Consumer Theory – A Recap

So, let's start with the basics.

Given our income, the _____________ ______________, represents how much we can buy of any two goods given our income.

If we have more income, it means that the budget constraint shifts (right/left). Since we have more money, we can buy more, which is represented by the shift mentioned previously.

So far, we have talked about an increase in income, but we can also break down what would happen if we had less. As we have less, we shift our budget constraint to the (right/left).

We have just been discussing a pure change in income, and all possible combinations of goods available for a given income and set of prices. But we have yet to decide how much we will buy.

First let us discuss the types of goods. We know that there are two:

- A ____________ good, which when we have more(less) money, we buy more(less) of the good.

- An ____________ good, which when we have more(less) money, we buy less(more) of that good.

Now, if we see that our optimal quantity bought increases after an increase in income we are looking at a _____________ good.

If we see that our optimal quantity bought decreases after an increase in income we are looking at an _______________ good.

Although the change in income leads to straightforward conclusions, a change in price is a bit more complicated.

There are two different effects at work when there is a change in price.

1. Substitution Effect
2. Income Effect

Let us assume we have income I, and are trying to buy two goods X and Y, at respective prices Px and Py.

<u>The Substitution Effect</u>

- Represents the impact on the quantity bought due to a change in price when the consumer, hypothetically, remains indifferent between the original prices and the new ones

- As Price of Good X changes, changes the quantity demanded of Good X and Y changes, but I am just as happy

- Individuals shift away from the relatively more ______________ good to the relatively _________ good

<u>Price of X Increases</u>

The Price of X increases → the quantity demanded of Good X decreases → the quantity demanded of good Y increases (because Good Y is relatively less expensive)

<u>Price of X Decreases</u>

The Price of X decreases → the quantity demanded of Good X increases → the quantity demanded of good Y decreases (because Good Y is relatively more expensive)

Regardless of the type of good, the substitution effect of a change in the relative price change of a good, and the quantity demanded of the good will always work in opposite directions.

<u>Graphically</u>

- We find the point where the slope of our original indifference curve, matches our NEW budget constraint.

- We are finding where I am buying a combo of goods under new prices that makes me just as happy as my original set of goods. Its why I am willing to substitute away from one good to another

- Graphically this is shown by a movement along the original indifference curve.

The Income Effect

- also referred to as 'buying power' effect, represents the impact that a change in the price of a product has on a consumer's real income.
- As price changes, purchasing power changes and therefore quantity ___________ changes
- Graphically, it is a movement to a new indifference curve

Price Fall
The P of one good falls → Relative Income increases → an increase in real purchasing power

Price Increase
The P of one good rises → Relative income decrease → a decline in real purchasing power

Income Effect, Substitution Effect & Types of Goods
When the income and substitution effect move in the same direction, the good is a normal good.

Decrease in Price of Normal Good X
If we have a normal good, X, we buy _______ when we have more money. If the price of good X decrease, we have relatively _________ income and can buy more of Good X (the ________ effect), and because it is now cheaper relative to good Y, we ___________ away from Y to buy more X (the _____________ effect).

When the income & substitution effect move in opposite directions, the good is an inferior good.

Decrease in Price of Inferior Good S
If we have an inferior good, S, we buy __________ when we have more money. If the price of good S decreases, we have relatively __________ income and we would buy _______ of good S (the income effect). Because Good S is relatively ____________ we ___________ away from Good T ___________ Good S (the ____________ effect)

Demand curves are normally __________ sloping because the ____________ effect outweighs the _______________ effect, for both normal and inferior goods.
Giffen goods have ______________ sloping demand curves because the _____________ effect outweighs the ______________ effect.

When a Price of Good Decreases

	Normal Good	Inferior Good	Giffin Good
Income Effect	Positive	Negative	Negative
Substitution Effect	Positive	Positive	Positive
Which is stronger, and the impact	Doesn’t Matter, always buying more	Substitution, overall, buy More	Income overall, buy less

When a Price of Good Increases

	Normal Good	Inferior Good	Giffin Good
Income Effect	Negative	Positive	Positive
Substitution Effect	Negative	Negative	Negative
Which is stronger, and the impact	Doesn’t Matter, always buying less	Substitution, overall, buy Less	Income overall, buy more