

Using the cardinalist approach of consumer behaviour, distinguish between income and substitution effects of a price rise for a normal good.

Answer:

Substitution effect is a change in consumption patterns due to a change in the relative prices of goods. For instance, it can be observed if private universities increase their tuition by 10% and public universities increase their tuition by only 2%. In this case, it is very likely that there will be a shift in attendance from private to public universities.

Income effect is a change in consumption patterns due to change in purchasing power. It can be observed in case if from income increases, price changes, currency fluctuations.

Figure 1 gives an understanding of their interrelation.

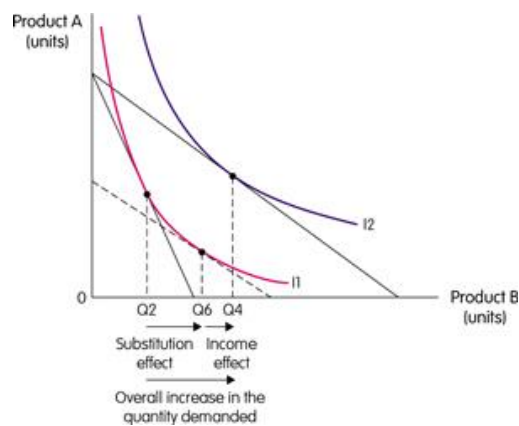


Figure 1 – Interrelation of substitution and income effect