# How Do Wages Affect Labor Supply?

- Suppose there are two goods: Consumption and Leisure.
- The price of the consumption good is P, while the price (opportunity cost) of Leisure is Wage (w).
- Suppose w goes up.
- Leisure becomes relatively more expensive.
- SE dictates reduction of leisure.

- Note that even after consuming the initial (Consumption, Leisure) bundle at the post-change scenario with higher w, the consumer will now have a higher income.
- This will generate an income effect, according which a higher income will increase leisure.

- SE and IE work in opposite directions:
- According to SE, when wage rises leisure should be reduced
- According to IE, when wage rises leisure should be increased

- If the substitution effect is greater than the income effect for the worker, he or she reduces leisure and therefore works more.
- If income effect is greater than the substitution effect, he or she increases leisure and therefore works less.

# Summary

- A consumer's budget constraint shows the possible combinations of different goods he can buy given his income and the prices of the goods.
- The slope of the budget constraint equals the relative price of the goods.
- The consumer's indifference curves represent his preferences.

# Summary

- Points on higher indifference curves are preferred to points on lower indifference curves.
- The slope of an indifference curve at any point is the consumer's marginal rate of substitution.
- The consumer optimizes by choosing the point on his budget constraint that lies on the highest indifference curve.

# Summary

- When the price of a good falls, the impact on the consumer’s choices can be broken down into an income effect and a substitution effect.
- The income effect is the change in consumption that arises because a lower price makes the consumer better off.
- The income effect is reflected by the movement from a lower to a higher indifference curve.

# Summary

- The substitution effect is the change in consumption that arises because a price change encourages greater consumption of the good that has become relatively cheaper.
- The substitution effect is reflected by a movement along an indifference curve to a point with a different slope.

# Summary

- The theory of consumer choice can explain:
  - Why demand curves can potentially slope upward.
  - How wages affect labor supply.