

Lesson 04: Supply and Demand

Lesson Objectives:

- Students will experiment using an online interactive activity and develop an understanding of the laws of supply and demand.
- Students will list and describe the factors affecting demand: price effect; marginal/diminishing marginal utility; substitution/complementary goods effect; and income effect.
- Students will understand and describe equilibrium price and market price.



In this lesson, we will examine the laws of supply and demand. Understanding the laws of supply and demand is the key to understanding how the capitalist economy works. The economic system of free enterprise relies on market forces instead of government forces, or the interactions between the economic sectors, to make the decisions on how to answer the three basic economic questions discussed in lesson one. (Which goods and services should be produced, and in what quantity? How should the goods and services be produced? Who should receive and consume the goods and services?) In other words, the interactions between those who sell and those who buy drive the market in a capitalist economy.

This is where the laws of supply and demand come in. Combined together, supply and demand drive the economy by influencing what is produced and by setting prices. Pricing is important because when prices are low enough, consumers are willing to buy. When prices are high enough, producers are willing to sell.



The Law of Demand

Demand has three components demonstrated by consumers: want, ability to pay, and willingness to pay.

Demand is determined by which and what quantity of particular goods and services consumers want, have the ability to afford, and are willing to buy at a particular time. As prices rise for a particular good or service, demand goes down. As prices come down for a particular good or service, demand goes up. Consumers are not willing to buy the same quantity of an item when the price is high as they are when the price is lower. However, there are factors that affect demand.

Some factors that affect demand are: price effect; marginal/diminishing marginal utility; substitution/complementary goods effect; and income effect.

Price Effect

The price effect on demand varies according to the eagerness of the consumer to purchase the goods or services. The measurement of the consumer response to price change is referred to as *elasticity*. Elasticity is a measure of the degree of change in demand due to a change in prices. When a change in price has a small effect on demand, demand is inelastic. The price change did not cause demand to change a lot. When a change in price has a large effect on demand, demand is elastic. The price change caused demand to change a lot. Demand is typically more elastic if purchases are easily substituted or if they make up a large percentage of the consumer budget. If a particular item cannot be easily substituted, or if it requires a small portion of consumer income, demand is inelastic.

For example: If the cost of coffee increases, consumers can drink tea instead. Tea would be a substitute for coffee. Demand for coffee would decrease, thus demand is elastic. On the other hand, gasoline currently has no real substitute, therefore, consumers have no choice but to purchase gasoline regardless of price, thus demand is inelastic.

Marginal/Diminishing Marginal Utility

Marginal utility is the satisfaction effect or usefulness of purchasing a unit or item of a good or service. As the satisfaction or usefulness begins to diminish, the marginal utility begins to diminish, and is referred to as *diminishing marginal utility*. For example, a hungry consumer may purchase a snack, and if still hungry, wants to purchase a second unit of the snack. However, as hunger is satisfied, the usefulness of the item decreases, therefore, the desire to purchase another unit of the snack decreases.



Profit Motive

The main purpose of businesses is to earn money. They are successful, or profitable, if they earn more money than they spend. Profit is the amount of money left over after subtracting business expenses from business income. The goal of business owners is to keep expenses at a minimum while increasing income from sales of goods and services. The better they do this, the higher the profit. Economists describe this effort to gain more profit as the *profit motive*.

Substitution/Complementary Goods Effect

If prices are lower for a good of similar usefulness to the consumer than another good of similar usefulness, consumers will purchase the less expensive good as a substitute. A substitute good replaces another good for the consumer, and has an effect on demand. Another way to look at the substitution effect is the purchase of an unrelated good because of price. For example, if a particular good is offered at a sale price, consumers may decide to purchase more of that item instead of purchasing items they normally would have purchased. The item that was not purchased becomes an opportunity cost and the item purchased is considered a substitute good.

Complementary goods are goods that are often purchased because of the purchase of another good. For example, during summer, consumers purchase more hot dogs and hamburger for grilling. As a result, demand for ketchup, mustard, and buns increase because of the demand of hot dogs and hamburger. Also, when demand for hot dogs and hamburger decreases, demand for the complementary goods also decreases.

Income Effect

The income effect is the result of the buying power of the consumer. If consumers have more money, they can afford and have the willingness to purchase more. An increase in income increases demand. Consequently, if income decreases, the result is a decrease in buying power of the consumer. A decrease in income, possibly as the result of unemployment or career change, results in a decrease in what consumers are willing and able to purchase. A decrease in income decreases demand.

The Law of Supply

Supply is related to the willingness and ability of businesses to produce amounts of goods and services at different times.



Businesses are more willing to produce and supply goods and services when consumers are willing to pay more for the goods and services. Consequently, businesses are less willing to produce and supply goods and services when consumers are not willing to pay more for the goods and services. Higher prices result in more profit and are an incentive for businesses to pay the higher costs involved in higher amounts of production. The price that businesses are willing to sell for and the price consumers are willing to pay is called the *equilibrium price*. The equilibrium price is the *market price* or the price that goods and services will sell for.

The amount of goods and services businesses are able to supply depends on *market supply*. Market supply refers to the amount of raw materials and resources available at a given time. Limited resources have an effect on what can be produced and supplied. If more is demanded than can be supplied, consumers are willing to pay more for the goods and services. Therefore, if resources are scarce, supply is limited and price goes up. This has a definite effect on prices because if consumers are willing to purchase goods and services at any price increasing demand, and supply does not increase to meet the demand, market price will increase. This happens because if there is less availability of an item that consumers want, they are willing to pay more money to get what they want, forcing prices up.

The opposite is true when consumer desire for a good or service decreases and supply stays the same. Prices will drop so that producers can sell off the extra available supply. Obviously, businesses lose money when they produce more than consumers want to buy. This is why we said in the beginning of this lesson, combined together, supply and demand drive the economy by influencing what is produced and by setting prices.

Grading Rubric:

To get a 10: In the first submission, or first revision, assignment questions are completed, facts are correct, responses are thoughtful, presentation is clear, grammar and spelling are correct.

To get a 9: In the first submission, or first revision, a few assignment questions are incomplete OR a few facts are incorrect OR a few responses are careless OR there are a few grammar and spelling errors. After prompting, all corrections are made in later revisions.

To get an 8: In the first submission, or first revision, many assignment questions are incomplete OR many facts are incorrect OR many responses are careless OR there are numerous grammar and spelling errors. After prompting, all corrections are made in later revisions.

To get a 7: After prompting, a few assignment questions remain incomplete OR a few facts remain incorrect OR a few responses remain careless OR a few grammar and spelling errors remain.

To get a 6: This grade is reserved for administrative use.

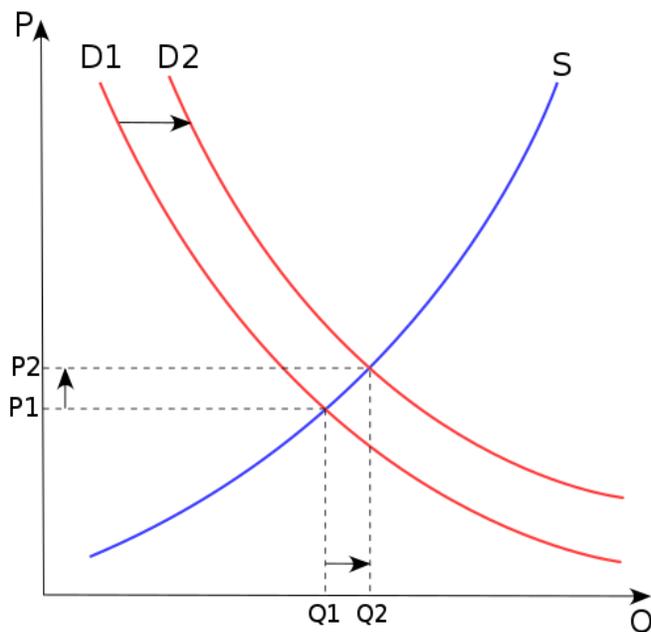
To get a 5: Plagiarism, purposeful or mistaken, which will lower your final grade for the course (so be very careful when posting your work!) OR lack of effort, disrespect, or attitude (we are here to communicate with you if you don't understand something). Lesson requirements have been met.

Also be aware that you will have a chance to revise your work. Since revisions can result in a lower grade, remember to read the directions carefully and make sure you meet the requirements.



Assignment:

Do not submit text that you have copied from sources, including websites. All of your work should be in your own words. Using copied text would be considered plagiarism. For more information, review our page on [Plagiarism and Citation](#).



1. Using the information you learned in this lesson, explain the above supply and demand chart in your own words. Give a real-life example of something that could cause the shift illustrated in the chart.

Answer the following questions according to the information presented in the lesson.

2. What are the three components demonstrated by consumers affecting demand?
3. What are the four factors that affect demand?
4. According to the lesson, when are businesses more willing to produce and supply goods and services?



Complete the following by inserting the correct information in the blank:

5. The measurement of the consumer response to price change is referred to as _____.

6. _____ is determined by which and what quantity of particular goods and services consumers want, have the ability to afford, and are willing to buy at a particular time.

7. The interactions between those who _____ and those who _____ drive the market in a capitalist economy.

8. Combined together, _____ and _____ drive the economy by influencing what is produced and by setting prices.

9. As prices rise for a particular good or service, demand goes _____.

10. As prices come down for a particular good or service, demand goes _____.

11. The _____ on demand varies according to the eagerness of the consumer to purchase the goods or services.

12. Demand is typically more _____ if purchases are easily substituted or if they make up a large percentage of the consumer budget.

13. Demand is typically more _____ if the purchases are not easy to substitute or make up a small percentage of the consumer budget.

14. _____ is the satisfaction effect or usefulness of purchasing a unit or item of a good or service.

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