Applications

Part 1: Elasticity

Elasticity measures the responsiveness of demand to price changes. High elasticity means responsiveness is high while low elasticity means that demand is relatively unchanged by changes in price.

On a scale of 1 to 10, how elastic do you think demand is in the following markets?

- chocolate
- insulin (medicine for diabetics)
- clothing
- water
- cocaine
- automobiles
- cigerettes
- steel
- text books

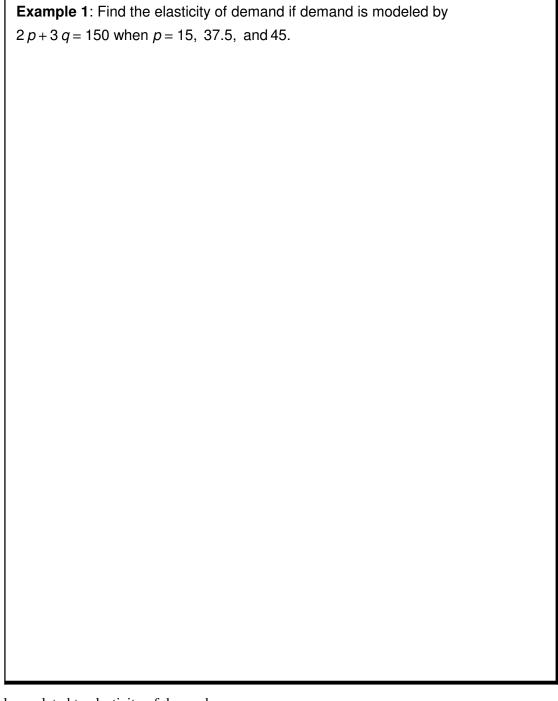
Do you think that elasticity is constant for a given product? That is, do you think that the responsiveness of demand to price changes might depend upon the price in any way?

Elasticity of Demand: $\eta = -\frac{p}{q} \cdot \frac{dq}{dp} = -\frac{p}{q(p)} \cdot q'(p)$.

Note that η is the Greek letter "eta."

We have skipped over a topic called implicit differentiation. For that reason, skip over example 2 in the text.

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Vocabulary related to elasticity of demand:

If $\eta > 1$, we say that demand is elastic

If η < 1, we say that demand is inelastic

If $\eta = 1$, we say that demand is unitary elastic

Example 2: Demand is given by $p = \frac{1000}{(q+1)^2}$. Find η when q = 19.

Elasticity and Reve-

nue:

$$R(p) = p \cdot q(p)$$

where q(p) is the quantity demanded at a price p.

$$R'(p) = p \cdot q'(p) + q(p)$$

$$= q(p) \cdot \frac{p}{q(p)} \cdot q'(p) + q(p)$$

$$= q(p)(-\eta) + q(p)$$

$$= q(p)(1 - \eta)$$

Summary:

If $\eta > 1$, then R' < 0 and a price increase will result in a revenue decrease and visa versa

If η < 1, then R' > 0 and a price increase will result in a revenue increase and visa versa

If $\eta = 1$, then R' = 0 and an increase in price will not result in a change in revenue. Revenue is optimized at this point.

Example 3: Given the demand function $p = 120 \sqrt[3]{125 - q}$, answer the following.

a.) Find $\eta(p)$

b.) Find the point (q, p) where $\eta = 1$

c.) Construct a sign diagram of R'

d.) Find the maximimum revenue

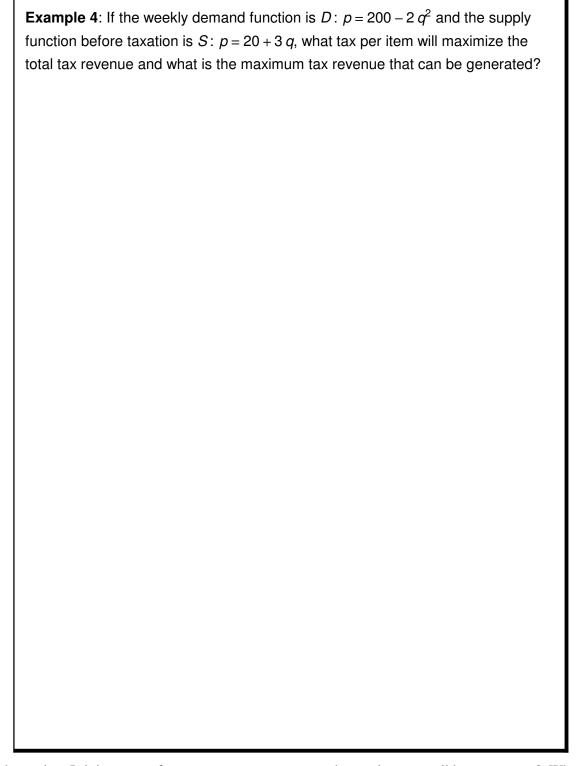
Part 2: Taxation in a competitive market

The goal of this section is to determine the level of taxation that will maximize tax revenue.

The picture:

So, rather than working with the supply function S: p(q), work with the supply function after taxation S: p(q) + t. Also remember the simple formula that total tax is equal to $T = t \cdot q$.

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Ethical question: Is it important for a government to generate the maximum possible tax revenue? Why or why not?