

## Answer on Question #60705 – Economics – Microeconomics

1. Research the price elasticity of demand for a good or service on retail and answer the following:
  - a. What is the good or service and its elasticity coefficient? If you are not able to find this number, take an educated guess. Explain the meaning of his number.
  - b. What is the main factor affecting the price elasticity of demand for your case study good or service? Explain.

### CONSUMER CHOICE

2. Think of a recent purchase you made or are about to make.

Use the following 5 terms in proper context in a paragraph of no more than 150 words to explain your purchasing decision: the law of diminishing marginal utility, income effect, indifference, marginal rate of substitution, consumer optimum.

Please Underline or highlight each of the terms.

### Solution

1. a) The price elasticity of demand (PAD) could be calculated using the following formula:

$$PAD = \frac{(Q_1 - Q_0) / (Q_1 + Q_0)}{(P_1 - P_0) / (P_1 + P_0)}$$

where PAD is the price elasticity of demand,  $Q_0$  – initial quantity given that the price is at the level  $P_0$ .  $Q_1$  is the new quantity given that the price of the good or service changes to  $P_1$ .

Let's assume that the good is a travel card in Oslo, Norway. It is called RuterBillett and cost 400 Norwegian Kroner. However, from 01.02.2016 its price increased to 412 Kroner. So,  $P_0 = 400$ ,  $P_1 = 412$ . However, as I need the travel ticket every month in order to travel, I still buy one travel ticket each month:  $Q_0 = Q_1 = 1$ .

Therefore, we can estimate PAD:

$$PAD = \frac{(1-1)/(1+1)}{(412-400)/(412+400)} = \frac{0 \cdot 2}{12 \cdot 812} = 0$$

Thus, the demand on this good, a travel card, is perfectly inelastic ( $PAD=0$ ), which means that my quantity of demand for the travel card will not vary when the price on it changes.

- b) I think the main factor affecting the PAD of the travel card I use is that no substitutes of this product are available – only this card allows to use public transportation in the city. Level of price is also important, as if the tickets become too expensive, then people would tend to use alternative means of transport, e.g., bikes or cars.

2. Let's assume that I am going to buy a yoghurt. Under the law of diminishing marginal utility, I will buy no more than 3 similar yoghurts, as my satisfaction and utility from eating each next yoghurt will decrease. If taking income effect into consideration, I will be buying more different yoghurts when the level of my increases, as I will demand more yoghurts in quantity. Regarding indifference, it will not matter for me whether to buy 2 yoghurts and 1 banana or 1 yoghurt and 2 bananas. It is closely connected with marginal rate of substitution, because I

would be ready to give up one yoghurt for receiving one more banana. Taken everything into consideration, while buying yoghurts I am willing to reach **consumer optimum**, thriving to maximize my utility of yoghurts however having consumer budget constraint.

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