

other in markets. A thorough understanding of the demand and supply theory is therefore essential for any business firm. We shall study the theory of demand in this Unit. The theory of supply will be discussed in Unit-3.

1.0 MEANING OF DEMAND

demand

The term 'demand' refers to the quantity of a good or service that buyers are willing and able to purchase at various prices during a given period of time. It is to be noted that demand, in Economics, is something more than the desire to purchase, though desire is one element of it. For example, people may desire much bigger houses, luxurious cars etc. But there are also constraints that they face such as prices of products and limited means to pay. Thus, wants or desires together with the real world constraints determine what they buy. The effective demand for a thing depends on (i) desire (ii) means to purchase and (iii) willingness to use those means for that purchase. Unless desire is backed by purchasing power or ability to pay and willingness to pay, it does not constitute demand. Effective demand alone would figure in economic analysis and business decisions.

Two things are to be noted about the quantity demanded.

- (i) The quantity demanded is always expressed at a given price. At different prices different quantities of a commodity are generally demanded.
- (ii) The quantity demanded is a flow. We are concerned not with a single isolated purchase, but with a continuous flow of purchases and we must therefore express demand as 'so much per period of time' i.e., one thousand dozens of oranges per day, seven thousand dozens of oranges per week and so on.

In short "By demand, we mean the various quantities of a given commodity or service which consumers would buy in one market during a given period of time, at various prices, or at various incomes, or at various prices of related goods".

1.1 WHAT DETERMINES DEMAND?

Knowledge of the common determinants of demand for a product or service and the nature of relationship between demand and its determinants are essential for a business firm for estimating the market demand for its products. There are a number of factors which influence the demand for a commodity. All these factors are not equally important. Moreover, some of these factors cannot be easily measured or quantified. The important factors that determine demand are given below.

- (i) **Price of the commodity:** Obviously, the good's own price is a key determinant of its demand. Ceteris paribus i.e. other things being equal, the demand for a commodity is inversely related to its price. It implies that a rise in the price of a commodity brings about a fall in the quantity purchased and vice-versa. This happens because of income and substitution effects.
- (ii) **Price of related commodities:** Related commodities are of two types: (i) complementary goods and (ii) competing goods or substitutes.

PS
NC

Car & Petrol

Complementary goods and services are those that are bought or consumed together or simultaneously. Examples are: tea and sugar, automobile and petrol and pen and ink. The increase in the demand for one causes an increase in the demand for the other. When two commodities are complements, a fall in the price of one (other things being equal) will cause the demand for the other to rise. For example, a fall in the price of petrol-driven cars would lead to a rise in the demand for petrol. Similarly, computers and computer

Inverse

Direct
Positive
or Negative

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software are complementary goods. A fall in the price of computers will cause a rise in the demand for software. The reverse will be the case when the price of a complement rises. An increase in the price of a complementary good reduces the demand for the good in question. Thus, we find that, there is an inverse relation between the demand for a good and the price of its complement.

Two commodities are called competing goods or substitutes when they satisfy the same want and can be used with ease in place of one another. For example, tea and coffee, ink pen and ball pen, different brands of toothpaste etc. are substitutes for each other and can be used in place of one another easily. When goods are substitutes, if the price of a product being purchased goes up, buyers may switch to a cheaper substitute. This decreases the demand for the product at a given price, but increases the demand for the substitute. Similarly, a fall in the price of a product (*ceteris paribus*) leads to a fall in the quantity demanded of its substitutes. For example, if the price of tea falls, people will try to substitute it for coffee and demand more of it and less of coffee i.e. the demand for tea will rise and that of coffee will fall. Therefore, there is direct or positive relation between the demand for a product and the price of its substitutes.

(iii) **Disposable Income of the consumer:** The purchasing power of a buyer is determined by the level of his disposable income. Other things being equal, the demand for a commodity depends upon the disposable income of the potential purchasers. In general, increase in disposable income tends to increase the demand for particular types of goods and services at any given price. A decrease in disposable income generally lowers the quantity demanded at all possible prices.

The nature of relationship between disposable income and quantity demanded depends upon the nature of goods. A basic description of the nature of goods is useful in describing the effect of income on demand.

Normal goods are those that are demanded in increasing quantities as consumers' income increases. Most goods and services fall under the category of normal goods. Household furniture, clothing, automobiles, consumer durables and semi durables etc. fall in this category. When income is reduced (for example due to recession), demand for normal goods falls.

There are some commodities for which the quantity demanded rises only up to a certain level of income and decreases with an increase in money income beyond this level. These goods are called **inferior goods**.

Essential consumer goods such as food grains, fuel, cooking oil, necessary clothing etc. satisfy the basic necessities of life and are consumed by all individuals in a society. A change in consumers' income, although will cause an increase in demand for these necessities, but this increase will be less than proportionate to the increase in income. This is because as people become richer, there is a relative decline in the importance of food and other non durable goods in the overall consumption basket and a rise in the importance of durable goods such as a TV, car, house etc. Demand for luxury goods and prestige goods arise beyond a certain level of consumers' income and keep rising as income increases.

Business managers should be fully aware of the nature of goods which they produce (or the nature of need which their products satisfy) and the nature of relationship of quantities demanded with changes in buyers' incomes. For assessing the current as well as future demand for their products, they should also recognize the movements in the macro economic variables that affect buyers' incomes.

(iv) **Tastes and preferences of buyers:** The demand for a commodity also depends upon the tastes and preferences of buyers and changes in them over a period of time. Goods which are modern or more in fashion command higher demand than goods which are of old design or are out of fashion. Consumers may perceive a product as obsolete and discard it before it is fully utilised and then prefer another good which is

currently in fashion. For example, there is greater demand for the latest digital devices and trendy clothing and we find that more and more people are discarding these goods currently in use even though they could have used it for some more years.



External effects on utility such as 'demonstration effect', 'bandwagon effect', 'Veblen effect' and 'snob effect' do play important roles in determining the demand for a product. Demonstration effect, a term coined by James Duesenberry, refers to the desire of people to emulate the consumption behaviour of others. In other words, people buy or have things because they see that other people are able to have them. For example, an individual's demand for cell phone may be affected by his seeing a new model of cell phone in his neighbour's or friend's house, either because he likes what he sees or because he figures out that if his neighbour or friend can have it, he too can.

~~Demonstration effect~~ Bandwagon effect refers to the extent to which the demand for a commodity is increased due to the fact that others are also consuming the same commodity. It represents the desire of people to purchase a commodity in order to be fashionable or stylish or to conform to the people they wish to be associated with.

~~Bandwagon effect~~ By snob effect we refer to the extent to which the demand for a consumers' good is decreased owing to the fact that others are also consuming the same commodity. This represents the desire of people to be exclusive; to be different; to dissociate themselves from the "common herd." For example, when a product becomes common among all, some people decrease or altogether stop its consumption.

Highly priced goods are consumed by status seeking rich people to satisfy their need for conspicuous consumption. This is called 'Veblen effect' (named after the American economist Thorstein Veblen). For example, expensive cars and jewels. The distinction between the snob effect and the Veblen effect is that the former is a function of the consumption of others and the latter is a function of price. We conclude that people have tastes and preferences and these do change - sometimes, due to external and sometimes due to internal causes - and influence demand.

Knowledge regarding tastes and preferences is extremely valuable for the manufacturers and marketers as it would help them appropriately design new models of products and services and plan production to suit the changing tastes and needs of the customers.

(v)

Consumers' Expectations

Consumers' expectations regarding future prices, income, supply conditions etc. influence current demand. If the consumers expect increase in future prices, increase in income and shortages in supply, more quantities will be demanded. If they expect a fall in price or fall in income they will postpone their purchases of nonessential commodities and therefore, the current demand for them will fall. Levels of consumer and business confidence about their future economic situations also affect spending and demand.

Other factors: Apart from the above factors, the demand for a commodity depends upon the following factors:

- (a) **Size of population:** Generally, larger the size of population of a country or a region, larger would be the number of buyers and the quantity demanded in the market would be higher at every price. The opposite is the case when population is less.
- (b) **Age Distribution of population:** If a larger proportion of people belong to older age groups relative to younger age groups, there will be increased demand for geriatric care services,

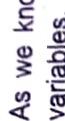
spectacles, walking sticks, etc and less demand for children's books. Similarly, if the population consists of more of children, demand for toys, baby foods, toffees, etc. will be more. Likewise, if there is migration from rural areas to urban areas, there will be decrease in demand for goods and services in rural areas.

(c) **The level of National Income and its Distribution:** The level of national income is a crucial determinant of market demand. Higher the national income, higher will be the demand for all normal goods and services. The wealth of a country may be unevenly distributed so that there are a few very rich people while the majority is very poor. Under such conditions, the propensity to consume of the country will be relatively less, because the propensity to consume of the rich people is less than that of the poor people. Consequently, the demand for consumer goods will be comparatively less. If the distribution of income is more equal, then the propensity to consume of the country as a whole will be relatively high indicating higher demand for goods.

(d) **Consumer-credit facility and interest rates:** Availability of credit facilities induces people to purchase more than what their current incomes permit them. Credit facilities mostly determine the demand for investment and for durable goods which are expensive and require bulk payments at the time of purchase. Low rates of interest encourage people to borrow and therefore demand will be more.

(e) **Government policies and regulations;** The governments influence demand through its taxation, quantity demanded, subsidies and subsidy policies. While taxes increase prices and decrease the example taxes on luxurious goods and subsidies for solar panels. Similarly total bans, restrictions and higher taxes may be used by government to restrict the demand for socially undesirable goods and services. Government's policy on international trade also will affect the domestic demand for goods and services. Apart from above, factors such as weather conditions, business conditions, stage of business cycle, wealth, levels of education, marital status, socioeconomic class, group membership, habits of the consumer, social customs and conventions, salesmanship and advertisements also play an important role in influencing demand.

1.2 THE DEMAND FUNCTION



As we know, a function is a symbolic statement of a relationship between the dependent and the independent variables.

The demand function states in equation form, the relationship between the demand (the dependent variable) and its determinants (the independent or explanatory variables). Any other factors that are not explicitly listed in the demand function are assumed to be irrelevant or held constant. A simple demand function may be expressed as follows:

$$Q_x = f(P_x, Y, P_c)$$

Where Q_x is the quantity demanded of product X

P_x is the price of the commodity

- Y is the money income of the consumer, and
- P_x is the price of related goods

The demand function stated as above does not indicate the exact quantitative relationship between Q_x and P_x , M and P_y . For this, we need to write the demand function in a particular form with specified values of the explanatory variables appearing on the right-hand side. For example, we may write $Q_x = 45 + 2y + 1P_x - 2P_y$. In this unit, we will be studying demand as a function of only price, keeping everything else constant.

1.3 THE LAW OF DEMAND



Most of us have an implicit understanding of the law of demand. The law of demand is one of the most important laws of economic theory. The law states the nature of relationship between the quantity demanded of a product and its price. Prof. Alfred Marshall defined the Law thus: "The greater the amount to be sold, the smaller must be the price at which it is offered in order that it may find purchasers or in other words the amount demanded increases with a fall in price and diminishes with a rise in price".

The law of demand states that other things being equal, when the price of a good rises the quantity demanded of the good will fall. Thus, there is an inverse relationship between price and quantity demanded, *ceteris paribus*. The 'other things' which are assumed to be equal or constant are the prices of related commodities, income of consumers, tastes and preferences of consumers, and all factors other than price which influence demand. (Refer section 1.1 above). If these factors which determine demand also undergo a change, then the inverse price-demand relationship may not hold good. For example, if incomes of consumers increase, then an increase in the price of a commodity may not result in a decrease in the quantity demanded of it. Thus, the constancy of these 'other factors' is an important assumption of the law of demand.

The quantity demanded is the amount of a good or service that consumers are willing to buy at a given price, holding constant all the other factors that influence purchases. The quantity demanded of a good or service can exceed the quantity actually sold.

1.3.0 The Demand Schedule

Table form

A demand schedule is a table showing the quantities of a good that buyers would choose to purchase at different prices, per unit of time, with all other variables held constant. To illustrate the relation between the quantity of a commodity demanded and its price, we may take a hypothetical data for prices and quantities of ice-cream. A demand schedule is drawn upon the assumption that all the other influences remain unchanged. It thus attempts to isolate the influence exerted by the price of the good upon the amount sold.

Table 1: Demand Schedule of an Individual Buyer

	Price per cup of ice-cream (In Rupees)	Quantity of ice-cream demanded (per week) (Cups)
A	60	0
B	50	2

C	40	4
D	30	6
E	20	8
F	10	10
G	0	12

Table 1 shows how many cups of ice-cream this particular buyer buys each week at different prices of ice-cream, holding constant everything else that influences how much of ice-cream this particular consumer wants to buy. If ice-cream is free (price = 0), she consumes 12 cups of ice-cream per week. As the price rises, she buys fewer and fewer cups of ice-cream. When the price reaches ₹ 60 per cup, she does not buy ice-cream at all. The above table depicts an inverse relationship between price and quantity of ice-cream demanded. We may note that that the demand schedule obeys the law of demand: As the price of ice-cream increases, *ceteris paribus*, the quantity demanded falls.

1.3.1 The Demand Curve

Graphical Representation

A demand curve is a graphical presentation of the demand schedule. By convention, the vertical axis of the graph measures the price per unit of the good. The horizontal axis measures the quantity of the good, which is usually expressed in some physical measure per time period. By plotting each pair of values as a point on a graph and joining the resulting points, we get the individual's demand curve for a commodity. It shows the relationship between the quantities of a good that buyers are willing to buy and the price of the good. We can now plot the data from Table 1 on a graph.

In Fig. 1, we have shown such a graph and plotted the seven points corresponding to each price-quantity combination shown in Table 1. The demand curve hits the vertical axis at price ₹ 60 indicating that no quantity is demanded when the price is ₹ 60 (or higher). The demand curve hits the horizontal quantity axis at 12, the amount of ice-cream that the consumer wants if the price is zero. Point A shows the same information as the first row of Table 1, and Point G shows the same information as does the last row of the table.

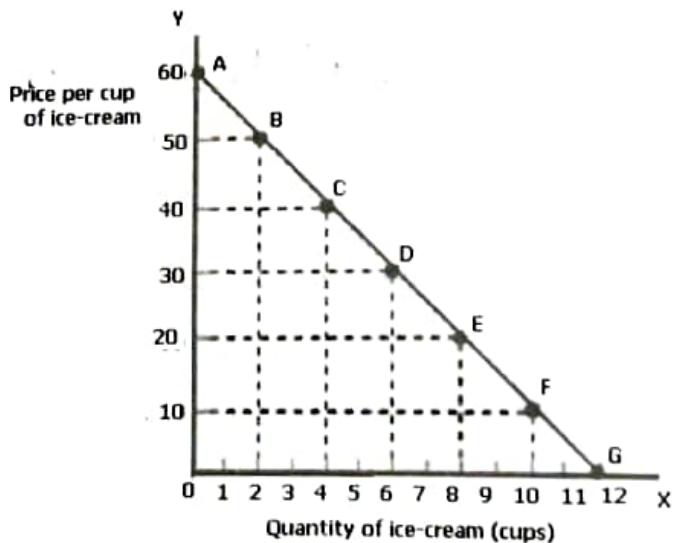


Fig. 1 : Demand Curve for Ice-cream

We now draw a smooth curve through these points. The curve is called the demand curve for ice-cream and shows the quantity of ice-cream that the consumer would like to buy at each price. The negative or downward slope indicates that the quantity demanded increases as the price falls. Consumers are usually ready to buy more if the price is lower. Briefly put, more of a good will be purchased at lower prices. Thus, the downward sloping demand curve is in accordance with the law of demand which, as stated above, describes an inverse price-demand relationship.

The slope of a demand curve is $-\Delta P/\Delta Q$ (i.e. the change along the vertical axis divided by the change along the horizontal axis). The negative sign of this slope is consistent with the law of demand.

The demand curve for a good does not have to be linear or a straight line; it can be curvilinear - meaning its slope may vary along the curve. If the change in quantity demanded does not follow a constant proportion, then the demand curve will be non linear. However, linear demand curves provide a convenient tool for analysis.

1.3.2 Market Demand Schedule *Summation of All Individual Buyers*

The market demand for a commodity gives the alternative amounts of the commodity demanded per time period, at various alternative prices, by all the buyers in the market. In other words, it is the total quantity that all the buyers of a commodity are willing to buy per unit of time at a given price, other things remaining constant. The market demand for a commodity thus depends on all the factors that determine the individual's demand and, in addition, on the number of buyers of the commodity in the market.

When we add up the various quantities demanded by different consumers in the market, we can obtain the market demand schedule. How the summation is done is illustrated in Table 2. Suppose there are only two individual buyers of good X in the market namely, A and B. The Table 2 shows their individual demand at various prices.

Table 2: Market Demand Schedule of Good X (per day)

Quantity demanded by			
Price of Good X in (Rs)	A	B	Total Market Demand
0	3	2	<u>A+B</u> 5
10	2	1	3
20	1	0	1
30	0	0	0

When we add the quantities demanded at each price by consumers A and B, we get the total market demand. Thus, when good X is free or price is zero per unit, the market demand for commodity 'X' is 5 units (i.e. 3+2). When price rises to Rs 10, the market demand is 3 units. At a price of Rs. 20, only one unit is demanded in the market. At price Rs 30, both A and B do not buy good X and therefore, market demand is zero. The market demand schedule also indicates inverse relationship between price and quantity demanded of 'X'.

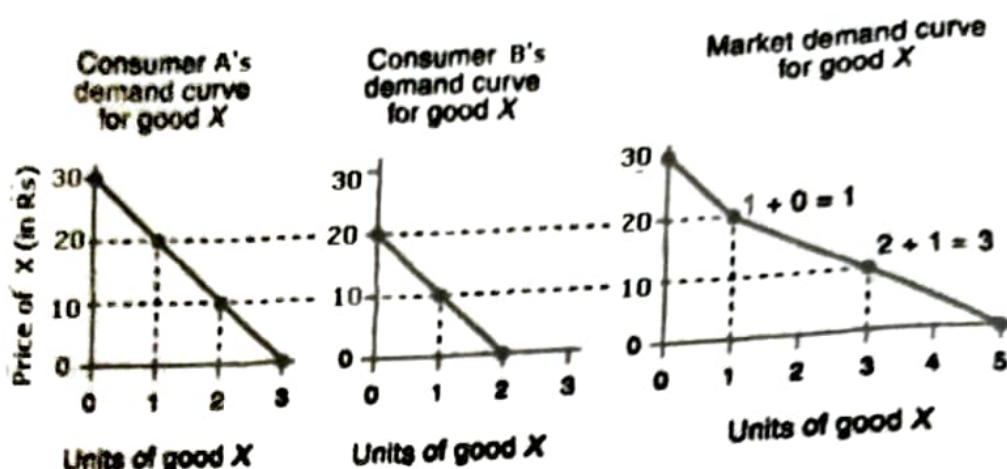


Fig. 2 : The Market Demand Curve for Good X

1.3.3 The Market Demand Curve

The market demand curve for good X represents the quantities of good X demanded by all buyers in the market for good X. The market demand curve is obtained by horizontal summation of all individual demand curves.

If we plot the market demand schedule on a graph, we get the market demand curve. Figure 2 shows the market demand curve for commodity 'X'. The two consumers A and B have different individual demand curves corresponding to their different preferences for good X. The two individual demand curves are shown in Figure 2 along with the market demand curve for good X. When there are more than two consumers in the market for some good, the same principle continues to apply and the market demand curve would be the horizontal summation of all the market participants' individual demand curves. The market demand curve, like the individual demand curve, slopes downwards to the right because it is nothing but the lateral summation of individual demand curves.

In addition to the demand schedule and the demand curve, the buyers' demand for a good can also be expressed algebraically, using a demand equation. The demand equation relates the price of the good, denoted by P, to the quantity of the good demanded, denoted by Q.

The straight-line demand curve where we hold everything else constant is described by a linear demand function. We can write a demand function as follows:

$$Q = a - bP$$

Where 'a' is the vertical intercept and 'b' is the slope.

For example: For a demand function $Q = 100 - 2P$,

$$P = \frac{a}{b} - \frac{Q}{b}; P = 50 - \frac{Q}{2}$$

1.3.4 Rationale of the Law of Demand

Normally, the demand curves slope downwards. This means people buy more at lower prices. We shall now try to understand why do demand curves slope downwards? Put in other words, why do people buy more at lower prices? Different economists have given different explanations for the operation of the law of demand. These are given below :

Price effect = Substitution effect + Income effect

(1) **Price Effect of a fall in price:** The price effect which indicates the way the consumer's purchases of good X change, when its price changes, is the sum of its two components namely: substitution effect and income effect.

(a) **Substitution effect:** Hicks and Allen have explained the law in terms of substitution effect and income effect. The substitution effect describes the change in demand for a product when its relative price changes. When the price of a commodity falls, the price ratio between items change and it becomes relatively cheaper than other commodities. Assuming that the prices of all other commodities remain constant, it induces consumers to substitute the commodity whose price has fallen for other commodities which have now become relatively expensive. The result is that the total demand for the commodity whose price has fallen increases. This is called substitution effect. When the price falls, the substitution effect is always positive; i.e. it will always cause more to be demanded. The substitution effect will be stronger when:

- (a) the goods are closer substitutes
- (b) there is lower cost of switching to the substitute good
- (c) there is lower inconvenience while switching to the substitute good

(b) **Income effect:** The increase in demand on account of an increase in real income is known as income effect. When the price of a commodity falls, the consumer can buy the same quantity of the commodity with lesser money or he can buy more of the same commodity with the same amount of money. In other words, as a result of fall in the price of the commodity, consumer's real income or purchasing power increases. A part or whole of the resulting increase in real income can now be used to buy more of the commodity in question, given that the good is normal. Therefore, the demand for that commodity (whose price has fallen) increases. However, there is one exception. In the case of inferior goods, the income effect works in the opposite direction to the substitution effect. In the case of inferior goods, the expansion in demand due to a price fall will take place only if the substitution effect outweighs the income effect.

(2) **Utility maximising behaviour of Consumers:** A consumer is in equilibrium (i.e. maximises his satisfaction) when the marginal utility of the commodity and its price equalize. According to Marshall, the consumer has diminishing utility for each additional unit of a commodity and therefore, he will be willing to pay only less for each additional unit. A rational consumer will not pay more for lesser satisfaction. He is induced to buy additional units only when the prices are lower. The operation of diminishing marginal utility and the act of the consumer to equalize the utility of the commodity with its price result in a downward sloping demand curve.

(3) **Arrival of new consumers:** When the price of a commodity falls, more consumers start buying it because some of those who could not afford to buy it earlier may now be able to buy it. This raises the number of consumers of a commodity at a lower price and hence the demand for the commodity in question increases.

(4) **Different uses:** Many commodities have multiple uses. When the price of such commodities are high (or rises) they will be put to limited uses only. If the prices of such commodities fall, they will be put to more number of uses and therefore their demand will increase. Thus, the increase in the number of uses

consequent to a fall in price make the buyer demand more of such commodities making the demand curve slope downwards. For example: Electricity

~~1.3.5~~ Exceptions to the Law of Demand

According to the law of demand, other things being equal, more of a commodity will be demanded at lower prices than at higher prices. The law of demand is valid in most cases; however there are certain cases where this law does not hold good. The following are the important exceptions to the law of demand.

(i)

Prestige goods: Articles of prestige value or snob appeal or articles of conspicuous consumption are used by the rich people as status symbol for enhancing their social prestige or /and for displaying wealth. These articles will not conform to the usual law of demand as they become more attractive only if their prices are high or keep going up. This was found out by Veblen in his doctrine of "Conspicuous Consumption" and hence this effect is called Veblen effect or prestige goods effect. Veblen effect takes place as some consumers measure the utility of a commodity by its price i.e., if the commodity is expensive they think that it has got more utility. As such, they buy less of this commodity at low price and more of it at high price. Diamonds are often given as an example of this case. Higher the price of diamonds, higher is the prestige value attached to them and hence higher is the demand.

(ii)

Giffen goods: Sir Robert Giffen, a Scottish economist and statistician, was surprised to find out that as the price of bread increased, the British workers purchased more bread and not less of it. This was something against the law of demand. Why did this happen? The reason given for this is that, when the price of bread went up, it caused such a large decline in the purchasing power of the poor people that they were forced to cut down the consumption of meat and other more expensive foods. Since bread, even when its price was higher than before, was still the cheapest food article, people consumed more of it and not less when its price went up.

Inferior goods - Subjective concept

Such goods which exhibit direct price-demand relationship are called 'Giffen goods'. Generally those goods which are inferior, with no close substitutes available and which occupy a substantial place in consumers' budget are called 'Giffen goods'. All Giffen goods are inferior goods; but all inferior goods are not Giffen goods. Examples of Giffen goods are coarse grains like bajra, low quality rice and wheat etc.

(iii)

Conspicuous necessities: The demand for certain goods is affected by the demonstration effect of the consumption pattern of a social group to which an individual belongs. These goods, due to their constant usage, become necessities of life. For example, in spite of the fact that the prices of television sets, refrigerators, air-conditioners etc. have been continuously rising, their demand does not show any tendency to fall.

(iv)

Future expectations about prices: It has been observed that when the prices are rising, households, expecting that the prices in the future will be even higher, tend to buy larger quantities of such commodities. For example, when there is wide-spread drought, people expect that prices of food grains would rise in future. They demand greater quantities of food grains even as their price rises. On the contrary, if prices are falling and people anticipate further fall, rather than buying more, they postpone their purchases. However, it is to be noted that here it is not the law of demand which is invalidated. There is a change in one of the factors which was held constant while deriving the law of demand, namely change in the price expectations of the people.

- (v) **Incomplete information and irrational behaviour:** The law has been derived assuming consumers to be rational and knowledgeable about market-conditions. However, at times, consumers have incomplete information and therefore make inconsistent decisions regarding purchases. Similarly, in practice, a household may demand larger quantity of a commodity even at a higher price because it may be ignorant of the ruling price of the commodity. Under such circumstances, the law will not remain valid.
- Sometimes, consumers tend to be irrational and make impulsive purchases without any rational calculations about the price and usefulness of the product and in such contexts the law of demand fails.
- (vi) **Demand for necessities:** The law of demand does not apply much in the case of necessities of life. Irrespective of price changes, people have to consume the minimum quantities of necessary commodities.
- (vii) **Speculative goods:** In the speculative market, particularly in the market for stocks and shares, more will be demanded when the prices are rising and less will be demanded when prices decline.

The law of demand will also fail if there is any significant change in other factors on which demand of a commodity depends. If there is a change in income of the household, or in the prices of related commodities or in tastes and fashion etc., the inverse demand and price relation may not hold good.

1.4 EXPANSION AND CONTRACTION OF DEMAND (*Increase*) (*Decrease*)

The demand schedule, demand curve and the law of demand all show that when the price of a commodity falls, its quantity demanded increases, other things being equal. When, as a result of decrease in price, the quantity demanded increases, in Economics, we say that there is an expansion of demand and when, as a result of increase in price, the quantity demanded decreases, we say that there is a contraction of demand. For example, suppose the price of apples is Rs 100/ per kilogram and a consumer buys one kilogram at that price. Now, if other things such as income, prices of other goods and tastes of the consumers remain the same but the price of apples falls to Rs 80 per kilogram and the consumer now buys two kilograms of apples, we say that there is a change in quantity demanded or there is an expansion of demand. On the contrary, if the price of apples rises to Rs 150 per kilogram and the consumer then buys only half a kilogram, we say that there is a contraction of demand.

The phenomena of expansion and contraction of demand are shown in Figure 3. The figure shows that when price is $O P_1$, the quantity demanded is OM , given other things equal. When as a result of increase in price ($O P_2$), the quantity demanded falls to OL , we say that there is 'a fall in quantity demanded' or 'contraction of demand' or 'an upward movement along the same demand curve'. Similarly, as a result of fall in price to $O P_1'$, the quantity demanded rises to ON , we say that there is an 'expansion of demand' or 'a rise in quantity demanded' or 'a downward movement on the same demand curve.'

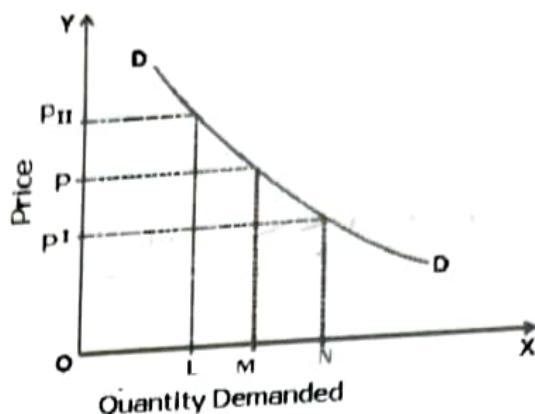


Fig. 3 : Expansion and Contraction of Demand

1.4.1 Increase and Decrease in Demand

Till now we have assumed that the other determinants of demand remain constant when we are analysing the demand for a commodity. It should be noted that expansion and contraction of demand take place as a result of changes in the price while all other determinants of price viz. income, tastes, propensity to consume and price of related goods remain constant. The 'other factors remaining constant' means that the position of the demand curve remains the same and the consumer moves downwards or upwards on it.

There are factors other than price (non-price factors) or conditions of demand which might cause either an increase or decrease in the quantity of a particular good or service that buyers are prepared to demand at a given price. What happens if there is a change in consumers' tastes and preferences, income, the prices of the related goods or other factors on which demand depends? As an example, let us consider what happens to the demand for commodity X when the consumer's income increases:

Table 3 shows the possible effect of an increase in income of the consumer on the quantity demanded of commodity X.

Table 3 : Two demand schedules for commodity X

	Price (Rs)	Quantity of 'X' demanded when average household income is Rs 5,000 per month	Quantity of 'X' demanded when average household income is Rs 10,000 per month	
A	5	10	15	A1
B	4	15	20	B1
C	3	20	25	C1
D	2	35	40	D1
E	1	60	65	E1

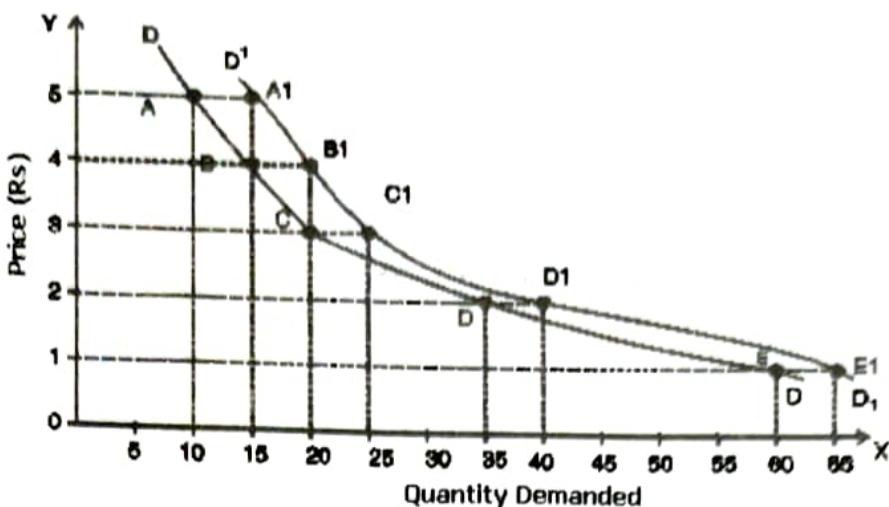


Fig. 4: Figure Showing Two Demand Curves at Different Incomes

The two sets of data are plotted in Figure 4 as DD pertaining to demand when average household income is Rs 5000/- and D'D' when income is Rs.10, 000/. We find that with increase in income, the demand curve for X has shifted [in this case it has shifted to the right]. The shift from DD to D'D' indicates an increase in the desire to purchase 'X' at each possible price. For example, at the price of Rs 4 per unit, 15 units are demanded when average household income is Rs 5,000 per month. When the average household income rises to Rs 10,000 per month, 20 units of X are demanded at price Rs 4. You can find similar increase in demand at each price. Since this increase would occur regardless of what the market price is, the result would be a shift to the right of the entire demand curve.

Alternatively, we can ask what price consumers would be willing to pay to purchase a given quantity, say 15 units of X. With greater income, they should be willing to pay a higher price of Rs 5 instead of 4. A rise in income thus shifts the demand curve to the right, whereas a fall in income will have the opposite effect of shifting the demand curve to the left.

Any change that increases the quantity demanded at every price shifts the demand curve to the right and is called an increase in demand. Any change that decreases the quantity demanded at every price shifts the demand curve to the left, and is called a decrease in demand.

Figure 5(a) and (b) illustrate increase and decrease in demand respectively. When there is an increase in demand, the demand curve shifts to the right and more quantity will be purchased at a given price (Q_1 instead of Q at price P). A decrease in demand causes the entire demand curve to shift to the left and we find that less quantity is bought at the same price P .

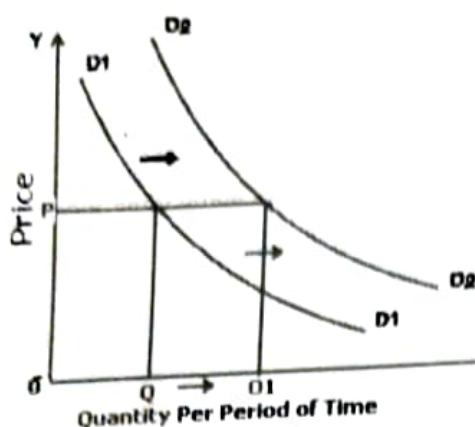
Increase in Demand

Fig. 5(a): Rightward shift in the demand Curve

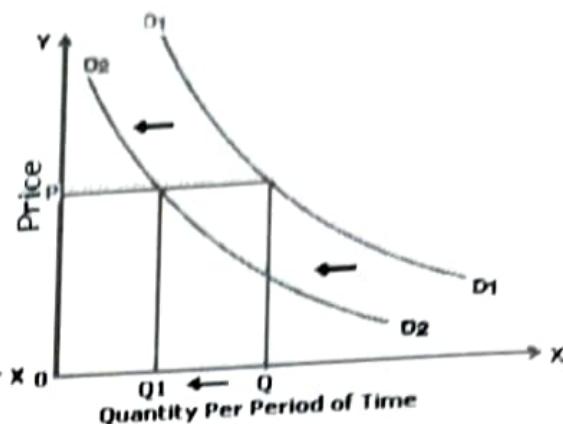
Decrease in Demand

Fig. 5(b): Leftward shift in the demand Curve

The table below summarises the effect of non - price determinants on demand

Changes in determinants other than price that cause increase in demand (Rightward shift of demand curve when more is demanded at each price)	Changes in determinants other than price that cause Decrease in Demand (Leftward shift of demand curve when less is demanded at each price)
Rise in income in the case of normal goods	A fall in income in case of normal goods, and a rise in income in case of inferior goods
Increase in wealth in the case of normal goods	Decrease in wealth in case of normal goods, and an increase in wealth in case of inferior goods
Rise in the price of a substitute good	Fall in the price of a substitute good
Fall in the price of a complement	Rise in the price of a complement
An increase in the number of buyers	A decrease in the number of buyers
A change in tastes in favour of the commodity	A change in tastes against the commodity
A redistribution of income to groups of people who favour the commodity	Redistribution of income away from groups of people who favour the commodity.
An expectation that price will rise in the future	An expectation that price will fall in the future
Government policies encouraging consumption of the good . Eg. Grant of consumer subsidies	Government regulations discouraging consumption e.g. ban on cigarette smoking / ban on consumption.

4.4.2 Movements along the Demand Curve vs. Shift of Demand Curve

It is important for the business decision-makers to understand the distinction between a movement along a demand curve and a shift of the whole demand curve.

A movement along the demand curve indicates changes in the quantity demanded because of price changes, other factors remaining constant. A shift of the demand curve indicates that there is a change in demand at each possible price because one or more other factors, such as incomes, tastes or the price of some other goods, have changed.

Thus, when an economist speaks of an increase or a decrease in demand, he refers to a shift of the whole curve because one or more of the factors which were assumed to remain constant earlier have changed. When the economists speak of change in quantity demanded he means movement along the same curve (i.e., expansion or contraction of demand) which has happened due to fall or rise in price of the commodity.

In short 'change in demand' represents shift of the demand curve to right or left resulting from changes in factors such as income, tastes, prices of other goods etc. and 'change in quantity demanded' represents movement upwards or downwards on the same demand curve resulting from a change in the price of the commodity.

When demand increases due to factors other than price, firms can sell more at the existing prices resulting in increased revenue. The objective of advertisements and all other sales promotion activities by any firm is to shift the demand curve to the right and to reduce the elasticity of demand. (The latter will be discussed in the next section). However, the additional demand is not free of cost as firms have to incur expenditure on advertisement and sales promotion devices.

1.5 ELASTICITY OF DEMAND

Till now we were concerned with the direction of the changes in prices and quantities demanded. From the point of view of a business firm, it is more important to know the extent of the relationship or the degree of responsiveness of demand to changes in its determinants.

Often, we would want to know how sensitive is the demand for a product to its price; for example, if price increases by 5 percent, how much will the quantities demanded change? Also, how much change in demand will be there if the average income rises by 5 percent? What effect will an advertising campaign have on sales? Economists use a number of different types of elasticities to answer questions like these so as to make demand predictions and to recommend changes in strategies.

Consider the following situations:

- (1) As a result of a fall in the price of headphones from Rs 500 to Rs 400, the quantity demanded increases from 100 headphones to 150 headphones.
- (2) As a result of fall in the price of wheat from Rs 20 per kilogram to Rs 18 per kilogram, the quantity demanded increases from 500 kilograms to 520 kilograms.
- (3) As a result of fall in the price of salt from Rs 9 per kilogram to Rs 7.50, the quantity demanded increases from 1000 kilogram to 1005 kilograms.

What do you notice? You notice that the demand for headphones, wheat and salt responds in the same direction to price changes. The difference lies in the degree of response of demand. The differences in responsiveness of

demand can be found out by comparing the percentage changes in prices and quantities demanded. Here lies the concept of elasticity.

The amount of a commodity purchased is a function of many variables such as price of the commodity, prices of the related commodities, income of the consumers and other factors on which demand depends. A change in one of these independent variables will cause a change in the dependent variable, namely, the amount purchased per unit of time. The elasticity of demand measures the relative responsiveness of the amount purchased per unit of time to a change in any one of these independent variables while keeping others constant. In general, the coefficient of elasticity is defined as the proportionate change in the dependent variable divided by the proportionate change in the independent variable.

Elasticity of demand is defined as the responsiveness of the quantity demanded of a good to changes in one of the variables on which demand depends. More precisely, elasticity of demand is the percentage change in quantity demanded divided by the percentage change in one of the variables on which demand depends.

We may find different measures of elasticity such as price elasticity, cross elasticity, income elasticity, advertisement elasticity and elasticity of substitution. It is to be noted that when we talk of elasticity of demand, unless and until otherwise mentioned, we talk of price elasticity of demand. In other words, it is price elasticity of demand which is usually referred to as elasticity of demand.

1.5.1 Price Elasticity of Demand

Perhaps, the most important measure of elasticity of demand is the price elasticity of demand which measures the sensitivity of quantity demanded to 'own price' or the price of the good itself. The concept of price elasticity of demand is important for a firm for two reasons.

- Knowledge of the nature and degree of price elasticity allows firms to predict the impact of price changes on its sales.
- Price elasticity guides the firm's profit-maximizing pricing decisions.

Price elasticity of demand expresses the responsiveness of quantity demanded of a good to a change in its price, given the consumer's income, his tastes and prices of all other goods. In other words, it is measured as the percentage change in quantity demanded divided by the percentage change in price, other things remaining equal. The price elasticity of demand (also referred to as PED) tells us the percentage change in quantity demanded for each one percent (1%) change in price. That is,

$$\text{Price Elasticity} = Ep = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in Price}}$$

The percentage change in a variable is just the absolute change in the variable divided by the original level of the variable.

Therefore,

$$Ep = \frac{\frac{\text{Change in quantity}}{\text{Original Quantity}} \times 100}{\frac{\text{Change in Price}}{\text{Original Price}} \times 100}$$

$$\text{OR } Ep = \frac{\text{Change in quantity}}{\text{Original Quantity}} \times \frac{\text{Original Price}}{\text{Change in price}}$$

In symbolic terms

$$Ep = \frac{\Delta q}{q} \times \frac{p}{\Delta p} = \frac{\Delta q \times p}{q \Delta p}$$

Where Ep stands for price elasticity

q stands for original quantity

p stands for original price

Δ stands for a change.

A negative sign on the elasticity of demand illustrates the law of demand: less quantity is demanded as the price rises. Notice that the change in quantity was due solely to the price change. The other factors that potentially could affect sales (income and the competitor's price) did not change.

The greater the value of elasticity, the more sensitive quantity demanded is to price. Strictly speaking, the value of price elasticity varies from minus infinity to approach zero. This is because $\frac{\Delta q}{\Delta p}$ has a negative sign. In other words,

since price and quantity are inversely related (with a few exceptions) price elasticity is negative.

While interpreting the coefficient of price elasticity, we consider only the magnitude of the price elasticity- i.e. its absolute size. For example, if $Ep = -1.22$, we say that the elasticity is 1.22 in magnitude. That is, we ignore the negative sign and consider only the numerical value of the elasticity. Thus if a 1% change in price leads to 2% change in quantity demanded of good A and 4% change in quantity demanded of good B, then we get elasticity of A and B as 2 and 4 respectively, showing that demand for B is more elastic or responsive to price changes than that of A. Had we considered minus signs, we would have concluded that the demand for A is more elastic than that for B, which is not correct. Hence, by convention, we take the absolute value of price elasticity and draw conclusions.

A numerical example for price elasticity of demand:

Illustration 1

The price of a commodity decreases from Rs 6 to Rs 4 and quantity demanded of the good increases from 10 units to 15 units. Find the coefficient of price elasticity.

Solution

$$\text{Price elasticity} = (-) \Delta q / \Delta p \times p/q = 5/2 \times 6/10 = (-) 1.5$$

(minus)

Illustration 2

A 5% fall in the price of a good leads to a 15% rise in its demand. Determine the elasticity and comment on its value.

Solution

$$\text{Price Elasticity} = Ep = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in Price}}$$

$$= 15\% / 5\% = 3$$

Comment: The good in question has elastic demand

Illustration 3

The price of a good decreases from ₹100 to ₹60 per unit. If the price elasticity of demand for it is 1.5 and the original quantity demanded is 30 units, calculate the new quantity demanded.

Solution

Here

$$E_p = \frac{\Delta q}{\Delta p} \times \frac{P}{q}$$

i.e.,

$$1.5 = \frac{\Delta q}{40} \times \frac{100}{30} = 18$$

Therefore new quantity demanded = $30 + 18 = 48$ units

Illustration 4

The quantity demanded by a consumer at price Rs 9 per unit is 800 units. Its price falls by 25% and quantity demanded rises by 160 units. Calculate its price elasticity of demand.

Solution

Change in quantity demanded = 160

Therefore, % change in quantity demanded = 20%

% change in price = 25%

$$E_d = \frac{\% \text{ change in } q}{\% \text{ change in } p}$$

$$E_d = \frac{20}{25} = 0.8$$

Illustration 5

A consumer buys 80 units of a good at a price of Rs 4 per unit. Suppose price elasticity of demand is - 4. At what price will he buy 60 units?

Solution

$$E_d = \frac{\Delta q}{\Delta p} \times \frac{P}{q}$$

Or

$$4 = \frac{20}{x - 4} \times \frac{4}{80}$$

Or

$$4 = \frac{1}{x - 4}$$

$$\therefore x = 4.2 \text{ per unit}$$

1.5.2 Point Elasticity

The point elasticity of demand is the price elasticity of demand at a particular point on the demand curve. The concept of point elasticity is used for measuring price elasticity where the change in price is infinitesimal. Price elasticity is a key element in applying marginal analysis to determine optimal prices. Since marginal analysis works by evaluating "small" changes taken with respect to an initial decision, it is useful to measure elasticity with respect to an infinitesimally small change in price.

Point elasticity makes use of derivative rather than finite changes in price and quantity. It may be defined as:

$$E_p = \frac{-dq}{dp} \times \frac{p}{q}$$

Where $\frac{dq}{dp}$ is the derivative of quantity with respect to price at a point on the demand curve, and p and q are the price and quantity at that point. Economists generally use the word "elasticity" to refer to point elasticity.

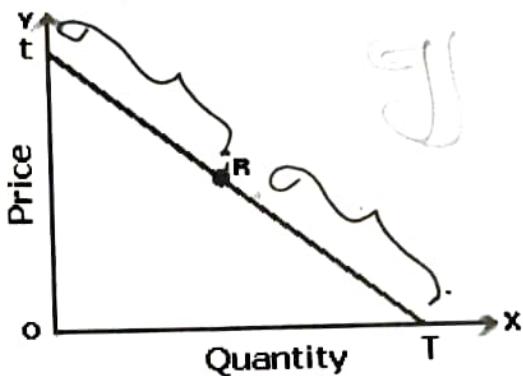


Fig 6: Point Elasticity

Point elasticity is, therefore, the product of price quantity ratio at a particular point on the demand curve and the reciprocal of the slope of the demand line.

1.5.3 Measurement of Elasticity on a Linear Demand Curve – Geometric Method

By definition, the price elasticity of demand is the change in quantity associated with a change in price ($\Delta Q / \Delta P$) times the ratio of price to quantity (P/Q). Therefore, the price elasticity of demand depends not only on the slope of the demand curve but also on the price and quantity. The elasticity, therefore, varies along the curve as price and quantity change. The slope of a linear demand curve is constant. However, the elasticity at different points on a linear demand curve would be different. When price is high price is high and quantity is small, the elasticity is high. The elasticity becomes smaller as we move down the curve.

Given a straight line demand curve tT, (Fig.6 above) point elasticity at any point say R can be found by using the formula

$$\frac{RT}{Rt} = \frac{\text{lower segment}}{\text{upper segment}}$$

Using the above formula we can get elasticity at various points on the demand curve.

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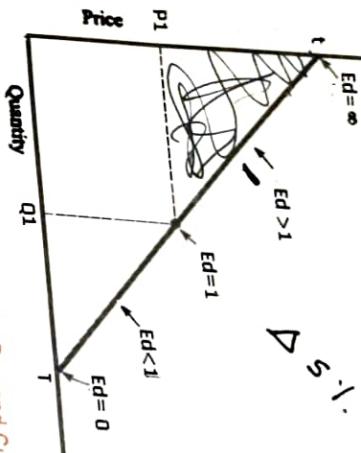


Fig. 7: Elasticity at Different Points on the Demand Curve

Thus, we see that as we move from T towards t , elasticity goes on increasing. At the mid-point it is equal to one, at point t , it is infinity and at T it is zero.

1.5.4 Arc-Elasticity

Often we may be required to calculate price elasticity over some portion of the demand curve rather than at a single point. In other words, the elasticity may be calculated over a range of prices. When price and quantity changes are discrete and large we have to measure elasticity over an arc of the demand curve.

When price elasticity is to be found between two prices (or two points on the demand curve say, A and B in figure 8) the question arises as to which price and quantity should be taken as base. This is because elasticities found by using original price and quantity figures as base will be different from the one derived by using new price and quantity figures. Therefore, in order to avoid confusion, rather than choose the initial or the final price and quantity, the mid-point method is used i.e. the averages of the two prices and quantities are taken as (i.e. original and new) base. The midpoint formula is an approximation to the actual percentage change in a variable, but it has the advantage of consistent elasticity values when price moves in either directions.

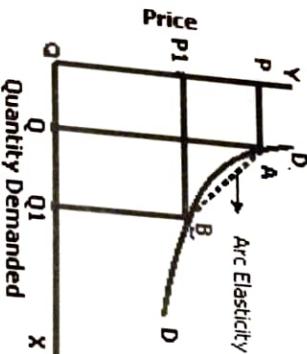


Fig. 8: Arc Elasticity

The arc elasticity can be found out by using the formula: We drop the minus sign and use the absolute value.



$$E_p = \frac{\frac{Q_2 - Q_1}{P_2 - P_1} \times \frac{(Q_2 + Q_1)/2}{(P_2 + P_1)/2}}{\frac{Q_2 - Q_1}{P_2 - P_1} \times \frac{P_2 + P_1}{P_2 - P_1}}$$

Where P_1, Q_1 are the original price and quantity and P_2, Q_2 are the new ones.

Thus, if we have to find elasticity of demand for headphones between:

$$P_1 = \text{Rs. } 500 \quad Q_1 = 100$$

$$P_2 = \text{Rs. } 400 \quad Q_2 = 150$$

We will use the formula

$$E_p = \frac{Q_2 - Q_1}{Q_2 + Q_1} \times \frac{P_2 + P_1}{P_2 - P_1}$$

Or

$$E_p = 1.8$$

The arc elasticity will always lie somewhere (but not necessarily in the middle) between the point elasticities calculated at the lower and the higher prices.

1.5.5 Interpretation of the Numerical Values of Elasticity of Demand

Economists have found it useful to divide the demand behaviour into different categories, based on values of price elasticity. Since we draw demand curves with price on the vertical axis and quantity on the horizontal axis, the steeper the slope of the curve, the less ($1/\text{slope of curve}$). As a result, for any price and quantity combination, the steeper the slope of the curve, the less elastic is demand.

The numerical value of elasticity of demand can assume any value between zero and infinity.

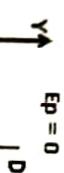
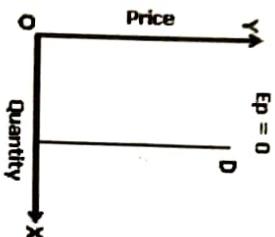
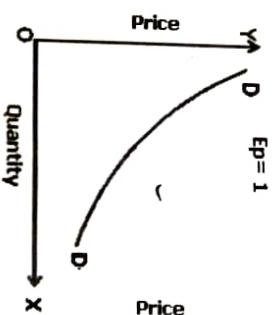
Elasticity is zero, ($E_p = 0$) if there is no change at all in the quantity demanded when price changes i.e. when the quantity demanded does not respond at all to a price change. In other words, any change in price leaves the quantity demanded unchanged and consumers will buy a fixed quantity of a good regardless of its price. Perfectly inelastic demand is as an extreme case of price insensitivity and is therefore only a theoretical category with less practical significance. The vertical demand curve in figure 8(a) represents perfectly or completely inelastic demand.

Elasticity is one, or unitary, ($E_p = 1$) if the percentage change in quantity demanded is equal to the percentage change in price. Figure 8 (b) shows special case of unit-elastic demand, where the demand curve is a rectangular hyperbola.

Elasticity is greater than one ($E_p > 1$) when the percentage change in quantity demanded is greater than the percentage change in price. In such a case, demand is said to be elastic. [Figure 8 (d)]. In other words, the quantity demanded is relatively sensitive to price changes. When drawn, the elastic demand line is fairly flat.

Elasticity is less than one ($E_p < 1$) when the percentage change in quantity demanded is less than the percentage change in price. In such a case, demand is said to be inelastic. [Figure 8 (e)] In this situation, when price falls the buyers are unable or unwilling to significantly contract demand. In other words, the quantity demanded is relatively insensitive to price changes. When drawn, the inelastic demand line is fairly steep.

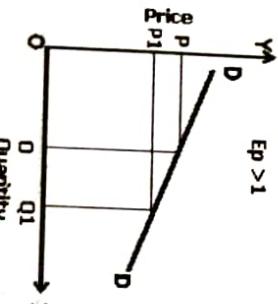
(Elasticity is infinite, ($E_p = \infty$) when a 'small price reduction raises the demand from zero to infinity.) The demand curve is horizontal at the price level (where the demand curve touches the vertical axis). As long as the price stays at one particular level any quantity might be demanded. Moving back and forth along this line, we find that there is a change in the quantity demanded but no change in the price. If there is a slight increase in price, they would not buy anything from the particular seller. That is, even the smallest price rise would cause quantity demanded to fall to zero. Roughly speaking, when you divide a number by zero, you get infinity, denoted by the symbol ∞ . So a horizontal demand curve implies an infinite price elasticity of demand. This type of demand curve is found in a perfectly competitive market. The horizontal demand curve in figure 8 (c) represents perfectly or infinitely elastic demand,

 $E_p = \infty$  $E_p = 1$  $E_p = 0$

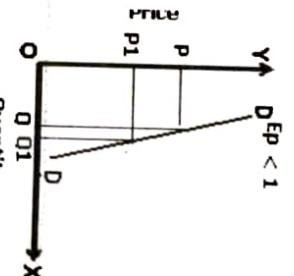
Demand curve of zero elasticity

Demand curve of unitary elasticity

Demand curve of infinite elasticity

 $E_p > 1$

Demand curve of elasticity greater than one

 $E_p < 1$

Demand curve of elasticity less than one

Table 4 : Elasticity Measures, Meaning and Nomenclature

Numerical measure of elasticity	Verbal description	Terminology
Zero	Quantity demanded does not change as price changes	Perfectly (or completely) inelastic
Greater than zero, but less than one	Quantity demanded changes by a smaller percentage than does price	Inelastic
One	Quantity demanded changes by exactly the same percentage as does price	Unit elasticity
Greater than one, but less than infinity	Quantity demanded changes by a larger percentage than does price	Elastic
infinity	Purchasers are prepared to buy all they can obtain at some price and none at all at an even slightly higher price	Perfectly (or infinitely) elastic

Now that we are able to classify goods according to their price elasticity, let us see whether the goods mentioned below are price elastic or inelastic.

Sl. No.	Name of the Commodity	Calculation of Elasticity $E_p = \frac{Q_2 - Q_1}{Q_2 + Q_1} \times \frac{P_2 - P_1}{P_2 + P_1}$	Nature of Elasticity
1.	Headphones	$\frac{100 - 150}{100 + 150} \times \frac{500 + 400}{500 - 400} = 1.8 > 1$	Elastic
2.	Wheat	$\frac{500 - 520}{500 + 520} \times \frac{20 + 18}{20 - 18} = 0.37 < 1$	Inelastic
3.	Common Salt	$\frac{1000 - 1005}{1000 + 1005} \times \frac{9 + 7.50}{9 - 7.50} = 0.02743 < 1$	Inelastic

What do we note in the above hypothetical example? We note that the demand for headphones is quite elastic, while demand for wheat is quite inelastic and the demand for salt is almost the same even after a reduction in price. The price elasticity of demand for the vast majority of goods is somewhere between the two extreme cases of zero and infinity. Generally, in real world situations also, we find that the demand for goods like refrigerators, TVs, laptops, fans, etc. is elastic; the demand for goods like wheat and rice is inelastic; and the demand for salt is highly inelastic or perfectly inelastic. Why do we find such a difference in the behaviour of consumers in respect of different commodities? We shall explain later at length those factors which are responsible for the differences in elasticity of demand for various goods. Before that, we will consider another method of calculating price-elasticity which is called total outlay method.

1.5.6 Total Outlay Method of Calculating Price Elasticity

Price + Outlay

The price elasticity of demand for a commodity and the total expenditure or outlay made on it are significantly related to each other. As the total expenditure (price of the commodity multiplied by the quantity of that commodity purchased) made on a commodity is the total revenue received by the seller (price of the commodity multiplied by quantity of that commodity sold of that commodity), we can say that the price elasticity and total revenue received are closely related to each other. By analysing the changes in total expenditure (or total revenue) in response to a change in the price of the commodity, we can know the price elasticity of demand for it.

Price Elasticity of demand equals one or Unity: When, as a result of the change in price of a good, the total expenditure on the good or the total revenue received from that good remains the same, the price elasticity for the good is equal to unity. This is because the total expenditure made on the good can remain the same only if the proportional change in quantity demanded is equal to the proportional change in price. Thus, if there is a given percentage increase (or decrease) in the price of a good and if the price elasticity is unitary, total expenditure of the buyer on the good or the total revenue received from it will remain unchanged.

Price elasticity of demand is greater than unity: When, as a result of increase in the price of a good, the total expenditure made on the good or the total revenue received from that good falls or when as a result of decrease in price, the total expenditure made on the good or total revenue received from that good increases, we say that price elasticity of demand is greater than unity. In our example of headphones, as a result of fall in price of headphones, from Rs 500 to Rs 400, the total revenue received from headphones increases from Rs 50,000 (500×100) to Rs 60,000 (400×150), indicating elastic demand for headphones. Similarly, had the price of headphones increased from Rs 400 to Rs 500, the demand would have fallen from 150 to 100 indicating a fall in the total revenue received from Rs 60,000 to Rs 50,000 showing elastic demand for headphones.

Price elasticity of demand is less than unity: When, as a result of increase in the price of a good, the total expenditure made on the good or the total revenue received from that good increases or when as a result of decrease in its price, the total expenditure made on the good or the total revenue received from that good falls, we say that the price elasticity of demand is less than unity. In the example of wheat above, as a result of fall in the price of wheat from Rs 20 per kg. to Rs 18 per kg. the total revenue received from wheat falls from Rs 10,000 (20×500) to Rs 9360 (18×520) indicating inelastic demand for wheat. Similarly, we can show that as a result of increase in the price of wheat from Rs 18 to Rs 20 per kg., the total revenue received from wheat increase from Rs 9360 to Rs 10,000 indicating inelastic demand for wheat.

The main drawback of this method is that by using this we can only say whether the demand for a good is elastic or inelastic; we cannot find out the exact coefficient of price elasticity.

Why should a business firm be concerned about elasticity of demand? The reason is that the degree of elasticity of demand predicts how changes in the price of a good will affect the total revenue earned by the producers from the sale of that good. The total revenue is defined as the total value of sales of a good or service. It is equal to the price multiplied by the quantity sold.

1.5.7 Total Revenue

$$\boxed{\text{Total revenue (TR)} = \text{Price} \times \text{Quantity sold}}$$

Except in the rare case of a good with perfectly elastic or perfectly inelastic demand, when a seller raises the price of a good, there are two effects which act in opposite directions on revenue.

- **Price effect:** After a price increase (decrease), each unit sold sells at a higher (lower) price, which tends to raise (lower) the revenue.

- **Quantity effect:** After a price increase (decrease), fewer (more) units are sold, which tends to lower (increase) the revenue.

The price elasticity of demand tells us what happens to the total revenue when price changes: its size determines which effect, the price effect or the quantity effect, is stronger.

If demand for a good is unit-elastic (the price elasticity of demand is equal to one; Figure 9), an increase in price or decrease in price does not change total revenue. In this case, the quantity effect and the price effect exactly balance each other. When price rises from P to P_1 , the gain in revenue (Area A) is equal to loss in revenue due to lost sales (Area B).

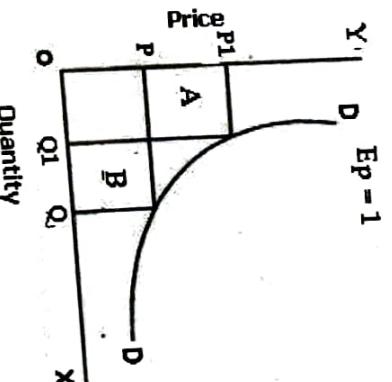


Figure 9: Total revenue when Elasticity = 1

If demand for a good is inelastic (the price elasticity of demand is less than one), a higher price increases total revenue. In this case, the quantity effect is weaker than the price effect. On the contrary, when demand is elastic, a fall in price reduces total revenue because the quantity effect is dominated by the price effect. Refer Figure 8 (e) above.

If demand for a good is elastic (the price elasticity of demand is greater than one), an increase in price reduces total revenue and a fall in price increases total revenue. In this case, the quantity effect is stronger than the price effect. Refer Figure 8 (d) above.