1.2.2 Demand

Notes on demand for Edexcel Economics A

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Contents

What is demand?

Demand is the amount of a good or service that consumers are willing and able to buy (at a given price).

Which factors influence demand?

Demand depends on several factors:

- **Price**.
  - Usually as price goes up, we would expect demand to go down. This is called the **law of demand**. This could be because as the price increases, consumers can afford less of the good or consumers buy other goods instead.
  - Another explanation is the idea of **diminishing marginal utility**. As you consume more units of a good, each extra unit gives less and less extra satisfaction, we assume. This means the consumer is willing to pay less for each extra unit. Hence, for the consumer to be willing to buy extra units of a good, the price needs to fall.
  - See the section on diminishing marginal utility and how this affects the demand curve for more information.
- **Income**.

    - For normal goods, as income goes up, demand goes up.
        - As income rises, consumers have more disposable income to spend on items that give them satisfaction. So demand increases.
    - However there are other goods where as income rises, demand goes down. These are called inferior goods.
        - Examples include own-brand products, used goods, cheap clothing and public transport.
        - When there is a recession and incomes fall, consumers may switch away from luxuries and instead buy more used goods or value options.
- **Price of other goods**.
    - If the price of Pepsi goes down, the demand for Coca-Cola goes down. These are ‘substitute’ goods.
    - If the price of flights abroad goes down, the demand for hotel rooms abroad will go up. These are ‘complementary goods’.
- **The expected future price** of a good
    - Suppose consumers believe the price of a good is likely to be higher in the future. An example of this could be housing.
    - This could lead some consumers to bring forward their purchase, as buying today may be cheaper than buying in the future.
    - Hence demand for the good **today** rises.
- **Changes in tastes**
    - Various products may go in or out of fashion, for example different types of clothing.
    - Another example is increased awareness of the pollution associated with petrol and diesel cars. This could encourage some consumers to switch away from petrol and diesel cars towards electric vehicles or public transport, to reduce pollution.
- **Advertising**
    - Firms may spend money on advertising their products on social media, TV channels or internet search.
    - This increases consumer awareness of the product, which may boost demand for the product.
- **Population growth**
    - An increase in the population could occur because of an increase in the birth rate, a reduction in the death rate or an increase in the rate of net migration into the country.

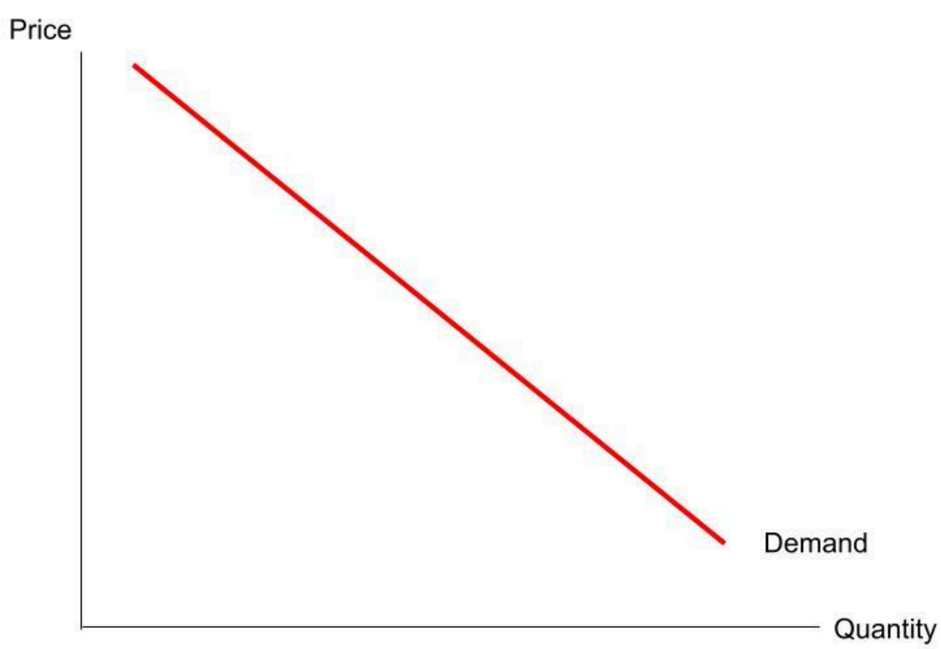
    - A greater population means there are more consumers in the economy. This increases demand for the good
- **The quality of the good**
    - Higher quality of a good, such as an iPhone with extra functions or faster software, may increase the utility consumers get from consuming the good.
    - As a result, demand for the good may rise.

<u>Demand curve</u>

The relationship between demand and price means we can draw a “demand curve”. The demand curve is downward sloping. In other words as price increases, the quantity demanded decreases.

Note if price changes, this leads to a movement along the demand curve.

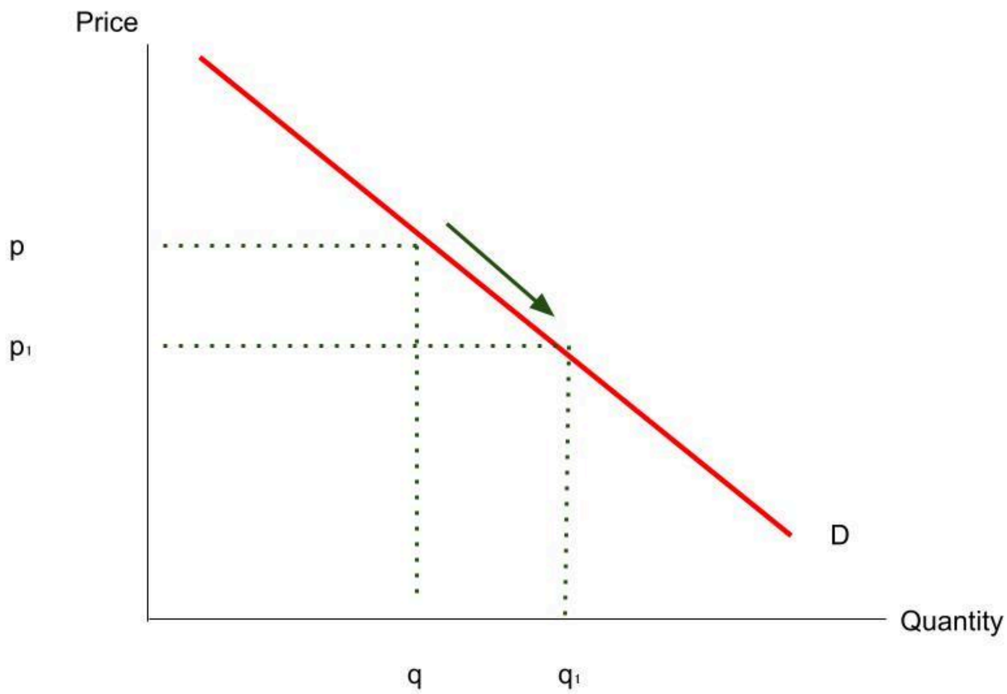
But if any other factor changes that influences demand, the demand curve shifts. For example if incomes increase for a normal good, then demand will shift to the right.



Changes to demand: movement along the demand curve

If the price of a good changes, demand changes. If the price falls, we expect demand to increase, assuming other factors remain the same (such as advertising, tastes and income).

The diagram below shows the movement along the demand curve. The price falls from p to p1 and the quantity demanded increases from q to q1.



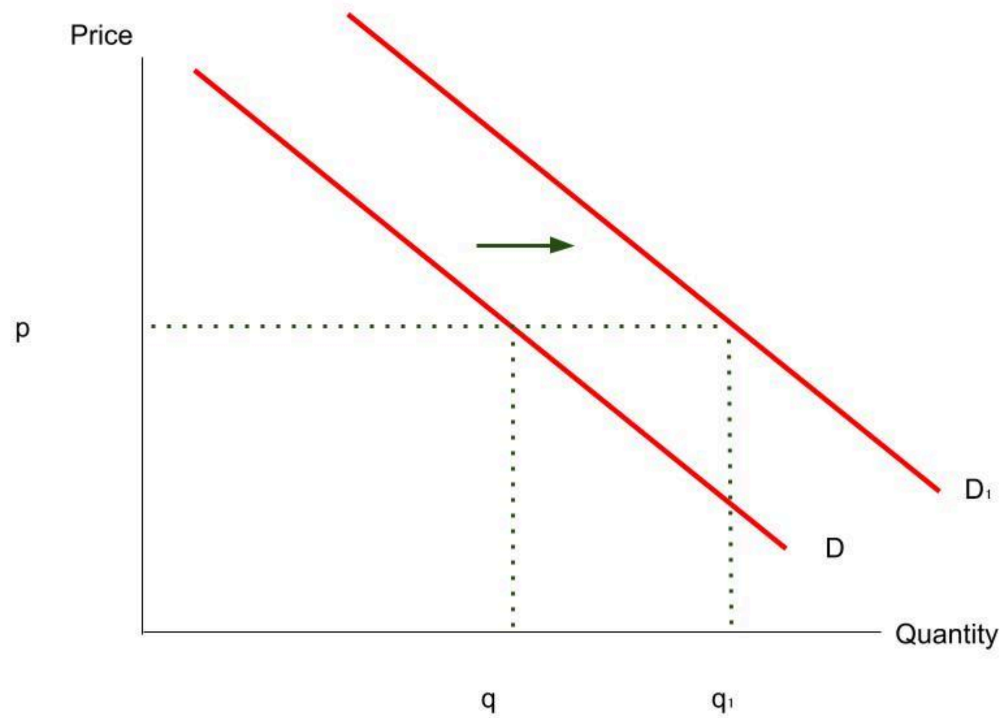
Changes to demand: demand curve shifts

When a factor other than price changes, then the demand curve shifts, other things being equal.

Suppose there is an increase in incomes. This will increase demand for normal goods and decrease demand for inferior goods.

On a diagram, this will mean a demand shift right for normal goods and a demand shift left for inferior goods.

Another way to interpret the shift in demand is: for a given price, demand is lower. For example at the given price p in the diagram, demand has risen from q to q1.



Diminishing marginal utility and how this influences the demand curve

Utility is the satisfaction from consuming a good or service.

The demand curve being downward sloping comes from the assumption of diminishing marginal utility (DMU).

Marginal utility = the change in utility from consuming one more unit.

Diminishing marginal utility = as a consumer consumes more, marginal utility falls.

In other words, each unit consumed offers less and less extra satisfaction.

Consider the following example:

- A consumer is deciding how many slices of cake to buy.
- Suppose the total utility is as stated in column two of the table below. This means for two slices of cake, the consumer receives six pounds worth of satisfaction.
- We can then calculate the change in utility from consuming an extra slice of cake (the marginal utility column).

Number of slices of cakes	Total utility (£)	Marginal utility (£)
0	0	N/A
1	6	+6
2	10	+4
3	12	+2
4	13	+1

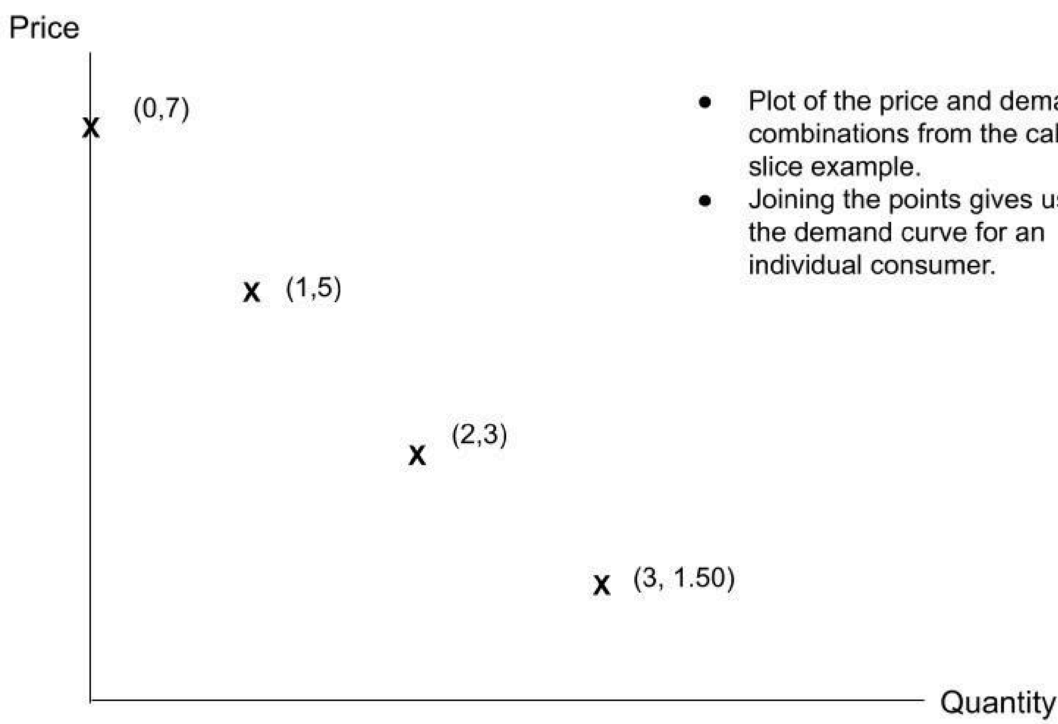
How many slices of cake should the consumer buy?

- This depends on the price of a slice of cake.
- Suppose for example a slice of cake is £7 per slice.
  - Then the first slice is only worth £6 of utility for the consumer, which is less than the price of £7.
  - So no slices are consumed.
- If the price is £5, the consumer only consumes one slice.
  - The first slice gives utility of £6, which is greater than the price paid.
  - The second slice would only offer £4 of utility, which is less than the £5 paid.
- Similarly if the price is £3, the consumer consumes two slices.
- If the price is £1.50 per slice, the consumer consumes three slices etc.

As a general rule, the consumer should consume another unit if marginal utility exceeds the price paid. If marginal utility is less than the price paid, the consumer should not consume more units. Total utility is therefore maximised when the marginal utility = price.

We can plot these points on a diagram (see below). For example, if the price is £7 per slice, the consumer consumes zero slices of cake and so on.

Connecting these points gives the demand curve for an individual consumer. To find demand for the whole market (all consumers), we could add up the quantity demanded for all consumers at each price point.



<u>Evaluating the determinants of demand</u>

1) Elasticities

- **Sensitivity of demand to price changes**
    - For some goods, even if the price increases significantly, demand may fall relatively little.
    - An example would be an addictive good, such as cigarettes.
    - In this case, we say demand is “price-inelastic”, meaning demand is relatively insensitive to price changes.
- **Sensitivity of demand to income changes**
    - The demand for some goods is highly sensitive to income changes. For example, luxuries may be the first item that consumers cut back on, if their income falls.
    - In this example, we would say demand would be “income-elastic”.
- **Sensitivity of demand for good A to changes in the price of good B**
    - Some goods are close substitutes, while other goods are distant substitutes.
    - For example, Coca-Cola and Pepsi could be seen as close substitutes.
    - However, some consumers may be loyal to Coca-Cola and would not switch to Pepsi even if Pepsi were cheaper.
- More on the elasticities of demand.

2) Exceptions to the law of demand - Giffen and Veblen goods

- There are some goods whose demand increases as price goes up. These are exceptions to the law of demand.
- One category of goods is “Veblen” goods that refer to certain luxury goods.
    - This could include goods where the higher price denotes status, for example an expensive watch or car.
    - Buying a more expensive item is a sign of status and allows the consumer to show off their wealth.
    - So the more expensive a luxury item is, the more it allows a wealthy individual to show off their wealth. So demand for the luxury item may increase.
- There are also “Giffen” goods that are staples such as rice.
    - If the price of rice goes up, then consumers may not have the income to afford luxury food items.
    - So, consumers might stop buying the luxury food items and could spend all their budget on rice.
    - Because of this, consumers could buy more rice, even when the price is higher.

3) Other factors

- Changes in tastes may be temporary rather than permanent. For example, clothing brands going in and out of fashion.
- Advertising may not always reach consumers, who may not see the advert. It is easy to skip adverts in social media feeds or some people may use software that blocks adverts on their computer.

Practice question on demand

This is a practice question written in the style of Edexcel Economics A. It contains a short extract, followed by a practice question.

Extract A: Demand for restaurant meals

On average, prices at restaurants and cafés increased by 8.2% by January 2024 compared to a year prior. Rises in food and energy costs, as well as the rising minimum wage and national insurance contributions are contributing to higher restaurant prices.

Moreover, rising food and energy bills have hit consumers' pockets. Those whose incomes rise more slowly than inflation may cut back on restaurant visits first before other essentials.

Starting in the Covid-19 pandemic, there has been a switch in consumer preferences to delivery rather than dining in a restaurant. However, more restaurants are listing on delivery apps such as Uber Eats and Deliveroo or running their own delivery service.

Sources: ONS, miscellaneous others.

Question: With reference to Extract A, discuss **two** factors that influence the demand for restaurant meals. (12 marks)

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