Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

2.2 Firms, Consumers and Elasticities of Demand

2.2.4 Income elasticity of demand (YED)

Notes

The significance of YED to firms

Income elasticity of demand is the responsiveness of a change in demand to a change in income. The formula for this is:

$$YED = \frac{\%\Delta QD}{\%\Delta Y}$$

When the average level of income in an economy changes, businesses are affected and they might have to take action. They will have to consider how a fall or rise in the average income level will affect their sales, which is dependent on the income elasticity of demand of their products. In response to this, businesses will have to plan the quantity they want to sell and the price they want to sell their products at.

The income level changes if the economy improves or worsens or if there is a change in government policy. For example, economic growth will cause a general rise in disposable income, whilst an increase in the income tax rate will cause a general fall in disposable income. During economic growth, demand for luxury products is likely to increase, whilst demand for inferior goods and services is likely to fall.

Interpretation of numerical values of YED and the factors influencing YED

Inferior goods are those which see a fall in demand as income increases. For example, the 'value' options at supermarkets could be seen as inferior. As income increases, consumers switch to branded goods. YED < 0.

With **normal necessary goods**, demand increases as income increases. YED >0. When YED = 0, demand for the product does not change when incomes change. A value of YED between 0 and 1 indicates that demand only increases by a smaller proportion than the increase in income, which is income inelastic.

With **normal luxury goods**, an increase in income causes an even bigger increase in demand. YED > 1. For example, a holiday is a luxury good. Luxury goods are also normal goods, and they have an elastic income.

During periods of prosperity, such as economic growth when real incomes are rising, firms might switch to producing more luxury goods and fewer inferior goods, because demand for luxury goods will be increasing. A value of YED = 1 suggests that demand changes proportionally to income, so the product has unitary income elasticity.