costs, then local ice firms would run overtime shifts, ice houses in distant locations would begin delivering to the disaster area, and other types of businesses would divert freezer capacity to commercial ice production. The shortage would eventually disappear and, in order to sell inventory, the competing producers would have to charge prices no higher than would be adequate to cover all costs.

Key Money

A special case of the problems that result from government restrictions on markets involves rent control. Many cities across the country have imposed limits on rents that landlords can charge; public officials in these areas view lessors as wealthy price gougers who prey on poor tenants (though some may support rent control primarily to gain tenants' votes). It is interesting that renters in rent controlled areas within New York City include well-known names from industry and politics; some of these rich tenants rent from families of modest means who had bought buildings before rents were restricted.

Consider a rent control ordinance that permits any resident of a controlled unit, regardless of whether this individual is listed as a lessee on the lease, to continue to live in the unit at the controlled price for as long as he or she desires. Because of the inhospitable atmosphere that building owners face, no units have been constructed recently, and a severe shortage of apartments exists. Tenant A has, for several years, leased a unit for which the rent is controlled at a price far below what an unimpeded market would dictate, but now she is moving to another state. She allows an acquaintance, Tenant B, to move in temporarily as a roommate so that B can continue to occupy the unit at the controlled rent.

Tenant A realizes, though, that B would willingly pay a much higher price to obtain an apartment in the shortage-plagued market. Before receiving a key to the unit, B therefore must tender a sizable cash payment to A. This practice has come to be called paying *key money*; the amount paid is whatever the market will bear (A is likely to have accepted the highest bid from among several potential roommates). As occurred in the earlier ice example, the ultimate user pays the market price, but much of that price is directed to an individual who has done nothing to earn a profit and who can take no action to stem the shortage. (Note that landlords are reputed, in some areas with controlled rents, to illegally charge key money themselves; it is ironic that laws must be violated in order for payments to go to parties who deserve them. Note also that real estate service actually constitutes a complex commodity, and therefore the landlord could attempt to deal with price restrictions by such means as reducing services. This topic is discussed in detail in the following article.)

Closing Thoughts

An unrestricted market establishes prices for simple commodities in an equitable manner: goods move to whoever is willing to make necessary sacrifices in order to pay the highest price. It is true that some consumers have more money than do others, but the pricing mechanism allows each potential buyer, regardless of wealth, to choose the most preferred manner in which to spend the resources available. Is an old, low-income person with a medical need for ice better off when the cubes sell for $1 per bag, but sellers have no inventories; or when ice is actually available at $5 per bag? This unfortunate individual might face some daunting choices; keeping medicine cold might mean sacrificing food or other necessities. But he could make the choice that would maximize his well-being.

When we do not allow markets to respond to shortages with higher prices, we create serious problems. First, we prevent producers from covering their risk-adjusted costs, and thereby discourage those who could alleviate shortages from taking appropriate steps. Second, we create conditions that move resources not directly to those who value them most, but rather to those who happen to have time on their hands or who have little need for the restricted commodity. Goods may move only indirectly to those who value them most, with intermediary parties receiving undeserved windfalls.

Some who could not reach the stores quickly surely had greater needs than did those who carried goods away for free, yet the latecomers were not able to express their needs through the more equitable approach of bidding higher prices.

After the January earthquake, some Los Angeles store owners *lowered* prices on such essential products as blankets and batteries, and a few even gave goods away. No one would contend that such individuals were motivated by anything other than a sense of generosity and public spiritedness (albeit a misguided one). It is ironic that their well-meaning actions are likely to have moved vital resources into the hands of people who did not truly value them. Some who could not reach the stores quickly surely had greater needs for certain goods than did those who were able to carry them away for free, yet the latecomers were not able to express their needs through the more equitable approach of bidding higher prices. At least one Angeleno must have sat unprotected in the cold and dark of a January night, cursing those who would not be price gougers. ■