

B.A PART 1

MICRO ECONOMICS

GIFFIN PARADOX

Price Demand Relationship: Normal, Inferior and Giffen Goods

Indifference curve analysis with its technique of looking upon the price effect as a combination of income effect and substitution effect explains relationship between price and quantity demanded in a better and more analytical way.

A distinct advantage of viewing the price effect as a sum of income effect and substitution effect is that through it the nature of response of quantity purchased to a change in the price of a good can be better and easily explained.

In case of most of the goods, the income effect and substitution effect work in the same direction. But, in some cases, they may pull in different directions. The direction of substitution effect is quite certain. A fall in the relative price of a good always leads to the increase in quantity demanded of the good. In other words, substitution effect always induces the consumer to buy more of the cheaper good.

But the direction of income effect is not so certain. With a rise in income, the individual will generally buy more of a good. But with the rise in income the individual will buy less of a good if it happens to be an inferior good for him since he will use better or superior substitutes in place of the inferior good when his income rises. Thus the income effect may be either positive or negative. For normal goods, the income effect is positive.

Therefore, when price of a normal good falls and results in increase in the purchasing power, income effect will act in the same direction as the substitution effect, that is, both will work towards increasing the quantity demanded of the good whose price has fallen. For the inferior good in which case income effect is negative, income effect of the price change will work in opposite direction to the substitution effect.

The net effect of the price change will then depend upon the relative strengths of the two effects. To sum up, price effect is composed of income effect and substitution effect and further that the direction in which quantity demanded will change as a result of the change in price will depend upon the direction and strength of the income effect on the one hand and strength of the substitution effect on the other.

Price Demand Relationship: Normal Goods:

In order to understand the way in which price-demand relationship is established in indifference curve analysis, consider Fig 8.43. Given the price of two goods and his income represented by the budget line PL_1 , the consumer will be in equilibrium at Q on indifference curve IC_1 . Let us suppose that price of X falls, price of Y and his money income remaining unchanged so that budget line now shifts to PL_2 .

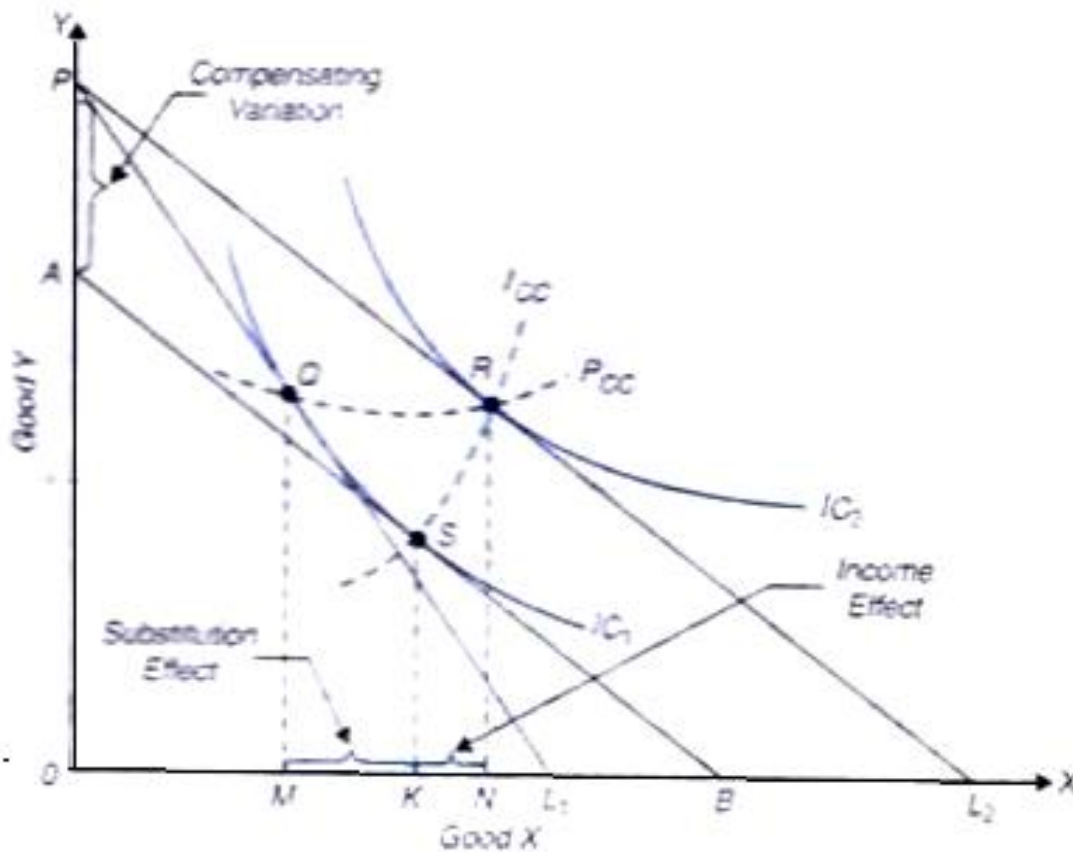


Fig. 8.43. Price Effect Split up into Substitution and Income Effects through Compensating Variation Method

The consumer will now be in equilibrium at a point on the new budget line PL_2 . If the equilibrium position on PL_2 lies to the right of Q such as at R in Fig. 8.43, it will mean that the consumer buys more quantity of good X than at Q . Now, it can be proved that in case of normal

goods the new equilibrium point on budget line PL_2 thereby that the quantity demanded of the good X will increase as its price falls.

The direction and magnitude of the change in quantity demanded as a result of fall in price of a good depend upon the direction and strength of income effect on the one hand and substitution effect on the other. As for normal goods, the income effect is positive, it will work towards increasing the quantity demanded of good X when its price falls. The substitution effect which is always negative and operates so as to raise the quantity demanded of the good if its price falls and reduces the quantity demanded of the good if its price rises.

Thus, in case of normal goods both the income effect (when positive) and negative substitution effect work in the same direction and cause increase in the quantity purchased of good X whose price has fallen with the result that the new equilibrium point will lie to the right of the original equilibrium point Q such as point R in Fig. 8.43 above. Substitution effect causes MK increase in quantity demanded. Income effect which is positive here also leads to the increase in quantity demand by KN. Each effect therefore reinforces the other.

As a result, the total effect of a fall in price of X from the level indicated by PL_1 to the level indicated by PL_2 is the rise in quantity demanded of good X from OM to ON, that is, quantity demanded increases by MN which is equal to $MK + KN$. To sum up, the income effect and substitution effect in case of normal goods work in the same direction and will lead to the increase in quantity demanded of the good whose price has fallen. In other words, quantity purchased of a normal good will vary inversely with its price as in its case income effect is positive.

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