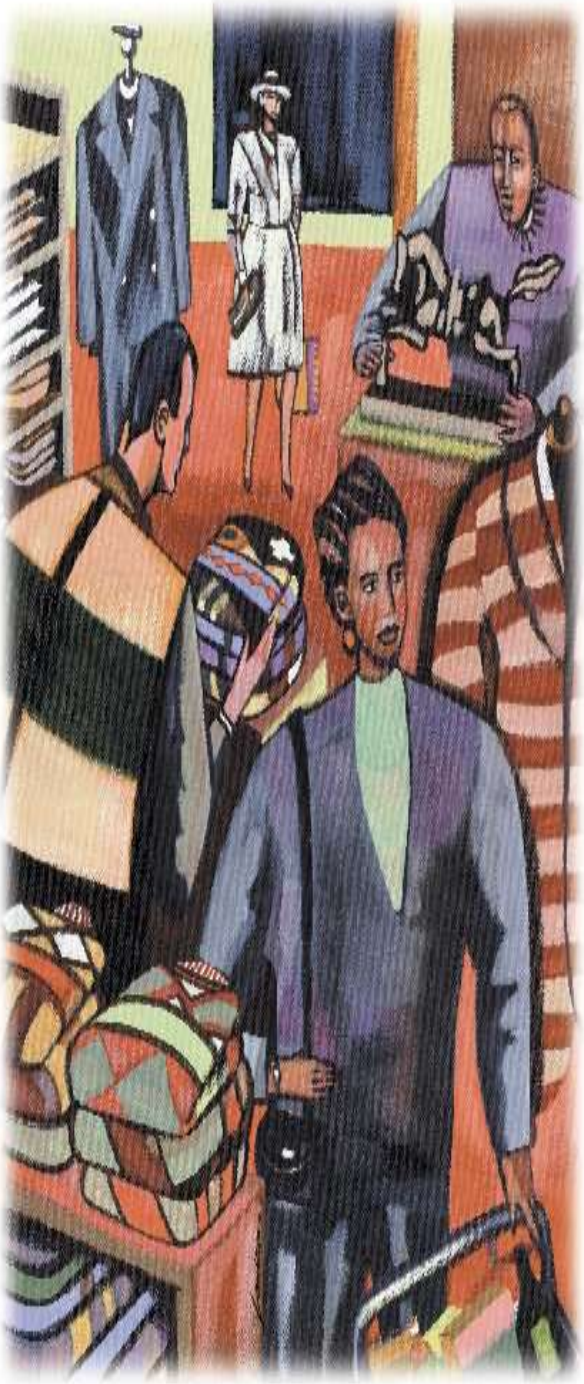


The Theory of Consumer Choice

The theory of consumer choice addresses the following questions:

- Do all demand curves slope downward?
- How do wages affect labor supply?
- How do interest rates affect household saving?
- Do the poor prefer to receive cash or in-kind transfers?

The Budget Constraint

- The **budget constraint** depicts the consumption "bundles" that a consumer can afford.
  - People consume less than they desire because their spending is constrained, or limited, by their income.

The Budget Constraint

It shows the various combinations of goods the consumer can afford given his or her income and the prices of the two goods.

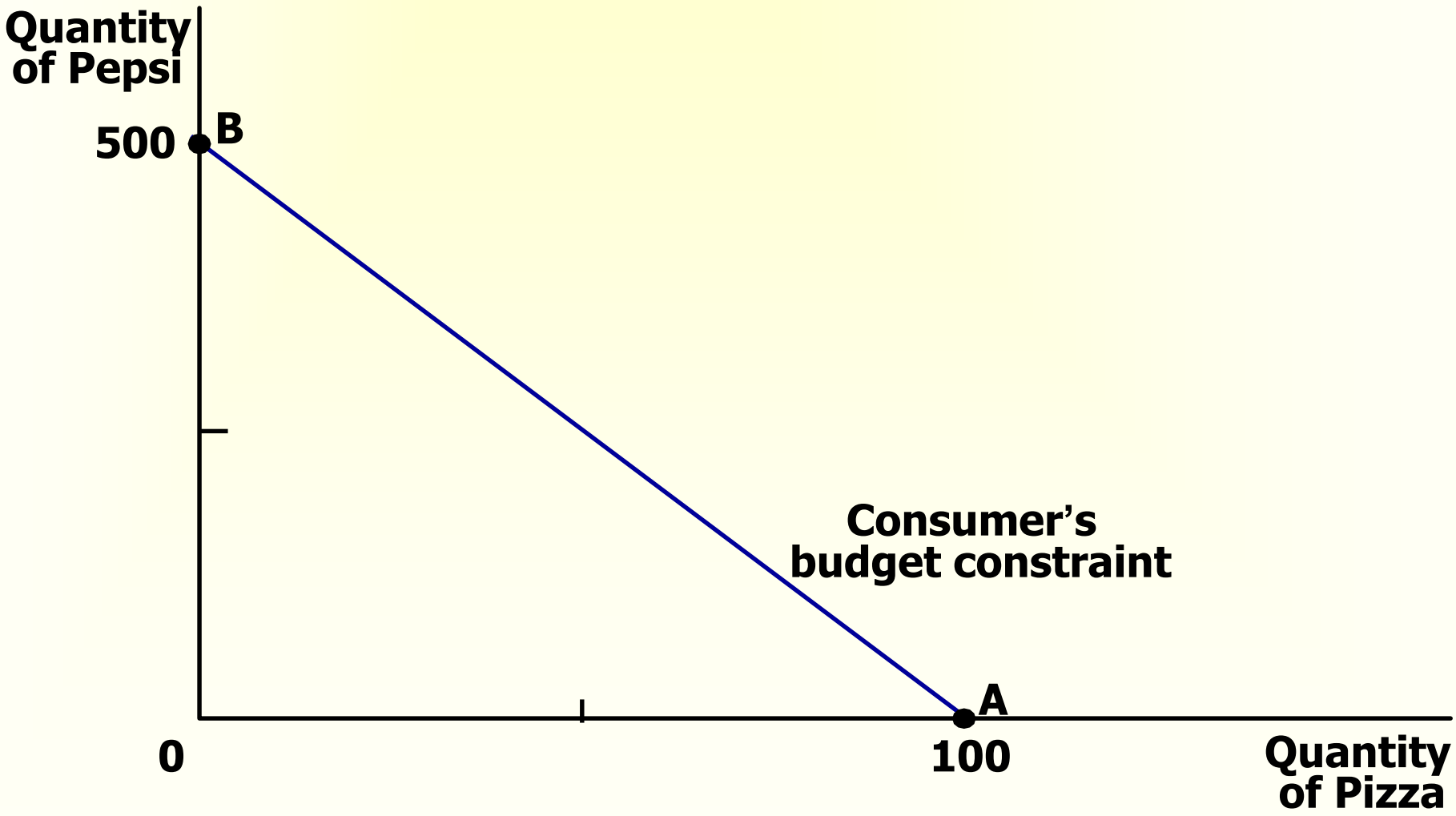
The Consumer's Opportunities

Pints of Pepsi	Number of Pizzas	Spending on Pepsi	Spending on Pizza	Total Spending
0	100	$ 0	$1,000	$1,000
50	90	100	900	1,000
100	80	200	800	1,000
150	70	300	700	1,000
200	60	400	600	1,000
250	50	500	500	1,000
300	40	600	400	1,000
350	30	700	300	1,000
400	20	800	200	1,000
450	10	900	100	1,000
500	0	1,000	0	1,000

The Consumer's Budget Constraint

- Any point on the budget constraint line indicates the consumer's combination or tradeoff between two goods.
- For example, if the consumer buys no pizzas, he can afford 500 pints of Pepsi (point B). If he buys no Pepsi, he can afford 100 pizzas (point A).

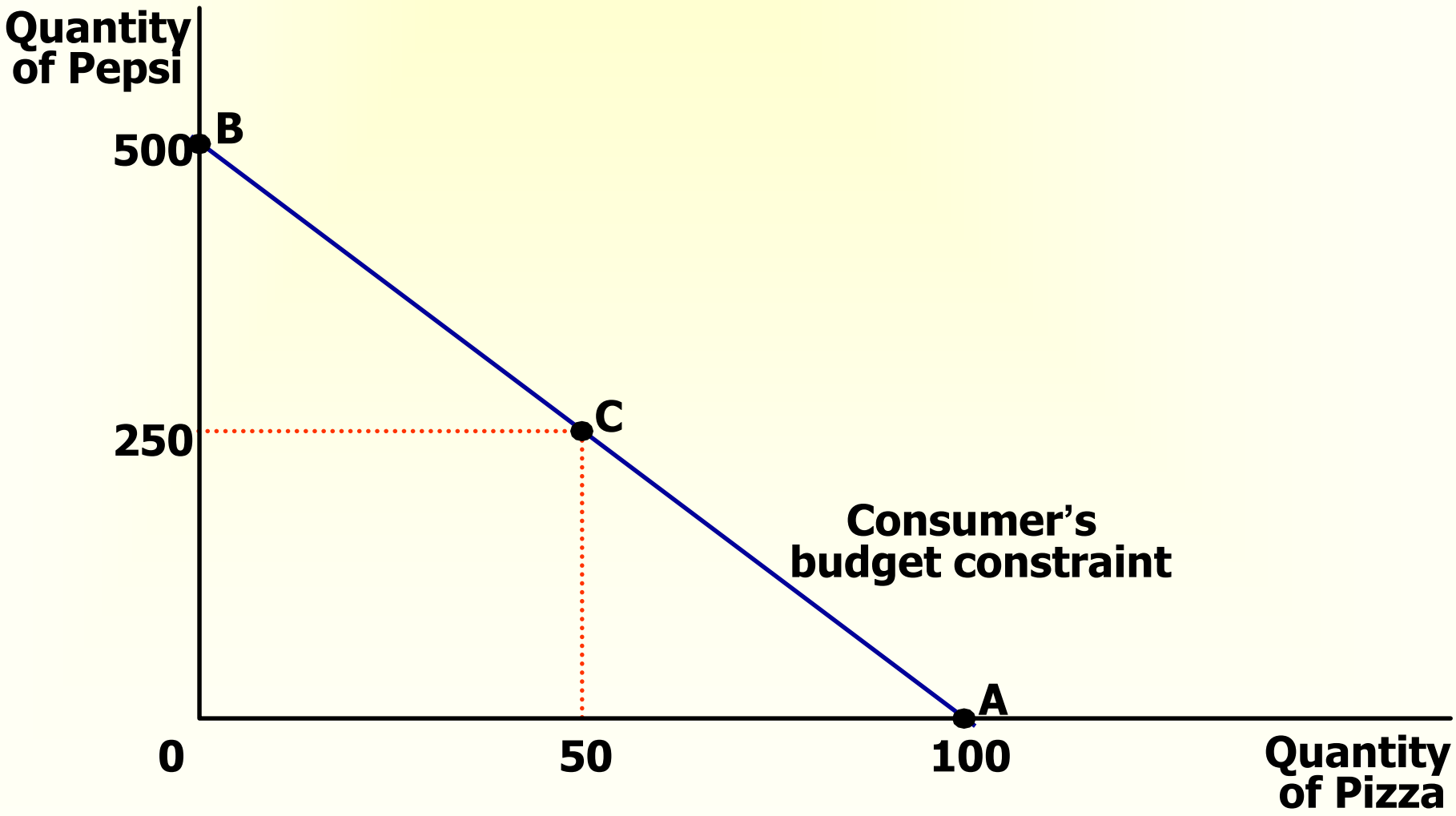
The Consumer's Budget Constraint...



The Consumer's Budget Constraint

- **Alternately, the consumer can buy 50 pizzas and 250 pints of Pepsi.**

The Consumer's Budget Constraint...



The Consumer's Budget Constraint

- The <u>slope</u> of the budget constraint line equals the relative price of the two goods, that is, the price of one good compared to the price of the other.
- It measures the rate at which the consumer will trade one good for the other.

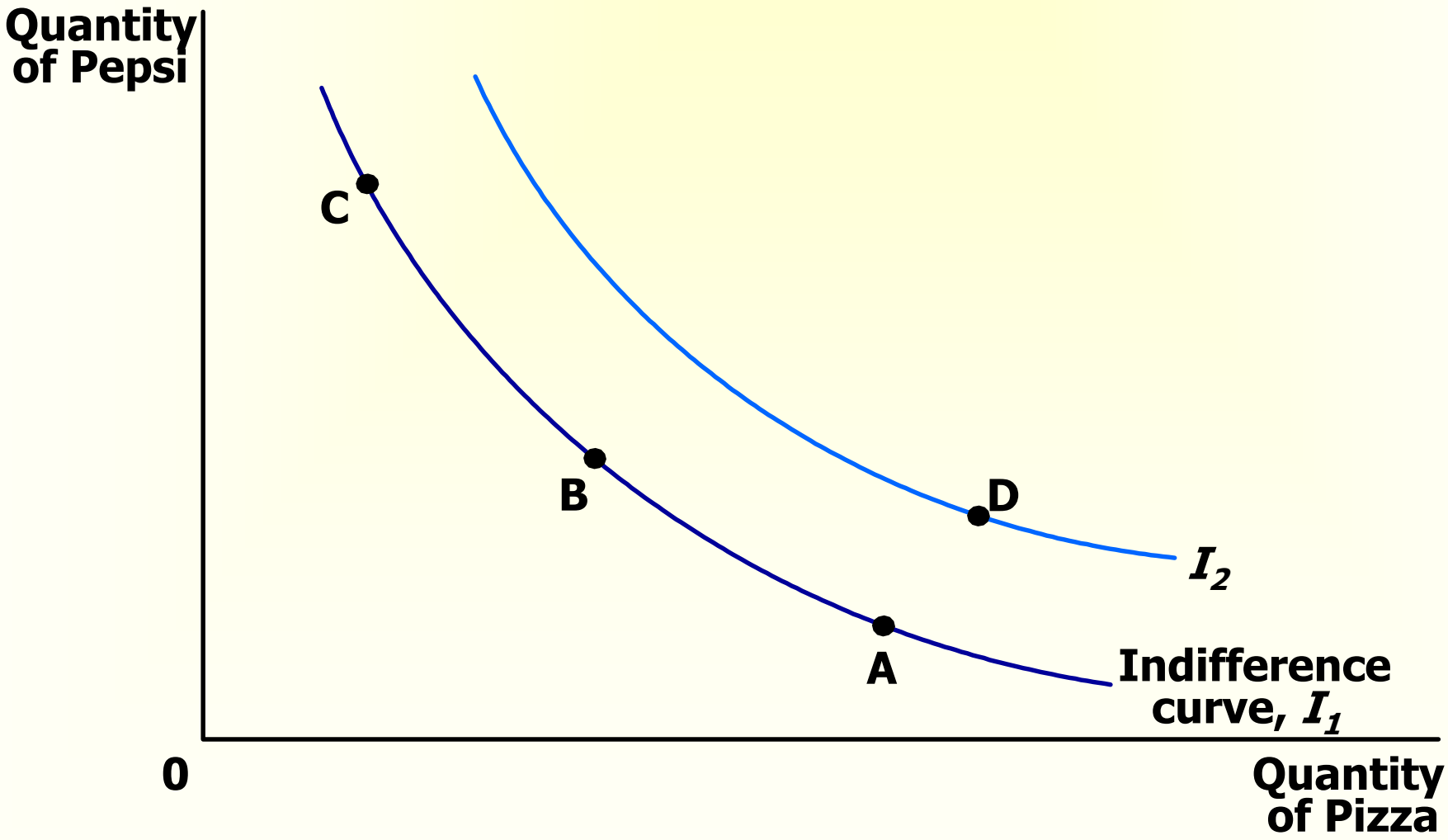
Preferences:
What the Consumer Wants

A consumer's preference among consumption bundles may be illustrated with indifference curves.

Representing Preferences with Indifference Curves

An indifference curve shows bundles of goods that make the consumer equally happy.

The Consumer's Preferences...



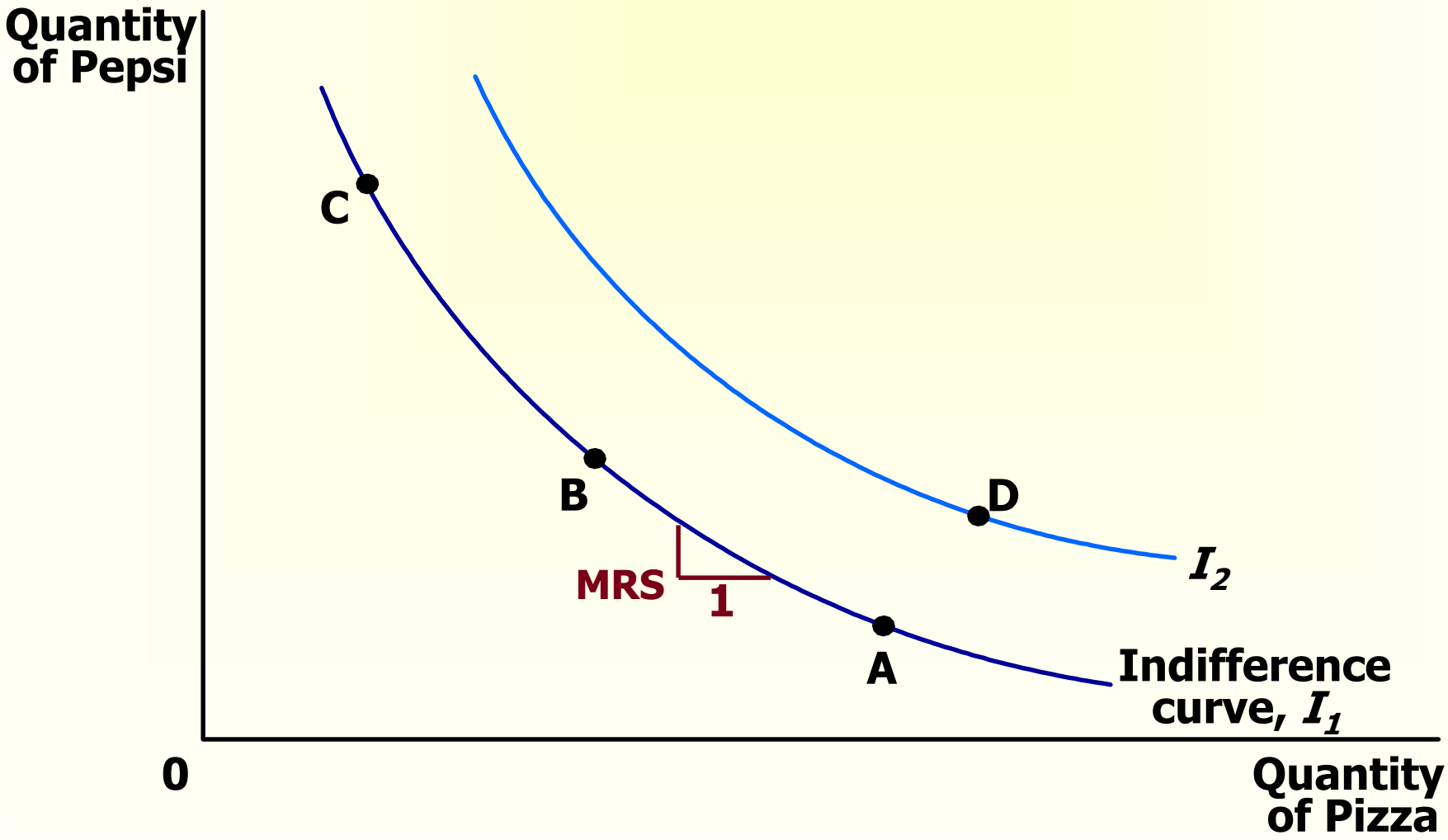
The Consumer’s Preferences

- The consumer is indifferent, or equally happy, with the combinations shown at points A, B, and C because they are all on the same curve.

The Marginal Rate of Substitution

- The slope at any point on an indifference curve is the **marginal rate of substitution**.
  - It is the rate at which a consumer is willing to substitute one good for another.
  - It is the amount of one good that a consumer requires as compensation to give up one unit of the other good.

The Consumer's Preferences...



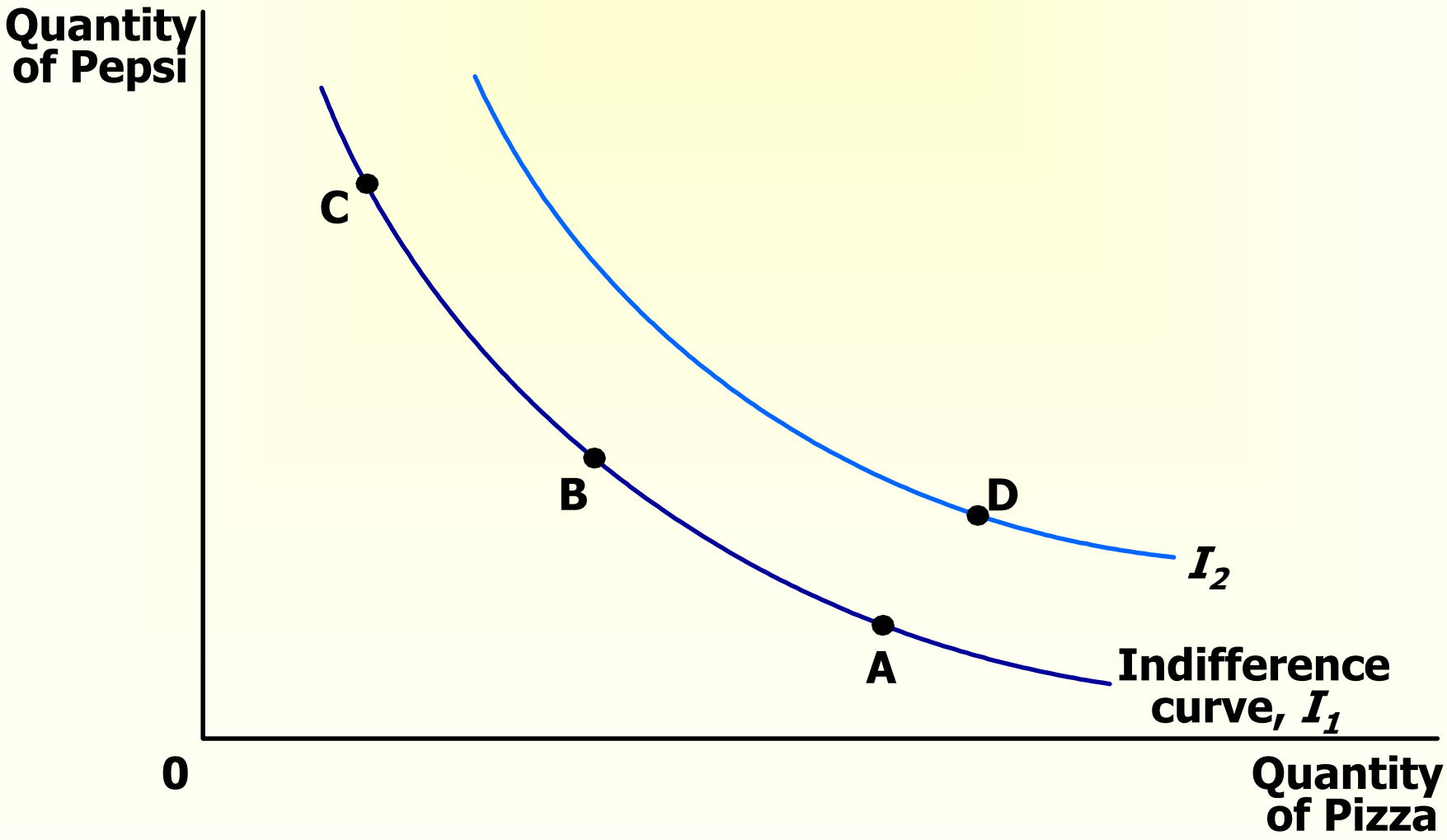
Properties of Indifference Curves

- Higher indifference curves are preferred to lower ones.
- Indifference curves are downward sloping.
- Indifference curves do not cross.
- Indifference curves are bowed inward.

Property 1: Higher indifference curves are preferred to lower ones.

- Consumers usually prefer more of something to less of it.
- Higher indifference curves represent larger quantities of goods than do lower indifference curves.

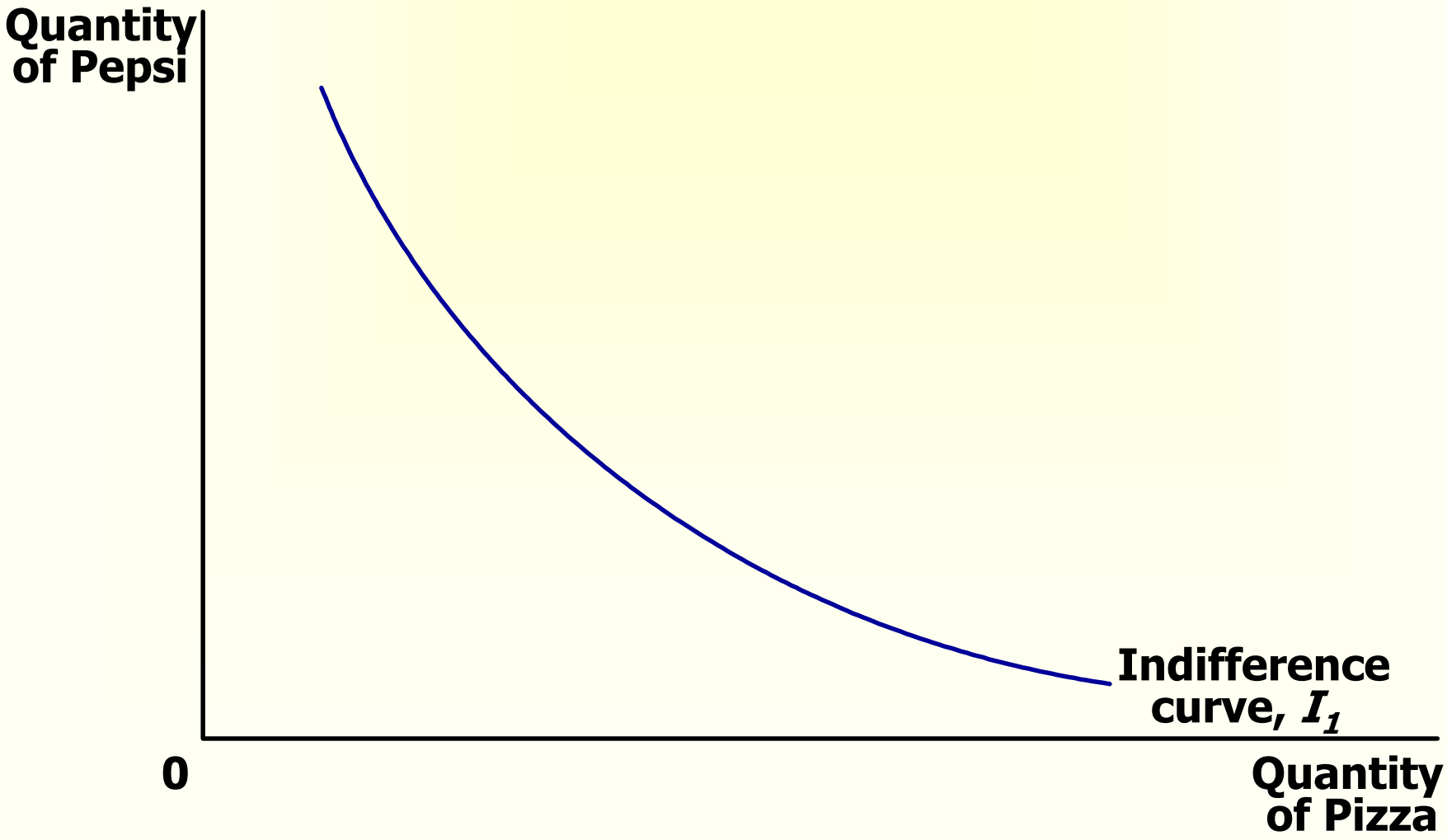
Property 1: Higher indifference curves are preferred to lower ones.



Property 2: Indifference curves are downward sloping.

- A consumer is willing to give up one good only if he or she gets more of the other good in order to remain equally happy.
- If the quantity of one good is reduced, the quantity of the other good must increase.
- For this reason, most indifference curves slope downward.

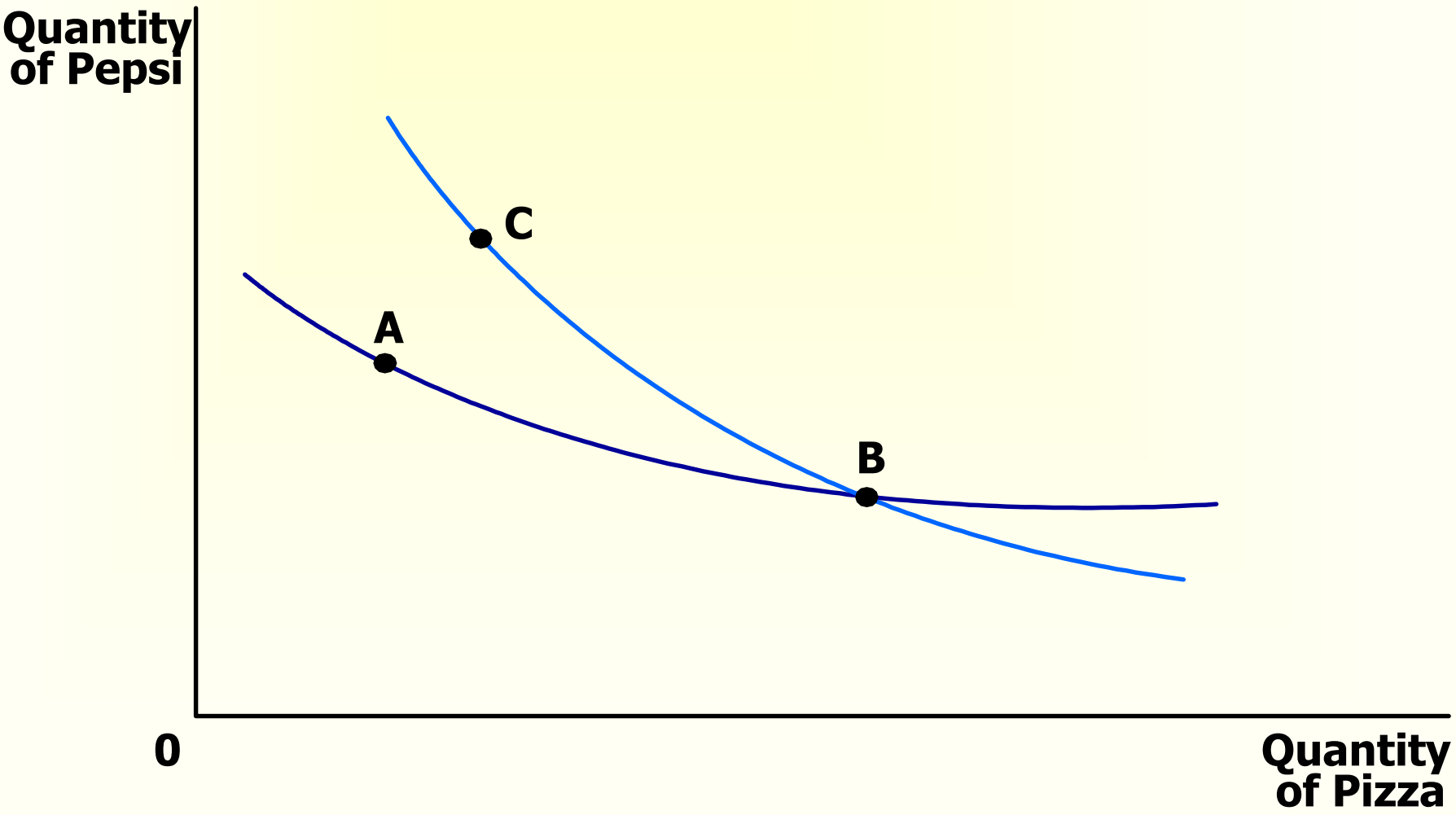
Property 2: Indifference curves are downward sloping.



Property 3: Indifference curves do not cross.

- Points A and B should make the consumer equally happy.
- Points B and C should make the consumer equally happy.
- This implies that A and C would make the consumer equally happy.
- But C has more of both goods compared to A.

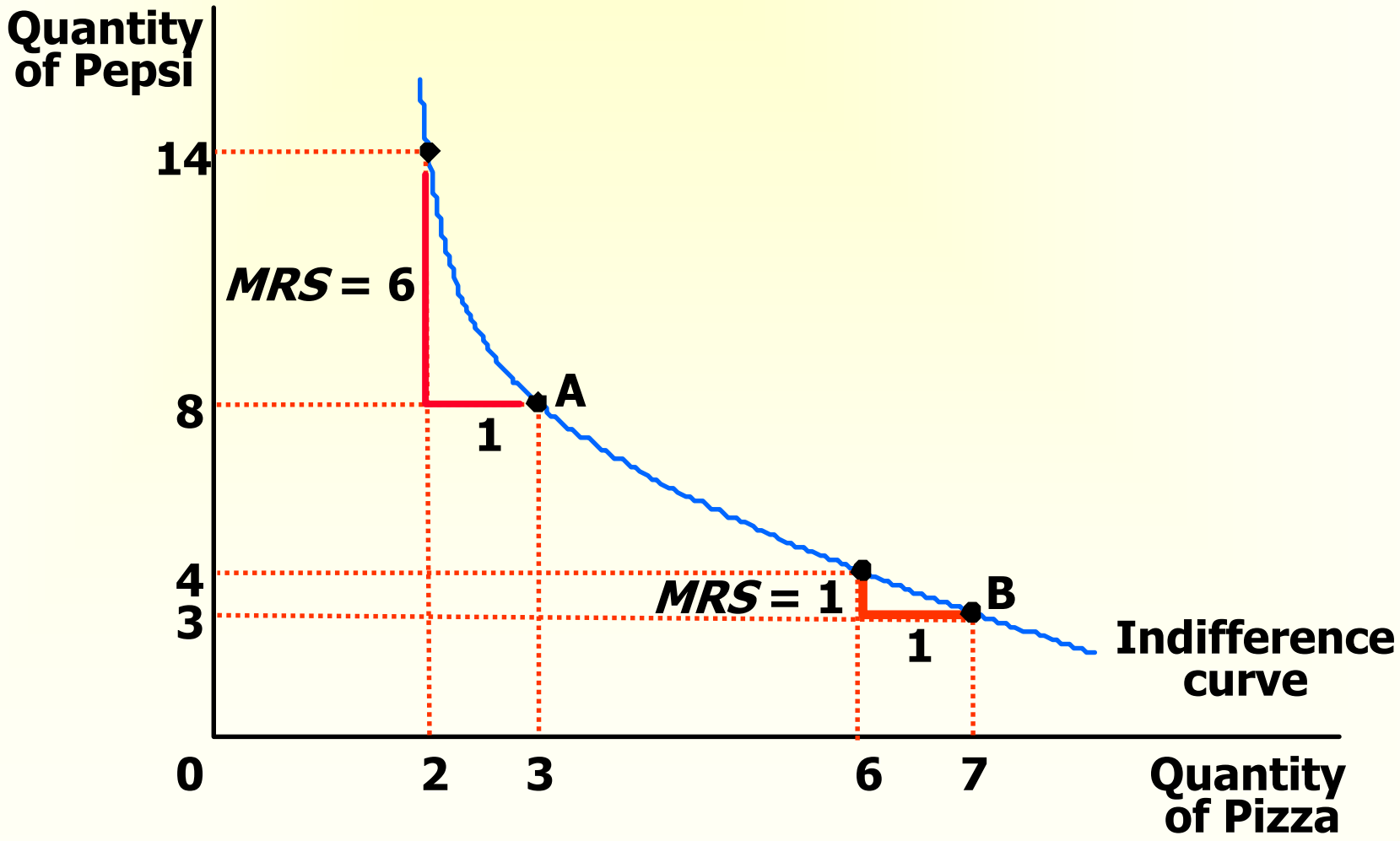
Property 3: Indifference curves do not cross.



Property 4: Indifference curves are bowed inward.

- People are more willing to trade away goods that they have in abundance and less willing to trade away goods of which they have little.
- These differences in a consumer's marginal substitution rates cause his or her indifference curve to bow inward.

Property 4: Indifference curves are bowed inward.



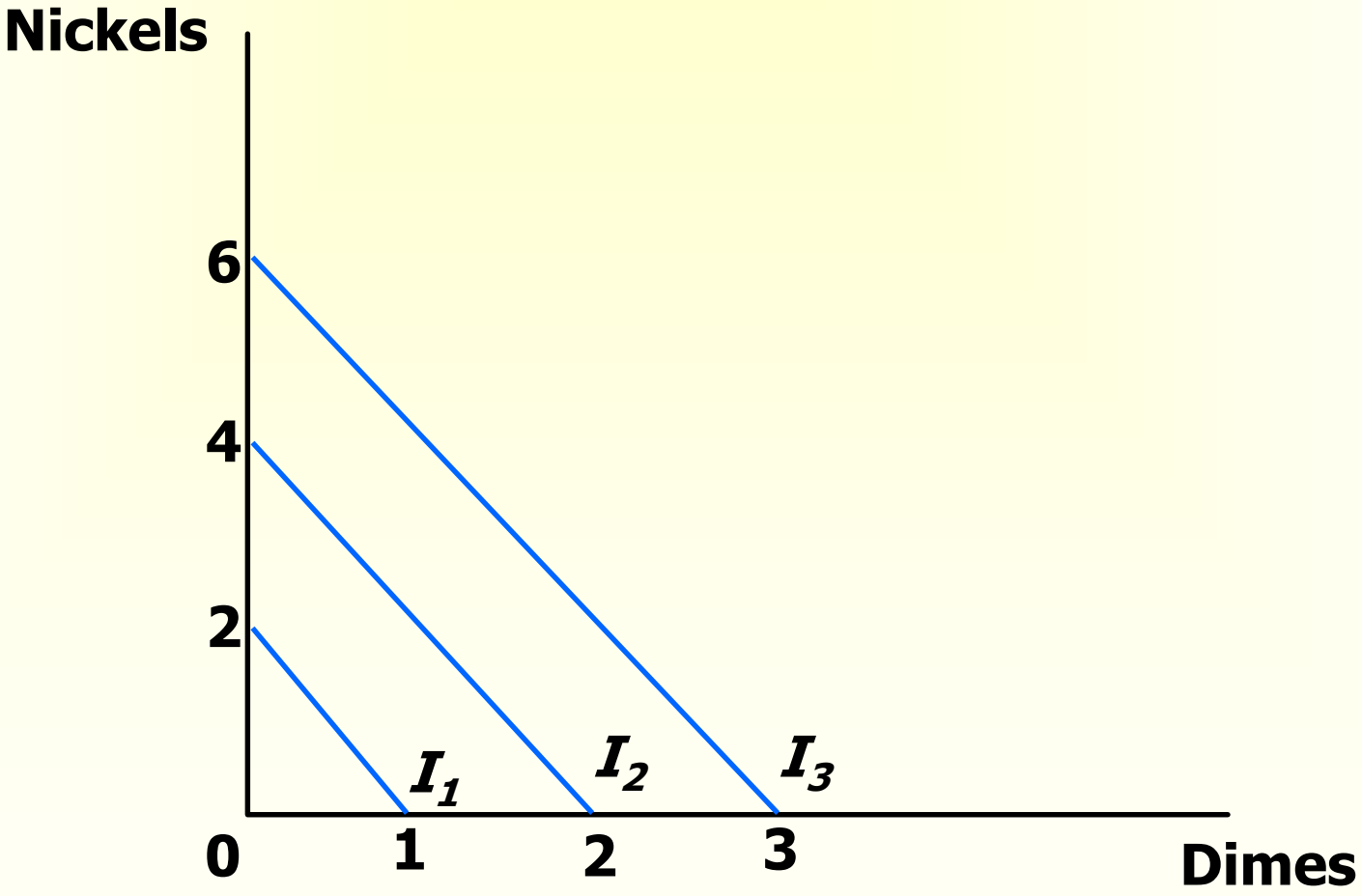
Two Extreme Examples of Indifference Curves

- Perfect substitutes
- Perfect complements

Perfect Substitutes

- **Two goods with straight-line indifference curves are perfect substitutes.**
  - **The marginal rate of substitution is a fixed number.**

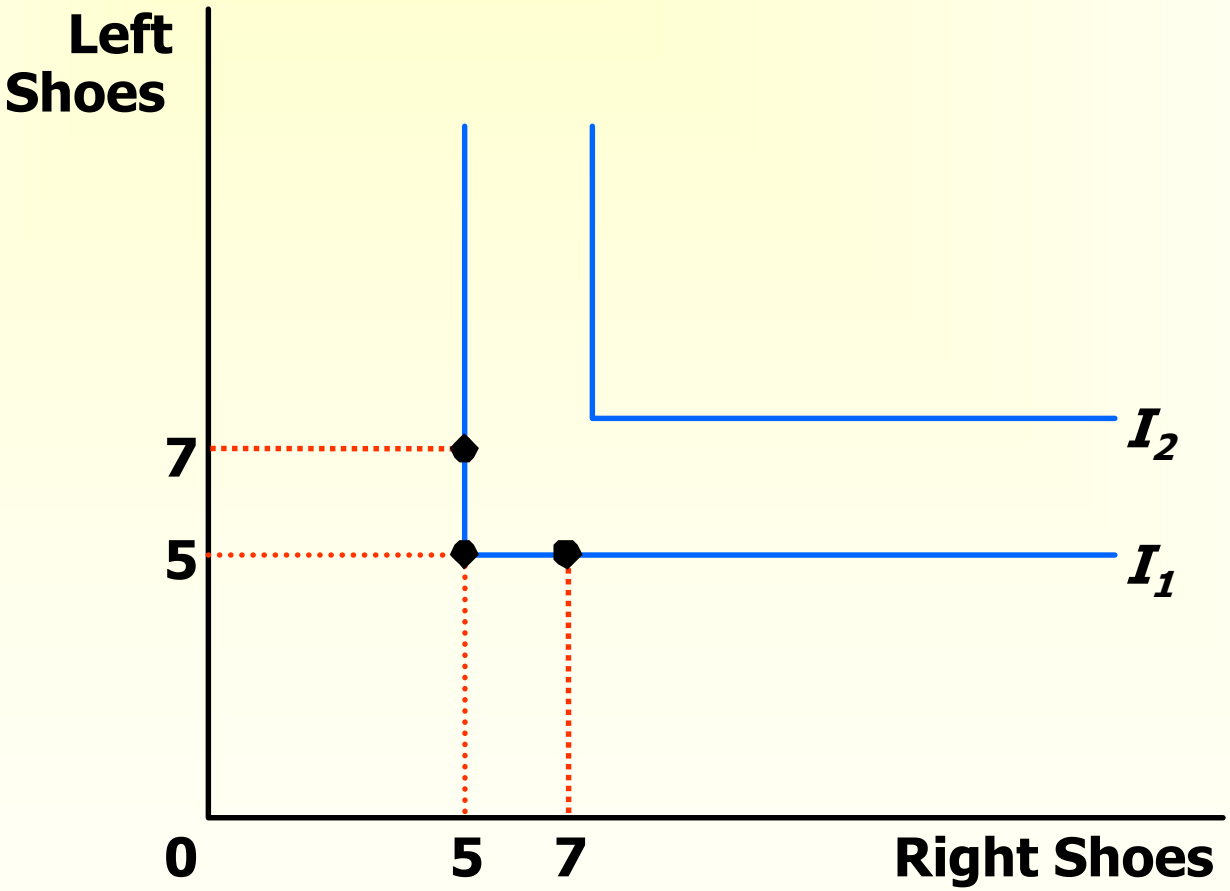
Perfect Substitutes



Perfect Complements

Two goods with right-angle indifference curves are perfect complements.

Perfect Complements



Optimization: What the Consumer Chooses

- Consumers want to get the combination of goods on the highest possible indifference curve.
- However, the consumer must also end up on or below his budget constraint.

Optimization: What the Consumer Chooses

- Combining the indifference curve and the budget constraint determines the consumer's optimal choice.
- Consumer **optimum** occurs at the point where the <u>highest</u> indifference curve and the budget constraint are tangent.

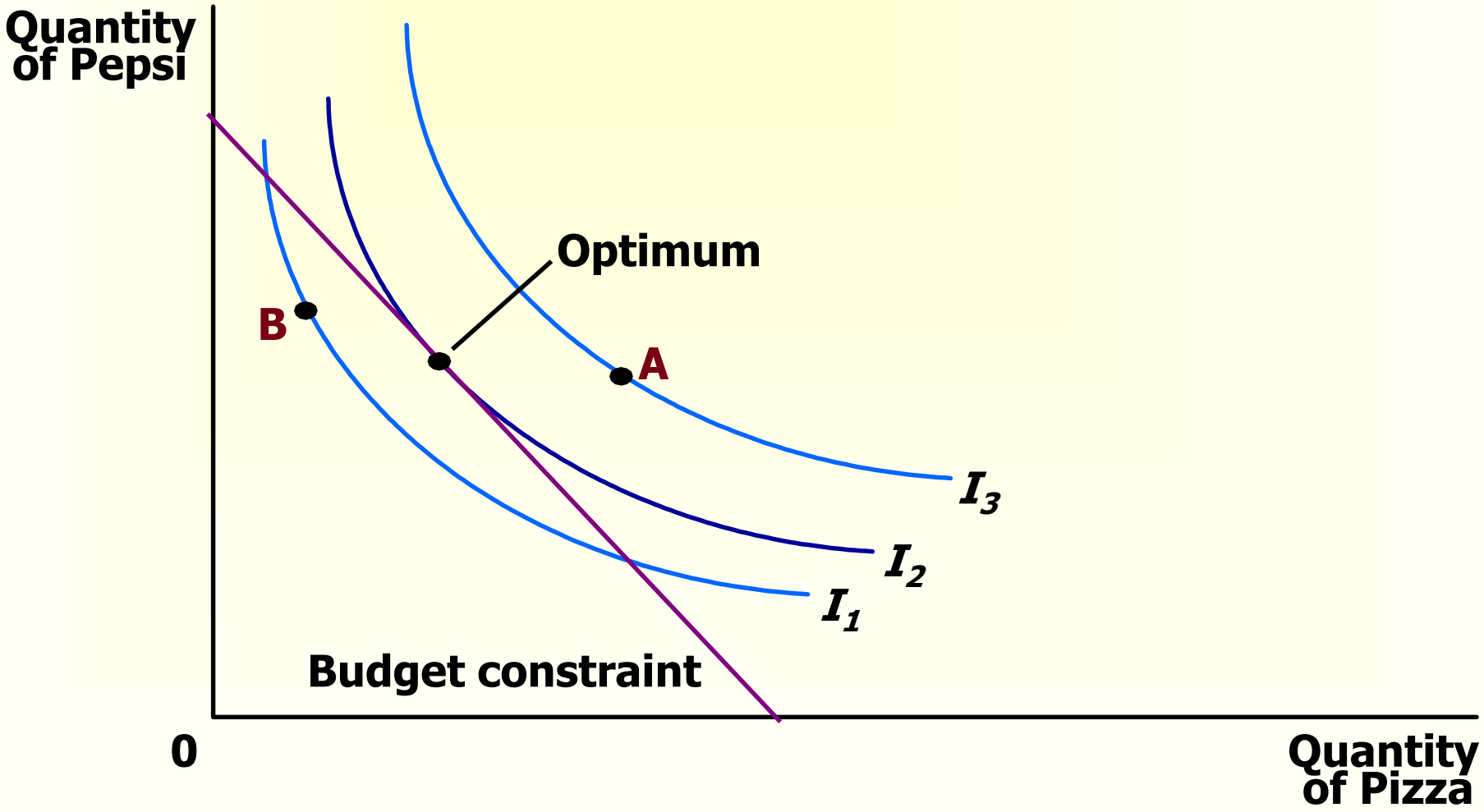
The Consumer’s Optimal Choice

The consumer chooses consumption of the two goods so that the marginal rate of substitution equals the relative price.

The Consumer’s Optimal Choice

At the consumer’s optimum, the consumer’s valuation of the two goods equals the market’s valuation.

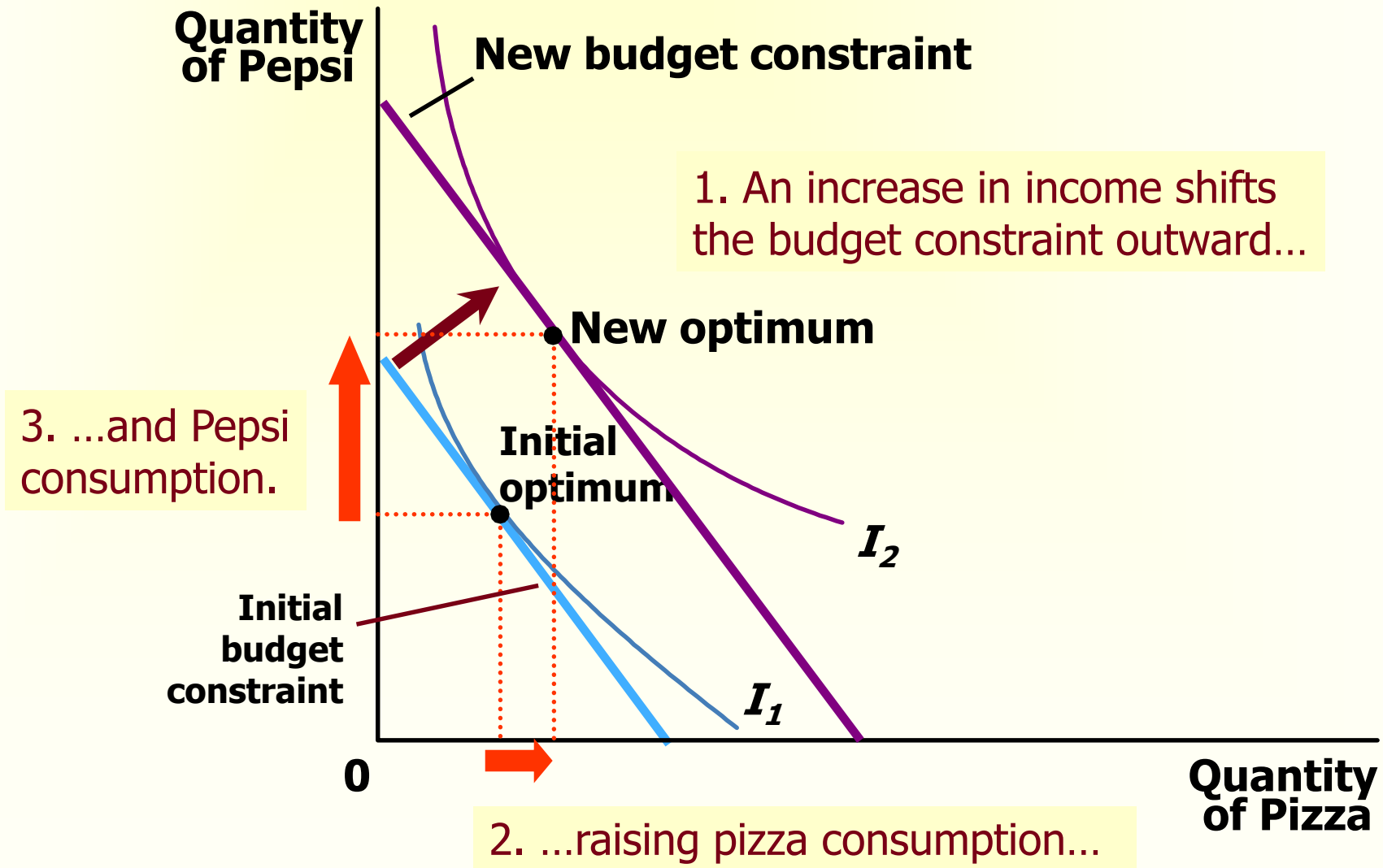
The Consumer's Optimum...



How Changes in Income Affect the Consumer's Choices

- An increase in income shifts the budget constraint outward.
  - The consumer is able to choose a better combination of goods on a higher indifference curve.

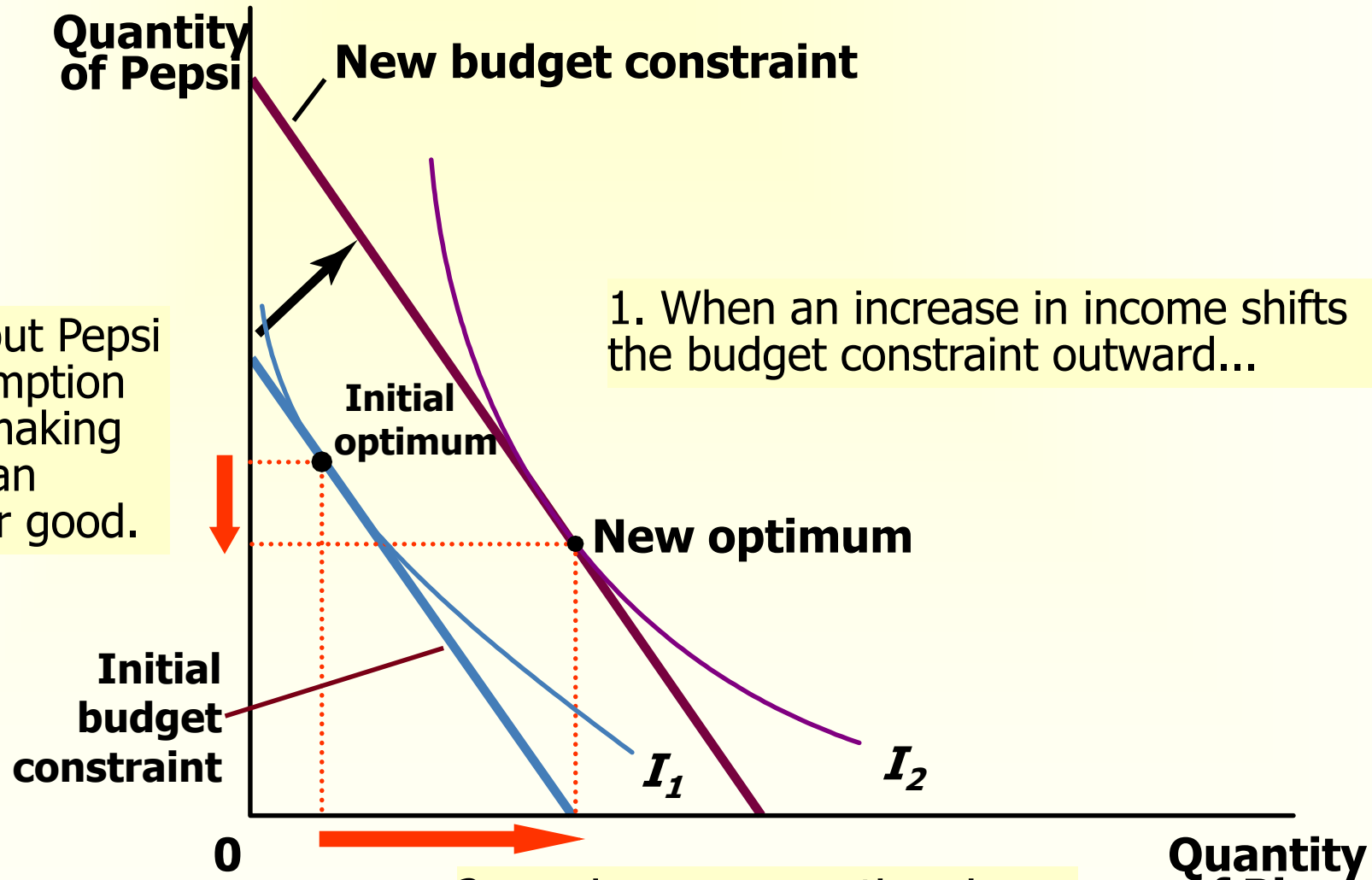
An Increase in Income...



Normal versus Inferior Goods

- **If a consumer buys more of a good when his or her income rises, the good is called a normal good.**
- **If a consumer buys less of a good when his or her income rises, the good is called an inferior good.**

An Inferior Good...



1. When an increase in income shifts the budget constraint outward...

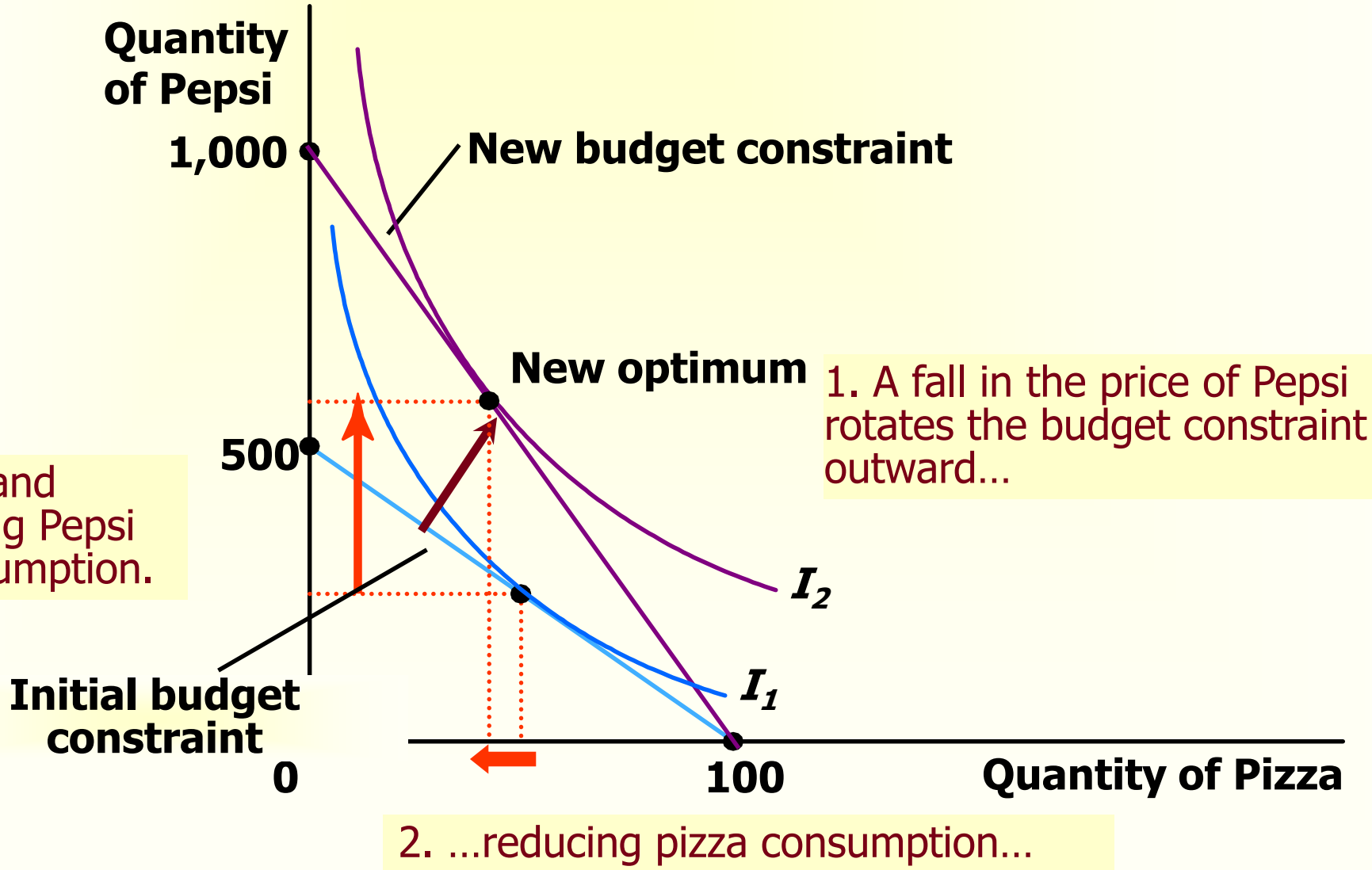
2. ... pizza consumption rises, making pizza a normal good...

3. ... but Pepsi consumption falls, making Pepsi an inferior good.

How Changes in Prices Affect Consumer Choices

A fall in the price of any good rotates the budget constraint outward and changes the slope of the budget constraint.

A Change in Price...



Income and Substitution Effects

- A price change has two effects on consumption.
  - An income effect
  - A substitution effect

The Income Effect

The income effect is the change in consumption that results when a price change moves the consumer to a higher or lower indifference curve.

The Substitution Effect

The substitution effect is the change in consumption that results when a price change moves the consumer along an indifference curve to a point with a different marginal rate of substitution.

A Change in Price: Substitution Effect

A price change first causes the consumer to move from one point on a indifference curve to another on the same curve.

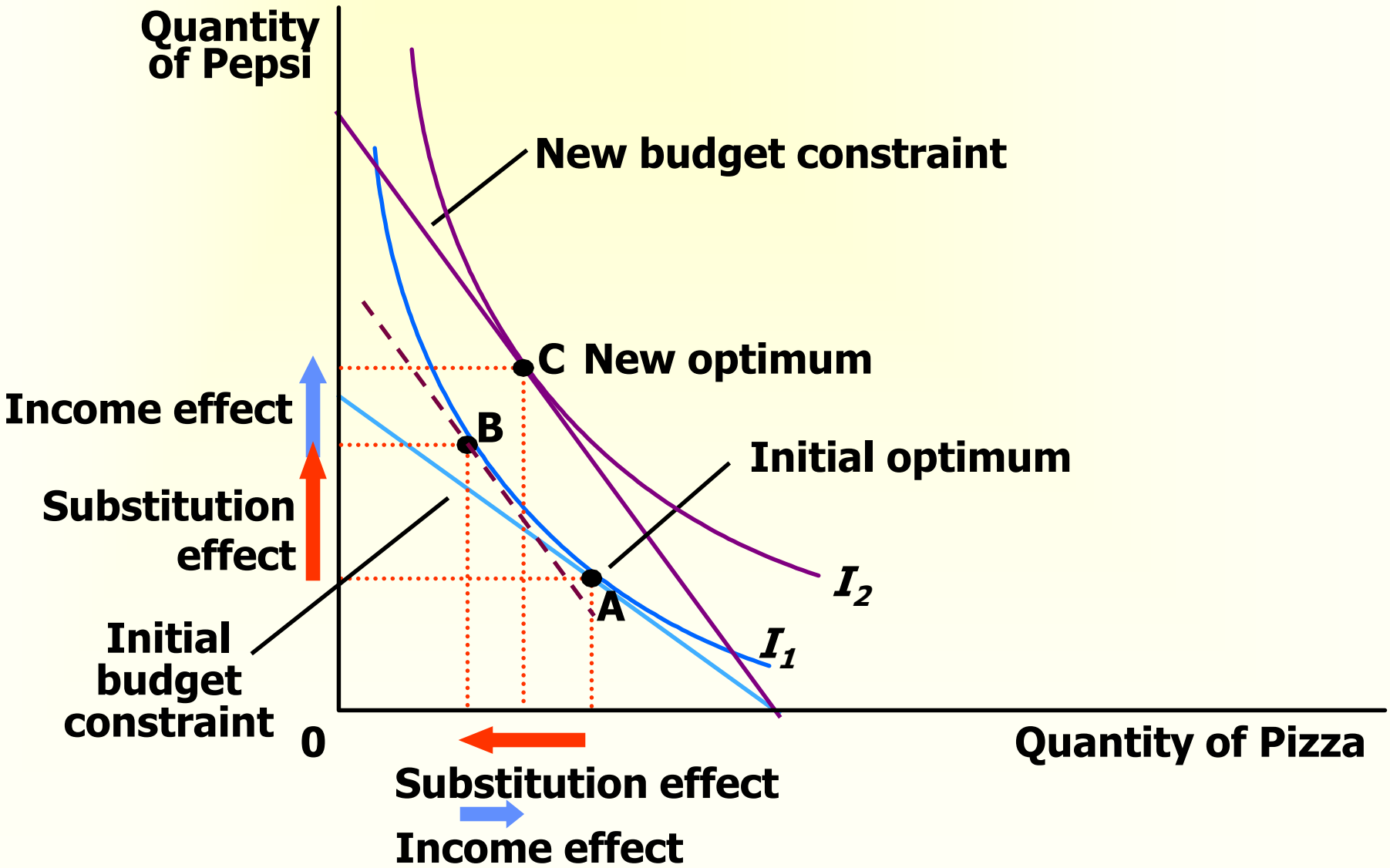
- Illustrated by movement from point A to point B.

A Change in Price: Income Effect

After moving from one point to another on the same curve, the consumer will move to another indifference curve.

- Illustrated by movement from point B to point C.

Income and Substitution Effects...



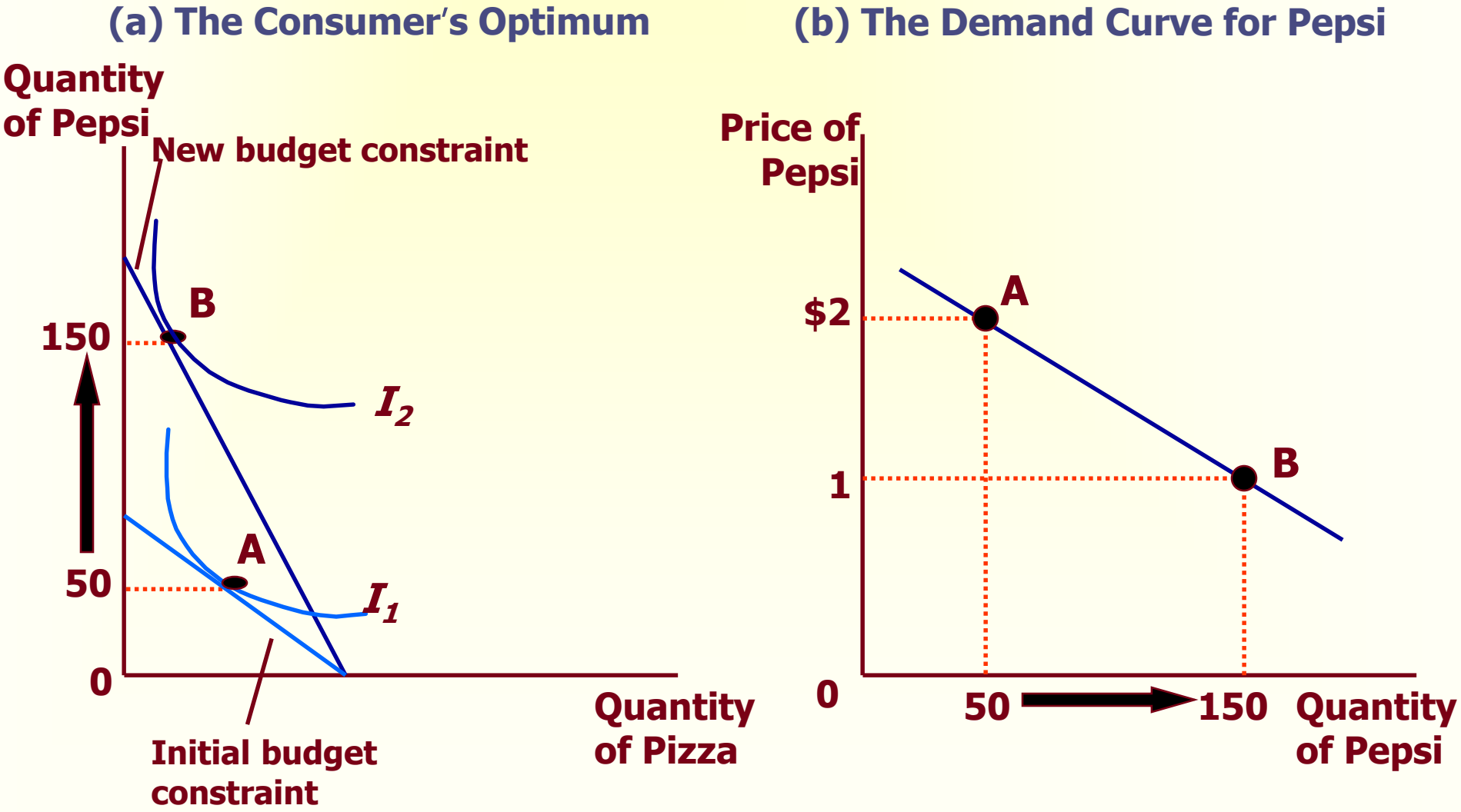
Income and Substitution Effects When the Price of Pepsi Falls

Good	Income Effect	Substitution Effect	Total Effect
Pepsi	Consumer is richer, so he buys more Pepsi.	Pepsi is relatively cheaper, so consumer buys more Pepsi.	Income and substitution effects act in same direction, so consumer buys more Pepsi.
Pizza	Consumer is richer, so he buys more pizza.	Pizza is relatively more expensive, so consumer buys less pizza.	Income and substitution effects act in opposite directions, so the total effect on pizza consumption is ambiguous.

Deriving the Demand Curve

A consumer's demand curve can be viewed as a summary of the optimal decisions that arise from his or her budget constraint and indifference curves.

Deriving the Demand Curve...



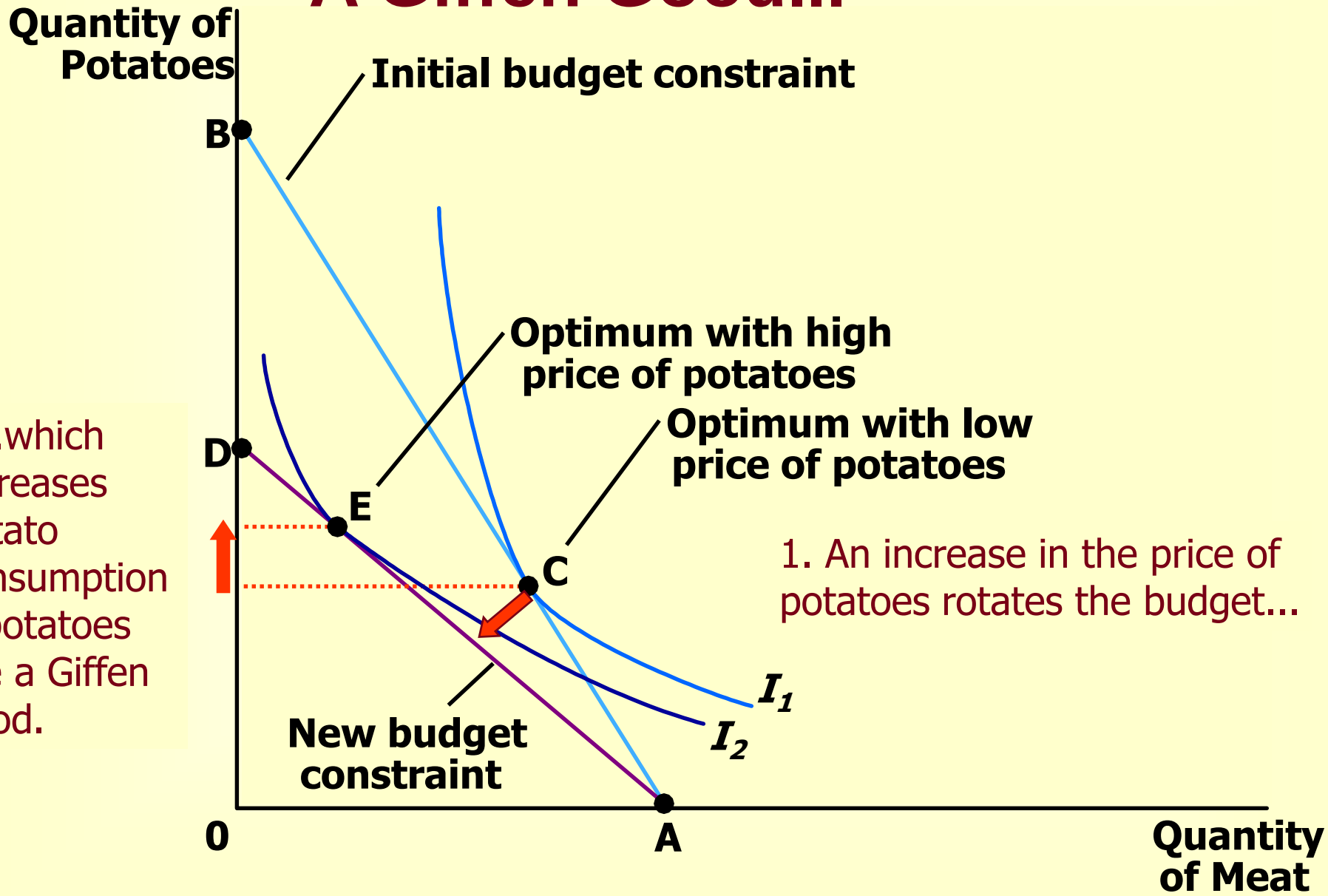
Do all demand curves slope downward?

- Demand curves can sometimes slope upward.
- This happens when a consumer buys more of a good when its price rises.

Giffen Goods

- Economists use the term **Giffen good** to describe a good that violates the law of demand.
- **Giffen goods** are inferior goods for which the income effect dominates the substitution effect.
- They have demand curves that slope upwards.

A Giffen Good...



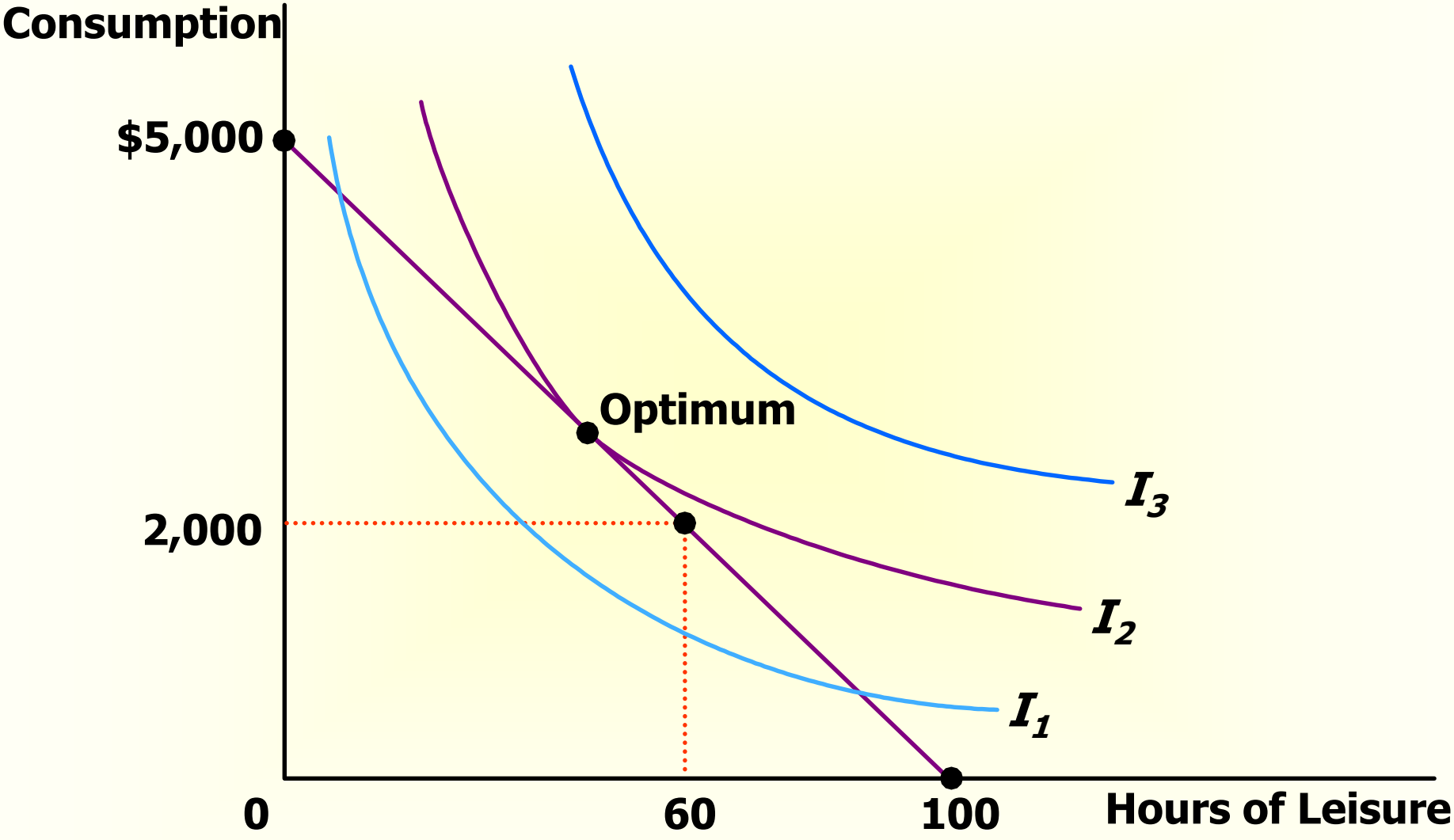
2...which increases potato consumption if potatoes are a Giffen good.

1. An increase in the price of potatoes rotates the budget...

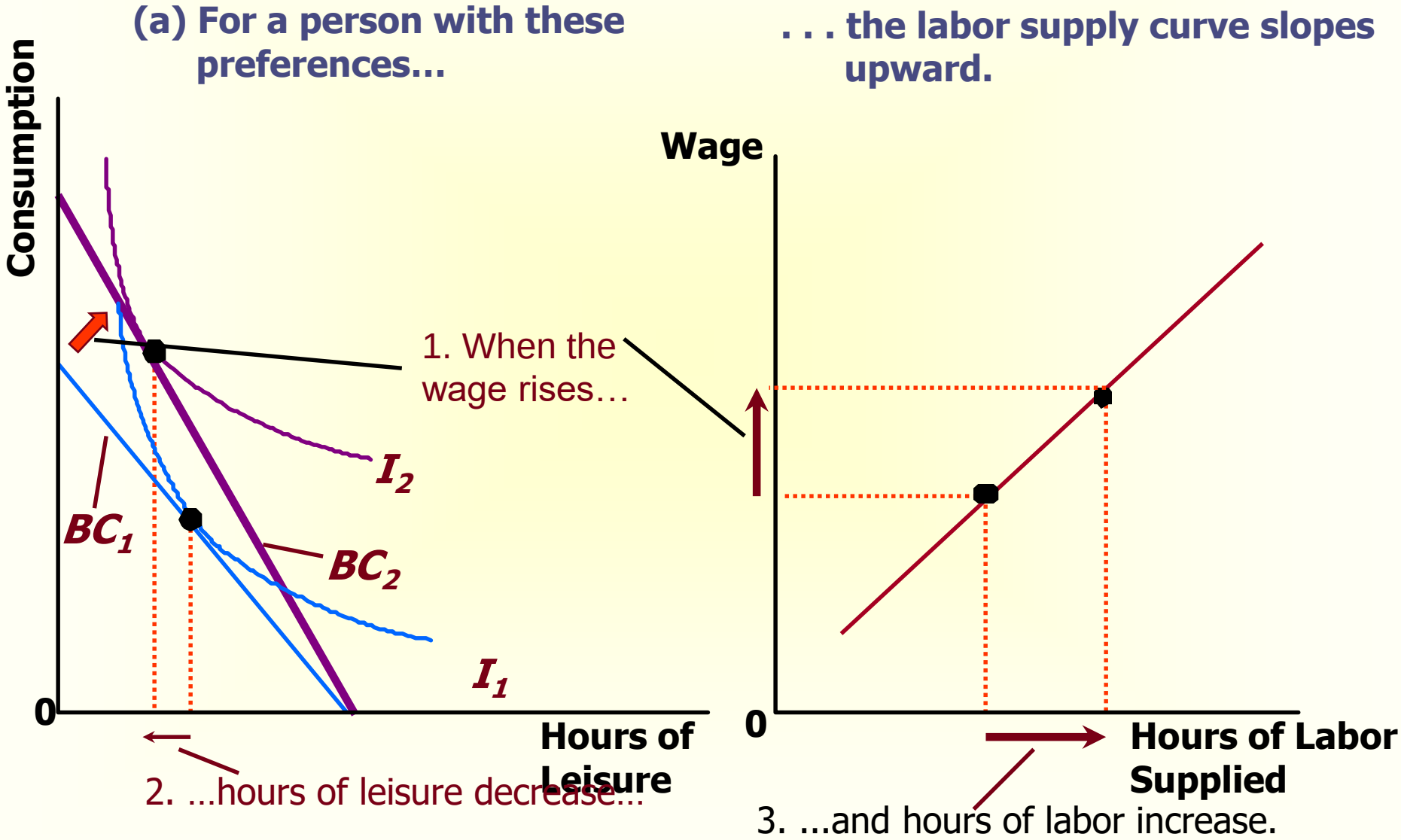
How do wages affect labor supply?

- If the substitution effect is greater than the income effect for the worker, he or she works more.
- If income effect is greater than the substitution effect, he or she works less.

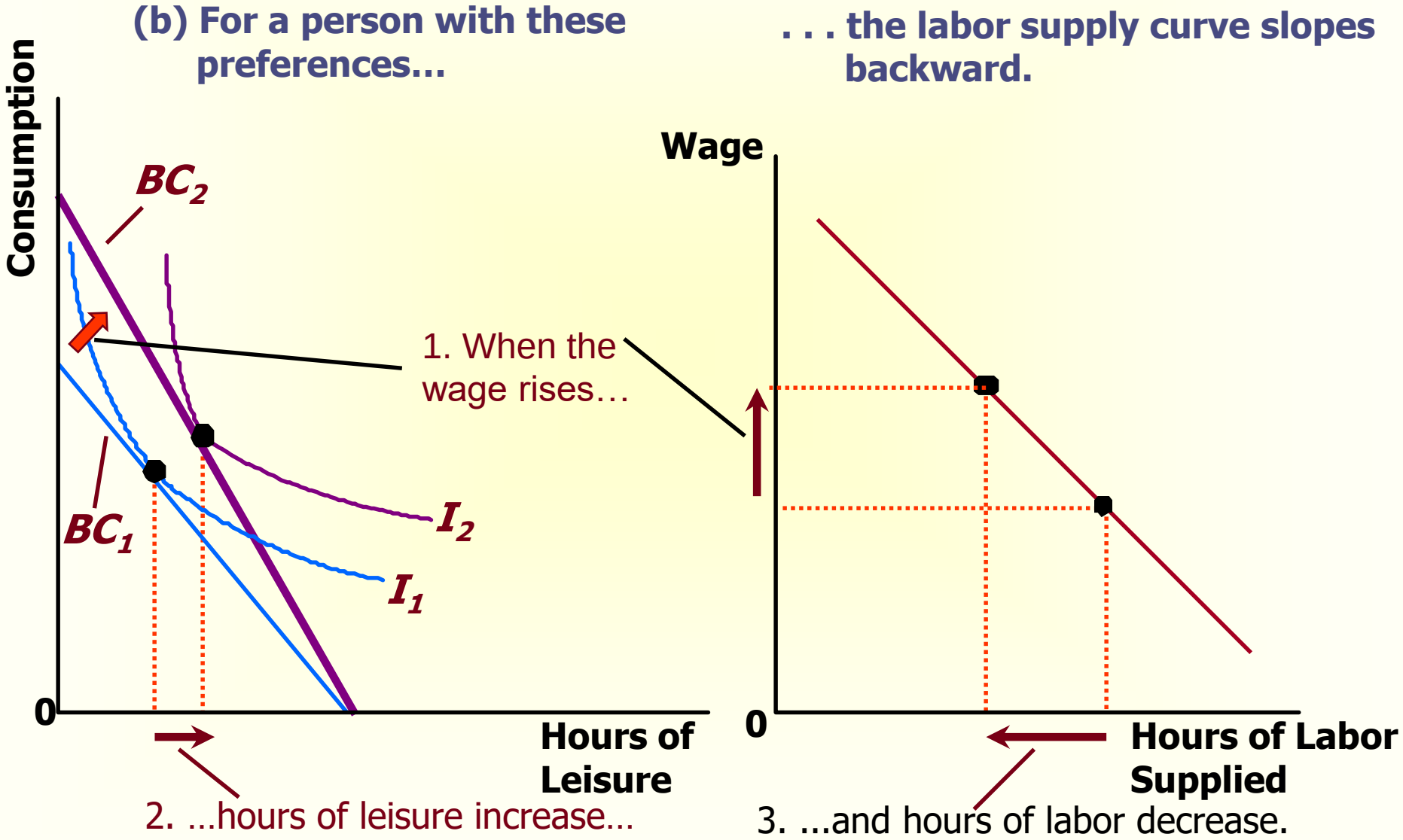
The Work-Leisure Decision...



An Increase in the Wage...



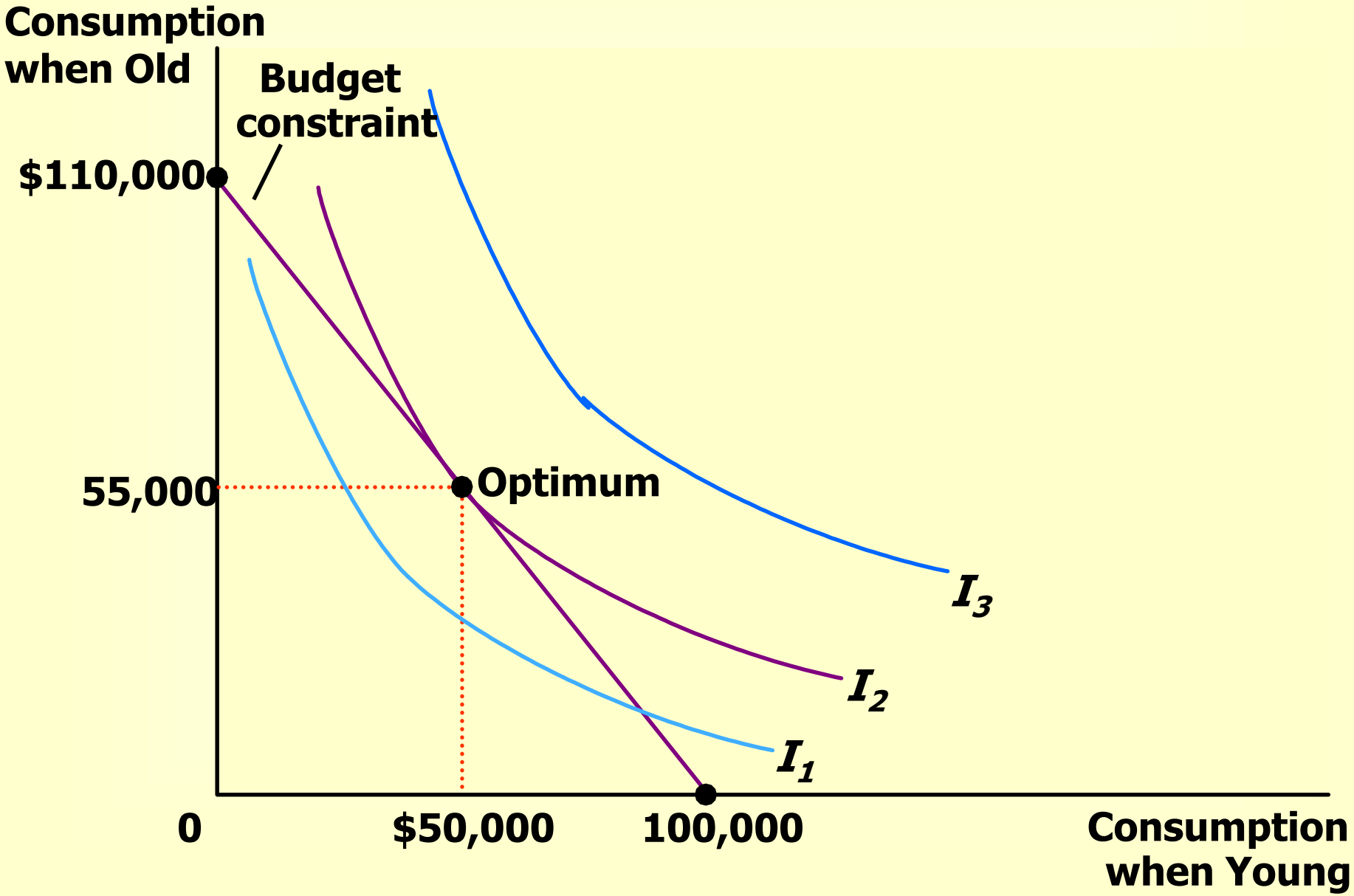
An Increase in the Wage...



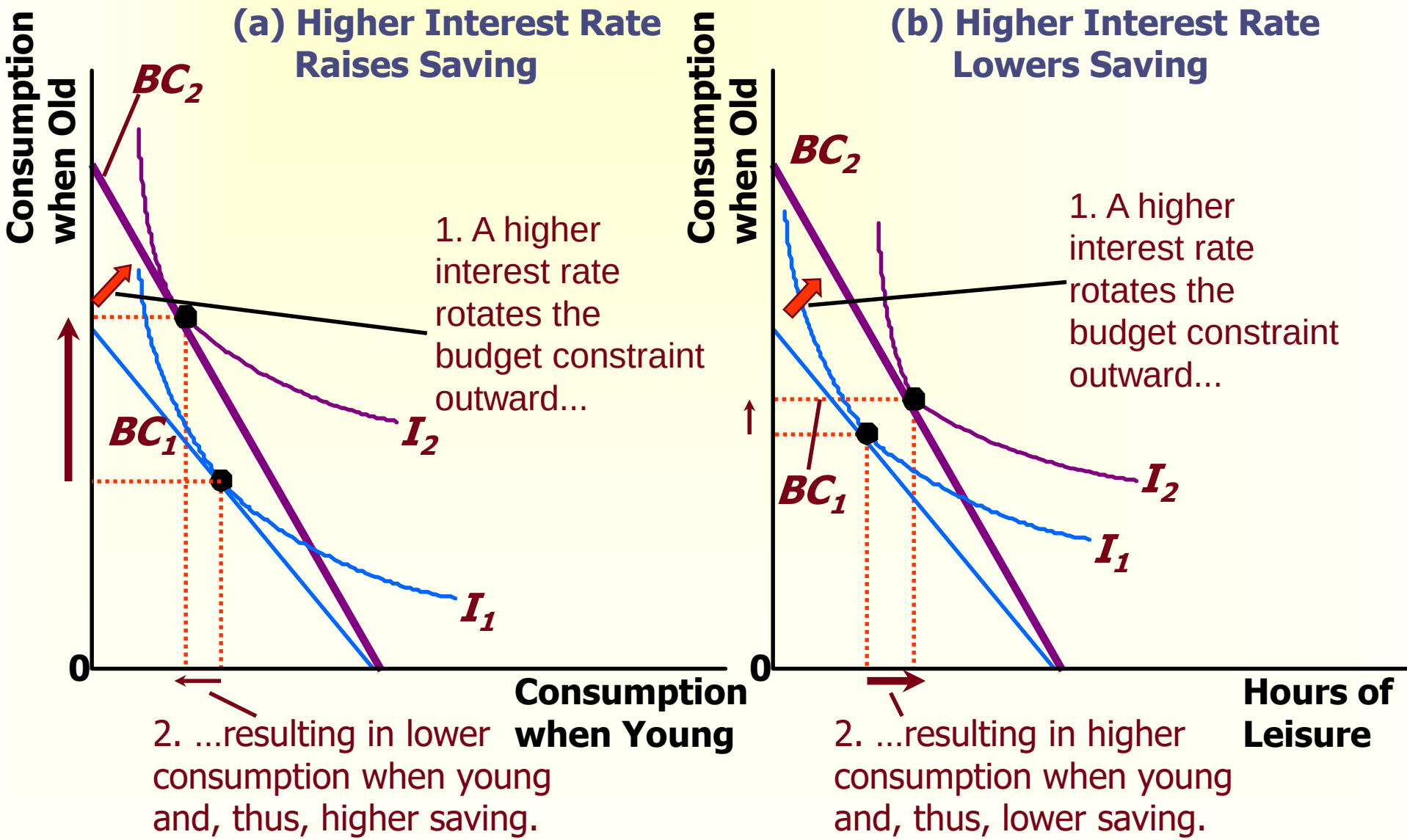
How do interest rates affect household saving?

- If the substitution effect of a higher interest rate is greater than the income effect, households save more.
- If the income effect of a higher interest rate is greater than the substitution effect, households save less.

The Consumption-Saving Decision...



An Increase in the Interest Rate...



How do interest rates affect household saving?

Thus, an increase in the interest rate could either encourage or discourage saving.

Do the poor prefer to receive cash or in-kind transfers?

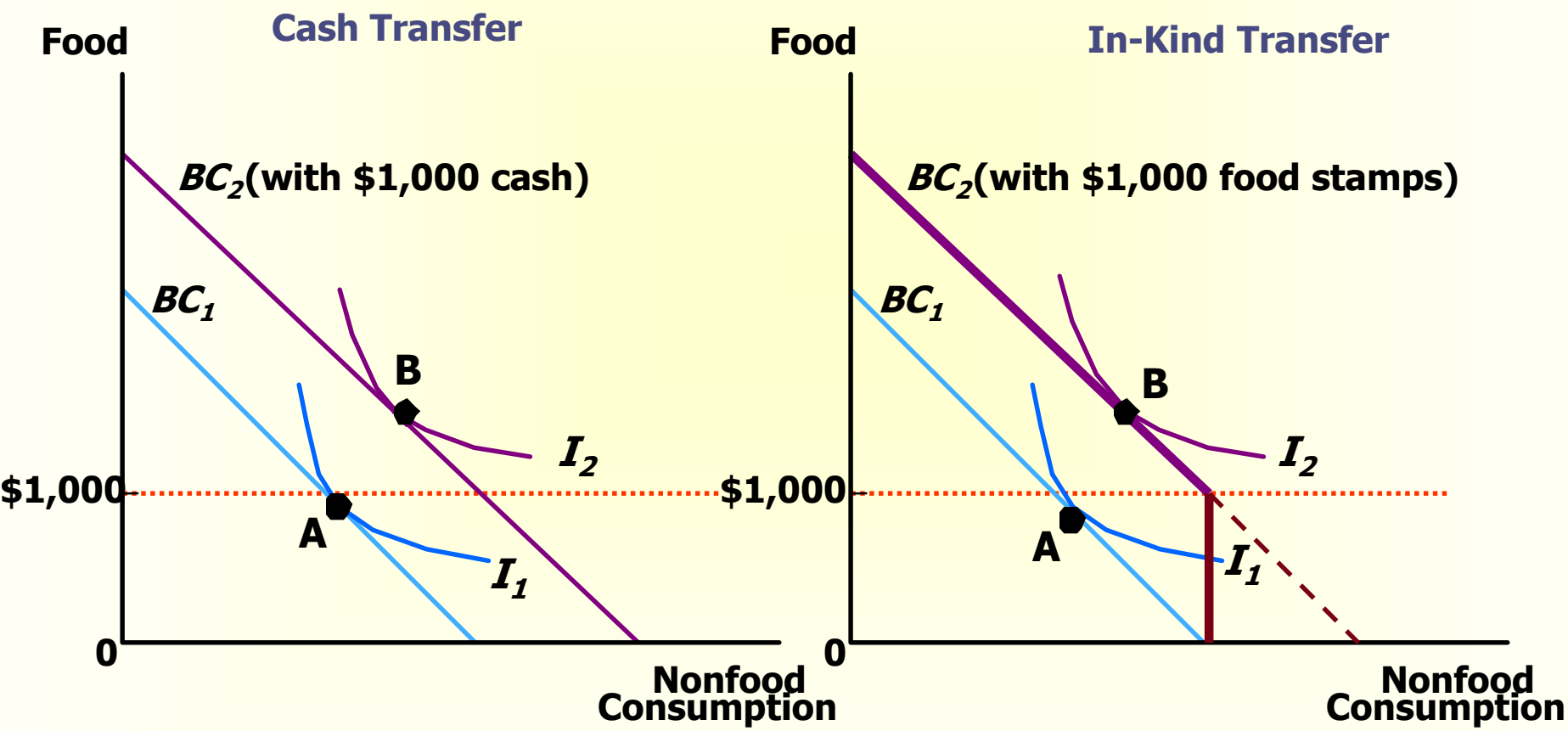
If an in-kind transfer of a good forces the recipient to consume more of the good than he would on his own, then the recipient prefers the cash transfer.

Do the poor prefer to receive cash or in-kind transfers?

If the recipient does not consume more of the good than he would on his own, then the cash and in-kind transfer have exactly the same effect on his consumption and welfare.

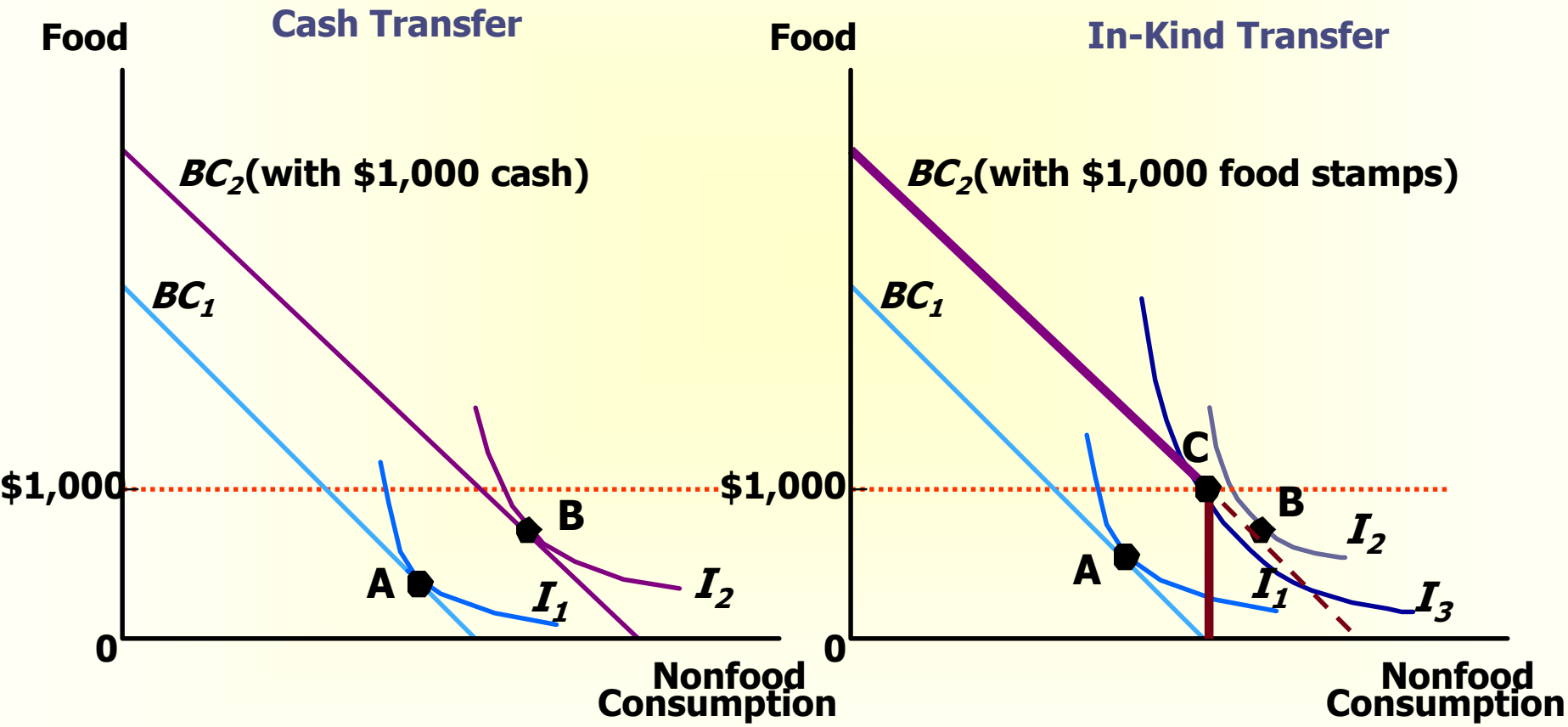
Cash versus In-Kind Transfers...

(a) The Constraint Is Not Binding



Cash versus In-Kind Transfers...

(b) The Constraint Is Binding



Summary

- A consumer's budget constraint shows the possible combinations of different goods he can buy given his income and the prices of the goods.
- The slope of the budget constraint equals the relative price of the goods.
- The consumer's indifference curves represent his preferences.

Summary

- Points on higher indifference curves are preferred to points on lower indifference curves.
- The slope of an indifference curve at any point is the consumer's marginal rate of substitution.
- The consumer optimizes by choosing the point on his budget constraint that lies on the highest indifference curve.

Summary

- When the price of a good falls, the impact on the consumer's choices can be broken down into an income effect and a substitution effect.
- The income effect is the change in consumption that arises because a lower price makes the consumer better off.
- The income effect is reflected by the movement from a lower to a higher indifference curve.

Summary

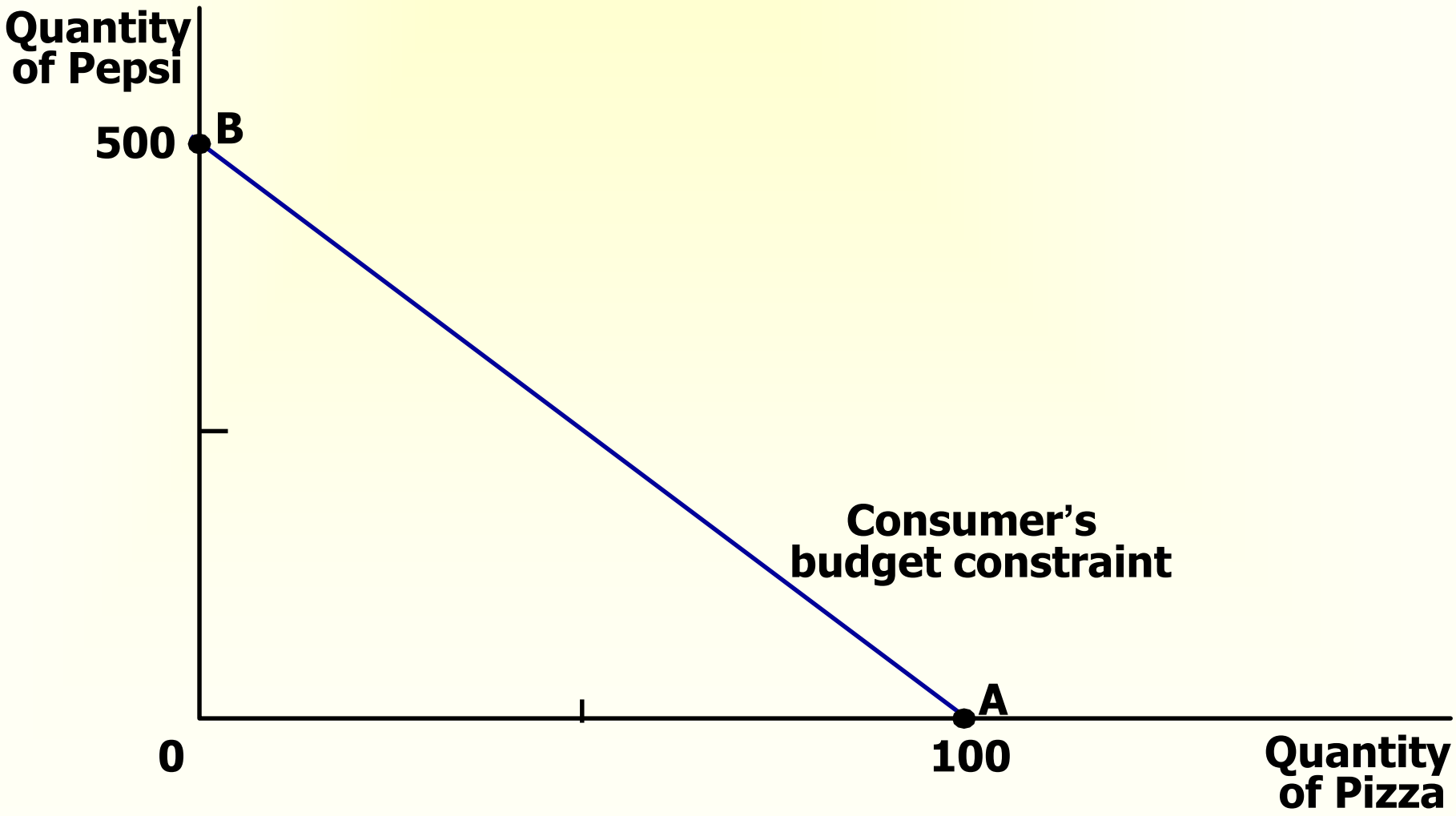
- The substitution effect is the change in consumption that arises because a price change encourages greater consumption of the good that has become relatively cheaper.
- The substitution effect is reflected by a movement along an indifference curve to a point with a different slope.

Summary

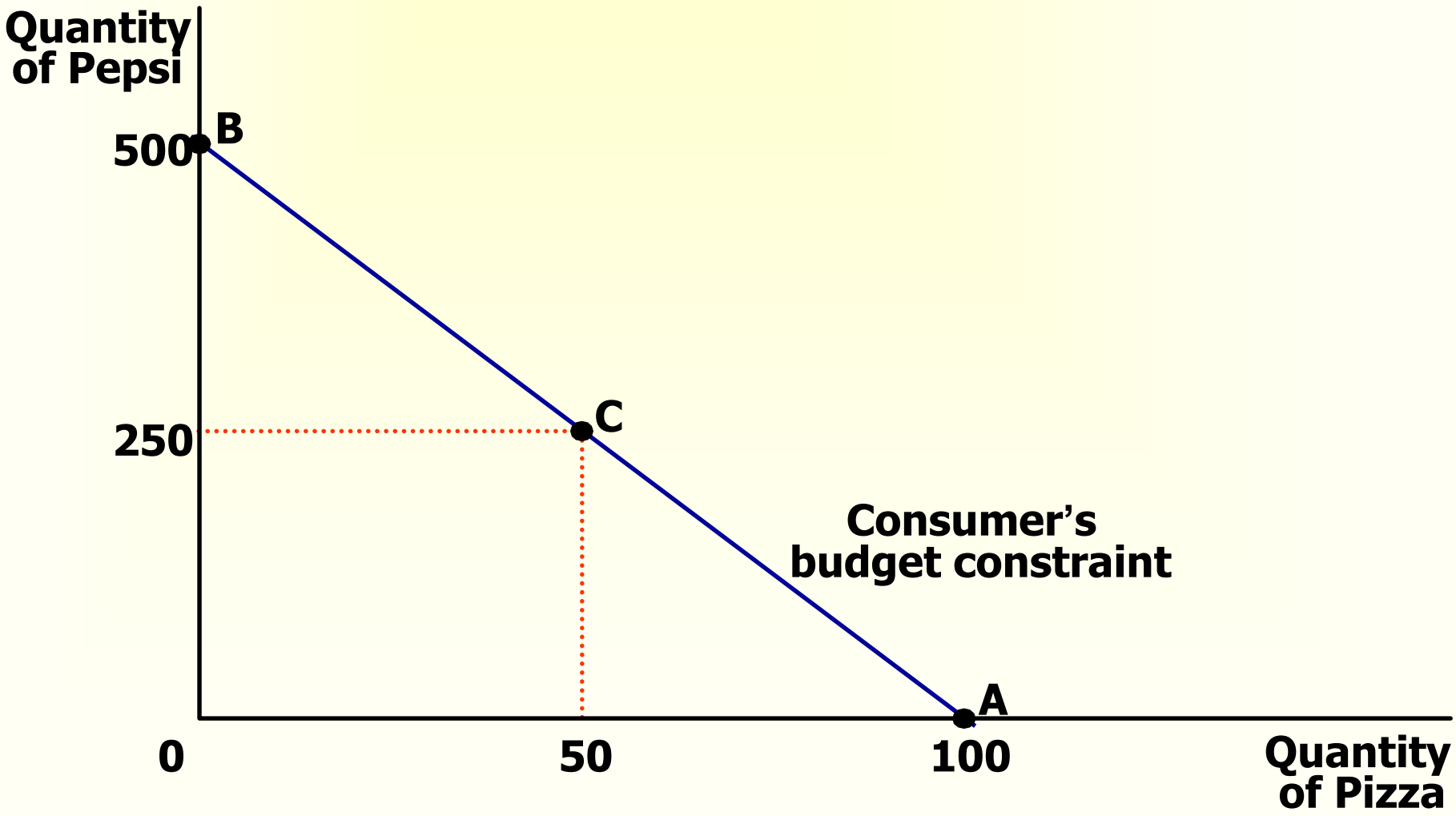
- The theory of consumer choice can explain:
  - Why demand curves can potentially slope upward.
  - How wages affect labor supply.
  - How interest rates affect household saving.
  - Whether the poor prefer to receive cash or in-kind transfers.

Graphical Review

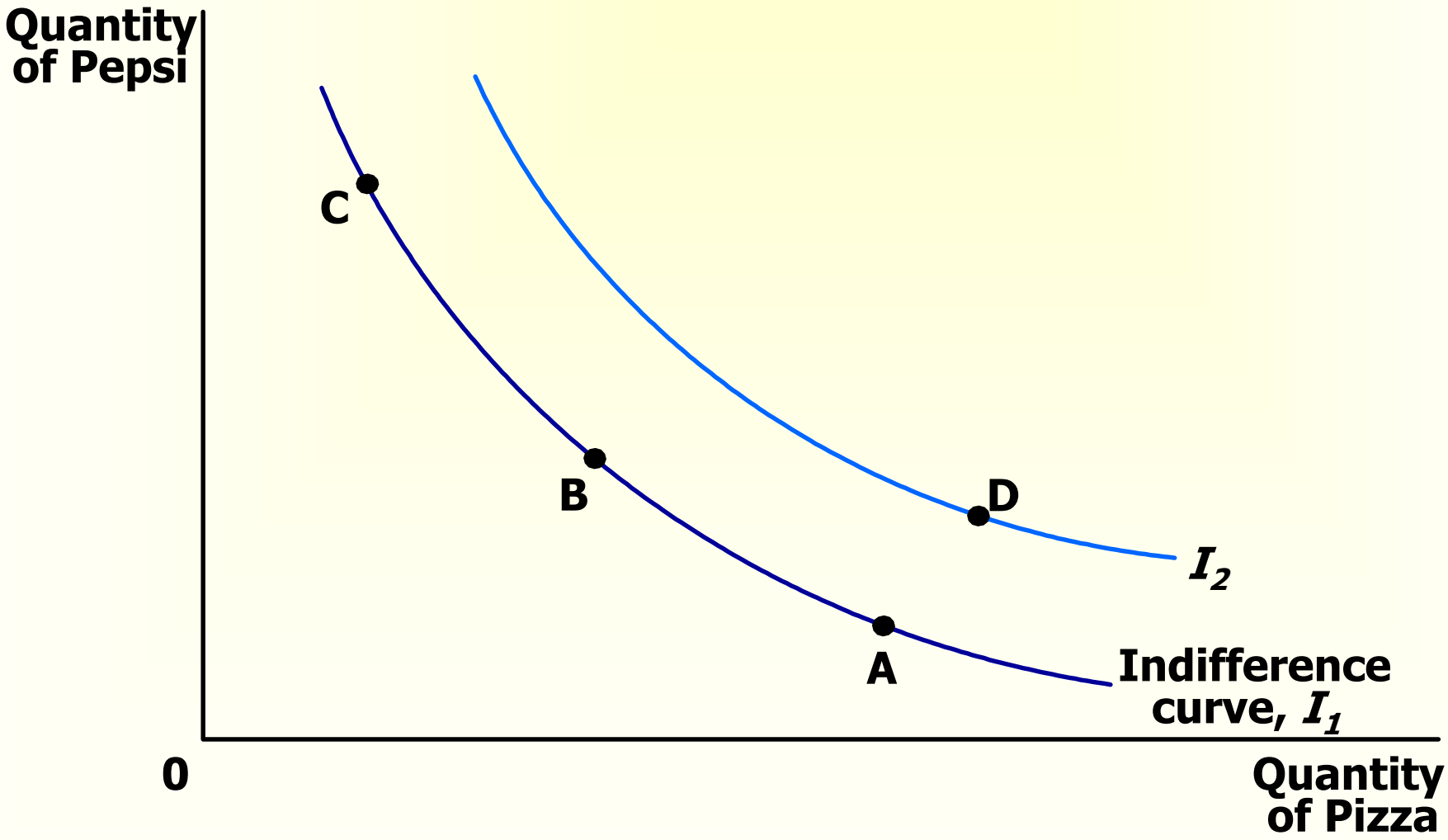
The Consumer's Budget Constraint...



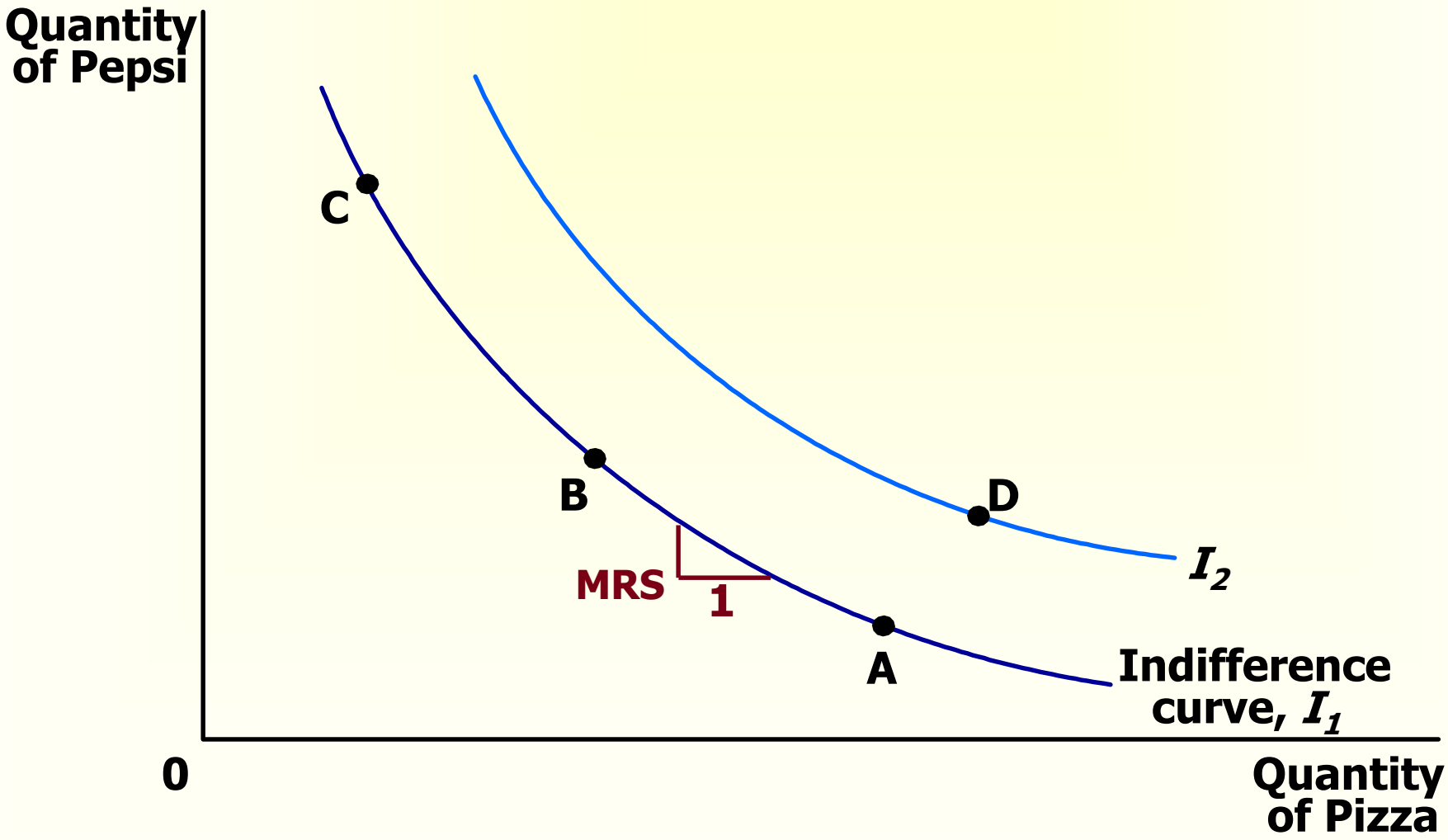
The Consumer's Budget Constraint...



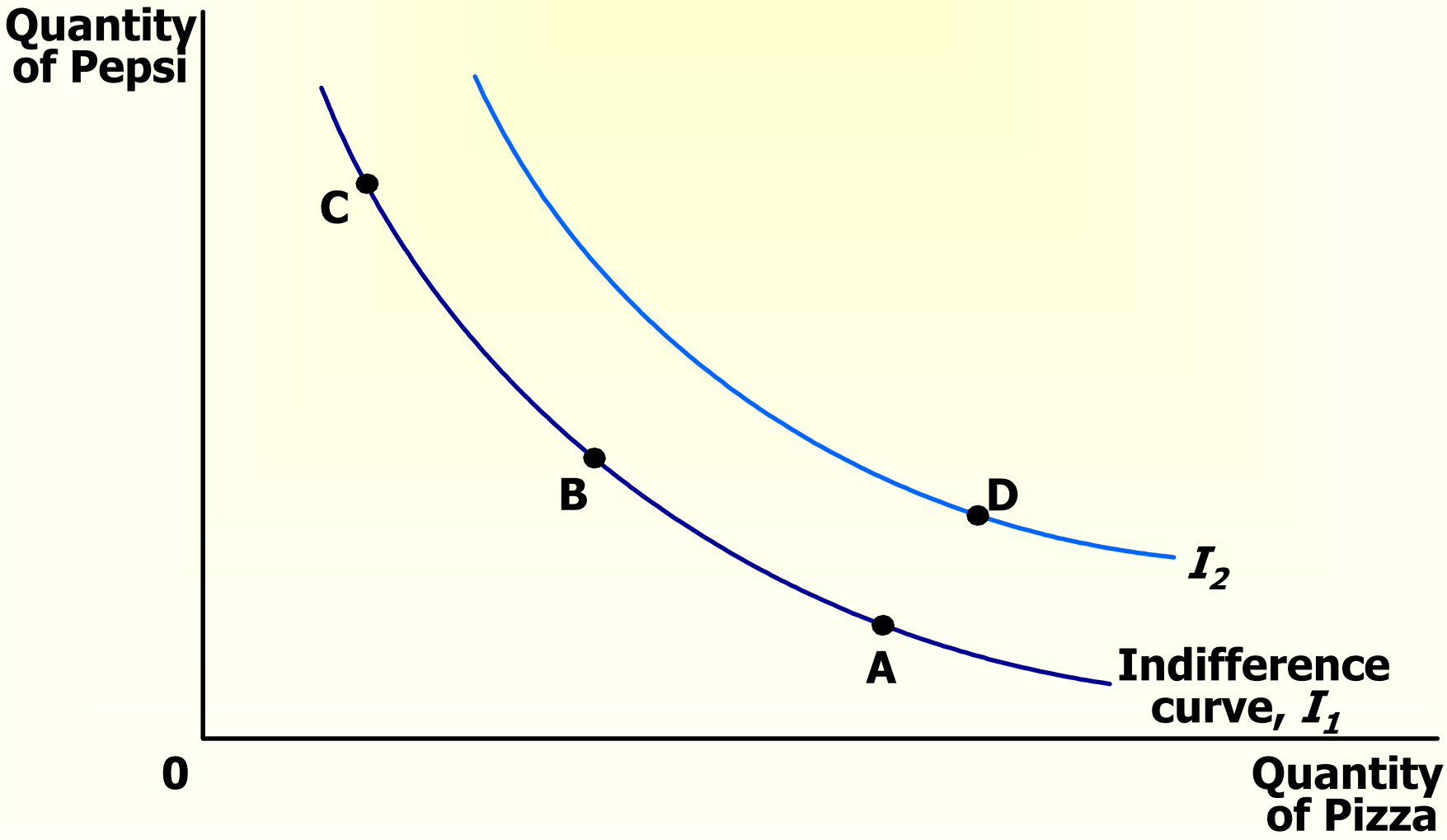
The Consumer's Preferences...



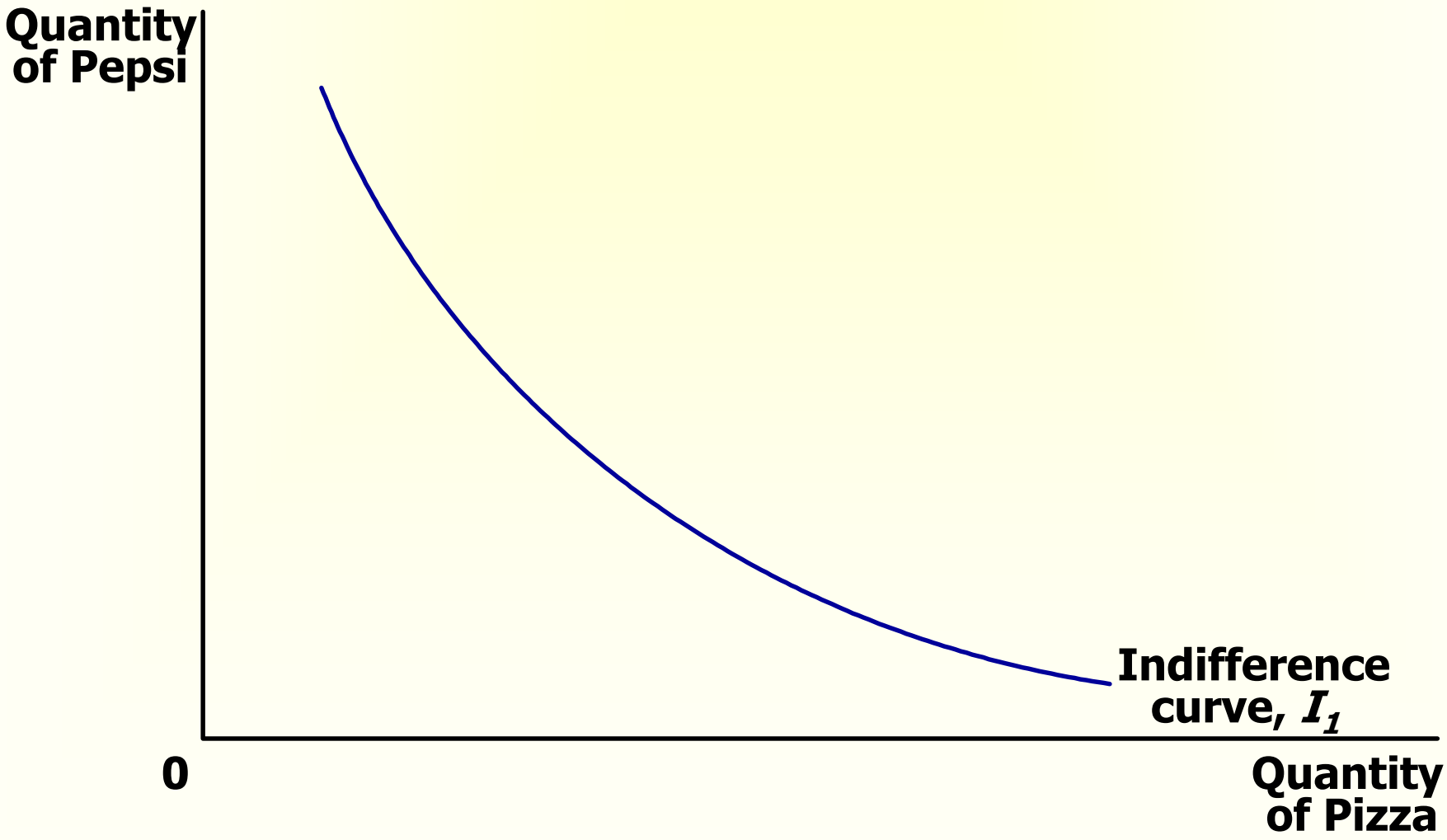
The Consumer's Preferences...



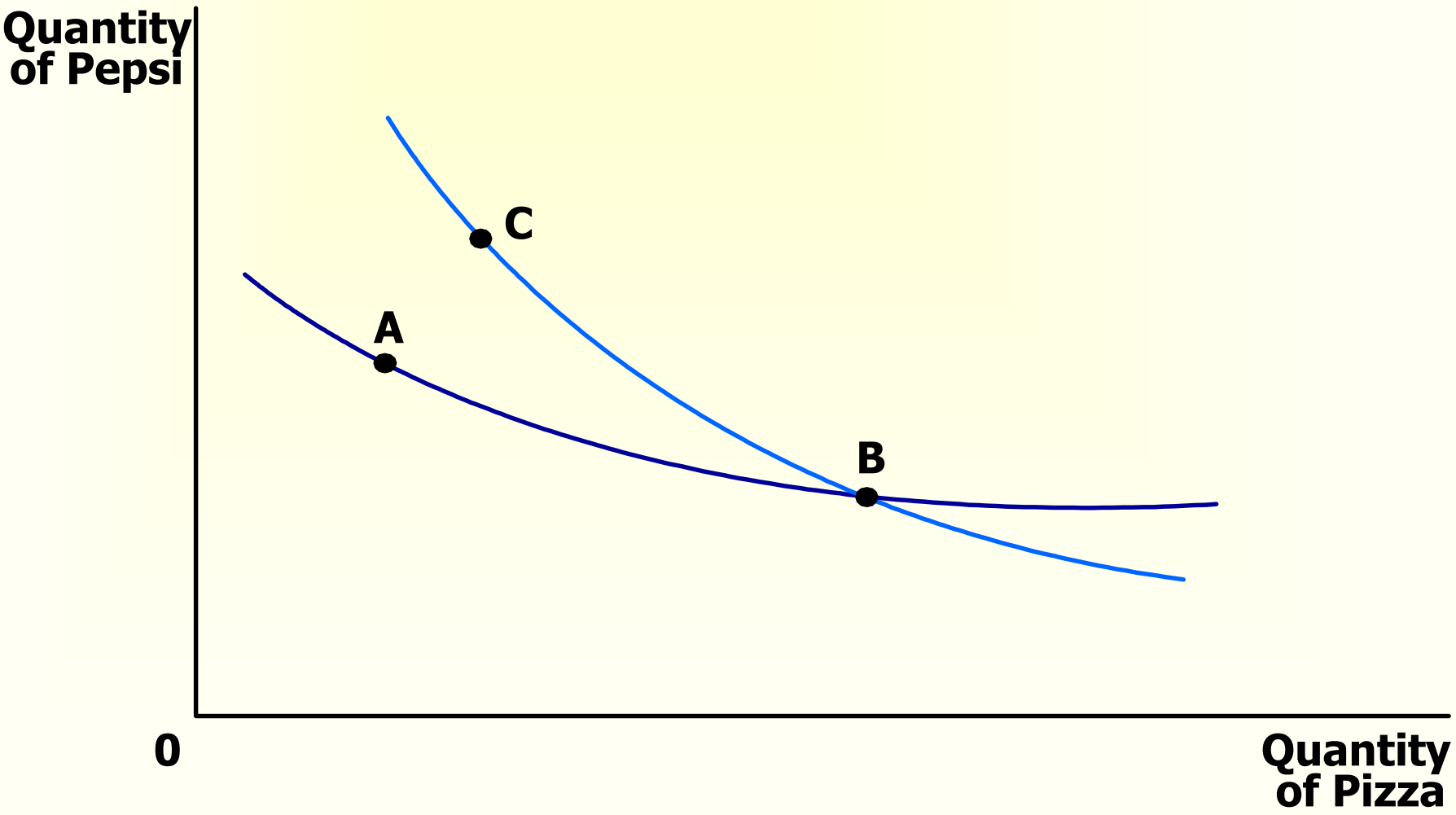
Property 1: Higher indifference curves are preferred to lower ones.



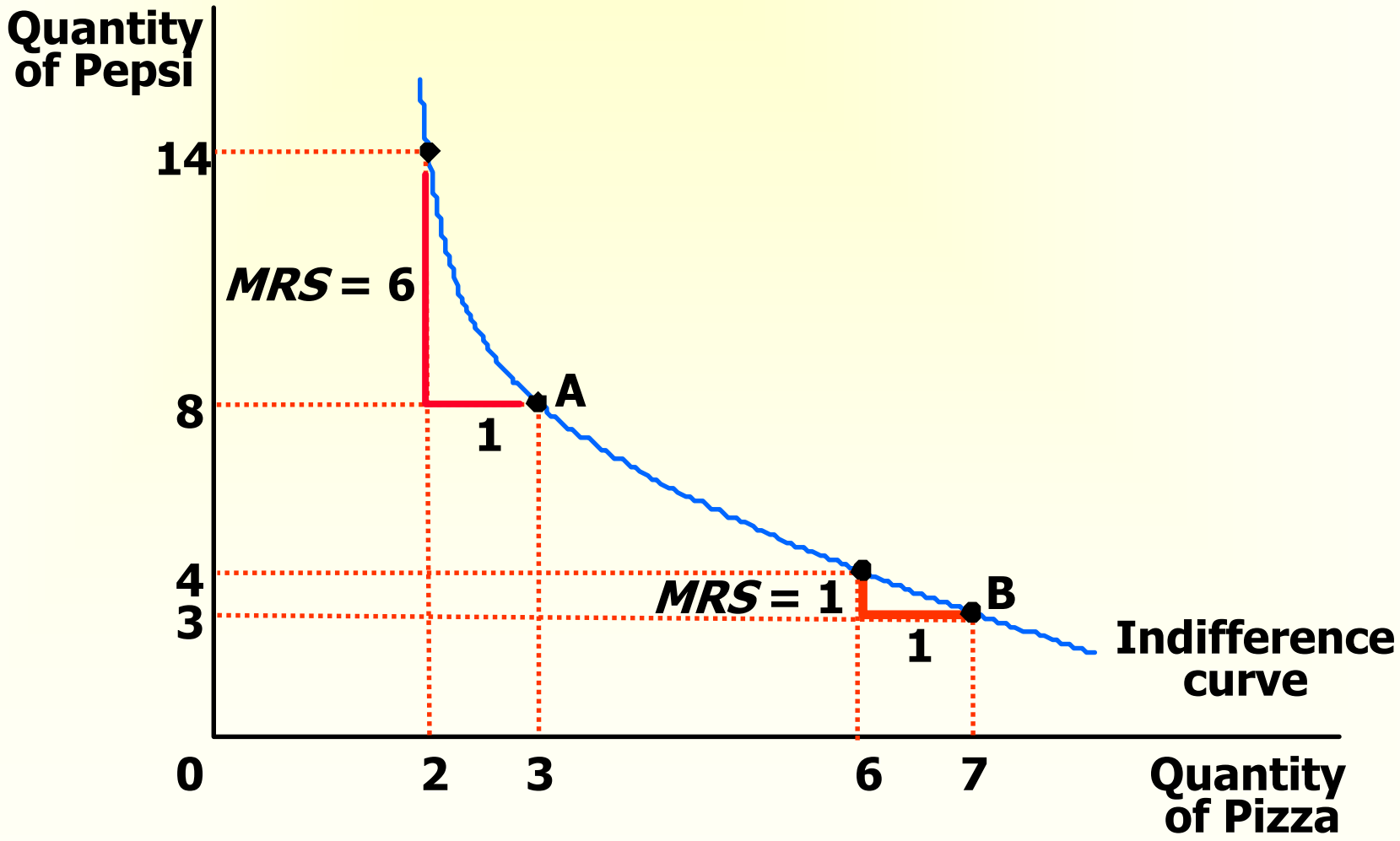
Property 2: Indifference curves are downward sloping.



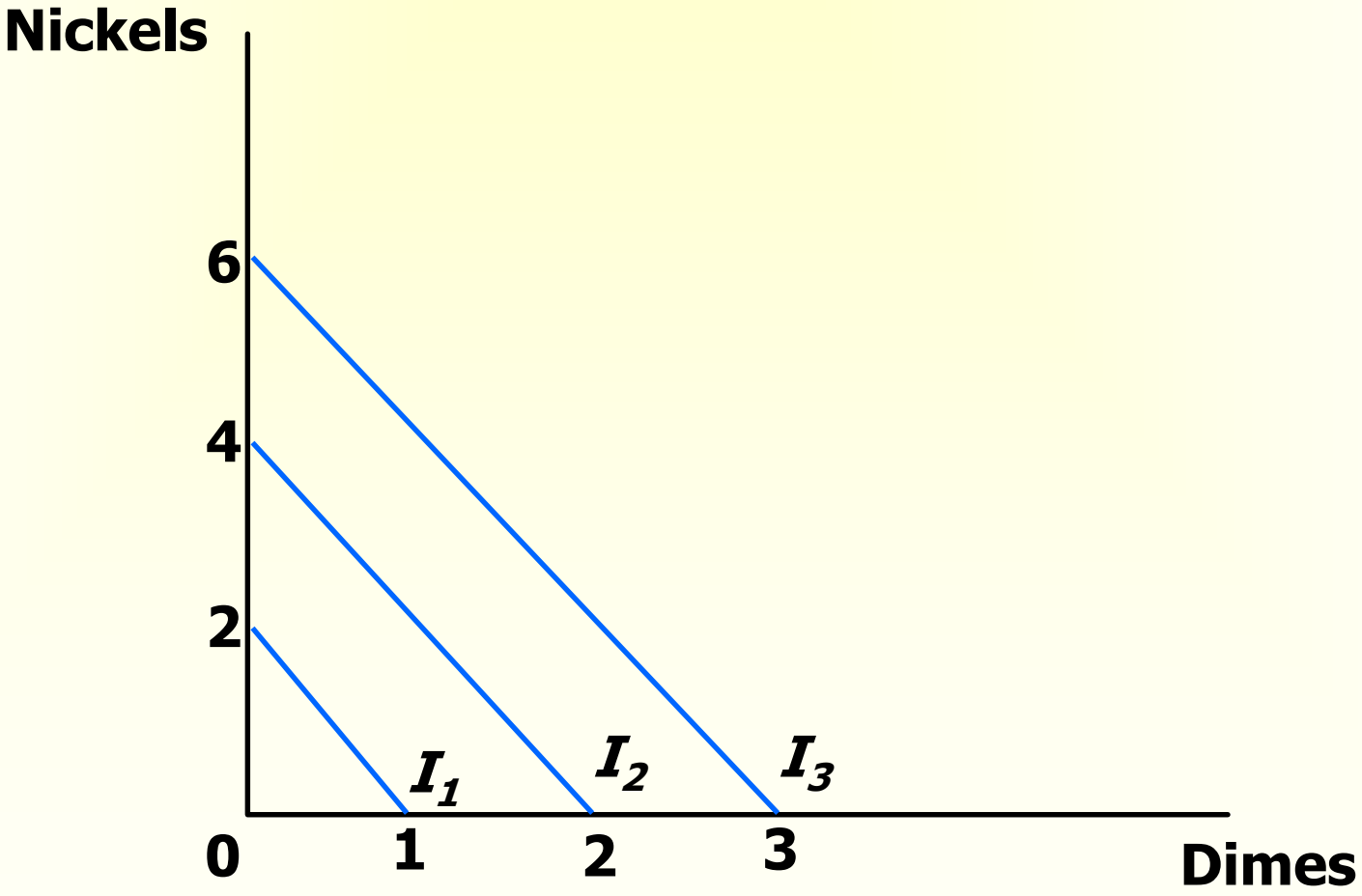
Property 3: Indifference curves do not cross.



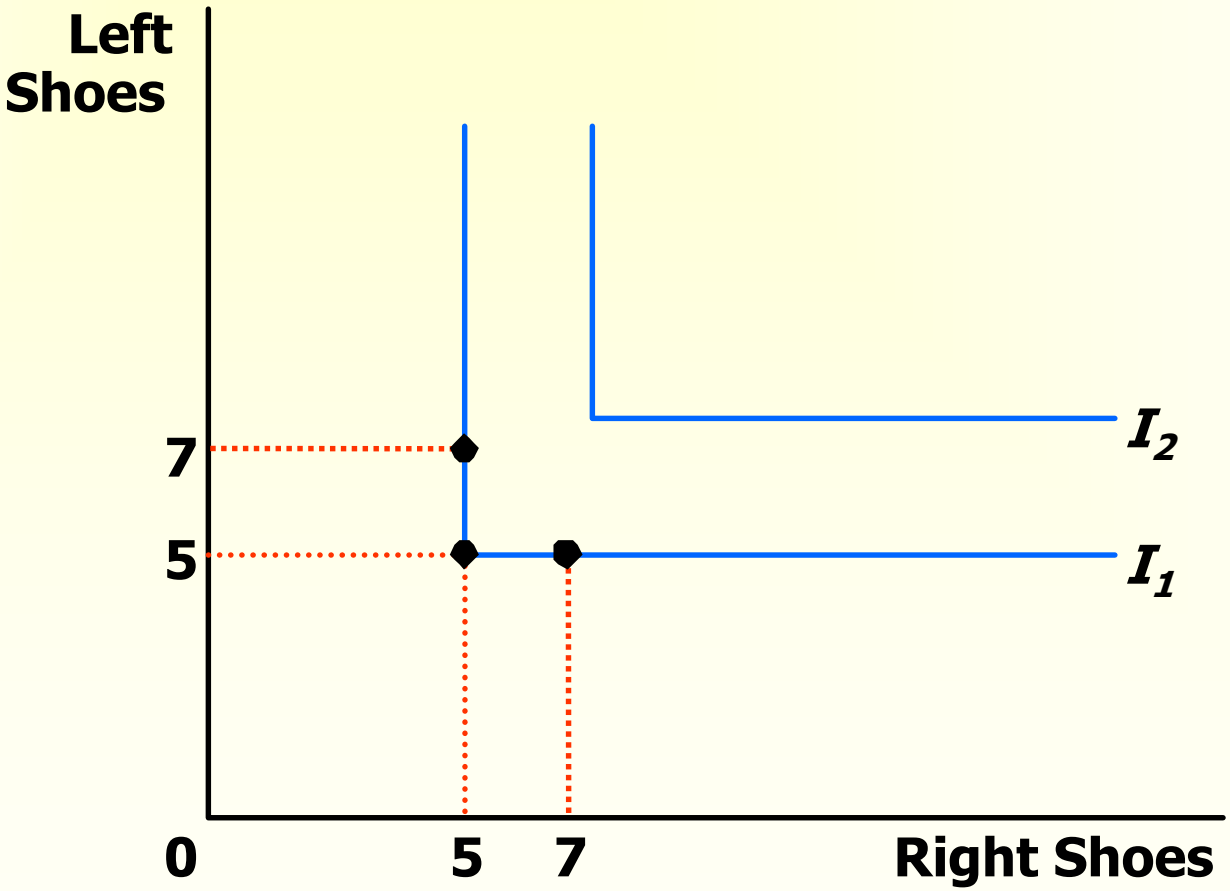
Property 4: Indifference curves are bowed inward.



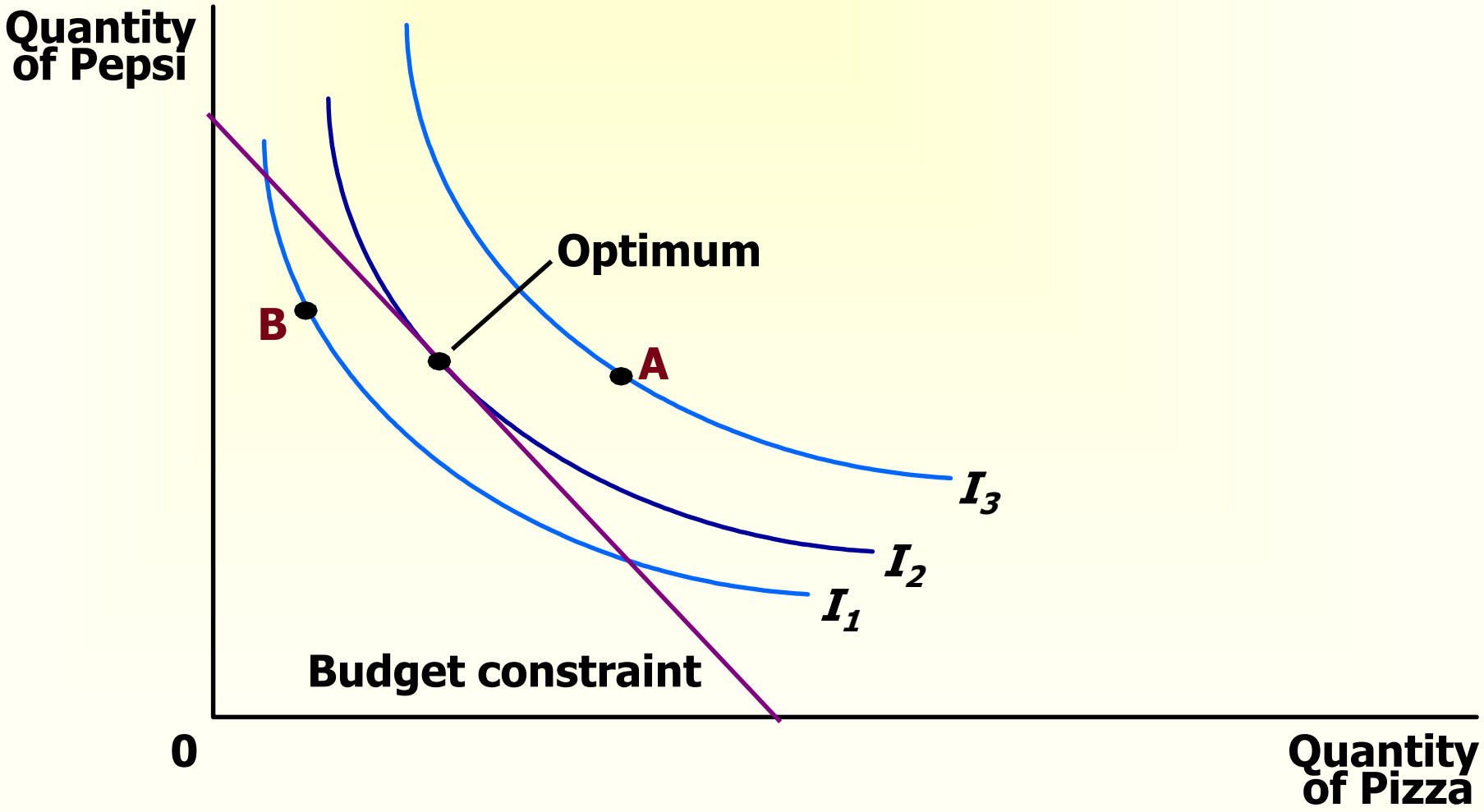
Perfect Substitutes



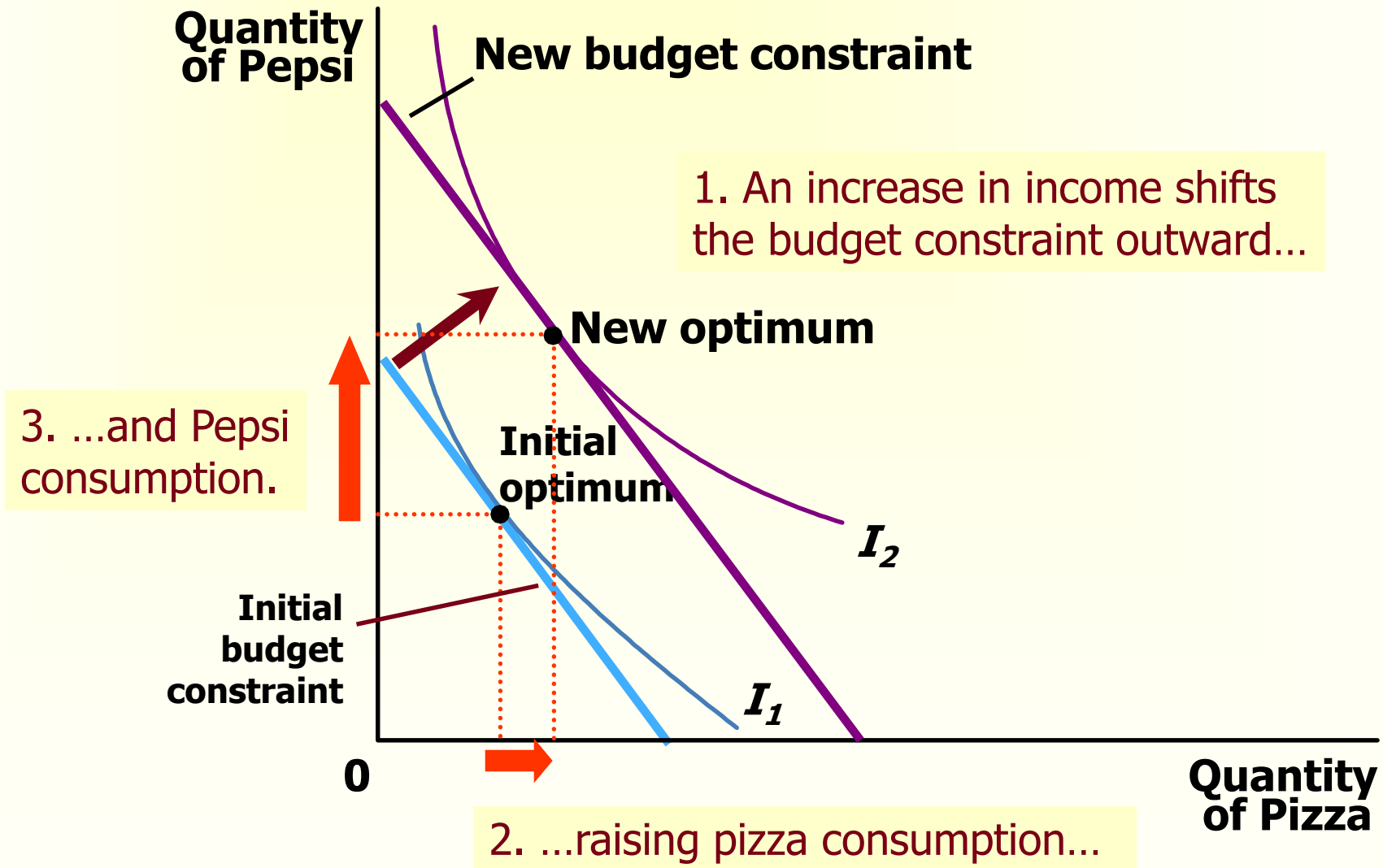
Perfect Complements



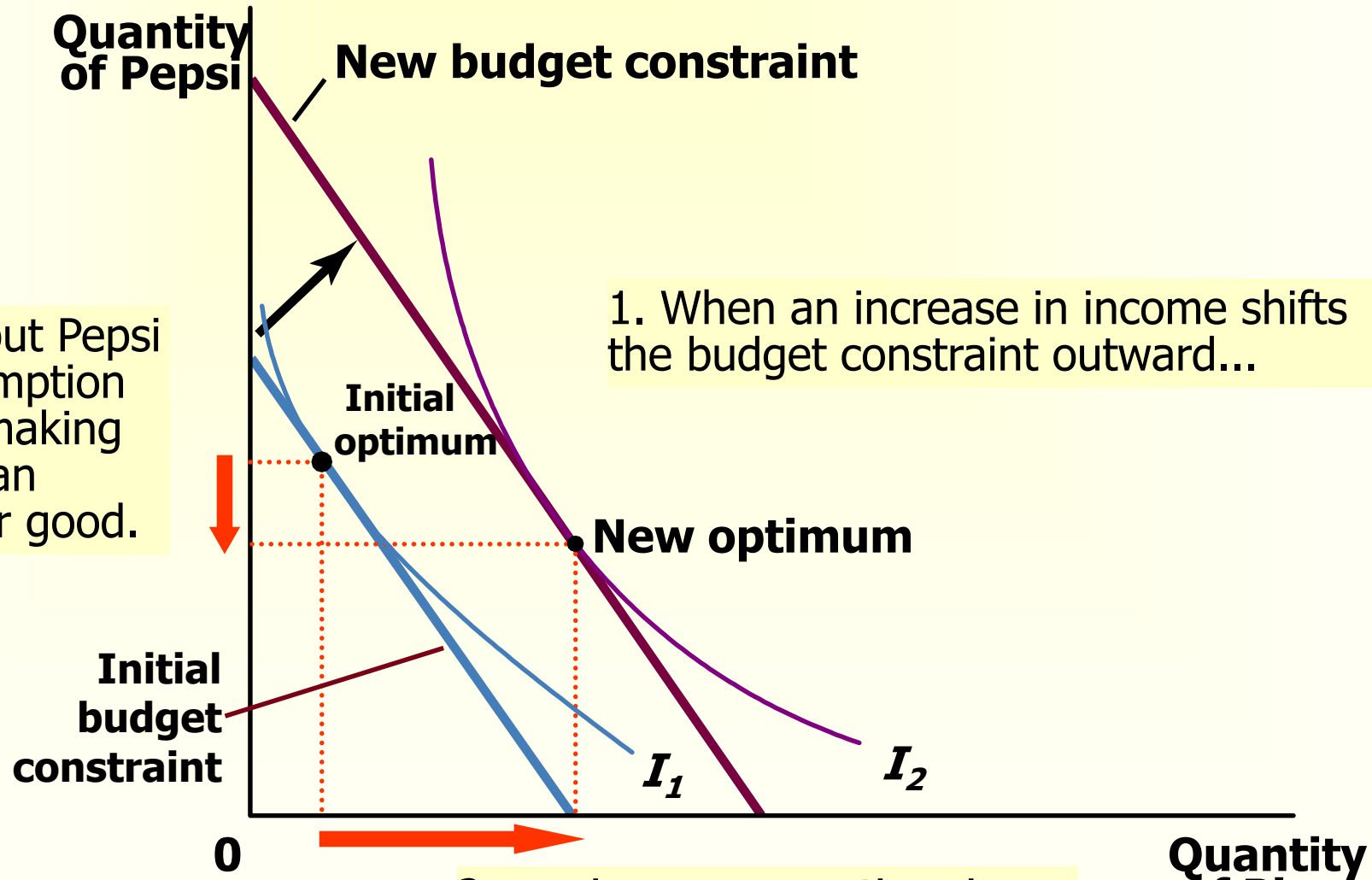
The Consumer's Optimum...



An Increase in Income...



An Inferior Good...

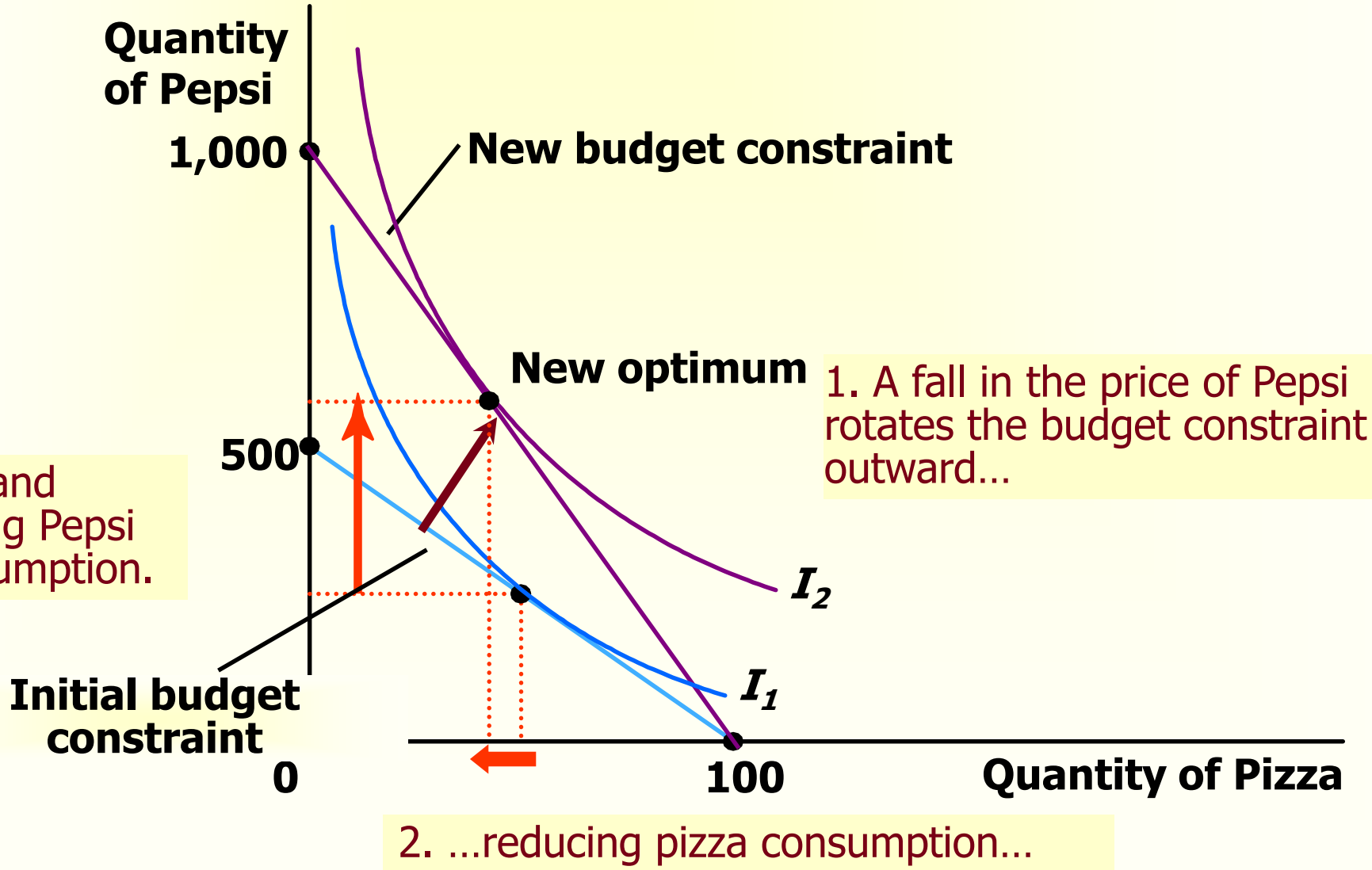


1. When an increase in income shifts the budget constraint outward...

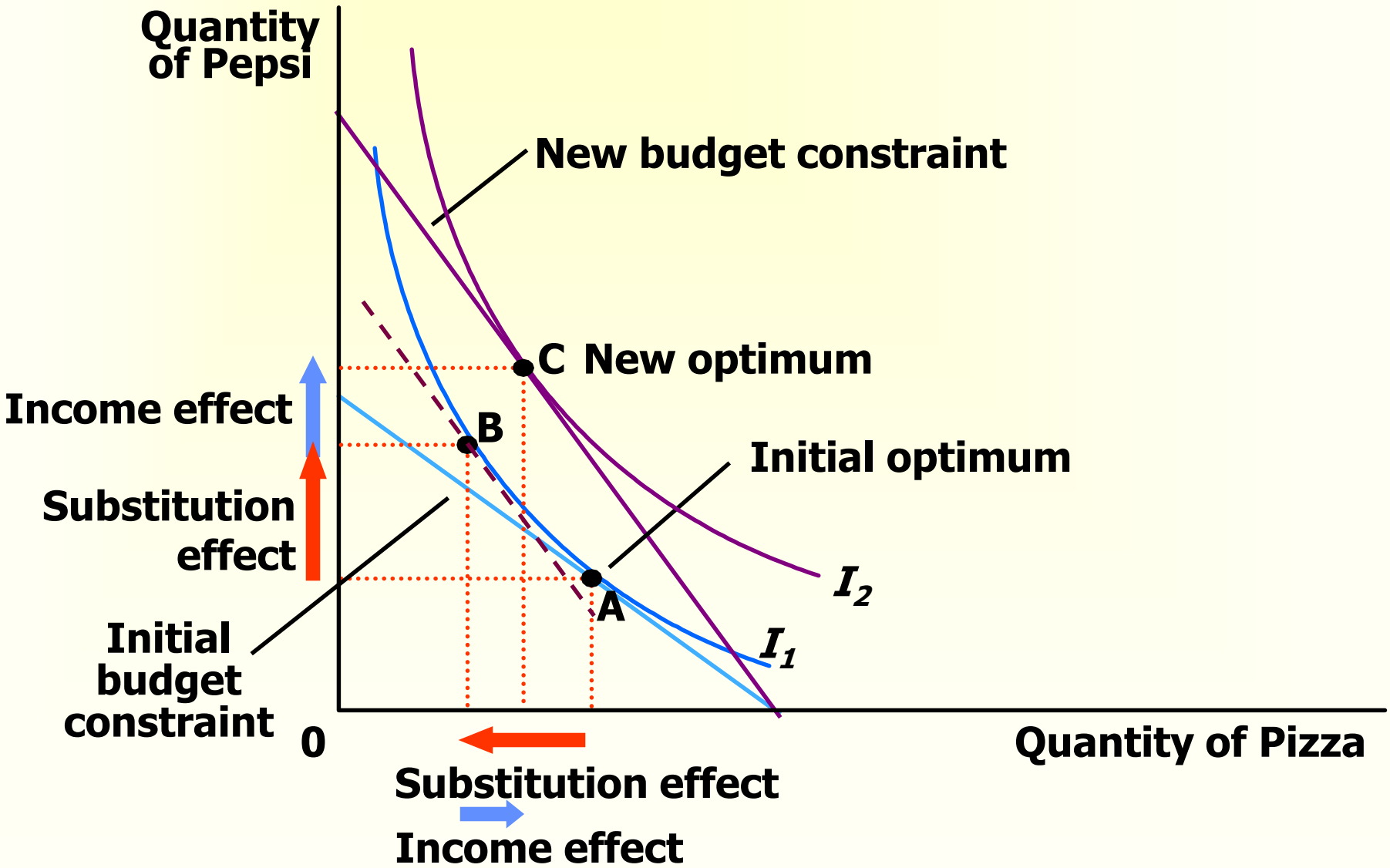
2. ... pizza consumption rises, making pizza a normal good...

3. ... but Pepsi consumption falls, making Pepsi an inferior good.

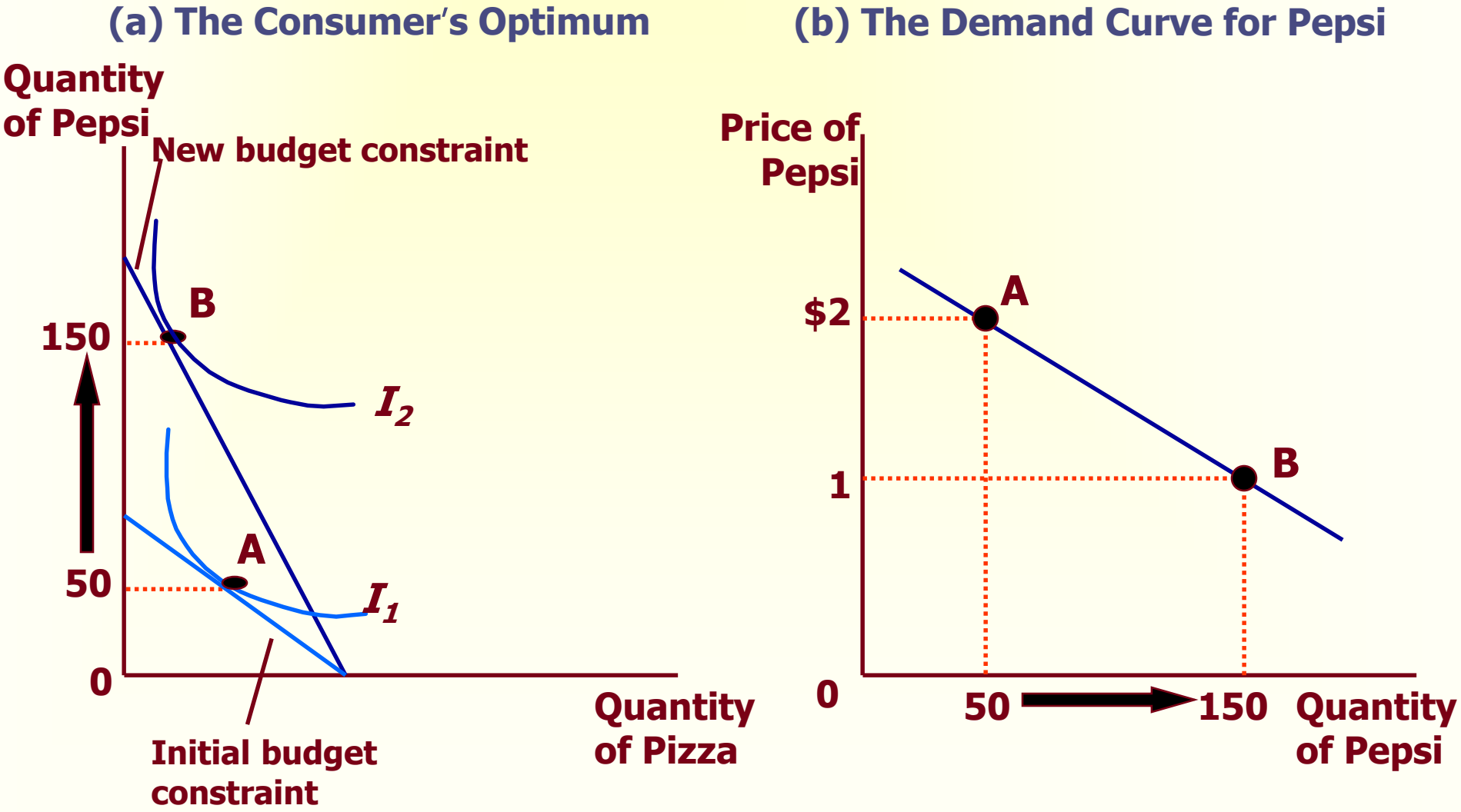
A Change in Price...



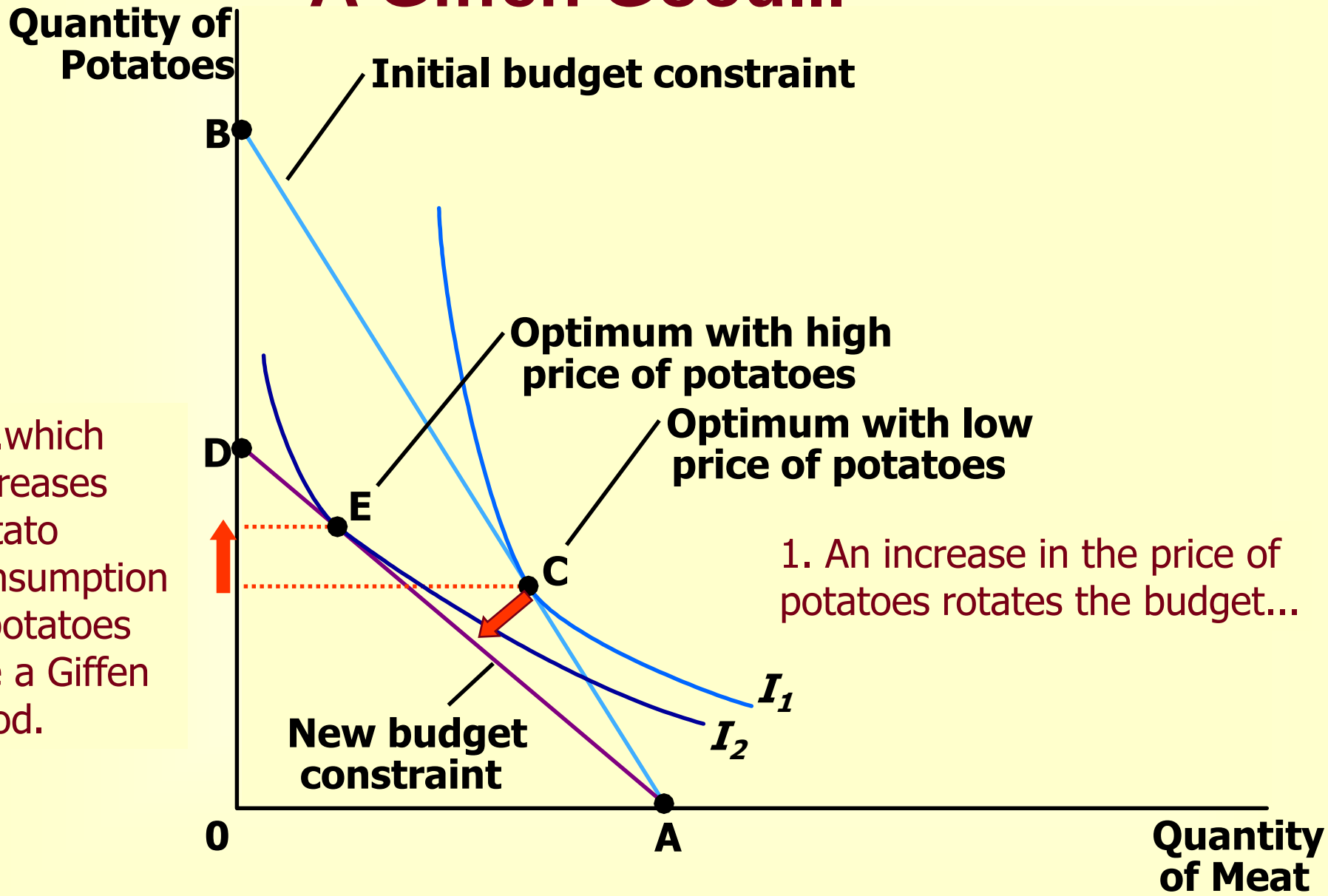
Income and Substitution Effects...



Deriving the Demand Curve...



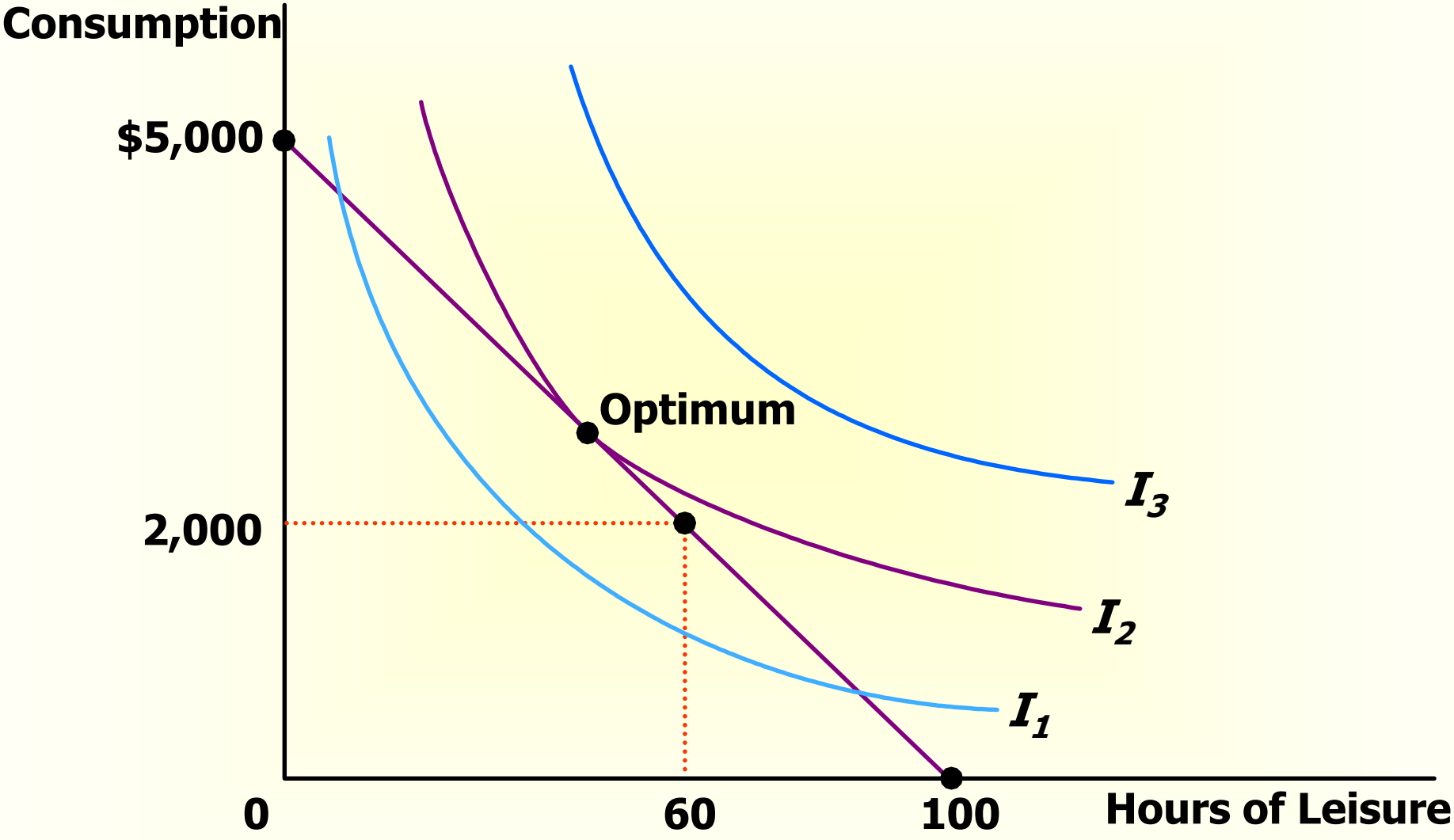
A Giffen Good...



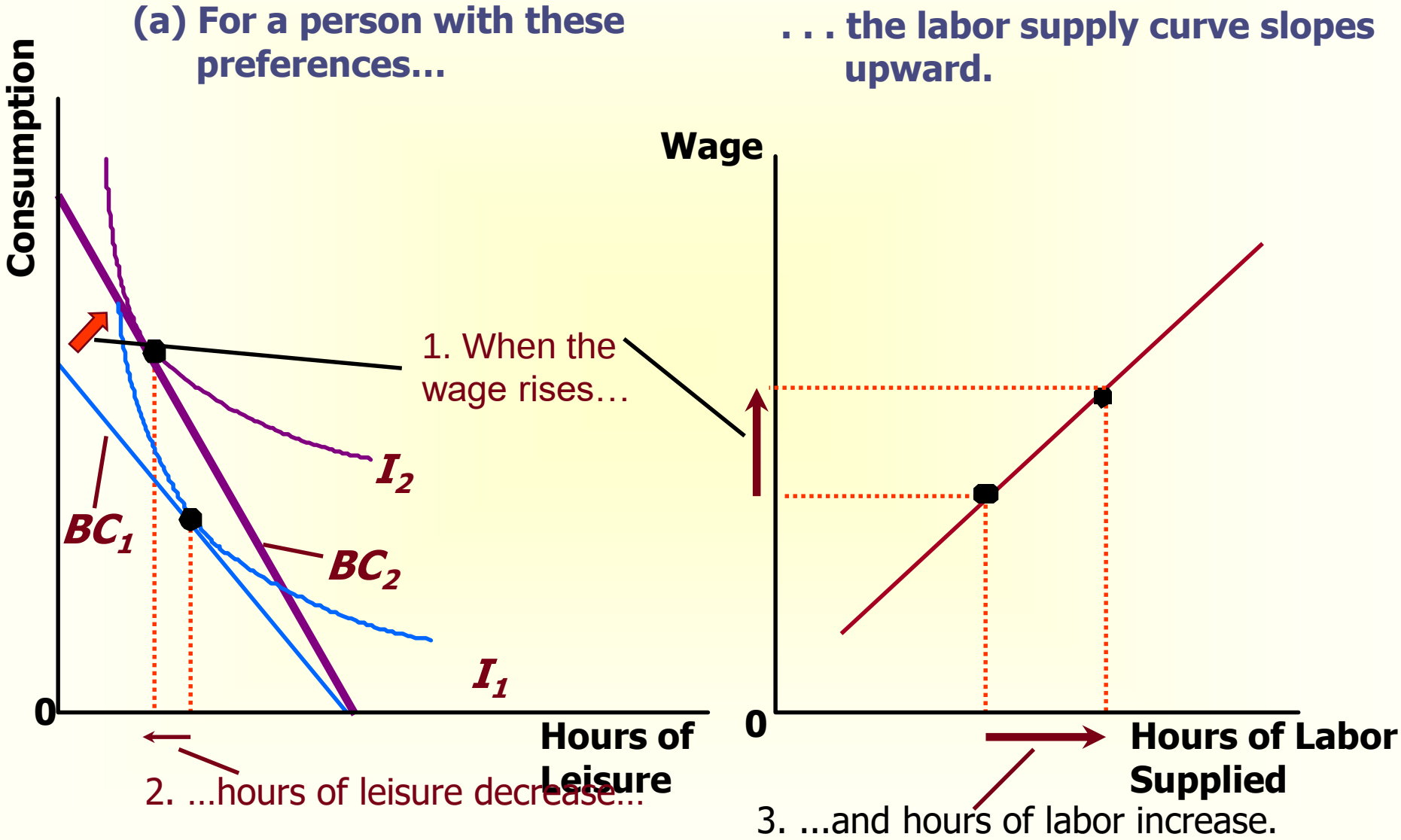
2...which increases potato consumption if potatoes are a Giffen good.

1. An increase in the price of potatoes rotates the budget...

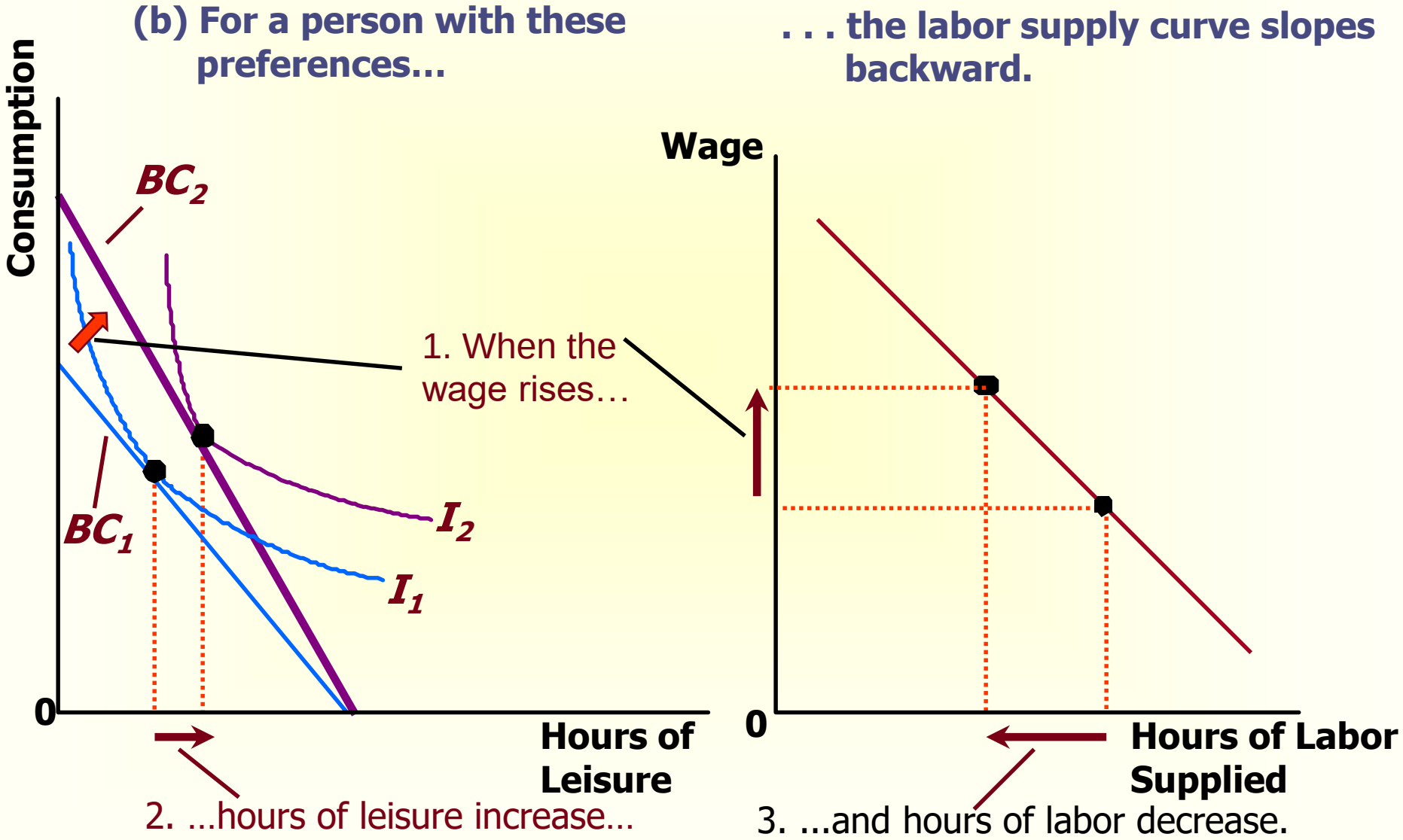
The Work-Leisure Decision...



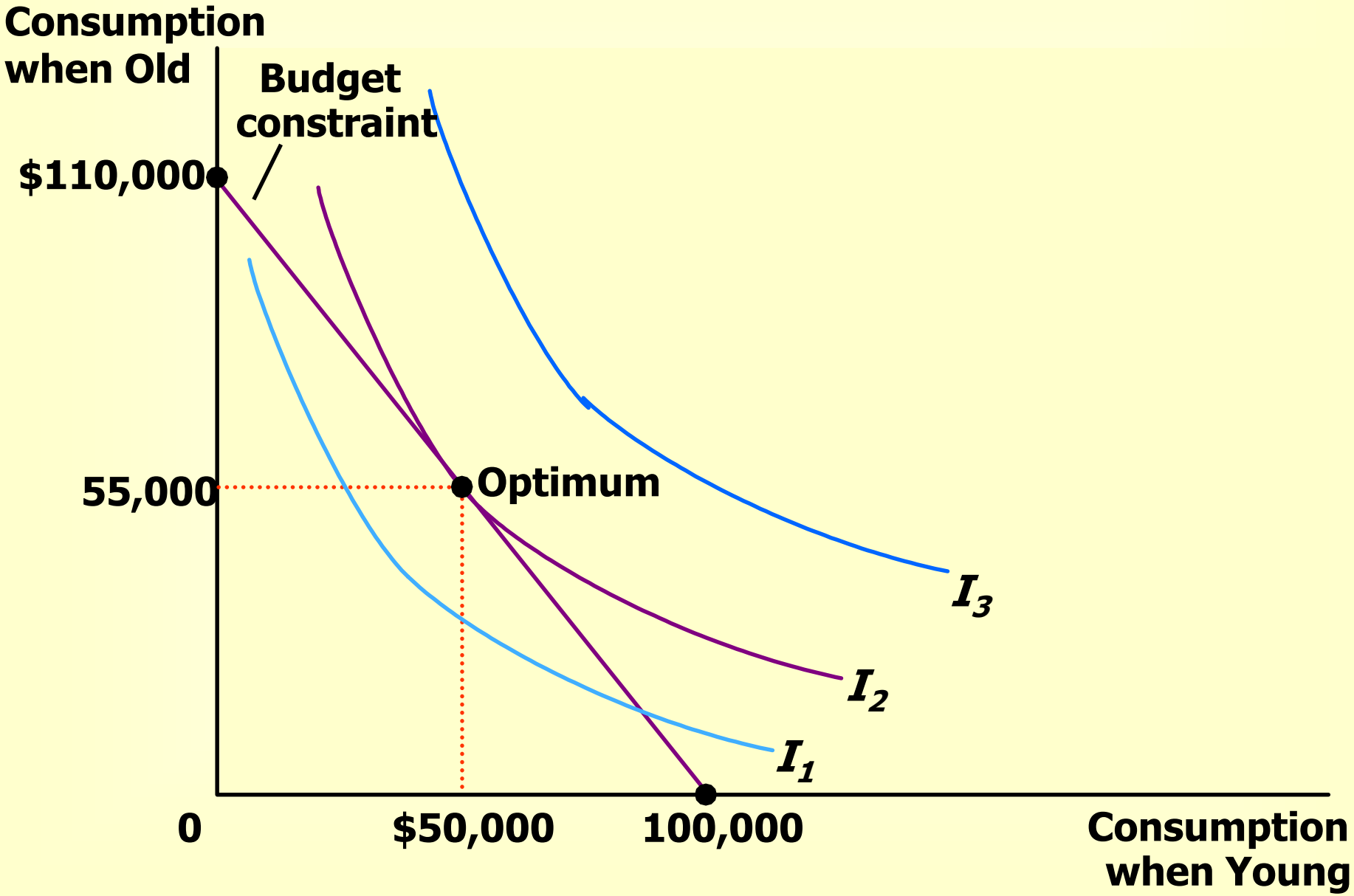
An Increase in the Wage...



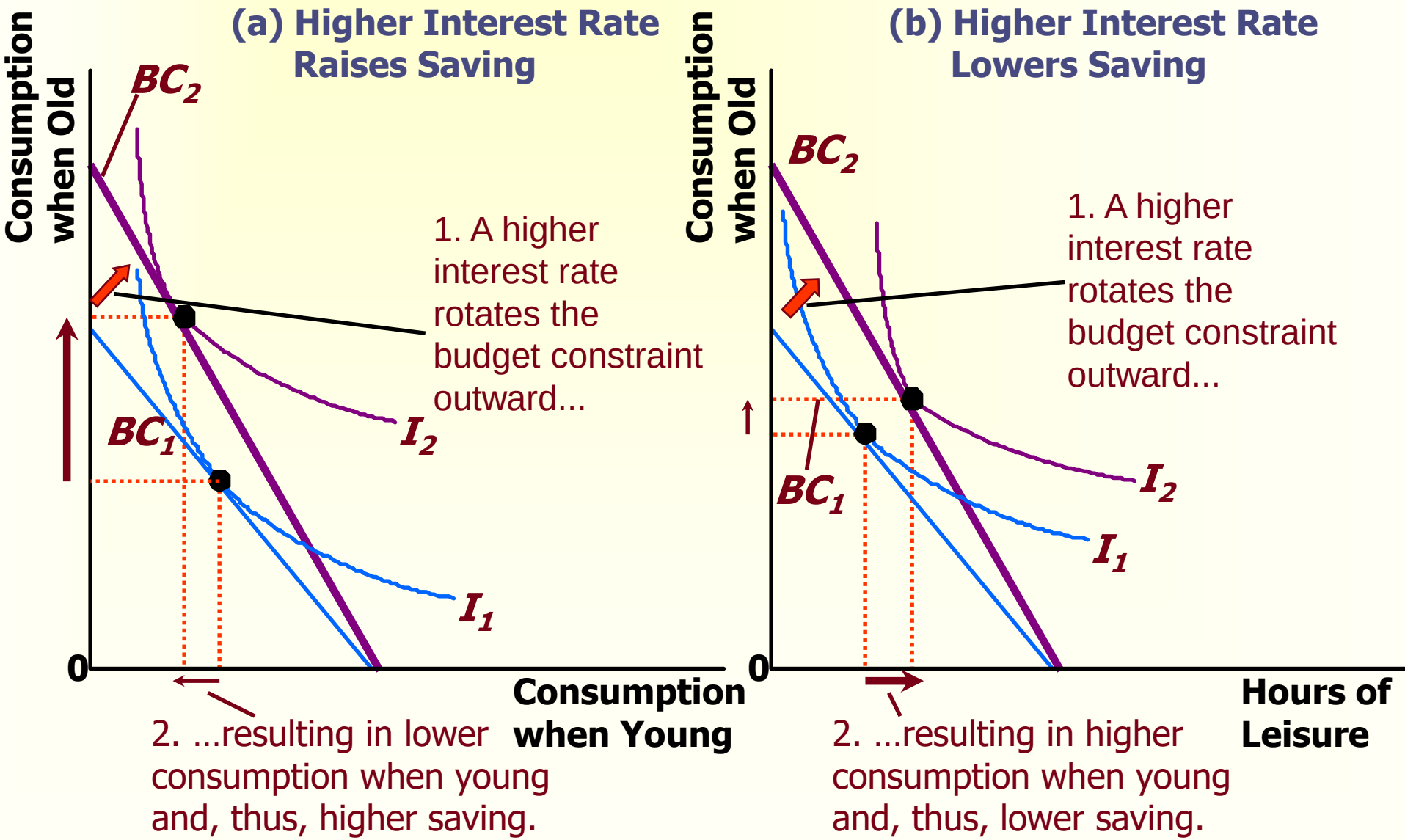
An Increase in the Wage...



The Consumption-Saving Decision...

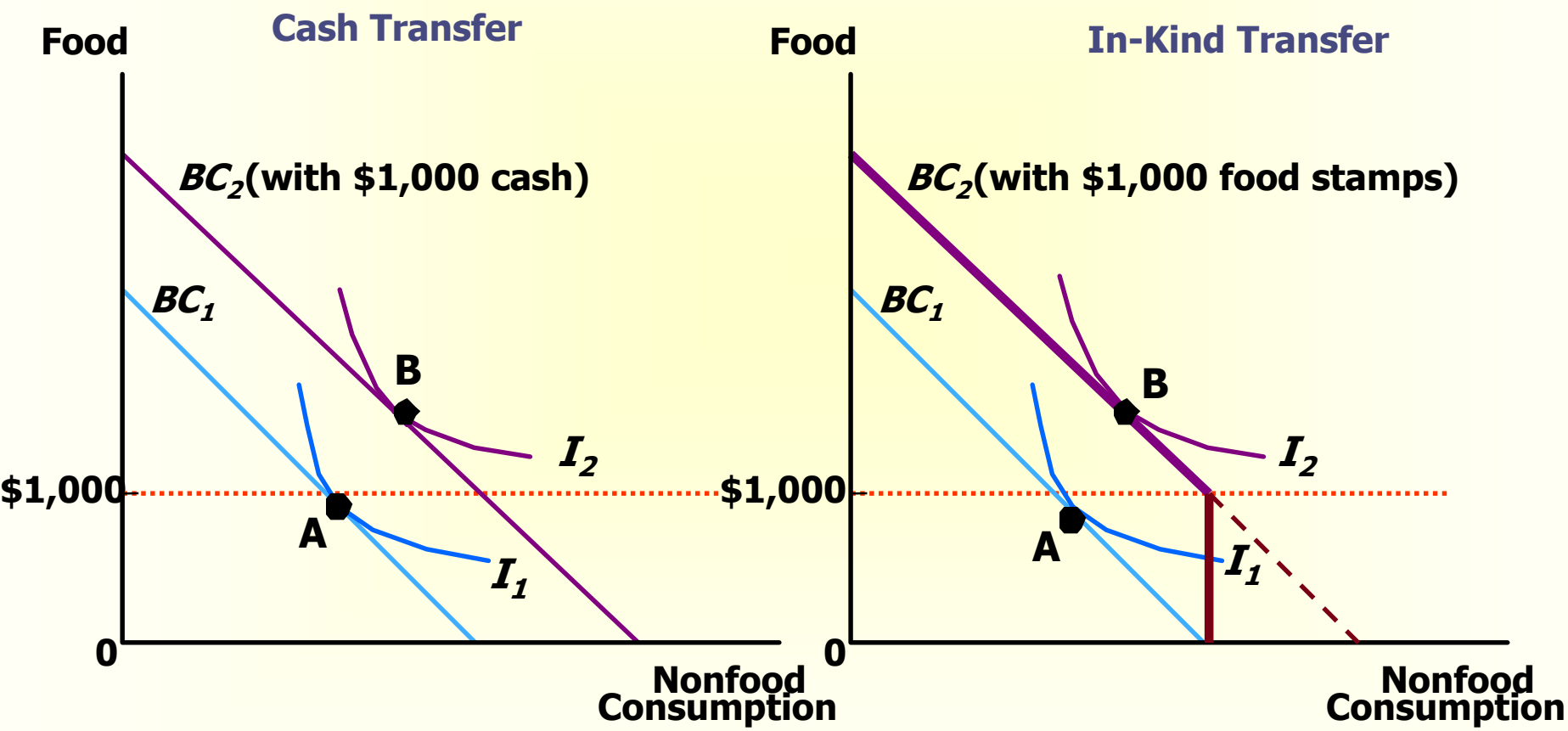


An Increase in the Interest Rate...



Cash versus In-Kind Transfers...

(a) The Constraint Is Not Binding



Cash versus In-Kind Transfers...

(b) The Constraint Is Binding