Exceptions to the law of demand economics essay

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The law of demand states that there is a direct relationship between the price of a good and the demand for it. In particular, people generally buy more of a good when the price is low and less of it when the price is high. This is a general rule that applies to most goods called normal goods. As the price of a normal good increases, people buy less of it because they are usually able to switch to cheaper goods. An example is butter, which can be substituted for margarine when the price of butter increases. However there are certain goods that defy this general rule. One such category of goods is called " Giffen goods". With " Giffen goods", there are no cheap substitutes and these goods are so important to the livelihood of the consumer that he devotes overwhelmingly more of his income towards its purchase when the price increases. " Giffen goods" are extremely rare but one popular historical example of this phenomenon is potato during the Irish potato famine in the mid 19th century. It has also been suggested that gasoline may be an example of a modern day " Giffen good

EXCEPTIONS TO THE LAW OF DEMAND:

The law of demand does not apply in every case and situations. There are certain circumstances where the law of demand becomes ineffective and are known as exceptions of the law of demand.

1) Conspicuous Consumption:

This exception to the law of demand is associated with the doctrine propounded by Thorsten Veblen. A few goods like diamonds etc are purchased by the rich and wealthy sections of the society. The prices of these goods are so high that they are beyond the reach of the common man. The higher the price of the diamond the higher the prestige value of it. So when price of these goods falls, the consumers think that the prestige value of these goods comes down. So quantity demanded of these goods falls with fall in their price. So the law of demand does not hold good here

2) Ignorance-

A consumer's ignorance is another factor that at times induces him to purchase more of the commodity at a higher price. This is especially so when the consumer is haunted by the phobia that a high-priced commodity is better in quality than a low-priced one

3) Inferior goods or Giffen goods –

Giffen goods: Giffen goods are some special varieties of inferior goods. Cheaper varieties of goods like bajra, potatoes, salt etc. comes under giffen goods. So, rise in price of these goods does not change the demand for these goods.

When income increases, demand increases. Therefore, this is against the law of demand.

Inferior goods: Inferior goods are those goods whose demand decreases with the rise in income of the household. For example, with an increase in income, a consumer may start using wheat in place of barley.

4) Goods expected to become scarce or costly in future –

Such goods are purchased by the household in increased quantities even when their prices are soaring upwards. This is due to the fear of further rise in prices.

5) Fashion –

The demand for goods which are in fashion does not fall even when their prices increase.

6) Necessities –

A law of demand is not seen operating in the case of necessities of life such as food grains, salt, matches, milk for children, etc.

7) Miscellaneous –

Future change in prices, change in weather conditions, and ignorance of prevailing prices and loss of faith are some of the other exceptions where law may not hold good.

Inferior goods:

These are the goods whose income effect is negative, i. e., demand for such goods falls as income increases.

Alternatively, when rise in income of a customer leads to fall in his demand for a good, that good is called an inferior good. Thus, there is inverse relationship between income and demand for an inferior good.

In case of inferior goods, income effect is negative, i. e., when income goes up, demand for such goods falls because with extra purchasing power cause by rise in income, people start consuming normal or superior goods.

(In the figure, good X is an inferior good because as income increases, the amount bought decreases.

And as the budget constraint shifts from BC1 to higher income BC2 and the amount purchased increases form Y1 to Y2, shows Good Y is a normal good.)

Example of inferior goods:

With an increase in income, a consumer may start using wheat in place of barley. Thus, there is inverse relationship between income and demand for inferior goods. Consequently, income demand curve of inferior goods slopes down rightwards.

INCOME EFFECT:

A change in the quantity demanded as a result of change in real income (i. e., purchasing power) caused by change in price of the commodity is called Income effect.

For example, when price of a commodity falls, less has to be spent on purchase of that commodity. With money thus saved a consumer with the result that he buys more when price falls.

Similarly, a rise in price virtually amounts to fall in real income (or purchasing power) of the consumer leading to contraction of his demand. This part of increase in demand is called Income Effect which explains why people buy more when price falls and less when price rises.

So, “ income effect is related to change in income due to change in price and not due to change in money income.

In other words

The income effect depicts the change in an individual or economy’s income and how that change in the income of an individual or economy will impact the quantity demanded of a good or a service.

There is a direct relationship between income of the consumer and the quantity demanded, as income increase the demand also increases, other things remaining constant and also increases the consumption level.

If a consumer spends one-half of his/her income on food alone, 50% decrease in price of food product will increases his/her purchasing power to buy more food products.

“ ALL GIFFEN GOODS ARE INFERIOR GOODS, ALL INFERIOR GOODS ARE NOT GIFFEN GOODS”

This statement can be explained as-

Inferior goods are those goods which decrease in demand when consumer's income rises.

There is an inverse relationship between demand and consumer's income.

Where as,

Giffen goods are those goods whose demand does not change with the change in income of a person or change in price of goods.

There is a direct relationship between demand and price, where law of demand fails.

Examples of inferior goods: bargain food, second hand products, clothing from charity etc. whereas, wine is an example of giffen good, which is judged by its price, if the price falls the demand for it will fall, because it is no longer considered a premium product.

Also, giffen goods have a unique trait i. e. negative income effect which is always greater than positive substitution effect (true for giffen goods, but not for all inferior goods).

Since, giffen goods always have negative income effect, they must always be inferior goods, but not inferior good is not always a giffen good.

Therefore, it is true that all giffen goods are inferior goods, but all inferior goods are not giffen goods!

A giffen good is a good where quantity demanded increases with the increase in price.

There is positive elasticity of demand in case of giffen goods.

These goods do not have close substitute.

Example: Fine wine is an example of giffen good. The quality of a fine wine is judged by its price. As the price of any fine wine decreases, its demand also decreases because it is no longer considered a premium product.

A condition which is true for giffen goods but not for inferior goods is that the negative income effect is always greater than the positive substitution effect.

Giffen goods always must be inferior goods as they always have negative income effects.

Thus, a giffen good is always an inferior good, but an inferior good is not always a giffen good.