



Elasticity

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Price elasticity of demand

Price elasticity of demand



Price elasticity of demand (PED) measures the degree of responsiveness of quantity demanded for a product following a change in its price.

Price elasticity of demand is calculated using the formula:


$$PED = \frac{\% \text{ change in quantity demanded of a product}}{\% \text{ change in price of that product}}$$

For example, if a cinema increases its ticket price from \$10 to \$11 and this leads to demand falling from 3500 to 3325 customers per week, then the PED for cinema tickets is calculated as :

▶ percentage change in quantity demanded = $\frac{3325 - 3500}{3500} \times 100 = -5\%$

▶ percentage change in price = $\frac{11 - 10}{10} \times 100 = +10\%$

▶ $PED = \frac{-5}{10} = -0.5$

Elastic demand

Elastic demand

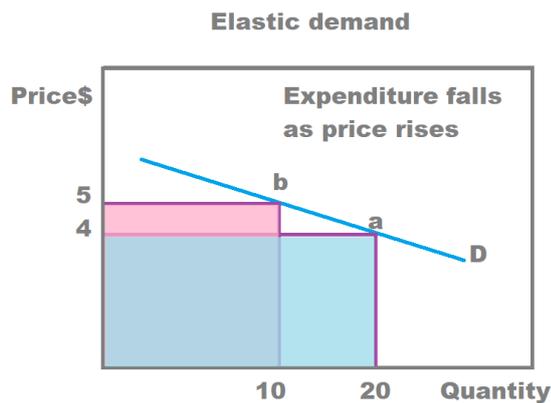


Demand is said to be price elastic if there is a relatively large change in the quantity demanded of a product following a change in its price: that is, buyers are very responsive to changes in price.



If the PED for a product is greater than 1 (ignoring the minus sign), then demand is price elastic.

This is because the percentage change in quantity demanded is larger than the percentage change in the price of the product



Demand is elastic between points a and b.



A rise in price from \$4 to \$5 causes a proportionately larger fall in quantity demanded: from 20 units to 10 units.



Total expenditure falls from \$80 (the blue area) to \$50 (the pink area).

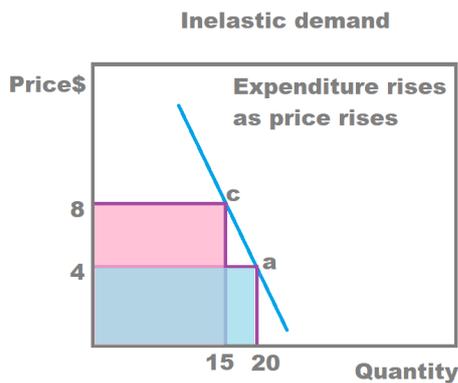
Inelastic demand

Inelastic Demand

 If a price change causes a relatively small change in the quantity demanded, then demand is said to be price inelastic that is, buyers are not highly responsive to changes in price.

 If the PED for a product is less than 1 demand is price inelastic.

This is because the percentage change in quantity demanded is smaller than the percentage change in the price.



Demand is inelastic between points a and c.



A rise in price from \$4 to \$8 causes a proportionately smaller fall in quantity demanded: from 20 units to 15 units.

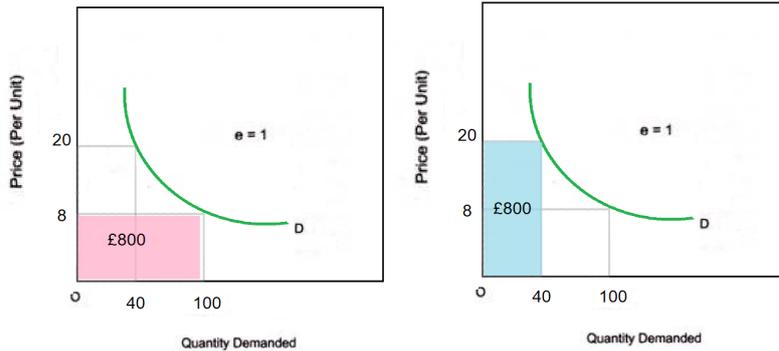


Total expenditure rises from \$80 (the blue area) to \$120 (the pink area)

Special cases of price elasticity of demand

Unit elasticity

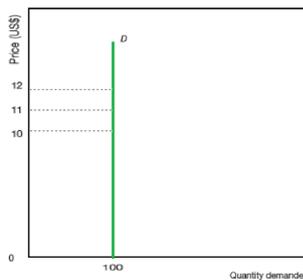
If the PED for a product is equal to 1 (ignoring the minus sign), then demand has unitary price elasticity: that is, the percentage change in the quantity demanded is proportional to the change in the price.



Price and quantity change in exactly the same proportion. Any rise in price will be exactly offset by a fall in quantity, leaving total consumer expenditure unchanged

Perfectly inelastic demand

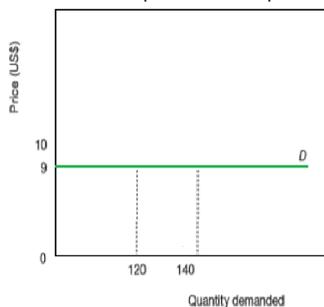
If the PED for a product is equal to 0, then demand is perfectly price inelastic: that is, a change in price has no impact on the quantity demanded. This suggests that there is absolutely no substitute for such a product, so suppliers can charge



Irrespective of the price charged, consumers are willing and able to buy the same amount.

Infinitely elastic demand

If the PED for a product is equal to infinity (∞) then demand is perfectly price elastic: that is, a change in price leads to a change in quantity demanded such that customers switch to buying other substitute products if suppliers raise



At a price of \$10 per unit, consumers are not prepared to buy any of this product; however, if price falls to \$9, they will buy all that is available. The relative change in quantity demanded here is infinite, since the original demand was zero.

Uses of price elasticity of demand

1 Helping firms to decide on their pricing strategy

A firm while fixing the price of the market has to determine whether its product is of elastic or inelastic nature.

- ▶ If the product is inelastic, the producer can earn a profit by setting a high price.
- ▶ If the product is elastic, the producer must set low or at least a reasonable price so that the consumers are attracted to buy the goods.

For example, fuel is a necessity for consumers. Therefore, firms that run the market of fuel can generate profit even by setting a high price for fuel. On the other hand, luxury goods have a high price elasticity of demand because they are sensitive to price changes.

2 Predicting the impact on firms following changes in the exchange rate

Firms that rely on exports will generally benefit from lower exchange rates (as the price of exports become cheaper) and thus will become more price competitive. This assumes that the PED for exports is elastic.

3 Price discrimination

This occurs when firms charge different customers different prices for essentially the same product because of differences in their PED. For example, theme parks charge adults different prices from children and they also offer discounts for families and annual pass holders.

4 Deciding how much of a sales tax can be passed on to customers

For example, products such as alcohol, tobacco and petrol are price inelastic in demand, so government taxes on these products can quite easily be passed on to customers without much impact on the quantity demanded.

Determinants of price elasticity of demand

Determinants of price elasticity of demand

1 The number and closeness of substitute goods.

The more substitutes there are for a good and the closer they are, the more people will switch to these alternatives when the price of the good rises: the greater, therefore, will be the price elasticity of demand.

A good example would be in the case of canned drinks where there are many types of cola, iced tea and fruit juice so a small change in price could see quite large changes in what consumers purchase.

2 The proportion of income spent on the goods.

The higher the proportion of our income we spend on a good, the more we will be forced to cut consumption when its price rises: the bigger will be the income effect and the more elastic will be the demand

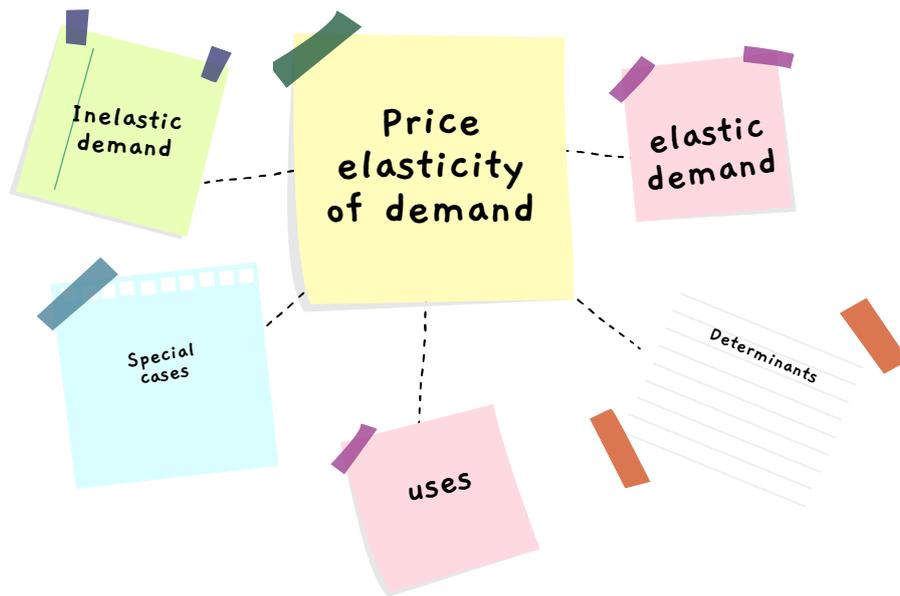
For example, a 10% increase in the price of a flight to China will have a bigger impact than a 10% rise in the price of a bus trip into town.

3 The time period.

When price rises, people may take a time to adjust their consumption patterns and find alternatives.



MAKE A MINDMAP



Cross elasticity of demand

Cross elasticity of demand



Cross elasticity of demand (XED) is a numerical measure of the responsiveness of the quantity demanded for one product following a change in the price of another related product, ceteris paribus.



The formula for cross elasticity of demand used is as follows :

XED =

% change in quantity demanded of product A

% change in the price of product B

- 1 Products that are substitutes for each other will have positive values for the XED
- 2 Products that are complements will have negative values of XED
- 3 Two goods that are independent have a zero cross elasticity of demand

XED for substitutes

Products that are substitutes for each other will have positive values for the XED.

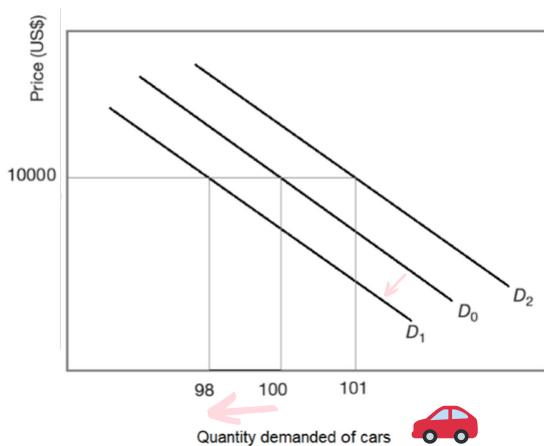


A substitute good is a good that can be used in place of another.

Example: cars and motorbikes.

If the price of cars increases, then people can turn to motorbikes instead because of their more favourable relative price. If the price of cars falls, then consumers will start to buy cars instead of motorbikes.

Assume that the current average market price of a car is \$10,000 and current sales are 100 cars per day. This is shown below.



Following a 2% decrease in the price of motorbikes (a substitute product), demand for cars falls from 100 units to 98 units per day at the original price. The demand curve for cars shifts from D_0 to D_1 .

The cross elasticity of demand can be calculated as follows;

XED =

$$\frac{2\% \text{ fall in demand for cars } \img alt="red car icon" data-bbox="318 771 361 791}}{2\% \text{ decrease in price of motorbikes } \img alt="red motorcycle icon" data-bbox="358 808 398 831}}$$

= +1

► The positive sign indicates that the products are substitutes.

XED for complements

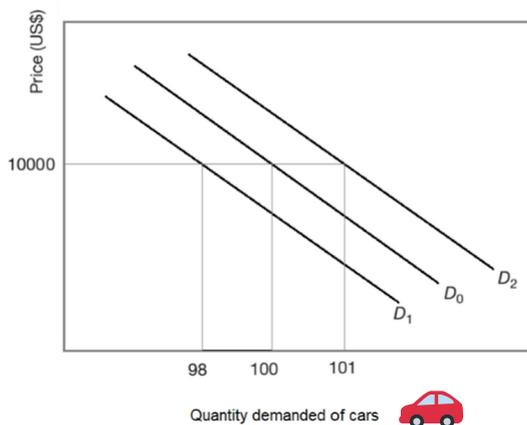
Products that are complements will have negative values of XED.



A complementary good is a good used in conjunction with another good.

Example: cars and car tyres.

If the price of cars go up, the quantity demanded of cars will drop and so will the complementary demand for car tyres. Vice versa.



Consider that the average price of car tyres (a complement to cars) falls by 5%. This encourages extra sales of cars tyres and cars as well. The demand for cars rises to 101 per day at the original price. The demand curve for cars shifts from D0 to D2.

The cross elasticity calculation is:

XED =

1% increase in sales of cars 

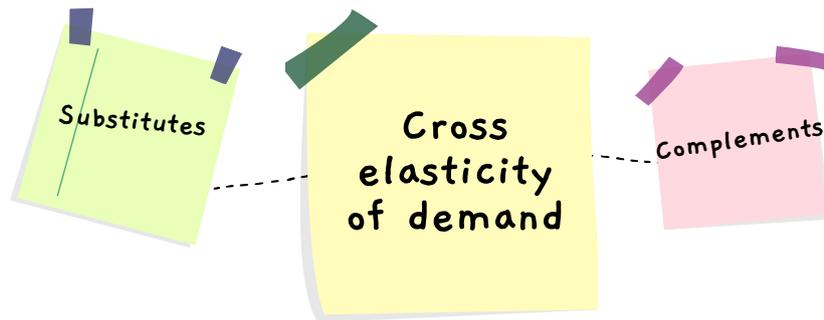
5% falling price of car tyres 

= - 0.2

▶ The negative sign indicates that the products are complements.



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Income elasticity of demand (YED)

Income elasticity of demand (YED)



Income elasticity of demand (YED) is defined as a numerical measure of the responsiveness of the quantity demanded following a change in income.

The formula for income elasticity of demand formula is as follows :



$$\text{YED} = \frac{\% \text{change in quantity demanded}}{\% \text{change in income}}$$

1 Normal goods

A positive income elasticity of demand is associated with normal goods. An increase in income will lead to a rise in demand for a normal good.

An increase in income leads to an increase in the quantity demanded for a normal good. Conversely, a decrease in income leads to a decrease in the quantity demanded for a normal good. Since there is a positive relationship, the YED has also has positive coefficient. Examples of normal goods include food staples, clothing, and household appliances.

2 Necessity goods

Necessity goods are products and services that consumers will buy regardless of the changes in their income levels, therefore making these products less sensitive to income change.

A necessity good is a type of normal good. Normal necessities have an income elasticity of demand of between 0 and +1. As income rises, the demand for necessity goods rises by only a little : it is said that demand rises less than proportionately to income. Items such as staple food products such as bread and vegetables are necessity goods. This is because they have a low income elasticity of demand.

3 Luxury goods

Luxury or superior goods have an income elasticity of demand greater than 1, which means they are income elastic.

This implies that consumer demand is more responsive to a change in income. The demand for luxury goods expands rapidly as people's incomes rise. Thus items such as cars and foreign holidays have a high income elasticity of demand. Other examples of luxury goods include fine wines spirits, high quality chocolates and sports cars

4 Inferior goods

Inferior goods have a negative income elasticity of demand.

An increase in income will cause a decrease in the quantity demanded for an inferior good. Conversely, a decrease in income would cause an increase in the quantity demanded for an inferior good. Here, the YED has a negative coefficient. The demand for inferior goods actually decreases as people's incomes rise beyond a certain level. An example of an inferior good is cheap margarine. As people earn more, they switch to butter or better quality margarine.

5 Income Elasticity of Demand = 0

This means that the demand for the good isn't affected by a change in income.

Price elasticity of supply (PES)

Price elasticity of supply (PES)



Price elasticity of supply (PES) measures of the responsiveness of quantity supplied to a change in price.



The formula for PES is as follows :

% change in quantity supplied

% change in price

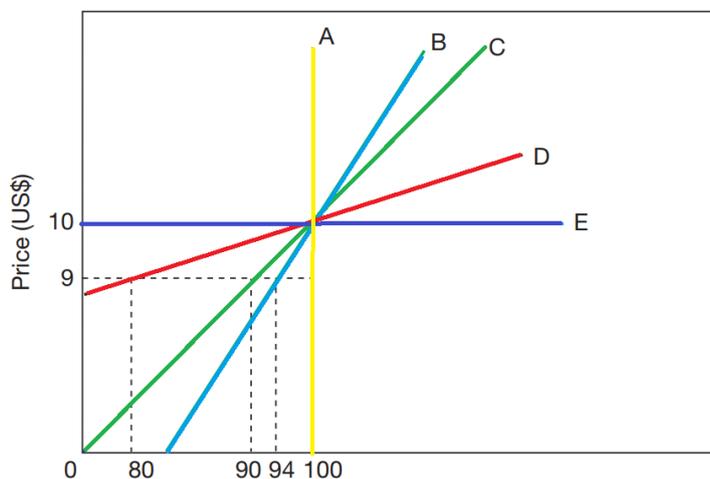
For example, if the market price of beans increased from \$2 per kilo to \$2.20 per kilo, causing quantity supplied to rise from 10000 units to 10 500 units, then the PES is calculated as:

$$\text{percentage change in quantity supplied} = \frac{10500 - 10000}{10000} \times 100 = +5\%$$

$$\text{percentage change in price} = \frac{\$2.20 - \$2.0}{\$2.0} \times 100 = +10\%$$

$$PES = \frac{+5\%}{+10\%} = 0.5$$

The figure above below five supply curves each with different PES values.



	PES
A= Perfectly inelastic	0
B= Relatively inelastic	<1
C= Unitary elasticity	1
D= Relatively elastic	>1
E= Perfectly elastic	+ ∞

Factors influencing PES

The price elasticity of supply can differ between products for several reasons

1 The production time may differ between products.

Products that can be produced quickly will have elastic supply, for example, pencils and notebooks can be produced within a few days. Price elasticity of supply will be elastic for such products. By contrast, in agricultural markets, the supply of fresh fruits and vegetables depends on the time it takes to harvest them. It takes months for crops to be harvested and be ready for sale. Climatic conditions are beyond the control of the suppliers. Hence, supply is less responsive to changes in price in the short run. The supply is inelastic for agricultural products.

2 The perishability and the level of stocks is not the same for all products.

Products that can be stored easily and are non-perishable will have elastic supply. Some types of stock (such as pencils) are easier to store than others (such as fresh milk or fruits), so it will be easier to increase supply if prices increase. Thus, stocks that can be stored easily will have an elastic supply whereas stocks that are difficult to store will have an inelastic supply.

3 The availability of raw materials.

Products that are made with raw materials in short supply will have inelastic supply. However, if a firm has unused raw materials, components and finished products that are available for use, then the firm is able to respond quickly to a change in price, as it can supply these stocks on to the market. Products whose raw materials are readily available will have a more elastic supply.

4 The degree of spare productive capacity.

Products made by firms with spare capacity will have elastic supply. For example, a beverage company can produce 10 000 cans of soft drink in just 60 seconds, thus it is very easy for the company with plenty of spare production capacity to respond to changes in price. PES will be elastic. By contrast, if a firm does not have spare capacity for a product, its PES will be inelastic.



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Price elasticity of supply

Price influencing PES

Income elasticity of demand

Producer surplus

Consumer surplus

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01

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21. Macroeconomic policies
22. International Trade
23. Exchange rates
24. Balance of payments
25. Policies to correct Balance of payments Disequilibrium

The fundamental economic problem

The fundamental economic problem is:

'scarce resources in relation to unlimited wants.'

1 2 3

1 Scarcity: The excess of human wants over what can actually be produced to fulfil these wants

2 Resources: inputs available for the production of goods and services.

3 Wants: needs that are not always realised.

Choice

Choice underpins the concept that resources are scarce so choices have to be made by consumers, firms, and governments.



Sacrifice

Choice involves sacrifice. The more food you choose to buy, the less money you will have to spend on other goods.



Opportunity cost

In other words, the production or consumption of one thing involves the sacrifice of alternatives. This sacrifice of alternatives in the production (or consumption) of a good is known as its opportunity cost.

Opportunity cost is the cost expressed in terms of the best alternative that is forgone.

EXAMPLE

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Question

'Both the take-up rate and number of journeys per bus pass have been falling in recent years.'

Explain two factors which could lead to an increase in the demand for bus travel in the future.

(10 marks)

Category: Demand and supply

AQA AS ECONOMICS November 2020

Answer

Tip: Generally, AQA exam questions are accompanied by an extract (although we have not included it here for simplicity). To score higher marks, refer back to the data (facts and figures) given in the extract, when writing your essay! Note that in this question you are asked to 'explain TWO factors'. In this case, it's a good idea to break your essay into two parts: Factor 1 and factor 2.

(Step 1: Define 'demand' in the introduction)

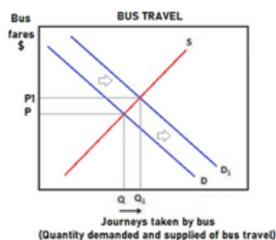
Demand refers to both the willingness and the ability of customers to pay a given price to buy a good or service. There are several factors which could lead to an increase in the demand for bus travel in the future.

(Step 2: Explain TWO factors which could increase the demand for bus travel)

Factor 1: A change in tastes or social norms will increase the demand for bus travel.

Today, travelling by bus has the image of being unpleasant, unreliable and for the 'lower class'. However, more awareness is being raised about air pollution, climate change and CO₂ emissions. People in the future may perceive bus travel as being more ecologically and economically efficient. Furthermore, with the introduction of smart lanes and electric buses, the experience of travelling by bus will improve with time. These factors will encourage people to take the bus.

If more people become aware that travelling by bus is environmentally friendly, more people will opt for bus travel to reduce their carbon footprint. The demand for bus travel will increase. The effect of an increase in demand for bus travel can be shown using a diagram. The diagram below shows the demand and supply curves of bus travel.



Initially, people are unaware of the environmental benefits of bus travel, the equilibrium price (bus fare) is P and the equilibrium quantity (number of journeys taken by bus) is Q . Following campaigns raising awareness about air pollution, more people will be encouraged to travel by bus instead of using their cars. The demand curve for bus travel shifts rightward from D to D_1 . The quantity demanded and supplied for bus travel increases from Q to Q_1 .

Factor 2: If the price of substitutes such as car travel increases, then people will turn to bus travel instead because of its more favourable relative price.

Substitutes are alternative goods and can satisfy the same want or need. Examples of substitutes are car travel and bus travel. For example, if the price of car travel increases significantly, people will look for cheaper alternatives, such as bus travel.

The cost of travelling by car can increase in the future, for instance, due to higher fuel prices. Consequently, if the cost of travelling by car goes up in the future, people will avoid travelling by car, and take the bus instead. The demand for bus travel will increase.

The government may also subsidise bus travel in the future, making bus fares cheaper. This will encourage people to switch away from using their cars to travelling by bus.

(Step 3: Conclude)

To conclude, the demand for bus travel could increase in the future if people perceive buses as being more ecologically and economically efficient. Also, if the price of substitutes such as car travel increases, then people will turn to bus travel instead because of its more favourable relative price.

MARKING SCHEME

- Relevant issues include:
 - meaning of demand
 - lower relative price and/or greater availability compared with substitute goods
 - increased subsidy
 - changes in tastes and/or social norms
 - changes in income and/or consideration of bus travel as an inferior good
 - increased population and/or changes in age structure
 - the significance of elasticities.

Level 3

- An answer that:
 - identifies two valid factors
 - shows sound knowledge and understanding of relevant economic terminology, concepts and principles
 - includes good application of relevant economic principles and/or good use of data to support the response
 - includes well-structured analysis with a clear, logical chain of reasoning
 - may include a relevant diagram to support their explanation

EXAMPLE

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03

Economics Data Questions.

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SKIM THE DATA
Start by skimming the data. Read the text quickly to get a general idea of meaning.

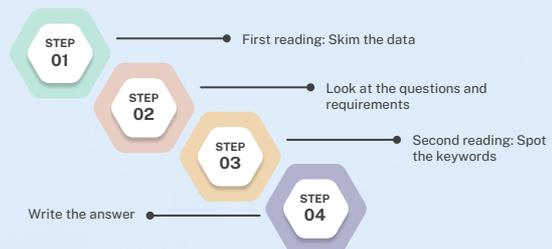
LOOK AT THE TITLE
Look at the title as it may give some clues about its content.

ANALYSE FACTS, FIGURES AND TABLES
Analyse facts, figures tables and diagrams. See if you know what they mean. Pick out any notable features of a chart or diagram.

COMPETITION IN THE SKIES OVER EUROPE

It was predicted that this would lead to an increase in the market share for the top five European airlines from 50% of the European market in 2019 to match the top five United States (US) airlines, which control 77% of the US market.

STEPS TO ANSWER A DATA RESPONSE QUESTION



Read the Requirements

Always read the requirement first as this enables you to focus on the detail of the question with the specific task in mind.

What is the point in reading a scenario if you don't know what you are looking for? If you don't read and understand the requirements carefully, then you will find that you are not actually answering the question. If you are not answering the question, then you are not earning marks.

Pay attention to (1) The content and (2) The instructions

Explain what is meant by a contestable market and discuss how making the airline market more **contestable** could benefit passengers.

... contestable market...benefit

THE CONTENT
When you read each part of the requirement, highlight the content. This is simply what the question is about. This helps you to focus your mind on answering the actual question rather than answering what you thought the question was going to ask you.

THE INSTRUCTIONS
This instruction could be a whole variety of verbs ranging from numerical requirements such as calculate, interpret, outline or compare. The verb used has been carefully thought about by the examiner, taking into account any restrictions imposed by the syllabus.

Explain

Explain what is meant by a contestable market and discuss how making the airline market more contestable could benefit passengers.

(d) Explain two reasons why a government may privatise an industry. [4]

There are several reasons why a government may privatise an industry, such as air travel.

STRUCTURE

CLEAR HEADINGS

Reason 1: Privatising an industry may lead to an increase in government revenue.

The government may earn more tax revenue if it privatises a state-owned industry. This is because a privately owned industry has to pay corporation tax. A corporation tax is a tax levied on companies profits.

PARAGRAPHS

The sale of a state-owned enterprise to the private sector will also raise money for the government.

REFERENCE TO THE DATA

In the data, it was mentioned that a successful sale of Air India to the private sector would have raised money for the Indian government.

More tax revenue will enable the government to increase its spending on education, healthcare or infrastructure. This will help to promote development in the country.

SIMPLE ENGLISH

Reason 2: The government may privatise an industry because the industry is making a loss.

The need to use tax revenue to finance the loss-making industry will be reduced. The private sector may also manage the industry with greater efficiency and turn the loss into a profit. This is because the private sector, motivated to make a profit, will increase productivity and reduce costs.

EXAMPLE

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02	Factors of Production
03	Economic Systems
04	Demand, Supply and Equilibrium
05	Perfect Competition and Monopoly
06	Aims of Government and its Role
07	Market Failure
08	Public Expenditure vs Private Expenditur
09	Banks and Stock Exchanges
10	Labour Market
11	Motives for Spending, Saving and Borrowing
12	Different Types and Sizes of Firms
13	Production, Costs, Revenues and Profits

Topic

Questions

Paper and year

Answers and Explanations

Scarcity, Choice and Opportunity Cost Multiple Choice Questions

1. Which terms summarise the nature of the economic problem?
 A finite resources and limited wants
 B finite resources and unlimited wants
 C infinite resources and limited wants
 D infinite resources and unlimited wants
 [1/10/P1/021]

2. The government of a country with a rapidly increasing population decides to switch resources from investment to increased subsidies to farmers. What is the opportunity cost of this decision?
 A the profit earned by farmers
 B the rest of the land on which food is grown
 C the reduction in investment
 D the wages of the farm workers
 [2/10/P1/04]

3. Which economic change would increase the problem of scarcity?
 A a decrease in fish stocks
 B a discovery of a new oil field
 C an increase in labour productivity
 D a reduction in waste
 [3/10/P1/05]

4. What makes choice an important element in the basic economic problem?
 A increased demand leads to higher market prices.
 B limited resources have many alternative uses.

C Reaching a market equilibrium may take a long time.
 D Scarce economic resources are distributed equally.
 [1/10/P1/011]

A government of a country is faced with the need to end the drought due to a severe drought.
 A conservation of resources
 B monetary policy
 C opportunity cost
 D substitution of factors
 [2/10/P1/053]

5. A firm decides stop manufacturing & producing a product washing machines instead. What is the opportunity cost to the firm?
 A the additional washing machines produced
 B the cost of producing ovens
 C the cost of producing washing machines
 D the cost of the production of ovens
 [2/11/P1/001]

6. What is meant by the economic problem?
 A how to achieve the maximum utility for the least cost
 B how to allocate resources between public and private sectors
 C how to allocate unlimited wants against finite resources
 D how to decide which methods to use to exploit all resources

7. The basic economic problem is that human wants are unlimited while the resources available to satisfy these wants are limited. Which of the following is not a result of this problem?
 A the need to produce goods and services
 B the need to allocate resources
 C the need to produce goods and services
 D the need to produce goods and services

8. The problem of scarcity arises because in a free market economy, a limited resource, which is the most abundant in the economy, must increase the limited resource.
 A. It is a limited resource that is used in many different ways. B. It is a limited resource that is used in many different ways. C. It is a limited resource that is used in many different ways. D. It is a limited resource that is used in many different ways.

9. A firm decides to produce ovens instead of washing machines. What is the opportunity cost to the firm?
 A the additional washing machines produced
 B the cost of producing ovens
 C the cost of producing washing machines
 D the cost of the production of ovens
 [2/11/P1/001]

10. What is meant by the economic problem?
 A how to achieve the maximum utility for the least cost
 B how to allocate resources between public and private sectors
 C how to allocate unlimited wants against finite resources
 D how to decide which methods to use to exploit all resources

AS level topics

01	Basic Economic Ideas And Resource Allocation
02	Production Possibility Curves
03	Classification Of Goods And Services
04	The Price System And The Micro Economy
05	Price Elasticity
06	The Macro Economy
07	International Trade
08	Protectionism
09	Exchange Rates
10	Government Macro Intervention

A level topics

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10	Economic Growth, Economic Development and Sustainability
11	Government Macroeconomic Policy Aims

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