Thou Shalt Not Cut Prices!

Sales-Below-Cost Laws for Gas Stations

Robert N. Fenili and William C. Lane

IT SEEMS ONLY yesterday that the federal government was busy trying to hold prices down at the nation's gasoline stations. But the regulatory pendulum has had time to swing. Early this year, Georgia enacted a law that does the opposite—it prohibits the sale of certain petroleum products at prices *below* cost. Alabama enacted a similar law last year. Other such bills have been introduced in over a dozen states.

These new proposals apply only to gasoline, but general laws prohibiting the sale of products below cost have been on the books in many states since the 1930s. They were inspired by the same economic philosophy that nurtured the New Deal's Blue Eagle—the philosophy that above all sought to avoid "overproduction" and "ruinously" low prices. Many of these laws are still actively enforced: a pending case under the Oklahoma law, for example, has attracted the intervention of the Federal Trade Commission. Until now, however, there has been little empirical evidence on the effect of these laws in practice. Many observers have considered them unenforceable for all practical purposes, but this has been only a hunch.

To fill this gap, we used quantitative tools to analyze the effects of both general and specifically targeted sales-below-cost (SBC) laws on the retail market for gasoline. In our analysis, we asked three questions: How do these laws affect retail gasoline prices? Can we extrapolate from their effect on gasoline prices to their effect on prices in the economy as a whole? And is there any justification for enacting more of them?

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What the Laws Do

Almost universally, laws prohibiting merchants from selling goods below cost define cost as the sum of three elements: (a) the lesser of the invoice or replacement cost of the item, (b) freight costs and excise taxes, and (c) a markup to cover a proportionate part of the marketer's cost of doing business. The third item in the list, the minimum permissible markup, is the one that is most often in dispute, with plaintiffs trying to establish that a defendant's cost of doing business is high, and the defendant trying to prove that it is low.

Most laws use one or more short cuts for determining cost. Some fix a minimum percentage markup, commonly 6 percent at retail. Others provide that a cost survey of industry members by a trade association will establish a presumption about a defendant's overhead costs, even if the defendant did not participate in the survey. Both these cost-of-business presumptions can be rebutted if the defendant is able to prove that its costs justify a lower markup.

(The plaintiff, for its part, can likewise try to prove that the defendant's costs were *higher* than the presumed level.)

Most commentators who view SBC laws as unimportant have emphasized the pro-defendant provisions of the laws. Many states require a showing that the defendant specifically intended to injure competitors or competition. Many allow only state agencies to enforce SBC laws, which is likely to lead to less active enforcement than if competing merchants, whose interest is obviously more intense than that of elected or appointed officials, are allowed to file suit as well. Finally, many states accept a "meeting competition" defense similar to that of the Robinson-Patman Act: price-cutting merchants can get off the hook by showing that their prices equaled or exceeded the prices of any competitor.

General SBC statutes are frequently supplemented with SBC legislation directed at particular commodities—liquor, baked goods, cigarettes, drugs, fresh fruit, gasoline, groceries, milk, and so forth. The laws covering specific commodities are far more varied in format than the general laws, but most of them also provide for one or more of the standard defenses.

In 1982, twenty-eight states maintained either general SBC laws that applied to gasoline sales, or SBC laws specifically targeted at gasoline. Twenty-two states and the District of Columbia had no law applying to gasoline sales, though some of these jurisdictions did target other products.

The Effect on the Gasoline Market

Did these laws raise or lower gasoline prices? We examined weekly retail prices for 1982 from forty-three Standard Metropolitan Statistical Areas (SMSAs) as compiled by the Lundberg Survey, Inc. Nineteen of these areas were located in states that did not have a sales-below-cost law, while the other twenty-four were in states that did. For each SMSA, we computed the yearly average retail prices (excluding sales and excise taxes) of regular gasoline, including both leaded and unleaded, and both self-serve and full-serve, making a total of four combinations in all. Prices proved to be higher across the board in areas having an SBC law.

We were aware of the danger that a straightforward comparison might be too simple, since factors other than SBC laws also affect retail gasoline prices. We therefore developed an econometric model that correlated retail gasoline prices in an area with a range of other factors in addition to SBC laws, including wholesale prices, household income, labor costs, climate, land values, the number of service stations in an area, and the population of automobiles. We also classified the twenty-eight state SBC laws as either "strong" or "weak," depending on such factors as whether the law had been recently and successfully enforced, whether it was specifically targeted to gasoline or applied generally to all commodities, whether it required the plaintiff to prove anticompetitive intent, and whether it could be enforced by private parties.

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These much more refined correlations yielded both predictable and surprising results. After accounting for other factors, it turned out that prices for all four combinations of gasoline grade and service category were consistently higher in states with SBC laws than in states without them. In SBC states, leaded regular averaged 0.9 cents a gallon higher at the self-serve pump and 2.67 cents a gallon higher at the full-serve pump; unleaded regular averaged 0.68 cents higher for self-serve and 2.47 cents higher for full-serve. All these results were statistically significant, but the findings were statistically stronger for leaded than for unleaded gasoline.

What is surprising is the substantially greater impact of SBC laws on full-serve than on self-serve gasoline. Full-service gas carries a much higher markup than self-service gas: the average retail full-serve markup in 1982 was 20 percent for leaded and 21 percent for unleaded, compared to 4 and 7 percent for self-serve gas. In many SBC states, a retailer that prices its goods more than 6 percent above delivered cost is presumptively safe (though a plaintiff can still try to rebut the presumption). As a result, one might assume that SBC laws would not much affect products whose retail markups were greater than 6 percent. But with gasoline, at least, they did.

Another surprise was our finding that prices in states with "weak" SBC laws were inflated nearly as much as prices in states with "strong" laws. Prices for unleaded self-serve gas were indeed higher in strong-law than in weak-law states, as might be expected. But we found no statistically significant price differences between weak- and strong-law states when it came to any of the other three goods/service combinations.

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While all the price effects of SBC laws are reckoned in pennies per gallon, the cumulative impact on motorists is far from trivial. We estimate that in 1982 alone, the added cost to consumers of regular gasoline was more than $640 million. Based on the volume of gasoline sold in the various states, $600 million of this cost arose in the twenty-five states with general SBC laws; the remaining $40 million is attributable to the laws specifically targeted to gasoline. These figures do not include the cost borne by consumers of premium gasoline, which we did not estimate.

When a Bark Is as Good as a Bite

What is one to make of these findings? At a minimum, SBC laws are not dead letters. One way or another, they are costing consumers a lot of money. Precisely how this happens is less clear, in view of our findings that more expensive gas is more strongly affected and that the weak laws have nearly as much impact as the strong ones.

One partial explanation for the unexpectedly large effect on higher-priced gas might involve consumer substitution. Perhaps what happens is that SBC laws drive up self-serve prices, which in turn encourage consumers to move to the full-serve pumps, resulting in higher prices for that commodity. Since less gasoline is sold at full-serve than at self-serve, a small percentage reduction in self-serve purchases could translate into a relatively large percentage increase in full-serve purchases.

But this explanation is at best incomplete. In fact, the gap between self-serve and full-serve prices is higher in SBC states than it is elsewhere. A bigger price gap should encourage potential consumers to switch from full-serve to self-serve, not vice versa. While some of the increase in full-serve prices might be a side effect of higher self-serve prices, the SBC laws must also be affecting full-serve prices directly.

The laws, after all, provide a legal justification for avoiding losses—something most businessmen find desirable. A natural desire to obey the law, along with some possibility of being sued, may be enough to induce full-service retailers to keep prices high. This effect is more likely where most retailers find such a "statesmanlike" pricing policy to be profitable over the long run and where it tends to be industry practice to establish a standard price or markup that is easy to identify and comply with—what lawyers call a "bright-line" rule. Such a practice, if engaged in by many market participants, insulates merchants both from competition and from potential SBC liability. Retailer self-restraint would affect full-serve more than self-serve prices because price is a more important element in marketing competition for self-serve gas. This psychological effect might also explain why it makes little difference whether SBC laws are strong or weak. If the mere existence of the law is the mechanism for price coordination, the vigor with which the law is enforced may not matter much.

An example we found in Idaho may be relevant here. A brief price war in that state ended after one independent gasoline marketer threatened to file legal action against a competitor under the state's SBC law. No suit was in fact brought, the mere threat having been enough to restore peace. In short, SBC laws may commonly be used to communicate about price in ways that would otherwise be illegal.

Implications for Other Products

Regular gasoline constitutes about 9 percent of all merchandise sold in retail trade. Extrapolating boldly from the gasoline market to the larger economy, we would hypothesize that general SBC laws cost consumers more than

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Is direct extrapolation appropriate? Not if —as has commonly been assumed—SBC laws are effective only when the retail markup on a product is relatively low. But the greater impact of the laws on full-serve prices seems to contradict that assumption. And the average markup for full-serve gasoline is about the same as that for grocery stores and some other retail merchants.

Direct extrapolation is also inappropriate if other merchants' trade associations are less vigorous and well-organized than those of gasoline retailers, and thus less capable of enforcing price discipline. But there is no evidence that gasoline marketers have brought more than their share of recent actions under SBC laws. The case now pending in Oklahoma, for example, was brought by retail druggists.

Projections based on limited research are hazardous. However, because we can find little about gasoline marketing to preclude extrapolation to other markets, we tentatively conclude that SBC laws have a substantial effect on general consumer prices.

Why Gas Stations Are Fewer

For thirty years, the main policy rationale for SBC laws has been that they prevent "predatory" pricing by large firms aimed at smaller independent competitors. Predatory pricing consists of selling below cost with the intent to drive a competitor out of business and then reap monopoly profits. A true predatory campaign can be seen as an illegal form of investment: by losing money now in order to clear the field of rivals, the would-be monopolist can secure a comfortable profit in the future.

The last stage in this progression is both important and frequently overlooked. Predatory campaigns cannot last forever; they must culminate in a period of high prices and monopoly profits in order to make sense. Companies will not throw away their money on driving current competitors out of business unless there are actual or potential barriers to entry that will keep new competitors from entering to take the place of the old. In years of research on this topic, relatively few verified examples of predation have been found, and in most of these some law or government regulation has served as the requisite barrier to entry.

SBC laws entirely neglect the question of whether today's low prices are likely to lead to future monopoly profits. Some of the laws require an intent to harm a competitor, but many do not. And none requires proof that a defendant has the ability to monopolize the market in question. As a result, the laws inhibit both anticompetitive predatory pricing and vigorous competition. While both forms of conduct may be found in the American economy, all evidence suggests that the latter is far more common than the former and far more commonly suppressed by such laws. SBC laws do not, on balance, make sense as a curb on predation.

The laws seem particularly inappropriate in the field where they are currently attracting much support, the retail market for gasoline. Two massive studies of gasoline marketing by the U.S. Department of Energy—we participated in one of them—found no evidence that there is widespread predatory pricing in the retail gasoline market. (See *The State of Competition in Gasoline Marketing*, 1981, and *Deregulated Gasoline Marketing: Consequences for Competition, Competitors, and Consumers*, 1984.) Instead the studies found that consumers are the prime beneficiaries when retailers compete vigorously.

Gasoline retailers and wholesalers have persisted, however, in accusing refiners of anticompetitive practices. As evidence, they cite the dramatic decline in the number of independent gasoline dealers over the past fifteen years.* The

*Their chosen remedies include not only SBC laws but also other protective legislation at both federal and state levels, including laws restricting a refiner's right to terminate a franchisee, prohibiting refiners from operating their own retail outlets, and restricting the price at which refiners can sell to various classes of trade. For more details, see "A Dubious Bill of Divorcement: The Case of Oil Refiners and Gas Stations," by John Barron and John Umbeck, *Regulation*, January/February 1983.

Department of Energy studies cast doubt on the accusation. They found that the decline in the number of dealers has been brought about primarily by an ordinary change in the market: because of several factors, it has become more costly to operate large numbers of low-volume, full-service outlets. One of these factors, the studies hypothesized, was the rapidly increasing cost of roadside land suitable for stations. Our current research provides quantitative support for this interpretation. As land costs (represented by appraised housing values) increase in an area, the number of retail gas stations per capita decreases sharply. In common-sense terms, as corner plots become more valuable, it becomes less profitable to maintain low-volume gas stations there. Twenty years ago, three or even four corners at a suburban crossroads could have been occupied by gasoline dealerships; now one corner will be occupied by a Wendy's or a McDonald's and another by a branch bank. But that is how the market is supposed to operate, and there is no reason to try to arrest the process by law.

Another normal market factor, the growth of self-service marketing, may also have contributed to the decline in service station numbers. Self-service gasoline has risen from about 2 percent of retail gas sales in 1969 to about 75 percent today. The average volume of a self-serve outlet is much greater than the volume of a full-serve outlet, which further reduces the number of stations needed to meet the gasoline demand. The popularity of self-serve gas is, once again, a reflection of normal market forces. Consumers prefer it, our research clearly shows, because it is cheaper, and it is cheaper largely because of its lower labor costs. Minimum wage employees are the largest single item on a full-serve retailer's list of operating expenses, and both the scope of coverage and the real level of the minimum wage has increased markedly over the past fifteen years.

IN GASOLINE MARKETING, as in other retail sectors, there is little evidence that sales-below-cost laws represent a needed response to market imperfections. They may offer some temporary protection for high-cost retailers, but they cannot reverse the changing economics of the marketplace. And for consumers—who also deserve consideration—they offer little but higher prices and market stagnation. ■