NO PREP

The Law of Demand

Consumer Behavior in Action

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Name: Period: Date:

The Law of Demand: Consumer Behavior in Action

Introduction to the Law of Demand

The Law of Demand is one of the foundational principles in economics. It states that, ceteris paribus, when the price of a good rises, the quantity demanded by consumers falls; conversely, when price decreases, quantity demanded increases. This inverse relationship forms the downward-sloping demand curve on a standard price-quantity graph. Why? As goods become more expensive, consumers face a higher opportunity cost—every dollar spent on an expensive good is a dollar that can't be spent on something else. The Law of Demand isn't just academic; it explains everyday choices from groceries to gadgets. Understanding this concept empowers you to analyze how markets respond to price changes and to predict consumer reactions when you launch a new product or negotiate a purchase.

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Income and Substitution Effects

When price changes, two distinct forces shape consumer decisions: the income effect and the substitution effect. The income effect occurs because a price increase effectively reduces consumers' real purchasing power. Your budget buys fewer goods than before, so you cut back on purchases. The substitution effect emerges as consumers switch from a relatively more expensive good to a relatively cheaper one. For example, if coffee's price jumps, some coffee lovers might brew tea at home as a substitute. Together, these effects explain why demand falls when price climbs. Although intertwined, isolating each effect helps economists design policies, like taxes, that minimize unintended burdens on low-income households.

Everyday Applications of Demand

Consider some real-world scenarios. When concert ticket prices surge due to high demand, some fans wait for resale discounts or watch streamed performances

instead. When gasoline prices spike, commuters may carpool or use public transit, reflecting both income and substitution responses. Shoppers at a grocery store might buy fewer organic apples if prices rise sharply, turning instead to bananas, which remain more affordable. These examples highlight how the Law of Demand governs decision-making: consumers constantly weigh price against satisfaction. Businesses leverage this behavior by running promotions or dynamic pricing strategies. Airlines adjust ticket prices based on booking patterns, and ride-hail apps surge-price when supply can't meet demand.

Exceptions to the Rule

Not every good adheres strictly to the inverse price–quantity rule. Two notable exceptions are Giffen goods and Veblen goods. Giffen goods are inferior staples—like bread or rice in a famine—where a price increase can paradoxically lead to higher consumption because households can no longer afford more expensive alternatives and must buy even more of the staple. Veblen goods, by contrast, are luxury items (designer handbags, high-end watches) whose higher prices confer status; as price rises, these goods become more desirable, and demand increases. While rare, these exceptions remind us that human behavior and social context can sometimes override pure economic logic. This breakdown helps you trace precisely how each effect contributes to overall demand changes—and where exceptions might arise.

Key Information: Visualizing Demand: A Quick Reference

Price Change	Income Effect	Substitution Effect	Net Demand Response
Price ↑ (e.g., coffee)	Purchasing power ↓ → buy less	Switch to tea or lower-cost brew	Demand ↓
Price ↓ (e.g., widgets)	Purchasing power ↑ → buy more	Shift from alternatives	Demand ↑
Price ↑ for staple (Giffen)	Real budget squeeze → buy more	Limited substitutes	Demand ↑ (exception)

Price Change	Income Effect	Substitution Effect	Net Demand Response
Price ↑ for luxury (Veblen)	Income effect minimal	Status appeal ↑	Demand ↑ (exception)

Case Study Excerpt: The Coffee Craze in Millennial Cities

In 2018, urban neighborhoods across North America saw a proliferation of specialty coffee shops. As demand for artisanal brews soared, prices climbed from an average of $2.50 per cup to nearly $5.00 in some districts. Despite the doubling of price, foot traffic at these cafés continued to rise. Observers noted that many patrons—particularly young professionals—valued the 'Instagrammable' latte art and the perceived craftsmanship. For them, coffee was not merely a beverage but a lifestyle accessory. In contrast, when a national coffee chain introduced a $1.99 drip special, many budget-conscious students abandoned the indie spots, illustrating a classic substitution effect. By 2021, however, the specialty market began to segment. A subset of consumers became highly price-sensitive as inflation strained monthly budgets; they shifted back to home brewing or lower-cost chains. Meanwhile, a loyal cohort—willing to pay for ethical sourcing and unique blends—continued purchasing despite prices nearing $6.00. Surveys showed this group prioritized quality and brand identity over cost, indicating a Veblen-type preference within an otherwise downward-sloping demand curve.

1. How did consumers' perception of value influence demand despite rising prices?

2. Identify which economic effect (income or substitution) best explains students switching to the $1.99 drip special.

Multiple Choice

1. When coffee prices rise and consumers switch to tea, which effect is at work?

    a) Veblen effect

    b) Status effect

    c) Giffen effect

    d) Substitution effect

2. The Law of Demand illustrates that, all else equal, demand curves slope:

    a) Downward

    b) Horizontally

    c) Vertically

    d) Upward

3. Which of the following is a Giffen good scenario?

    a) A luxury designer handbag grows more desirable as its price doubles

    b) Students brew more home coffee when shop prices fall

    c) Consumers buy more rice when its price rises because they can't afford meat

    d) A concert ticket resale market causes prices to spike

Matching

Write the letter of the correct definition on the line next to each term.

Term	Definition
1. ___ Veblen good	A) Switch to a cheaper alternative
2. ___ Income effect	B) Downward-sloping price–quantity graph
3. ___ Demand curve	C) Change in purchasing power
4. ___ Substitution effect	D) Inferior staple consumed more if price ↑
5. ___ Giffen good	E) Higher price increases status appeal

Fill-in-the-Blank

1. The Law of Demand states that price and quantity demanded move in _____ directions.

2. A _____ good is one where higher prices make the item more desirable for its status.

3. The two effects explaining consumer response to price changes are the _____ effect and the _____ effect.

Short Answer

Answer each question in 2-4 complete sentences.

1. Explain why some consumers continued buying $6.00 specialty coffee despite tight budgets.

_____

_____

_____

2. Describe how the table of income vs. substitution effects clarifies demand responses.

3. In your own words, distinguish between a Giffen good and a Veblen good.