Substitution effect and income effect

When the price of a good changes, so does the quantity demanded: An increase in the price usually leads to a reduction in the quantity demanded, a reduction in the price to an increase in the quantity demanded. The change in the quantity demanded is due to the sum of two effects, the substitution effect and the income effect.

Substitution effect (SE)	Income effect (IE)
It depends on the possibility of substituting the good for another one (Examples: drugs with few substitutes, pizza with many substitutes).	It depends on two factors: • Share of the good in the total budget (compare car / spices) • Income elasticity of demand (normal good if positive / inferior good if negative)

There exist the following possibilities for changes in the quantity demanded (qd):

	Increase in price			**Decrease** in price		
	SE	IE	Sum	SE	IE	Sum
Normal good	qd **-**	qd **-**	qd **-**	qd **+**	qd **+**	qd **+**
Inferior good *	qd **-**	qd **+**	qd **-** or **+**	qd **+**	qd **-**	qd **+** or **-**

* Giffen good: Increase in price, qd **+** or decrease in price, qd **-**