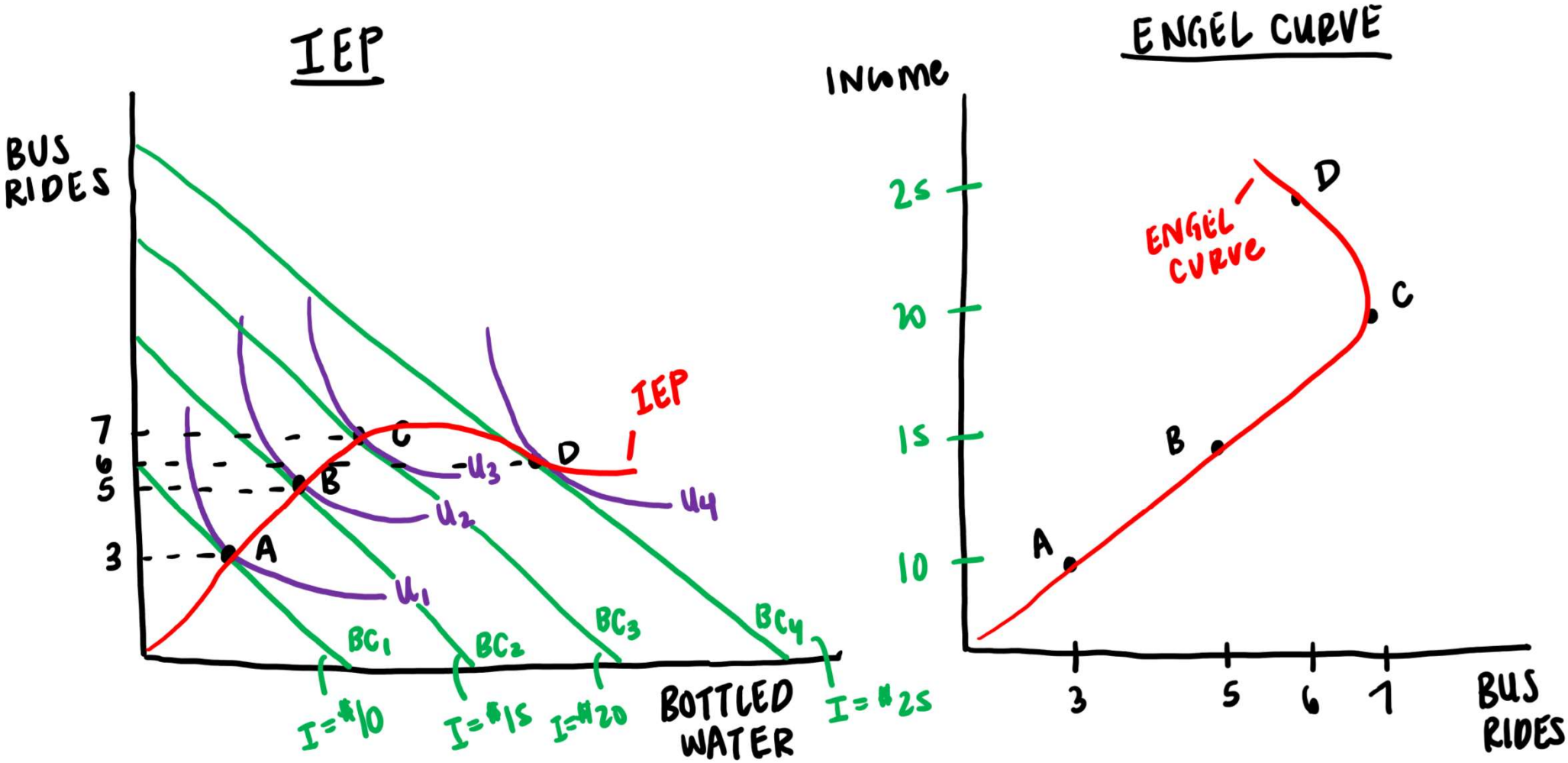
Unit 1
Individual and Market Demand (Ch. 5)
9/11

ECON 323 – MICROECONOMIC THEORY – DR. STRICKLAND

Income Expansion Path & Engel Curve

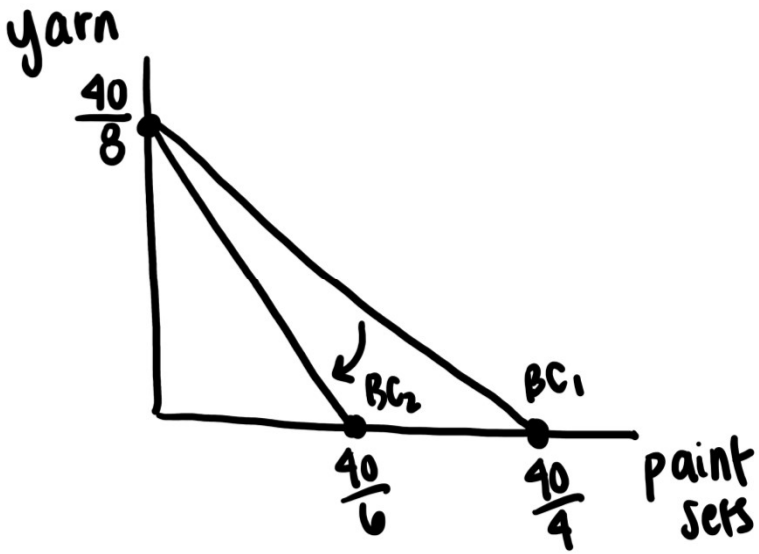


iClicker

Jess likes to craft. She has $40 per week she can spend on yarn at $8 each or paint sets at $4 each.

Suppose the price of paint sets rises to $6. What happens to Jess's budget constraint? (Suppose the graph has yarn on the y-axis and paint sets on the x-axis.)

A. Shift inward
B. Shift outward
C. Rotate inward
D. Rotate outward



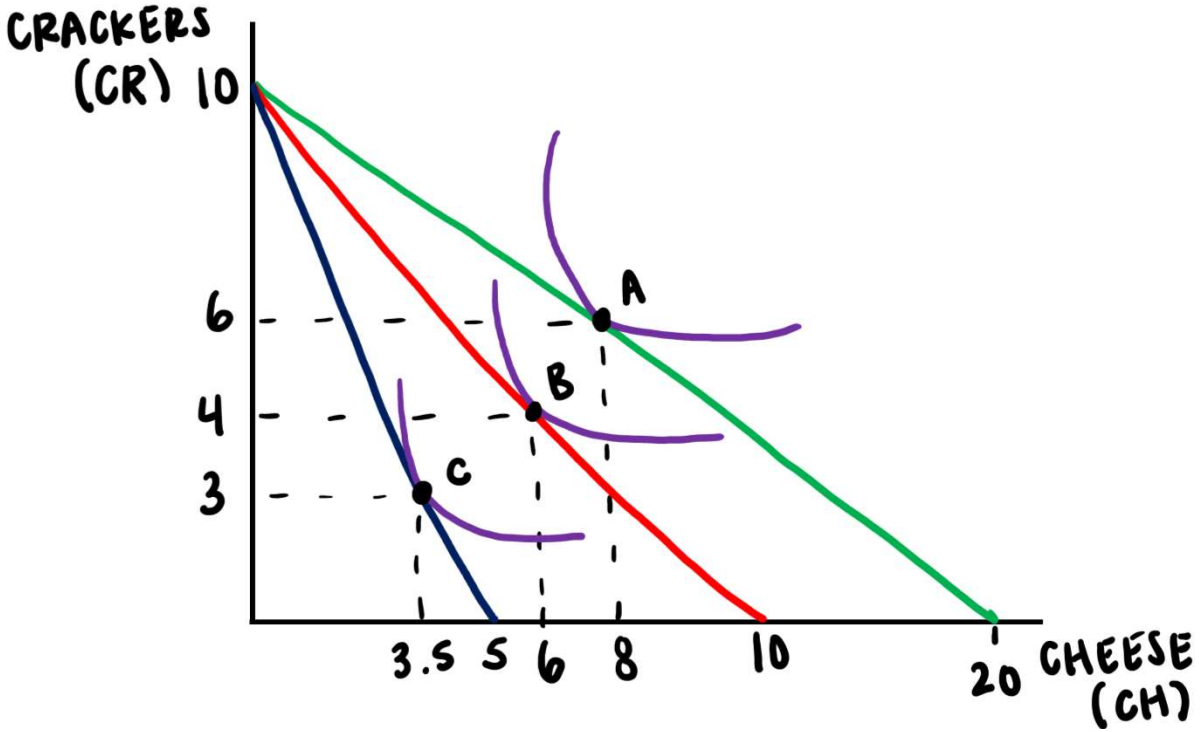
Price & Choice

Changes in **relative** prices (*holding all else constant*) matter too!

Consider two goods: cheese and crackers

- By changing the price of cheese (and holding the price of crackers, income, and preferences constant) we will observe various (optimal) consumer choices
- We summarize these choices with the **demand curve for cheese**

IC-BC MAP



$I = \#20$

$P_{CR} = \#2$

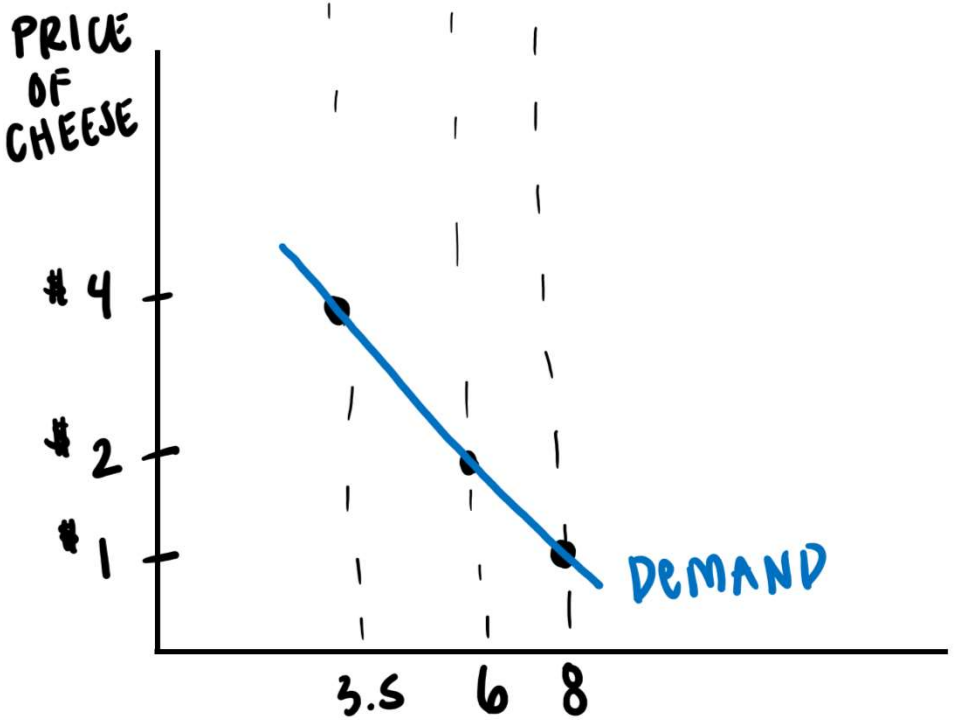
BC_1: $P_{CH} = \#1$

BC_2: $P_{CH} = \#2$

BC_3: $P_{CH} = \#4$

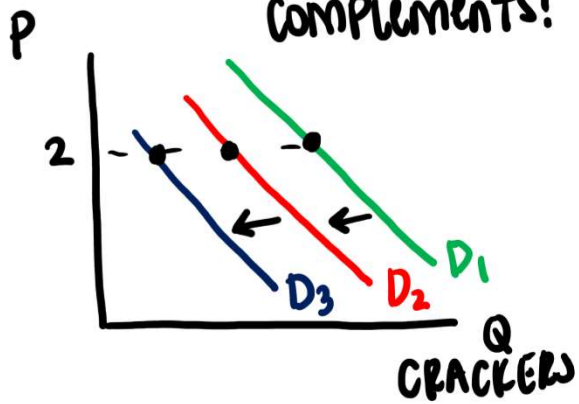
DEMAND CURVE CHEESE

LAW OF DEMAND:
$\uparrow P \Rightarrow \downarrow Q_D$



$P_{CH} \uparrow \Rightarrow \downarrow Q_{CR}$

COMPLEMENTS!



Choice & Demand

The demand curve for cheese will **shift** following changes* in:

- Income
- Price of crackers
- Preferences

**These are isolated changes; for example, we change income but hold everything else constant*

Choice & Demand: Changes in Price

Hill Country Fare

Hill Country Fare Grade A Large White Eggs

12 ct

$4.92 each ($0.41 / ct)

Choice & Demand: Decomposing Price Effects

Why is there an inverse relationship between consumption and price?

- To better understand behavior, we can (theoretically) decompose total price effects on consumption into **substitution** and **income effects** TE = SE + IE

Substitution effect: CHANGING CONSUMPTION FROM CHANGE RELATIVE PRICES HOLDING P.P. CONSTANT

Income effect: CHANGING CONSUMPTION FROM CHANGE IN PURCHASING POWER (P.P.) HOLDING RELATIVE PRICES CONSTANT

Decomposing Price Effects for a Normal Good