Lecture 2 Summary (1)

LO. Calculate and interpret price, income, and cross-price elasticities of demand, and describe factors that affect each measure.

Elasticity of demand is measured as a ratio of percentage change in quantity demanded to a percentage change in other variables.

Own-price elasticity

- $\text{Own price elasticity} = \frac{\%\text{ change in quanitity demanded}}{\%\text{ change in own price}}$
- Own-price elasticity of demand is usually negative.
- If |own-price elasticity| > 1, then demand is elastic.
- If |own-price elasticity| < 1, then demand is inelastic.

Income elasticity

- $\text{Income elasticity} = \frac{\%\text{ change in quanitity demanded}}{\%\text{ change in income}}$
- If income elasticity > 0, then the good is a normal good.
- If income elasticity < 0, then the good is an inferior good.

Cross price elasticity

- $\text{Cross price elasticity} = \frac{\%\text{ change in quanitity demanded}}{\%\text{ change in price of related good}}$
- If cross price elasticity > 0, then the related good is a substitute.
- If cross price elasticity < 0, then the related good is a complement.

Lecture 2 Summary (2)

LO. Compare substitution and income effects.

Substitution effect

- When a good's price falls, due to the substitution effect, consumers buy more of this good as compared to other goods for which the prices have remained the same.
- Substitution effect is always positive.

Income effect

- When a good's price falls, real income rises.
- If the good is a normal good, the income effect will be positive and more of this good will be purchased.
- If the good is an inferior good, the income effect will be negative and less of this good will be purchased.

Lecture 2 Summary (3)

LO. Contrast normal goods with inferior goods.

If income elasticity > 0, then the good is a normal good. If income increases, more of this good is demanded.

If income elasticity < 0, then the good is an inferior good. If income increases, less of this good is demanded.

Giffen goods

- Giffen goods are highly inferior, for which the negative income effect outweighs the positive substitution effect.
- Therefore, even though price falls, the quantity demanded still decreases.
- Giffen goods have positively sloped demand curves (which means that as price decreases the quantity demanded also decreases.)

Veblen goods

- Veblen goods are “high status” goods.
- If price increases, this makes the goods even more desirable and quantity demanded increases.
- Veblen goods also have a positively sloped demand curve.