Elements of Microeconomics

AS.180.102 (03)

Chapter 22

Adam Edwards

March 14, 2025

Outline

What drives demand? How do consumers make choices about what goods to buy?

Budget Constraints

Consumers have a finite amount of money to spend on goods: the budget constraint.

Typically, we are only interested in the consumption possibilities when the consumer spends all of their budget on goods.

Since **relative prices are constant**, the budget constraint is a **straight line**.

Budget Constraint: Example

Income of \$100 to spend, apples cost \$5, avocados cost \$10. Draw the budget constraint.

What happens if income increases to \$200?

What happens if the price of apples falls to \$4?

Consumer Preferences: Indifference Curves

Indifference curves tell us the combinations of goods that would make a person equally happy. There are four key properties:

1. Higher indifference curves are preferred
2. Indifference curves are sloped downward
3. Indifference curves do not cross
4. Indifference curves are bowed inwards

Consumer Optimum

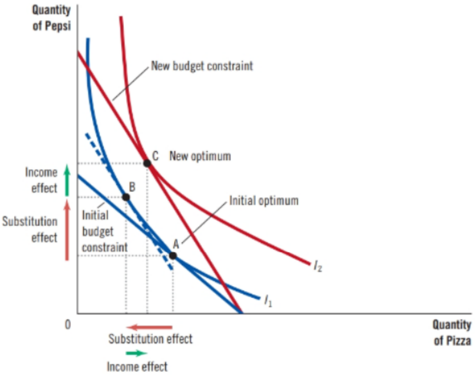
The consumer's optimal consumption bundle is the point where an indifference curve is **tangent to the budget constraint**.

At this point, the marginal rate of substitution (slope of the indiff curves) equals the relative price of the goods (slope of the budget constraint).

Income and Substitution Effects

Substitution Effect: The change in consumption from moving to a different point on the **same**, original indifference curve.

Income Effect: The change in consumption from then moving to a point on a **different**, new indifference curve.



Types of Goods

Normal Good: Buy more when income increases.

Inferior Good: Buy less when income increases.

Giffin Good: Buy more when price increases. It is an inferior good for which the income effect dominates the substitution effect.