PRICE GOUGING IN A TIME OF SEA CHANGE

BY TIMOTHY SNAIL & MARY BETH SAVIO[1]

1 Timothy Snail, Ph.D., and Mary Beth Savio, Ph.D., are vice presidents at Charles River Associates. The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, Competition Policy International, or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

The purpose of price gouging laws is to prevent excessive pricing and profiteering in a state of emergency. But price gouging laws in the United States, exemplified by those enacted by state governments, were generally designed in anticipation of particular types of emergencies or natural disasters and as a result may embody approaches that strain to address the economic effects of novel emergencies such as the COVID-19 global pandemic. This article discusses challenges that arise in applying existing price gouging laws in the wake of widespread economic shocks with long-lasting dimensions and explains how economic analysis and modeling may help sort out these issues.

I. THE ROLE OF PRICE GOUGING LAWS IN AN EMERGENCY

Price gouging laws have been enacted by most states, and actions may also be brought under states' unfair and deceptive practices laws or under powers granted by executive orders.[2] California's Penal Code Section 396 illustrates the nature and objectives of many state price gouging laws. It was enacted following the 1994 Northridge earthquake. The earthquake buckled freeways, collapsed apartment buildings, set gas mains ablaze, and resulted in a power outage affecting large swaths of the city. Sixty people died and more than 9,000 people were injured. In the days following the quake, reports emerged of price spikes in essential goods like eggs, batteries, and plywood. Penal Code Section 396 was enacted soon thereafter to prevent sellers from profiting from consumers' sudden, short-term desperation.

California's restrictions are triggered by a declaration of a state of emergency by the President of the United States, Governor of California, or a local governmental entity, and the state of emergency remains in force for 30 days unless extended. During this period, price increases for essential goods and services are capped at 10 percent above the seller's price immediately before the state of emergency was declared. California allows the post-emergency price to reflect cost increases incurred by the seller, including the seller's customary markup on cost. Furthermore, California Senate Bill 1196 proposes to amend the law to allow new entrants to apply a 50 percent markup to costs they incur in providing essential goods during the state of emergency. In states like California where limits on price increases include an allowance for post-emergency increases in cost, the net effect of the law is to cap the increase in a seller's profit margin.[3]

2 Actions have also been brought under Section 102 of the Defense Production Act, which focuses mainly on hoarding and excessive pricing.

3 For reconstruction or emergency cleanup services, the law remains active for 180 days. https://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?lawCode=PEN&sectionNum=396; https://leginfo.legislature.ca.gov/faces/billTextClient.xhtml?bill_id=201920200SB1196. https://www.gov.ca.gov/wp-content/uploads/2020/04/4.3.20-EO-N-44-20-text.pdf.

California's legislation attempts to strike a balance between the interests of sellers and consumers in the immediate aftermath of a disaster. The law provides sellers some inducement to offer goods during the state of emergency, while simultaneously limiting the increase in prices, thus creating a kind of temporary, muted marketplace in which the plight of consumers and the incentives of sellers are each accounted for to some degree.

What the law does not allow is for a seller to profit from the full increase in consumer demand or the full decrease in consumer price sensitivity that may stem from distress in a state of emergency. All else equal, when demand increases or consumer price sensitivity is reduced, sellers can increase price somewhat without losing so much demand as to make the price increase unprofitable; but price gouging laws limit sellers' ability to do this. Economists have noted the implicit trade-offs that result: the incentives for pre-emergency preparation, post-emergency expansion, and entry are reduced, and queuing or rationing replace allocation based on consumers' willingness to pay for a good. The contours of state price gouging laws imply that lawmakers view these trade-offs as acceptable in the short run. However, queuing and rationing do not ameliorate the underlying problem of excess short-run demand; instead, allowing prices to adjust to market conditions would provide incentives for entry and expansion to meet the demand, which would ultimately drive prices back down again.

Given that price gouging laws are designed to prevent profiteering from short-run surges in demand, how do these laws perform when market shocks recur or have long-lasting reverberations? This question naturally arises in the context of the current COVID-19 pandemic, which has had a material impact on supply and demand for numerous products and services. The emergence of pandemic hot spots and the potential for additional waves of infection make it likely that markets will be characterized by ongoing shifts in supply and demand as the pandemic ebbs and flows. What are the implications for states that have extended the emergency period covered by their price gouging laws — such as California, where price gouging restrictions are currently slated to be in effect from February 4, 2020 to March 4, 2021 — and for states that may reactivate their price gouging laws with the onset of new waves of infection? Do the objectives of state price gouging laws fit these economic circumstances? What kinds of challenges arise in determining whether or to what degree the laws have been violated?

II. THE ROLE OF PRICE GOUGING LAWS IN A SERIES OF EMERGENCIES

During the pandemic, consumers have lodged complaints of potential price gouging for goods and services amid increasing prices and rapidly changing market conditions, such as shifts in demand. What are the implications of price gouging laws in these circumstances? To fix ideas, consider the sale of meat in grocery stores. Meat processing and delivery are mainly performed on a just-in-time basis, with meat processing facilities commonly operating at large scale with high capacity utilization. The emergence of the pandemic created unexpected supply reductions due to illness-winnowed workforces in meatpacking plants[4] and increased costs.[5] Simultaneously, consumer demand for meat shifted from restaurants to grocery stores due to restaurant closures, prohibitions on on-site dining, and consumer concerns about exposure to illness.[6] The shift in dining at restaurants to home also changed the demand for specific cuts of meat since meat bound for restaurants generally involves larger cuts for which buyers need space to store and the ability to butcher. Consumer surveys suggest this shift in demand may endure while consumers avoid public places like restaurants.[7] Consumers may also decide to reduce household spending for a time, including eating out, due to job losses and future economic uncertainty. While the surge in demand for meat at grocery stores may wane as consumer concerns dissipate, the emergence of new infection hotspots could lead to new rounds of restaurant closures and safety concerns as well as associated imbalances of supply and demand at grocery stores.[8]

The reduction in supply and increase in demand for meat at grocery stores resulted in higher prices.[9] A number of grocery store chains — including Giant Eagle, Kroger, Costco, Sam's Club, Wegmans, Tops, Hy-Vee, and H-E-B — also instituted rationing, placing limits on the num-

4 https://www.nytimes.com/2020/04/13/business/coronavirus-food-supply.html?searchResultPosition=3.

5 Meat processing facilities experienced pandemic-related increases in costs, for example, due to increased sanitation and safety measures, worker recruitment costs and bonuses, staggered shifts, and keeping facilities open for Saturday shifts.

6 https://www.wsj.com/articles/two-months-that-tore-apart-the-food-chain-11588174236.

7 https://www.forbes.com/sites/daphneewingchow/2020/03/31/five-ways-that-coronavirus-will-change-the-way-we-eat/#10145e7b1a2b.

8 https://www.cnn.com/2020/07/16/business/farmers-restaurants-closures/index.html; https://www.cnn.com/2020/07/17/perspectives/coronavirus-meat-shortages-mcdonalds/index.html.

9 https://abcnews.go.com/Health/wireStory/us-food-prices-historic-jump-stay-high-70969164.

ber of packages of meat that consumers may purchase at the register, when demand exceeded supply for specific types of meat.[10] The use of rationing suggests that these stores' price increases did not fully reflect changes in supply and demand, because if they did, the available supply of meat could be sold without rationing to consumers who were willing to pay more than the current price.

The reluctance of grocery stores to increase prices to market-clearing levels might represent an investment in consumer goodwill aimed at ensuring repeat business. But it is likely that compliance with price gouging laws also plays a role, especially considering the cautionary tales provided by grocery stores and chains that have been accused of price gouging in recent months.[11]

If the increased demand for meat in grocery stores persists or recurs with resurgences of infection, a question arises as to the objectives achieved by the extension or reactivation of states of emergency that trigger price gouging laws. For example, a longer-term shift in demand creates a greater opportunity for expansion by existing suppliers or entry by new or alternative suppliers, which (through increased supply) would lead to lower prices, all else equal. Examples of such suppliers could include smaller meat processing companies (although without the advantages of economies of scale) or makers of plant-based products that consumers view as meat alternatives.[12] The incentive for new and alternative suppliers to enter the marketplace increases with price, but price gouging laws place limits on price increases. This highlights one of the trade-offs inherent in price gouging laws — by artificially limiting price increases, price gouging laws constrain the ability of market forces to incentivize and match willing buyers and potential sellers. While lawmakers may have determined this trade-off to be appropriate in the short run, the current pandemic raises the question as to whether this trade-off is optimal in the longer run.

III. APPLYING PRICE GOUGING LAWS IN A SERIES OF EMERGENCIES

The economic upheaval created by the current pandemic also raises several questions about the practical application of price gouging laws. As noted above, price gouging laws are generally triggered by the declaration of a state of emergency of limited duration (e.g. a month or two), although some declarations may be renewed or extended. These provisions are not surprising as many price gouging laws were enacted with a specific type of emergency or natural disaster in mind, such as a hurricane or wildfire, which are relatively discrete events. These provisions also seem to envision that the shocks to supply and demand accompanying the emergency will be relatively short-lived. In contrast, the COVID-19 pandemic has been an evolving crisis accompanied by a series of shocks to the economy that have not yet subsided, receding and (re)emerging in different geographic locations within the United States and around the world. It remains to be seen whether actions taken under various price gouging laws will treat the COVID-19 pandemic as a single emergency or a series of emergencies, and how evolving conditions will be evaluated.

Why does the discrete nature of price gouging triggers matter? One reason is that it may have a substantial effect on how one estimates the price increase due to price gouging. Price gouging laws that codify excessive price increases usually prohibit those of at least a specific percentage above the prices in a pre-emergency benchmark period (e.g. 30 days, 60 days, or immediately prior to the emergency), a period that is meant to reflect sales without price gouging. Most price gouging laws allow defenses for increased costs during the emergency, which may also involve a comparison to the benchmark period. The date on which the triggering emergency is declared generally marks the end of the benchmark period. Since prices may be sensitive to the specific benchmark period chosen, the position and duration of the benchmark period is likely to affect the determination of whether and the extent to which prices were elevated during the emergency. Other considerations involving benchmark periods may arise. If there are two contiguous declared states of emergency, could the latter one's benchmark period fall within the first one's emergency period? If there is a gap between emergency declarations that could potentially serve as a benchmark period, will sufficient time have elapsed for the market to come into equilibrium? And to the extent that a state of emergency lasts for many months or even over a year, how comparable are the market conditions that existed before the emergency to those during the emergency?

Further, what if the post-emergency events that affect businesses do not line up with the time period covered by the declared state of emergency? The COVID-19 pandemic has disrupted supply chains in complex ways over time due to its effects on business operations and how

10 https://www.supermarketnews.com/meat/grocery-chains-limit-meat-purchases-prevent-hoarding; https://www.seattletimes.com/business/meat-prices-are-going-up-and-grocers-are-putting-limits-on-your-purchases/.

11 https://www.nytimes.com/2020/05/06/us/coronavirus-eggs-price-gouging-lawsuit.html; https://www.sfchronicle.com/crime/article/Coronavirus-Price-gouging-charges-filed-against-15254753.php.

12 https://www.npr.org/2020/04/30/848179283/small-meatpacking-plants-thrive-as-covid-19-forced-bigger-ones-to-close; https://www.seattletimes.com/business/meat-prices-are-going-up-and-grocers-are-putting-limits-on-your-purchases/; https://www.foodnavigator-usa.com/Article/2020/03/04/Impossible-Foods-slashes-prices-Our-goal-is-to-reach-price-parity-and-then-undercut-the-price-of-conventional-ground-beef.

governments have responded. For example, the pandemic has periodically knocked out key manufacturing operations, disrupted normal sources of supply and the transportation of goods, and reduced the pool of available labor and its productivity. Some of these effects may have been evident when the emergency was declared, while others were realized only later. Further, at various times following declarations of emergencies many state governments have issued stay-at-home or shelter-in-place orders and ordered closures of non-essential businesses — some of which have been phased in or lifted and reinstated.[13] These attempts to flatten the curve of infection and achieve longer-term gains to the health of the population and its workforces have generated vigorous public discourse in part because some actions have reduced short-run economic activity and increased the costs of doing business (e.g. through capacity restrictions). Governments have also augmented unemployment benefits, provided stimulus payments to those who satisfy income limits, and offered grants or loans to aid qualified businesses at various times during the pandemic. The wide range of short-lived and longer-lasting economic shocks affecting businesses, which vary over time and geography, may complicate the application of price gouging laws during the COVID-19 global pandemic. Thus, the application of price gouging laws in the wake of a series of emergencies requires a careful assessment of economic circumstances so as to determine appropriate benchmark periods.

Once appropriate benchmark periods are determined, the parties to a price gouging dispute are faced with two fundamental economic questions: what is an excessive price, and what costs or changes in market conditions are viewed as mitigating factors for price or markup increases? These considerations can generally be addressed through econometric modeling.

Most price gouging laws expressly specify that excessive pricing is to be ascertained through a comparison over time, and even laws with ambiguous definitions of excessive pricing (e.g. "unconscionable") may invite a similar temporal comparison. These questions can be addressed with econometric tools familiar to antitrust practitioners as they resemble models commonly used in evaluating alleged cartel overcharges. For example, the extent of price elevation can be determined using a regression analysis that compares pricing during the emergency to that in the benchmark period, in its simplest form by using a dummy variable for the time period. This is what is commonly called a "before/during/after" or "benchmark" model. Mitigating factors — such as changes in costs and market conditions — can be accounted for by adding control variables or by separately estimating factors that drive costs. If the analysis finds the seller's prices during the emergency to be similar to those during the benchmark period after controlling for appropriate costs and market factors, it is unlikely that the seller was engaging in price gouging. However, unlike antitrust matters, some price gouging laws may limit the extent to which changes in exogenous market factors can be used as a defense to the contested conduct.[14]

Businesses may experience increased costs due to the pandemic in many forms, such as increased costs of production (e.g. "hero" pay for essential workers, increased sanitation, more costly purchased inputs); increased search costs for new suppliers of goods in short supply; the purchase of new equipment or packaging as a result of the emergency; decreased capacity due to supply chain interruptions leading to higher unit costs (e.g. workforce absences among truck drivers, maritime port congestion, limited air cargo space due to reduced passenger flights); and higher costs for new entrants who had not previously produced the products at issue — a few states' price-gouging statutes even incentivize entry through graduated price increase thresholds for incumbents and new entrants.

Some price gouging laws allow comparisons to benchmarks for similar products or other geographic areas. These so-called "yardstick" models compare, for example, prices of the seller and product at issue to those of its peers (i.e. its rivals). If the analysis finds the seller's prices to be similar to those of its peers, it is unlikely that the seller was engaging in price gouging. "Difference-in-differences" econometric models are among those that may be used if the price gouging law allows comparisons that involve not only prices that vary across time, but cross-sectional variation across similar products, different sellers, and various sets of customers who could obtain the products in the relevant trade area. These models control not only for observable changes, but for unobservable changes that impacted both comparison groups in the same manner.

13 See Kaiser Family Foundation, State Data and Policy Actions to Address Coronavirus, https://www.kff.org/coronavirus-covid-19/issue-brief/state-data-and-policy-actions-to-address-coronavirus/.

14 While most state price gouging laws allow costs as a defense to price increases, a few expressly mention changes in market conditions (e.g. seasonality) as a defense.

IV. CONCLUSION

A situation like the current pandemic — characterized by widespread and recurring shifts in demand and supply — poses challenges that might not have been fully foreseen when state price gouging laws were established. The nature of the trade-offs inherent in price gouging laws change when a state of emergency endures or recurs, suggesting that the value of imposing these laws should be reassessed as a state of emergency wears on. Furthermore, the practical application of price gouging laws in a time characterized by ongoing economic upheaval requires a careful assessment of a wide scope of economic factors to determine appropriate benchmark periods, prices, and costs.

CPI Subscriptions

CPI reaches more than 35,000 readers in over 150 countries every day. Our online library houses over 23,000 papers, articles and interviews.

Visit competitionpolicyinternational.com today to see our available plans and join CPI's global community of antitrust experts.