The role of prices
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The fallout from Hurricane Katrina has featured a lot of ignorance and demagoguery about prices. Let’s look at some of it. One undeniable fact is that the hurricane disaster changed scarcity conditions. There are fewer stores, fewer units of housing, less gasoline and a shortage of many other goods and services used on a daily basis. Rising prices are not only a manifestation of these changed scarcity conditions, they help us cope, adjust and get us on the road to recovery.

Here’s a which-is-better question for you. Suppose a hotel room rented for $79 a night prior to Hurricane Katrina’s devastation. Based on that price, an evacuating family of four might rent two adjoining rooms. When they arrive at the hotel, they find the rooms rent for $200; they decide to make do with one room. In my book, that’s wonderful. The family voluntarily opted to make a room available for another family who had to evacuate or whose home was destroyed. Demagogues will call this price-gouging, but I ask you, which is preferable: a room available at $200 or a room unavailable at $79? Rising prices get people to voluntarily economize on goods and services rendered scarcer by the disaster.

After Hurricane Katrina struck, gasoline prices shot up almost a dollar nearly overnight. Some people have been quick to call this price-gouging, particularly since wholesalers and retailers were charging the higher price for gasoline already purchased and in their tanks prior to the hurricane. The fact of business is that what a seller paid for something doesn’t necessarily determine its selling price. Put in a bit more sophisticated way: Historical costs have nothing to do with selling price. For example, suppose you maintained a 10-pound inventory of coffee in your cupboard. When I ran out, you’d occasionally sell me a pound for $2. Suppose there’s a freeze in Brazil destroying much of the coffee crop, driving coffee prices to $5 a pound. Then I come around to purchase coffee. Are you going to charge me $2 a pound, what you paid for it, or $5, what it’s going to cost you to restock your coffee inventory?

What about the house that you might have purchased for $50,000 in 1970 that you’re selling today? If you charged me $250,000 for it, today’s price for its replacement, as opposed to what you paid for it, are you guilty of price-gouging?

Recovering from Katrina means resources will have to be moved to the Gulf Coast. I ask you, how does one get electricians, plumbers and other artisans to give up their comfortable homes and livelihoods in Virginia and Pennsylvania and travel to Mobile and New Orleans to help in the recovery? If you said pay them higher prices, go to the head of the class. Higher prices, along with windfall profits, are economic signals of unmet human wants. As such, they encourage producers to meet those human wants.

Politicians of both parties have rushed in to exploit public ignorance and emotion. Last week Illinois Gov. Rod Blagojevich (Democrat) threatened to prosecute gas companies. Texas Attorney General Greg Abbott (Republican) is threatening legal action against what he called “unconscionable pricing” by hotels. Alabama Attorney General Troy King (Republican) promises to vigorously prosecute businesses that significantly increase prices during the state of emergency. The Bush administration has called for the Justice Department and the Federal Trade Commission to look for evidence of price-gouging, and Congress plans to hold hearings on oil company “price-gouging.”

There’s an important downside to these political attacks on producers. What about the next disaster? How much sense does it make for producers to make the extra effort to provide goods and services if they know they risk prosecution for charging what might be seen as “unconscionable prices”? Politicians would serve us better by focusing their energies on tax-gouging.

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