**Essay Question 39**

**(a) Discuss the usefulness of the elasticity concepts of demand to a designer coffee retailer such as Starbucks. [13]**

Introduction (definition of elasticity of demand/ state that the info is used to set price and business staretgy to raise total revenue)

Concepts of elasticity of demand measures the responsiveness of change in quantity demanded in relation to the change in variables such as the price of good itself, the price of the related goods (substitute or complement) or the income of the consumers. These concepts are useful to designer coffee supplier like Starbucks, as they provide information about the consumers and the competitive market which would help retailers to derive appropriate price and market strategy to increase total revenue.

Main Body (definition of PED, state how it is used to increase total revenue, state the situation of PED - whether it is price elastic and price inelastic

For price-elasticity of demand (PED), it measures the responsiveness of the change in quantity of Starbucks designer coffee in relation to the change in price of Starbucks designer coffee. **This information is useful to Starbucks as it can help them to derive price strategy. When the demand is price-inelastic**, the percentage change in quantity demanded of coffee would be less than proportionate to the percentage change in price of Starbucks’s coffee. This would influence Starbucks to **increase price for the coffee** as it could raise the total revenue since the gain in revenue due to increase in price would be greater than the loss in revenue due to reduction in quantity demanded. On the other hand, **if demand for Starbucks coffee is price-elastic**, it implies that the percentage change in quantity demanded is greater than the percentage change in the price of the Starbucks. **This will explain why Starbucks will lower price of the Starbucks coffee** as the total revenue will increase since the gain in revenue due to increase in quantity demanded is greater than the loss in revenue due to a reduction in the price of Starbucks drink.

(reasons for why Starbuck coffee is price elastic or price inelastic)

For Starbucks, the demand for the coffee is price-inelastic during the weekends as the consumers have a **high degree of necessity of demand** since they view Starbucks outlets as an essential location for gatherings and leisure. Furthermore, the consumers are usually adults who have a high income and the proportion of income spent on the good is small, implying that the consumer is price-insensitive and thus, the demand is more price-inelastic. As for weekdays, the demand for Starbucks coffee is price-elastic as the consumers have a **low degree of necessity of demand** since most consumers are students and they may choose other places to spend their consumption on leisure drinks. Furthermore, the consumers are students who have a large proportion of income spent on the goods which mean that the consumers are price-sensitive and thus, the demand is price-elastic.

Availability of substitutes , proportion of income spent on it, time period for consideration for purchase

Price of Starbucks Coffee

Price of Starbucks Coffee

P1

P0

P0

P1

D

D

Qty of Starbucks Coffee

Qty of Starbucks Coffee

Q0

Q0

Q1

Q1

Diagram 1

Diagram 2

As seen from **diagram 1,** the reduction in price from P0 to P1 will lead to a more than proportional increase in quantity demanded from Q0 to Q1 which will raise the total revenue. As for **diagram 2,** the increase in price from P0 to P1, will lead to a more than proportional reduction in quantity demanded from Q0 to Qwhich will also increase the total revenue.

**(definition X-elasticity of demand, usefulness)**

As for cross-elasticity of demand (XED), it measures the responsiveness of change in quantity demanded of the Starbucks coffee in relation to the change in price of other related goods, either substitutes or complements. **This concept is useful as it can help Starbucks in formulating price and marketing strategy in relation to the competitive market. If the value of the XED with the related good is negative and large, the good is said to be a complement and is highly related.** In this situation, Starbucks can conduct joint promotion or bundle sales to raise the demand for Starbucks coffee and other related products which will raise the total revenue for Starbucks.

(reasons for how the related goods are classified to help to derive business plan)

**If the value of XED with the related good is positive and large, the good related to Starbucks is a substitute as the good is in a competitive market.** In this case, Starbucks will conduct price reduction in the short run to raise the price competitiveness of Starbucks in this market to prevent the loss of customers when there is intense competition and capture more consumers for Starbucks so as to raise total revenue. However, in the long run, Starbucks may need to resort to product differentiation through branding and advertising to reduce the market competition, shaping the product to become price-inelastic, which will enable Starbucks to raise price and avoid price competition. This will help Starbucks to raise total revenue despite the presence of a competitive market.

(Definition of Y-elasticity of demand. uses of the concept to raise total revenue)

As for income elasticity of demand (YED), it measures the responsiveness of change in quantity demanded in relation to the change in the income level. The income elasticity of demand is **useful in helping Starbucks on how to conduct their product classification in relation to the change in income which is affected by economic growth.** It is also helpful to Starbucks in the **formulation of discount package to increase the total revenue.**

As the income elasticity of demand for Starbucks is considered normal or luxury since the proportion in income spent on the good occupies a large proportion of income for most consumers. When income falls due to an economic recession, the demand for normal or luxury goods like Starbucks will decrease. Thus, it is imperative that Starbucks needs to devise an inferior product like regular coffee to suit the demand for inferior good where there is a fall in income. Starbucks may introduce discount package for students who are price sensitive since the coffee of Starbucks occupies a large proportion of their income. This will ensure Starbucks can retain their demand and thus sustain the total revenue.

Explain the limitations of elasticity of demand

* Magnitude of the value of PED and PES will vary as time span is longer
* Ceteris paribus condition is not possible in reality, and thus, the complexity of the economic environment will affect the value PED and PES simultaneously
* Social variables will distort the implication of the value of PED as the consumer with similar proportion of income spent on a good will have different response to change in quantity demanded because of their family background
* Concepts of elasticity cannot account for social variables which will distort the value (e.g. marriage status will distort price sensitivity), as concept of elasticity of dd/ss is a general concept

Conclusion

In sum, the three concepts of elasticity of demand are useful in helping Starbucks to raise total revenue as they provide information in derivation of price and market strategy. However, these concepts are linked under certain circumstances as it is difficult to consider the application under ceteris paribus condition in the real world. The data would not be applicable when it applies over a longer time span. Lastly, the three concepts are economic concepts which will not take in the consideration of social variables like family background which will distort the degree of price sensitivity of the demand.