

Income and substitution effects

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Income and Substitution Effects Inferior goods are those which react negatively to changes in buyers' income in that any change in income results into an opposite change in demand. Few Inferior goods are bought when the buyer's income goes up but much is bought when the consumer's income goes down (Hyman 2010, p. 153). Also, it is worth noting that change in price can lead to change in the consumer's decision to buy. However, inferior goods are not faulty or may be made by low quality materials. Inferior goods normally earn the name because they are always cheaper than the desirable goods. Hall and Lieberman (2010, p. 166-168) argue that changes in price of product may greatly change the decision of a buyer and this kind of effect is called income effect. An increase in price makes an individual poor than before since it makes one buy less even without decrease in income. However, any reduction in price would make a consumer feel richer than before hence prompting the buyer to purchase more of particular product. Also, an individual may be forced to buy a particular product because the substitute for the good is more expensive due to an increase in price. Hyman (2010, p. 153) argues that any individual's decision to change purchase decision prompted by fluctuations in relative price is known as substitution effect. Income effect is always effective when there are two different products in such a way that any change in price of one product would make the buyer either relatively poorer or richer than before. Considering both income and substitution effects, it is important to note that the total effect is not normally clear. Looking at the income effect, an increase in price of a certain product would definitely reduce the demand for two substitute products. On the other hand, substitution effect reduces consumption of the

product whose price is increased while boosting the demand of the substitute good. Hall (2008, p. 138) posits that although the net result may not be ascertained accurately, the substitution effect always overpowers the income effect. In the case of Adam and Kim, Kim is a vegetarian and would therefore not be affected by the decrease in the chicken. Adam who really loves chicken may be affected by the reduction in the chicken price. Nevertheless, Adam considers chicken as an inferior product and therefore a decrease in price may mean that Adam will become richer than before. Adam only buys chicken because the food stuff he loves may be expensive (Taylor 2008, 126-128). Chicken is therefore like a second choice to him because he loves something much better. Actually, when Kim and Adam had more money, neither of them would have bought chicken. Both are forced to buy chicken because their income is less and if their income would be increased they would definitely forgo chicken. Kim is a vegetarian who would not go to chicken when he had enough money to buy his favorite vegetables (Hall and Lieberman 2010, p. 166-168). Taylor (2008, 126-128) believes that income and substitution effects would differently alter the consumption of goods contrarily especially when it comes to inferior goods. A decrease in the price of chicken would positively influence the substitution effect while negatively influence income effect. Generally, substitution and income effect would be positively affected by the decrease in the chicken price. Reduction of chicken price leads to a decrease in the total expenditure for it by Adam while nominal income and the price of another desirable product do not change (Hall 2008, p. 138). Adam will consume more of his desirable food stuff while reducing demand for chicken thus spending more on his desirable

product. As much as the nominal income is not changed Adam does not spend much on chicken. The demand curve for chicken remains elastic and any increase in its price would reduce the total expenditure on chicken. Any change in the price of the chicken causes the demand curve to shift due to change in income. A reduced price would mean that Adam would be richer but less interested in chicken hence decreasing its demand as demonstrated in the graph. “ Z” Y X Z YZ1 YZ2 Substitution Effect {+} Income Effect {-} Total Effect {+} Considering the graph of the chicken which is an inferior good, the YZ2 reflects decrease in price. A decrease in price of chicken would lead to a movement from point X to point Y on YZ2 and this represents the positive total effect. Substitution effect is represented by the movement from X to Z and it is evident that the effect was positive while the income effect is from point Z to point Y. From the graph, the income effect is negative although the total effect is shown as positive and is represented by the equation total effect= substitute effect + income effect. Bibliographies Hall, R, & Lieberman, M 2010, Microeconomics: Principles and Applications, Mason, Oh, South-Western, Cengage Learning. Hall, R., E 2008, Economics: Principles and Applications, Cincinnati, South-Western. Hyman, N 2010, Public Finance: A Contemporary Application of Theory, Australia, South-Western Cengage Learning, C2010, 2011. Taylor, B 2008, Economics, Boston, Mass, Houghton Mifflin.