Substitution and income effect

ASSIGN
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The price of any given product will always change the customer’s choice of purchasing this can be in terms of quantity, quality or choosing the opportunity cost. In my essay I will be looking at how an increase in prices affect the substitution effect and the income effect and how customers react if the good has many close substitutions when there is an increase in price.

Under the Substitution effect it suggest that the rise of the price in a good or decrease in income will leave the customers having to choose the alternative goods for example when the price of Coca-Cola drink raises this will lead to the rise of demand in Pepsi because Pepsi is the next best thing to a Coca-Cola. The substitution effect can also be used in reference in how workers can have a pick between leisure and wages, the more money on wages the less leisure time since wages will be more profitable than leisure. This effect tends to limit the customers buying demand behaviour that is limiting the choice of the consumer since they will not be able to purchase their choice of good. as shown below (in figure 1. 1) The impact that a change in the price of a good has on the quantity demanded of a certain good, this will always lead to change in relative prices the rise of the price will make the quantity demanded to be less forcing some of the customers away to the next best thing that they can have.

The income effect is the response of the quantity that is demanded to a change of real income or the price that is the rise of price in goods, (refer to figure 1. 1) in the graph below shows the demand curve as it links up the relationship between the price of a certain item and the quantity that is demanded that is over a certain time. When the price falls there are two

reasons why there will be more demand and this includes the substitution effect and income effect . the impact that a change in the price of a good has that effect on the quantity demanded of the good which then leads to the change of price of the good (substitution). the impact of a change in the quantity demanded of the good due to the change of their real income not being able to meet the quantity of goods that will satisfy them but still buy the good anyway but only have to make it lesser.

The demand curve enlightens up the relationship between the price of the goods and the quantity demanded that is after a period of time.

Considering both sides the substitution effect as shown on the diagram above from both sides of a price change that is going up and down. If we consider the both sides the higher the price an increase in price causes a decrease in the relative prices of substitute goods. Buyers tend to buy more of the other substitute goods and less of the good. The result is a decrease in thequantity demanded, and the lower the price then it leads to a decrease in price causing an increase in the relative prices of substitute goods. Buyers are inclined to buy less of the other substitute goods and more of this good. The result is an increase in the quantity demanded. As price falls, a person’s opportunity cost of purchasing the product falls as shown in the diagram above.

A good with many close substitutes is likely to have an elastic demand . This is due to the price rise, buyers can actually choose to buy one of the close substitutes if there is a price increase of a good by shifting to one of the cheaper substitutes. However fewer substitutes’ choices will limit the options

to shift. It is Important to distinguish between the income effect and the substitution effect of a price increase and the separation of the two is shown in figure 2 and it’s called the indifference theory. The price change can affect the way the buyers’ decisions in terms of buying staff this is called the income effect. Increases in price, while they don’t affect the amount of your available budget, make you feel poorer than you were before, and by so you buy less of the product. Decrease in the price make you feel more superior and confident in terms of buying, and can the lead you of buying more of that good. When price increases, the demand for x changes because (1) good x is now more expensive relative to good y, and (2) the consumer’s purchasing power has gone down. Substitution Effect—the change in demand resulting from a change in the price ratio, leaving utility unchanged. Income Effect this is the change in demand resulting from the change in purchasing power (movement from the initial indifference curve to the final indifference curve), leaving the price ratio unchanged. The total effect = substitution effect + income effect. The substitution effect is always negative, due to diminishing MRS. The income effect is negative for normal goods(the substitution effect), and positive for inferior goods.

A giffen good is an inferior good with the unique characteristic that an increase in price actually increases the quantity of the good that is demanded. This provides the unusual result of an upward sloping demand curve. This happens because of the interactions of the income and substitution effects. Depending on whether the good is inferior or normal, the income effect can be positive or negative as the price of a good increases.

An inferior good means an increase in income causes a fall in demand. an inferior good has a negative PED. An example, of an inferior good is Tesco value bread. When your income rises you buy less Tesco value bread and more high quality, organic bread. Normal Good This means an increase in income causes an increase in demand. It has a positive PED. Note a normal good can be income elastic or income inelastic. The graph below shows the income effect and the substitution effect of a price increase for a normal good and inferior goods after a rise in price of a certain good. The Income Effect is the effect due to the change in real income. When the price goes up that means the consumer is not able to buy as many bundles that she could purchase before. In real terms this means that the customer now feels poorer. On the diagram 1. 3 it shows the quantity of goods consumed for a normal good and it shows the figures A= 14, B= 4 and C= 7 . from C to A it shows the substitution effect after subtracting 14 from 7 and from C to B after subtracting 7 from 4 it shows the income effect and the total effect is the total between the substitution and income effect as shown in the diagram (-7-3=-10). The same workings also applies to the inferior goods too. As shown in the diagrams when the price of the good goes up the quantity goes down

Summing up my essay if a good is inferior, a drop in income (represented by a price increase) increases the quantity of the good that is demanded. The substitution effect is negative for any good that experiences a price increase. A giffen good faces an upward sloping demand curve because the income effect dominates the substitution effect, meaning that quantity demanded increases as price rises.