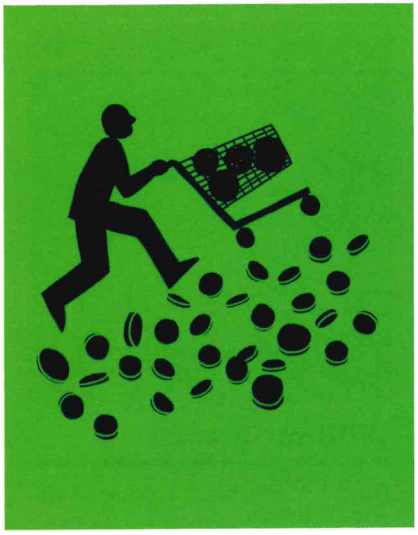


WHEN THE PRICE GOES UP, SOME PEOPLE BUY MORE

SPENDING PARADOXES

IN CONTEXT

FOCUS
Decision making

KEY THINKER
Robert Giffen (1837–1910)

BEFORE
1871 Austrian economist Carl Menger demonstrates how the demand for commodities is determined by their marginal utility.

AFTER
1909 British economist Francis Edgeworth doubts the existence of Giffen goods in *Free Trade in Being*.

1947 US economist George Stigler dismisses Marshall's examples of Giffen goods in *Notes on the History of the Giffen Paradox*.

2007 US academics Robert Jensen and Nolan Miller revive the argument in *Giffen Behavior: Theory and Evidence*, which reports the existence of a Giffen good in poor, urban areas of China.

In 1895, British economist Alfred Marshall (p.110) demonstrated how supply and demand create the price of goods. After he explained the general rules, such as the greater the demand, the smaller the price, he went on to show how there can be an interesting exception. Marshall suggested that a price rise could, in some circumstances, create a surprising increase in demand. He attributed the discovery of this exception to a well-known Scottish economist and statistician of the time, Sir Robert Giffen. Today, commodities for which demand rises as their prices rise are known as Giffen goods.

The original Giffen good was bread, the most important staple of the poorest section of the British population in the 19th century. The poorest of the working classes spent a large part of their income on bread, a food that was necessary for life but was seen as inferior to the perceived luxury of meat. Marshall said that as the price of bread rose, the poorest people had to spend more of their income on bread to get enough calories to



See also: Supply and demand 108–13 ▪ Elasticity of demand 124–25 ▪ Conspicuous consumption 136

survive—they had to buy bread instead of meat. As a result, if the price of bread increased, so did demand.

Inferior and poor

Giffen goods rely on a number of assumptions. First, the commodity has to be an inferior good, that is, a good that people choose to buy less of as their income rises because there are better alternatives—in this case meat in preference to bread. Second, the consumer must spend a large portion of their income on this product, hence the fact that the example refers to the poorest section of society. Finally, there must be no alternatives to the product. In the case of bread, there is no cheaper alternative staple.

Given these assumptions, an increase in the price of bread creates two effects. It causes people to buy less bread because the satisfaction it creates per pound of spending falls compared to other goods. This substitution effect would cause bread to follow the general rule of higher price causing lower demand. However, as the price of bread rises, it also reduces the power to spend on other things, and because bread is an inferior good, this lower income will make the demand for bread rise. What makes the Giffen good so special is that because the poor spend so much of their income on bread, the income effect is so large that it outweighs the substitution effect, and so when the price goes up, some people buy more. Another example of a Giffen good is that of potatoes during the Irish Potato Famine of 1842–53, where rising prices allegedly caused an increase in the demand for potatoes.

Elusive evidence

Marshall came under attack from Francis Edgeworth (1845–1926), another British economist, for postulating the existence of a good that contradicts a basic rule of demand, without any hard evidence. In theory, Giffen goods are consistent with consumers' behavior—the interaction of income and substitution effects—that underlies demand curves. But if Giffen goods exist at all, they are rare: evidence comes from special contexts, and some of the most famous cases are dubious. Yet economists continue to search for them. In a 2007 study Harvard economists Robert Jensen and Nolan Miller presented evidence of Giffen behavior in the demand for rice among poor families in China. ■



A girl buys rice in Bangladesh, where the government subsidized the price of staples in 2011 in a drive to improve food security for the poor.



A new Rolls Royce limousine goes on show in Shaanxi Province, China. Economists believe that luxury cars are desirable for their high price.

Veblen goods

Veblen goods are named after Thorstein Veblen, a US economist who formulated the theory of "conspicuous consumption" (p.136). They are strange because demand for them increases as their price rises. Unlike Giffen goods, however, which must be inferior, these goods must signal high status.

A willingness to pay higher prices is to advertise wealth rather than to acquire better quality. A true Veblen good, therefore, should not be noticeably higher quality than the lower-priced equivalents. If the price falls so much that it is no longer high enough to exclude the less well off, the rich will stop buying it.

There is much evidence of this behavior in the markets for luxury cars, champagne, watches, and certain clothing labels. A reduction in prices might see a temporary increase in sales for the seller, but then sales will begin to fall.