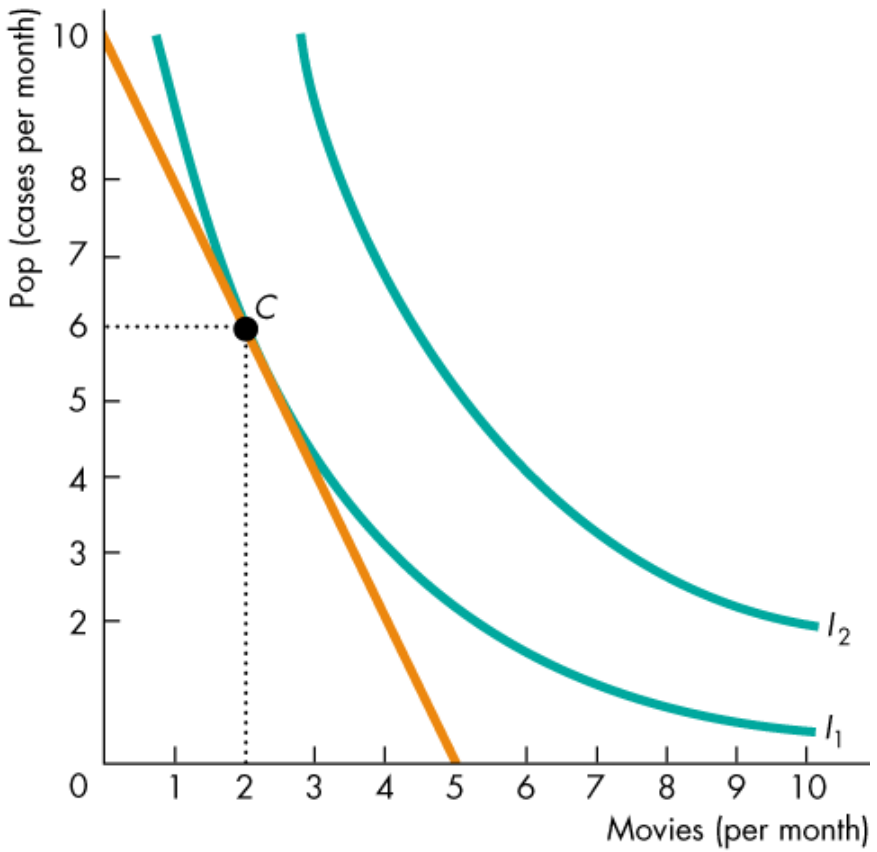
Predicting Consumer Choices

- We're going to break the move from point *C* to point *J* into two parts.
- The first part is the substitution effect and the second is the income effect.

(a) Price effect

Predicting Consumer Choices

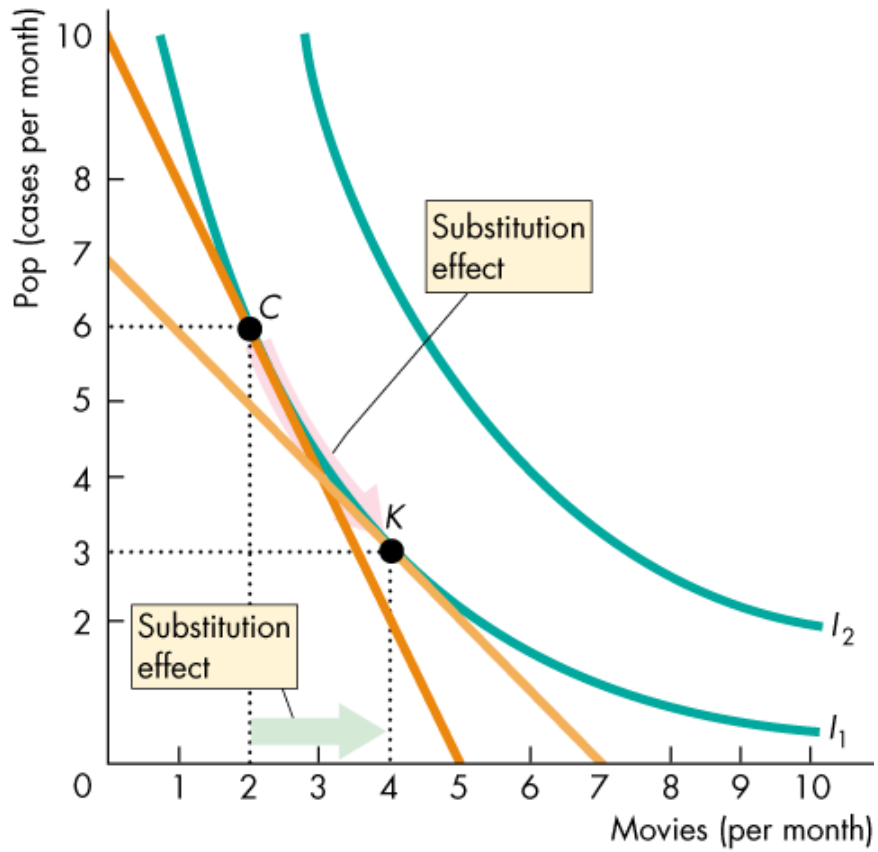
- **Substitution Effect**
- The **substitution effect** is the effect of a change in price on the quantity bought when the consumer remains on the same indifferent curve.



(b) Substitution effect and income effect

Predicting Consumer Choices

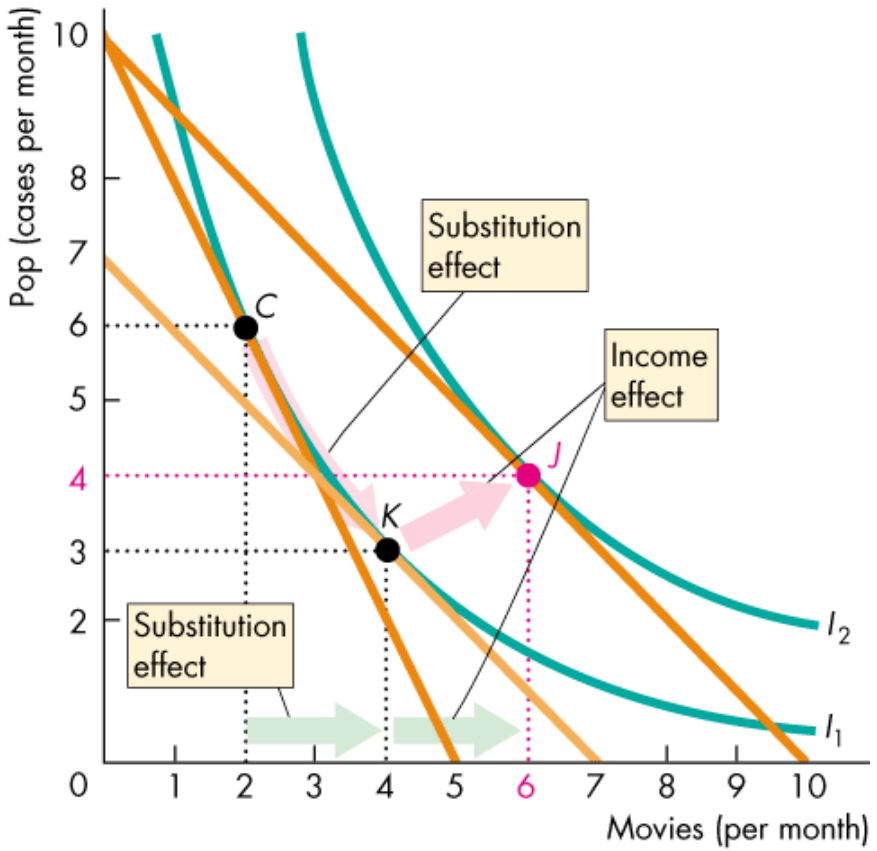
- The direction of the substitution effect never varies:
- When the relative price falls, the consumer always substitutes more of that good for other goods.
- The substitution effect is the first reason why the demand curve slopes downward.



(b) Substitution effect and income effect

Predicting Consumer Choices

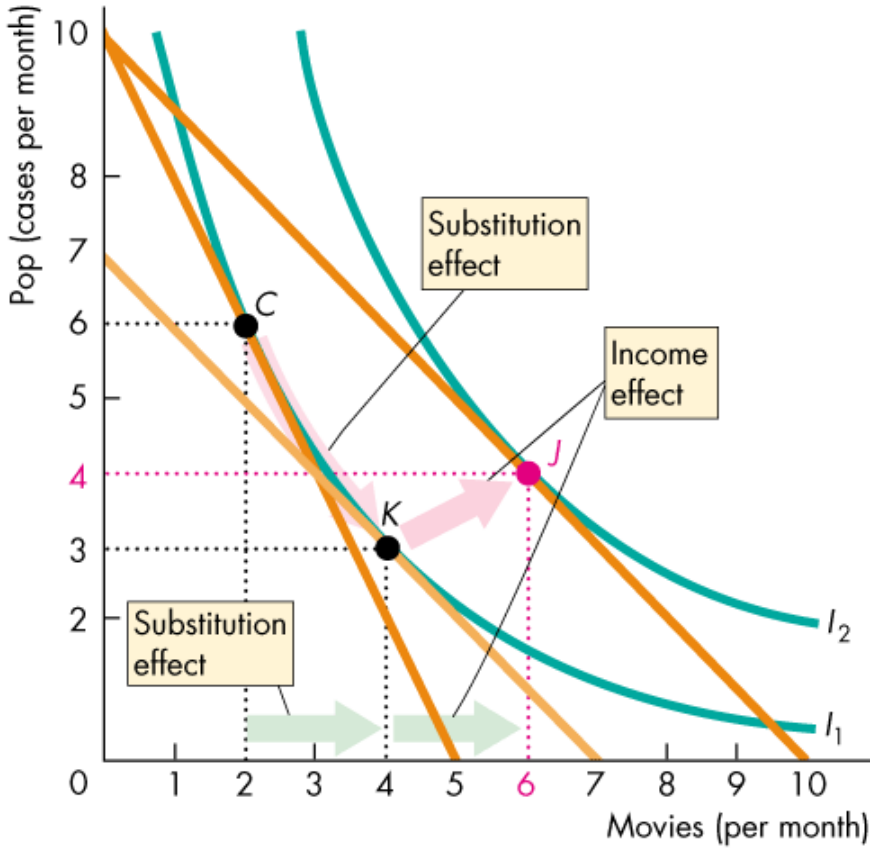
- **Income Effect**
- To isolate the income effect, we reverse the hypothetical pay cut and restore Lisa's income to its original level (its actual level).
- Lisa is now back on indifference curve I_2 and her best affordable point is *J*.
- The move from *K* to *J* is the income effect.



(b) Substitution effect and income effect

Predicting Consumer Choices

- For Lisa, movies are a normal good.
- With more income to spend, she sees more movies—the income effect is positive.
- For a normal good, the income effect *reinforces* the substitution effect and is the second reason why the demand curve slopes downward.



(b) Substitution effect and income effect

Predicting Consumer Choices

- **Inferior Goods**
- For an inferior good, when income increases, the quantity bought decreases.
- The income effect is negative and works against the substitution effect.
- So long as the substitution effect dominates, the demand curve still slopes downward.

Predicting Consumer Choices

- If the negative income effect is stronger than the substitution effect, a lower price for inferior goods brings a *decrease* in the quantity demanded—the demand curve slopes upward!
- This case does not appear to occur in the real world.