Income—Leisure Trade-Off

Income Tax raises cost of producing income (by lowering take-home pay). Thereby creates incentive to pursue nontaxed activities (i.e., Leisure); that is, to substitute Leisure for Labor

Substitution Effect = new rel. prices that preserve old utility (B).

There is also an income effect ($B \rightarrow C$) in which workers might choose to work more (as shown, but not always).

Substitution Effect = $A \rightarrow B$
Income Effect = $B \rightarrow C$
Net of 2 Effects = $A \rightarrow C$