Politics, gasoline prices, and price controls

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MAY 16, 2022

When gasoline prices increase rapidly bad economic ideas soon follow. This week House Speaker Nancy Pelosi, D-CA, said that “Price gouging needs to be stopped,” referring to the practice of firms hiking prices significantly during crises.

A bill introduced in the House would grant the President the power to declare an “energy emergency,” during which large price increases in a defined geographic market would be unlawful. During this designated time period, wholesalers and retailers would be banned from charging **unconscionably** excessive” prices, where “the seller is exploiting the circumstances related to an energy emergency to increase prices **unreasonably**.” [our emphasis] These terms are highly subjective, granting lots of discretion to the Federal Trade Commission (FTC) over how to effectively cap prices. The legislation promises the FTC will “take into account” whether the offending price “grossly exceeds” the average price the seller charged in the preceding month, or the price charged by other sellers in the area. This sounds like a blank check for the FTC to use whichever benchmark it chooses.

Politicians react to gasoline prices because the quantity demanded is not very responsive to prices in the short run. Thus, when prices rise because of a demand surge or a shock to production or distribution, the immediate consequence is only a small secondary increase in the quantity supplied, a slight mitigation in the quantity demanded, and a large transfer of income from numerous consumers (also called voters) to far fewer producers. And because these producers are not farmers (culturally admired) but oil companies (culturally despised ever since Standard Oil) voters and politicians react.

The first reaction is to blame OPEC. Officials and the public largely blamed OPEC and the “oil embargo” for the 1970s “oil shock.” OPEC was originally blamed last fall when gasoline prices started to increase. Prices continued to increase, and elections are on the horizon, so blaming companies for “price gouging” is now the response of the day.

The good news is that the direct price controls of the past appear to be dead and buried. Even though the public and officials blame the 1970s gas lines and rationing on OPEC and the “embargo,” economists have concluded that our troubles were the result of price controls imposed by President Nixon on large oil companies leading to significant shortages.

Congress also appears to have learned that real price controls are a terrible idea. Tasking the FTC with investigating mischief in the price-setting process is instead the bipartisan preferred solution of late. After Hurricane Katrina reduced oil production in the Gulf of Mexico, the Republican-controlled House passed anti-price gouging legislation in October 2005. The bill gave the

Federal Trade Commission the power to define price gouging and empowered the agency to impose fines of $11,000 a day on companies found to be gouging the public. The bill got 57 votes in the Senate but failed to get the 60 required to overcome the filibuster. In 2006, despite the failure of the legislation, the FTC issued a report that found that the post-Katrina price increases were not the result of price manipulation.

The current Democratic proposal can be seen as the most recent instance of this, by now, standard political response. It may pass the House but will surely die in the Senate as in 2005. The FTC probably will issue a report, especially now that the commission has a Democratic majority in place. And the majority will be under pressure to blame the oil companies. We predict an interesting conflict between the staff and the commissioners about the content of the report. If it is not as economically sound as the 2006 report, that will signal a sad loss of intellectual integrity on the part of the staff, but the hopeful outcome is that the FTC will stop there and direct price controls remain off the agenda.

If passed, of course, anti-price gouging laws such as this would introduce new uncertainty for wholesalers and retailers. They would face the additional legal prospect of having to prove a demand surge was a mitigating factor for increasing prices and are only offered an affirmative defense if they can show that their price hike is the result of a cost explosion. On the margin, these additional threats would likely suppress price hikes somewhat, leading to some of the shortage effects and inefficiencies during emergencies we have previously discussed. Given the context of an already-tumultuous energy squeeze, though, this bill should be understood as an effort by politicians to “do something” on gas prices. History shows that “something” could be worse still.

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