

# Price Elasticity of Demand and Its Implications for Firms

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*This microeconomics essay stays tightly focused on one concept and develops it through two business applications. It is representative of the shorter, more concept-focused essays typical of A Level examinations. Notice how each section connects the theory back to a specific firm behavior, avoiding the common mistake of describing PED without showing why it matters to decision-making.*

Price elasticity of demand (PED) measures the responsiveness of quantity demanded to a change in price. A product is price elastic when a given percentage change in price produces a larger percentage change in quantity demanded (PED greater than 1), and price inelastic when the reverse holds (PED less than 1). Understanding PED is essential for firms because it determines whether a price change increases or reduces total revenue, and therefore shapes the pricing strategies available to them.

## **PED and Pricing Strategy**

For a firm selling a price inelastic product, a price rise increases total revenue because the percentage fall in quantity demanded is smaller than the percentage rise in price. This situation is typical of products with few close substitutes, strong brand loyalty, or significant switching costs. Pharmaceutical firms selling patented drugs, for example, face highly inelastic demand because patients have no comparable alternative. This allows them to charge prices substantially above marginal cost.

Conversely, a firm selling a price elastic product must be cautious about raising prices. A price increase will cause a proportionally larger fall in quantity demanded, reducing total revenue. Firms in competitive markets with homogeneous products, such as commodity suppliers or budget airline routes where alternatives are plentiful, face elastic demand and compete primarily on price. For these firms, reducing price can increase revenue, making price cuts a viable revenue growth strategy where they would not be for an inelastic seller.

## **PED and Market Segmentation**

Firms can also exploit differences in PED across consumer segments through price discrimination. If business travelers have less elastic demand for flights than leisure travelers, an airline can charge higher prices to business passengers while offering discounted fares to leisure travelers, provided the segments can be kept separate. This increases total revenue beyond what a single price would generate. The practice requires that resale between segments is prevented and that each segment's elasticity is distinct.

## Conclusion

Price elasticity of demand is a practical tool for firms as much as a theoretical concept. A firm that understands the elasticity of its product can set prices that maximize revenue, identify the limits of its pricing power, and design segmentation strategies that extract surplus from different consumer groups. The key determinants of PED, including the availability of substitutes, consumer necessity, and the time horizon, are therefore directly relevant to business decision-making rather than purely academic analysis.

