

## Is High Price a Rip-off?

A recent article in the Courier Mail (15 November 2012) reported that an iconic rock band was charging fans to meet the band at a concert and concluded this was a rip-off. Other examples of supposed rip-offs one will read about from time to time include the price of major sporting event tickets and concert tickets.

What should be done about these “rip-offs”? A little bit of information on the role of prices and how they bring together buyers and sellers in a market should convince you that doing nothing is usually the best course of action for all.

Prices perform a number of important functions in a market economy like ours. By market economy I mean a situation where products are sold to buyers who pay the price asked by sellers.

The first function of a price is to recover the costs a supplier incurs in producing the products. If the sale price does not at least recover costs, the supplier must either find a lower cost way of providing the good or not produce it, either at all or in lesser quantity. Charging a high price, where high means a price greater than other alternatives available to buyers, is a very risky strategy. The supplier risks losing potential customers to other suppliers and not recovering their costs. In our examples above, it could mean a very small line outside the dressing room door or empty seats at a concert or in a stadium.

The second function of a price is to provide products to those who value them most. Value in this context means how much a buyer feels they benefit from consuming the product compared to the products they forgo to consume it. In an efficient market, prices provide the real test of value, not a judgement of someone external to the transaction. Buyers use prices to decide what types of goods and in what quantities benefit them most from their disposable income. Judgements by external observers on the reasonableness of consumption choices, such as spending \$1500 to meet an iconic rock band are irrelevant. The only information an external judgement conveys is that the commentator doesn't place a \$1500 value on meeting the band.

The third and final function is to coordinate the actions of buyers and sellers. When there is more demand than products available prices rise to allocate the quantity available to those who value it most. The higher price also signals to suppliers that it is profitable to start producing or produce more of the product. Suppliers will increase the quantity

available until the market price is equal to their cost. It is an efficient method of coordinating millions of daily decisions.

In fairness to the journalist, there are circumstances of market failure where the price mechanism cannot prevent a rip-off. For example, a supplier acts deceptively or dishonestly and doesn't deliver what they promise. There are general laws to regulate this behaviour. In exceptional cases, prices won't provide an incentive to increase the quantity of product. Usually this is because the ability to compete is constrained. Removing the constraint is the best solution but regulating prices might be the necessary option. For many thousands of products bought and sold each day the price mechanism does an excellent job and rip-offs do not occur.

This article has focussed on high prices. Prices that are too low also inefficiently allocate resources. Of course, private sector firms cannot hold prices below costs over the long term. Only governments have this ability because they cover the gap between prices and costs from taxes. The incentives and reasons why governments might do this is the subject of a future article.

*Written by: Jeff Lassen, Principal, Synergies Economic Consulting Pty Ltd*



**Jeff Lassen – Principal**

**p:** +61 7 3227 9558

**e:** j.lassen@synergies.com.au

### **Brisbane**

Level 8, 10 Felix Street  
Brisbane QLD 4000  
GPO Box 2605  
Brisbane QLD 4001  
P 61 7 3227 9500  
F 61 7 3221 0404

### **Sydney**

Level 26, 44 Market Street  
Sydney NSW 2000  
P 61 2 9089 8666  
F 61 2 9089 8989

### **Melbourne**

Level 40, 140 William Street  
Melbourne VIC 3000  
P 61 3 9607 8499  
F 61 3 9607 8282