

Substitution and Income Effects Breakdown

1) Substitution Effect:

The pure change in quantity demanded caused from a change in **relative prices**.

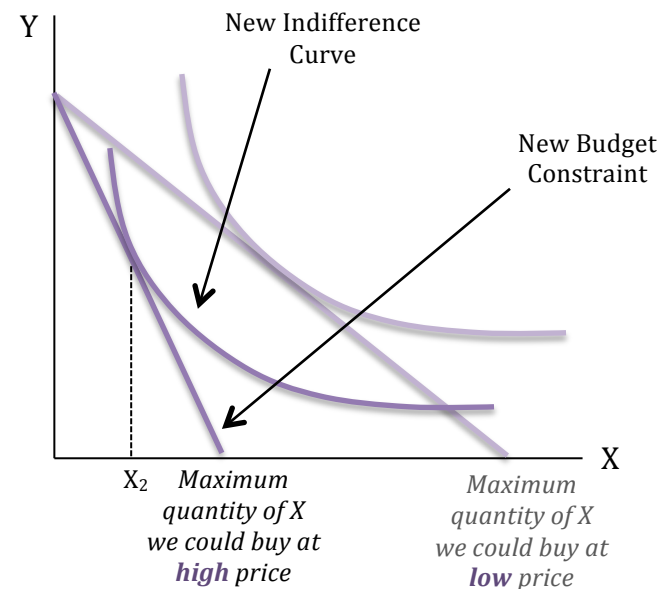
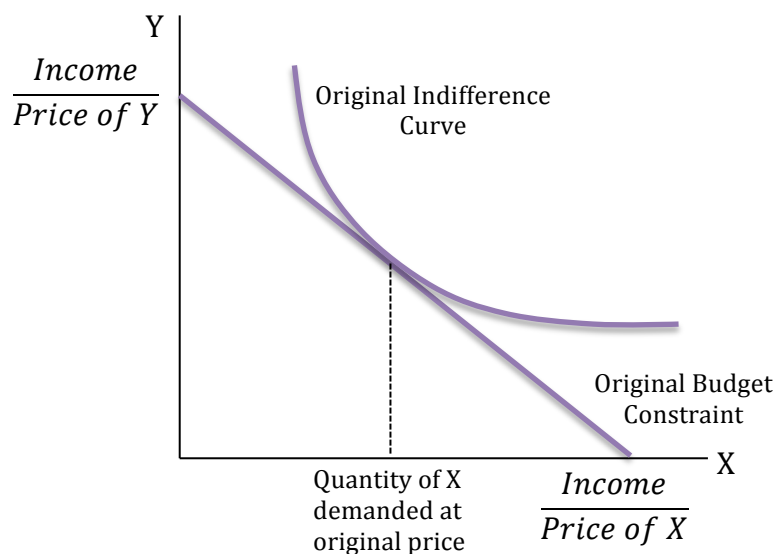
We always substitute towards the relatively cheaper good – ie demand moves with the change of the curve.

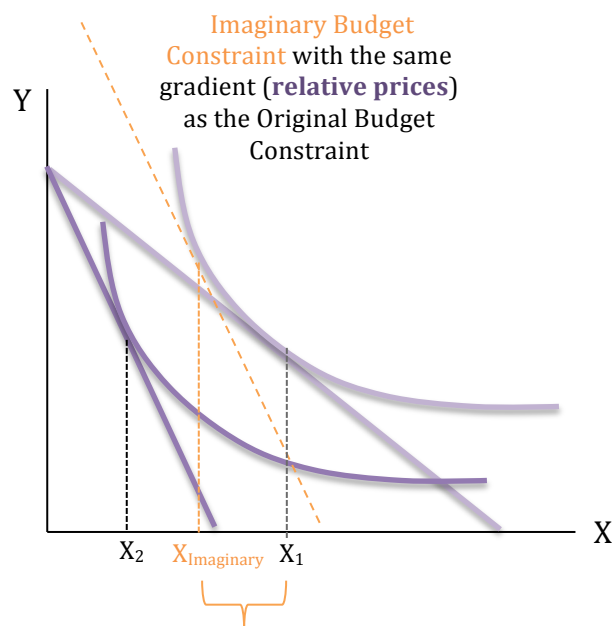
2) Income Effect:

The pure change in quantity demanded caused by a change in purchasing power – how far our money now goes.

Normal Goods' demand moves with the curve and with the substitution effect.
Inferior Goods' demand moves against the curve and substitution effect.

$$[\text{Price of X}] \times [\text{Quantity of X}] + [\text{Price of Y}] \times [\text{Quantity of Y}] = \text{Income}$$





1) Substitution Effect:

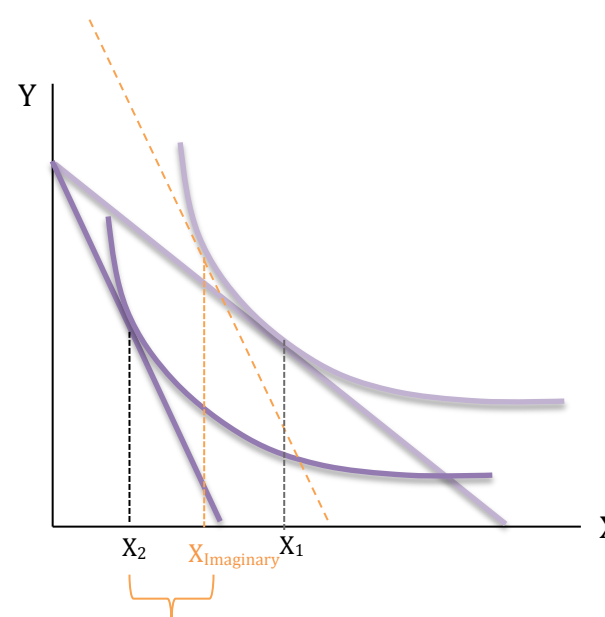
The pure change in quantity demanded caused from a change in **relative prices**.

We always substitute towards the relatively cheaper good – ie demand moves with the change of the curve.

Here the curve shifted inwards, and so too did the quantity demanded of X.

We imagine have much X we would have bought to give us the same utility as we originally had, but at the new prices.

We use create an **Imaginary Budget Constraint**



2) Income Effect:

The pure change in quantity demanded caused by a change in purchasing power – how far our money now goes.

Normal Goods' demand moves with the curve and with the substitution effect

Here the price of X has increased so the consumer's real purchasing power has decreased. The change in X caused by the move from $X_{\text{Imaginary}}$ to X_2 is the pure change in demand from an inward shift of the budget constraint.

X must be a **normal good** because a fall in income has decreased the demand for it.