

Webnote 217

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2.1 Demand: Utility, Income + Substitution: effects of a price change in Demand

Section 1.1 Markets

The **BIG** ideas!

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Key concepts in section 2.1: Demand

1. Demand + Utility: Diminishing marginal utility-see slide 3 4 units of consumption. Consumers want to pay lower prices because satisfaction (utility – utils) fall as consumption increases
2. Demand: Substitution effect - (falling price then consumers buy more as they see gains in utility levels. Do you buy more of a good as price falls?)
3. Demand: Income effect – falling price increases real income (see slide 6) and consumers take advantage and buy more (price fall) or less (price rise).

Webnote 217:
utility+income+substit
ution effects

Utility: diminishing marginal utility

Glasses of beer drink (units)	Total Utility (TU)	Marginal Utility (MU)
1	15	15
2	35	20
3	55	20
4	67	12
5	75	8
6	78	3

Section 1.1 Markets

The **BIG** ideas!

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Key concepts in section 2.1: **Demand Assumptions:**

1. Consumers purchase good X to gain utility (theoretically measured in utils)
2. When price of X falls the consumer substitutes more money into buying good X due to the gain in utility and therefore Q demanded of X is affected by price **but** there is also an income impact on the consumer as falling prices increases income the consumer is encouraged to buy more of the good.

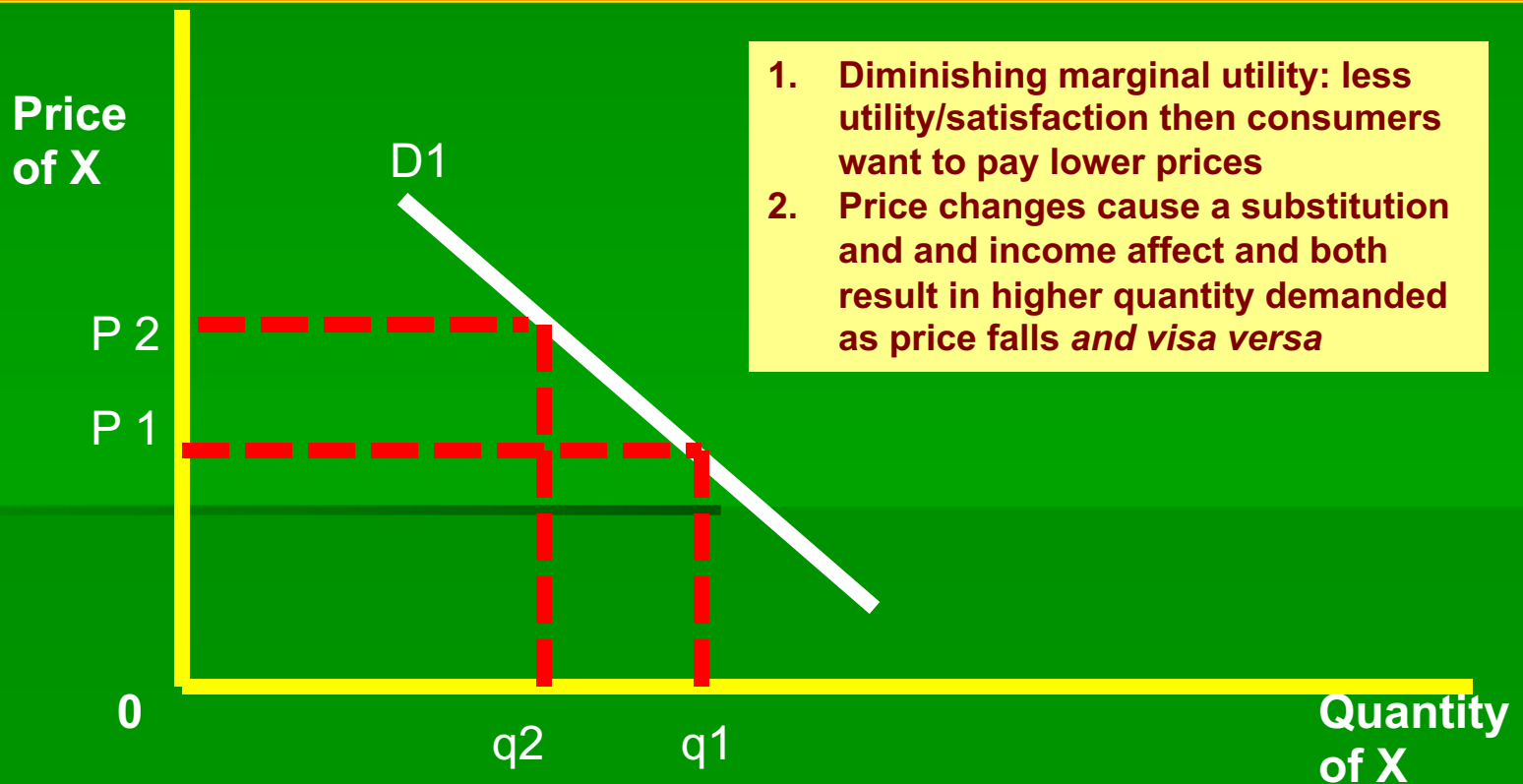
Section 2.1 Markets

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See webnote 202

Why does Demand slope downwards?



Income Effect of a price fall

Income : Nominal vs real income effect of a price change

A

Wine price: **\$4**

Nominal Income (money): **\$12**

- **Max wine consumption = 3 bottles or**
- **3 bottles can be bought with income of \$12**



B

Wine price falls: **\$3**

Nominal Income (money): **\$12**

- **Max wine = 4**
- **Real income has risen as now the consumer can buy 4 bottles of wine**
- **Result: changes in price affect our income and this affects our demand for wine.**

Substitution Effect

Income : Nominal vs real income effect of a price change

A

Wine price: **\$4**

Nominal Income (money): **\$12**

- **Max wine = 3 bottles**
- **1 bottle then Income remaining: \$8**



B

Wine price: **\$3**

Nominal Income (money): **\$12**

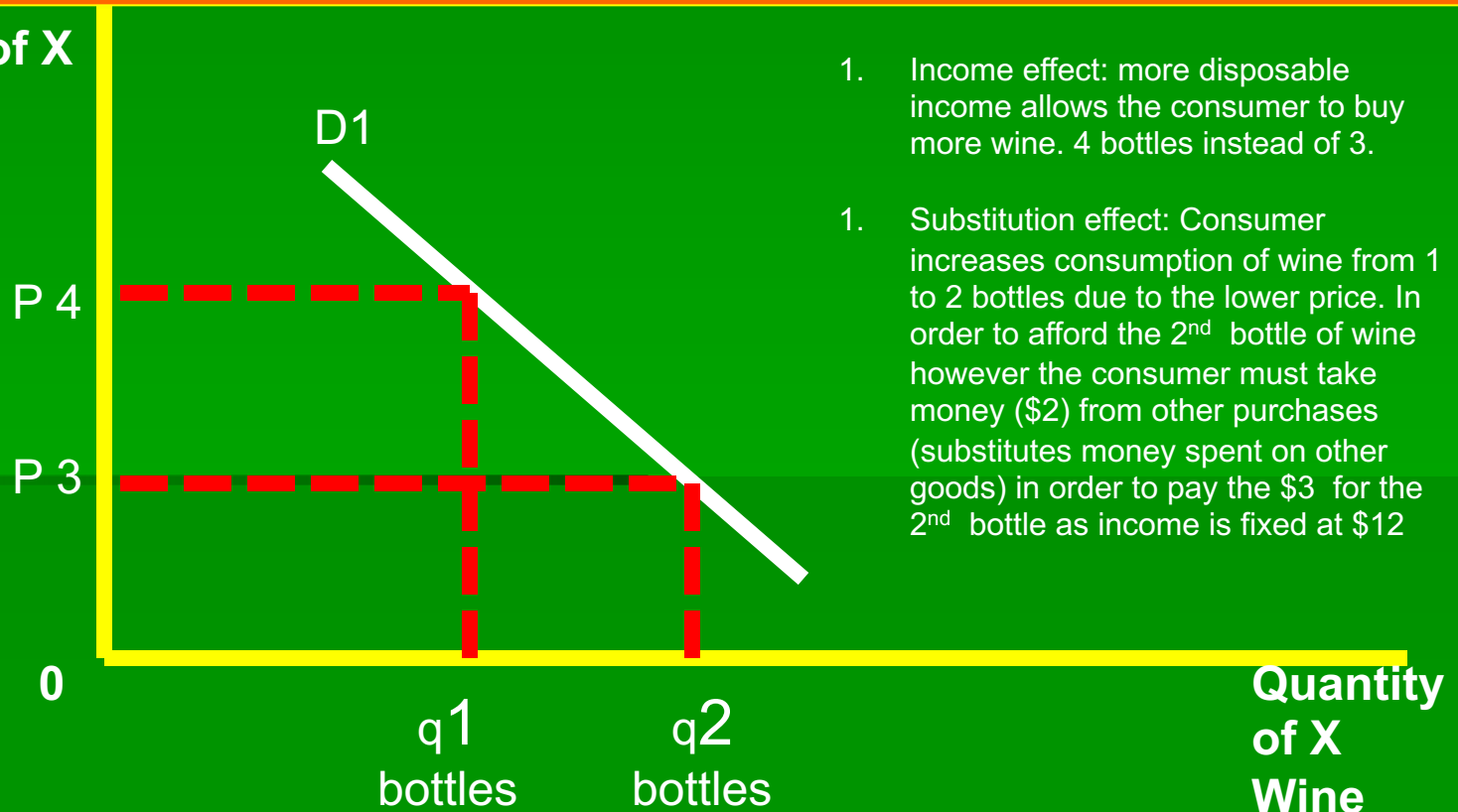
- Due to price fall then money income remaining = \$9**
- **Result: Consumer notices that price is lower and shifts consumption of other goods (substitutes) into the consumption of wine so that less of other goods can be consumed i.e. substitution effect.**
 - **See slide 8 for example.**

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See webnote 202

Income + Substitution effects cause demand to rise due to a lower price

Price of X
WINE



Demand: income+substitution effects of a price fall of good X

Table 1			Substitution	Income		
Example	Good	Price Change	Substitution effect	Income effect	Full Price Effect	Explanation
1	Good X, normal good e.g. Wine	Price falls	<p>Demand rises</p> <p>'movement' effect</p> <p>Price rises of X then 'D' down</p> <p>Price falls of X then 'D' up</p>	<p>Demand Rises</p> <p>Price change also causes a movement in terms of it's income effect.</p> <p>As a result of having more income we buy more of good X</p>	Demand Rises	<p>Overall substitution effect combines with income effect so in both cases demand rises.</p> <p>Consumer considers him/herself better off with more utility</p>