

CHAPTER 5 KEY CONCEPTS AND SUMMARY

5.1 Price Elasticity of Demand and Price Elasticity of Supply

Price elasticity measures the responsiveness of the quantity demanded or supplied of a good to a change in its price. We compute it as the percentage change in quantity demanded (or supplied) divided by the percentage change in price. We can describe elasticity as elastic (or very responsive), unit elastic, or inelastic (not very responsive). Elastic demand or supply curves indicate that quantity demanded or supplied respond to price changes in a greater than proportional manner. An inelastic demand or supply curve is one where a given percentage change in price will cause a smaller percentage change in quantity demanded or supplied. A unitary elasticity means that a given percentage change in price leads to an equal percentage change in quantity demanded or supplied.

5.2 Polar Cases of Elasticity and Constant Elasticity

Infinite or perfect elasticity refers to the extreme case where either the quantity demanded or supplied changes by an infinite amount in response to any change in price at all. Zero elasticity refers to the extreme case in which a percentage change in price, no matter how large, results in zero change in quantity. Constant unitary elasticity in either a supply or demand curve refers to a situation where a price change of one percent results in a quantity change of one percent.

5.3 Elasticity and Pricing

In the market for goods and services, quantity supplied and quantity demanded are often relatively slow to react to changes in price in the short run, but react more substantially in the long run. As a result, demand and supply often (but not always) tend to be relatively inelastic in the short run and relatively elastic in the long run. A tax incidence depends on the relative price elasticity of supply and demand. When supply is more elastic than demand, buyers bear most of the tax burden, and when demand is more elastic than supply, producers bear most of the cost of the tax. Tax revenue is larger the more inelastic the demand and supply are.

5.4 Elasticity in Areas Other Than Price

Elasticity is a general term, that reflects responsiveness. It refers to the change of one variable divided by the percentage change of a related variable that we can apply to many economic connections. For instance, the income elasticity of demand is the percentage change in quantity demanded divided by the percentage change in income. The cross-price elasticity of demand is the percentage change in the quantity demanded of a good divided by the percentage change in the price of another good. Elasticity applies in labor markets and financial capital markets just as it does in markets for goods and services. The wage elasticity of labor supply is the percentage change in the quantity of hours supplied divided by the percentage change in the wage. The elasticity of savings with respect to interest rates is the percentage change in the quantity of savings divided by the percentage change in interest rates.

CHAPTER 6 KEY CONCEPTS AND SUMMARY

6.1 Consumption Choices

Economic analysis of household behavior is based on the assumption that people seek the highest level of utility or satisfaction. Individuals are the only judge of their own utility. In general, greater consumption of a good brings higher total utility. However, the additional utility people receive from each unit of greater consumption tends to decline in a pattern of diminishing marginal utility.

We can find the utility-maximizing choice on a consumption budget constraint in several ways. You can add up total utility of each choice on the budget line and choose the highest total. You can select a starting point at random and compare the marginal utility gains and losses of moving to neighboring points—and thus eventually seek out the preferred choice. Alternatively, you can compare the ratio of the marginal utility to price of good 1 with the marginal utility to price of good 2 and apply the rule that at the optimal choice, the two ratios should be equal:

$$\frac{MU_1}{P_1} = \frac{MU_2}{P_2}$$
$$MU_1 P_1 = MU_2 P_2$$

6.2 How Changes in Income and Prices Affect Consumption Choices

The budget constraint framework suggest that when income or price changes, a range of responses are possible. When income rises, households will demand a higher quantity of normal goods, but a lower quantity of inferior goods. When the price of a good rises, households will typically demand less of that good—but whether they will demand a much lower quantity or only a slightly lower quantity will depend on personal preferences. Also, a higher price for one good can lead to more or less demand of the other good.

6.3 Labor-Leisure Choices

When making a choice along the labor-leisure budget constraint, a household will choose the combination of labor, leisure, and income that provides the most utility. The result of a change in wage levels can be higher work hours, the same work hours, or lower work hours.

6.4 Intertemporal Choices in Financial Capital Markets

When making a choice along the intertemporal budget constraint, a household will choose the combination of present consumption, savings, and future consumption that provides the most utility. The result of a higher rate of return (or higher interest rates) can be a higher quantity of saving, the same quantity of saving, or a lower quantity of saving, depending on preferences about present and future consumption. Behavioral economics is a branch of economics that seeks to understand and explain the "human" factors that drive what traditional economists see as people's irrational spending decisions.