

## Lecture notes companion 3 (Chapter 5)

### A. Can demand curves slope upward? (1) The case of the (elusive) Giffen good

During the Irish potato famine of the 1840's, the economist Sir Robert Giffen observed—or at least thought he observed—a paradox which still bears his name. By the mid-nineteenth century, potatoes had become the main agricultural crop grown in Ireland, and were almost the only crop planted in some areas. A virus epidemic caused a blight which destroyed a very large part of the crop in 1845 and following years. This great decrease in the supply of potatoes, of course, drove the price sharply higher. Many people perished in the famine, and millions of others emigrated to America and such English cities as Liverpool. (Even today, Ireland's population is smaller than it was before the famine.) Giffen believed that many families, however, actually *increased* their consumption of potatoes as the price rose, a seeming exception to the law of demand. How can this be explained?

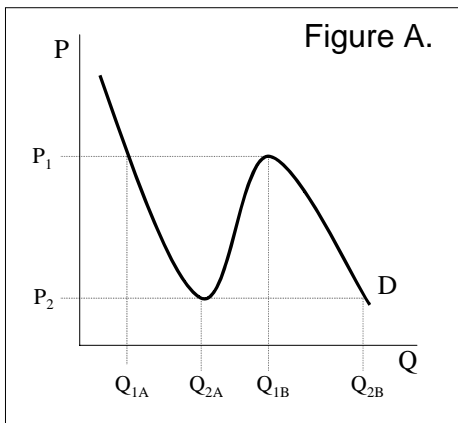
Recall that, when the price of a good changes, there are *two* effects that modify the quantity demanded. First, and usually by far most important, consumers substitute cheaper goods for dearer (more expensive) goods. The strength of this effect depends on the number and closeness of available substitutes. The effect on quantity demanded is always in the opposite direction of the change in price: An increase in price causes consumers to substitute away from a good and hence quantity demanded falls. The second effect, which is usually much weaker, is the income effect. An increase in the price of a good effectively reduces the consumer's income and hence spending on all goods, including the one which underwent a price increase. But this effect can either accentuate or offset the substitution effect; in the case of an inferior good, an increase in price leads to a fall in income which leads to an increase in quantity demanded!<sup>1</sup>

So how can a good be Giffen? Three characteristics are probably necessary: (1) When the price of a good increases, there must be few if any close substitutes, or available substitutes must still be relatively expensive even after the price increase. Thus, the substitution effect will be weak or nonexistent. (2) The consumer must spend a large proportion of his or her income on the good, so that the income effect—which is usually weak—is instead very strong.<sup>2</sup> (3) The good must be strongly inferior. Thus, the substitution effect is negligible, the income effect is strong and moves quantity demanded in the “wrong” direction.

Were potatoes in Ireland really a Giffen good? Nobody knows for sure, since reliable data on the subject are nonexistent. Are there any other instances of Giffen goods? No researcher has ever conclusively shown that one exists, so it is in the same category as the Loch Ness Monster and the Abominable Snowman. Regardless, the theoretical case of the Giffen good is a good thought exercise to help us understand the substitution and income effects.

### B. Can demand curves slope upward? (2) Trends and demand

The following excerpt from “Why a queue?” *The Economist*, 2/8/92, explains another reason why demand curves might slope upward. It summarizes an article by Gary Becker.<sup>3</sup>



Why, [Becker] pondered, did one restaurant refuse reservations and have a queue outside at peak times, when a similar one across the street seemed never more than half-full? Why did the restaurant with the queue not charge more? Being a fine economist, Mr Becker decided not to ask, but to work it out from first principles.

The answer, he argues, is that certain goods are demanded partly, if not primarily, because other people demand them, too. These are not “Giffen goods” (where the relationship between demand and price is peculiar because the good makes up a large part of the consumer's budget). Mr Becker is concerned with otherwise ordinary goods, that are preferred for their popularity. A queue is an indicator of this crowd effect. People want to eat at restaurants that are “in”, go to the “big” game, see the new block-busting movie, pretend to have read the latest best-selling novel. It need not be that the queue is a mark of quality: as far as Mr Becker is concerned, what is in or out may be entirely arbitrary. But once something has been designated as “in” (a cheap wristwatch, “A Brief History of Time”), people want it for that reason alone.

Perhaps this seems obvious. But next Mr Becker draws the demand curve for such a product, and suggests some striking properties. To begin with, Mr Becker surmises, the demand curve might slope downwards in the normal way: the cheaper the good, the greater the demand. But after a certain point, the good's popularity itself generates further demand, allowing the producer to raise the price and still sell more—that is, the demand curve slopes upwards. But eventually another turning-point is reached, where price rises begin to outweigh the good's popularity. Beyond this point, to achieve further increases in sales, prices must be cut again: in this third phase, the demand curve slopes downwards once more. (See Figure A.)

### Status goods and conspicuous consumption

Economists largely ignored the consumption of goods for the acquisition of social status until the publication of Thorstein Veblen's *The Theory of the Leisure Class* in 1899. In it, Veblen developed the concept of *conspicuous consumption*—that is, consuming goods for the

<sup>1</sup> Actually, an increase in *demand*; but in the Marshallian or “ordinary” demand curve framework, the distinction is blurred.

<sup>2</sup> Consider a 5 percent increase in the price of a \$2 pack of hot dogs, which are commonly thought of as an inferior good. If you buy one pack of hot dogs every two weeks, the income effect of that 5 percent price increase—that is, of the 10 cent *decrease* in available income—will be negligible. But a 5 percent increase in apartment rents will have a larger income effect because a larger share of income is spent on that.

<sup>3</sup> Becker, Gary S. “A Note on Restaurant Pricing and Other Examples of Social Influences on Price.” *Journal of Political Economy*, October 1991.

purpose of being seen consuming them by others. And for almost a century after that, despite the popular acclaim of Veblen's theory, the economics profession still ignored status. But in the past decade or so, great interest—and lots of research, including your instructor's doctoral dissertation—has been directed at this topic.

The idea is simple. Why do people consume goods? To satisfy basic biological "needs" (that word!)—hunger, thirst, and protection from the elements. But what about automobile travel and computers and vacations at the beach? Apparently, we consume goods to make us feel better—to increase our utility—in other ways, too. But what about driving a Cadillac Escalade or a Mercedes? And having to have the fastest computer in the office even though you never use more than a fraction of its power? And vacations at the beach can range from a weekend in a rental cabin at a state park or a month in an expensive time-share condo in a tony resort town.

Veblen made the crucial distinction between the "instrumental" and the "ceremonial" uses of resources for consumption. Buying and driving a car to get you around to where you want to go is *instrumental*; buying a head-turning, expensive car is *ceremonial*, and is intended to raise your status among your peers. Expensive goods confer status, and if they rise in price, that's all the better.

If you look around you, you will see that much of the consumption in our society (indeed, any society that provides people with more than bare subsistence) is not intended to benefit the consumer directly, but is meant to impress other people and so provide the consumer with utility derived from gaining status. Here are a few not-quite-random observations to illustrate.

- Why do people choose the colleges they do for their kids? I have a status-obsessed neighbor (actually, I have a *lot* of status-obsessed neighbors) who is sending his older daughter to Vanderbilt. Why Vanderbilt? Well, it's a good school, and it's not too far from home, and . . . it's a way to advertise how much money he makes, because everybody knows that Vanderbilt tuition isn't cheap. Another neighbor has sent his two daughters to obscure but very, very expensive colleges in the northeast. I don't think the girls are very bright, but money talks. Which is all the better from a status perspective—if your friends and acquaintances know your kids are dim bulbs, but you manage to get them into an expensive school anyway, well, that's a sure sign that you really are loaded. Sometimes I think the main reason people send their kids to upscale colleges is to be able to put the college's sticker on the rear window of their car.
- There are motorcycles, and then there are Harleys. Maybe Harley-Davidson riders choose their bikes because they really, really prefer them over other makes, and derive utility from them in a practical, that is, instrumental, way. But given the number of Harley riders who wouldn't be caught dead on a Suzuki, I have to conclude that that there's more to it than that.
- Weddings have been a favorite way of advertising status for centuries. (Consider the numerous references to ostentatious weddings in both the Old and New Testaments.) What better way to show that you have so much wealth that you can afford to just burn money than to blow thousands on your daughter's wedding? This morning, my family and I were discussing this, since my wife is playing the organ in a wedding this Saturday. The bride is the daughter of the owner of a very large, very successful construction company in Huntsville. I anticipate that it will be an event marked with ostentation and excess at every turn. (They have a wedding director, which my wife tells me is standard procedure for these things.) We noted that it's nothing for a really wealthy family, even in Huntsville, to spend over a half-million dollars on a wedding. (My poor 12 year old daughter observed that she would probably have to make do with only \$300,000 for her wedding. I told her to divide by a hundred.) What purpose does all this spending serve? Does it make the couple any more likely to stay married? No, but it's a great way for dad to show the world that he's made it, big. Flowers and food and chefs and booze and a huge wedding dress and on and on . . . there's no end to what you can do with a wedding to show off.
- The development of the lawn in western societies is an interesting case. In earlier, poorer, times, people grew wheat and barley and other staple crops on whatever land they could cultivate. Land that was planted in grass would be used strictly for instrumental purposes—keeping cows or goats or sheep. Then, in the 18<sup>th</sup> century, rising output levels and hence the rising incomes made it possible for some particularly wealthy individuals to grow some grass for a less important instrumental purpose, to provide a place for play and leisure. Since grazing animals were kept off these areas (to eliminate manure), the grass had to be cut short, which was costly. Since these lawns were right in front of the owner's houses, where everybody could see them, they also developed a ceremonial purpose. They were a great way to demonstrate how wealthy you were. After all, if ordinary poor schnooks could only afford to keep a grassy plot if it paid its way, you could show off by having a lawn that not only didn't provide food but also cost you to keep it up! And so lawns became bigger and showier. And once everyone had lawns, then you could only keep your status by having better lawns, so Tru-Green and other lawn maintenance services came into being. I can't keep count of the people I've spoken to who complain about how much grass they have to mow, and about how big a lawn mower they have to have, and are even thinking of getting a bigger mower . . . Sometimes I have suggested that they simply sell the property, or plant trees on it, or just let part of it go to wild flowers and grasses. They don't, of course, because the main reason to have such a big lawn is that you can tell people about it. Come to think of it, I don't have much of a lawn, but I do have a flower garden that covers almost the entire area between our house and the street (and we live on a corner lot). I grow it mostly because I like flowers and plants and so does my family, i.e., my purpose is instrumental. Surely I don't do it to show off, do I?
- Cars. The automobile is an essential part of American society, and it's no surprise that we use our cars to gain status. Wealthy individuals buy expensive imported cars (German cars are really big in Huntsville, probably because a) there are so many engineers, and engineers are generally impressed by well-engineered cars, and b) the large Army population, many of whom served in Germany, give German cars a certain cachet with them. Young men seeking to impress their friends and chicks go for Mustangs and the like. Corvettes are preferred by a different group; they are expensive, and so are restricted to older men with higher incomes, and have a different image—I think they connect with a segment of the Harley culture somehow. And young rednecks go for big, jacked up, 4-wheel drive pickups. (Back in the '70s and '80s there seemed to be a sort of arms race to see who could put the biggest tires on their trucks, with the result that the road was covered with trucks that looked like tractors. These have become pretty rare now.) Married women like expensive SUVs; single women, sexy little convertibles. (There's a reason why so many convertibles are red. If you want to stand out, red's the ticket.) And you would think that rising gas prices would kill the market for big, overgrown, gas-guzzling SUVs. While sales of these have fallen, they are still quite popular. What better way to advertise your wealth than to have your wife tooling around town in car that everyone knows gets only 13 miles to the gallon?

For an interesting summer read, you can pick up a copy of Veblen's book and read it. There's no math, unlike modern economics works, and you'll find it illuminating. (You can even read it free online; one source is <http://xroads.virginia.edu/~HYPER/VEBLEN/veblenhp.html>)