

Course
on
HS205: consumer Behaviour and Welfare Economics
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Instructor

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Lecture 6: Substitution effect

Substitution effect means the change in the purchases of a goods as a result of a change in relative prices alone, real income remaining constant

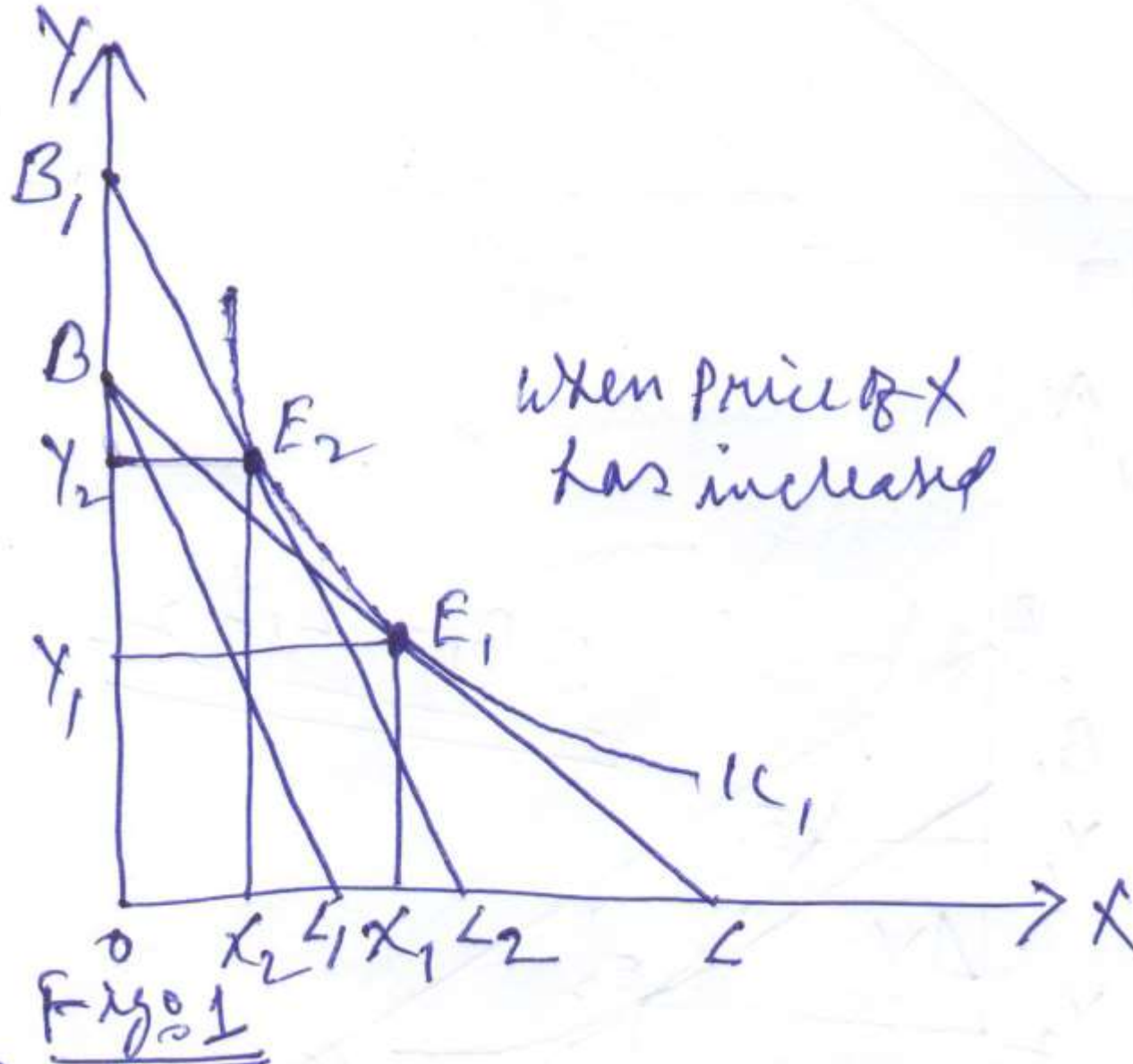
Two type of substitution effect:

- 1. Hicksian substitution effect (Compensating variation in income)**
- 2. Slutsky substitution effect**

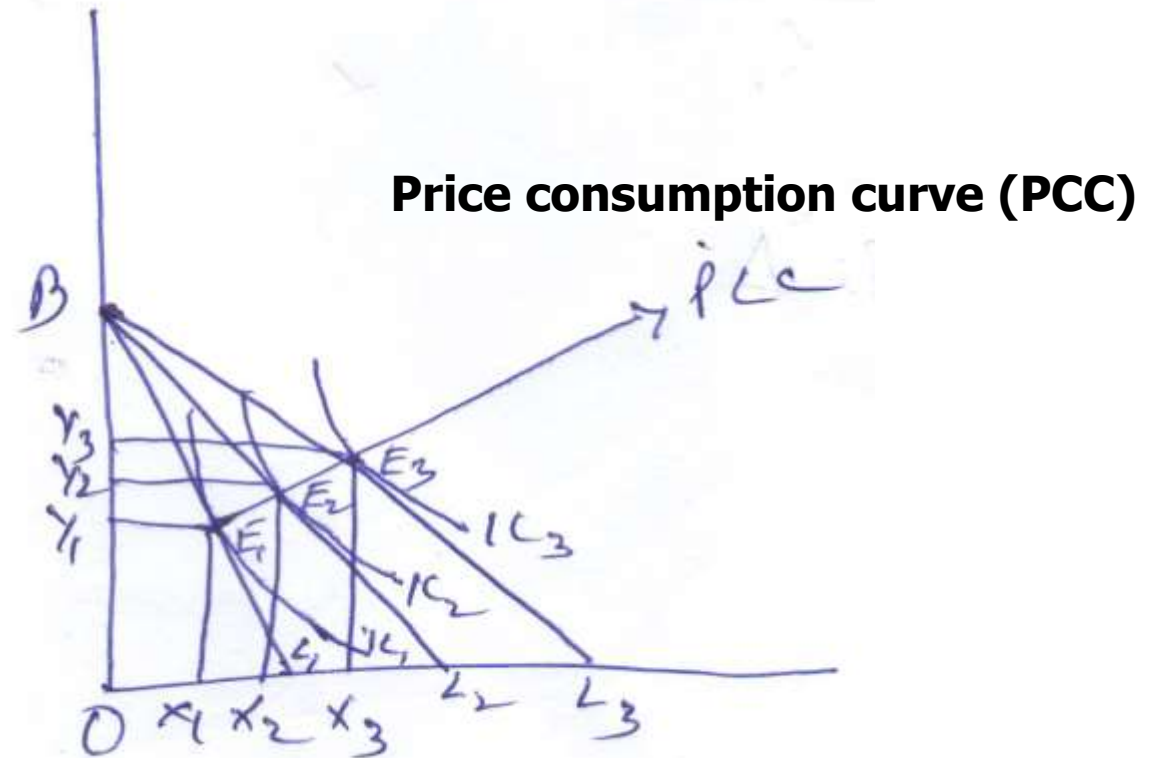
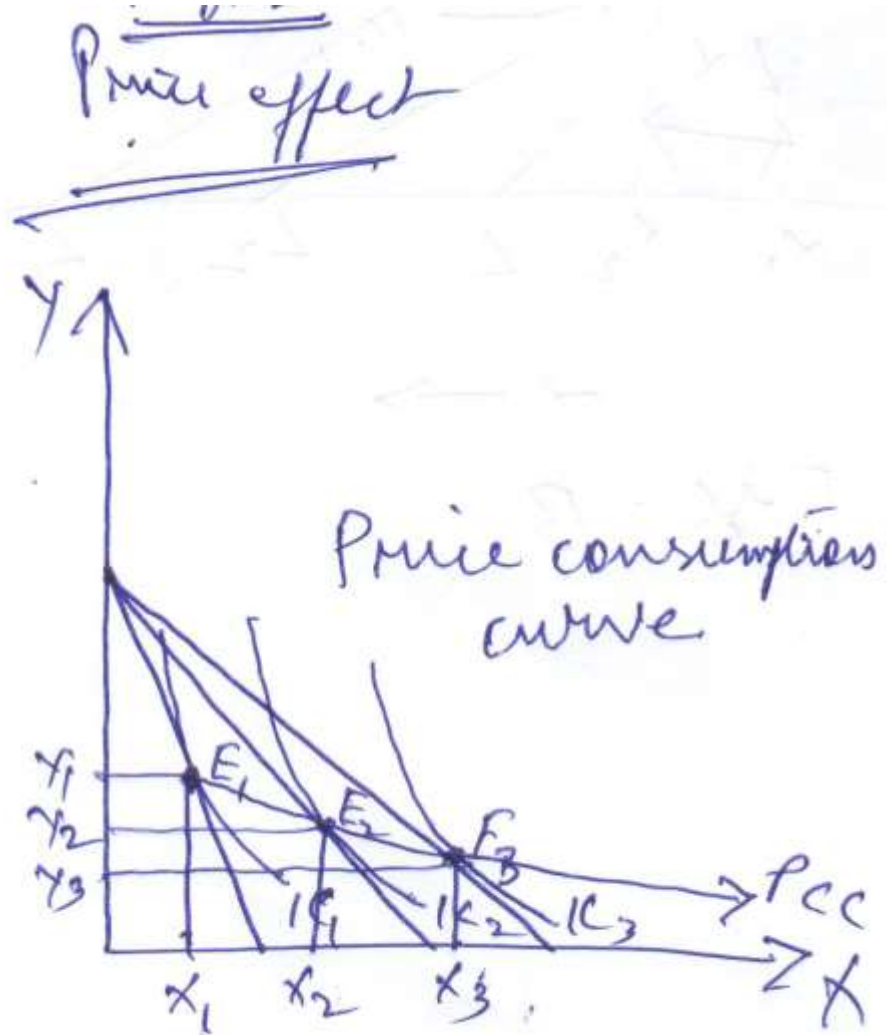
Note:

The Less the convexity of the indifference curve, the greater will be the substitution effect.

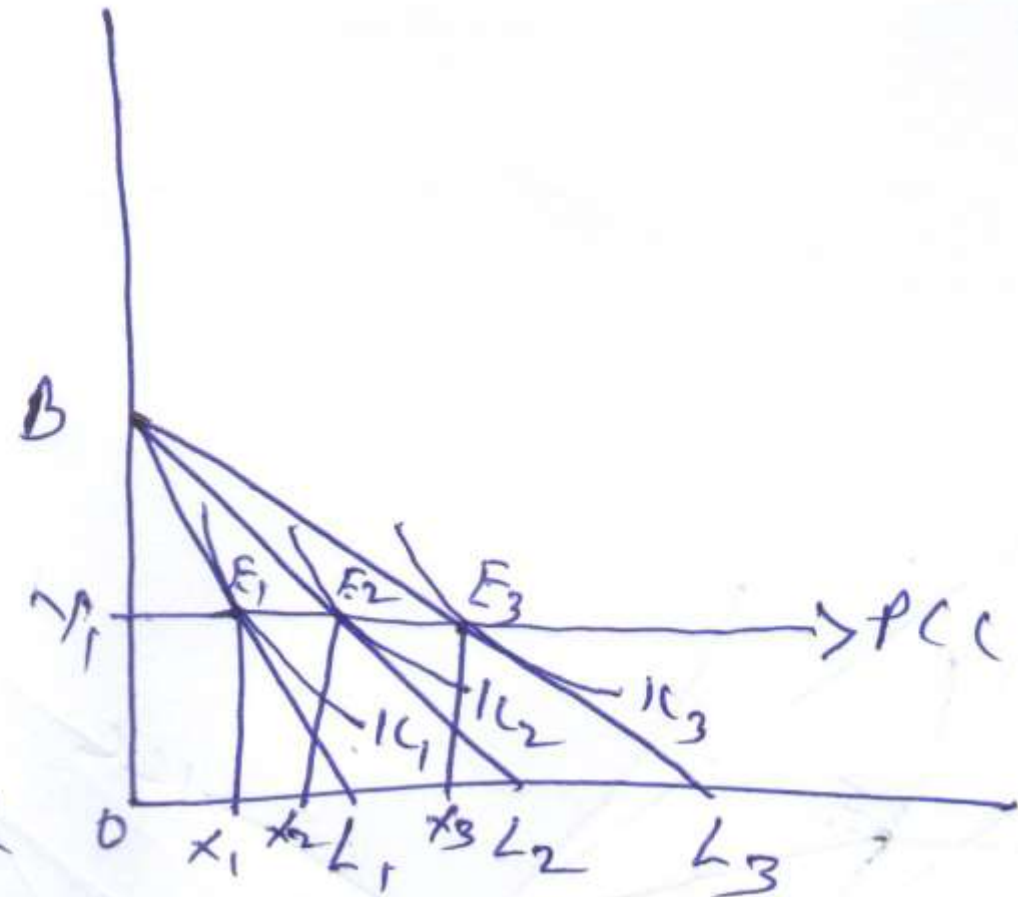
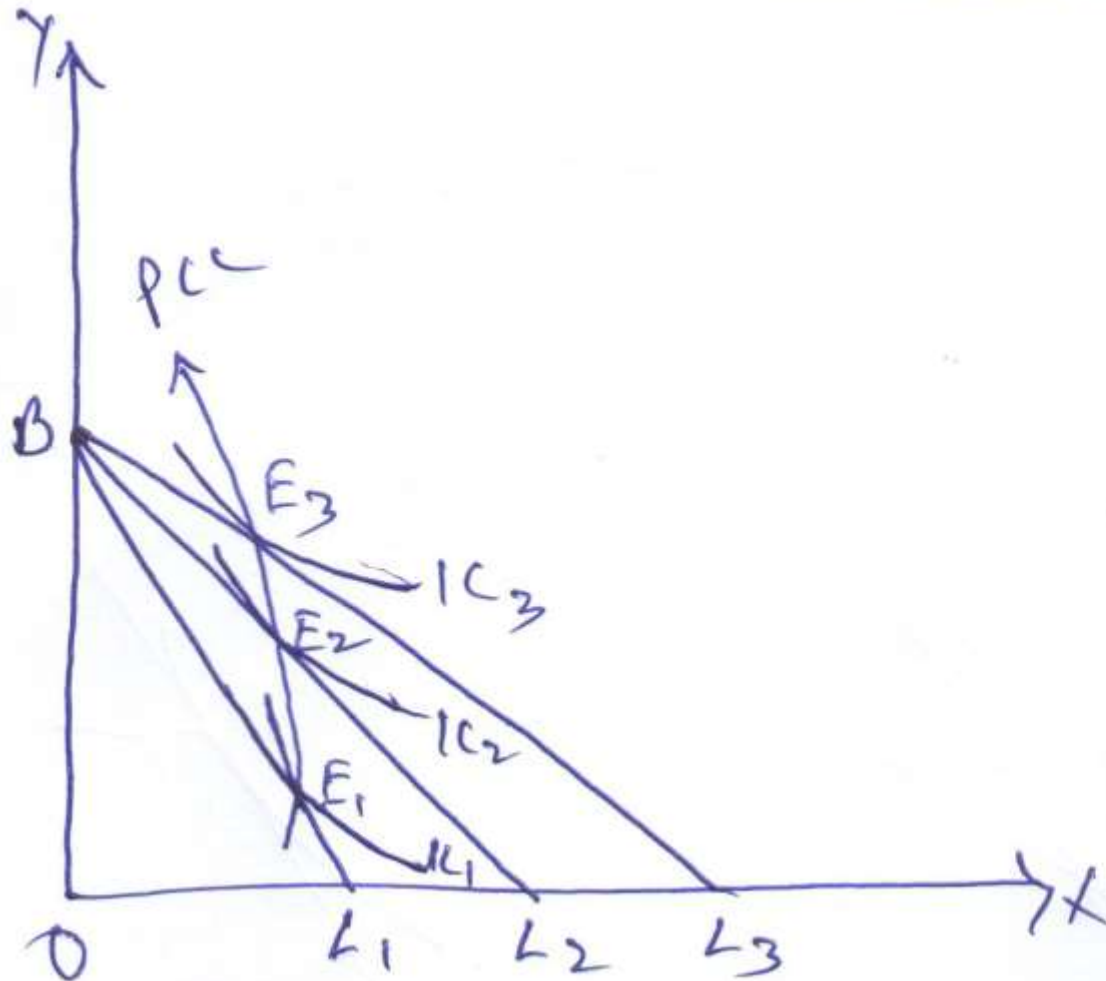
Substitution effect



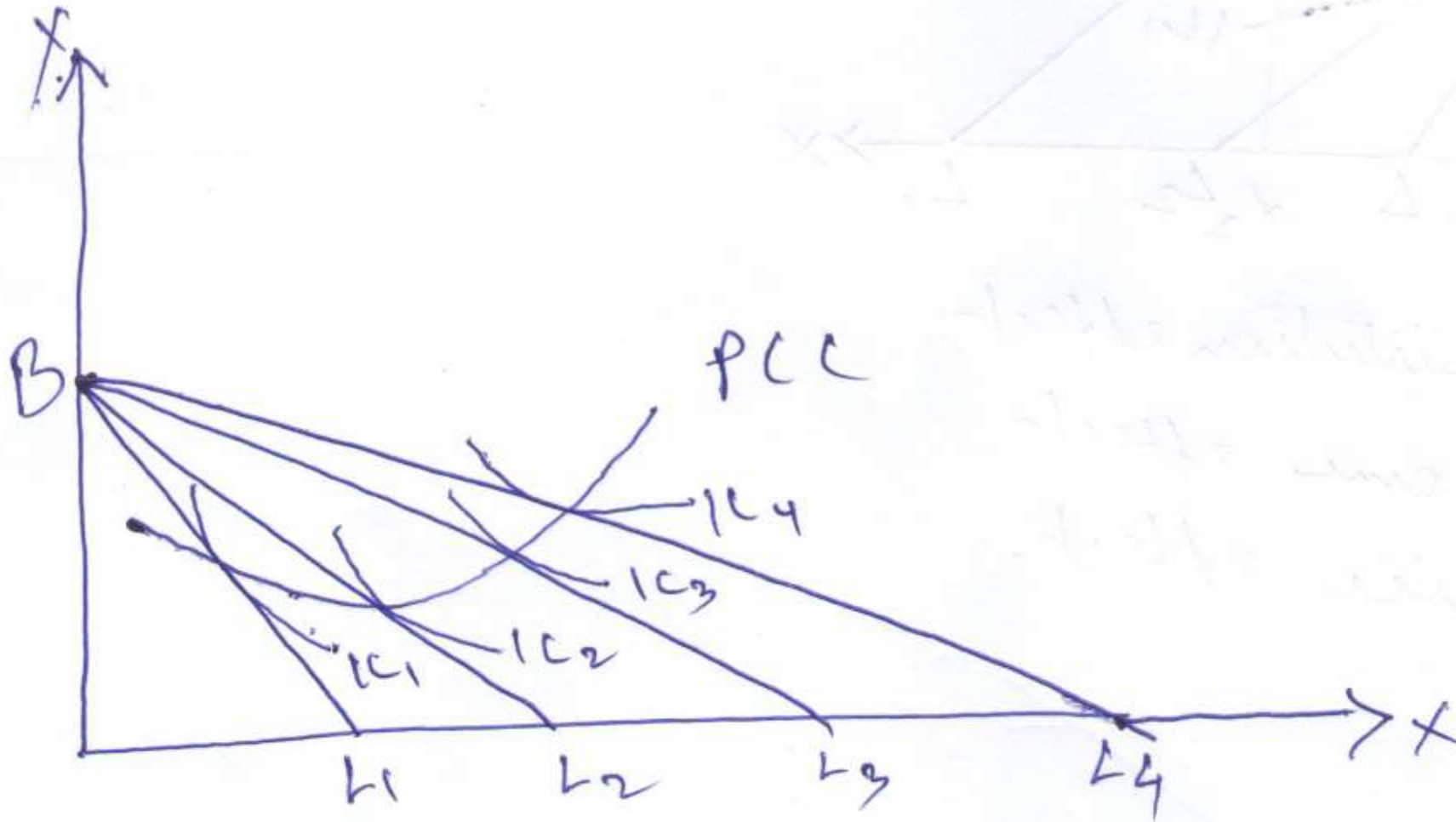
Price effect: Downward and Upward PCC



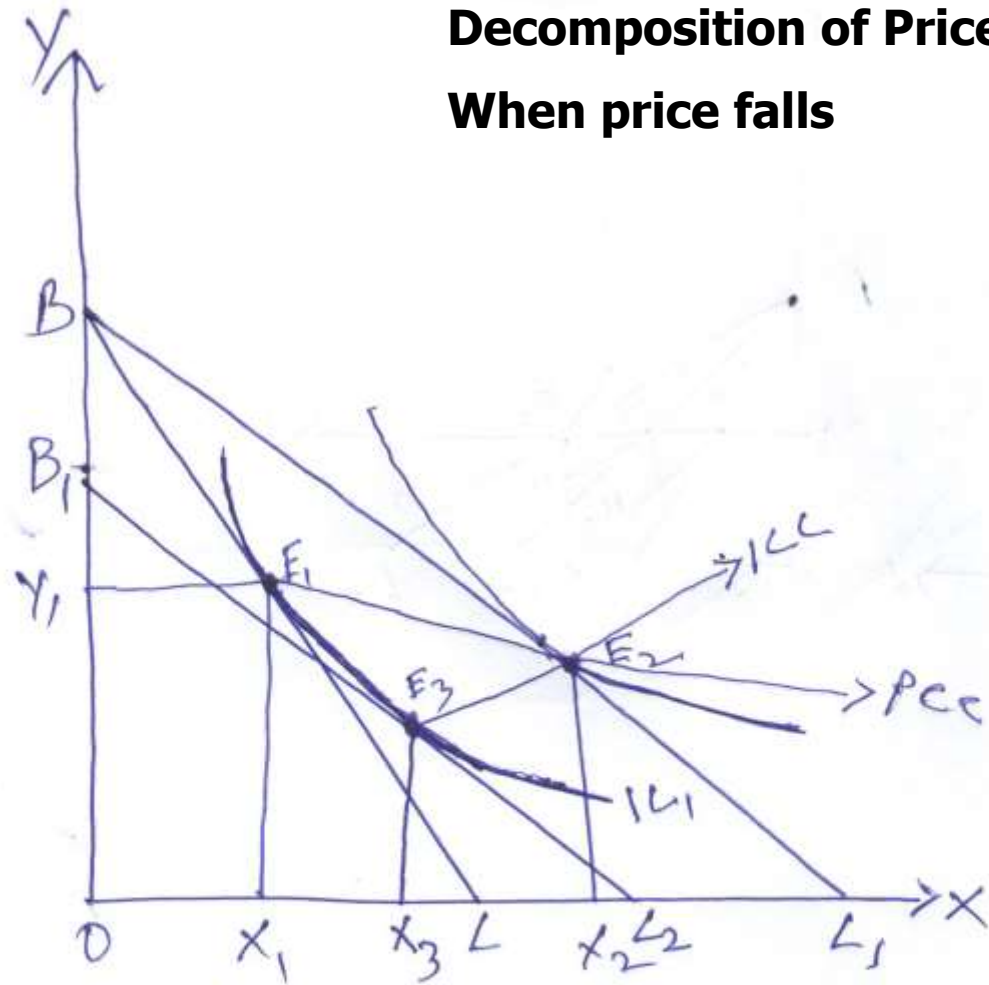
Price effect: Backward bending and straight line PCC



Price effect: U shape PCC



Decomposition of Price effect into Income and Substitution Effect: When price falls



$X_1 X_3$ = Substitution effect
 $X_3 X_2$ = Income effect
 $X_1 X_2$ = Price effect.

