Here’s how so-called price gouging may save lives in a disaster

Ryan Bourne

August 30, 2017

Disasters seem just about the worst possible time to discuss economic concepts. Ask Forbes columnist Tim Worstall, whose column on “price gouging” in the aftermath of Hurricane Harvey has purportedly been removed from their site.

At times of human suffering, a host of people apparently consider it crude to discuss the best response, if that response incorporates the functioning of a market economy. Yet for those of us who worry about outcomes rather than platitudes, it is incumbent to denounce bad ideas, and seek to propose better ones. Natural disasters such as Hurricane Harvey reap enough destruction, emotional and physical, without compounding it with policies that make things worse.

CNBC reported yesterday that Texas Attorney General Ken Paxton has said 500 complaints about so-called “price gouging” have been made following the storm:

That includes reports of up to $99 for a case of water, hotels that are tripling or quadrupling their prices and fuel going for $4 to $10 a gallon.

Such price increases in emergency situations can lead to significant fines under current Texas law. The traditional justification is that raising prices in emergencies reflects greedy profiteering. Indeed, in reaction to natural disasters and terrorist attacks worldwide it is common for companies to be denounced for heartlessness (here’s something I wrote about criticism of Uber after the Manhattan bomb attack).

The real question we should be concerned with though is surely not moralizing, but whether “price gouging” laws improve outcomes and responses or worsen the situation?

Natural disasters such as hurricanes often lead to shortages of certain products, many of which might be considered essential. Fresh water might be the obvious example. If water supplies get cut off, the demand for bottled water will surge, and if there is uncertainty about how long until those supplies will be back online, some consumers may seek to stockpile. The knockout of transportation routes will likely restrict new supply too. At the moment the storm hits supply will therefore be relatively inelastic, meaning that increases in demand feed through almost exclusively into rising prices.

Opponents of price gouging seem to believe that these price increases reflect sellers using their market power to unfairly profit from the disaster. In most cases, however, prices are merely messengers letting us know the relative scarcity of the good.

Laws which, in effect, fix prices below market-clearing levels are therefore akin to hijacking the messenger and forcing him to tell a comforting lie. A maintained low price of water in effect tells users "everything is fine, buy as much as you like."

This can have perverse consequences. It encourages the over-purchase of water by certain consumers and therefore can lead to water ending up away from those who value it most. Similarly, holding the price down discourages other suppliers from seeking to supply their goods to market. This can be particularly important when, as likely with Houston, those transporting new supplies of water may have to make difficult and expensive journeys, including having to rent or utilize boats to get to certain locations. A rise in the market price would have changed the economic calculation, making it profitable to make such journeys in some cases.

The result of price gouging laws is therefore an exacerbation of the cause of the surge in the first place – a greater gap between the supply and customer demand arising because new suppliers are not incentivized to meet wants and need. Though well-intended, price gouging laws hurt more than they help.

Two economic objections tend to be held up against this operation of market forces.

The first relates to the allocation of the goods. If prices rise too much, then people worry that those on lower incomes will simply not be able to afford them. This is an argument made in an LA Times op-ed by Michael Hiltzik, who explains that in times of crisis, it is understandable that people consider a first-come-first-served approach to be fairer and more reflective of need than a "most-money-best-served advantage."

For sure there are those desperately in need, and civil society, charities and, in some cases, government, may have a role to play to ensure they are catered for. And civil society does respond – see how sports teams and celebrities have already founded support funds.

But in such extreme cases it is equally likely that those with few resources would not have the means or ability to access the water in the first place (think the vehicles or boats needed, for example). It is not entirely clear why the ability to queue or travel long distances is a more efficient form of rationing than the use of the price mechanism in reflecting real need.

More importantly though, the artificially low price might encourage hoarding (and the development of a black market anyway), whilst discouraging other suppliers from entering the market and ordinary truckers from attempting to make their usual deliveries.

A more sophisticated critique of those who oppose anti-price gouging laws comes from the economist Jeff Ely. He argues that when natural disasters have happened, supply by-and-large cannot respond, so policymakers should simply seek to maximize the "consumer surplus" and not worry about the "producer surplus." If the disaster has no effect on production decisions, then the benefits to consumers from keeping prices low can exceed the benefits associated with allocating the goods to those who value them most.

But the key assumption here is that supply is fixed. In fact, the mere existence of price gouging laws affects supplier expectations about how they should respond when they know a crisis will hit, making them less likely to prepare some of what Tyler Cowen calls "option ready supply." (As an example: if an Uber driver knew surge pricing was banned, they would not be as likely to head out to an area where they knew a concert was just about to finish). Walmart, for example, already operates an emergency operations center, which plans and coordinates responses to these disasters, as evidenced in New Orleans after Katrina – clearly supply is not fixed.

A high price is also likely again to change the decision of many small potential suppliers, who might otherwise have just hoarded the product. If I had 10 packages of water stored in a warehouse, a higher price may make more likely to venture to obtain and supply them.

Hurricanes and natural disasters are destructive and lead to no good outcomes overall. But that does not mean we should throw out the price mechanism, which has important benefits in crises in terms of allocating scarce resources to those who value them most, and encouraging others to bring their goods to market.

Ryan Bourne occupies the R. Evan Scharf Chair for the Public Understanding of Economics at Cato.