9/25/18

Income Substitution Effects.

When P changes, obviously there is a change in quantity demanded. People change their consumption as the result of two separate effects.
We isolate these two effects in a model of consumer's behavior by adding a hypothetical (or imaginary) budget line.

* We add a hypothetical budget line PARALLEL to the new (after price change) budget line, and TANGENT to the original indifference curve!

Substitution effect - the change in consumption that results from the change in relative prices.
e.g., when the P_{beer} falls, it becomes cheaper relative to other stuff, compared to before the price change. So you'll buy more beer than before.

Income effect - the change in consumption that results from the change in real income (or purchasing power).
e.g., when the P_{beer} falls, and you consume beer, then your purchasing power increases
(a) you'll buy more beer if it's a normal good for you
(b) you'll consume less beer if it's an inferior good

3.17 : Income & Substitution effects, cont. 9/25/12

- Substitution effect always conforms to law of demand; it's shown by sliding down an IC, so "flattening" means lower price of X, and will always mean more X consumed.

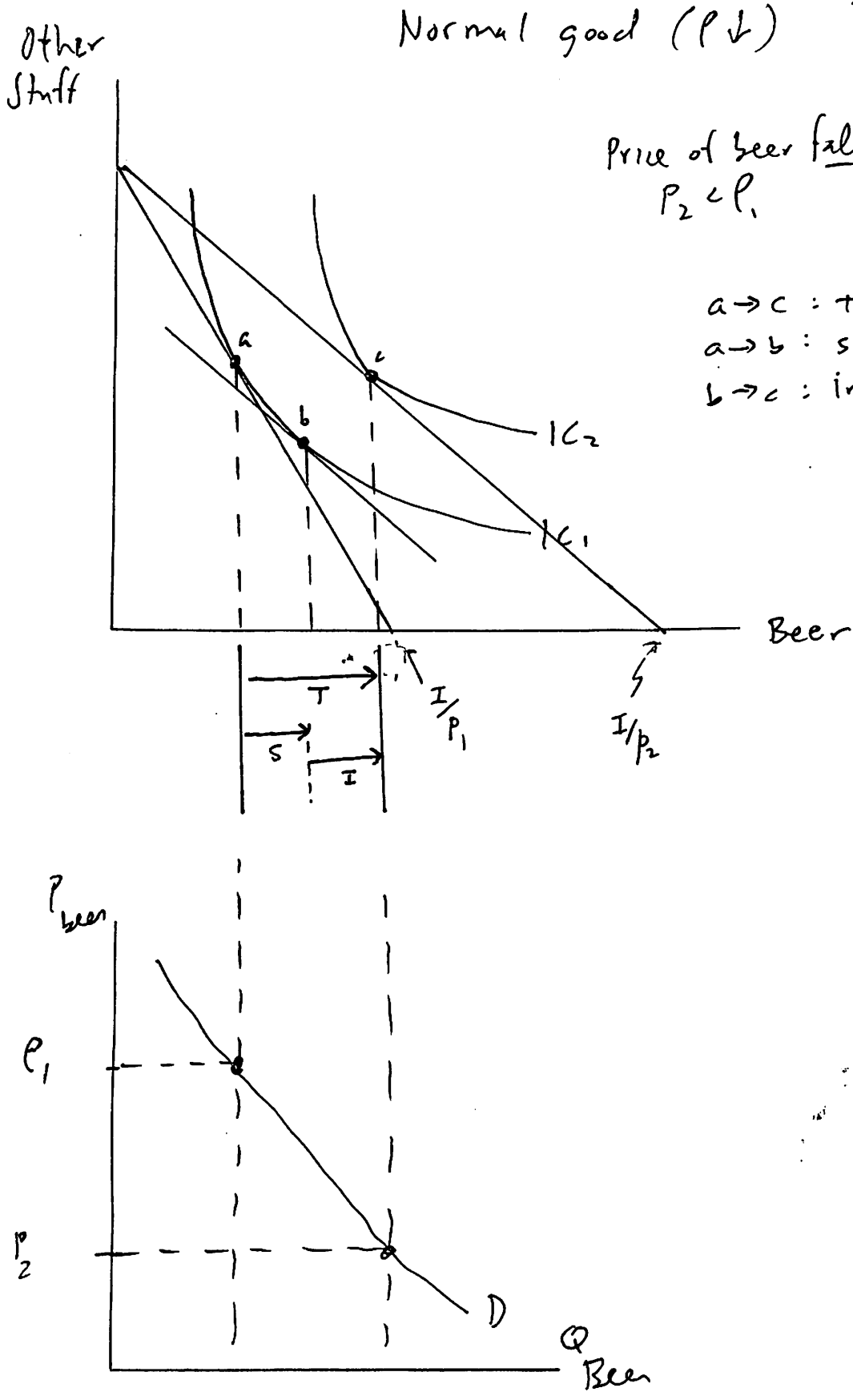
- Income effect depends, of course on whether it's a normal or inferior good.

  - If it's an inferior good, then P falling means income ↑; so consumption will fall. So this effect offsets the substitution effect.

- When $S_{effect} > I_{effect}$, it's still a downward-sloping D curve, just an inferior good.

- When $I_{effect} > S_{effect}$, D is upward-sloping, called a Giffen good. (Potatoes in Ireland during famine)

Normal good ($P \downarrow$)

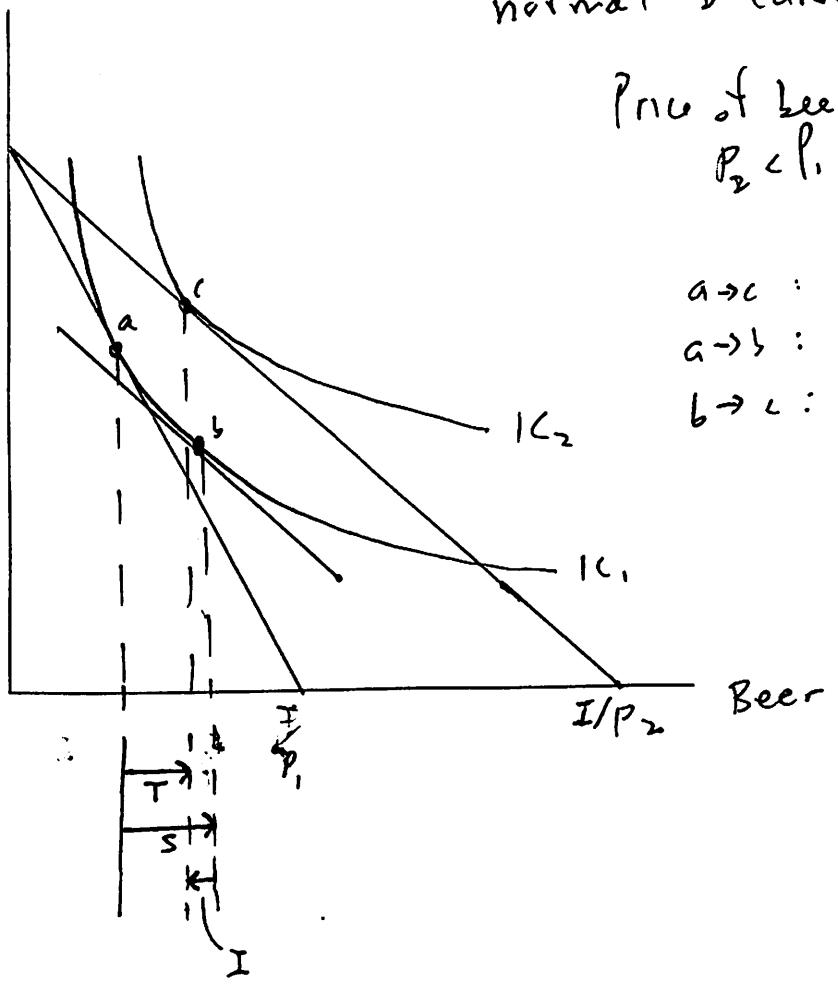


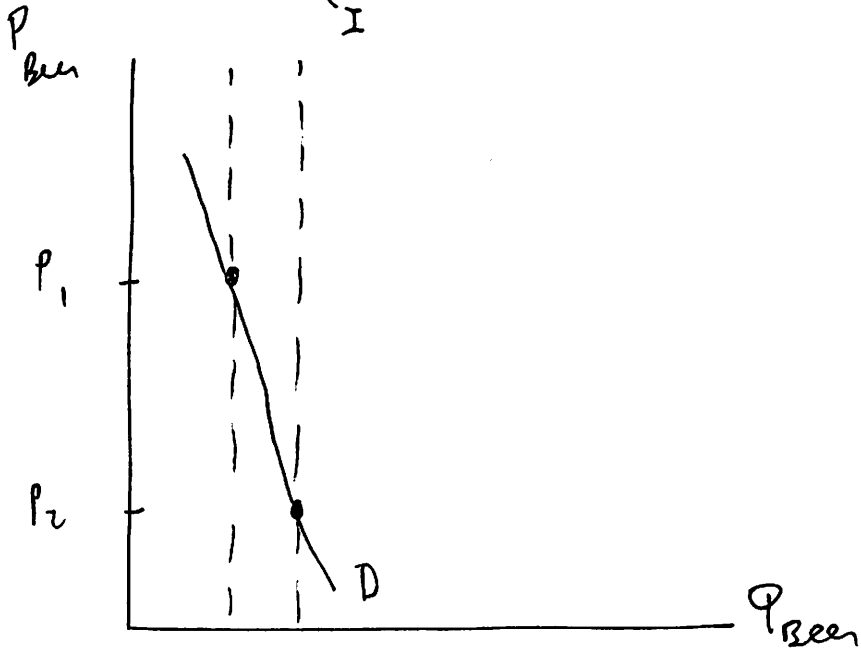
Case 1

Inferior good ($P \downarrow$)
normal D curve

Price of beer falls
$P_2 < P_1$

a → c : total
a → b : subst.
b → c : inc.





case 2

Inferior (Giffen) good
upward-sloping D curve

Price of Beer falls
$P_2 < P_1$