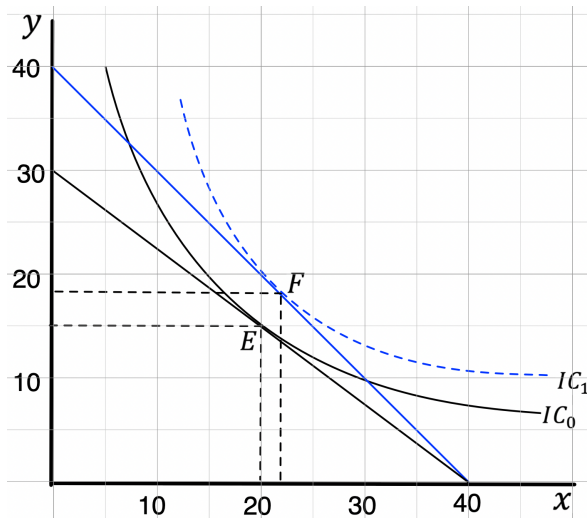


**Chapter 14.b Substitution and Income Effects**

3.  $p_y$  decreases from  $p_y = 4$  to  $p'_y = 3$ .



- The equilibrium point changes from  $E = (x_0, y_0)$  to  $F = (x_2, y_2)$ .
- The relative price changes from  $\frac{p_x}{p_y} =$  to  $\frac{p_x}{p'_y} =$
- To keep the same satisfaction with the new relative price  $\frac{p_x}{p'_y}$  draw an **imaginary budget line** with slope  $\frac{p_x}{p'_y}$  to be tangent with the original Indifference Curve  $IC_0$ .
- The Substitution Effect is:

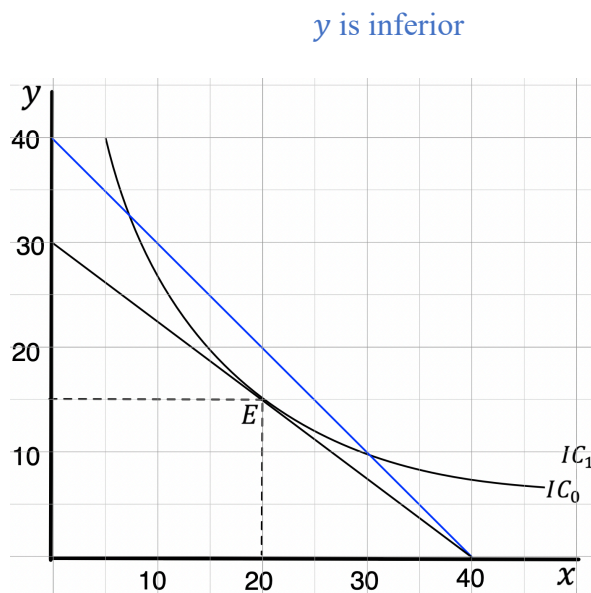
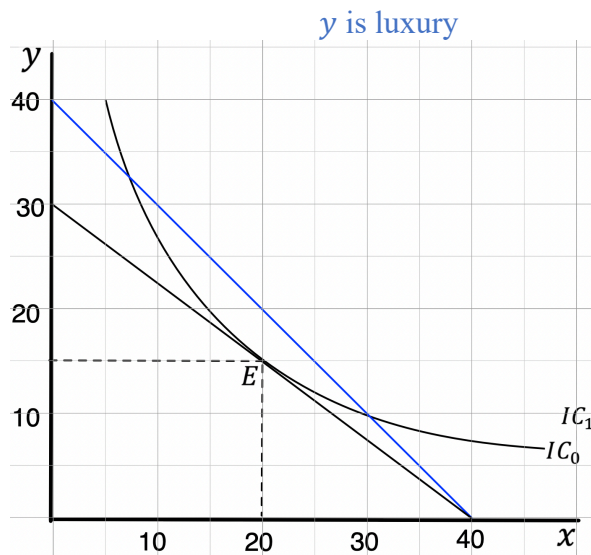
$$S.E. = \begin{cases} \Delta x = x_1 - x_0 = < 0 \\ \Delta y = y_1 - y_0 = > 0 \end{cases}$$

- When price changes in such a way that  $x$  is relatively more expensive, the Substitution Effect is always such that  $\Delta x < 0$  and  $\Delta y > 0$ . Why?
- Income Effect can be found by moving the imaginary budget line to be tangent with the new budget line.

$$I.E. = \begin{cases} \Delta x = x_2 - x_1 = \\ \Delta y = y_2 - y_1 = \end{cases}$$

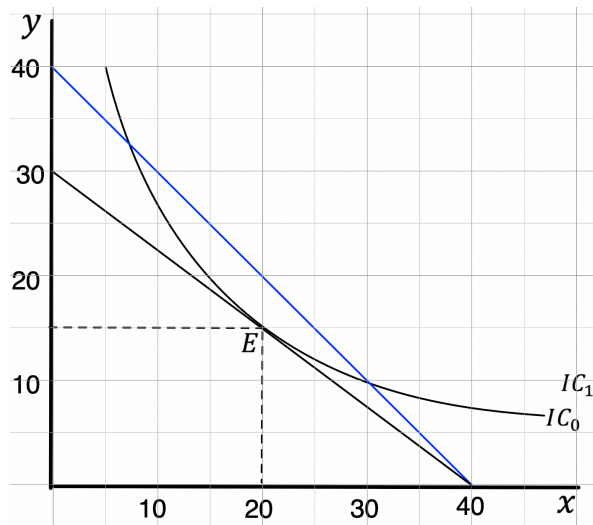
- According to the resulting  $I.E.$ ,  $x$  and  $y$  are normal goods because as the real income increases, the consumer consumes more of both  $x$  and  $y$ .
- **Total Effect** =  $T.E. = S.E. + I.E.$   

$$= \begin{cases} \Delta x = (x_1 - x_0) + (x_2 - x_1) = x_2 - x_0 \\ \Delta y = (y_1 - y_0) + (y_2 - y_1) = y_2 - y_0 \end{cases}$$
- In the following graphs, draw  $IC_1$  in such a way that  $y$  is luxury and inferior.



- Can  $y$  be so inferior such that when the price  $p_y$  decreases, the consumer buys less of  $y$ ?

$y$  is Giffen good



- This means that when price  $p_y$  decreases, the consumer ends up buying less of  $y$ . Thus, this violates the Law of Demand even when the consumer is being rational.