

MGM 112

Introduction to Economics

Prepared by Dr. Maryem ZORGUI



Lecture 4 Theory of Consumer Choice



جامعة الجميع الذكية
EVERYONE'S SMART UNIVERSITY

Syllabus

**I- The Budget
Constraint**

**II- Mapping
Preferences with
Indifference Curves**

**III- Impact of
Income on
Consumer Choices**

**IV- Impact of Price
on Consumer
Choices**

Session Outline

I- Introducing the Budget Constraint

I-1- Trade-offs

I-2- Budget Curves

I-3- Indifference Curves

II- Mapping Preferences with Indifference Curves

II-1- The indifference curves

II-2- Implications of Indifference

Maps

III- Impact of Income on Consumer Choices

III-1- Income from a Consumer Theory Perspective

III-2- Effects of Income on Different Goods

IV- Impact of Price on Consumer Choices

IV-1- Deriving Overall Demand

IV-2- Price Elasticity

I- Introducing the Budget Constraint

I-1- Trade-offs

I-2- Budget Curves

I-3-Indifference Curves

I-1-Trade-offs

- To expand upon this definition further, the business concept of opportunity cost via trade-offs is a central building block in understanding budget constraints.
- An opportunity cost is defined as the foregone value of the next best alternative in a given action.

I-2- The concept of budget constraint

- The idea is that a given consumer is limited in consumption relative to the amount of capital they possess.
- As a result, consumers analyze the optimal way in which to leverage their purchasing power to maximize their utility and minimize opportunity costs.
- This is achieved through using **budget constraints**, which represent the plausible combinations of products and/or services a buyer is capable of purchasing with its capital on hand.

I-3- The Budget line

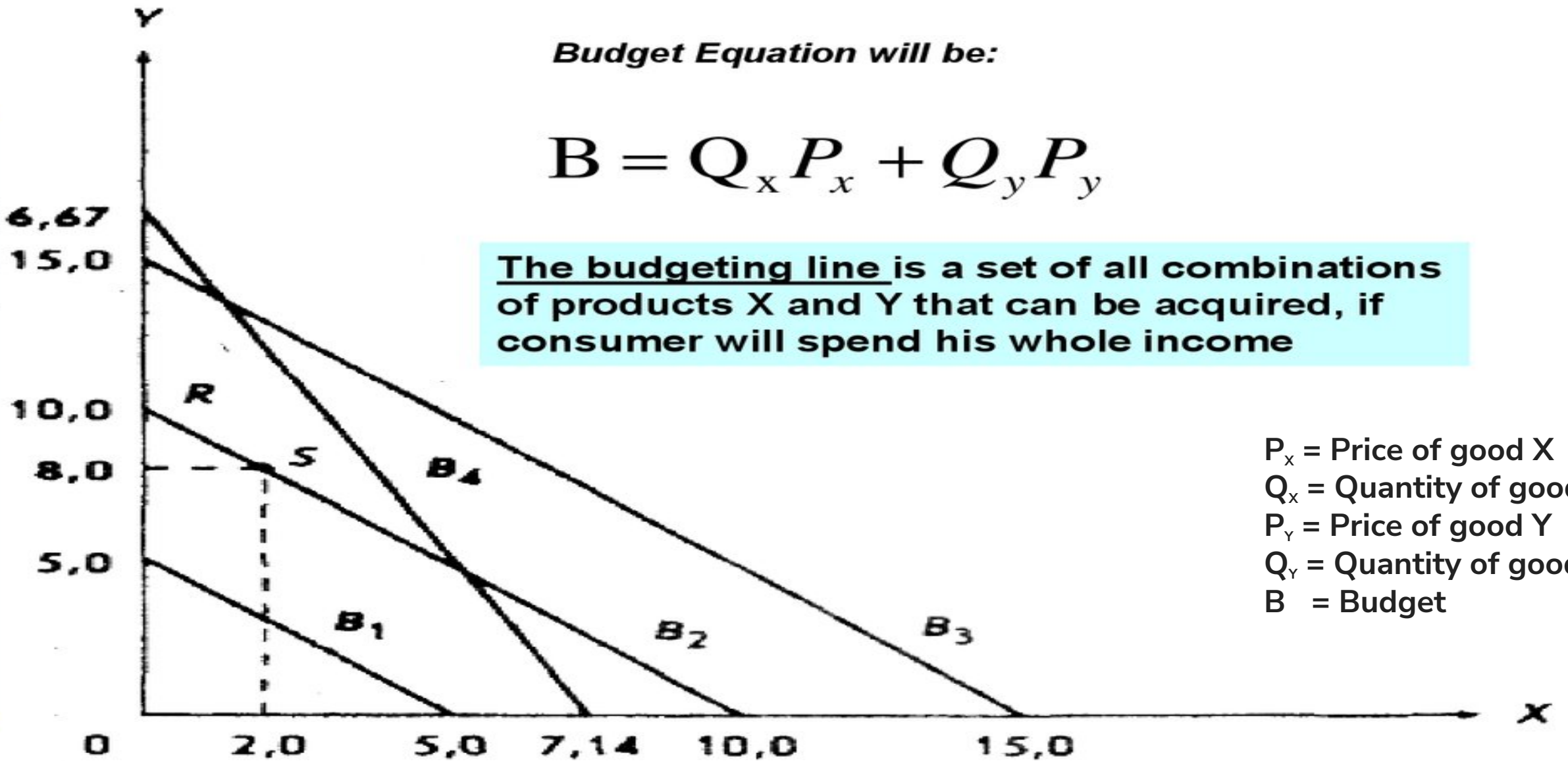
It indicates the relationship between two goods relative to opportunity costs, which defines the value of each good relative to one another.

Budget line: A line curve demonstrates the relationship between two goods relative to opportunity costs, essentially deriving the relative value of each good based on quantity and utility.

Budget Equation will be:

$$B = Q_x P_x + Q_y P_y$$

The budgeting line is a set of all combinations of products X and Y that can be acquired, if consumer will spend his whole income



P_x = Price of good X
 Q_x = Quantity of good X
 P_y = Price of good Y
 Q_y = Quantity of good Y
 B = Budget

Quantity of X, consumed for some definite period

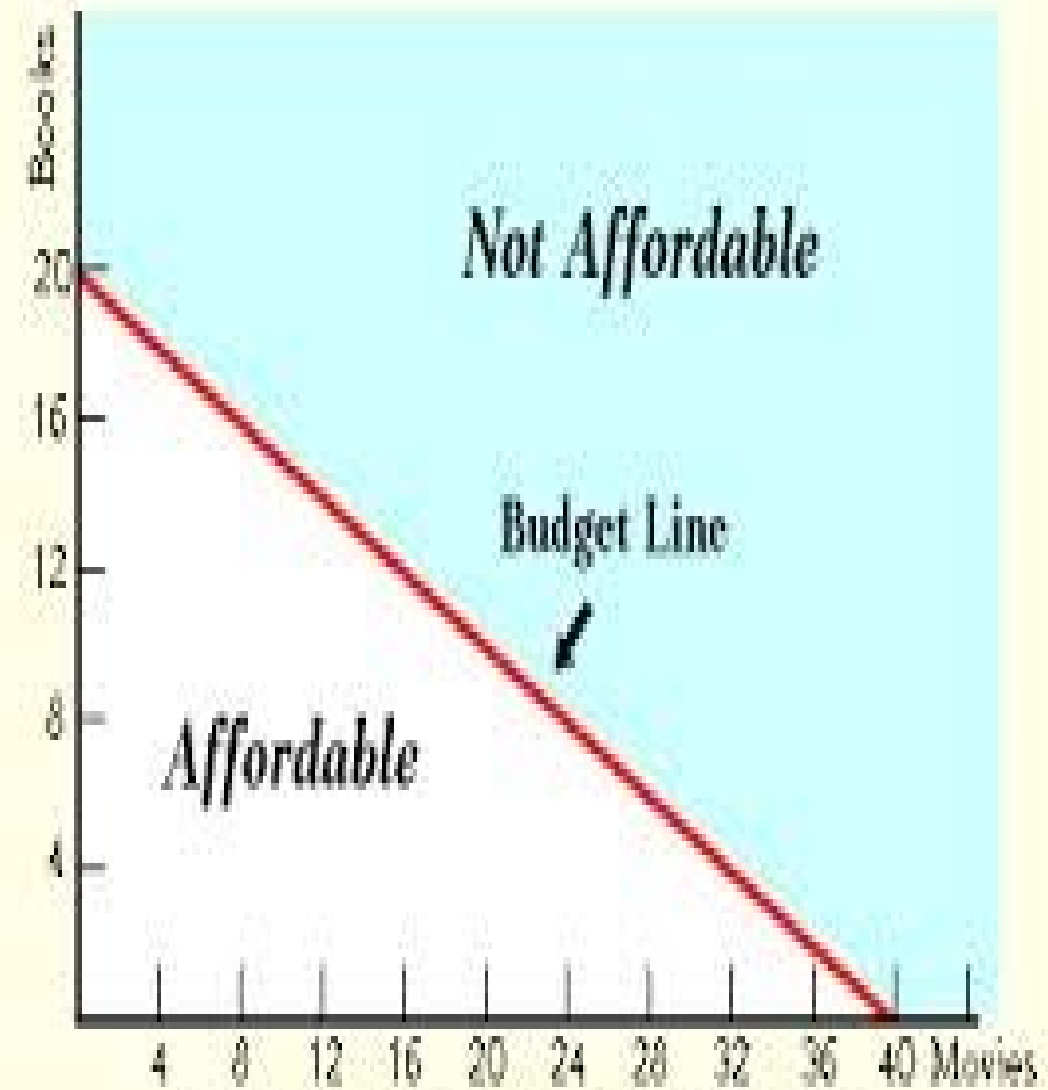
I-4- The Budget line

- **Budget Set** implies the set of all the possible combinations of two goods that the consumer can afford or buy, which his/her income, at the existing market prices. Basically, it contains all those combinations in the positive quadrant, fall under or on the budget line. It can be expressed as:

$$P_x Q_x + P_y Q_y \leq B$$

- Where,

P_x = Price of good x
 Q_x = Quantity of good x
 P_y = Price of good y
 Q_y = Quantity of good y
 B = Income



A budget line separates what is affordable from what is not affordable

Lecture

4

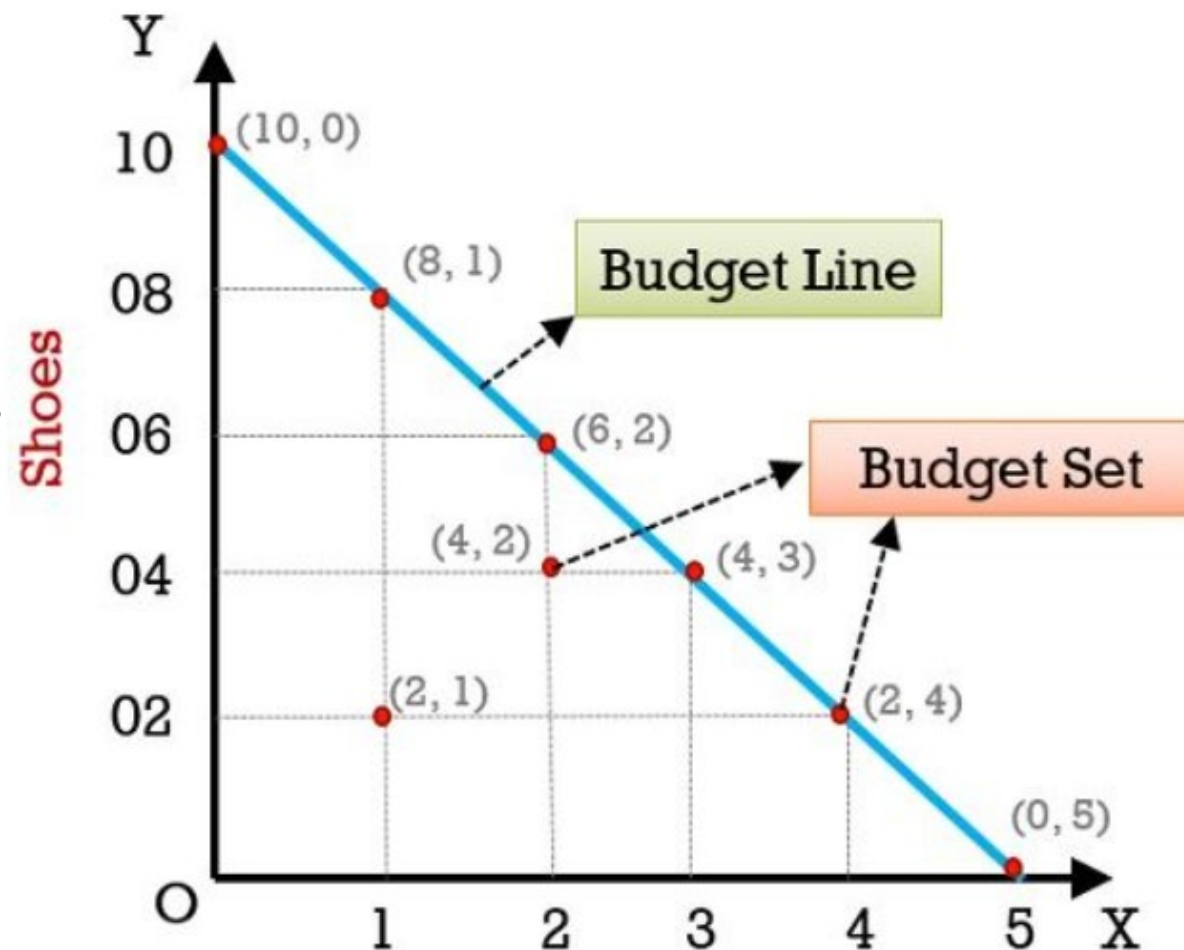
Exercise: The Budget line and The Budget Set

The table represented below highlights the bundles of clothes ($P_x = \$200$) and shoes ($P_y = \100) a consumer can buy, spending his income (budget), i.e. \$1000.

Consumption Possibility Schedule

Shoes	Clothes
0	5
2	4
4	3
6	2
8	1
10	0

Now let's take a look at the graph representing Budget Line and Budget Set:

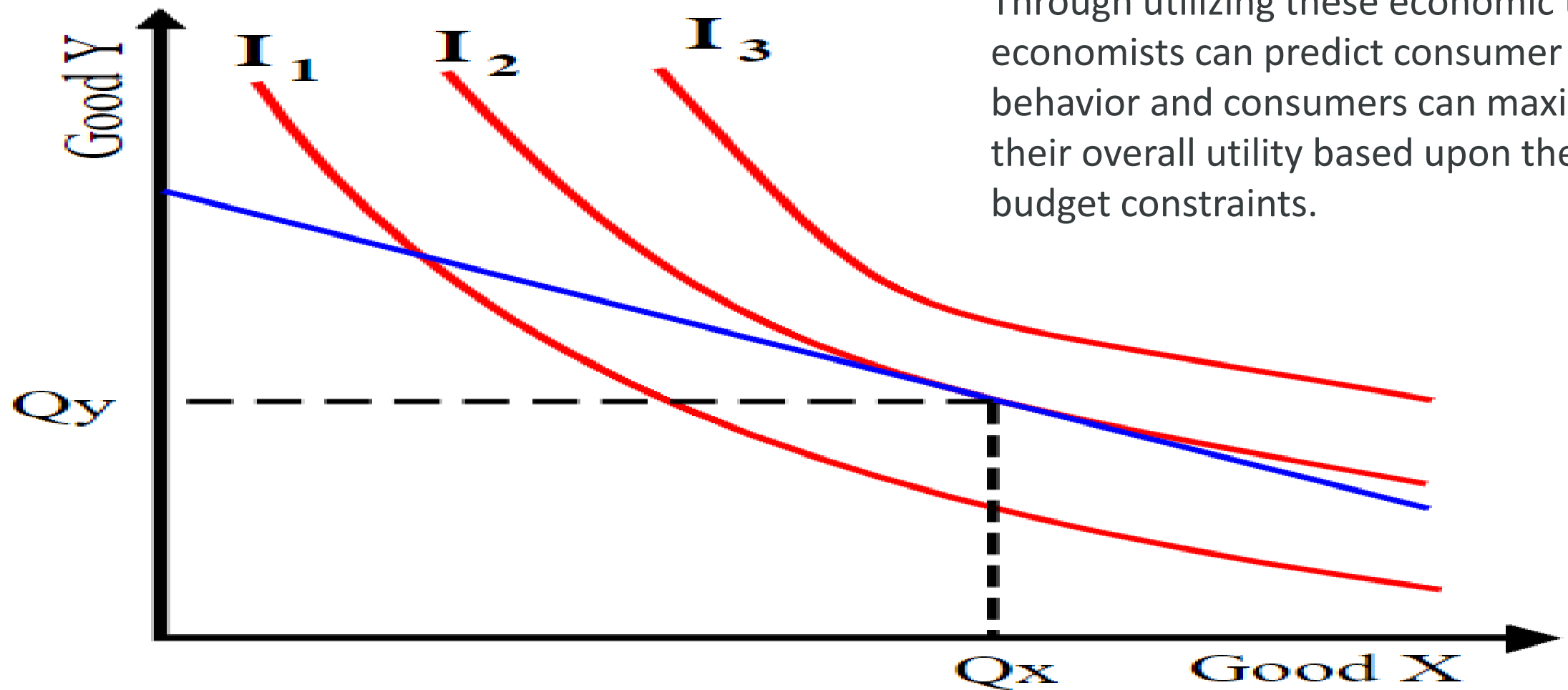


Conclusion

Basically, Budget Line shows the price ratio between two goods, i.e. X and Y or the rate at which one commodity can be exchanged for the other, where the prices of the two goods are given. Budget line depends on the consumer's income and price of the commodities.

I-4- The Indifference Curves

- **Indifference curves:** Indifference curves underline the way in which a given consumer interprets the value of each good relative to one another, demonstrating how much of 'good xx' is equivalent in utility to a certain quantity of 'good yy' (and vice versa).
- Any point along the indifference curve will represent indifference to the consumer, or simply put equivalent preference for one combination of goods or the other. In the figure it is clear that the budget curve has been included in conjunction with the indifference curves, which allows insight as to the ideal actual quantity of each good is optimal for this specific consumer.



Through utilizing these economic tools, economists can predict consumer behavior and consumers can maximize their overall utility based upon their budget constraints.

Indifference Curves: Indifference curves are designed to represent an equal perception of overall value in a given basket of goods relative to a specific consumer. That is to say that each point along the curve is considered by the consumer of equivalent value despite alterations in the quantity of each good, as these trade-offs are considered of equal value and thus indifferent.

II- Mapping Preferences with Indifference Curves

II-1- The indifference Maps

II-2- Implications of Indifference Maps

II-1- The Indifference Maps

- Economists mapping consumer preferences use indifference curves to illustrate **series of goods** that represent **equivalent utility**.
- A critical input to understanding consumer purchasing behaviors and the general demand present in a given market or economy for specific goods and services is the identification of consumer preferences. Consumer preference varies substantially from individual to individual and market to market, requiring comprehensive economic observation of consumer choices and behaviors

II- Mapping Preferences with Indifference Curves

-2-

These indifference curves, when mapped graphically alongside other curves, is called an **indifference map** that allow us to compare more than two products/services, each specific standard indifference map will be about creating a benchmark between two.

For example one could compare relatively similar goods/services (i.e. apples vs. oranges) or dramatically different goods/services (i.e. university training vs. automobile purchasing). These two items being compared represent the x and y axis of a indifference map.

A consumer will always prefer to be on the indifference curve farthest from the origin.

II- Mapping Preferences with Indifference Curves

-3-

II-2-Implications of Indifference Maps

- After constructing the required inputs to generate a comprehensive indifference map, an economist can derive conclusions based upon the properties of the illustration.
- In framing these implications it is useful to identify the two potential extremes that can be outlined via with indifference curves.

II- Mapping Preferences with Indifference Curves

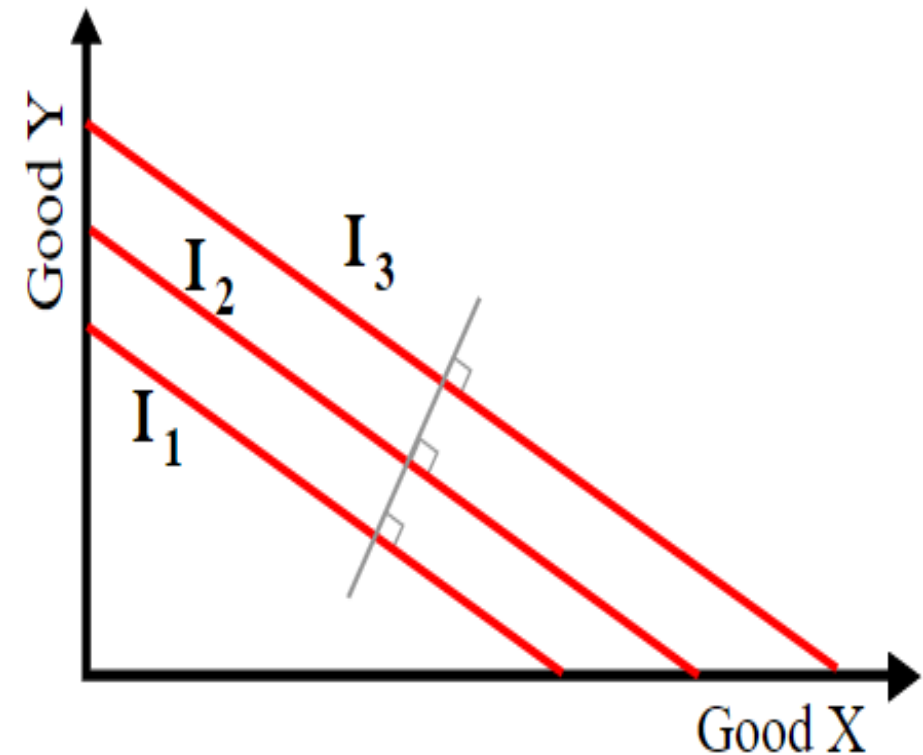
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Combining an understanding of these inputs with the extremes demonstrated an indifference map, economists are able to draw meaningful conclusions regarding consumer choices and purchasing behaviors in the context of two goods.

The comparison between the goods demonstrates the relative utility one has compared to another, and the way in which consumers will act when posed with a decision between various products and services.

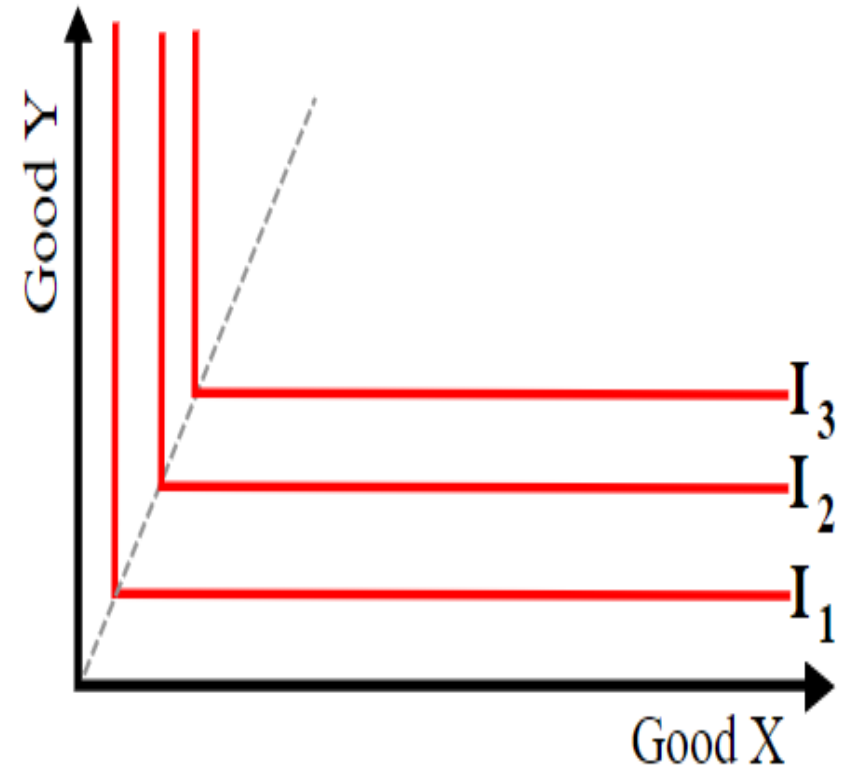
Perfect Substitutes:

- A perfect substitute is a situation where two goods are viewed as identical.
- When products are perfect substitutes, indifference curves will look the graph. These lines are essentially perfectly straight, and that demonstrates that the relative utility of 'Good X' compared to that of 'Good Y' is equivalent regardless of the amount in question



Perfect Substitute Indifference Curve: In this particular series of indifference curves it is clear that 'Good X' and 'Good Y' are perfect substitutes for one another. That is to say that the utility of one is identical to the utility of the other across all quantities represented on the map.

Perfect Complements: The opposite of a perfect substitute is a perfect complement, which is illustrated graphically through curves with perfect right angles at the center. These right angles, and the subsequent straight horizontal and vertical lines, demonstrate that 'Good X' and 'Good Y' are inherently tied to one another and that the consumption of one is dependent upon the consumption of the other



Perfect Complement Indifference Curve: The perfect right angle in this series of indifference curves implies that the utility of 'Good X' and 'Good Y' are entirely interdependent. This is to say that in order to enjoy one good it is necessary to also have the other.

III-Impact of Income on Consumer Choices

III-1- Income from a Consumer Theory Perspective

III-2- Effects of Income on Different Goods

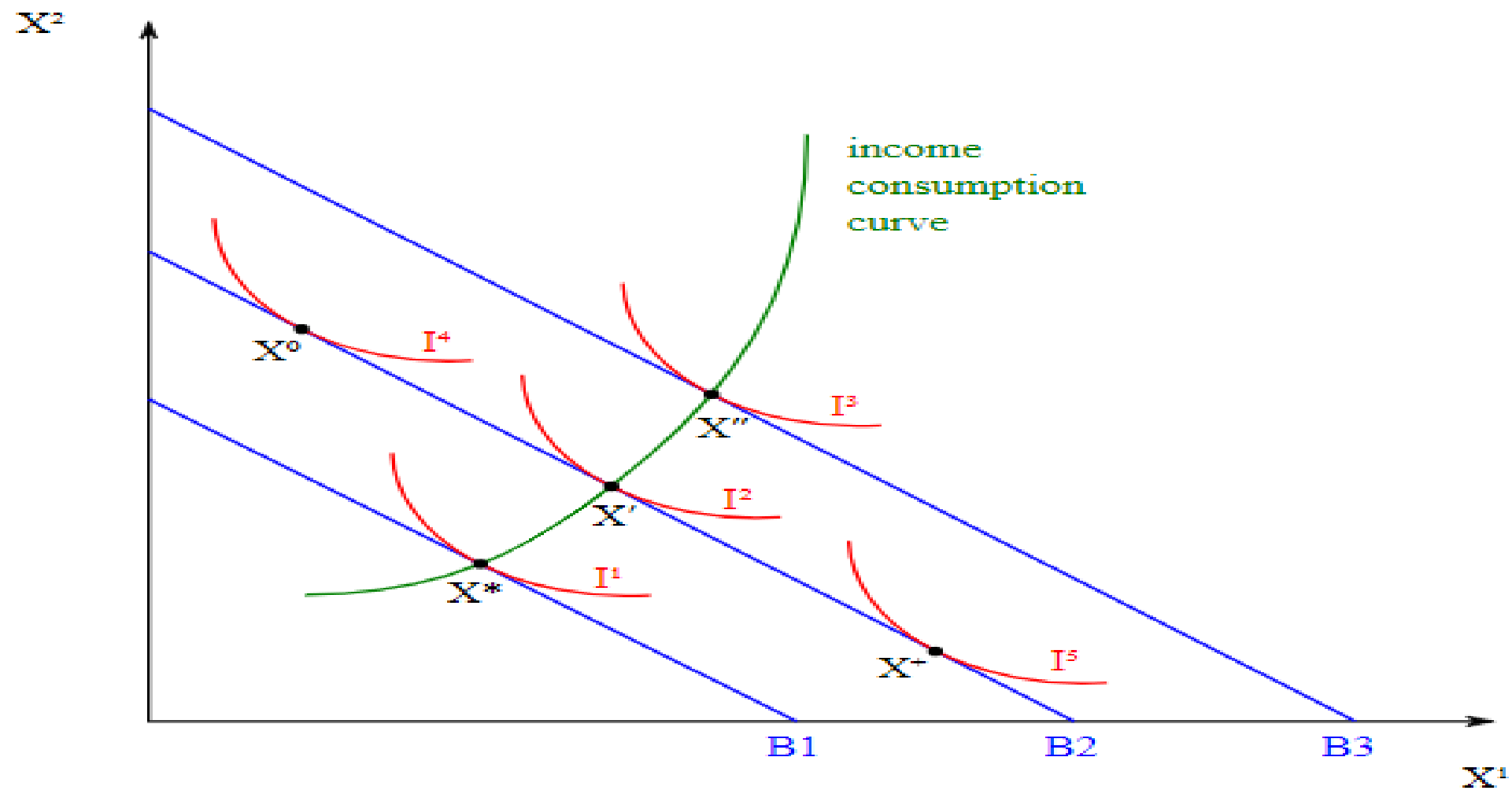
III- Impact of Income on Consumer Choices

-1-

- Consumer choices are predicated on various economic circumstances, and recognizing the relationship between these circumstances and an individual's purchasing behavior allows economists to recognize and predict consumer choice trends.
- One of the central considerations for a consumer in deciding upon their purchasing behaviors is their overall income or wage levels, and thus their budgetary constraints. These budgetary constraints, when applied to a series of products and services, can be optimized to capture the most utility for the consumer based on their purchasing power.

III-1- Income from a Consumer Theory Perspective

- The simplest way to demonstrate the effects of income on overall consumer choice, from the viewpoint of Consumer Theory, is via an income-consumption curve for a normal good.
- The basic premise behind this curve is that the varying income levels (as illustrated by the green income line curving upwards) will determine different quantities and balanced baskets along the provided indifference curves for the two goods being compared in this graph.
- These differences in quantity reflect the increase or decrease in a given individual's purchasing power, thus the income effect could be summarized as the increase in relative utility captured by a consumer with more monetary power.



Income-Consumption Curve: Simply put, increases or decreases in income will alter the optimal quantity (and thus relative utility) of a given basket of goods for a specific consumer.

III- Impact of Income on Consumer Choices

-3-

- **The wealth effect** differs slightly from the income effect:

The wealth effect reflects changes in consumer choice based on *perceived wealth*, not actual income.

For example, if a person owns a stock that appreciates in price, they perceive that they are wealthier and may spend more, even though they have not realized those gains so their income has not increased.

III-2- Effects of Income on Different Goods

- Income effects on consumer choice grow more complex as the type of good changes, as different product and services demonstrate different properties relative to both other products/services and a consumers preferences and utility.
- As a result, it is useful to outline the differences in income effects on normal, inferior, complementary and substitute goods:

III- Impact of Income on Consumer Choices

Normal: A normal good is a good with incremental increases or decreases in utility as quantity changes, demonstrating a predictable and simple linear relationship as income increases or decreases. demonstrates a graphical representation of the effects of income changes upon preference map.

Inferior: Inferior goods, or goods that are less preferable, will demonstrate inverse relationships with income compared to normal goods.

- That is to say that an increase in income will not necessarily result in an increase in quantity for the inferior good, as the consumer derives minimal utility in purchasing the inferior good compared to other goods.
- Inferior goods are often sacrificed as income rises and consumers gain more choice/options.
- This can be represented in.

III- Impact of Income on Consumer Choices

-6-

Complementary: Complementary goods are goods that are interdependent in consumption, or essentially goods that require simultaneous consumption by the consumer. An example of this would be like purchasing an automobile and car insurance, the consumption of one requires the consumption of the other. As income increases, these will increase relative to one another (as a ratio). demonstrates this concept in graphical form

Substitutes: Perfect substitutes are essentially interchangeable goods, where the consumption of one compared to another has no meaningful impact on the consumer's utility derived.

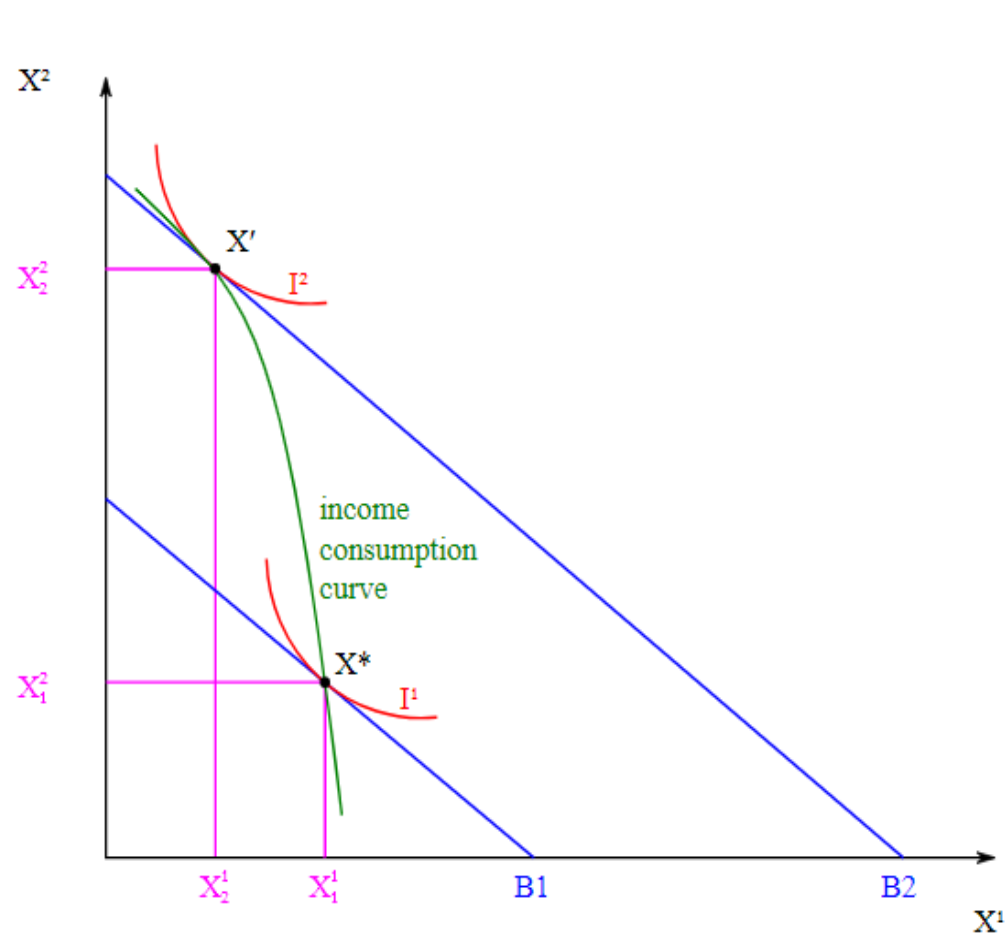
Substitutes are goods that a consumer cannot differentiate between in terms of the need being filled and the satisfaction obtained.

Income increases will thus affect the consumption of these goods interchangeably, resulting in increase in the quantity of either or both.

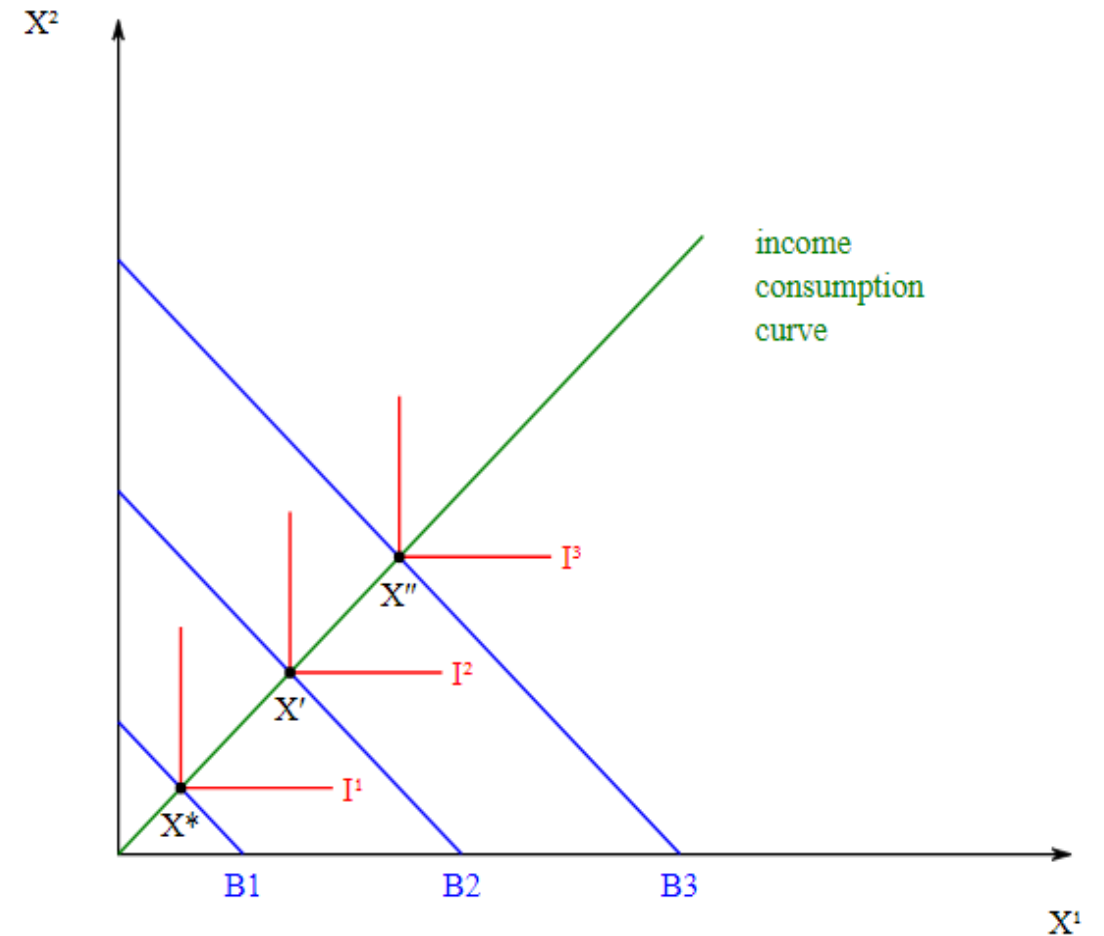
III- Impact of Income on Consumer Choices

-7-

- In merging Consumer Theory and consumer choices with income level, the primary takeaway is that an increase in income will increase the prospective utility that consumer can acquire in the market.
- Understanding how this applies in a general fashion, alongside the specific circumstances dictating specific types of goods, it becomes fairly straight-forward to predict consumer purchasing behaviors at differing income levels.



Income Levels and Inferior Goods: This graph demonstrates the inverse relationship between income and the consumption of inferior goods. As income rises, the quantity consumed of 'X1' decreases. This illustrates increased variance in consumer choice as income rises.



Income Effect on Complementary Goods: In this graphical depiction of income increases, the consumption of these two goods are complementary and thus interdependent.

IV- Impact of Price on Consumer Choices

IV-1- Deriving Overall Demand

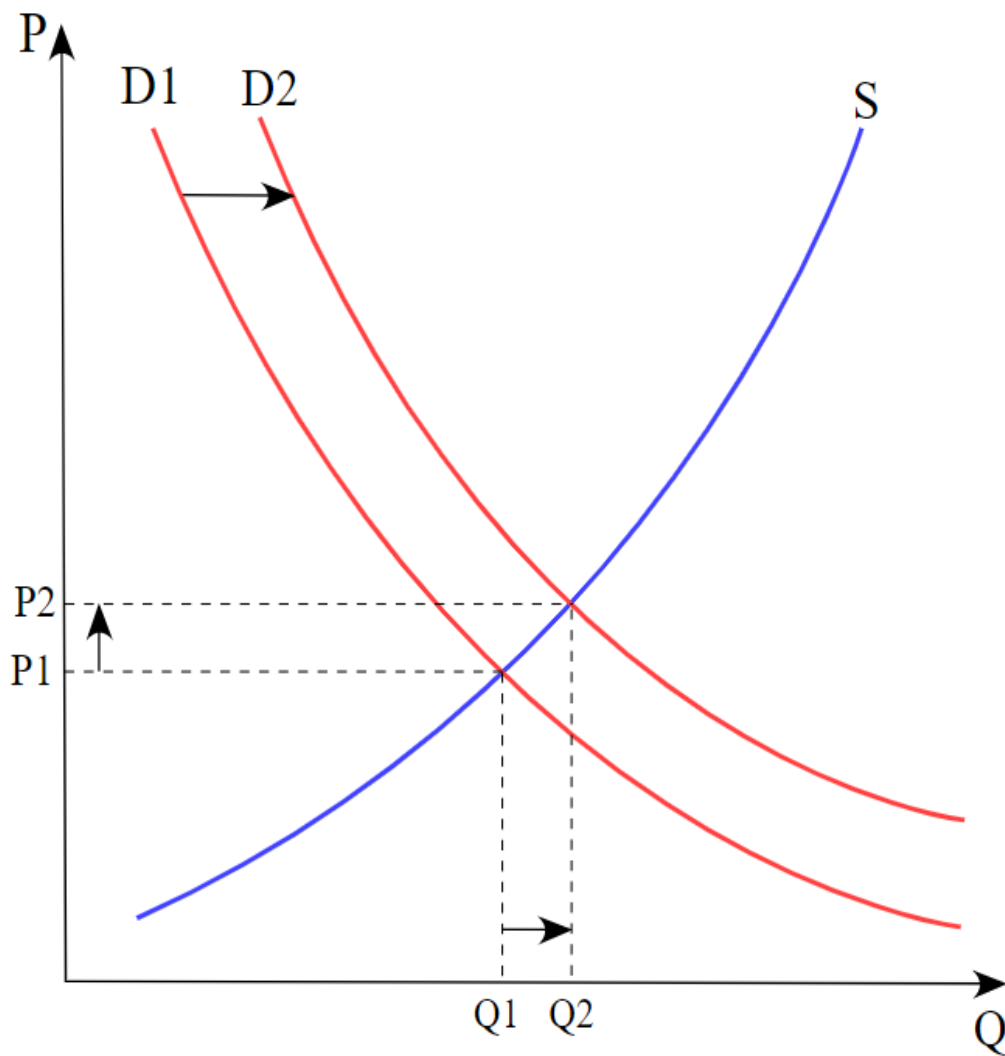
IV-2- Price Elasticity

- The demand curve shows how consumer choices respond to changes in price.
- In almost all cases, consumer choices are driven by prices. As price goes up, the quantity that consumers demand goes down. This correlation between the price of goods and the willingness to make purchases is represented clearly by ***the generation of a demand curve*** (with price as the y-axis and quantity as the x-axis).
- The construction of demand, which shows exactly how much of a good consumers will purchase at a given price, is defining of consumer choice theory.

IV- Impact of Price on Consumer Choices-2-

IV-1- Deriving Overall Demand

- The generation of a demand curve is done by calculating what price consumers are willing to pay for a given quantity of a good or service.
- For normal goods or services, demand is illustrated with a downward sloping curve, where the quantity on the x-axis will generally increase as the price on the y-axis decreases (and vice versa).
- The quantity demanded may change in response to both to shifts in demand (and the creation of a new demand curve, as demonstrated in) and movements along the established demand curve.



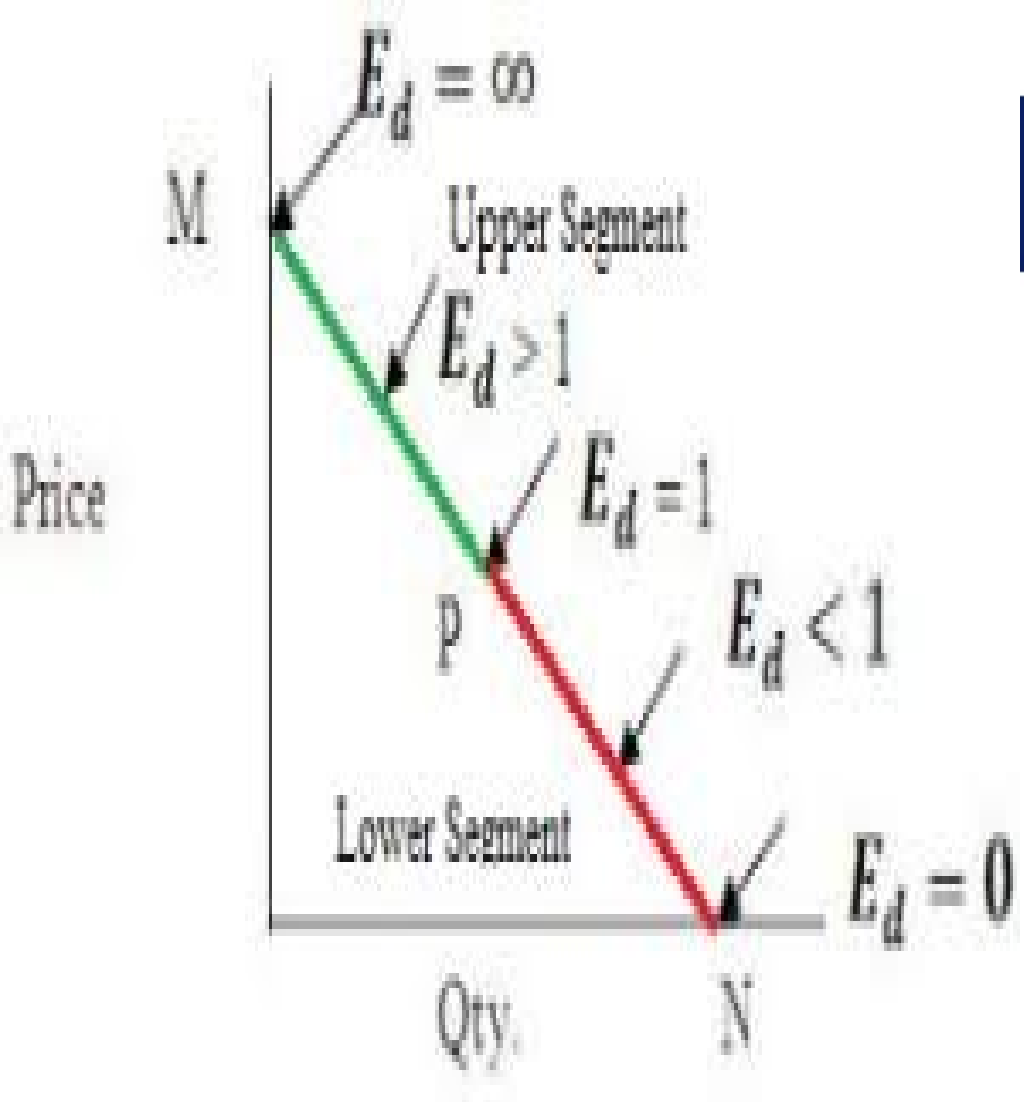
Demand Shifts: This graph demonstrates a shift in overall demand in the market, where the generation of a new parallel demand curve is required to accurately represent consumer choices.

As the demand curve implies, price is often the central driving force behind a decision to purchase a given product or service. Consumers must weigh the overall utility they can capture by making a purchase and benchmark that against their overall monetary resources to optimize their purchasing decisions.

IV- Impact of Price on Consumer Choices -3-

VI-2- Price Elasticity

- A critical consideration of product/service pricing is the price elasticity of a given good, which indicates how responsive demand is to a change in price.
- Price elasticity is essentially a measurement of how much any deviations in price will drive the overall quantity purchased up or down, underlining to what extent consumer purchasing decisions will be dictated by pricing.
- A highly elastic good will see consumers much less likely to purchase when prices are high and much more likely to purchase when prices are low, while a good with low elasticity will see consumers purchasing the same quantity regardless of small price changes.



Using demand curves, economists can project the impact of a price change on the consumer choices in a given market.

Price Elasticity: As this graph demonstrates, the slope of the demand curve will vary as a direct result of how elastic consumer purchasing behaviors will be compared to price changes.

Review

Summary

The Budget Constraint

Budget constraint

Equation of budget constraint (budget line – BL):

$$I = P_x \cdot X + P_y \cdot Y$$

or:

RESOURCES = USE OF RESOURCES

consumer spends his/her entire disposable income,
or, if he/she saves, the savings are one of the
„bought“ goods



Indifference Curves

Indifference Maps

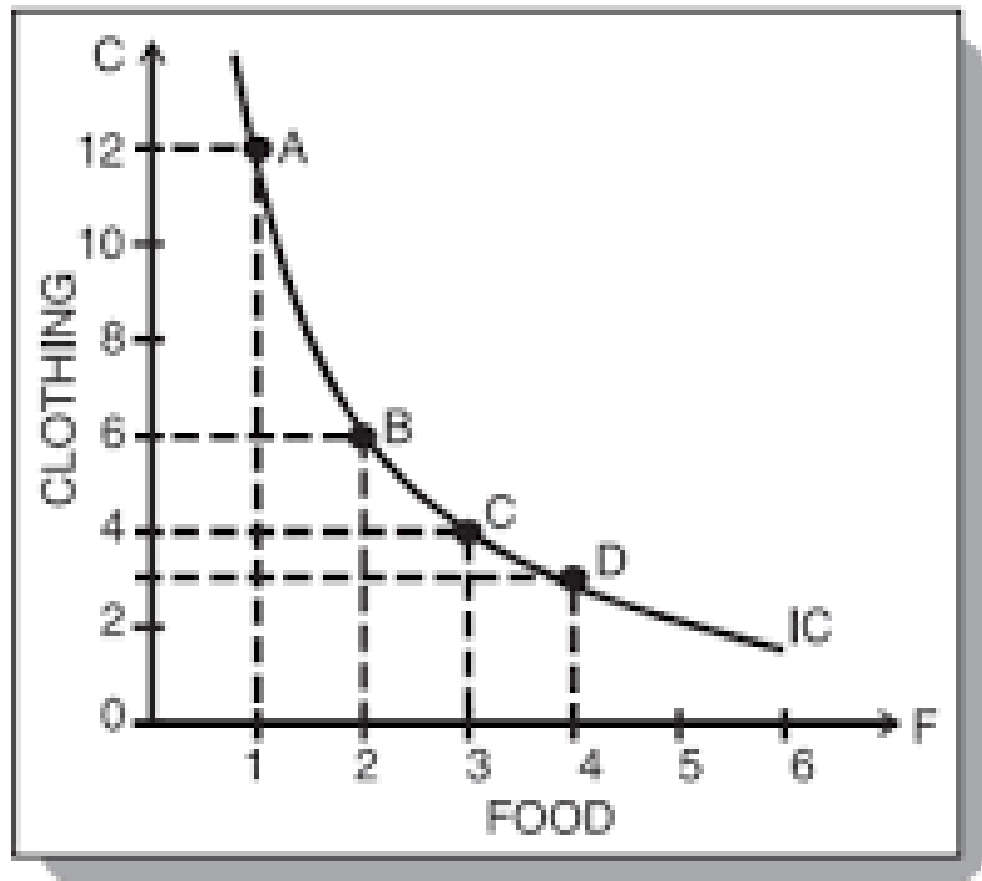


Fig. 1 : A Consumer's Indifference Curve

An Indifference Map

• Figure A.2 An Indifference Map

Number of
Movies
per Month

20

1 Max prefers any point on
this indifference curve...

3 And any point on this curve
is preferred to any point on
the other two.

2 to any point
on this one

11

6

1

2

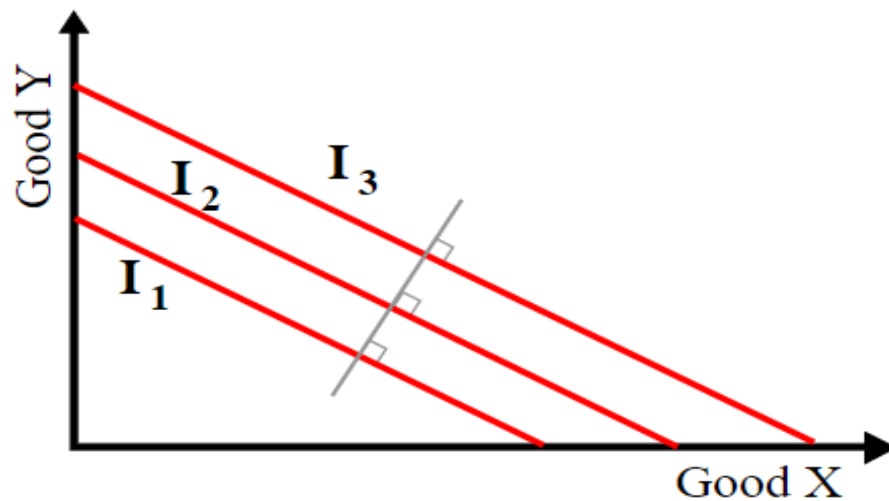
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Number of Concerts
per Month

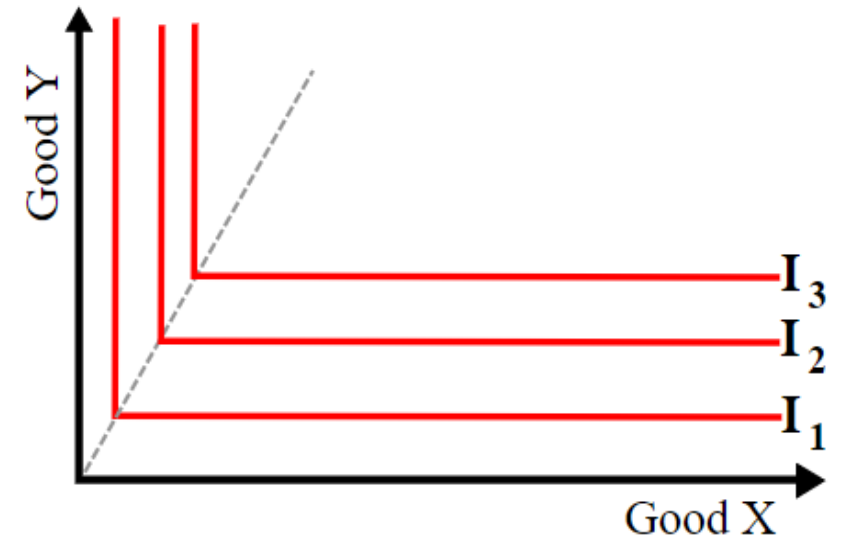
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Perfect Substitute Indifference Curve

Perfect Complement Indifference Curve

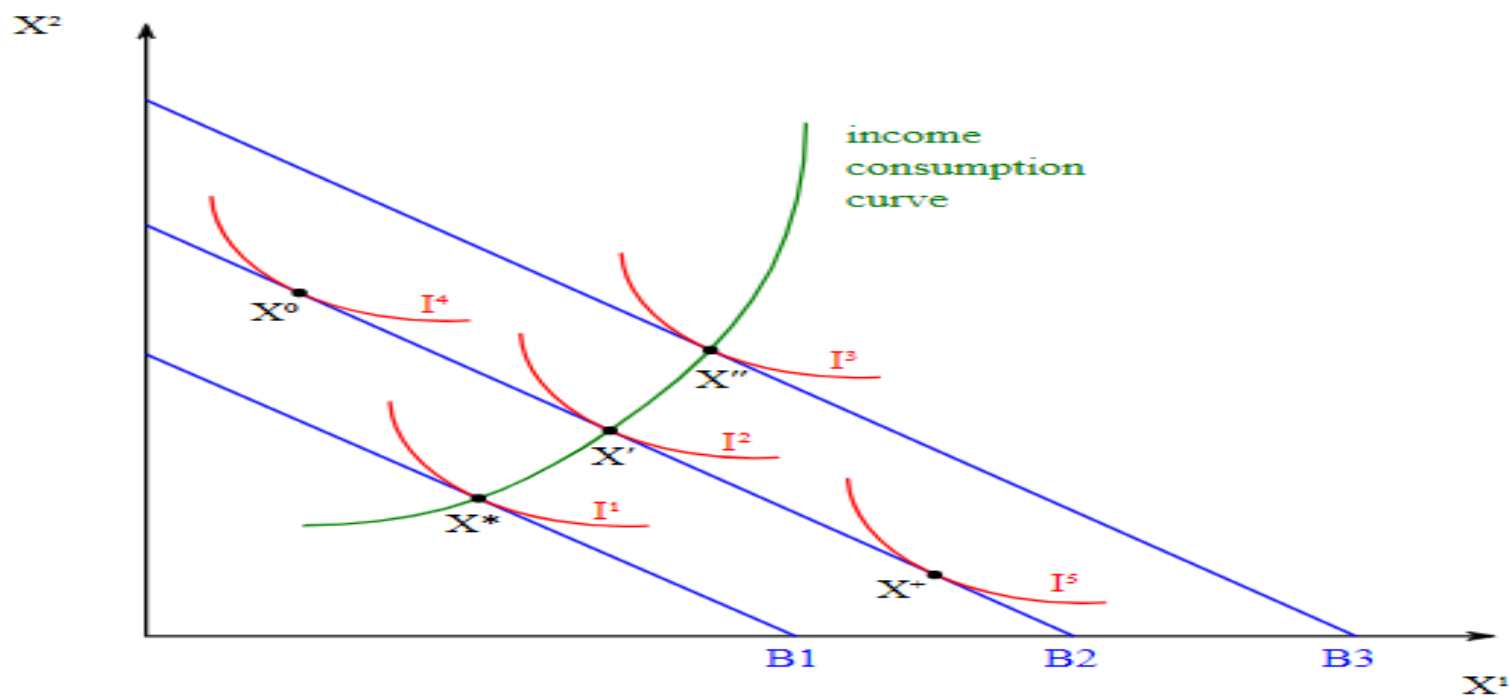


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Perfect Complement Indifference Curve: The perfect right angle in this series of indifference curves implies that the utility of 'Good X' and 'Good Y' are entirely interdependent. This is to say that in order to enjoy one good it is necessary to also have the other.

Income-consumption Curve



Income-Consumption Curve: Simply put, increases or decreases in income will alter the optimal quantity (and thus relative utility) of a given basket of goods for a specific consumer.

Good bye

