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EMERGENCIES, BODY PARTS AND PRICE GOUGING

J. Shahar Dillbary

Forthcoming in Law, Politics and Society,
Cambridge University Press, 2009

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Emergencies, Body Parts and Price Gouging

J. Shahar Dillbary*

(Forthcoming in Law, Politics and Society,
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Abstract

The study of emergency has received much attention from political theorists. Relying on the realms of philosophy, theology and morality, these scholars have focused on whether acts of the sovereign in times of emergency should lie "inside" the law (i.e., be subject to scrutiny) or "outside" the law (i.e., enjoy some form of immunity). This article, on the other hand, utilizes economic theory to analyze emergencies. It argues that some emergencies are subject to the same laws of demand and supply and often do not mandate any intervention; while others may deserve a unique treatment (often within the law) that can be premised on simple rational behavior models. Specifically, this paper discusses two types of emergencies: private and public. The discussion of private emergencies focuses on decisions in which courts were asked to compel one to undergo a medical procedure to give an organ that would save the life of another. The article employs economic theory to reconcile the seemingly contradictory decisions. The article also investigates strategic behaviors, remedial reactions and under what conditions, if any, courts (or regulators) should intervene in organ transactions. The discussion of public emergencies focuses on price gouging. It reviews a number of anti-price gouging laws, the conditions that trigger them as well as the justifications for and against these laws. Using a number of examples, the article demonstrates how the so called "exorbitant prices" help decrease shortages, enable inflow and storage of essential commodities, allocate scarce resources, reduce strategic behavior and queues and stabilize demand. It argues that the assumption underlying anti-price gouging laws—that markets fail in times of emergency—is often erroneous.

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I. INTRODUCTION

The study of emergency has received much attention from political theorists such as Carl Schmitt, Michel Foucault and Giorgio Agambden. Relying on the realms of philosophy, theology and morality, these scholars and their contemporary counterparts have focused on whether acts of the sovereign in times of emergency lie "inside" the law (i.e., whether they are subject to scrutiny) or "outside" the law.[1] Many of those who place states' actions in emergencies outside the law, like Schmitt, analogize the power of the sovereign to the miracle in theology. "Just as an omnipotent God performs miracles by suspending the laws of nature," the argument goes, "the political sovereign suspends positive law."[2] Some analogize "legal exceptions" in times of emergency to another religious concept: The Christian Pastorate. Foucault, for example, compares the sovereign's function to a relation between "the pastor [and] his flock."[3] Others support a middle ground. They propose the adoption of a separate body of law that would deal with emergencies.[4] Under the latter's proposal, once a declaration of emergency has been issued, this unique body of law would provide the executive with special authorities that would trump "normal law." Proponents of this approach place emergencies "outside" of normal law but still inside the legal framework.

This article, however, takes a different approach. Rather than resorting to theology or philosophy, it relies on the study of economics to analyze two types of emergencies. I refer to the first type of emergency as "public emergencies." Public emergencies require the sovereign to modify or suspend the entire existing order.[5] Natural disasters such as hurricanes and earthquakes as well as man made accidents or acts of terror are but a

[1] Leonard Feldman, *The Banality of Emergency*, published in this issue at p. _ Law, Politics and Society (Cambridge University Press, 2009)(Feldman).

[2] *Supra* note 1 at p. _ (discussing the Schmittian approach). *See also* Clement Fatovic, *The Political Theology of Prerogative: The Jurisprudential Miracle in Liberal Constitutional Thought*, PERSPECTIVES ON POLITICS 6, 3 (September, 2008), p. 488 ("If prerogative is analogous to the miracle, then the executive who invokes prerogative is analogous to God, if only for a moment."). The theistic discourse can be traced back to Carl Schmitt's famous argument that "all significant concepts of the modern theory of the state are secularized theological concepts". Carl Schmitt, *Political Theology*, Translated by George Schwab (Chicago: University of Chicago Press, 1985), p. 38.

[3] Michel Foucault, *Security, Territory, Population: Lectures at the College De France 1977-1978* (New York, Palgrave Macmillan, 2007), p. 192, 233. Professor Feldman describes this power as "natural" but one which is limited to "community caretaking." *Supra* note 1, *a*t 20.

[4] *See, e.g.,* Bruce Ackerman, *Before the Next Attack*, (New Haven: Yale University Press, 2006), p. 47-9.

[5] This definition follows Carl Schmitt's definition of an emergency: "what characterizes an exception is principally unlimited authority, which means the suspension of the entire existing order." (Carl Schmitt, *Political Theology*, translated by George Schwab (Chicago: University of Chicago Press, 1985), p. 12).

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few examples. "Private" emergencies, on the other hand, do not impact the entire population. They are more limited or, as the name suggests, "private" in nature. Examples include a sailor mooring her boat to another's dock due to extreme weather,[6] or a patient in need of an organ transplant.[7] These are clearly life threatening situations. The sailor would surely die if denied access to the dock, and so would the patient absent the organ transplant. Albeit private, the state is often involved in such emergencies. A state may have the right to directly deprive (or "take") someone's property, limb or life under its police authority; or it can authorize one individual to "take" from another. In the examples above, the state (via its courts or legislation) must decide whether the dock owner can exercise its property right to stop the sailor from mooring her boat and under what conditions, if any, one can coerce another to "give" her limb.

A preliminary question that comes immediately to mind is whether economic analysis should answer these questions at all; or whether matters of life and death should be analyzed through the prism of theology, philosophy or morality only. What if economic analysis and deontological considerations lead to different directions? After all, economic analysis of the law has been often accused of being revolting in a moral sense. Members of the law and economics movement, to give a few examples, refer to accidents as "sunk cost." They seek to design laws that would result in an "efficient level of accidents," not ones that are designed to compensate the victim (or avoid accidents altogether). For them, babies, body parts and sex are commodities and services; and criminals, even rapists, are actors in markets.[8] The argument made here, however, is quite modest and does not require a determination as to which rationales should govern in case of a conflict. It is simply that economic rationales should be considered in analyzing emergencies. Specifically, this article argues that emergencies are often subject to the same laws of supply and demand and do not mandate any special legal treatment. Intervention in these situations can reduce total (societal) welfare and harm the very victims of these emergencies.

The remainder of the article is organized as follows. Part II focuses on private emergencies. It investigates two different decisions in which courts were asked to compel one to undergo a medical procedure to give an organ that would save the life of another. The first, refusing to issue an

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[6] *See*, *e.g.*,, Ploof v. Putnam, 81 Vt. 471 (Vt. 1908).

[7] Compare Strunk v. Strunk, 445 S.W.2d 145 (Ky. 1969), McFall v. Shimp, 1978 Pa. Dist. & Cnty. Dec. LEXIS 70 (Pa. C.P. 1978).

[8] *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 216 (7th Ed. 2007), Elisabeth M. Landes & Richard A. Posner, *The Economics of the Baby Shortage*, 7 J.LEGAL STUD. 323 (1978); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857 (1983); Richard A. Epstein, *The Human and Economic Dimensions of Altruism: The Case of Organ Transplantation*, John M. Olin Law & Economics Working Paper No. 385 (2nd Series); J. Shahar Dilbary, *Famous Trademarks and The Rational Basis To Protect Irrational Beliefs*, 14 GEO. MASON L. REV. 605 (2007).

injunction, premised its decision on society's "respect to the individual." The other reached the opposite conclusion based on the state's "inherent authority" as the "father of the people." This article argues that these seemingly contradictory decisions can be easily reconciled using economic theory. The article also investigates strategic behaviors, remedial reactions and under what conditions, if any, courts (or regulators) should intervene in organ transactions. Part III focuses on price gouging that often follows public emergencies. It reviews a number of anti-price gouging laws, their structure and the conditions that trigger them as well as the justifications for and against these laws. After discussing the economic role of pricing, it demonstrates, using a number of examples, how the so called "exorbitant prices" help decrease shortages, enable inflow of essential commodities, allocate scarce resources, reduce strategic behavior and queues and stabilize demand. It argues that the assumption underlying anti-price gouging laws—that markets fail in times of emergency—is erroneous; and it concludes that anti-price gouging laws reduce total welfare, interfere with evacuation and reconstruction efforts and therefore should be repealed. Part IV provides concluding remarks.

II. PRIVATE EMERGENCIES

The analysis of private emergencies begins with a short contour of a well known private mechanism: contracts. Contracts undoubtedly enhance efficiency. Among other things, they enable parties to allocate risks, extract information and transfer goods thereby leading to a better resource allocation and an increase in total welfare. The following example is illustrative. Assume a seller is willing to sell for $20 a widget for which a buyer is willing to pay $40. If transaction costs are not prohibitive, the parties will agree on a price between $20 and $40. Assume the parties agree on a price of $25. By simply exchanging a product she values at only $20 for $25, the seller would make a profit of $5. The buyer would also be better off. She would pay $25 for a widget she values at $40. The result is that the widget would gravitate from the low value individual (the seller) to the higher value one (the buyer) and total (or societal) welfare would increase by $20.

Contracts are undeniably welfare enhancing; but what if the widget is a body organ? In the face of a "private emergency," should the sovereign be allowed to "take" an organ from one person and give it to another? This very question arose in *McFall v. Shimp*[9] and *Strunk v. Strunk*.[10] The plaintiff in *McFall* was a 39 year old male who suffered from a rare disease, curable only by a bone marrow transplant from a close relative. After the defendant, the only suitable donor, refused to submit to the transplant, the plaintiff

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[9] *McFall*, 1978 Pa. Dist. & Cnty. Dec. LEXIS 70 (Pa. C.P. 1978).
[10] *Strunk*, 445 S.W.2d 145 (Ky. 1969).

sought a preliminary injunction compelling the operation. The question before the court was whether "in order to save the life of one of its members by the only means available, may society infringe upon ones…right to his 'bodily security'?"[11] The court treated the issue as one of first impression, noting that a "diligent search has produced no authority" save an ancient 700 year old English statute.[12] With no guiding precedents, the court refused to compel the defendant to undergo the surgery. It explained:

> "Our society, contrary to many others, has as its first principle, the respect for the individual, and that society and government exist to protect the individual from being invaded and hurt by another… Morally, this decision [refusing donation] rests with defendant, and, in the view of the court, the refusal of defendant is morally indefensible. For our law to compel defendant to submit to an intrusion of his body…would defeat the sanctity of the individual, and would impose a rule which would know no limits, and one could not imagine where the line would be drawn."

In *Strunk*, however, the court arrived at a different conclusion. The plaintiff in *Strunk* was the mother of two sons. The eldest, Tommy, suffered from a fatal kidney disease and the youngest, Jerry, was an incompetent ward of the state with an I.Q. comparable to that of a six-year-old. Upon discovering that Tommy's life could only be saved by a kidney transplant from Jerry, the plaintiff petitioned the court to compel the transplant. Unlike *McFall*, the *Strunk* court believed that it had an "inherent authority" to compel an individual to undergo emergency medical procedures in order to save the life of another.[13] The court noted that "with regard to the origin and source of…jurisdiction [over the persons of others], the doctrine now commonly maintained is that it represents a delegation to the chancellor of the *Crown's right as parens patriae* [father of the people] to interfere in particular cases for the benefit of such persons as are incapable of protecting themselves."[14]

How can one square *McFall* with *Strunk*? The dogmatist would argue that the two decisions are distinguishable. One involved a situation in

[11] *Id*. at 91.
[12] *Id*.
[13] The court found authority to supplant the defendant's (Jerry) inability to consent with its own in "a universal rule of equity that where a person is not equal to protecting himself in a particular case, the court will . . . afford whatever relief may be necessary to protect his interests and preserve his estates." *Id*. at 147.
[14] *Id*. (Emphasis added). The dissent was of the view that the court does not have the authority to compel the surgery (noting that "parents may be free to become martyrs themselves. But it does not follow they are free, in identical circumstances, to make martyrs of their children before they have reached the age of full and legal discretion when they can make that choice for themselves.") *Id*. a 150.

which the "donor" was competent, while the other dealt with a donor who suffered from a "mental defect."[15] The cynical view would be that *McFall* took a utilitarian approach: preferring the life of a productive married and working adult over that of the "mentally defective" (much emphasized facts in a very short decision).[16] The political theorist, on the other hand, would argue that the two decisions represent two different philosophies (or prosaic treatments) of the "exception." Specifically, it would argue that the *Strunk* court followed a Foucauldian approach. The court description of its authority, especially the reference to the king as the "father of the people" is reminiscent of Foucault's analogy of the royal function ("to procure the common good of the multitude" [17]) to the pastoral power. "To that extent," noted Foucault, "the king's function is not substantially different from that of the pastor."[18]

To the economist, however, *McFall* and *Strunk* are two sides of the same coin. The only difference between them is that the first occurred in a low transaction cost setting (and thus did not require any intervention) while in the latter transaction costs were prohibitive. When two adults, as in *McFall*, can make a determination as to whether they are willing to sell or buy an organ there is no need to intervene. As long as the parties find the transaction beneficial, they will reach an agreement. Just like the widget example, if the donee (buyer) values the organ more than the donor (seller), the parties will reach an agreement that will make both better off.[19] In *Strunk*, on the other hand, transaction costs were prohibitive. Although both parties were interested in the transaction,[20] one of the parties (Jerry) was unable to communicate his wishes (he was incompetent). In such situations, where the market fails, an intervention by the court (or regulation) can be justified. The court in these cases is asked to mimic the market and ensure that a desirable transaction takes place.[21]

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[15] This seems to be the majority's view. *Id*. at 146.
[16] *Id*.
[17] Michel Foucault, *Security, Territory, Population: Lectures at the College De France 1977-1978* (New York, Palgrave Macmillan, 2007), p. 233.
[18] *Id*.
[19] The fact that one party, the donor, had an advantageous bargaining power (Shrimp was the *only* suitable donor) only means that the surplus generated by the transaction will not be evenly distributed between the parties.
[20] The majority opinion was predicated upon Jerry's emotional and psychological dependence on his older brother and the limited risks involved with the surgery.
[21] Contracts, it should be noted, are superior to regulatory (or court) intervention for a number of reasons. First, contracts save wasteful costs to society. Instead of relying on judges and juries and a long and costly litigation process, agreements represent a much cheaper alternative. Second, and related, a judicial determination is also likely to result in a mistake. A court (or a jury) would have to determine the damages to the "donor" in case the latter is compelled to give an organ and may either over or under compensate the donor. Finally, contracts ensure that desirable transactions take place and that inefficient ones do not.

But if contracts are such a great device, why could not the parties in *McFall* reach an agreement (assuming that McFall was willing and able to pay Shimp)? Sometimes there are strategic reasons for a party to channel a transaction from the market into the court system. For instance, suppose that a donee is willing to pay $10,000 for an organ that the donor is willing to sell for $5,000. Assume further that the donee believes that if the court compels the transplant the jury will set the damages (or price) at $4,000. In such a case (and assuming litigation costs are low), the donee's best strategy is to ask the court for an injunction to compel the transplant. An injunction would enable the donee to bypass the market for organs (i.e., avoid paying the contract price of $5,000) in the same way that theft bypasses the market for ordinary goods.[22] A private transaction is superior to a court's proceedings for a variety of other reasons. An agreement ensures that both parties are better off (otherwise they would not enter into a binding agreement), it saves unnecessary and wasteful litigation costs thereby allowing society to better allocate its (scarce) resources and avoid the costly mistakes that a third party (judge or jury) is bound to make from time to time.

The legal system recognizes the superiority of market mechanisms over courts' intervention. Rules regarding remedies designed to deal with "emergencies," such as specific performance, injunctions and punitive damages, can often be justified on the feasibility (and superiority) of market transactions:

> "Punitive damages are necessary in some cases to make sure that people channel transactions through the market when the costs of voluntary transactions are low. We do not want a person to be able to take his neighbor's car and when the neighbor complains tell him to go sue for its value. We want to make such expropriations valueless to the expropriator and we can do this by adding a punitive exaction to the judgment for the market value of what is taken. This function of punitive damages is particularly important in areas such as defamation and sexual assault, where the tortfeasor may, if the only price of the tort is having to compensate his victim, commit the tort because he derives greater pleasure from the act than the victim incurs pain."[23]

McFall and *Strunk* are rightly decided but their legal premise seems to be lacking. These decisions have little to do with morality, "the

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[22] This is a paraphrase on Judge Posner's analysis of rape. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW (7th Ed. 2007) at p. 216 ("Rape bypasses the market in sexual relations (marital or otherwise) in the same way that theft bypasses the markets in ordinary goods and services, and it should therefore be forbidden.").

[23] *Kemezy v. Peters*, 79 F.3d 33 (7th Cir. 1996).

Crown's right as parens patriae" or "respect for the individual." Rather, they can be explained by a Coasian approach to transaction costs. Simply put, when parties can negotiate, an injunction to compel an action will often interfere with the market.

III. PUBLIC EMERGENCIES

Natural disasters and other forms of public emergencies undoubtedly pose immense challenges. In addition to the large number of casualties, survivors of the catastrophe, as well as rescue and reconstruction teams, face a hard reality. The disruption of commerce due to severely damaged or destroyed businesses and supporting infrastructure creates a real shortage in essential commodities and services that cripples rescue and repair efforts. This shortage in essentials is often accompanied by a much debated and often condemned phenomenon: price gouging[24]—a situation where sellers offer their goods in distressed areas at what is often perceived as "unreasonable," "opportunistic" or "excessive" prices.

Many states have promulgated laws to fight and eradicate price gouging.[25] These laws are dormant in times of peace, but they enter into effect upon a declaration of a "state of emergency" or "abnormal market disruption."[26] Some statutes specify the type of events that may trigger the declaration (such as hurricanes or terror attacks), while others also refer to declarations and advisories issued by state and federal authorities.[27] The definition of price gouging also varies among states and is often vague and

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[24] See, for example, the series of comments and responses to Judge Posner and Professor Becker's Blog, *available at* http://www.becker-posner-blog.com/archives/2005/10/ (last visited on Dec 22, 2008).

[25] *See e.g.*, infra notes 27-32. Some anti-price gouging laws apply to a large number of commodities and services not only those which are on high demand in times of emergency but broader definitions are commonplace. *Compare e.g.*, IND. CODE 4-6-9.1-2 (defining price gouging" as "charging a consumer an unconscionable amount for the sale of fuel") with ARK. CODE ANN. § 4-88-303.

[26] See, e.g., N.Y. GEN. BUS. LAW § 396-r (noting that "during periods of abnormal disruption of the market… or other extraordinary adverse circumstances, some parties within the chain of distribution of consumer goods [take] unfair advantage of consumers by charging grossly excessive prices for essential consumer goods and services"); ARK. CODE ANN. § 4-88-303 ("Upon the proclamation of a state of emergency resulting from a… natural or man-made disaster declared by the President of the United States or the Governor and upon the declaration of a local emergency… by the executive officer of any city or county… or during any period of time during which a red condition under the Homeland Security Advisory System has been declared by either the United States Department of Homeland Security or the Arkansas Department of Emergency Management, it is unlawful for any person… to sell or offer to sell any consumer… goods… for a price of more than ten percent (10%) above the price charged by that person for those goods or services immediately prior to the proclamation of emergency")

[27] *See*, *e.g.*, ARK. CODE ANN. § 4-88-303.

open-ended.[28] Many anti-price gouging laws use terms such as "unconscionable" or "unfair."[29] Some states prohibit sales at above the average price in a defined period of time prior to the declaration of emergency,[30] while others are willing to tolerate price increases up to a certain percentage.[31]

The standard argument supporting anti-price gouging laws is that they prevent unscrupulous sellers of essential products—those which are most needed after a disaster—from "taking advantage" of those who are in dire distress.[32] Their goal is to impede "opportunistic" attempts by sellers "to capitalize on other people's hardship and misery."[33] "Anyone who is trying to take advantage of this situation" the argument goes, "should be investigated and prosecuted."[34] Despite the strong sentiments that price gouging generates, there now exists a consensus among economists that anti-price gouging laws do not mitigate shortages but rather exacerbate them.[35]

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[28] This of course results in high enforcement and litigation cost. *See e.g.*, The White House Paper on *The Economic Consequences of Gasoline "Price Gouging" Legislation* (Jun. 20, 2007) *available at* http://www.whitehouse.gov/cea/Price_Gouging_WP_062007.html (agreeing with the FTC Chairman's conclusion that anti price gouging laws 'likely will do consumers more harm than good'" and noting that "the difficulty in defining 'price gouging' would create an unnecessary regulatory regime with potentially high litigation costs and great uncertainty" that "would deter investment in new supply, increasing prices in the long run").

[29] N.Y. GEN. BUS. LAW § 396-r (prohibiting "unconscionably excessive prices" which are defined as prices that are "unconscionably extreme" or prices that are charged using "unfair leverage or unconscionable means"). *See also* N.Y. GEN. BUS. LAW § 396-r(3) (providing that "whether a price is unconscionably excessive is a question of law for the court"); VA. CODE ANN. § 59.1-527.

[30] *See*, *e.g.,* FLA. STAT. ANN. § 501.160.

[31] *See* ALA. CODE § 8-31-4 (defining an "unconscionable price" as "a price that exceeds, by an amount equal to or in excess of twenty-five percent the average price at which the same or similar commodity… was obtainable in the affected area during the last 30 days immediately prior to the declared state of emergency and the increase in the price charged is not attributable to reasonable costs incurred in connection with the rental or sale of the commodity").

[32] N.Y. GEN. BUS. LAW § 396-r (1).

[33] Joseph Treaster, Hurricane Charlie: The Economics; With Storm Gone, Floridian Are Hit With Price Gouging" (New York Times, Aug. 18, 2004)(*available at* http://query.nytimes.com/gst/fullpage.html?res=9D01E1DC113FF93BA2575BC0A9629C8B63) (last visited Dec 23, 2008).

[34] Mark Preston, *GOP Urges Price Gouging Prob on Gas* (CNN.Com, April 25, 2006), *available at* http://www.cnn.com/2006/POLITICS/04/24/gas.investigation/index.html (last visited Dec. 22, 2008)(Citing House Speaker Dennis Hastert, R-Illinois, and Senate Majority Leader Bill Frist, R-Tennessee letter to President Bush).

[35] Geoffrey Rapp, *Gouging: Terrorist Attacks, Hurricanes, and the Legal and Economic Aspects of Post Disaster Price Regulation*, 94 Ky. L. J. 535 (2005); W. David Montgomery et al*, Potential Effects of Proposed Price Gouging Legislation on The Cost and Severity of Gasoline Supply Interruptions*, J. COMP. L. & ECON. 3 (3) 357, 359 (2007) (concluding that "imposing temporary price controls could increase the overall economic losses due to a

The assumption underlying anti-price gouging laws is that in times of emergencies *markets fail*. New York, for example, limits the application of its anti-price gouging law to situations of "abnormal disruption of the market," which it defines as "any change in the market… resulting from stress of weather, convulsion of nature, failure or shortage of electric power or other source of energy, strike, civil disorder, war, military action, national or local emergency...." Market failure and abnormal situations (emergencies included), however, are not synonymous terms. One does not necessarily imply the existence of the other. A shortage simply means that at a certain price level the demand for some goods exceeds supply or, put differently, that resources are scarce.[36] This scarcity is the very subject of economic theory:

> "The economist studies the disposal of scarce means. He is interested in the way different degrees of scarcity of different goods give rise to different ratios of valuation between them, and he is interested in the way in which changes in conditions of scarcity, whether coming from changes in ends or changes in means—from the demand side or the supply side—affect these ratios. Economics is the science which studies human behavior as a relationship between ends and scarce means which have alternative uses."[37]

To understand the role that price gouging serves, we must first understand the role of prices. Prices are not just a dollar value assigned to goods, they are signals. Prices are declarations of sellers' willingness to part

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supply interruption of the same magnitude as that followed Katrina and Rita by almost $1.9 billion"); Judge Posner and professor Becker's Blog *available at* http://www.becker-posner-blog.com/archives/2005/10/ (last visited on Dec 22, 2008)(referring to anti-price gouging laws as a "profound mistake"); Michael Brewer, *Planning Disaster: Price Gouging Statutes and the Shortage They Create*, 72 BROOKLYN L. REV. 1101 (2007); David Skarbek, *Market Failure and Natural Disasters: A Reexamining of Anti-Gouging Laws*, PUB. CONTRACT L. J., Vol. 37 No. 4 (2008).

[36] *See* Federal Trade Commission, *Investigation of Gasoline Price Manipulation and Post Katrina Gasoline Price Increases*, p. Ix *available at* http://www.ftc.gov/reports/060518PublicGasolinePricesInvestigationReportFinal.pdf ("In the cities with the largest price increases, the sizes of the increases were consistent with the standard supply and demand competitive paradigm. Moreover, in general, the wholesalers and retailers that raised prices the most within particular cities in the weeks following the hurricanes were not firms that experienced increases in market power (stemming, for example, from the closing of rivals). Rather, they were firms that experienced the largest reductions in their own supplies and the greatest increases in their own costs." For a review of other studies reaching similar conclusions, see W. David Montgomery et al, *Potential Effects of Proposed Price Gouging Legislation on The Cost and Severity of Gasoline Supply Interruptions*, Journal of Competition Law and Economics 3 (3) 357 (2007), p. 370-374.

[37] Robbins, Lionel, *An Essay on the Nature and Significance of Economic Science.* London: Macmillan and Co., Limited. p. 16 *available at* http://www.mises.org/books/robbinsessay2.pdf.

with goods and buyers' willingness to pay. They also inform sellers of opportunities available to potential buyers in the market. In a competitive market, the price informs each seller that if she prices her product above the "market price," consumers are likely to decline her offer. It also informs the seller that if she can come up with a more efficient manufacturing or marketing process, she may be able to offer the same good for less and attract more business. Pricing above cost (such as monopoly pricing) also serves as a magnet. It informs potential entrants that rents are available and (absent barriers to entry) helps attract new entrants and revive competition. In a market in long term equilibrium, the price may inform a seller of its competitors' cost structure.[38] To firms that attempt to conspire (in violation of antitrust laws), the price charged by members of the cartel often indicates possible deviation from a price fixing agreement. A unified price, under certain circumstances, may alert the antitrust and competition authorities that a cartel may be in operation. A price can even provide information about the product's qualities, and is often an indicator of high search costs.[39]

Prices are also a measure of scarcity. A high price indicates that a certain commodity is scarce, while a low price indicates abundance. Diamonds and gold are scarce, not because of their inherent attributes, but because they are hard (or just costly) to locate and harvest.[40] In contrast, air, while certainly not less useful than diamonds, is costless because it is everywhere. It is not scarce. Prices also help allocate resources, or to use the economists' jargon, achieve "allocative efficiency." Allocative efficiency ensures that scarce resources are allocated to those consumers who value them the most. It is achieved by allowing scarce commodities and services to gravitate from the low user to the high user.

But how do these understandings help us analyze price gouging? In times of emergencies, commodities are often scarce. Generators, gas and even water can be hard to find. The price of goods in these situations must rise. The price is the voice of scarcity. It announces to the world that a certain commodity is in short supply or in high demand (or both). Sellers—often an attentive audience for such cries—will likely respond. In their ears, the sound of scarcity translates to a prospect for high profits. Motivated by greed and a primal rent seeking instinct, these sellers would flock from localities in which their commodities are less scarce to distressed areas.

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[38] Gil Sadka, *The Economic Consequences of Accounting Fraud in Product Markets: Theory and a Case from the US Telecommunications Industry (WorldCom)*, AMERICAN L. & ECON. REV. Vol. 8, No. 3, pp. 439-475, 2006.

[39] *See* J. Shahar Dilbary, *Famous Trademarks and The Rational Basis To Protect Irrational Beliefs*, 14 GEO. MASON L. REV. 605 (2007); J. Shahar Dillbary, *The Role of Trademarks in Intra-Brand Settings: An Economic Analysis* (2008). U of Alabama Public Law Research Paper No. 1126857 (*available at* SSRN: http://ssrn.com/abstract=1126857).

[40] For a different view see: Edward J. Epstein, THE RISE AND FALL OF DIAMONDS: THE SHATTERING OF A BRILLIANT ILLUSION (1982)

Those who arrive first will receive a prize for their efforts – they will be able to charge high prices (and thus realize large profits). But overtime, with the inflow of sellers, the commodities will become less scarce and pre-emergency prices will be restored.

The high, so called "exorbitant," prices also achieve allocative efficiency. In times of emergency, where chaos manifests, prices help sort users into different groups according to the value they assign to the scarce resources. Those who value the essential commodities more than others will be willing to purchase the goods at higher prices (as long as their benefits from these commodities exceed the cost); and thus, should be accorded priority.

Price regulation tampers with this (efficient) market mechanism. A price cap mutes the voice of scarcity. It stops those sellers who are willing to rush into distressed areas to offer their much desired goods, from doing so. The following example is illustrative. Assume that a hurricane hits two localities. The first is directly hit, causing the price of generators to increase from $250 to $2000.[41] The second suffered only minor damages, causing the price of generators to increase by only $1000. Assume further that the sellers' cost to produce a generator is only $100 and that transportation and shipping costs between the two localities are $300. In this situation, the rent seeking seller located in the less affected area faces one of two options. She can either (a) continue to sell in the less affected locality and realize a profit of $900 (1000-100); or (b) she can ship her generators to the severely impacted area and realize a profit of $1600 (2000-100-300). Motivated by the prospect of high profits, sellers located in the relatively unaffected area would of course sell at the distressed area.[42] If, however, an anti-price gouging law in the distressed locality prohibits price increases, those sellers will not offer their commodities to those who need them the most.

Some anti-price gouging laws, it should be noted, allow a price increase up to a certain percentage (e.g., 25% in Alabama)[43] or a price

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[41] *See* Joseph Treaster, *Hurricane Charlie: The Economics; With Storm Gone, Floridian Are Hit With Price Gouging*, (New York Times, Aug. 18, 2004) *available at* http://query.nytimes.com/gst/fullpage.html?res=9D01E1DC113FF93BA2575BC0A9629C8B63 (last visited Dec 23, 2008).

[42] *See, e.g.*, Abhi Raghunathan, *South Florida Shortages Fuel Black Market*, St. Petersburg Times - St. Petersburg, Fla, Start page 1B, Oct. 29, 2005 ("They stand patiently in clumps at gas stations all over South Florida, lugging empty buckets, milk bottles, even pickle jars. While Hurricane Wilma has been a burden for most, it has been an opportunity for others. Kenol Pierre, 32, had just put $10 of gas in a red gas can at a service station in Miami's Little Haiti neighborhood. Some of it was for his own vehicle, and the rest was for some fast cash. 'I can sell it and get maybe $20 or $30,' said Pierre, an immigrant from Haiti. 'Waiting for an hour is easy for me.' Pierre is part of a thriving black market in South Florida, where ice and water are prized commodities and gasoline the new gold.").

[43] ALA. CODE § 8-31-4.

increase that is due to increase costs.[44] These exceptions, however, often have little or no effect. In the above example, the seller would decline to sell her merchandise even if the price increased by 300% from $250 to $750 simply because she can enjoy a profit of $900 if she sells at the less distressed locality. What these laws fail to recognize is that in addition to out of pocket expenses (such as shipping costs) sellers also incur opportunity costs. If the seller in our example chooses to sell her commodities at one locality she *forgoes* the profit she could have earned at the other.[45] Price caps on essential goods thus harm the very consumers these laws seek to protect.

Moreover, if prices are artificially kept at a low level, more people will be willing to purchase generators compared to the number of generators available. In such a case, allocation of generators may become inefficient. Generators may be sold on a first come first serve basis (until supply is depleted) rather than to the highest value consumer. Assume for example that Buyer-1 is willing to pay $300 for the same generator for which Buyer-2 is willing to pay $2,000. If the price is kept at $250 per unit, Buyer-1 may receive the generator instead of Buyer-2.

But there are more pieces in this puzzle: the forces of supply and demand are often much stronger than any anti-price gouging laws. Effective price caps actually *create* shortages. This is illustrated in Figure 1 below.

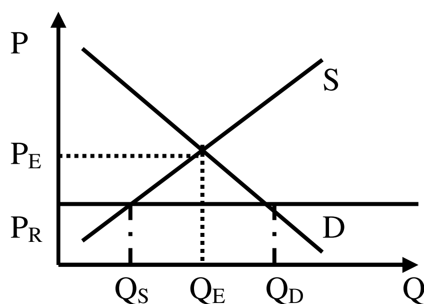

Figure 1: Price Regulation in the Market for Generators

Absent any price cap the market for generators will be in equilibrium where supply meets demand. Q_E units will be sold at price P_E. If the sellers cannot offer their merchandise at more than P_R, the quantity demanded at that price, Q_D, will exceed the number of units sellers are willing to sell at that price, Q_S ($Q_D > Q_S$). In such a situation, a "secondary" (or "black") market often develops. Ad hoc entrepreneurs will purchase the much desired goods at the regulated (low) price, only to offer them at a

[44] N.Y. GEN. BUS. LAW § 396-r(3)(b)(ii) (prohibiting "unconscionably excessive prices" but allowing a seller to "rebut a prima facie case with evidence that additional costs not within the control of the [seller] were imposed on the [seller] for the goods or services").

[45] The situation is even worse if one locality declares a state of emergency that triggers its anti-price gouging laws while an adjacent locality does not.

higher price to others.[46] To illustrate, assume that Buyer-1 in the above example purchased the generator for $250 because it was the first to arrive at the store. Buyer-2 would have been willing to pay Buyer-1 up to $2,000. If negotiation is possible, the parties will strike a deal at a price of $300 – $2000.[47] The prospect of rents generates a secondary market that results in a distributional affect, but will not eliminate desirable transactions from taking place (unless transaction costs are prohibitive). More people may try to engage in this arbitrage-like transactions, thereby increasing the demand for the already much demanded goods. They will seek to purchase goods at the regulated price in order to resell them to other consumers with a higher willingness to pay. This will likely increase transaction costs and enable tax evasion. More importantly, it will make it harder for high value customers to locate the goods they need (even at the higher price). The result is that anti-price gouging laws that are meant to eliminate "opportunistic" behavior foster one.

The so called "exorbitant" prices have another desirable effect. They incentivize sellers to *stock* commodities which are usually not on high demand but are much desired after a hurricane warning is issued. Commodities such as generators, planks of wood, flashlights and candles are often carried and sold only (or mainly) in times of emergency. Storing and shelving these goods, however, comes at a high (opportunity) cost. Sometimes, it is simply unprofitable to sell these goods. Price gouging, however, helps prepare for future shortages. Reverting back to the generator example, assume that it costs $100 to manufacture a generator for which consumers are willing to pay only $70 in times of tranquility but $1,500 in times of emergency. If price gouging laws prohibit price increases the seller will not carry generators. Selling a $100 generator for $70 is just a bad business. But if price increases are allowed and the seller believes that there is a 10% probability that a hurricane would hit the locality, generators will be available. The expected benefit of stocking a generator would be $140 (10%x[1,500-100]), $40 more than the cost of a generator.[48]

Not only do anti-price gouging laws provide little incentives to store essentials, but they also cause the little supply available to deplete faster compared to a no-price cap regime. This is especially the case in the market for gasoline. The fear of running out of gas causes consumers to fill up their

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[46] *See* Abhi Raghunathan, *South Florida Shortages Fuel Black Market*, *supra* note 43.

[47] The secondary transaction is efficient because it "clears the market," but it is inferior to an unregulated market. Anti price gouging laws, however, may increase transaction costs and even jeopardize this secondary market altogether. If the expected cost from a penalty (a function of the fines and enforcement efforts) are high enough it may deter such transaction.

[48] Assuming the risk neutral seller can return the generator to the manufacturer if it is not sold. If, however, the seller cannot return the generator to the manufacturer, the seller's expected benefit from carrying a generator would be $113 (10%x[1,500-100] + 90%x[70-100]), still $13 more than the cost of a generator.

tanks more frequently and maintain a higher-than-usual level of gas in their tanks. This in turn increases the already long queues at gas stations and dries up inventories.[49] This phenomenon can be easily modeled. Assume that the average tank size contains X gallons and that in times of tranquility the average consumer fills up her tank when it reaches α capacity. For example, if $\alpha = 0.25$ and X= 20 gallons, the average consumer fills her gas tank when it reaches quarter capacity (or when it reaches 5 gallons). Assume further that in times of emergency, afraid that gas will not be available, consumers fuel their tanks when they reach β capacity ($\beta > \alpha$). The average level of gas in consumers' tanks thus would increase from $X(\alpha+1)/2$ to $X(\beta+1)/2$[50] and demand for gas would thus increase at a magnitude of $(\beta+1)/(\alpha+1)$. For example, if consumers pump gas when the gas level of their tank reaches a level of ¾ instead of ¼, the average gas level in their tanks would increase from 5/8 to 7/8, causing a 40% increase in the demand for gas.

In sum, price gouging is often condemned for being immoral for taking advantage of consumers in need. Economic theory, however, proves this to be wrong. Price gouging is not the problem (scarcity is) but rather a remedy.

IV. CONCLUSION

Professor Feldman reports that much of the current debate amongst political theorists revolves around whether emergencies lie within or outside the law.[51] This article argues that economic theory can and does provide important insights into the proper placement and scope of emergency law; and therefore should not be ignored. It focuses on the markets for body parts and other essential goods in times of emergency and it concludes that emergencies are often subject to the same laws of supply and demand that control in times of tranquility, and thus often do not require any legal intervention. Emergencies, private or public, do not necessarily imply a market failure and thus do not require any form of unique or "exceptional" treatment.

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[49] W. David Montgomery et al, *Potential Effects of Proposed Price Gouging Legislation on The Cost and Severity of Gasoline Supply Interruptions*, J. COMP. LAW & ECON. 357, 376 (2007).

[50] The average levels in consumers' tanks, assuming gas in consumers' tanks is equally distributed, is $(X+\alpha X)/2$ or $X(\alpha+1)/2$.

[51] *Supra* note 1 at p. _