ECONOMIC APPLICATIONS

Elementary Theory of Demand

Concept of Demand

Demand for a good refers to the desire to buy a good backed with sufficient purchasing power and the willingness to spend.

Individual Demand and Market Demand

Individual demand for a commodity is the quantity of a commodity which an individual household is willing to buy at a particular price during a specific period.

Market demand is the horizontal summation of individual demands in the market. It indicates various quantities of a commodity which all consumers in the market are willing to buy at different possible prices of a commodity during a specific period.

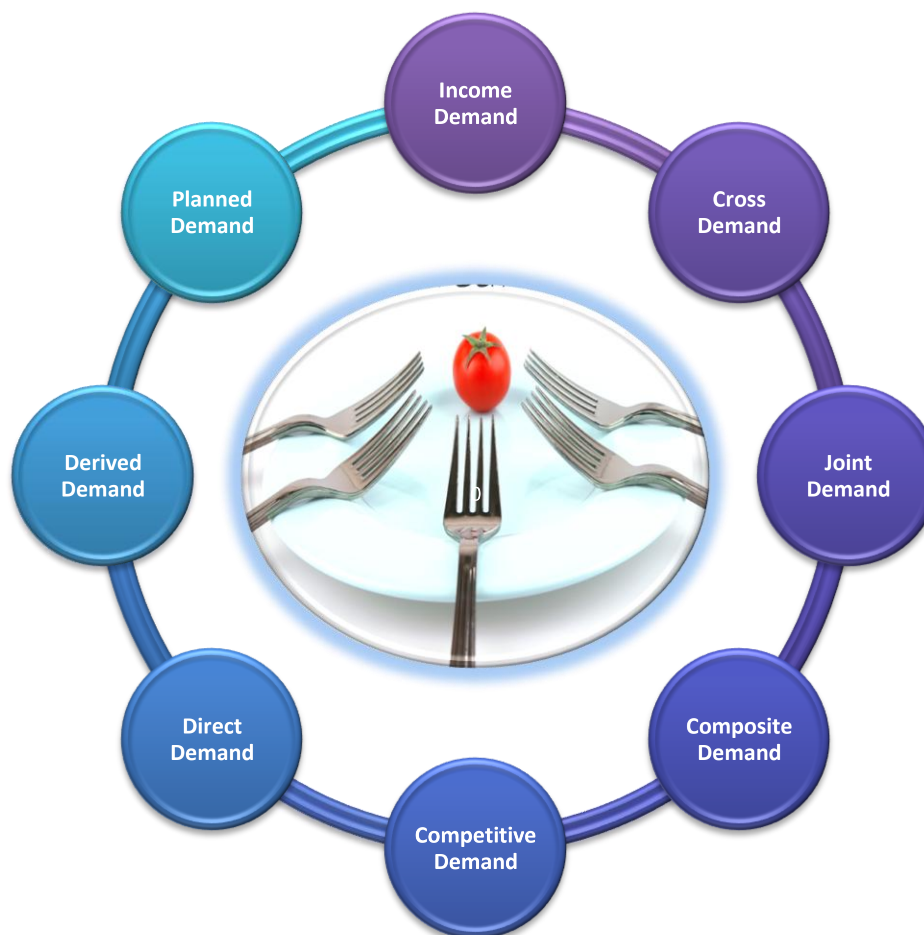
Determinants of Individual Demand

- Price of the commodity: With constant money income of the consumer and an increase in the price of a commodity, the purchasing power of the consumer reduces and vice versa. Thus, the consumer purchases less of a commodity with an increase in its price.
- Income of the consumer: An increase in the individual income, other things remaining constant, would mean an increase in the purchasing power of the consumer. Thus, the consumer can purchase commodities with an increased income.
- Price of related goods: The demand for a commodity depends not only on its own price but also on the prices of related goods. If there is a change in the price of one good, it affects the demand for another good. Related goods may be in the form of substitutes and complementary.
- Tastes and preferences: A change in the individual taste and preference pattern leads to a change in the demand for a commodity.

Determinants of Market Demand

- Pattern of income distribution: If the income distribution moves in favour of the poor people, the demand for commodities would increase among those people. On the other hand, if majority of the national income is concentrated with rich people, the demand for luxury goods would increase among those people. So, the pattern of income distribution affects the market demand for a commodity.
- Climatic condition: During winter, the demand for woollen clothes increases. During summer, the demand for cotton clothes increases. Hence, climatic conditions affect the market demand for a commodity.

Types of Demand



Law of Demand

The law of demand states that other things remaining constant, the quantity of a good demanded increases with a fall in the price and diminishes when the price increases.

Main Assumptions of the Law of Demand

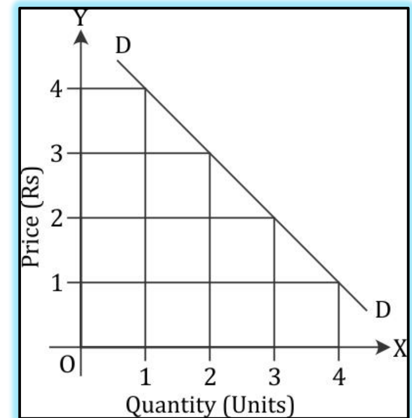
- Prices of related goods do not change.
- Incomes of consumers do not change.
- Tastes and preferences of consumers remain constant.
- No expectation of the consumer to any change in the price of a commodity in the near future.

Demand Schedule and Market Schedule

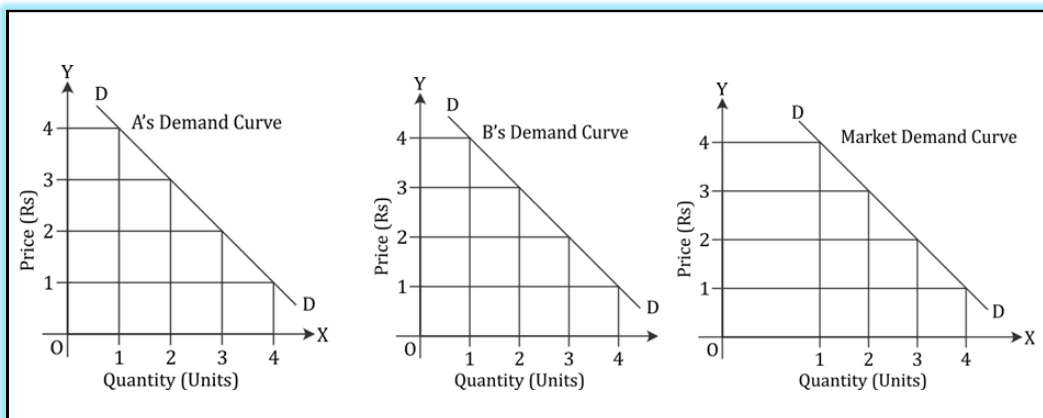
Demand schedule is a chart or a table showing the quantities of a commodity demanded at various prices. Market demand schedule shows the total demand for the commodity in the market at various prices.

Individual Demand Curve and Market Demand Curve

The individual demand curve is a curve showing different quantities of a commodity which one particular buyer is willing to buy at different possible prices of the commodity at a point of time. In the diagram, the quantity of a commodity is given on the x-axis and the price on the y-axis. DD is the demand curve representing the individual demand schedule. The demand curve slopes downwards from left to right, indicating an inverse relationship between the price and the quantity demanded.



The market demand curve is the horizontal summation of the individual demand curves. It indicates various quantities of a commodity which all consumers in the market are willing to buy at different possible prices of the commodity at a point of time. The diagram below shows that the market demand curve represents the market demand schedule assuming two consumers A and B in the market. The market demand curve also slopes downward indicating an inverse relationship between the price and quantity demanded.



Why does the demand curve slope downwards to the right?

The demand curve slopes downwards because more of goods purchased in response to a fall in price. Thus, there is inverse relationship between the price of a good and its quantity demanded.

Factors responsible for the downward sloping demand curve:

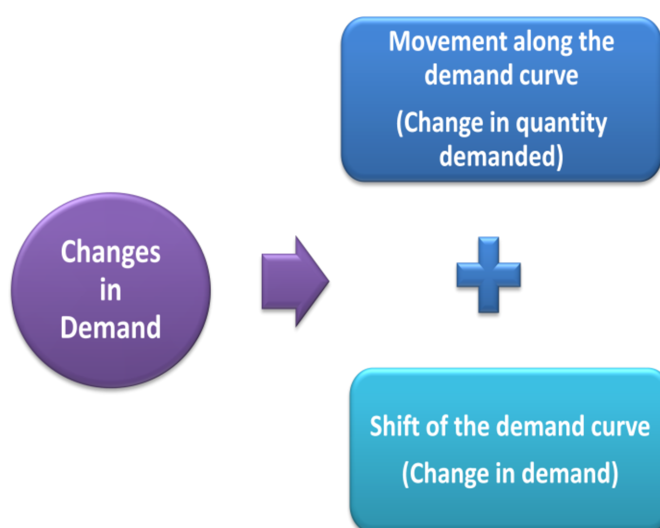
- Law of diminishing marginal utility: The additional utility that the consumer derives from the additional consumption of any commodity is known as marginal utility. A consumer gets maximum satisfaction from the consumption of a commodity when the price paid for the commodity is just equal to its marginal utility. If the consumer consumes more of that commodity at any given time period, the marginal utility will gradually fall. This is called the law of diminishing marginal utility.
- Substitution effect: Substitution of one commodity for the other when it becomes relatively cheaper.
- Income effect: A change in quantity demanded when real income of the buyer changes as a result of change in price of the commodity.

Exceptions to the Law of Demand

- Giffen effect: A typical inferior commodity consumed by poor people may display an odd behaviour. When the price of such a commodity rises, the poor people may cut down on their purchases of other expensive items and increase their purchases of this commodity.
- Bandwagon effect: The bandwagon effect means that the consumer's demand for a commodity is influenced by the taste and preference of the social class to which the consumer belongs.

Changes in Demand

Demand for any commodity depends on several factors besides its price. These factors were categorised as price of the commodity in category 1 and all factors other than price in category 2. Based on these categories of factors influencing demand, changes in demand are divided into



Change in Quantity Demanded and Change in Demand

Change in quantity demanded is the movements along the demand curve, i.e. the extension of demand caused by a decrease in the price of the same good and the contraction of demand caused by an increase in the price of the same good.

Change in demand means the shifts in the demand curve, i.e. the decrease in demand or the backward shift in the demand curve caused by a change in factors other than the price of the good and an increase in demand or a forward shift in the demand curve caused by a change in factors other than the price of the good.

Causes behind Shifts of Demand

- Change in Income: If there is an increase in income of consumers, they will usually buy more of any particular commodity and the demand curve will shift to the right. A fall in income will usually shift the curve to the left. This is applicable to most goods which are normal goods.
- Price of other commodities: If the price of substitute goods falls, consumers will be attracted to the other goods and the demand for the good to consume will fall at any given price. Hence, the demand curve will shift to the left. Likewise, a rise in the price of a substitute will shift the demand curve to the right. If the price of the complementary goods falls, consumers will buy more of the complementary goods and the demand for the good to consume will also rise at any given price. Hence, the demand

curve will shift to the right. Similarly, a rise in the price of complementary goods will shift the demand curve to the left.

- Consumer preference: If the producers spend more money on a product advertisement at any given price, consumers will demand the commodity in greater quantities than before. Hence, the demand curve for the commodity will shift to the right. Likewise, if consumers develop distaste for a commodity, the demand curve will shift to the left.