

Elasticity

BY AARON STEELMAN

In April and May, gasoline prices rose to nearly \$2 per gallon in most areas of the country. Did this cause people to drive less? Probably. For instance, some people may have foregone the proverbial Sunday drive in order to conserve gas. But it probably didn't deter many people from driving their cars to work. They figured that the convenience of using their own vehicles, instead of relying on mass transit or hitching rides with co-workers, was well worth the extra money paid at the pump.

This means that demand for gasoline is relatively price inelastic: Even though the price went up, people still decided to buy it. (Of course, if gasoline had shot up to \$5 per gallon, it might have been a different story. Public transit might have started to look a lot better then.)

Not all goods are as price inelastic as gasoline. For instance, it is possible to buy fresh peaches in the winter — if you are willing to pay the price. But most people are not. Perhaps the biggest reason is that many substitutes are available. For instance, you might prefer a peach but decide that an apple will do instead. The availability of substitutes boosts the price elasticity of fresh peaches.

Or consider coffee. You might think that coffee is one of the most price inelastic goods around. After all, some people would rather forego a shower in the morning than a cup of coffee. But if the price of coffee tripled, you would probably see a lot of coffee drinkers switch to tea or soda. The reason: It's not the coffee itself they crave so much as it is the caffeine the coffee provides. As long as low-cost caffeinated substitutes are available, coffee will remain a relatively price elastic good.

So when thinking about elasticity in economic terms, it can be useful to imagine a rubber band. Imagine that you are able to stretch the rubber band with ease if you switch to a substitute or stop consuming a good when its price rises. The good in that case is relatively price elastic. Now imagine that you have a hard time moving the rubber band if you continue to buy the good even though its price rises. The good in that case is relatively price inelastic.

In each case, demand and price move in opposite directions. The difference is one of degree, not principle. The

demand for peaches is reduced much more than demand for gasoline. But higher prices means less demand in both cases.

Are there examples where price and demand actually move in the same direction — that is, goods for which demand increases as price increases? The early 20th century economist and sociologist Thorstein Veblen thought so. He argued that people bought expensive goods to boost their status. The higher the price, the better the good, or so the thinking goes. There may be some cases of such conspicuous consumption. Indeed, many people can probably think of isolated examples from their own experience. But those examples are just that — isolated — and not the norm.

When economists discuss elasticity, they usually consider

how sensitive people are to changes in prices. But prices are not the only thing that can affect demand for goods. Income can as well. For example, you might really like cashmere sweaters but decide that a polyester pullover is a more sensible option. But that could all change if you got a higher-paying job. With more money at your disposal, cashmere sweaters might suddenly become part of your wardrobe. If so, the demand for cashmere sweaters is pretty income elastic. Items that fall into this

category are called “normal goods.” People demand more of them as their income increases. In contrast, the demand for “inferior goods” actually falls when income increases. In the example above, polyester pullovers are an inferior good, because you demand fewer of them after you get a raise. Another common example of an inferior good is bus service. With higher income, you may decide to fly or take the train to New York, instead of going by Greyhound.

Some products can move from normal goods to inferior goods relatively quickly as technology improves. Consider video cassettes. Until recently, if you wanted to watch a movie at home, you either rented or bought VHS tapes. But now most people choose DVDs instead. DVDs are generally more expensive, but they offer better picture quality and more special features. Video cassettes have gone from being a normal good to an inferior good, and the same may happen to DVDs as newer technologies emerge. **RF**



ILLUSTRATION BY TIMOTHY COOK