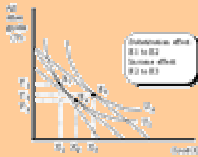


Income and Substitution Effects



Income and Substitution Effects

- We know that both price and income influence demand.

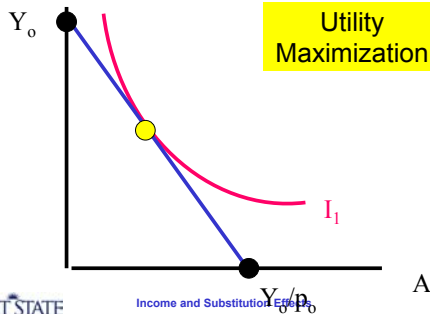
Income and Substitution Effects

- We know that both price and income influence demand.
- A price change means an income change.

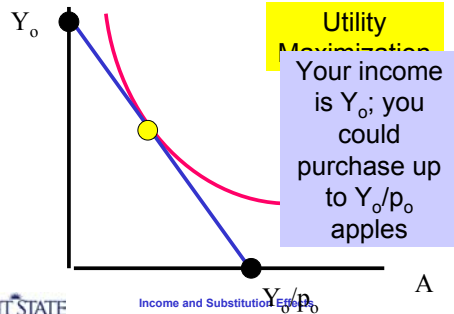
Income and Substitution Effects

- We know that both price and income influence demand.
- A price change means an income change.
- You are purchasing 10 apples at \$1 each.
- If the price falls to 50¢, you effectively get \$5 more income

The Basic Indifference Curve



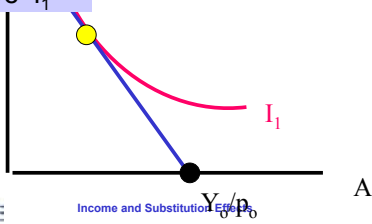
The Basic Indifference Curve



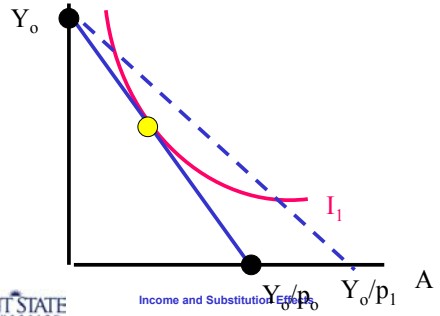
The Basic Indifference Curve

You are on indifference curve I_1

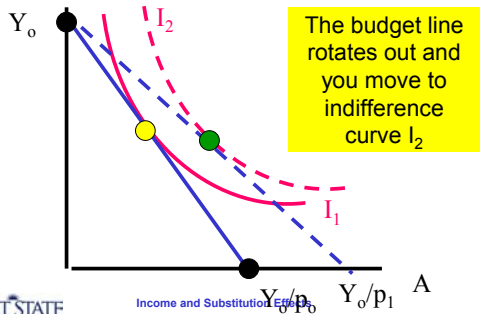
Utility Maximization



Apple Prices Drop

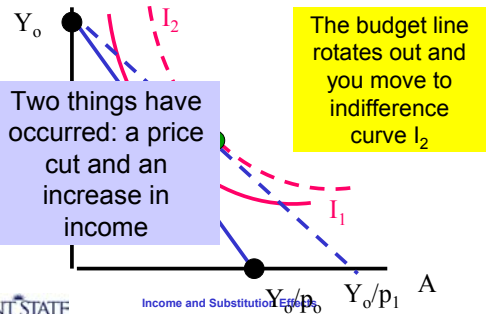


Apple Prices Drop



The budget line rotates out and you move to indifference curve I_2

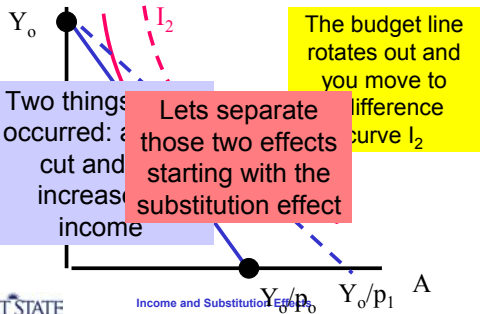
Apple Prices Drop



The budget line rotates out and you move to indifference curve I_2

Two things have occurred: a price cut and an increase in income

Apple Prices Drop



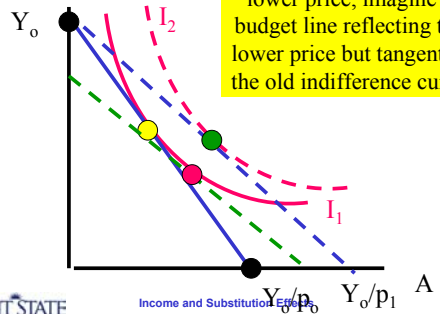
The budget line rotates out and you move to indifference curve I_2

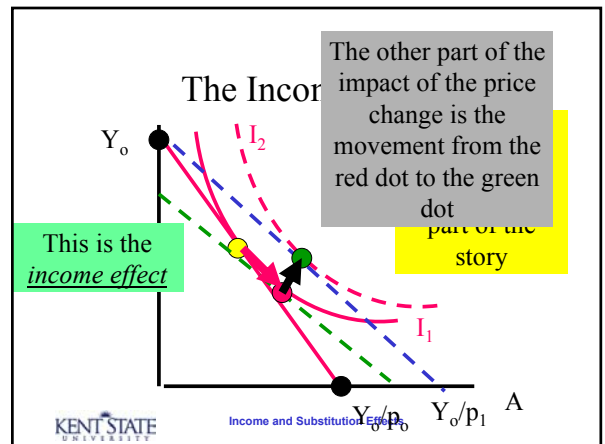
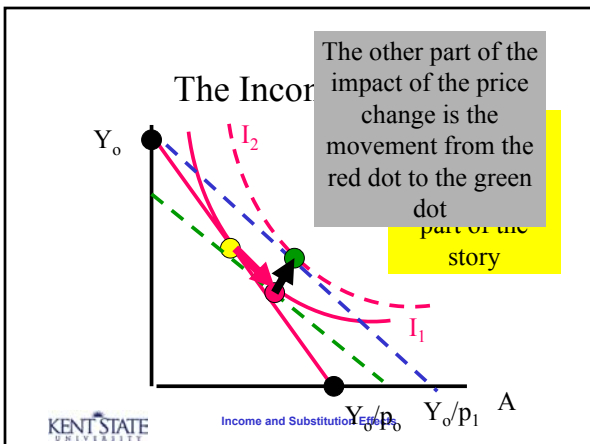
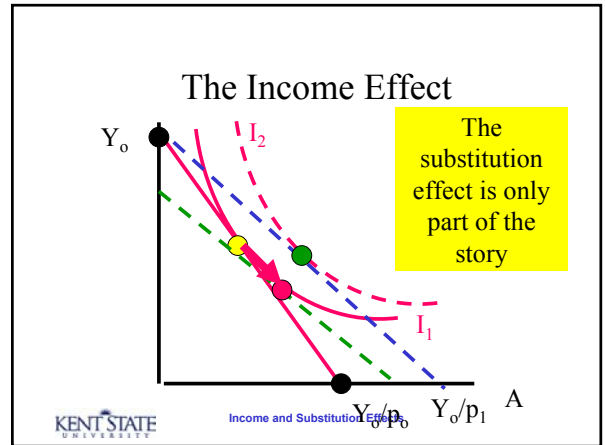
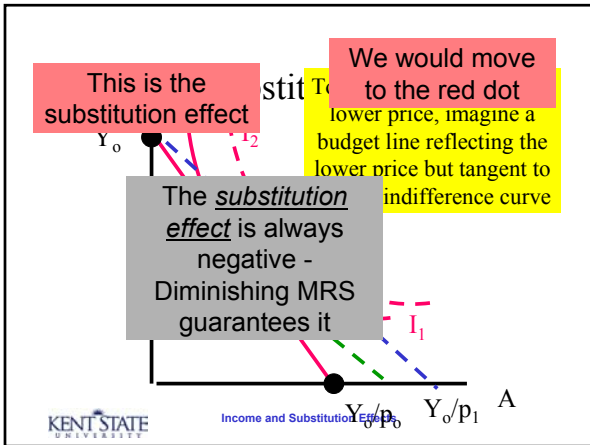
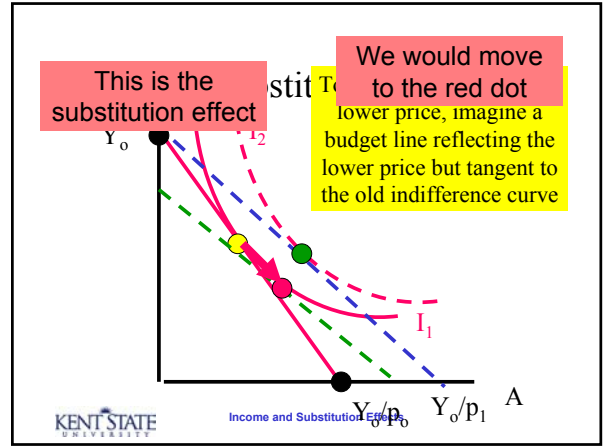
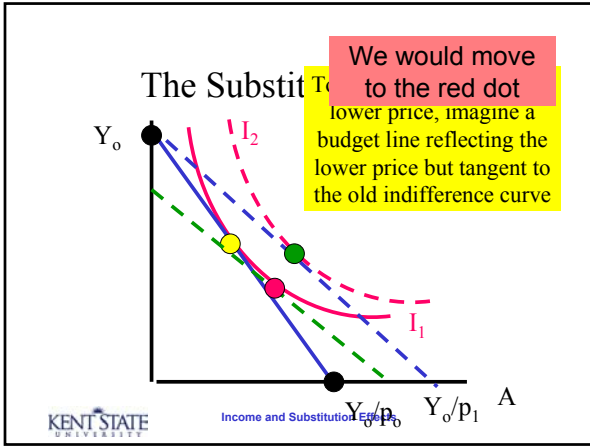
Two things have occurred: a price cut and an increase in income

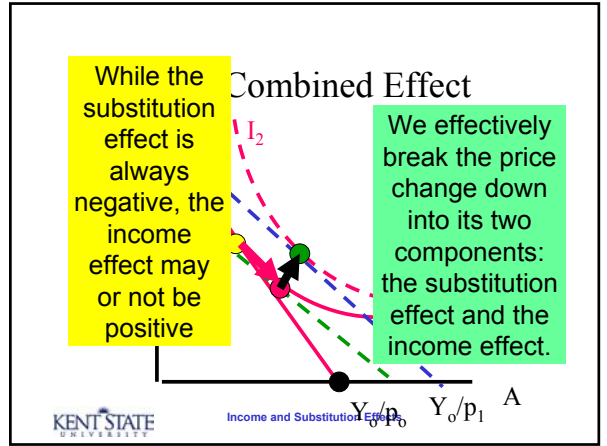
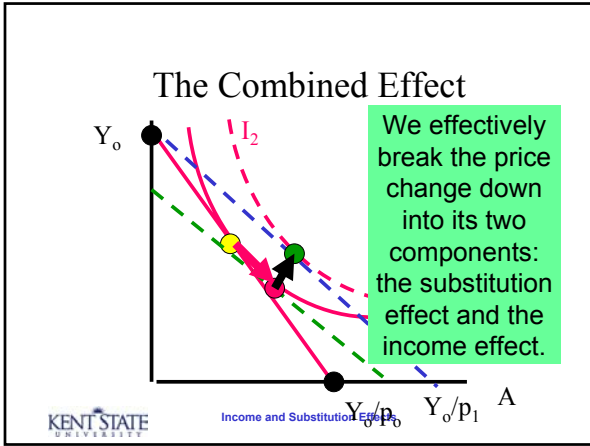
Let's separate those two effects starting with the substitution effect

The Substitution Effect

To isolate the effect of the lower price, imagine a budget line reflecting the lower price but tangent to the old indifference curve







Change in Quantity Demanded for Normal and Inferior Goods				
	Normal Good		Inferior Good	
	Price ↑	Price ↓	Price ↑	Price ↓
Change in quantity demanded due to substitution effect (holding utility constant)	(-)	(+)	(-)	(+)
Change due to income effect (holding prices constant)	(-)	(+)	(+)	(-)
Combined Effect	(-)	(+)	?	?

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Income and Substitution Effects

Change in Quantity Demanded for Normal and Inferior Goods				
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Income and Substitution Effects

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Income and Substitution Effects

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Combined Effect	(-)	(+)	?	?

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Income and Substitution Effects

End

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