Economics for the Citizen, Part IV

BY WALTER E. WILLIAMS

There's a reggae song that advises, "If you want to be happy for the rest of your life, never make a pretty woman your wife." Mechanics have been accused of charging women higher prices for emergency road repairs. Airlines charge business travelers higher prices than tourists. Car-rental companies and hotels often charge cheaper rates on weekends. Transportation companies often give senior-citizen and student discounts. Prostitutes charge servicemen higher prices than their indigenous clientele. Gasoline stations on interstate highways charge higher prices than those off the interstate. What are we to make of all of this discrimination? Should somebody notify the U.S. attorney general?

The fact that sellers charge people different prices for what often appear to be similar products is related to a concept known as elasticity of demand, but we won't get bogged down with economic jargon. Think about substitutes. Take the reggae song's advice about not taking a pretty woman as a wife. Pretty women are desired and sought after by many men. An attractive woman has many substitutes for you, and as such, she can place many demands on you. A homely woman has far fewer substitutes for you and can less easily replace you. Hence, she might be nicer to you, making what economists call "compensating differences."

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It's all a matter of substitutes for the good or service in question and the buyer's willingness to pay a higher price. Business travelers have less flexibility in their air-travel choices than tourists. Women generally see themselves as having fewer alternatives for emergency auto repairs. A man might have more knowledge about making the repair or be more willing to risk hitchhiking or walking. A prostitute might see a sailor on shore leave as having fewer substitutes, not to mention pent-up demand, for her services than the area's residents. Motorists traveling from city to city are less likely to have information about cheaper gasoline prices than local residents.

Politicians seem to ignore the idea of substitutability, namely, when the price of something changes people respond by seeking cheaper substitutes. New York City raised cigarette taxes, thereby making a pack of cigarettes $7. What happened? A flourishing cigarette black market emerged.

In 1990, when Congress imposed a luxury tax on yachts, private airplanes, and expensive automobiles, Senator Ted Kennedy and then-Senate Majority Leader George Mitchell crowed publicly about how the rich would finally be paying their fair share of taxes. But yacht retailers reported a 77 percent drop in sales, and boat builders laid off an estimated 25,000 workers. What happened? Kennedy and Mitchell simply assumed that the rich would behave the same way after the imposition of the luxury tax as they did before and the only difference would be more money in government coffers. They had a zero-elasticity vision of the world, namely, that people do not respond to price changes. People always respond, and the only debatable issue is how much and over what period.

This elasticity concept is not restricted to what are

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generally seen as economic matters; it applies to virtually all human behavior. When a parent asks his child, "How many of your privileges must I take away to get you to behave?" that's really an elasticity question. In other words, how great must the punishment be for the child to misbehave less? It's easy to see how the elasticity concept applies to law enforcement as well. What must be done to the certainty of prosecution and punishment to get criminals to commit less crime?

Economic theory is broadly applicable. However, a society's property-rights structure influences how the theory will manifest itself. It's the same with the theory of gravity. While it too is broadly applicable, attaching a parachute to a falling object affects how the law of gravity manifests itself. The parachute doesn't nullify the law of gravity. Likewise, the property-rights structure doesn't nullify the laws of demand and supply.

Property rights refer to who has exclusive authority to determine how a resource is used. Property rights are said to be communal when government owns and determines the use of a resource. They are private when it's an individual who owns it and has the exclusive right to determine how it is used. Private property rights also confer on the owner the right to keep, acquire, sell, and exclude from use property deemed his.

Property rights might be well-defined or ill-defined. They might be cheaply enforceable or costly to enforce. These and other factors play a significant role in the outcomes we observe. Let's look at a few of them.

A homeowner has a greater stake in the house's future value than a renter. Even though he won't be around 50 or 100 years from now, its future housing services figure into its current selling price. Thus homeowners tend to have a greater concern for the care and maintenance of a house than a renter. One of the ways homeowners get renters to share some of the interests of owners is to require security deposits.

Here's a property-rights test question. Which economic entity is more likely to pay greater attention to the wishes of its clientele and seek the most efficient methods of production? Is it an entity whose decision-makers are allowed to keep for themselves the monetary gain from pleasing the clientele and seeking efficient production methods, or is it an entity whose decision-makers have no claim to those monetary rewards? If you said it is the former, a for-profit entity, go to the head of the class.

While there are systemic differences between for-profit and nonprofit entities, decision-makers in both try to maximize returns. A decision-maker for a nonprofit will more likely seek in-kind gains, such as plush carpets, leisurely work hours, long vacations, and clientele favoritism. Why? Unlike his for-profit counterpart, the monetary gains from efficient behavior are not his property. Also, since a nonprofit decision-maker can't capture for himself the gains and doesn't suffer losses, there's reduced pressure to please clientele and seek least-cost production methods.

Tax-Wrought Changes

You say, "Professor Williams, for-profit entities sometimes have plush carpets, have juicy expense accounts and behave in ways not unlike nonprofits." You're right, and again, it's a property-rights issue. Taxes change the property-rights structure of earnings. If there's a tax on profits, then taking profits in monetary form becomes more costly. It becomes relatively less costly to take some of the gains in nonmonetary forms.

It's not just managers who behave this way. Say you're on a business trip. Under which scenario would you more likely stay at a $50-a-night hotel and eat at Burger King? The first scenario is where your employer gives you $1,000 and tells you to keep what's left over. The second is where he tells you to turn in an itemized list of your expenses and he'll reimburse you up to $1,000. In the first case, you capture for yourself the gains from finding the cheapest way of conducting the trip, and in the second, you don't.

These examples are merely the tip of the effect that property rights have on resource allocation. It's one of the most important topics in the relatively new discipline of law and economics.