Answer on Question #38580 – Economics - Microeconomics

If the price of a good increases, then there will be two effects.

1. The good is relatively more expensive than alternative goods and people can switch to other goods.
2. The increase in price reduces disposable income and this lower income may reduce demand.

The substitution effect states that an increase in the price of a good will encourage consumers to buy alternative goods. The substitution effect measures how much the higher price encourages consumers to use other goods, assuming the same level of income.

The income effect looks at how the price change effects consumer income, and how much the rise in income will lead to lower demand.

These two effects will be equal, if both the price and income change and the product is not of first need.