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## **Economics for the Citizen, Part 6**

**by Walter E. Williams**

My last article introduced the law of demand, which states that, holding everything else constant, the lower the price of something, the more people will take of it; and the higher the price, less will be taken. But there's a bit of complexity we must add. It's crucial to recognize that it's relative prices that determine choices, not absolute prices.

Relative price is one price in terms of another price. Here's an example; actually, it's a trick I pull on freshman students. I say, "Suppose your company offered to double your salary if you'd relocate to its Fairbanks, Alaska, office. Would you consider it a good deal and accept the offer?" Some students thoughtlessly answer yes. Then I ask, "What if upon 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 date 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 date, they sacrifice only two movies. The dinner-and-concert date is relatively cheaper for the married couple with children, since they sacrifice only two movies compared to the married couple without children's two and a half. Since it's cheaper, we can expect to observe married couples with children to take 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 replies,

“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?”

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 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 OK 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 about the future prices of commodities.

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