Elizabeth Warren forgets that demand affects prices too

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It seems as though failed economic policies are doomed to repeat themselves. Fresh off the back of a House proposal for a new federal anti-price gouging law targeting gas and energy, Senator Elizabeth Warren has introduced a more comprehensive bill to ban price gouging during emergencies. It is, to put it mildly, a mess.

The Price Gouging Prevention Act would make it generally unlawful "to sell or offer for sale a good or service at an unconscionably excessive price during an exceptional market shock." Exceptional market shocks are defined to include natural disasters, power outages, strikes, civil disorder, war, or public health emergencies. Extraordinary situations, in other words, must be met with ordinary product prices. That is a recipe for a whole host of shortages or misallocations of goods when demand for products surge, or when production and distribution get severely disrupted.

Warren's bill does not even acknowledge, in fact, that a spike in demand can be a legitimate cause of rising product prices during emergencies. It grants an affirmative defense to businesses accused of gouging only if they have revenues less than $100 million and can prove that price hikes arose due to them facing additional business costs.

But market prices can obviously rise because more consumers suddenly want certain goods and are willing to pay more to get them (think bottled water after a hurricane). Anti-price gouging laws like this can therefore prolong shortages by deterring price increases from reflecting the realities of the relative scarcity that the conditions of emergencies bring. This encourages overconsumption by consumers and provides businesses with less financial incentive to get the supply of the goods to where it is needed.

At the start of the pandemic, there was a surge in demand for hand sanitizer. Online prices went through the roof, as large retailers (concerned about their reputations) kept prices low and saw weeks of empty shelves. In states with anti-price gouging laws, consumers spent more time searching for products. Allowing prices to adequately reflect supply and demand in these situations encourages a faster adjustment. The price increasing raises the profitability of shifting facilities towards, or expanding production of, hand sanitizer, while encouraging those with large stocks to sell them. On the demand-side, the price rise deters small-scale consumers from hoarding the product to the detriment of hospitals or those who value sanitizer so much (perhaps because of health conditions) that they are willing to pay a very high price.

Warren's law would be even more punitive for large firms or those regarded as "critical trading partners." Businesses would automatically be presumed to have violated this law if they meet two conditions — charging "an excessive price" (determined by the FTC) compared with their or the product's average in the 120 days before the emergency, and having any one of:

- More than $1 billion in annual revenue
- The power to foreclose on others
- Differential prices between buyers

For these firms, the only ground for rebutting this charge is if they can prove in court, using a "preponderance of the evidence," that this price rise reflects cost increases that are outside their control. Firms that raised prices significantly to reflect rising wage costs in emergencies might find themselves in costly legal battles trying to prove they do not control workers' wages given competitive pressures in the sector.

The sheer scale of the fines will have big effects on company behavior. Firms deemed to hold unfair leverage that are found guilty of charging excessive prices during emergencies would pay 5 percent of the revenue of their parent company in fines. This exceeds the low profit margins seen in many hospitality and tourism industries. So, in effect, the risks this law presents would not only suppress prices following demand surges, but would encourage firms to abandon models that offer bulk discounts and other differential pricing strategies to avoid being ensnared in this regulatory net.

Intriguingly, Warren's proposed law demands that for quarter year periods covered during the emergency, a business must file information to the Securities and Exchange Commission (SEC) detailing the change in the average sale price of its products, its gross margins, the breakdown in increased revenue associated with price and volume changes, and the change in costs for the firm. The business would have to write a narrative explaining its gross margin changes and decisions made with respect to prices, as well as detail what would inform future pricing decisions. A "narrative" of saying "more consumers were willing to pay more for the market product, so we raised prices" would presumably not be accepted.

A Democratic cohort has blamed large firms with market power for the U.S.'s current inflation. This half-baked argument fails a logic test: unless these firms suddenly increased their market power, it is unclear why they would be able to charge much higher prices now. Some thinkers have therefore developed increasingly speculative theories, such as the idea that higher inflation allows opportunistic firms to figure out how to collude to raise prices on consumers without communicating directly. Yet, if anything, the enforced SEC filings outlined in this bill would make this sort of tacit collusion far, far easier. Firms are being asked to disclose a description of the conditions under which they would modify pricing. These are publicly available documents that their competitors can read too!

Not only then does this bill ignore how goods prices can rise in emergencies because of demand surges, but it risks facilitating exactly the oligopolistic collusive behavior that its proponents erroneously blame for inflation.

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