P.p1 in question 3, the substitution effect dominates

p. p1 {margin: 0. 0px 0.

0px 0. 0px 0. 0px; font: 12. 0px Georgia; color: #000000; -webkit-text-stroke: #000000}p. p2 {margin: 0. 0px 0.

0px 0. 0px 0. 0px; font: 12. 0px Georgia; color: #000000; -webkit-text-stroke: #000000; min-height: 14.

0px}span. s1 {font-kerning: none}In both examples, the substitution effect dominates the income effect. This is because, in question 2, the worker is on a relatively low wage and hence, is more responsive to higher wages in order to achieve his desired income.

Likewise, in question 3, the substitution effect dominates the income effect as the saver reacts strongly to an increase in the price of current consumption, consuming less and saving more as interest rates rose. However, in question 2, in the example, income and substitution effect work in the same direction. There’s a positive income effect as the worker is willing to work more to reach the desired income and a positive substitution effect as the higher opportunity cost of leisure encourages him to work more. Overall, the positive income and substitution effect leads to an increase in work hours and a decrease in leisure hours. But in question 3, in the example, income and substitution effect work in opposing directions.

The higher interest rates cause the saver to have higher disposable income (the value of his savings increases), encouraging the individual to increase current consumption (negative income effect). However, there is a positive income effect as the saver substitutes current spending for future spending as it is now more rewarding to save. However, in question 2, if the type of worker or the situation worker varies, the relationship between income and substitution effect can vary when wages rise. The income and substitution effect can work in opposing or the same direction. In question 2, if the worker had already achieved his desired income, the income and substitution effect would work in opposing directions. Although the substitution effect remains the same, there would be a negative income effect as he has already achieved his target income and would prefer to spend more time on leisure. Leisure is a normal commodity so as income rises, he would spend more time on leisure and less on work. However, in question 3, for a saver, the income and substitution effect would always work in opposing directions when there are high-interest rates.

A net saver would always have a negative income effect and a positive substitution effect. Although, whether or not current consumption falls or rises can change as it is dependent on the savers' reaction to increase in purchasing power and the increasing price of consumption. Had the saver reacted more strongly to the increase in purchasing power, the overall effect to his current consumption would be positive as the negative effect would dominate the substitution effect. Likewise, in question 2, there may be occasions where the income effect would dominate the substitution effect such as when the worker is already wealthy.