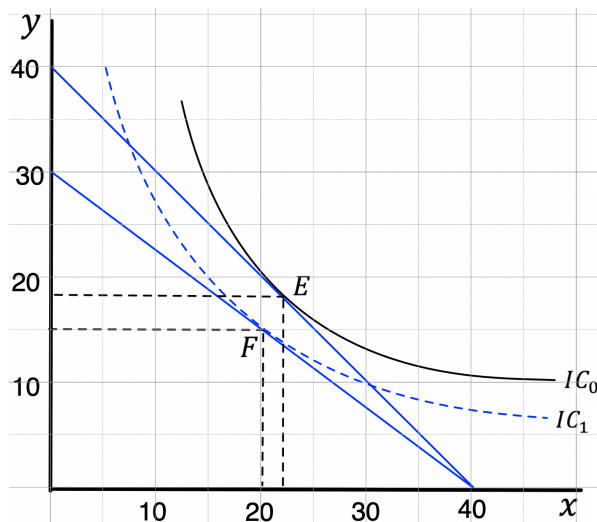


Chapter 14.b Substitution and Income Effects

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



- 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:

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

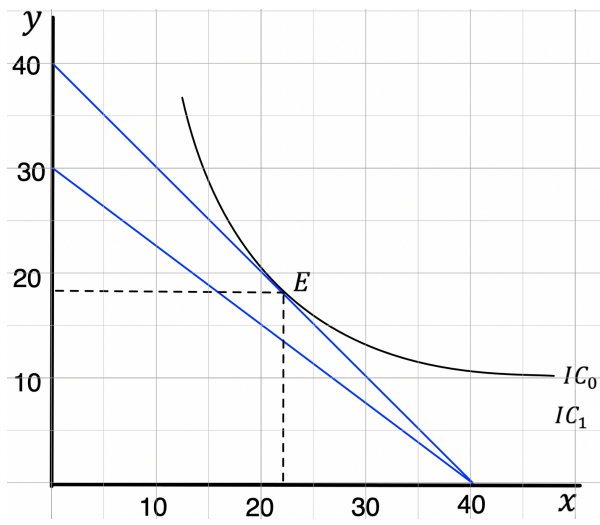
- When price changes in such a way that x is relatively less expensive, the Substitution Effect is always such that $\Delta x > 0$ and $\Delta y < 0$. Why?
- Income Effect can be found by moving the imaginary budget line to be tangent with the new budget line.

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

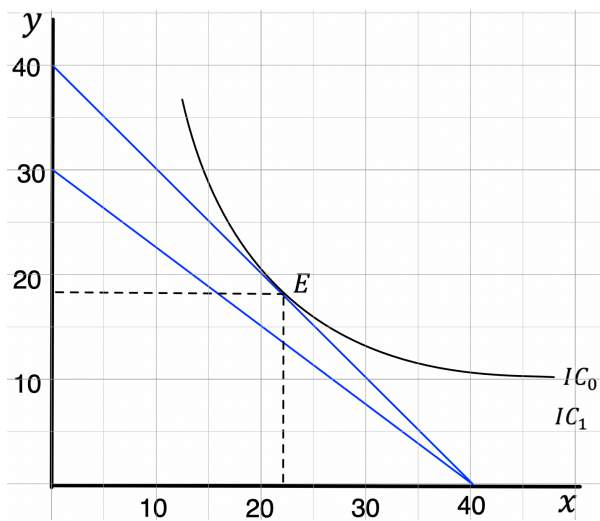
- According to the resulting $I.E.$, x and y are normal goods because as the real income decreases, the consumer consumes less of both x and y .
- **Total Effect** = $T.E. = S.E. + I.E.$

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

y is luxury

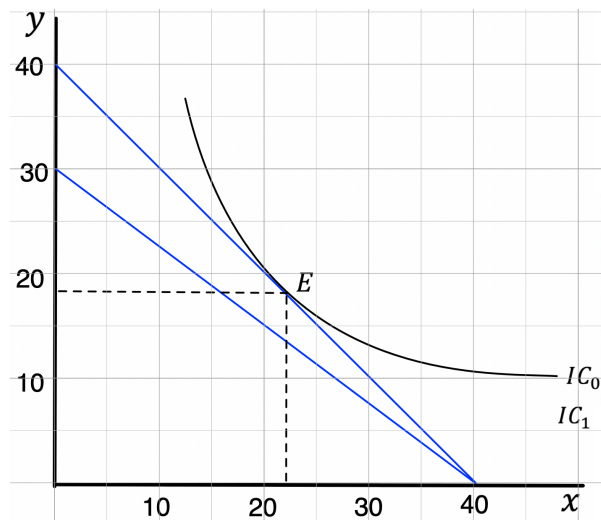


y is inferior



- Can y be so inferior such that when the price p_y increases, the consumer buys more of y ?

y is Giffen good



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