

# Inferior and luxury goods differences



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An inferior good is a good that decreases in demand when consumer income rises. It has a negative income elasticity of demand. Typically inferior goods or services tend to be products where there are superior goods available if the consumer has the money to be able to buy it. Examples include the demand for cigarettes, low-priced own label foods in supermarkets and the demand for council-owned properties

b)

Normal goods are those for which consumers' demand increases when their income increases. They will consume more of the goods if there is an increase in their income.

Good Y is a normal good since the amount purchased (Quantity demanded) increases from Y1 to Y2 as the budget constraint shifts from BC1 to the higher income BC2. Good X is an inferior good since the amount bought (Quantity Demanded) decreases from X1 to X2 as income increases.

c)

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Income elasticity measures how sensitive sales of a good are to changes in consumers' income. It can be explained as proportionate change in the demand for a good in response to a change in income. It is reflected in how people change their consumption habits with changes in their income levels.

(<http://www.businessdictionary.com/definition/income-elasticity-of-demand.html>)

It is:  $(\hat{Q}/Q)/(\hat{Y}/Y)$

Where:

Q is the quantity demanded

Y is income, and

$\hat{Q}$  has its usual meaning of indicating change

d)

The cross elasticity of demand or cross-price elasticity of demand measures the responsiveness of the demand for a good to a change in the price of another good. ([http://en.wikipedia.org/wiki/Cross\\_elasticity\\_of\\_demand](http://en.wikipedia.org/wiki/Cross_elasticity_of_demand))

It is measured as the percentage change in demand for the first good that occurs in response to a percentage change in price of the second good. For example, if, in response to a 10% increase in the price of fuel, the demand of new cars that are fuel inefficient decreased by 20%, the cross elasticity of demand would be  $\hat{Q}/\hat{P} = 20\%/10\% = 2$ .

The formula used to calculate the coefficient cross elasticity of demand is

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$$E_{\{A, B\}} = \frac{\% \text{ change in demand of product A}}{\% \text{ change in price of product B}}$$

Or :

Cross Elasticity Of Demand

e)

A luxury good is a good for which demand increases more than proportionally as income rises, in contrast to a “ necessity good”, for which demand is not related to income

Luxury goods are said to have high income elasticity of demand: as people become wealthier, they will buy more and more of the luxury good. This also means that should there be a decline in income its demand will drop. Income elasticity of demand is not constant with respect to income, and may change sign at different levels of income. That is to say, a luxury good may become a normal good or even an inferior good at different income levels, e. g. a wealthy person stops buying increasing numbers of luxury cars for his automobile collection to start collecting airplanes (at such an income level, the luxury car would become an inferior good). ([http://en.wikipedia.org/wiki/Luxury\\_good](http://en.wikipedia.org/wiki/Luxury_good) Retrieved 9/8/2010)

## Question 2

a)

Price elasticity measures the percentage change in quantity demanded due to a price change. The formula for the Price Elasticity of Demand (PEoD) is:

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**(% Change in Quantity Demanded)/ (% Change in Price)**

A very high price elasticity suggests that when the price of a good goes up, consumers will buy a great less of it and when the price of that good goes down, consumers will buy a great deal more.

A very low price elasticity implies just the opposite, that changes in price have little influence on demand.

b)

If  $PEoD > 1$  then Demand is Price Elastic (Demand is sensitive to price changes)

If  $PEoD = 1$  then Demand is Unit Elasticity

If  $PEoD < 1$  then Demand is Price Inelastic (Demand is not sensitive to price changes)

Inelastic Demand is that whether how much change in price of the goods, the quantity demanded is still the same or not change much.

c)

Unit Elasticity is situation where a change in one factor causes an equal or proportional change in another factor. Let's say if the price increase 10 percent, the quantity demanded is decrease 10 percent.

d)

Perfect Elasticity demand is represented by the horizontal line and Perfect elastic supply will represented by the vertical line. When the price elasticity

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of demand for a good is perfectly elastic any increase in the price, no matter how small, will cause demand for the good to drop to zero.

e)

Consumer Income

As income increases the demand for a normal good will increase.

As income increases the demand for an inferior good will decrease.

Demand curves for inferior and normal goods as income increase:

Source: Mankiw, G. (2009) Essentials of Economics, 5th Edition, South Western Publishing,

Cengage Learning

### **Question 3**

The elasticity of demand is the percentage decrease in demand in response to a one percent increase in price. The elasticity of supply is the percentage increase in supply in response to a one percent increase in price. The elasticities of supply and demand usually are higher in the long run than in the short run. There are more substitution possibilities in the long run than in the short run. When elasticities are high, market disturbances tend to affect prices relatively little and quantities transacted relatively a lot.

### **Elasticity of Demand:**

In the past, oil producing countries occasionally have engineered supply disruptions. In the short run, this tends to cause a spike in prices of oil

products, such as gasoline. In the long run, the prices of oil products tend to settle down. For example, in the oil market, in the short run people do not change their driving habits much in response to an increase in gasoline prices. In the long run, they may drive less and switch to more fuel-efficient cars. In the short run, competing suppliers cannot increase production much in response to an increase in price. In the long run, oil exploration rises when prices are higher; this helps to bring on more supply.

### **Elasticity of Supply:**

Short-run supply curves are not as elastic as long-run supply curves, because in the long run firms can respond to market conditions by varying their holdings of physical capital, and because in the long run new firms can enter or old firms can exit the market. ([http://en.wikipedia.org/wiki/Supply\\_and\\_demand](http://en.wikipedia.org/wiki/Supply_and_demand))

The main determinant of supply elasticity is time:

The market period is a short amount of time where supply is perfectly inelastic (vertical)

is a short amount of time where supply is perfectly inelastic (vertical)

In the short run, the plant size is fixed, but intensity can be adjusted. Supply curve looks like this:

elasti15

In the long run, everything can be adjusted, and firms are most elastic.

elasti16

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The elasticity of supply in an industry will be very large if there is no important resource that is fixed. For example, in the lawn mowing business, it is easy for new firms to get started, and it is easy to add new capital and labor to the industry. It is also easy for people to get out of the business if demand drops off. Overall, we would expect the elasticity of supply to be very high, so that we could have a large increase in the demand for lawn mowing service without having a large impact on price. (<http://www.theshortrun.com/classroom/glossary/micro/elasticity.html> )