MBA- I semester, paper- Managerial Economics, MB 102, TOPIC- The Substitution Effect.

The Substitution Effect-

Sometimes it may so happen that the price of the commodity may change at the same time-the income of the consumer may also change in such a proportion that the consumer is neither better nor worse off than he was before such changes. The gain due to rise in income is neutralised by the loss due to increase in the prices of the goods. However, in such a case a change will occur in the allocation of his income on different purchases. In this process, cheaper goods will be substituted for relatively dearer goods, i.e., the consumer remains on the same indifference curve but he moves to another position of equilibrium along with the same indifference curve.

Such a change in the quality of the goods purchased while the consumer remains on the same indifference curve is called in technical language "The Substitution Effect". This can be explained with the help of Fig.

At the margin along X-axis is measured the amount of money income. When money income is OA, the price ne is AB and the point E shows the position of equilibrium for the consumer when he purchases CM quantity of the commodity Now, suppose there is a rise in the A price of the commodity in question and there is also compensatory increased from OA to OA^1 and there arises a new price equilibrium quantity purchased has fallen from OM to OM^1. The movement E to E^1 shows the Substitution Effect on the indifference curve.

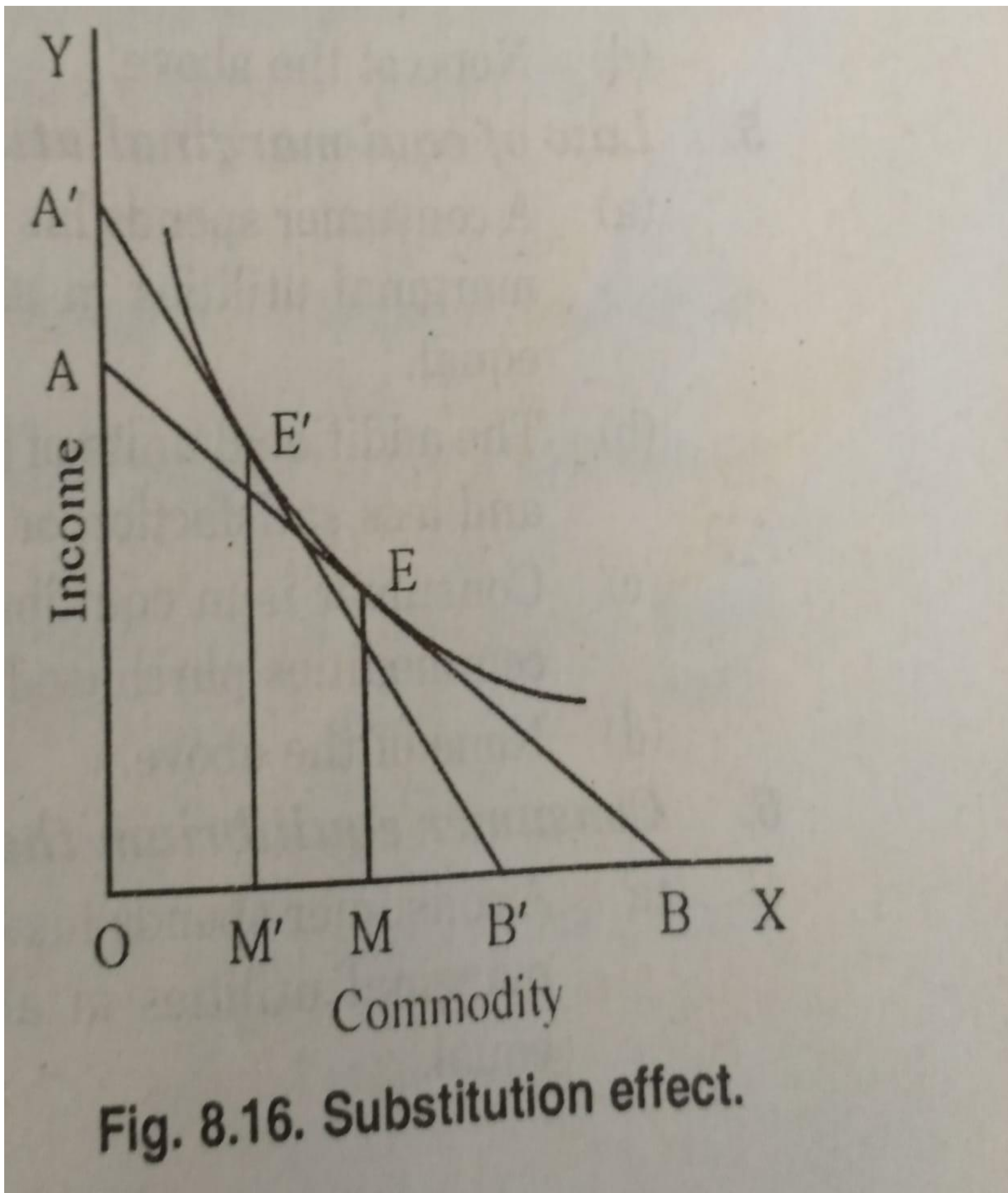

Fig. 8.16. Substitution effect.

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