

# Handout 10-1

## WHAT IS PRICE ELASTICITY OF DEMAND?

Name \_\_\_\_\_

Class \_\_\_\_\_

You have learned that when price changes, the quantity demanded changes. An increase in price causes a decrease in the quantity demanded. A decrease in price causes an increase in the quantity demanded.

However, it's not enough to know that the quantity demanded rises or falls in response to price changes. It is also important to know by how much the quantity demanded changes. A business may decide not to increase the price of a product if people will buy *much less* of it at the higher price. Or, a business may decide to increase the price of a product if people will buy only a *little less* of it at the higher price.

How much the quantity demanded changes in response to price changes is called the **price elasticity of demand**. If the quantity demanded changes considerably, the good or service has an *elastic* demand. Elastic demand means the quantity demanded is very responsive to changes in price. If the quantity demanded changes little, the good or service has an *inelastic* demand. Inelastic demand means the quantity

demanded responds relatively little to changes in price.

Several factors can determine if a product has an elastic or an inelastic demand schedule.

Necessities tend to have an inelastic demand. People find it hard to give up a necessity because they cannot readily buy less of it when its price rises. Luxuries tend to have an elastic demand. People can get along without them if the price becomes too high.

Products that have many substitutes tend to have an elastic demand because it is easy to buy a substitute if the price of one product in the group of substitutes rises too much. A product that has few substitutes tends to have an inelastic demand. Buyers don't have much choice if there are few substitutes, so they think twice before giving up such a product when its price rises.

Goods and services that take a large portion of a purchaser's budget tend to have an elastic demand schedule. Those that consume a small portion of a purchaser's budget tend to have an inelastic demand schedule.

**INSTRUCTIONS:** Determine whether the demand for the following items is price elastic or inelastic. Write your answer on the line after the item. Then write the reasons for your answer.

- 1 Salt \_\_\_\_\_ Why? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
- 2 New cars \_\_\_\_\_ Why? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
- 3 Pork chops \_\_\_\_\_ Why? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
- 4 European vacation trip \_\_\_\_\_ Why? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
- 5 Insulin \_\_\_\_\_ Why? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
- 6 Insulin at one of four drug stores in a shopping mall \_\_\_\_\_ Why? \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_