

# EE311

---

## Chapter 2: Consumer Behaviour and Demand Theory Part 2: Change in prices

Nitinant Wisaweesuan  
26 August 2020

# Change in Price

# Optimal Choice and Demand

# Decomposition of Income and Substitution Effect

- To understand how a consumer's behaviour changes in response to changes in economics environment, ie.  $\Delta P$
- Substitution effect: How a consumer substitutes on good for another when a price changes,
  - Holding the level of utility constant. In other words, consumer remains on the original IC (Hicks' Approach)
  - Holding the purchasing power constant (Slutsky Approach)
- Income effect: how a consumer change the amount of a good that consumer would by as purchasing power changes

# Hicks' and Slutsky's Approaches

Sir John R. Hicks, an English economist.

Eugene Slutsky, a Russian economist.

Hicksian approach has been criticized for its **lack of real-world applicability** because it is impossible to know by exactly how much income should be changed in order to keep the individual consumer on the original IC.

Usefulness of decomposing S.E. + I.E is to understand the nature of products, whether they are normal, inferior, or giffen good.

# Compensated Demand

- Consumer is compensated for a price rise by having enough income given back to him to purchase his old bundle,
- if the price goes down, he is compensated by having money taken away from him.