

Inferior Goods

BY RENEE COURTOIS

When the economy is in recession and incomes fall, there are certain items people may naturally choose to consume less of to save money. For example, people might take fewer vacations or be less inclined to buy an expensive pair of shoes.

People may substitute for those things instead by increasing their consumption of less expensive goods. Imagine that you cut expenses by taking the family out for hamburgers instead of prime rib. Or if you save money by giving up that season pass to the opera, you will still have leisure time to fill so you might rent more movies to watch at home. In these cases, your reduced income has actually increased your demand for hamburgers and movie rentals.

Those goods you buy more of when your income goes down are called “inferior goods.” In economics, an inferior good is one for which the “income elasticity of demand” — how much you change your demand for the good in response to a change in your income — is negative. In other words, you will buy less of an inferior good when your income increases and more of it when your income goes down. In contrast, demand increases for “normal goods” when income rises, and it falls when income declines.

But don’t misunderstand the phrase. Calling a good “inferior” isn’t a description of its quality per se. The name is not meant to imply that the product is somehow defective, or even that many people don’t enjoy it. It simply describes the demand for a good as income changes.

A recession is an interesting time to think about inferior goods because we might see the incomes of large groups of people falling — a natural environment for identifying inferior goods. For example, we would expect that sellers of inferior goods would thrive during these times. Wal-Mart, the low-cost retail chain, has generally outperformed its retail contemporaries during the recent recession.

Perhaps this shouldn’t be surprising. In a recent paper, University of Missouri economist Emek Basker found that demand increases for the products sold at Wal-Mart when disposable personal income falls, while demand for products sold at Target, a generally higher-priced competitor, has tended to fall in bad economic times. Basker says this suggests that for the average consumer, purchases at Wal-Mart are inferior while purchases at Target are normal. This is either because there are a greater number of households who view shopping at Wal-Mart as an “inferior” activity, or because those who view it as inferior have a

larger elasticity of demand than households that view it as normal.

It’s easy to think about inferior goods in terms of food items. People must make constant choices about what to eat, providing frequent data points on shifting consumption bundles as incomes change. It is no surprise that as demand for restaurant services — something generally thought of as a normal good — has fallen during the recession, grocery stores have thrived. This means that relative to restaurants, grocery store products may be inferior goods.

There is a special case of an inferior good for which the income effect associated with it is so strongly negative that when the price of that good rises, you actually demand more of it. (Note that this idea is quite separate from a “luxury good” that people may demand more of precisely because it is expensive and thus associated with status.) This is called a Giffen good, named after the economist Robert Giffen who may have first observed the concept in the mid-19th century. Giffen goods are typically discussed in connection with extreme poverty. It could be something that is an important enough part of the consumption bundle of very poor people and for which there are no close substitutes — like the basic staples of rice and noodles in some Asian countries — that when its price increases, people are made to feel even

poorer. This prices them out of the market for more expensive food, leaving the staple as the only affordable option. As a result, they may end up consuming even more of that inferior good to keep their caloric intake relatively constant. In other words, for a Giffen good the demand curve actually slopes upward.

Potatoes during Ireland’s Great Famine of the 1840s have long been considered a possible Giffen good. As the blighted potato supply increased potato prices, people consumed even more of them. But this behavior would be so at odds with consumer theory that economists have questioned whether that was the whole story. A perhaps more plausible explanation is that people were simply hoarding potatoes out of fear of starvation, or that maybe the price of a substitute good, like bread, had also shifted. Economists can’t be sure Giffen goods even exist except in extraordinarily unique situations.

While the possibility of Giffen goods may ultimately prove no more than a theoretical curiosity, the more conventional definition of inferior goods remains well-established today.



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