In this chapter, look for the answers to these questions:

- What is elasticity? What kinds of issues can elasticity help us understand?
- What is the price elasticity of demand? How is it related to the demand curve? How is it related to revenue & expenditure?
- What is the price elasticity of supply? How is it related to the supply curve?
- What are the income and cross-price elasticities of demand?

You design websites for local businesses. You charge $200 per website, and currently sell 12 websites per month. Your costs are rising (including the opportunity cost of your time), so you consider raising the price to $250. The law of demand says that you won’t sell as many websites if you raise your price. How many fewer websites? How much will your revenue fall, or might it increase?

### Price Elasticity of Demand

Price elasticity of demand  =  \( \frac{\text{Percentage change in } Q_d}{\text{Percentage change in } P} \)

- **Price elasticity of demand** measures how much \( Q_d \) responds to a change in \( P \).
- Loosely speaking, it measures the price-sensitivity of buyers’ demand.

### Elasticity

- Basic idea: Elasticity measures how much one variable responds to changes in another variable.
  - One type of elasticity measures how much demand for your websites will fall if you raise your price.
- Definition: Elasticity is a numerical measure of the responsiveness of \( Q_d \) or \( Q_s \) to one of its determinants.

#### Example:

\[
\text{Price elasticity of demand} = \frac{15\%}{10\%} = 1.5
\]
Along a D curve, P and Q move in opposite directions, which would make price elasticity negative. We will drop the minus sign and report all price elasticities as positive numbers.

**Price Elasticity of Demand**

Price elasticity of demand = \( \frac{\text{Percentage change in } Q^d}{\text{Percentage change in } P} \)

**Calculating Percentage Changes**

**Problem:**

The standard method gives different answers depending on where you start.

- From A to B, \( P \) rises 25%, \( Q \) falls 33%, elasticity = \( \frac{33}{25} = 1.33 \)
- From B to A, \( P \) falls 20%, \( Q \) rises 50%, elasticity = \( \frac{50}{20} = 2.50 \)

The standard method of computing the percentage (%) change:

\[
\text{end value} - \text{start value} \times 100\%
\]

Going from A to B, the % change in \( P \) equals \( \frac{250-200}{200} = 25\% \)

So, we instead use the midpoint method:

\[
\frac{\text{end value} - \text{start value}}{\text{midpoint}} \times 100\%
\]

- The midpoint is the number halfway between the start & end values, the average of those values.
- It doesn’t matter which value you use as the “start” and which as the “end” — you get the same answer either way!

Using the midpoint method, the % change in \( P \) equals:

\[
\frac{250 - 200}{225} \times 100\% = 22.2\%
\]

The % change in \( Q \) equals:

\[
\frac{12 - 8}{10} \times 100\% = 40.0\%
\]

The price elasticity of demand equals:

\[
\frac{40}{22.2} = 1.8
\]

**Calculate an Elasticity**

Use the following information to calculate the price elasticity of demand for hotel rooms:

- if \( P = 70, \ Q^d = 5000 \)
- if \( P = 90, \ Q^d = 3000 \)
What determines price elasticity?

To learn the determinants of price elasticity, we look at a series of examples. Each compares two common goods.

In each example:
- Suppose the prices of both goods rise by 20%.
- The good for which \( Q_d \) falls the most (in percent) has the highest price elasticity of demand. Which good is it? Why?
- What lesson does the example teach us about the determinants of the price elasticity of demand?

**EXAMPLE 1:**

**Breakfast cereal vs. Sunscreen**

- The prices of both of these goods rise by 20%.
  - For which good does \( Q_d \) drop the most? Why?
  - Breakfast cereal has close substitutes (e.g., pancakes, Eggo waffles, leftover pizza), so buyers can easily switch if the price rises.
  - Sunscreen has no close substitutes, so consumers would probably not buy much less if its price rises.
- Lesson: **Price elasticity is higher when close substitutes are available.**

**EXAMPLE 2:**

**“Blue Jeans” vs. “Clothing”**

- The prices of both goods rise by 20%.
  - For which good does \( Q_d \) drop the most? Why?
  - For a narrowly defined good such as blue jeans, there are many substitutes (khakis, shorts, Speedos).
  - There are fewer substitutes available for broadly defined goods. (There aren't too many substitutes for clothing, other than living in a nudist colony.)
- Lesson: **Price elasticity is higher for narrowly defined goods than broadly defined ones.**

**EXAMPLE 3:**

**Insulin vs. Caribbean Cruises**

- The prices of both of these goods rise by 20%.
  - For which good does \( Q_d \) drop the most? Why?
  - To millions of diabetics, insulin is a necessity. A rise in its price would cause little or no decrease in demand.
  - A cruise is a luxury. If the price rises, some people will forego it.
- Lesson: **Price elasticity is higher for luxuries than for necessities.**

**EXAMPLE 4:**

**Gasoline in the Short Run vs. Gasoline in the Long Run**

- The price of gasoline rises 20%. Does \( Q_d \) drop more in the short run or the long run? Why?
  - There's not much people can do in the short run, other than ride the bus or carpool.
  - In the long run, people can buy smaller cars or live closer to where they work.
- Lesson: **Price elasticity is higher in the long run than the short run.**
The Determinants of Price Elasticity: A Summary

The price elasticity of demand depends on:
- the extent to which close substitutes are available
- whether the good is a necessity or a luxury
- how broadly or narrowly the good is defined
- the time horizon – elasticity is higher in the long run than the short run

The Variety of Demand Curves

- The price elasticity of demand is closely related to the slope of the demand curve.
- Rule of thumb:
  The flatter the curve, the bigger the elasticity. The steeper the curve, the smaller the elasticity.
- Five different classifications of D curves:

  **“Perfectly inelastic demand”** (one extreme case)
  - Price elasticity of demand = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} = \frac{0\%}{10\%} = 0 \)
  - D curve: vertical
  - Consumers’ price sensitivity: none
  - Elasticity: 0
  - Consumers price sensitivity: none

  **“Inelastic demand”**
  - Price elasticity of demand = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} = \frac{<10\%}{10\%} < 1 \)
  - D curve: relatively steep
  - Consumers’ price sensitivity: relatively low
  - Elasticity: \(< 1\)
  - Consumers price sensitivity: relatively low

  **“Unit elastic demand”**
  - Price elasticity of demand = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} = \frac{10\%}{10\%} = 1 \)
  - D curve: intermediate slope
  - Consumers’ price sensitivity: intermediate
  - Elasticity: 1
  - Consumers price sensitivity: intermediate

  **“Elastic demand”**
  - Price elasticity of demand = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} = \frac{>10\%}{10\%} > 1 \)
  - D curve: relatively flat
  - Consumers’ price sensitivity: relatively high
  - Elasticity: \( > 1\)
  - Consumers price sensitivity: relatively high
"Perfectly elastic demand" (the other extreme)

Price elasticity of demand = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} \)

For any \( \% \text{ change in } P \) = infinity

**D curve:** horizontal

Consumers’ price sensitivity: extreme

Elasticity: infinity

**Price Elasticity and Total Revenue**

- Continuing our scenario, if you raise your price from $200 to $250, would your revenue rise or fall?

  Revenue = \( P \times Q \)

  - A price increase has two effects on revenue:
    - Higher \( P \) means more revenue on each unit you sell.
    - But you sell fewer units (lower \( Q \)), due to Law of Demand.
  - Which of these two effects is bigger? It depends on the price elasticity of demand.

**Price Elasticity and Total Revenue**

If demand is elastic, then price elast. of demand > 1

\( \% \text{ change in } Q > \% \text{ change in } P \)

- The fall in revenue from lower \( Q \) is greater than the increase in revenue from higher \( P \), so revenue falls.

Elastic demand (elasticity = 1.8)

- If \( P = $200 \), \( Q = 12 \) and revenue = $2400.
- If \( P = $250 \), \( Q = 8 \) and revenue = $2000.

When \( D \) is elastic, a price increase causes revenue to fall.

**Price Elasticity and Total Revenue**

If demand is inelastic, then price elast. of demand < 1

\( \% \text{ change in } Q < \% \text{ change in } P \)

- The fall in revenue from lower \( Q \) is smaller than the increase in revenue from higher \( P \), so revenue rises.
- In our example, suppose that \( Q \) only falls to 10 (instead of 8) when you raise your price to $250.
Price Elasticity and Total Revenue

Now, demand is inelastic:
elasticity = 0.82

If \( P = 200 \),
\( Q = 12 \) and
revenue = $2400.

If \( P = 250 \),
\( Q = 10 \) and
revenue = $2500.

When \( D \) is inelastic,
a price increase
causes revenue to rise.

ACTIVE LEARNING 2
Elasticity and expenditure/revenue

A. Pharmacies raise the price of insulin by 10%.
Does total expenditure on insulin rise or fall?

B. As a result of a fare war, the price of a luxury
cruise falls 20%.
Does luxury cruise companies’ total revenue
rise or fall?

ACTIVE LEARNING 2
Answers

A. Pharmacies raise the price of insulin by 10%.
Does total expenditure on insulin rise or fall?

Expenditure = \( P \times Q \)
Since demand is inelastic, \( Q \) will fall less
than 10%, so expenditure rises.

B. As a result of a fare war, the price of a luxury
cruise falls 20%.
Does luxury cruise companies’ total revenue
rise or fall?

Revenue = \( P \times Q \)
The fall in \( P \) reduces revenue,
but \( Q \) increases, which increases revenue.
Which effect is bigger?
Since demand is elastic, \( Q \) will increase more
than 20%, so revenue rises.

APPLICATION: Does Drug Interdiction Increase or Decrease Drug-Related Crime?

- One side effect of illegal drug use is crime:
Users often turn to crime to finance their habit.
- We examine two policies designed to reduce illegal drug use and see what effects they have
on drug-related crime.
- For simplicity, we assume the total dollar value
of drug-related crime equals total expenditure
on drugs.
- Demand for illegal drugs is inelastic, due to addiction issues.

Policy 1: Interdiction

Interdiction reduces the supply
of drugs.
Since demand for drugs is inelastic,
\( P \) rises proportionally more
than \( Q \) falls.
Result: an increase in total spending on drugs,
and in drug-related crime

new value of drug-related crime
initial value of drug-related crime

Price of Drugs

S1
S2
D1
D2
P1
P2
Q1
Q2
Quantity of Drugs
Policy 2: Education

Education reduces the demand for drugs. 

Result: A decrease in total spending on drugs, and in drug-related crime.

Price of Drugs

new value of drug-related crime

Price Elasticity of Supply

Price elasticity of supply = \frac{\text{Percentage change in } Q^s}{\text{Percentage change in } P}

Example:

Price elasticity of supply equals \frac{16\%}{8\%} = 2.0

The Variety of Supply Curves

- The slope of the supply curve is closely related to price elasticity of supply.
- Rule of thumb: The flatter the curve, the bigger the elasticity. The steeper the curve, the smaller the elasticity.
- Five different classifications....

"Perfectly inelastic" (one extreme)

Price elasticity of supply = \frac{\% \text{ change in } Q}{\% \text{ change in } P} = \frac{0\%}{10\%} = 0

S curve: vertical

Sellers' price sensitivity: none

Elasticity: 0

"Inelastic"

Price elasticity of supply = \frac{\% \text{ change in } Q}{\% \text{ change in } P} < \frac{10\%}{10\%} < 1

S curve: relatively steep

Sellers' price sensitivity: relatively low

Elasticity: < 1

P rises by 10%

Q changes by 0%

P rises less than 10%

Q rises less than 10%
"Unit elastic"
Price elasticity of supply = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} \)
\( = \frac{10\%}{10\%} = 1 \)
S curve: intermediate slope
Sellers’ price sensitivity: intermediate
Elasticity: = 1

"Elastic"
Price elasticity of supply = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} \)
\( > \frac{10\%}{10\%} > 1 \)
S curve: relatively flat
Sellers’ price sensitivity: relatively high
Elasticity: \( > 1 \)

"Perfectly elastic" (the other extreme)
Price elasticity of supply = \( \frac{\% \text{ change in } Q}{\% \text{ change in } P} \)
\( = \frac{\text{any } \%}{0\%} = \text{infinity} \)
S curve: horizontal
Sellers’ price sensitivity: extreme
Elasticity: infinity

The Determinants of Supply Elasticity
- The more easily sellers can change the quantity they produce, the greater the price elasticity of supply.
- Example: Supply of beachfront property is harder to vary and thus less elastic than supply of new cars.
- For many goods, price elasticity of supply is greater in the long run than in the short run, because firms can build new factories, or new firms may be able to enter the market.

**ACTIVE LEARNING 3**
**Elasticity and changes in equilibrium**
- The supply of beachfront property is inelastic. The supply of new cars is elastic.
- Suppose population growth causes demand for both goods to double (at each price, \( Q^d \) doubles).
- For which product will \( P \) change the most?
- For which product will \( Q \) change the most?

**ACTIVE LEARNING 3**
**Answers**
When supply is inelastic, an increase in demand has a bigger impact on price than on quantity.
**Other Elasticities**

- **Income elasticity of demand**: measures the response of \( Q^d \) to a change in consumer income

\[
\text{Income elasticity of demand} = \frac{\text{Percent change in } Q^d}{\text{Percent change in income}}
\]

- Recall from Chapter 4: An increase in income causes an increase in demand for a *normal* good.
- Hence, for normal goods, income elasticity > 0.
- For *inferior* goods, income elasticity < 0.

**Cross-price elasticity of demand**: measures the response of demand for one good to changes in the price of another good

\[
\text{Cross-price elast. of demand} = \frac{\% \text{ change in } Q^d \text{ for good 1}}{\% \text{ change in price of good 2}}
\]

- For substitutes, cross-price elasticity > 0 (e.g., an increase in price of beef causes an increase in demand for chicken)
- For complements, cross-price elasticity < 0 (e.g., an increase in price of computers causes decrease in demand for software)

**Cross-Price Elasticities in the News**

"As Gas Costs Soar, Buyers Flock to Small Cars"
- *New York Times*, 5/2/2008

"Gas Prices Drive Students to Online Courses"

"Gas prices knock bicycle sales, repairs into higher gear"

"Camel demand soars in India" (as a substitute for “gas-guzzling tractors”)
- *Financial Times*, 5/2/2008

"High gas prices drive farmer to switch to mules"

**CHAPTER SUMMARY**

- Elasticity measures the responsiveness of \( Q^d \) or \( Q^s \) to one of its determinants.
- Price elasticity of demand equals percentage change in \( Q^d \) divided by percentage change in \( P \). When it's less than one, demand is "inelastic." When greater than one, demand is "elastic."
- When demand is inelastic, total revenue rises when price rises. When demand is elastic, total revenue falls when price rises.
CHAPTER SUMMARY

- Demand is less elastic in the short run, for necessities, for broadly defined goods, or for goods with few close substitutes.
- Price elasticity of supply equals percentage change in $Q^s$ divided by percentage change in $P$. When it’s less than one, supply is “inelastic.” When greater than one, supply is “elastic.”
- Price elasticity of supply is greater in the long run than in the short run.

CHAPTER SUMMARY

- The income elasticity of demand measures how much quantity demanded responds to changes in buyers’ incomes.
- The cross-price elasticity of demand measures how much demand for one good responds to changes in the price of another good.