In capitalism firms produce commodities. Commodities are items—goods and services—produced to be sold. Not all economic systems involve the production of commodities; but the production of commodities is one of the four main characteristics of the capitalist economic system. A firm in capitalism can only earn profit if it is successful in selling the commodities that it produces.

A capitalist firm, however, cannot sell whatever goods and services it likes. It can only sell what people are interested in buying. People are not forced to buy what firms produce; consumers have the freedom to choose what they buy. Further, even if people are interested in buying some good, a firm cannot sell as much as it might like: consumers determine both what items they buy and how much they buy of any particular item.

“Demand” is the term that economists use to refer to what people are willing and able to buy. Demand needs to be investigated for two reasons.

First, demand places strict limits on the behavior of business firms: firms can’t do whatever they like but they are limited by consumers’ demand. Firms in capitalism cannot sell as much as they want at whatever price they want. They are constrained by what people in “the market” want to buy. For instance, if the price is too high, few people will likely be interested in buying the good. To get more people to buy the good the firm will have to lower the price they charge for their good.

Second, demand is the avenue through which the consumers affect the behavior of firms in a capitalist economy. Indeed, it is often argued—perhaps rightly or perhaps wrongly—that consumers “drive” the capitalist economic system. Firms can only survive by giving consumers what consumers are willing and able to buy.
DEMAND: PREFERENCES AND INCOME/WEALTH

PREFERENCES
Interestingly, standard economic theory has no theory about why consumers buy what they do. Most economists say that we can’t know for sure what goes on in people’s heads and so we should not attempt to come up with a theory of consumer motivation.

But this is actually not a concern to most economists. Although we can’t read people’s minds we can observe what consumers’ actually do. For instance, consumer Tom might buy 2 apples and 1 orange if the price of apples is 89¢ and the price of oranges is 69¢. The same consumer might buy 1 apple and 2 oranges if the prices of these two products are, respectively, $1.09 and 49 cents.

This information about what a consumer actually buys at different prices is (in principle) collected together and labeled as the consumer’s “preferences.” As each person acts differently in the marketplace, each consumer has his/her own preferences.

Suppose we have the following case: when the price of apples and oranges was, respectively, 89¢ and 69¢ Tom bought 2 apples and 1 orange. He could have bought 1 apple and 2 oranges at these prices but he did not. Economists say that with these prices Tom “prefers” the combination (2 apples and 1 orange) to the combination (1 apple and 2 oranges).

Although the word “prefer” suggests that Tom is “better off” by selecting the first combination over the second combination this should not be concluded. In economists’ theory of consumer behavior the word “prefer” is simply shorthand for the statement that one combination was chosen over another. We don’t know why such a choice was made.

The issue of the relationship, if any, between choices in the marketplace and notions of “better off” will be discussed more fully later in this text. Although this issue is quite abstract it is central to the discussion of whether capitalism is—or is not—a “good” economic system.

INCOME AND WEALTH
Not only do people act differently in the marketplace (that is, have different preferences), they have different incomes and levels of wealth. Income is the flow of money coming to a person during some period (perhaps a year). Some people have incomes of $15,000 per year while others have incomes of $500,000 per year.
Most people in capitalism earn income from working for a living: they have jobs in which they work for someone else. In fact, a large majority of the income that most people get comes from employment earnings either directly or indirectly. Most people earn income from working for someone else, have access to an income because their spouse or significant other has earned an income from working, or gain access to an income because a relative (a parent, say) has earned money from employment.

Income can also be earned from the “assets” a person owns. Among the income-earning assets a person can own are stocks, bonds, land, rental property, and/or a business. Many people own (or at least are paying a mortgage on) a house, which qualifies as an asset, but an owner-occupied house does not typically generate income for the homeowner. For most people, assets are purchased by using the income that they earn. People pay for their houses by each month using some of their income to pay off a mortgage. Holdings of stocks and bonds often come, initially, from someone using part of their income to buy these stocks and bonds.

Wealth is the value of the collection of assets someone owns. Even someone who earns little income might have vast wealth. Most assets can be sold. The sale of an asset brings to the owner a sum of money equal to the value of the asset. Having no income, but having access to wealth, can permit someone to have purchasing power.

DEMAND
To economists “preferences” and “demand” are two different concepts. Preferences denote what people in the abstract would do in the marketplace; it ignores the income and wealth of individuals. Demand denotes what people actually buy: demand depends on both preferences and income/wealth. Demand requires that not only do you prefer something but that you have the income to buy it.

For instance, if you were offered a million dollars you might buy a Mercedes Benz rather than a Geo Metro. But in your actual life you don’t buy a Mercedes Benz but the Metro. Why? Most likely you can’t afford it. From the point of view of economics, although you prefer the Mercedes Benz you have no demand for a Mercedes Benz.

Demand represents the choices people make that take into account both their preferences and their ability to obtain these items. Demand recognizes that you can’t have everything. What you can have is limited by your income and wealth, by your ability to make things, and by the tools and equipment that
you have. In capitalism, the key operative constraint most people face is their income, as most people do not have the skills and tools/equipment necessary to produce they need and want. For most people in capitalism, demand represents the choices people make that take into account both their preferences and the money they have access to because of their income and wealth.

The notion of “demand” is not a universal concept. Although demand plays a central role in capitalism, it plays little—or no—role in other economic systems.

For instance, in kinship production decisions about what people get are not made on the basis of demand: people don’t have to have income within family production in order to share in the production of the kinship group. What the members within kinship production get likely depends on their preferences and, perhaps, on their political power within the kinship group. It does not depend on income. Likewise, in slavery the resources going to an individual slave do not depend on the slave’s demand. Slaves generally had no income and, so, they had no demand. Rather, the master determined what would go to the slaves in order to keep the slaves fit enough to work for the master. The master might take into account the preferences of slaves, but he/she did not take into account the income of slaves.

The notion of “demand” presumes that some (or all) of the items produced are sold on markets and that people gain access to goods and services in these markets only if they have income. One economic system that has these characteristics is capitalism. Other economic systems in history have also had markets and these markets were driven by demand. But in many economic systems demand plays no role (such as within kinship production). This suggests that the notion of “demand” is not a natural or normal; the notion of “demand” is not even required within an economic system.

**DEMAND CURVES**

**INDIVIDUAL DEMAND TABLE**

Table 1 shows the number of videos someone might want to rent per week depending on the price to rent a video. If the price is $1, then this person wants to rent 6 videos per week. If the price increases to $2, the quantity demanded falls to 5 per week.
This table shows the demand this person has for rental videos. It illustrates, first, that the quantity demand depends on the price. It illustrates, further, that as the price for something increases the quantity demand typically falls. And, of course, as the price for something falls demand typically increases.

**INDIVIDUAL DEMAND CURVES**

Economists use a graphical device known as a “demand curve” to visually represent demand. A demand curve shows the relationship between the price of a particular good and how much of this good a consumer wants to buy.

Figure 0-1 presents a demand curve for an individual. It is based on the demand table above. This demand curve shows how many rental videos a consumer wants each month at various prices. When the price of videos is $5 this consumer would like to rent three videos a month. When the price of videos falls to $3, this consumer would like to rent five videos a month.
The demand curve slopes downward to the right. That is, the quantity of videos demanded increases as the price falls. Individuals typically want to buy more videos when the prices of videos fall. Of course, the reverse is true: an increase in the price of videos will lead to a smaller quantity demanded.

Most demand curves are sloped downwards (as is the demand curve above). This makes sense, as you would expect increases in the price of a good to result in a smaller quantity demanded by a potential buyer.

A demand curve represents a consumer’s desire to buy a particular product sold by a particular firm. For instance, a consumer has a demand curve for rental videos from Hollywood Video, a demand curve for rental videos from Blockbuster, and a demand curve for rental videos from each other video rental firm.

Why does a consumer have a demand curve for each rental video store? The main reason is that the different rental video stories offer slightly different products. Of course they rent the same videos, but the stores have different return policies, different levels of service, different shopping experiences, and, importantly, different locations (some of which might be closer or farther from where you live). A video rental from a store that is 1 mile away is different than the same video rented from a store 5 miles away.

At any given time the behavior of a given individual can be represented as a set of demand curves for everything he or she might consider buying: rental
videos, shoes, apples, cars, books, CDs, and so on. Each of these demand curves shows how much the individual wants to buy of particular commodities from particular firms at any given price.

Of course, people typically do not think about the demand curves that represent their buying behavior: there are, after all, possibly thousands of demand curves for each person. Demand curves are merely a conceptual tool that economists have invented to visually represent how the amount that a consumer wants to buy of a product depends on the price of the product.

**DEMAND CURVES FOR A FIRM’S PRODUCTS**

If we combine the demand curves of all consumers for a product sold by a single firm, we get the demand curve faced by this individual firm. The firm demand curve shows the quantity consumers “in the market” are willing to buy of a particular good sold by this firm at any given price.

To simply, assume that three people are the only people buying the product in question. Below are the three individual demand curves for these consumers. The figure indicates that if the price is $10, then Yi Sun demands 3, Ramon demands 5, and Chris demands 8. Together the three demand 16 (= 3 + 5 + 8) when the price is $10. A similar adding together of demand at different prices could be done.

![Demand Curves Diagram]

The result the horizontal adding together the individual demand curves is shown below.
Individual consumers are unaware of their individual demand curves—they simply decide how much to buy given the prices they see. Individuals certainly have little reason to be concerned with the demand curve facing a particular business.

Businesses, however, are very interested in the demand curve for the products they sell. They would like to know the exact position and shape of each of the demand curves for all the products they sell. The demand curve faced by a business acts as one of the most important constraints the business faces. I return to this idea below.

**DETERMINANTS OF DEMAND FOR A FIRM’S PRODUCTS**

Economists forsake the development of a theory of consumer motivation. Instead, economists limit their focus to what people actually buy. But this does not mean that we can’t predict how people’s buying behavior will change if certain changes happen in the economy.

For instance, as the price changes for a good the amount that consumers buy moves along an unchanging demand curve. An increase in the price leads to a reduction in the quantity demanded. A decrease in the price leads to an increase in the quantity demanded. Price change do not cause the demand curve itself to change; it merely causes consumers to move up or down an unchanged demand curve. A change in the price leads to a change in the quantity demanded. It does *not*, however, lead to a “change in demand” but only to a change in quantity demanded.

But demand curves do move. When a demand curve moves to the right, this indicates that at a given price consumers now want to buy more than before. When the demand curve moves left this indicates that at a given price consumers now want to buy less than before.
When a demand curve actually moves, this is called a “change in demand.” An increase in demand means the demand curve shifted to the right. A decrease in demand means the demand curve shifted to the left.

I discuss below events that cause demand curves to move left or right.

CONSUMER PREFERENCES

Consumer preferences are not set and unchanging. People’s buying behavior does change. It doesn’t necessarily change rapidly or in great amounts but it does change.

Sometimes consumers increase their interest in buying some good. The demand curve, in this case, shifts to the right. This shift merely indicates that at each price consumers will want to buy more than previously. A leftward shift in the demand curve is the result of consumers buying the product in lesser amounts than before. At each price, consumers buy less than previously.

Although we can’t say for such what goes on in consumers’ minds, empirical observation has revealed certain patterns. For instance, it appears that “changes in fashion” can sometimes be behind shifts in preferences as people buy more or less depending on fashion. It also appears that advertising campaigns can sometimes alter preferences. The discovery about, say, previously unknown benefits of some product can also shift preferences as people buy more of the good in question.

In Figure 0-2 a change in preferences so that people buy more of the item is illustrated. The extent of the movement to the right of the demand curve depends on how extreme the changes in preferences are.
An ad campaign by a business has the goal of shifting the demand curve it faces to the right. Some ads are primarily informational: they inform consumers of the (good) characteristics of the product the business sells. If a consumer did not know of these good characteristics before, the new information provided by the business should increase the consumer’s taste for the product.

Of course, many ads have very little to do with the facts about the product. Many, if not most, ads attempt to convince potential buyers that consuming the advertised product will make the buyer more popular, sexy, or successful. These claims are most often not really true. But such advertising approaches have proven to be successful in shifting demand curves to the right. Many businesses, therefore, rely on such non-informational types of advertising.

The development of people’s tastes is an important issue in economic analysis and will be discussed more fully in a later chapter.

INCOME DISTRIBUTION
Below are the demand curves for two people—Hector and Emily—for two different products—books and CDs. For the sake of simplicity I will assume only a single firm produces books and a single supplier produces CDs.

Two facts are important. First, Hector buys more books than Emily while Emily buys more CDs than Hector. Second, Emily has more income than Hector.
Figure 0-3 below shows the individual demand curves for Hector and Emily along with the market demand curve, which simply sums across the two demand curves.

The fact that Hector buys relatively more books is indicated by his demand curve for books being to the right of his demand curve for CDs. That Emily buys relatively more CDs is seen by Emily’s demand curve for CDs being to the right of her demand curve for books.

Because Emily is a CD buyer and because she has more income than does Hector, the market demand curve for CDs is to the right of the market demand curve for books.

But suppose that Hector was the one with a larger income. This scenario is illustrated in the next figure. Here, Hector’s demand plays a much larger role in both markets. Because Hector is a book buyer and because Hector now has more income, the market demand curve for books is now to the right of the market demand curve for CDs. This is illustrated in Figure 0-4.
Market demand curves, then, depend both on individual people’s preferences and on the “income distribution”—who has more income and who has less income—in society. If you shift income distribution within a capitalist economy then you might change market demands.

As noted above, not every person’s preferences are equal in the world of demand curves (or in capitalism). An individual’s demand curve is determined both by preferences and the income or wealth this person has. The poor maybe want good housing and, perhaps, maybe they even need it. But because they are poor their preferences have little impact on the market for housing.

INCOME LEVELS OF AVERAGE CONSUMER

When someone’s income grows, they buy more of some products. But they also typically buy less of other products. That is, the demand curve for some products shifts to the right as people’s income rises. But, the demand curve for other products shifts to the left if people’s income falls.

For instance, many people buy more “entertainment” (such as videos, CDs, and so on) as their income rises; their demand curve shifts to the right. This is shown in Figure 0-5.
But for other products, an increase in income leads to less demand for the product. Among these products are bus travel, ramen noodles, and boxed macaroni and cheese. The effect of increased income on demand for boxed macaroni and cheese is shown in Figure 0-6.

Figure 0-6
Impact on Demand for Macaroni and Cheese of an Increase in Consumers’ Income
Incomes do not always rise for either individuals or even for large groups of consumers. A *decline* in income will lead to a leftward shift on the demand curve for CDs. A *decline* in income will also lead to a rightward shift in the demand for macaroni and cheese.

**NUMBER OF CONSUMERS IN THE MARKET**

Los Angeles has many more consumers within it than does San Bernardino. As a result, the demand for CDs in LA will exceed demand for CDs in San Bernardino. Figure 0-7 illustrates this situation.

*Figure 0-7*

Impact of Consumer Population on Demand for CDs in Two Different Cities

At the same time, as more people move to San Bernardino, the demand curve of CDs in the city will shift to the right. This is shown in Figure 0-8.
Suppose you go to the store to buy some cereal. You see the cereal costs $4.00 and you are willing to pay that for a box of cereal. However, when you go to pick up some milk for your cereal you discover that milk prices have skyrocketed to $20.00 per gallon. You refuse to buy milk that is priced so high. But, then, it no longer makes any sense to buy your cereal because you won’t have any milk to put in it. So you return the cereal to its place on the shelf.

Your decision to buy cereal depends both on the price of cereal and on the price of milk. An increase in the price of one of these goods will reduce your desire to consume the other.

Milk and cereal are used together. Products used together are called “complements.”

Among complements are hot dogs and hot dog buns, pizza and beer, chips and dip, and paper and pens.
**Price of Substitutes**

When a consumer considers buying Coke, he is certainly concerned with the price of the good itself. The higher the price of Coke, the less likely he is to buy it. This merely states that the demand curve slopes downward.

But as the potential Coke buyer stands in front of a store shelf he is concerned not only with the price of Coke he is also concerned with the prices of the other soft drinks that surround him. For instance, suppose the price of Coke is $1.99. Suppose also that as the potential buyer of Coke reaches out to take a six-pack of Coke he sees that Pepsi, standing on the shelf next to Coke, is selling for $1.25 a six-pack. The buyer pauses for a second and considers whether he should buy the much cheaper Pepsi instead of Coke. Some people in this situation will decide to leave the store with Pepsi, instead of with the Coke they had originally thought they would buy.

For some—but not all—buyers, Coke and Pepsi are “substitutes”: they are products that can be used in place of each other. When a buyer goes to buy a particular product, he might instead buy a substitute product if the price of the substitute is low enough. The demand for a product, then, depends both on the price of the product and on the prices of other goods that can serve as a substitute for the good the buyer was originally considering.

Figure 0-10 illustrates the impact of a fall in the price of Pepsi from $1.99 to $1.25 on the demand for Coke. As the price of Pepsi (a substitute) falls, the demand for Coke shifts to the left.
Different classifications of substitutes exist. Two goods might be “perfect substitutes” if a consumer has absolutely no preference between them. For example, apples (of the same variety) grown by different farmers are likely perfect substitutes for most consumers. When you go to buy apples at the grocery store you are unlikely to attempt to determine where the apples are that were grown by Farmer Smith. In your eyes all apples (of a certain variety) are identical. Apples grown by different farmers are perfect substitutes.

Anything less than a perfect substitute is considered an “imperfect substitute.” One type of imperfect substitute is the “close substitute.” These are products that the consumer does have a slight preference between them, and so they are not perfect substitutes. But a relatively small shift in the prices of the substitutes might lead the buyer to shift from buying one of them in favor of the other because the differences in the consumer’s preferences between these goods are relatively small. For some people, Coke and Pepsi are close substitutes and small shifts in the prices of the two goods will cause them to shift from buying one to the other.¹

Another type of imperfect substitute is the “distant substitute.” Such products can be used in place of one another, but the substitution is not always

¹ But for other people Coke and Pepsi are not close substitutes. Some people will only drink one of these and will refuse to drink the other. Substitutability between products is often subjectively determined.
easy. For instance, oranges and apples are substitutes but are distant substitutes. For instance, you might go to the store to buy apples but you notice that the price of oranges is so low that you decide to buy oranges instead. But the price of oranges would likely have to be very much below those for apples before you would consider switching from one to the other. Further, you would be unlikely to switch to oranges if, say, you were planning to make apple pie. Apples and oranges might be reasonable substitutes as far as eating them goes, but they are lousy substitutes for, say, baking.

Coke and milk also are distant substitutes. Both might quench your thirst and you might consider some situations in which you went into the store planning to buy one product but left with the other instead because the second product was priced so low. But this probably doesn’t happen too often.

Some products are not substitutes at all. For instance, milk and motor oil are best considered to be non-substitutes. Birdseed and automobiles are also not substitutable for most uses one can image for the two products.

<table>
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<tr>
<th>What Causes the Demand Curve to Move?</th>
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<td>Consumers’ likes and dislikes (preferences)</td>
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<td>Increased liking of good → demand curve shifts right</td>
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<tr>
<td>Decreased liking of good → demand curve shifts left</td>
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<td>Income distribution</td>
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<td>The impact of a change in income distribution will have an uncertain impact on the demand for particular products.</td>
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<td>Consumers’ incomes</td>
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<td>For some goods, when incomes grow consumer buy more of the good. But for other goods, when incomes grow consumers buy less of the good.</td>
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<tr>
<td>Prices of Substitute, ( P_s ) (product used in place of)</td>
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<td>( P_s ) up → demand curve shifts right</td>
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<td>( P_s ) down → demand curve shifts left</td>
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<tr>
<td>Prices of Complement, ( P_c ) (product used with)</td>
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<td>( P_c ) up → demand curve shifts left</td>
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<td>( P_c ) down → demand curve shifts right</td>
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<tr>
<td>Number of consumers in the population</td>
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<td>More consumers → demand curve shifts right</td>
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