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 corresponds to the measure of responsiveness of quantity demanded for a good or service (ΔQd) when there is a change in price (ΔP). In case the responsiveness is low when a price rises, the good is inelastic, where PED < 1. On the other hand, a good or service is thought to be elastic when there is a greater response of consumers in relation to the change in price. In this case, PED > 1. There are several determinants that influence the elasticity of a good, including: number and closeness of substitutes, the level of necessity.

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Figure 1: PED of oil

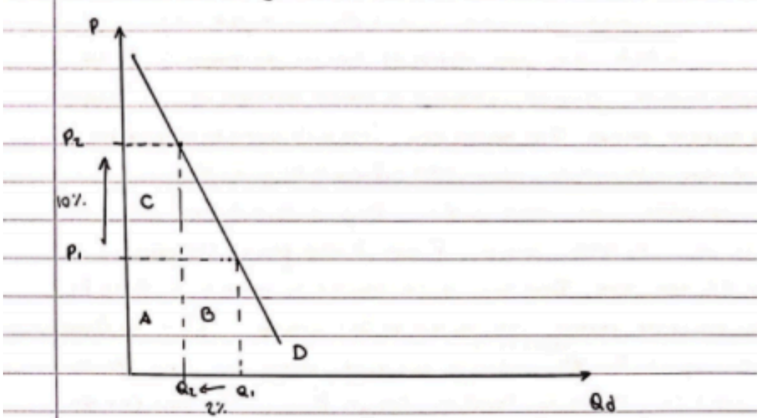
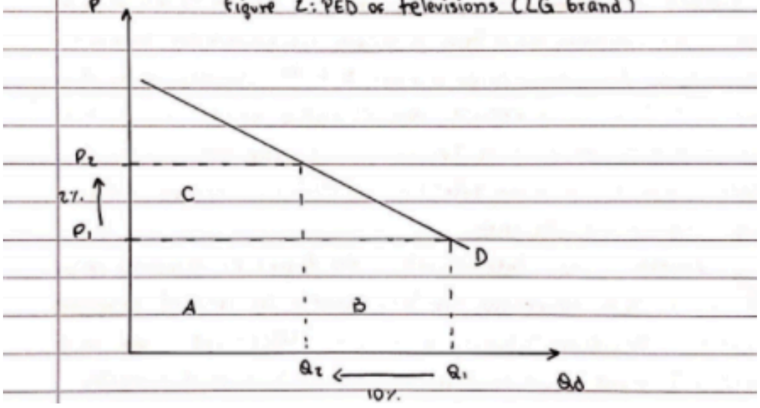


Figure 2: PED of televisions (LG brand)



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and the proportion of income being spent on a good.

Substitutes are goods considered similar or comparable to the one in question, giving the consumer a choice between similar products or different brands. The more close (similar) substitutes a good has, the more elastic it is, given that there will be a greater response of consumers when there is a rise in price, for instance, and they can recur to other brands. Figure 2 exemplifies the elasticity of LG televisions. There was a 2% change in price from P1 to P2, but one of the factors that caused a 10% change in quantity demanded (resulting in PED > 1 (greater than 1)) was the availability of substitutes for the same product (e.g. Samsung, Parasonic, Sony). Now, in the case of Figure 1, the good in question is oil. Oil is considered a necessity for being a primary good. Primary goods have relatively few substitutes, so when there is a 10% change in price from P1 to P2, the response will be lower (2%), giving a PED < 1, once oil's price won't influence the need for it as much as a TV, for instance, especially because it doesn't have enough close substitutes availables. Consumers will then buy it regardless of its price.

Another crucial determinant is the degree of necessity of a good. The more necessary the less elastic its demand, as opposed to what is considered a luxury good, which will present a more elastic demand. In figure 1, oil is a necessity good because it is needed to further sectors in the industry, once it is a primary commodity. As an essential raw material, its price change won't affect the quantity demanded as much as a television, which is the case of figure 2. In figure 2, if there is an increase in price of a television, there is a high responsiveness of consumers. This is due to the fact that it is a luxury good, considered to be not as essential, so people have more time to think about buying and investing on it.

The third determinant to be taken into account is the proportion of one's income being spent on a specific good. The greater the

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proportion of income, the more elastic the demand for a product. For instance, when buying a TV, a greater proportion of income will be spent, so the consumer will preferably opt to buy the TV in moments that its price is lower. Therefore, with a price increase, its demand will decrease from Q1 to Q2 in figure 2. Now, still taking into account the example of figure 2, if one's income increases, a smaller proportion of its income will be spent on the TV, even at higher prices. In that case, elasticity is quite low. It all depends on one's budget.