Prices in a time of corona: the law and economics of price-gouging

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The COVID-19 pandemic has prompted widespread calls for stricter regulation of price gouging across the European Union. Whilst the calls come from a good place, they are ignorant of the economic costs that this will impose. The TFEU already provides sufficient restrictions on price gouging, and any further efforts to clamp down on the practice would harm consumers.

Where an economic shock occurs, prices will often rise. If regulators were to intervene to prevent rising prices, then in the short run this would lead to those who need vital supplies the most being unable to procure them, and in the long-run it will ensure that any shortages that do occur become much worse. Instead, the European Commission should use the tools they already have at their disposal, which provide an effective mechanism against the more egregious offences.

The powers of the Commission

The main instrument the European Commission has at its disposal to act against price gouging is through Article 102 TFEU. This provision prohibits "any abuse by one or more undertakings of a dominant position within the internal market". The treaty provides a non-exhaustive list of actions that could be prohibited. The most relevant of these prohibits "directly or indirectly imposing (an) unfair purchase price". The key case defining how this works is *United Brands v Commission* [1978] ECR 207. This laid out that a price is unfair where it "has no reasonable relation to the economic value of the product". This test is answered by reference to: firstly, a comparison of actual prices and actual costs; secondly, to a normative judgment on the fairness of the price. (O'Donoghue et al. 2006).

This test applies not just to firms we would traditionally view to be dominant, but also to companies that have temporary dominance as a result of a crisis. In *ABG/Oil companies operating in the Netherlands (Case IV/28.841)* [1977] the meaning of dominance was interpreted in a way that applies perfectly to the alleged price gouges we saw at the advent of the pandemic. Here, a number of firms increased their prices and reduced supply of crude oil in response to the Organisation of Arab Petroleum Exporting Countries decision to impose an oil embargo on countries they perceived to support Israel during the Yom Kippur War. The crisis incidentally gave these firms a temporary dominant position, due to the shortage of oil. (Giosa 2020) This mimics the current situation where restrictions on movement, as well as disrupted supply chains have resulted in previously competitive firms gaining a new dominant position. This concept can best be described as "transitory market power" (Ezrachi 2018). This means that in certain economic conditions "customers can become completely dependent on them (companies) for the supply of scarce products". The European Commission, therefore, already has significant powers to prevent companies taking advantage of a dominant position granted by the crisis to harm consumers.

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Unlike Article 101, which also relates to competition issues, Article 102 TFEU infringements do not carry any defences within the treaty itself (Competition Law Forum's Article 82 Review Group 2006). However, the Court of Justice of the European Union have applied the concepts of objective justification and proportionality when assessing potential infringements. This means that a dominant firm may price gouge where there is an objective justification and that any detrimental effect can be equalled by advantages to consumers; this can be seen in Case 311/84 *Centre Belge D'Etudes du Marche-Telemarketing (CBEM) v SLT SA* [1985] ECR 3261 and Case C-95/04 *P British Airways v Commission* [2007] ECR I-2331. Although this provision has never been used as a defence for a price gouging, this is due to Commission's focus on other competition issues, rather than it being an inappropriate device to use in these cases (Sauter 2016). Suppose a shop with transitory market power wishes to expand to meet the additional demand that the pandemic has spurred. To do this, there will naturally be additional costs. Therefore, they may have to rise prices beyond the point that their own costs have risen to afford the initial investment for the expansion. Clearly, this is exploiting the greater inelasticity of demand that their temporary dominance has provided them with. Yet, this would be in the best interest of the consumer, so it would be very unlikely that the Court of Justice would interpret the defences differently to other infringements of Article 102.

This represents a successful compromise between the opposite needs of preventing the exploitation of consumers, and ensuring that regulators do not intervene excessively in the price mechanism. A firm in a competitive market may raise prices if they wish. This distinction is an appropriate one, because where there is competition a consumer can switch to competitors. However, if a monopoly unreasonably renders a necessary good unattainable during a time of crisis, then this would create significant difficulties to many people.

The immediate consequences of further restrictions

Given the restraint competition authorities exhibit not to be seen as price regulators, it is important to ascertain whether this fear is a justified one, and whether the costs of becoming more involved in the price mechanism during a time of crisis is a justified one. The classic criticism of state involvement in the price mechanism is that made by Nobel Prize winning economist Friedrich Hayek. He argues that there are two tiers of knowledge: scientific knowledge and local knowledge (Hayek 1945). Whilst Governments have the ability to understand the former; the latter is much more dispersed, unorganised, and therefore unquantifiable. This has the impact that where regulators aim to regulate the price mechanism, they lack the level of knowledge necessary to foresee how individuals will respond to the regulation (Kirzner 1984). The problem of regulating price gouging appears to be the perfect practical example of Hayek's knowledge problem. States may be able to quantify scientific knowledge, but without local knowledge they are vulnerable to unintended consequences from their actions (Bowes et al. 2017). The following will show that well-intentioned price gouging laws actually exacerbate the crises that they aim to address, and therefore their implementation would be an inappropriate one.

Price changes during a crisis follow the same laws of supply and demand, as one would expect during normal situations (Young 1995). The simplest, and usually correct, argument for why prices rise in a given crisis is a shortage. This is a situation where "people would like to buy something but they simply cannot find it for sale at the going price" (Stiglitz 1997). Whether this is due to rising demand or a fall in supply, the consequences are identical. Higher prices can be consistent with a functioning market. In a competitive market, a firm's ability to increase prices is limited by competition with other sellers. If they raise prices excessively, then consumers will switch to their competitors leading to a fall in their profits (Sullivan et al. 2019).

Even in the very short run there are significant problems that occur by preventing price rises. This is because by reducing a firm's ability to increase prices you are increasing the ability for people who do not need the item as urgently to purchase it, thus increasing the propensity for a shortage. This can be shown using the example of a DIY shop. Suppose a DIY shop is charging higher prices for torches and shovels in the wake of a hurricane. If the shop cannot raise prices in the short run, then someone may buy the last torch to use for an unessential purpose. Had the price been higher, then they might not choose to buy the torch for that higher price (Kades 1999). Yet, due to price gouging laws this has led to a less necessary purchase of the good, thus reducing the allocative efficiency of the market. This suggests that the wariness of competition authorities have in enforcing gouging laws is valid, given the high likelihood of significant economic costs.

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In the context of the COVID-19 pandemic we saw significant shortages due to a spike in demand for products like hand sanitiser and toilet rolls (Dicken et al. 2020). There are only two ways to rectify this: supply more or allocate supplies in a way to gain the most utility from their use (Brewer 2007). Although the former is preferable, increasing supply in the short-run is often difficult, especially during a pandemic where your supply chains may be disrupted. Therefore, becoming more efficient at allocating supply is often necessary. We know that the price mechanism is the most efficient way to distribute goods (Friedman 2000), thus it follows that using the price mechanism is the best way to correct a pandemic-driven shortage where increasing supply is not immediately possible.

This is because non-price rationing suffers from two problems: speculation and black markets (Swofford 1999). The example of how Florida coped with the disruption from Hurricane Wilma amidst stringent price gouging regulations demonstrates this well. Firstly, queuing was attempted. However, this failed as people merely paid others to wait in queues for them; thus, showing the same regressivity associated with a market-based approach (Raghunathan 2005). Even without these transactions arising, if you account for the opportunity cost of time wasted queuing, then this acts as a mere conversion of the time one would have spent doing more productive tasks to time spent queuing, representing a deadweight loss (Deacon et al. 1989). Had these laws been adopted in the European Union prior to the pandemic, then it is likely that there would have been huge inefficiencies in consumer activity, whereby any cost savings that consumers are lucky enough to realise before the inevitable shortages will be nullified by the lost hours in more productive uses of their time.

Secondly, this creates a clear incentive for illegality. Where producers are incentivised to raise prices, by the presence of excess demand, then some will clearly break the law (Posner 1987). Gary Becker explained that crime is a rational choice between the difference in expected net benefit of legal and illegal activities (Becker 1968). Under this model the key difference between one's choice to commit or not commit crime is the potential legal earnings weighed against the potential criminal earnings (Machin et al. 2004). In this context, the anti-price gouging legislation will limit the potential legal earnings and increase the potential criminal earnings. This will result in a bias in allocation towards those susceptible to breaking the law and unnecessarily harm law abiding citizens by providing a competitive advantage to criminals. The alternatives to the price mechanism are, therefore, clearly unsuitable in the short term. At best, and assuming the Hayekian knowledge problem could be overcome, they will create the same results, at worst it will facilitate a rise in thriving black market activity.

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Longer term consequences of the imposition of price gouging laws

It is in the long term where the biggest issues with price gouging laws exist. This is due to the signalling function of the price mechanism. This is because where you prevent prices from rising you lessen the effect of the signalling function (Hayek 1945), resulting in a reduced ability for suppliers to increase their supply relative to the needs of the consumer. Even a supplier who does not pay attention to the news can see that where their products are being sold quicker, to the extent they are running out; they would, thus, respond to this by supplying more of them to maximise profits. Using evidence from Hurricane Katrina it is clear that making price increases a criminal offence will likely discourage firms from taking necessary steps to increase supply such as obtaining more costly capital goods (Montgomery et al. 2007). Under Article 102 TFEU this would be recognised as an "objective purpose" and thus a lawful one. If these requirements were strengthened, then it would act as a clear disincentive to fix a shortage problem. Thus, if the extent of the price rises is lessened by arbitrary price caps, then this will reduce their necessity to increase supply. This has the long run impact of actually extending the length of any shortages.

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In the context of COVID-19, we initially saw a huge shortage of personal protective equipment (PPE) (Feng et al. 2020). Although there was an initial shortage, the response from both government and private enterprise was rather quick in increasing the supply to meet the additional demand (Department of Health and Social Care 2020). Whilst no substantial empirical review has been done to calculate how much slower this would have occurred if strict price gouging laws were in place, the evidence from areas with strict price gouging legislation, such as during American hurricanes, suggests that the growth in supply would have been significantly less (Carden 2008). Therefore, in the long-run any shortages caused by the pandemic would only be worsened if these laws were introduced. The European Commission already have the power to clamp down on any monopolies using the pandemic as an excuse to raise prices to the detriment of consumers. If they attempted to further regulate this conduct, then they would reduce the ability of the market to respond to emergencies causing a significant net welfare loss.

Finally, the ethical basis for intervention is tenuous at best, even if one ignores the above economic analysis. A key principle of voluntary exchange is that "individuals are effectively free to enter or not to enter into a particular exchange" (Friedman 1962). This is because a deal will not happen unless both parties perceive that one has come away better than they were before the deal (Friedman et al. 1980). Although, this relationship may be deemed to be exploitative; it is wrong to see a consensual and externally beneficial relationship (as evinced by the economic argument above) as unjust (Barnes 2013). A non-worseness claim can be used to demonstrate this. This posits that an interaction between A and B cannot be worse than non-interaction; when: i) A has a right not to interact with B at all; and ii) the interaction is mutually advantageous, consensual, and free from negative externalities (Powell et al. 2012). This can be demonstrated by the use of Kades's torch example used earlier to demonstrate rationing (Kades 1999). Suppose a man needs to buy a torch for a practical purpose during an emergency. The supplier is under no duty to contract with this person. If the supplier were to increase the price, recognising the necessity of the situation, then he still would be providing a service he is not obliged to provide. If he were to raise the prices beyond the price the purchaser is willing to pay, then he will not be able to sell it. This interaction involves both parties providing something that is mutually beneficial to the other, consensually, and creates the significant positive externalities detailed above in the economics section.

The economics on price gouging is quite simple and is largely unchallenged by the academic consensus. The use of strict anti-price gouging rules will lead to an inequitable outcome whereby resources will not be allocated effectively in the short run, and in the long-run will only lead to the shortages that do occur lasting longer and being more severe. Indeed, this is very much the consensus between economists. A poll conducted by the Chicago Booth School in 2012 revealed that just 7% of economists supported anti-price gouging legislation, whilst 77% came out against (Chicago Booth, 2012). The current approach the EU take on this issue is broadly in line with the economic consensus. The most egregious offences where a dominant firm is manifestly using its position to exploit individuals are already prohibited, whilst a firm merely responding to price signals to ensure sufficient supplies of essential goods and services are encouraged to do so.

Conclusions

The above has attempted to explicate the current law on price gouging. I have shown that the protections under the TFEU are sufficient to prevent the most exploitative of abuses that could occur during a crisis. Although, the present pandemic has been unprecedented in this precise form, the effect of a disaster on prices is not. Whilst shovels may be gouged during a snowstorm, hand sanitiser will be gouged during a pandemic. The literature considered has revealed that in the short run these laws are distortionary and help to develop and worsen any shortages. And in the long run they reduce the ability for supply to increase, and so help to prolong the shortage. Therefore, to minimise consumer harm, and maximise the ability for shortages the price mechanism must be allowed to function without worsening the effects of the pandemic through stricter anti-price gouging laws.

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