

down, consumers buy more of a commodity and vice versa. The demand curve drawn from this schedule is shown in Fig. 4.3. Along x-axis, quantity is measured and along y-axis price of the commodity is measured. By joining various points or combinations of price and quantity demanded, we get a curve 'dd' falling downwards from left to the right. This is known as the demand curve. The demand curve clearly indicates that price is inversely related to quantity demanded. As price falls, demand rises and it shrinks when price rises. It is to be noted here that we have assumed 'other factors' to be constant. Thus, any changes in these factors such as tastes, fashion, income or prices of related goods etc, will falsify the law of demand. In that case, the demand curve will not behave in the manner stated above. For instance, if income of consumer rises at the time when price of goods have risen, demand will not go down. Rather, it may increase. We do not bother of rise in price of goods when our income also increases.

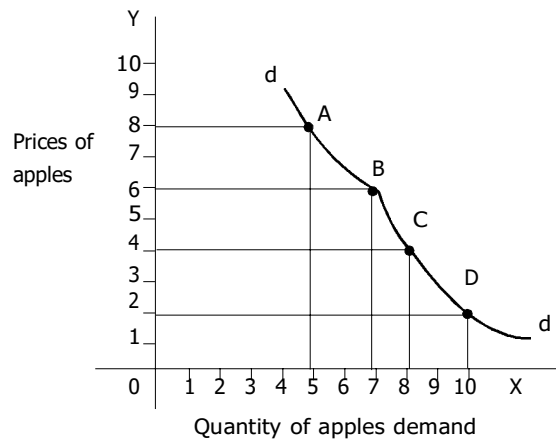


Fig. 4.3

Why does the Law of Demand Operate?

Demand curve by and large slopes downward to the right. This is because of operation of the law of diminishing marginal utility. When the price of a commodity decreases, new demand is created. Also that existing buyers buy more. As the particular commodity has become cheaper, some people will purchase it in preference to other commodities. If the law of diminishing marginal utility is true, the demand curve must slope downwards. This is because only a downward sloping demand curve represents increase in demand due to fall in the prices of a commodity. Further, when price of a commodity falls, real income of the people increases. In other words, they are able to buy more goods and services now with the same amount of money they have. This is called **income effect**.

Likewise, when the commodity is cheaper, it tends to be substituted for other commodities, which are dearer. This is called **substitution effect**. Both income effect and substitution effect together increase the capacity of the consumers to buy more of a commodity, when its price comes to low level.

Another reason for downward sloping demand curve is that when a commodity becomes cheaper, it can be put to more uses or not so urgent uses. This also makes demand to be greater when price falls.

Exceptions to the Law of Demand

There are a few exceptions to the law of demand. It means those conditions when the law does not hold good. These are:

1. There are certain goods called as Giffen goods. In case of such goods, the law of demand does not hold good. Sir Francis Giffen observed that when Irish potato prices increased in bad years, people curtailed spending on other commodities and increased their spending on potatoes. Because with high potato prices and no increase in their money incomes, they were now too poor to afford meat and other foodstuffs. So they had to sustain themselves by eating more potatoes. That is people demanded more potatoes when their prices increased and vice versa. This is called **Giffen Paradox**. (Also see note on Giffen goods at the end of this chapter.)
2. In case of conspicuous consumption, as observed by Thorstein Veblen, the demand curve does not slope downwards. Sometimes people buy some products to show their status in the society. The possession of such commodities, they feel, may confer a higher level of social status on their holder. These goods are diamonds and other precious stones etc. Rich class buys such goods at very high price to show that they belong to a prestigious class. (Also see note on Veblen goods at the end of this chapter.)
3. The law of demand also not applies to a commodity whose quality is judged by its high price. At high prices, some people buy more of such commodity than at lower price thinking that high priced are better than those priced lower. This is out of sheer ignorance that people act in such a way.
4. Speculation (a guesswork or prediction of a future event and act accordingly) is another exception to the law of demand. If the price of commodity is increasing and people expect a further rise in the price, they will tend to buy more of the commodity at higher price than they did at the lower price. It is observed that when there is a hike in edible oil prices recently, some people purchased more of it in the expectation that future prices will be even more.

MOVEMENT ALONG AND SHIFTS IN DEMAND CURVE

A distinction between movement along the demand curve and shifts in the demand curve is very important while studying demand theory. Movement along the demand curve takes place when there is a change in price of a good, other things remaining same. This is also termed as a change in Quantity demanded. That is changes in demand due to a change in the price of a commodity, other things being equal. In other words, when either due to increase or decrease in the price of a good, the demand increases, then it is seen that the demand curve remain the same; only the equilibrium position on the demand curve is changed. This is called extension and contraction in demand. Thus when quantity demanded of a good rises due to the decrease in price alone, it is said that extension of demand have taken place. And quantity demanded falls due to rise in price; it is called contraction in demand. The extension and contraction in demand is illustrated in the Fig. 4.4.

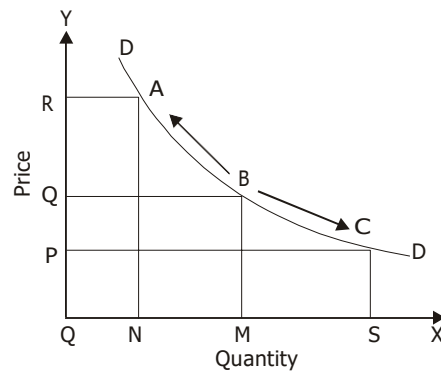


Fig. 4.4

Assuming other factors such as tastes, income and price of related goods constant, demand curve DD is drawn. At OQ price, OM of the commodity is demanded so that the equilibrium point is at B. If price falls to OP, the quantity demanded increases to OS but the consumer remains on the same curve DD; only equilibrium position moves from B to C. In case of rise in price to OR, demand shrinks to ON and the equilibrium position also moves to the left from B to A. This is called contraction in demand. The extension and contraction in demand take place only due to changes in the price of a commodity, other factors remaining same.

Now let us explain shifts in the demand curve. A demand curve either shifts to the right or left, due to changes taking place in other factors and not price of the commodity. The change in the position of the demand curve due to these changes can be termed as the increase and decrease in demand. When due to changes in the factors such as tastes, fashion, price of related commodities, income etc, the demand curve shifts upwards or to the right, increase in demand is said to have taken place. Similarly, when less is demanded at the same price due to changes in other factors, it is called decrease in demand. Here, the demand curve gets shifted leftward. Thus increase in demand is due to the following factors:

1. Taste and fashion/preferences are more favourable for the good.
2. Income of the consumer increases.
3. Price of substitutes has risen.
4. Price of complementary goods has declined.
5. Propensity to consume of the people has increased.
6. Numbers of consumers have increased.

Likewise, decrease in demand may take place due to the following reasons:

1. Taste and fashion/preferences are not favourable for the good.
2. Income of the consumers has fallen.
3. Price of substitutes has fallen.
4. Price of complementary goods has risen.
5. Propensity to save of the people has increased.

Increase and decrease in demand (shifts in the demand curve) is shown in the Fig. 4.5. DD is the demand curve when price is OP. At this price, ON quantity is bought. When consumer's income falls, price remaining same, demand curve shifts to the left as D'' D''. The consumer buys less of the same commodity, i.e, ON'' now. When income rises, price remaining same, consumer is able to buy more, i.e., ON'. In such case, the demand curve shifts to the right as D'D'.

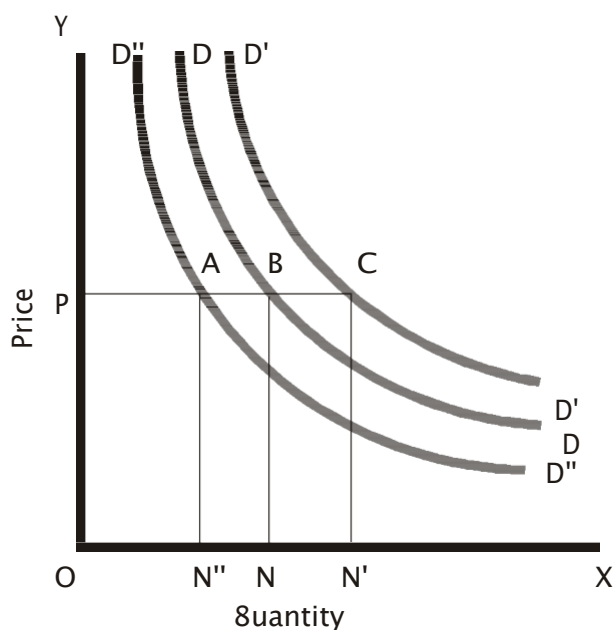
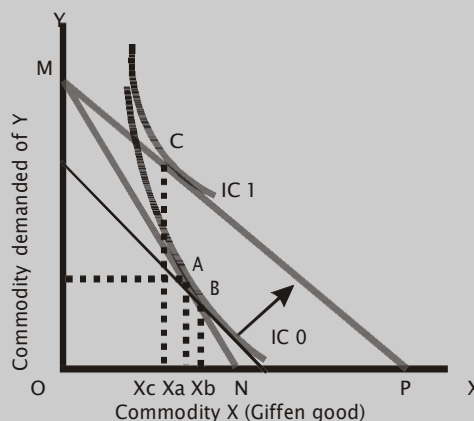


Fig. 4.5

A NOTE ON GIFFEN GOODS

Giffen goods have positive price elasticity of demand. We know that for most products, price elasticity of demand is negative. In other words, price and demand pull in opposite directions; price goes up and quantity demanded goes down, or vice versa. Giffen goods are an exception to this. When price goes up the quantity demanded also goes up, and vice versa. In order to be a true Giffen good, price must be the only thing that changes to get a change in demand. Giffen goods are named after Sir Robert Giffen, who was attributed as the author of this idea by Marshall in his book *Principles of Economics*. The classic example given by Marshall is of inferior quality staple foods whose demand is driven by poverty, which makes their purchasers unable to afford superior foodstuffs. As the price of the cheap staple rises, they can no longer afford to supplement their diet with



better foods, and must consume more of the staple food. Marshall wrote in the 1895 edition of *Principles of Economics*:

“As Mr. Giffen has pointed out, a rise in the price of bread makes so large a drain on the resources of the poorer labouring families and raises so much the marginal utility of money to them, that they are forced to curtail their consumption of meat and the more expensive farinaceous foods: and, bread being still the cheapest food which they can get and will take, they consume more, and not less of it.”

There are three necessary preconditions for this situation to arise:

1. The good in question must be an inferior good,
2. There must be a lack of close substitute goods, and
3. The good must comprise a substantial percentage of the buyer's income.

If precondition no-1 is changed to “The good in question must be so inferior that the income effect is greater than the substitution effect” then this list defines necessary and sufficient conditions. This can be illustrated with a diagram above. Initially the consumer has the choice between spending their income on either commodity Y or commodity X as defined by line segment MN (where M = total available income divided by the price of commodity Y, and N = total available income divided by the price of commodity X). The line MN is known as the consumer's budget constraint. Given the consumer's preferences, as expressed in the indifference curve IC_0 , the optimum mix of purchases for this individual is point A. If there is a drop in the price of commodity X, there will be two effects. The reduced price will change relative prices in favour of commodity X, known as the substitution effect. This is illustrated by a movement down the indifference curve from point A to point B (a pivot of the budget constraint about the original indifference curve). At the same time the price reduction causes the consumers' purchasing power to increase, known as the income effect (a outward shift of the budget constraint). This is illustrated by the shifting out of the dotted line to MP (where P = income divided by the new price of commodity X). The substitution effect (point A to point B) raises the quantity demanded of commodity X from X_a to X_b while the income effect lowers the quantity demanded from X_b to X_c . The net effect is a reduction in quantity demanded from X_a to X_c making commodity X a Giffen good by definition. Any good where the income effect more than compensates for the substitution effect is a Giffen good.

A 2002 preliminary working paper by Robert Jensen and Nolan Miller made the claim that rice and noodles are Giffen goods in parts of China. In 1991, Battalio, Kagel, and Kogut proved that quinine water is a Giffen good for lab rats. Some types of premium goods (such as expensive French wines, or celebrity endorsed perfumes) are sometimes claimed to be Giffen goods. It is claimed that lowering the price of these high status goods can decrease demand because they are no longer perceived as exclusive or high status products. However, the perceived nature of such high status goods changes significantly with a substantial price drop. This disqualifies them from being considered as Giffen goods, because the Giffen goods analysis assumes that only the consumer's income or the relative price level changes, not the nature of the good itself. If a price change modifies consumers' perception of the good, they should be analyzed as Veblen goods.

VEBLEN GOOD

A commodity is a Veblen good if people's preference for buying it increases as a direct function of its price. The definition does not require that any Veblen goods actually exist. However, it is claimed that some types of high-status goods, such as expensive wines or perfumes are Veblen goods, in that decreasing their prices *decreases* people's preference for buying them

because they are no longer perceived as exclusive or high status products. The Veblen effect is named after the economist Thorstein Veblen, who invented the concepts of conspicuous consumption and status-seeking.

The Veblen effect is one of a family of theoretically possible anomalies in the general theory of demand in microeconomics. The other related effects are:

1. The snob effect: preference for good decreases as the number of people buying it increases;
2. The bandwagon effect: preference for good increases as the number of people buying it increases;
3. The **counter-Veblen** effect, in which preference for good increases as its price falls.

The concept of the counter-Veblen effect is less well known, was introduced by Lea. [(Lea, S. E. G., Tarry, R. M., & Webley, P. (1987). *The individual in the economy*. Cambridge: Cambridge University Press.]

None of these effects in itself predicts what will happen to actual demand for the good (the number of units purchased) as price changes - they refer only to preferences or propensities to purchase. The actual effect on demand will depend on the range of other goods available, their prices, and their substitutability for the goods concerned. The effects are anomalies within demand theory because the theory normally assumes that preferences are independent of price or the number of units being sold. They are therefore collectively referred to as **interaction effects**.

Questions for Review

1. What do substitute goods mean?
2. What do complementary goods mean?
3. What is increase in demand?
4. What is contraction in demand?
5. Distinguish between increase in demand and extension in demand.
6. When does a consumer buy more of a commodity at a given price?
7. Mention any one determinant of demand for a commodity other than its price.
8. Why does demand curve slope downwards from left to right?
9. Define demand.
10. What is demand schedule?
11. Explain law of demand. Illustrate your answer with appropriate diagram.
12. What factors influence the demand for a commodity?
13. What are Giffen's goods?
14. What is the shape of a demand curve?
15. What happens to demand when there is a contraction in demand?
16. What factors determine demand?
17. What are inferior goods?
18. State the relationship between demand & price.
19. Give an example of a pair of commodities that are substitutes of each other. (NCERT)
20. Give an example of a pair of commodities such that one of them is complementary in consumption to the other. (NCERT)