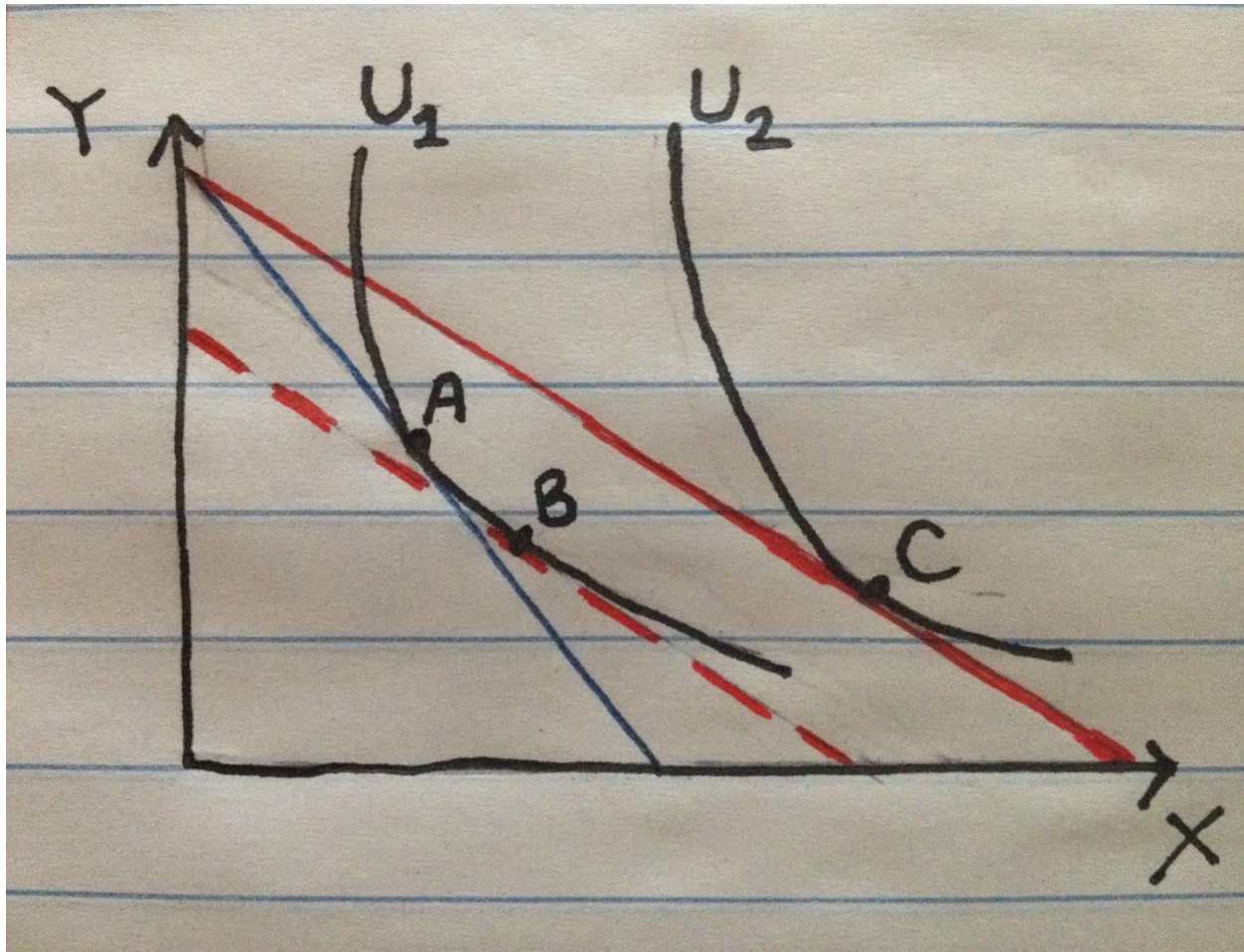


Extra Reading 6 : Income and Substitution Effect

Bibaswan Chatterjee: Eco 182 – Summer 2015



I said before an own price change can be decomposed or broken into Income effect (IE) and Substitution Effect(SE). This is why.

Look at the result of own price change: Price of X falls. So the Budget line twists from the blue line to the solid red line. As a result the optimum choice changes from A to C. What does this show us?

- The consumer has moved to a higher utility level or higher indifference curve (from U_1 to U_2).
- The consumer is consuming more of X.

b is the SE. When the price changes at first, good X is cheaper. So the consumer can stay on the same level of utility or same IC (U_1), and choose a larger amount of quantity of X to consume. So drawing a parallel budget line (dashed red) to the new solid red budget line, we find the consumer moves along the old indifference curve and *substitutes* Y with more X; he moves from point A to B.

a is the IE. Because X is cheaper, the consumer has more income to allocate between the two goods. So the consumer moves to a higher utility level or higher IC (U_2). He moves from B to C.

Please note that the diagram here is not drawn to scale and doesn't carefully take into account the different types of goods' reaction to price and income changes. In all likelihood, the point C would not be so far to the right.

Thus the total effect of own price change can be broken as follows:

Total Effect = Substitution Effect(A to B) +Income Effect(B to C).