Written by **Walter E. Williams** on August 3, 2016

Compensating Differences

What economists call an ability to make "compensating differences" is a valuable tool in everyone's arsenal. If people are prohibited from doing so, they are always worse off. You say, "Williams, I never heard of compensating differences. What are they?"

Jimmy Soul's 1963 hit song, "If You Wanna Be Happy," explained the concept of compensating differences. His lyrics went: "If you want to be happy for the rest of your life, never make a pretty woman your wife. So from my personal point of view, get an ugly girl to marry you." His point was that an ugly woman would treat you better. But more importantly, a less attractive woman's willingness to compensate for her differences enables her to effectively compete with a pretty woman.

It goes the other way around, too. I've presented people with the following scenario: Suppose you saw a fat, ugly cigar-smoking old man married to a beautiful young woman. What kind of prediction would you make about the man's income? Everybody I've asked guesses that he would have a high income. The fat, ugly cigar-smoking old man would essentially be telling the beautiful young woman, "I can't compete for your hand the same way a guy like Williams can, so I'm going to offset my handicap by offering you a higher price."

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Some might view it as unfair that a fat, ugly cigar-smoking old man could not win a pretty woman's hand on the same terms as a handsome man. Suppose they enacted a law saying beautiful women cannot treat fat, ugly cigar-smoking old men any differently than they treat handsome men. Then what would happen to the probability of a fat, ugly cigar-smoking old man's marrying a beautiful woman? Most people would guess that it would go to zilch. What the law would do would be to remove the less preferred man's most effective tool for competing with the more preferred man.

There are many real-world examples of compensating differences. Full-fledged doctors receive hourly pay that ranges between $80 and $157. A brand-new intern earns about $34 an hour. What do you think would happen to a hospital's willingness to hire an intern if there were a minimum hourly wage for interns of, say, $60, $70 or $100? There would be less willingness. Worse, there would be reduced learning opportunities for brand-new doctors. Worse still is that a hospital administrator would say, "If I must pay that higher minimum hourly wage no matter whom I hire, I might as well hire the most qualified." Thus, the higher minimum hourly wage would discriminate against the employment and skills acquisition of the least skilled intern.

During the 1930s, '40s and '50s, one could not prevent whole neighborhoods in the north from going from white to black occupancy virtually overnight. This was before government anti-discrimination laws related to housing. You might wonder how poor, discriminated-against people managed to seize the land-use control of neighborhoods. They did it through the market mechanism. For example, there might have been a racially discriminatory landlord who rented his three-story brown stone building to a white family for $100 a month. Maybe six black families approached the owner with the proposition that if he cut the building up into six apartments, each family would pay him $50 a month. That would mean that he could earn $300 a month renting to blacks rather than $100 renting to a white family. The evidence suggests that landlords opted for the higher earnings. Black people simply outbid white families.

Compensating differences abound. Even though chuck steak is less preferred, it outsells filet mignon. Less-preferred Toyotas compete effectively with Mercedes-Benzes. Costume jewelry competes with fine jewelry. In each, the lower price compensates for the difference. You might say, “Williams, people are not cars, steaks or jewelry!” That’s true, but they respond to the same economic laws as cars, steaks and jewelry — just as people would obey the law of gravity the same way bricks would if they fell off the Empire State Building.

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