

SECTION NOTES 6

Covering material from Lecture on January 31st

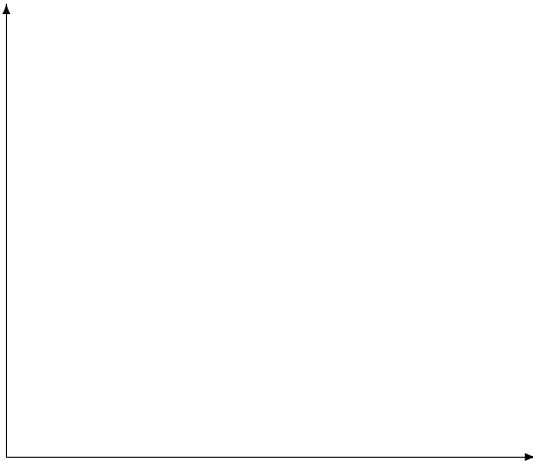
CLASS OUTLINE

1. Individual's Response to Income Changes
2. Individual's Response to Price Changes
3. Income and Substitution Effects

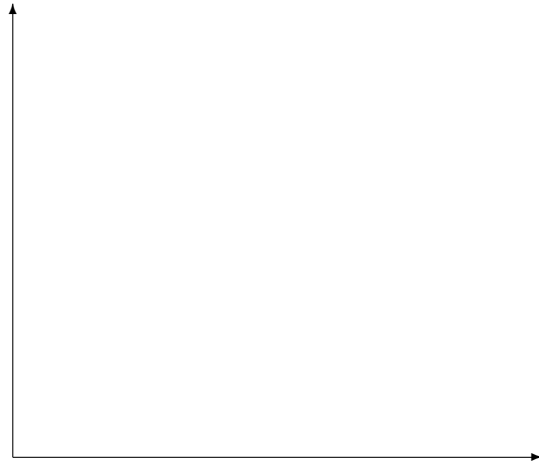
1 Individual's Response to Income Changes

We have been talking about choosing an optimal bundle when income is given, but what happens when we let income change? There are two possibilities.

Normal Good

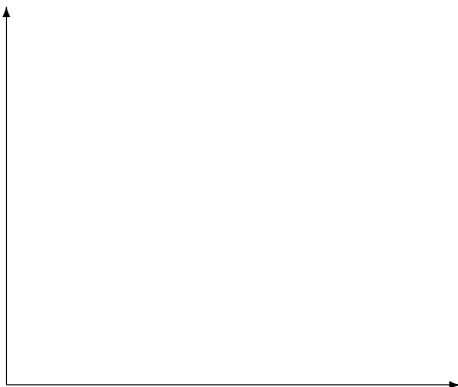


Inferior Good



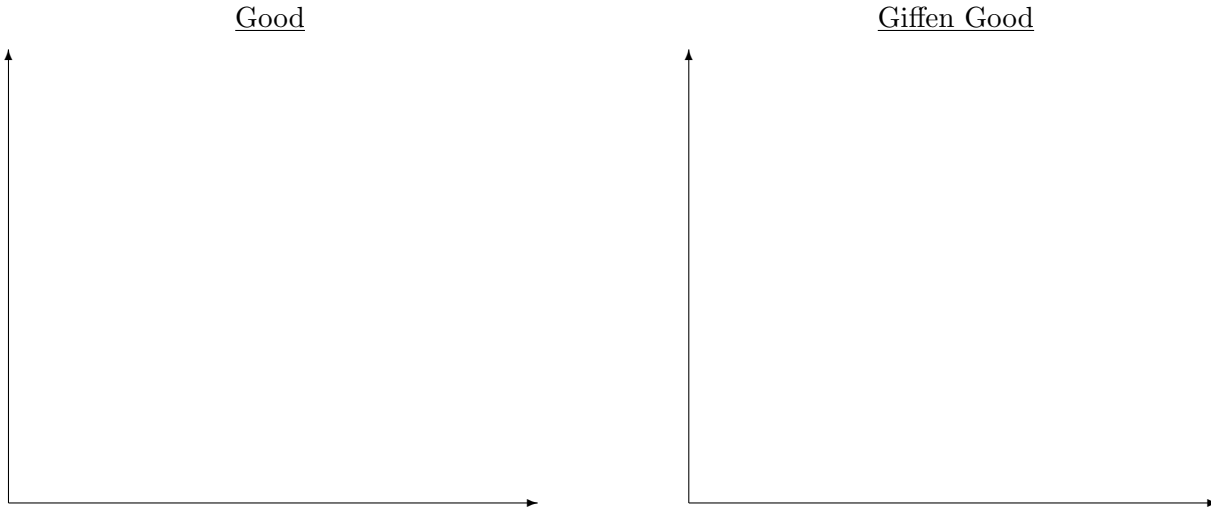
Engel Curve: The curve relating quantity of a good consumed and income.

We can see the “normal” and “inferior” parts on any Engel curve.



2 Individual's Response to Price Changes

Similar to a change in income, as we let the price of a certain good change, there are again two possibilities.

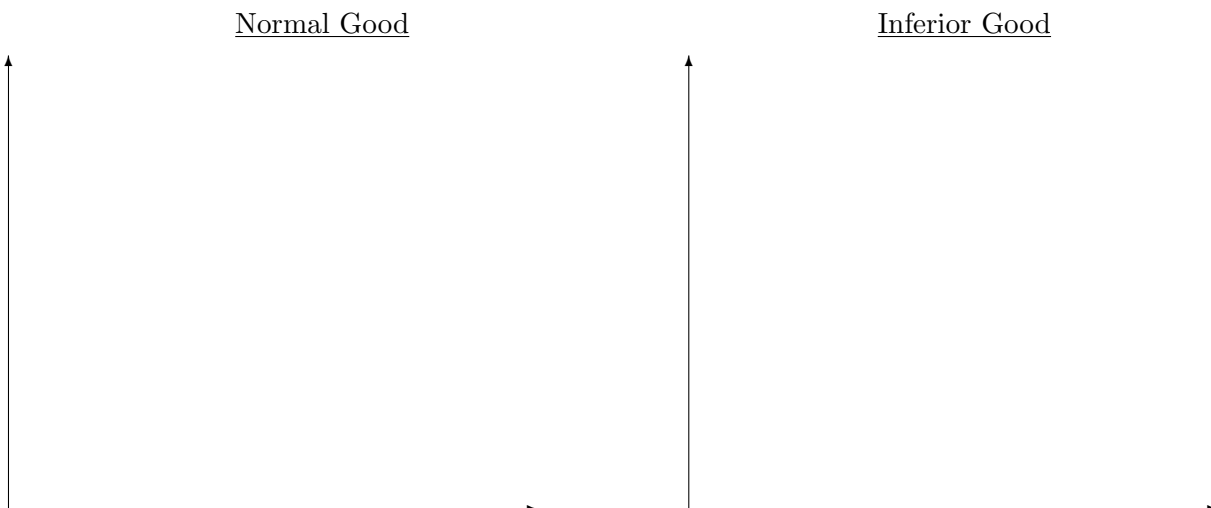


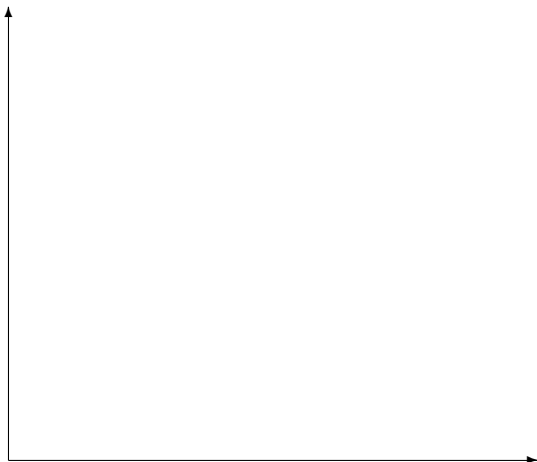
3 Income and Substitution Effects

For a change in the price of a certain good, we can break the move from bundle to bundle into two distinct parts. Both of which depend on the type of good it is.

Substitution Effect: Change in consumption of a good associated with a change in its price, holding the level of utility constant.

Income Effect: Change in consumption of a good resulting from an increase in purchasing power, holding relative prices constant.



Giffen Good

Problem: (P&R, Ch. 4, Exercise 5c)

Examine the following information about Jane's choices.

	x_1	x_2	P_1	P_2	I
Week 1	12	24	2	1	48
Week 2	16	32	1	1	48
Week 3	12	24	1	1	36

Draw a budget line-indifference curve graph that illustrates Jane's three chosen bundles. What can you say about Jane's preferences in this case? Identify the income and substitution effects that result from a change in the price of good x_1 .

