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Income Elasticity of Demand

AS Economics revision presentation on income elasticity of demand

Income Elasticity of Demand

- Income elasticity of demand (Yed) measures the relationship between a change in quantity demanded and a change in real income
- Yed = % change in demand / % change in income

Normal and Inferior Goods

- Normal goods have a positive income elasticity of demand so as consumers' income rises, so more is demanded at each price level
- Necessities have an income elasticity of demand of between 0 and +1
- Luxuries have an income elasticity of demand > +1 i.e. the demand rises more than proportionate to a change in income
- Inferior goods have a negative income elasticity of demand. Demand falls as income rises

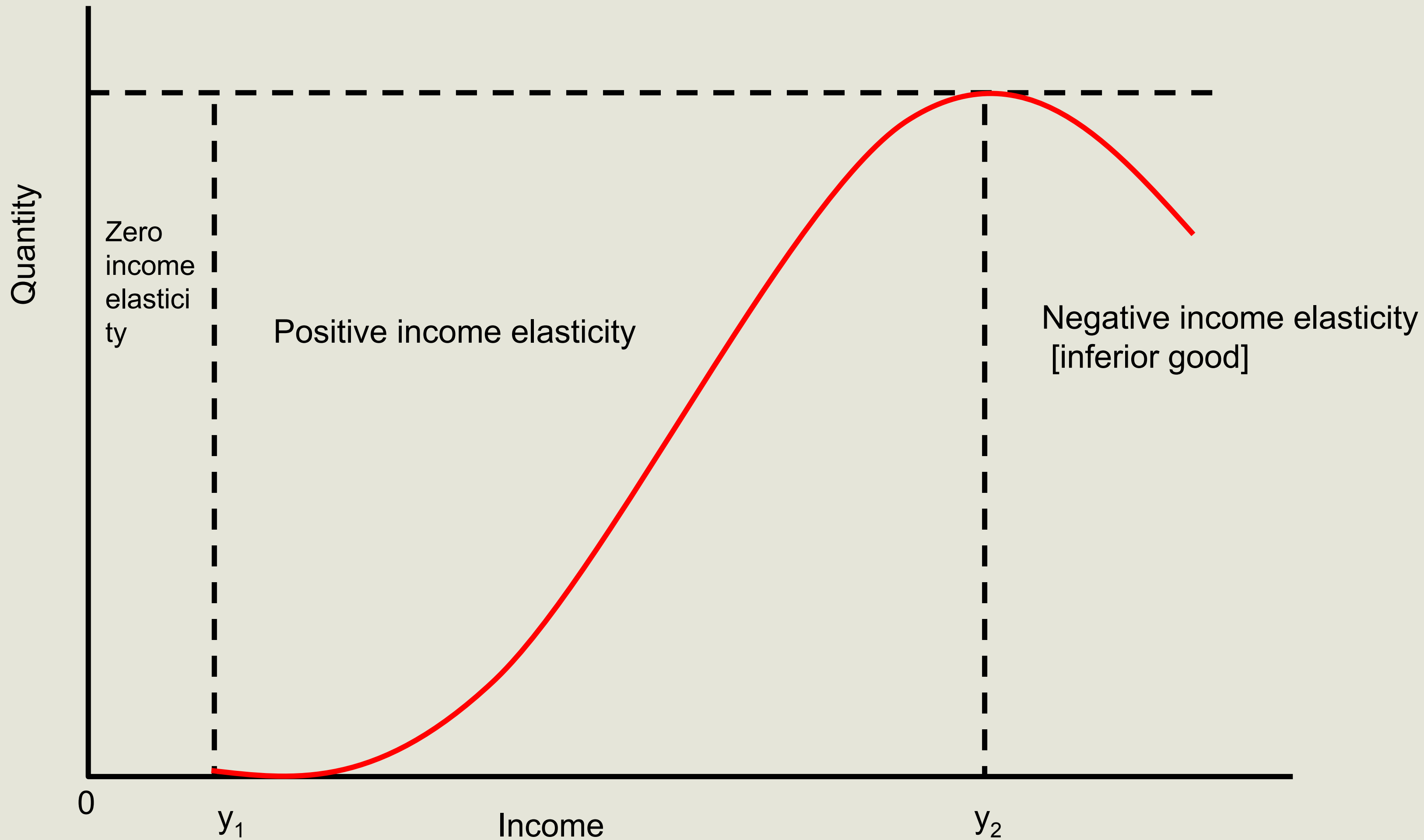
Different Types of Goods and their Income Elasticity

Normal Luxury	Normal Necessity	Inferior Good

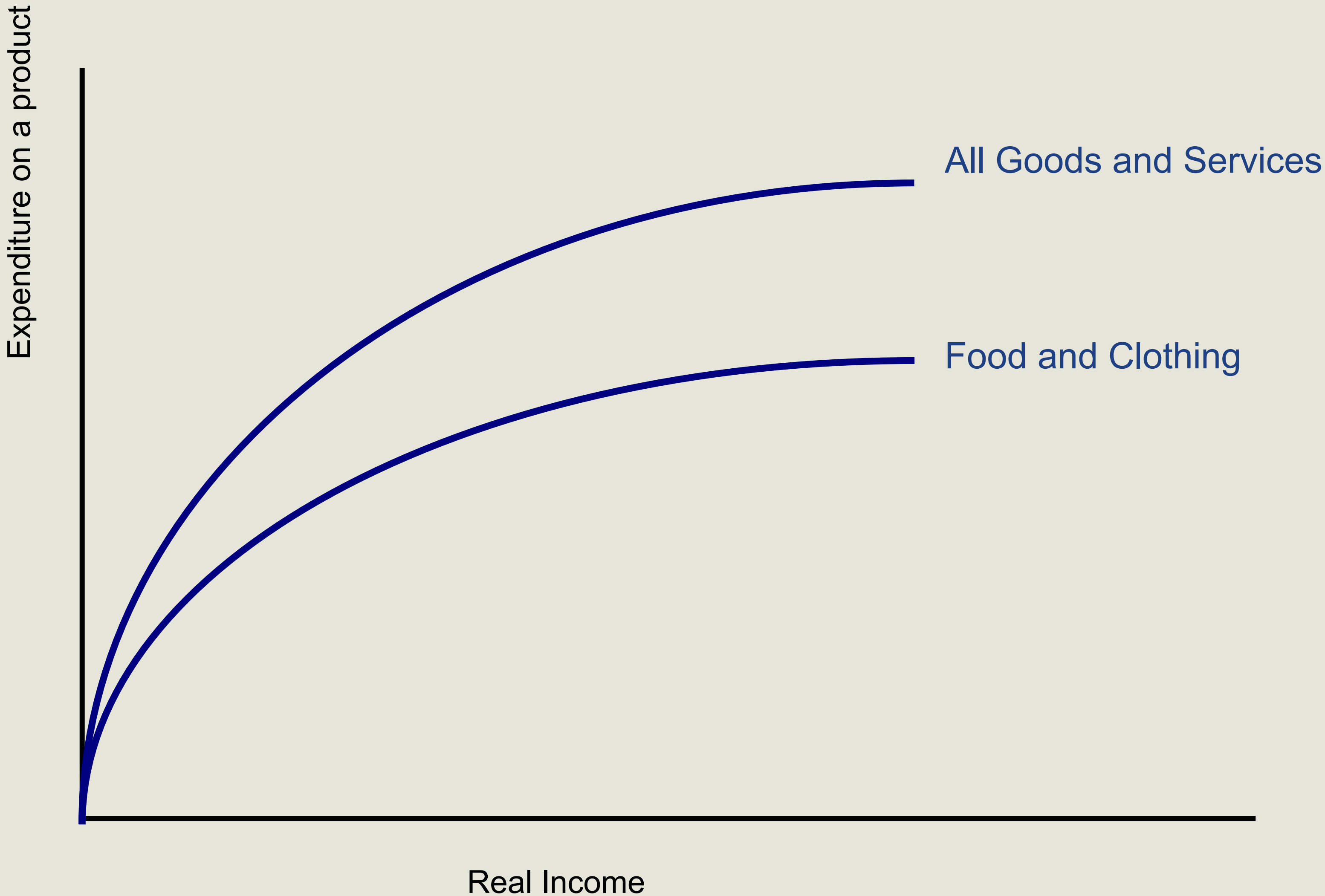
Different Types of Goods and their Income Elasticity

Normal Luxury	Normal Necessity	Inferior Good
International air travel	Fresh vegetables	Frozen vegetables
Fine wines	Instant coffee	Cigarettes
Luxury chocolates	Natural cheese	Processed cheese
Private education	Fruit juice	Margarine
Private health care	Spending on utilities	Tinned meat
Antique furniture	Shampoo / toothpaste / detergents	Value “own-brand” bread
Designer clothes	Rail travel	Bus travel

Relationship between Income and Quantity Demanded



The Engels Curve



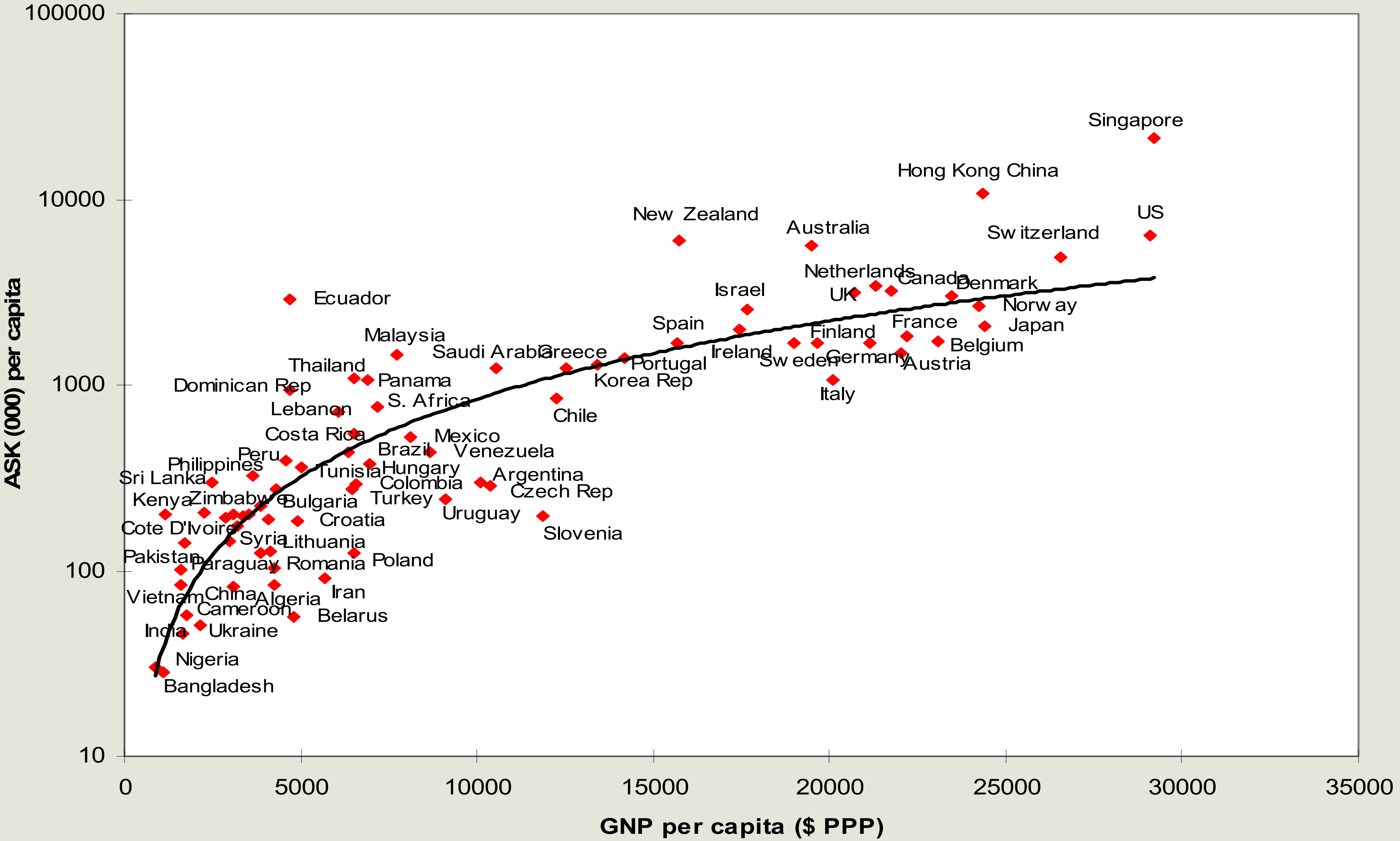
Income Elasticity of Demand for Chocolate

- Total consumption
- USA 0.79
- Germany 0.39
- United Kingdom 0.44
- France 0.60
- Japan 0.08
- Switzerland 1.06
- Reference: Henri Jason Trends in cocoa and chocolate consumption with particular reference to developments in the major markets. Malaysian International Cocoa Conference, Kuala Lumpur, 20-21 October 1994 (ICCO, ED(MEM) 686)

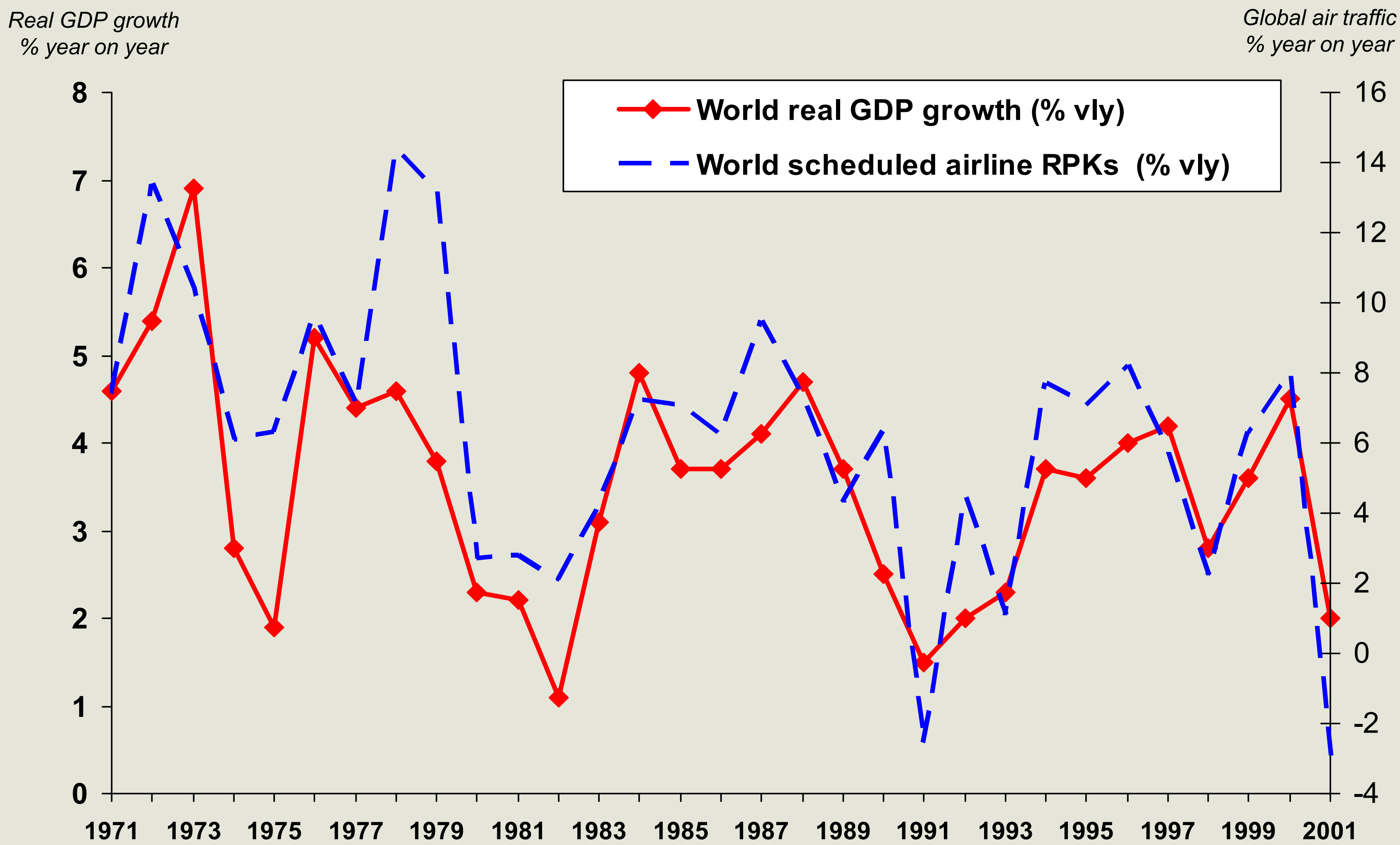
Income Elasticity and the Demand for Airline Travel

- Demand for airline travel has a highly positive income elasticity of demand
- The industry is cyclical
  – During an upturn, demand rises for business and leisure travel)
  – During a recession, the demand tails away
- In the long run, there is a *positive relationship* between real GDP per capita and the demand for air travel
- Income elasticity will vary according to the type of air travel
  – E.g. difference between low-cost “no-frills” and higher priced scheduled services on low-haul flights

Income Per Capita and Airline Travel by Country



Airlines – a Highly Cyclical Industry



Significance of Income Elasticity of Demand

- High Income Elasticity
  - Demand is sensitive to changes in real incomes
  - Demand is therefore cyclical – in an economic expansion, demand will grow strongly. In a recession demand may fall
  - Can be difficult for businesses to accurately forecast demand and make capital investment decisions
- Low Income Elasticity
  - Demand is more stable during fluctuations in the economic cycle
  - Over time, the share of consumer spending on inferior goods and normal necessities tends to decline
  - Long run – businesses need to invest in / focus on products with a higher income elasticity of demand if they want to increase total profits