

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.

3) Normal Goods

Goods that are demanded more when income increases and less when income decreases. (eg taxis)

Therefore the income effect for a normal good will move **with** the curve and the substitution effect.

4) Inferior Goods

Goods that are demanded *less* when income increases and *more* when income decreases. (eg buses)

Therefore the income effect for an inferior good will move **against** the curve and the substitution effect.

5) (Gross) Substitutes:

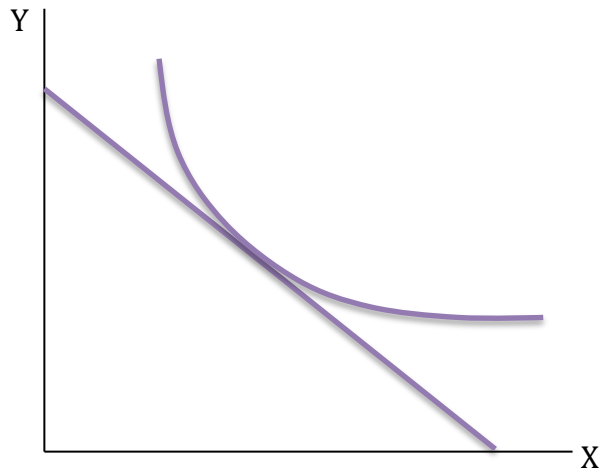
Goods that compete with one another. (eg PS4 and Xbox One).

When the price of an Xbox One increases, the demand of its **substitute** – PS4 - increases too because the PS4 is now **relatively cheaper**.

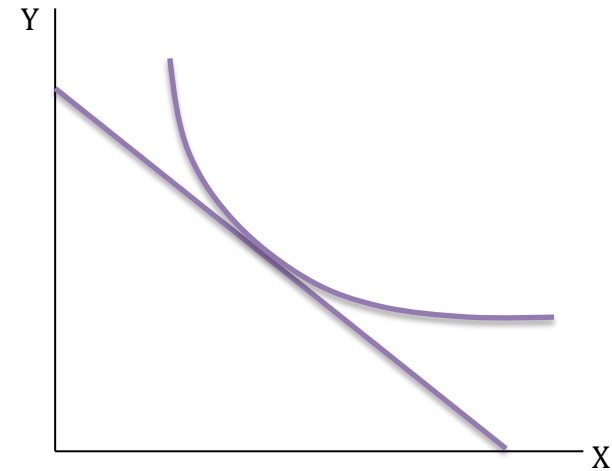
6) Complements:

Goods that compliment one another. (eg Xbox One and Xbox Controllers).

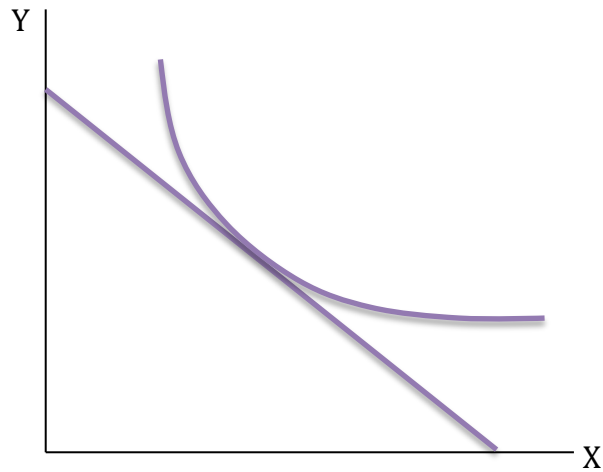
When the price of Xbox One increases, the demand of its **complement** – controllers - falls because the Xbox one is now **relatively more expensive**.



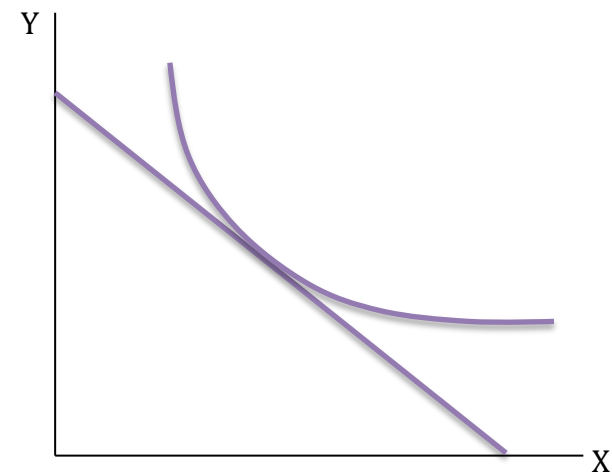
1) Show the income and substitution effects for a normal good when the price of X rises.



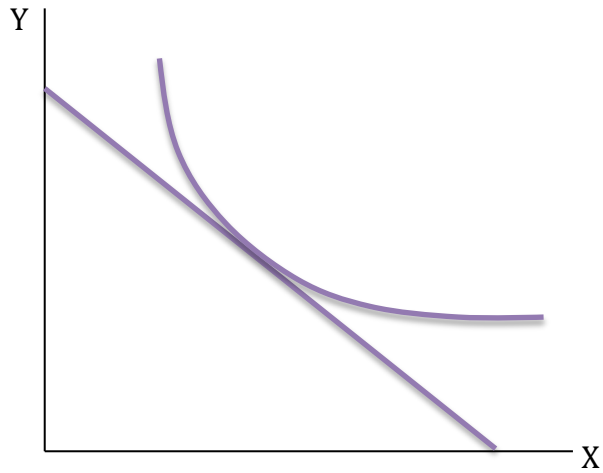
2) Show the income and substitution effects for an inferior good when the price of X rises.



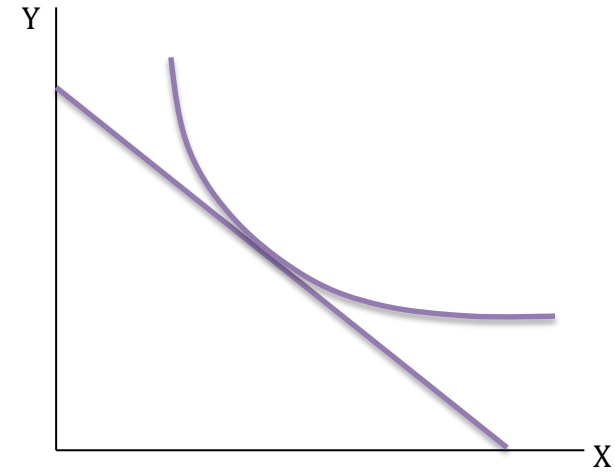
3) Show the income and substitution effects for a normal good when the price of X falls.



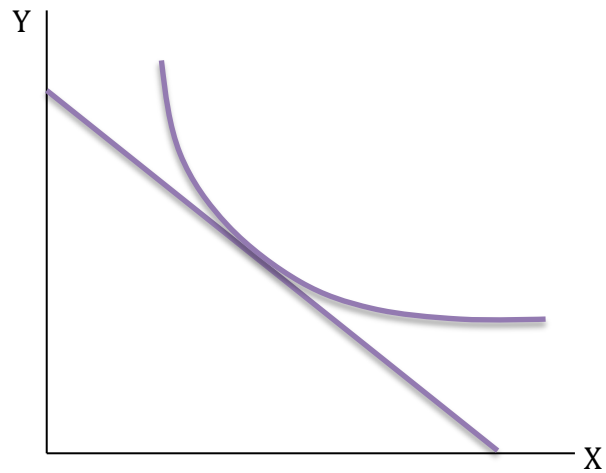
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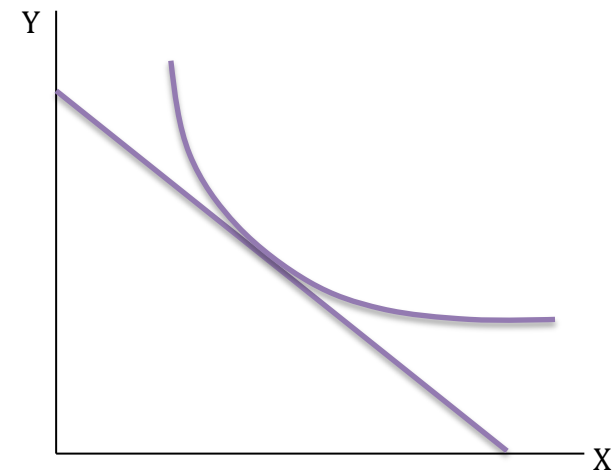
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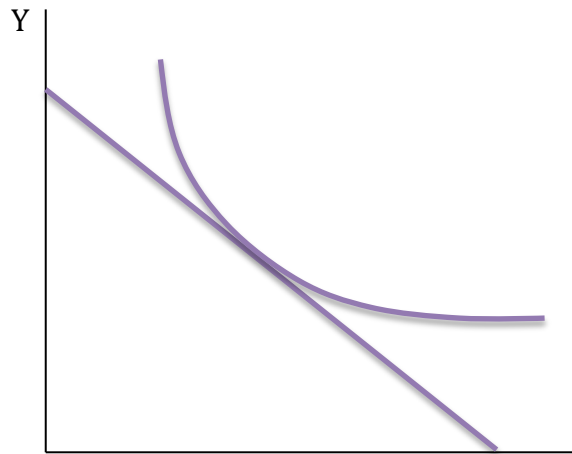
2) Show the income and substitution effects for a complement when the price of X rises



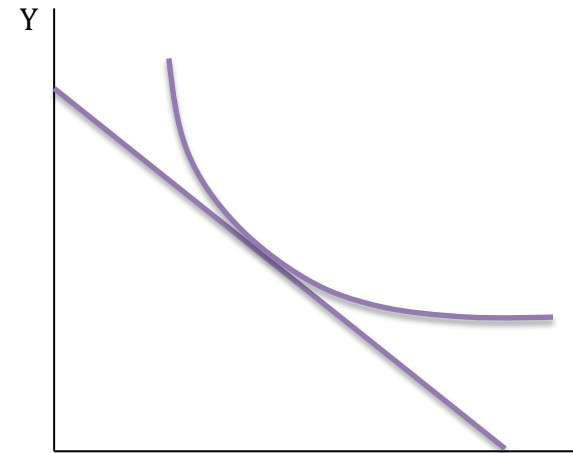
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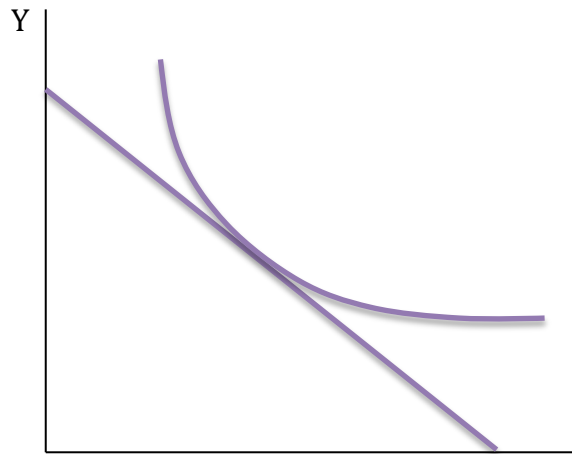
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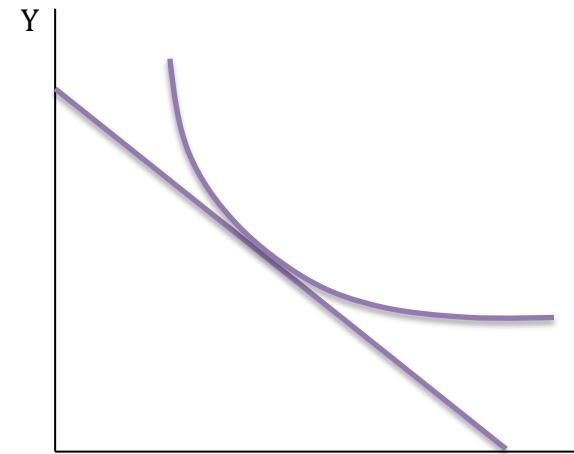
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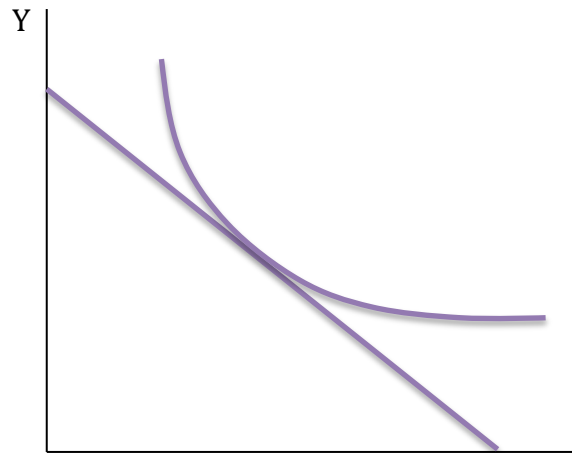
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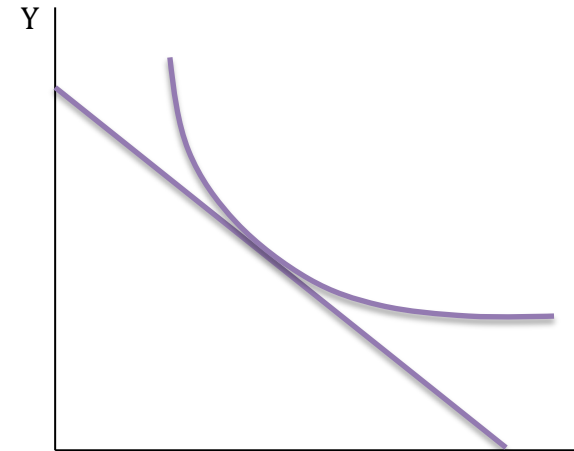
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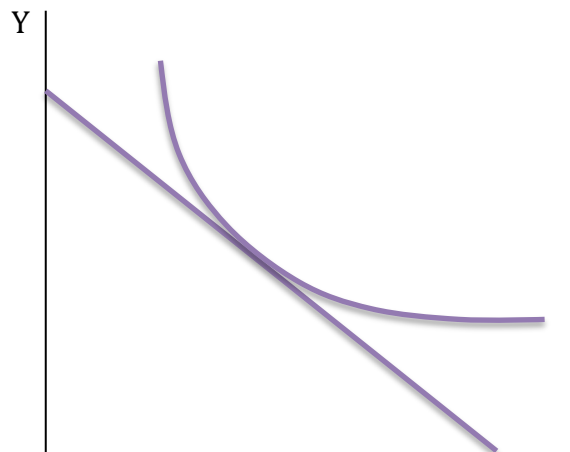
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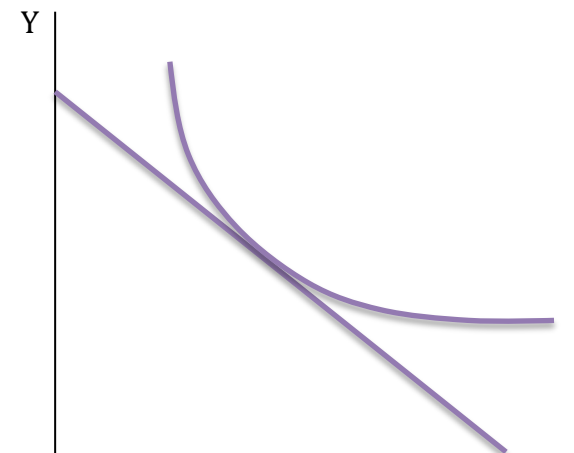
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2) Show the income and substitution effects for a complement when the price of Y rises.



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