

INCOME & SUBSTITUTION EFFECTS (Px decreases)

• Suppose $P_x = 3$, $P_y = 4$, and $B = 120$. $P_x \downarrow$

$X_{max} = \frac{120}{3} = 40$
 $Y_{max} = \frac{120}{4} = 30$
 $X'_{max} = \frac{120}{2} = 60$

$X'_1 - X_1^* = \text{Substitution effect}$
 $X'_2 - X_1^* = \text{Income effect}$

