

Demand

SECTION 1

UNDERSTANDING DEMAND

TEXT SUMMARY

The **law of demand** states that a good's price has an important effect on the amount of that good people will buy. The lower the price, the more consumers will buy. Similarly, the higher the price, the less consumers will buy. More people will buy a slice of pizza priced at \$1 than at \$10.

The law of demand results from two patterns of human behavior. The first, known as the **substitution effect**, says that as the price of a good rises, people are more likely to *substitute* alternative goods. When the price of pizza becomes more expensive compared to other foods, like tacos, people are more likely to buy those other foods. The result is that the demand for pizza drops.

However, if the price of pizza drops, consumers are more likely to substitute pizza for other choices. This causes the demand for pizza to rise.

The other pattern is known as the **income effect**. When the price of pizza and other goods rise, people are likely to feel poorer. The income effect takes place when a consumer responds to a price increase by spending more on that good, even though it is more expensive. They spend more, but usually buy less.

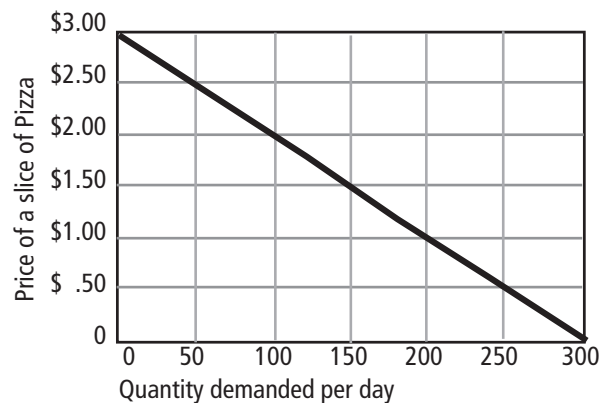
A **demand curve** illustrates the quantities demanded at each price by consumers in the market. The vertical axis shows price, and the horizontal axis shows the quantity demanded. Because demand rises as prices fall, the demand curve slopes down and to the right.

THE BIG IDEA

The law of demand says that people will buy less of a good when its price rises, and more of a good when its price falls.

GRAPHIC SUMMARY: Market Demand Curve

The demand curve shows the relationship between a good's price and the demand for that good. Since demand increases as prices fall, the curve slopes down to the right.



REVIEW QUESTIONS

1. According to the law of demand, a fall in the price of milk has what effect on the amount of milk people will buy?
2. **Graph Skills** At \$.50 per slice, what is the demand for pizza per day?

SHIFTS OF THE DEMAND CURVE

TEXT SUMMARY

Many other factors besides price can affect the demand for goods. For example, if it was discovered that tomato sauce was extremely good for your health, demand for pizza would rise. Consumers would want to buy more pizza at all price levels. This increase in demand shifts the entire demand curve to the right. If it was announced that tomato sauce was unhealthy, then people would buy less pizza at all price levels. This decrease in demand shifts the demand curve to the left.

Other factors can shift the demand curve. For example, if your income were to rise, you might buy more pizza. Higher income causes people to buy more of most goods at every price level. This creates a shift to the right of the

demand curve. Similarly, a decrease in income causes demand for most goods to fall.

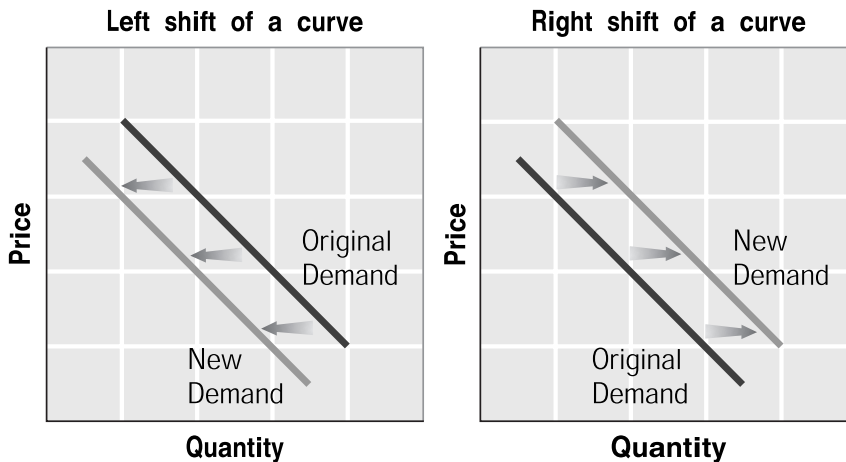
Changes in population will affect demand. For example, an increase in the number of senior citizens is likely to increase the demand for medical care. Advertising and fashion trends can also have a big effect on consumer demand.

The demand for one good can also affect the demand for other goods. **Complements** are two goods that are bought and used together. People who buy skis are likely to buy ski boots. **Substitutes** are goods used in place of one another. When people buy more snowboards they will buy fewer skis.

THE BIG IDEA

Many factors besides price can change the demand for goods.

GRAPHIC SUMMARY: Shifts of the Demand Curve



An increase in demand causes more of a good to be demanded at all price levels. This shifts the demand curve to the right. A decrease in demand causes less of a good to be demanded, shifting the demand curve to the left.

REVIEW QUESTIONS

1. How does an increase in income affect the demand for most goods?
2. **Graph Skills** What change in demand is illustrated by a shift to the left of the demand curve?

TEXT SUMMARY

Economists use the term **elasticity of demand** to describe the way people respond to price changes. If you keep buying despite a price increase, your demand is **inelastic**. If you buy less after a small price increase your demand is **elastic**. Demand tends to be inelastic for goods that have few substitutes, like medicines, or for goods that are considered essential, like milk.

THE BIG IDEA

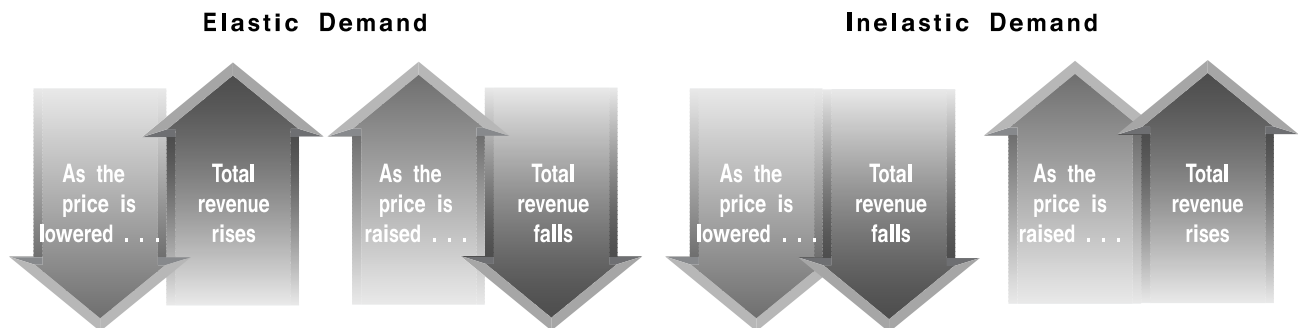
Elasticity of demand describes how people react to changes in prices.

To compute elasticity of demand, take the percentage change in the demand of a good and divide this number by the percentage change in the price of the good. Say that if the price of pizza rises from \$1.00 to \$1.50, demand falls from 4 to 3 slices per day. The change in demand is a 25

percent decrease. The change in price is a 50 percent increase. The elasticity of demand is 25 percent divided by 50 percent, or .5. Since this number is less than 1, the demand is inelastic—customers continue to buy even if the price increases. A demand that is more than 1 is elastic.

Elasticity is an important tool for business owners. It helps them to determine how a change in prices will affect their business's **total revenue**, or the amount of money the company receives by selling its goods. If a business faces elastic demand, then raising prices will result in a sharp drop in demand, decreasing total revenue. However, when a good has an inelastic demand, a business might be able to increase its total revenue by increasing the price.

GRAPHIC SUMMARY: Total Revenue and Elasticity



If a business sells a product with elastic demand, consumers are very responsive to price changes. A small price rise could result in much less demand, reducing total revenue. If demand is inelastic, a price rise will not affect demand quite so sharply. Consumers will buy nearly as much of the product at higher prices, and total revenue will rise.

REVIEW QUESTIONS

1. Explain why the demand for a particular brand of apple juice is elastic.
2. **Diagram Skills** What happens if demand is elastic and the price is lowered?

CHAPTER 4**Test****IDENTIFYING MAIN IDEAS**

Write the letter of the correct answer in the blank provided. (10 points each)

- _____ 1. The law of demand says
- A. the higher the price, the more consumers will buy.
 - B. the lower the price, the less consumers will buy.
 - C. the lower the price, the more consumers will buy.
 - D. the lower the price, the more consumers will substitute.
- _____ 2. A drop in price will
- A. increase the demand for goods.
 - B. decrease the demand for goods.
 - C. not affect the demand for goods.
 - D. not affect the law of demand.
- _____ 3. Which of the following describes the substitution effect?
- A. As the price of a good falls, people will substitute other products.
 - B. As the price of a good rises, people will substitute other products.
 - C. As demand rises, people will substitute other products.
 - D. As demand falls, people will substitute other products.
- _____ 4. A demand curve illustrates
- A. the differences in price charged by different stores.
 - B. the quantities demanded at each price by consumers.
 - C. the differences in demand for different products.
 - D. the products which are most in demand.
- _____ 5. For most goods, a rise in people's income means that there will be
- A. a substitution effect.
 - B. a rise in prices.
 - C. an increase in demand.
 - D. a decrease in demand.
- _____ 6. Which of the following is NOT an example of complements?
- A. skis and ski boots
 - B. row boat and oars
 - C. electric shaver and charging cord
 - D. calculator and cell phone
- _____ 7. Substitutes are
- A. goods that are bought and used together.
 - B. goods used in place of one another.
 - C. goods that cannot be replaced.
 - D. goods which cause a shift in the demand curve.
- _____ 8. If you keep buying despite a price increase, your demand is
- A. elastic.
 - B. strong.
 - C. normal.
 - D. inelastic.
- _____ 9. Which of the following is an example of a good with inelastic demand?
- A. life-saving medicine
 - B. television sets
 - C. computers
 - D. a particular brand of chewing gum
- _____ 10. Total revenue is defined as
- A. the amount of profit a company makes.
 - B. the amount of profit a company makes after paying taxes.
 - C. the amount of money a company makes by selling its goods.
 - D. the amount of money affected by price elasticity.