Economics for the Citizen, Part III

BY WALTER E. WILLIAMS

Someone might have made you a gift of *The Freeman*. Does that mean reading this article is free? The answer is a big fat no. If you weren't reading the article, you might have watched television, talked to your wife, or worked on your homework. The cost of having or doing anything is what had to be sacrificed. While reading this article might have a zero price, it most assuredly doesn't have a zero cost.

To reinforce the idea that price is not the full measure of cost, imagine that you live in St. Louis. The barber who cuts your hair charges $20. Suppose I told you that a barber in Charleston, S.C., would charge you $5 for an identical haircut, would you consider the Charleston haircut cheaper? While it has a lower price, it has a much greater cost. You'd have to sacrifice much more in terms of time, travel, and other expenses to get the Charleston haircut.

People often erroneously think of costs as only material things, but that which is sacrificed when a particular choice is made can include clean air, leisure, morality, tranquility, domestic bliss, safety, or any other thing of value. For example, a possible cost of a night out with the boys might be the sacrifice of domestic bliss.

Costs affect our choices in many ways, and for the purposes of this discussion we're going to assume that all the costs associated with a given choice are borne by the chooser.

Just about the most important generalization that we can make about human behavior is that the higher the cost of a particular choice the less of it will be chosen and the lower the cost the more of it will be chosen. This generalization underlies the law of demand. For simplicity let's assume price measures cost while we hold everything else influencing choice constant. The law of demand can be expressed several ways: the lower the price of something, the more will be taken; and the opposite is true of the higher price. We can also say there exists a price whereby one can be induced to take more or less of something. Finally, there's an inverse (reverse) relationship between the price of a good and the quantity demanded.

Why do people behave this way? The answer in a word or two is that people try to be as happy as they can. For example, if, when the price of oil rose, people simply ignored the price increase, they'd have less to spend on other things and be less happy. If they sought substitutes for the higher priced oil, they'd have more money left over and they'd be happier. That's why higher oil prices give people incentive to purchase more insulation, buy better windows, wear sweaters, and maybe move to a warmer climate. These choices, and many more, are substitutes allowing you to use less oil.

When people say a certain amount of one thing or other is an absolute must, that's like saying the law of demand doesn't exist and there are no substitutes. That's untrue—consider a diabetic. Can he do without 50 units of insulin a day? The law of demand says that at some price, say at a $1,000 a unit, he can. There's always at least one substitute for any good: doing without the good all together. In the diabetic's case, no insulin. While going without insulin has unpleasant consequences, it's a likely substitute at $1,000 a unit. You say, "Williams, that kind of economic analysis is cruel!" It's no more cruel than the law of gravity that predicts that if you jump off a skyscraper you're going to die. Both outcomes are unattractive, but it's reality. Indeed, tragically millions of our fellow men around the globe are forced to endure the unpleasant substitute for insulin.

There's a complexity to the law of demand that states: the lower the price the more people will take of something and the higher the price less will be taken. It's crucial to recognize that it's relative prices that determine choices, not absolute prices. Relative price is one

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price in terms of another price. Here's an example; actually it's a trick I pull on freshman students. Suppose your company offered to double your salary if you'd relocate to their Fairbanks, Alaska, office. Would you consider it a good deal and accept the offer? Some students thoughtlessly answer yes. Then I ask what if, on arrival, you find out that rents are more than double what you're paying now and the prices of food, clothing, gasoline, and other items are three and four times more expensive. The end result is that while your absolute salary has doubled, your salary, relative to other prices, has fallen.

A bit trickier example of how it's relative prices, not absolute prices, that influence behavior comes with the observation that married couples with young children who can't be left alone tend to choose more expensive dates than married couples without children. The couple's income and tastes have little to do with their decision; it's relative prices. Keeping the numbers small, say an expensive date, dinner and concert, has a $50 price tag and a cheap date, a movie, $20. The choice of the $50 dinner and concert requires that the married couple without children sacrifice two and a half movies that they could have otherwise enjoyed.

The married couple with children must pay a babysitter $10 whether they go on the expensive or cheap date. With the cost of the babysitter figured in, the dinner and concert will cost them $60 and the movie $30. In choosing the dinner and concert, they sacrifice only two movies. That date is therefore relatively cheaper for the married couple with children. Since it's cheaper we can expect to observe married couples with children taking more expensive dates when they go out. It doesn't take economic analysis to come up with this. A husband might suggest, "Honey, let's hire a babysitter and take in a movie." The wife explains, "That doesn't make sense. Since we have to pay $10 for a babysitter, whether we go on a cheap or expensive date, why not get our money's worth and take in a dinner and concert?"

Rising Coffee Prices

How about another example of relative prices? Suppose today's coffee price is $1 a pound and you typically purchase two pounds per week. You hear news that a freeze in Brazil destroyed much of its coffee crop and coffee prices are expected to soon rise. What would you do and why? I'm guessing you'd make larger coffee purchases now, but why? The average person would answer, to save money. That's an okay answer, but it doesn't tell the whole story. Once again it's the law of demand working. If coffee prices are expected to rise next week, that means coffee prices this week have fallen relative to those next week, and the law of demand says that when a price of a good falls people will take a larger quantity. It works in reverse as well. If coffee prices are expected to fall next week, you'd buy less coffee this week. Why? Coffee prices have risen this week relative to next week.

You might be tempted to ho-hum this coffee analysis as oversimplification, but it is the basic principle underlying the complexities of futures markets such as the Chicago Mercantile Exchange, where people, as speculators, become rich, sometimes poorer, guessing the future prices of commodities.

Our next lecture will see what the law of demand says about discrimination and other choices we make.