

Why is price gouging seen as unfair?

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Prices of consumer goods can change considerably in times of crisis. During the rapidly evolving coronavirus pandemic, we'd like to share our thoughts on why consumers see some price rises as unfair.

Social media has lit up over the last month with stories of hand sanitiser being sold online for many multiples of its pre-crisis price (i.e. 'price gouging'), generating outrage and condemnation.¹



These concerns over fairness have prompted state intervention. For example, in the UK, the Competition and Markets Authority said:²

We urge retailers to behave responsibly throughout the coronavirus outbreak and not to make misleading claims or charge vastly inflated prices. We also remind members of the public that these obligations may apply to them too if they resell goods, for example on online marketplaces.

Two issues appear to be at the heart of the fairness debate.

First, those who most need hand sanitiser may not be able to purchase it. For example, people who are more vulnerable to COVID-19, such as the elderly, may be less able to afford higher prices. Not only would greater risk of infection be a very poor outcome for vulnerable people, it would also increase the burden on public health systems—with potentially disastrous consequences for the rest of society.

Second, price gouging is seen as unfair. Below, we take a look at why this is the case.

How does the brain form views over fairness?

The burgeoning field of neuroeconomics tells us that people are keenly aware of unequal outcomes, and that unfairness generates an emotional reaction.³

•We are keenly aware of unequal outcomes. Real or potential unequal outcomes generate responses in the regions of the brain that play a fundamental role in human awareness—the anterior insula and anterior cingulate cortex (ACC).

•Unfairness generates an emotional reaction. The region responsible for emotional processing, the amygdala, creates emotional reactions to unfairness.

•We think about other people's perspectives. The region of the brain involved in thinking about other people's perspectives, the temporoparietal junction (TPJ), becomes engaged in situations where the outcomes and motives of other people are difficult to judge.

Perceived intentions matter

Behavioural economics tell us that perceptions of fairness are context-dependent; that is, whether something is seen as unfair will vary according to the specific circumstances.⁴

Importantly, when a firm raises prices, the way its intentions are perceived is crucial. The following situation was rated as unfair by 82% of participants in a famous study by three authors working in this field—including two Nobel laureates:⁵

A hardware store has been selling snow shovels for \$15. The morning after a large snowstorm, the store raises the price to \$20.

The authors conclude that **'it is unfair to exploit shifts in demand by raising prices'**.

In contrast, the same authors find in another experiment that most participants agree that it's fair for a firm to pass on a wholesale cost increase through higher retail prices, even if doing so causes consumers inconvenience.⁶

This explains the condemnation of people selling hand sanitiser online for vast sums—they are not reflecting an underlying cost increase, but appear to be taking advantage of increased demand (due to panic buying—see our previous post).

Caveat: could higher prices be good in the long term?

The Nobel laureate Friedrich Hayek would probably have argued that as higher prices of hand sanitiser encourage greater production of hand sanitiser, we should be willing to pay the premium.

In other words, prices are a signal of value, and this signalling mechanism ensures that scarce resources are allocated to their most valuable uses. Indeed, as a society, we may want to see greater production of hand sanitiser in the long run.

However, this argument does not resolve the issue that vulnerable people may not be able to afford hand sanitiser, nor the potential consequences for the rest of society. Further, it is unlikely that reselling hand sanitiser online would incentivise the supply of hand sanitiser (at least from a pure profit-maximising perspective) if it can merely be bought for the same price from supermarkets—which have not raised prices.

Meanwhile, some firms are now offering to adjust their production lines to switch away from their core product and produce hand sanitiser—such as LVMH in France—apparently without requiring higher retail prices.⁷ This is an example of how firms can seek to deliver fairness and value to all their stakeholders (for more in this vein, see *Beyond the Bottom Line*).

Playing clean

Fairness is important to consumers, and consumers react badly to price gouging. Perceived intentions hold the key to this reaction; consumers generally understand price rises in response to cost increases, but not in response to shifts in demand.

It has never been more important for businesses to communicate effectively with their customers, but it has never been harder for businesses to keep up rapidly unfolding events. Establishing and maintaining open channels of communication is vital to ensure that businesses take consumers with them through these uncertain times.

1 Brazell, E. (2020), 'Hand sanitiser sold for £360 on Amazon as vendors take advantage of coronavirus', *Metra*, 4 March, <https://bit.ly/3doGKqO>.

2 Competition and Markets Authority (2020), 'COVID-19: sales and pricing practices during Coronavirus outbreak', news story, 5 March, <https://bit.ly/33N2Peh>.

3 Fehr, E. and Krajbich, I. (2014), 'Social Preferences and the Brain' in Glimcher, P. W. and Fehr, E. (eds), *Neuroeconomics*, second edition, Elsevier, chapter 11.

4 Xia, L., Monroe, K. B. and Cox, J. L. (2004), 'The Price Is Unfair! A Conceptual Framework of Price Fairness Perceptions', *Journal of Marketing*, 68, October, pp. 1–15.

5 Kahneman, D., Knetsch, J. L. and Thaler, R. H. (1986), 'Fairness as a Constraint on Profit Seeking: Entitlements in the Market', *The American Economic Review*, 76:4, September, pp. 728–41.

6 Kahneman, D., Knetsch, J. L. and Thaler, R. H. (1986), 'Fairness and the Assumptions of Economics', *The Journal of Business*, 59:4, Part 2: The Behavioral Foundations of Economic Theory, October, pp. 285–300.

7 France 24 (2020), 'French alcohol, perfume producers lend a hand in coronavirus fight', 18 March, <https://bit.ly/2QO6IPN>.

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