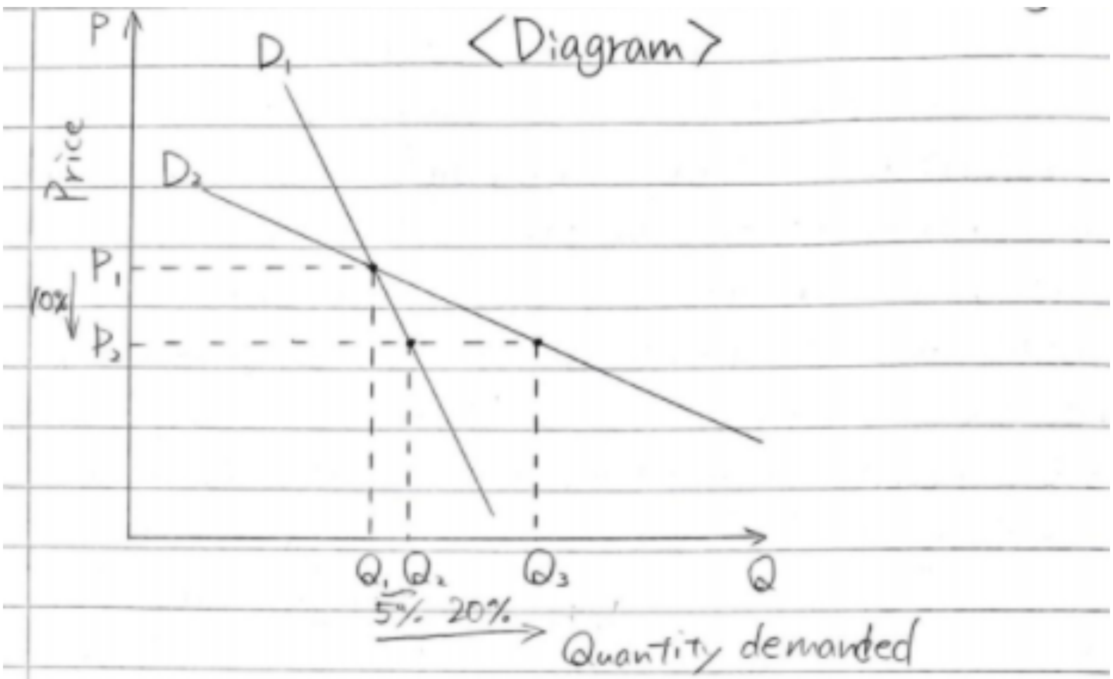
Sample 1 : Best answer work Topic: Syllabus 2.5 Elasticity **Webnote 980**

12. Explain three determinants of price elasticity of demand (PED). [10 marks] - N13/3/ECONO/SP1/ENG/TZ0/XX

What score do you think this student received?

Price elasticity of demand is the measurement of the responsiveness of quantity demanded to changes in price. High price elasticity of demand means that when prices change, quantity demanded ~~quo~~ change with relatively large response to them. There are three main determinants of PED. One is the degree of necessities, the second is the proportion spent of income on products and the last is the number and closeness of substitutes.



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First of all, goods with large degree of necessity tend to have inelastic demand. Necessities are goods which are essential for living. For examples, foods are essential goods. Such necessities are price inelastic because consumers will buy goods regardless of the price. Inelastic demand can be seen in <Diagram> as D_1 demand curve. Price change from P_1 to P_2 which is 10% drop results in 5% increase in quantity demanded from Q_1 to Q_2. Price change leads to relatively small change in quantity demanded, therefore it is price inelastic. On the other hand, goods that are not necessities but are luxuries tend to have elastic demand. For example, cars and restaurants. Such demand can be seen in <Diagram> as D_2 curve. Price change from P_1 to P_2 which is 10 % drop leads to relatively large increase in quantity demanded which is 20% increase from Q_1 to Q_3.

Second determinants of PED is the proportion spent on goods of the consumers' income. The more proportion of income spent on goods, the more elastic the demand will be. For example, pencils which are low proportion of income spent can be bought after 10% increase in price. But on the other hand, goods that spend high proportion of income such as cars, consumers tend to stop buying them when the price increases by 10%.

The third determinants of PED is the number and closeness of substitutes. Goods with a lot of substitutes such as notebooks, consumers can switch the product

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from one to another when one of the notebooks has increased in its price. Goods that have close substitutes such as Coca Cola and Pepsi, consumers are able to switch between them if one of the price increases. Substitutes are defined as goods that can be ~~placed~~ used in place of each other, thus the more substitutes a good ~~have~~ has, the more price elastic it will be. And the more close substitutes a good has, the more price elastic demand it will ~~has~~ have as well.

In conclusion to the question, there are mainly three determinants of price elasticity of demand. One is the degree of necessities which necessities tend to be price inelastic, and in contrast luxuries tend to be price elastic. The second is the proportion of income spent on goods which increases the elasticity as the proportion of income spent rises. The last is the number and closeness of substitutes which increases the elasticity with increasing number and closeness of substitutes.