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Why retailers should increase water prices after hurricanes

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What do landlords, foreign holiday resorts, Uber, and bottled water retailers in Houston have in common?
In recent years, all have been criticised for charging “excessive” or “extortionate” prices for their products. Landlords are accused of greedy profiteering in London.

Thousands signed petitions in 2014 criticising airlines and holiday companies for charging much more during school holidays – an issue eventually discussed in parliament.

Uber was panned for its surge pricing following the 2016 New York terror attack. And the selling of water at higher-than-normal prices following Hurricane Harvey in Texas was met with outrage.

The assumption of the upset in each case seems to be that firms decide their prices in the absence of any consideration of broader market conditions, purely on the basis of exploiting consumers and greedily fattening their profits.

The reality is quite different. In competitive markets, price tags are simply messengers of relative scarcity, or the interactions of supply and demand.

Rent levels are high in London because the supply of new properties is very unresponsive to demand, which rises through population and income growth.

Foreign holidays are more expensive in school holidays because demand explodes.

Uber pricing surges after terrorist atrocities because there’s a huge unforeseen spike in those wanting vehicles to depart the area, and a reluctance to use public transport.

And bottled water prices rise before and after hurricanes as demand rises (people stock up in case of losing water supplies), and supply falls (due to the increased costs and difficulty of delivery).

Price then is the market's messenger. It conveys important information about the relative scarcity of a product, which leads to adjustments in the quantity demanded or the quantity supplied. And it actually leads to some changes in behaviour that can be beneficial given the economic reality.

When prices are high because of restricted supply, such as bottled water in the aftermath of hurricanes or rental property in London, the price tag encourages a reduction in the quantity demanded.

The high price deters people from stockpiling bottled water, for example, making it likelier more consumers can obtain the product in stores. A high rental price in London likewise leads to people renting smaller apartments or commuting from further away, allocating the scarce properties within the city more efficiently to those who place the highest value on being closer to the city centre.

When prices are high because of increased demand, such as Uber surging following terror attacks, or foreign vacations during school holidays, the higher price likewise helps increase the quantity supplied. It encourages Uber drivers to come onto the road to service the increased needs of passengers, or airlines and hotels to ensure more rooms are available.

The longer term effect is perhaps even more important. If prices really are "too high", and companies are able to make large profits as a result, then new firms or entrepreneurs are encouraged to enter and serve the market. This increases overall supply and brings prices back down.

Arguably, Uber itself has done this, acting as a substitute for the taxi market, as has Airbnb in expanding the supply of rentable accommodation. As the hurricane pressures subside, a high market price will encourage lots of businesses who supply bottled water from further afield to bring their goods to this lucrative market.

The price mechanism plays an important role in both coordinating activity and allocating resources efficiently, which is why it can be so damaging to call for price controls that muffle these signals.

From rent controls, to bans on surge pricing, or laws that prohibit price gouging, restraining prices from increasing is akin to capturing the messenger and forcing him to tell a comforting lie (as my former colleague Kristian Niemietz has explained).

This comforting lie signals to people "this product is readily available", encouraging consumers to load up on it, and severely restraining firms' ability to make profits, thus discouraging innovative new supply.

The truth is, there are only two ways scarce goods or services can be allocated: either through the price system, allowing markets to clear, or through restrictions such as rationing or queuing. Difficult situations – including emergencies such as hurricanes or terror attacks, and decades of overly-restrictive planning laws – have limited positive outcomes.

But while we would all prefer goods to be cheap and abundant all the time, willing prices lower through legislation, price controls or consumer campaigns merely compounds the relative scarcity by discouraging new supply and encouraging over-use.

If we really want cheap goods, the only way forward is to remove restrictions on new entry as far as possible and to allow markets to operate.

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