



## CHAPTER 8

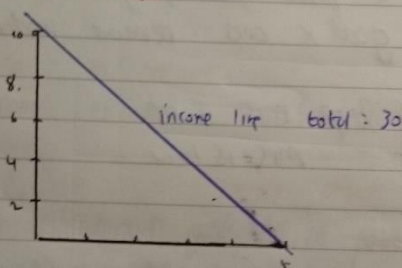
22/11/12 Household's Choices

Individuals demand for a particular product.  
Slope of budget constraint important.

Consumption choices are limited by income

Budget line describes the limits to a household's consumption choice.

### BUDGET LINE



Divisible and Indivisible goods:

- Divisible goods can be bought in any quantity eg. Petrol, electricity

- Affordable Quantities - budget line is constraint: can have any point inside line but not outside it.

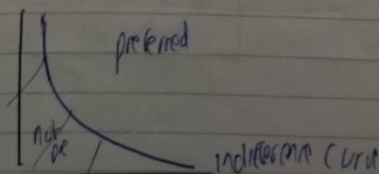
Real Income - money available changed into products: eg £30 or 10 petrol

Relative price - price of one good divided by another (opportunity cost)

A change in price moves budget line.

A change in income also moves budget line.

Preferred:



Indifference curve is the line showing combinations of goods among which a consumer is indifferent.

Preference map - Series of indifferent curves

Marginal rate of Substitution:

The rate at which a person gives up good y to get an extra unit of good x and remain indifferent

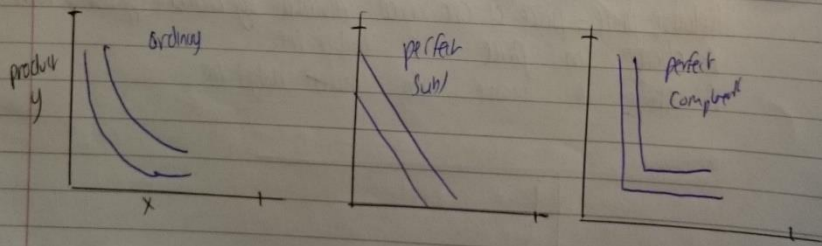
1. When indifference curve is steep mrs is high.
2. Indifference curve flat mrs is low

Degree of Substitutability

Close substitutes - different brands of same product - indifference curve are straight lines that slope downward

(Complements - Goods) cannot substitute for each other (L + R shoe!) having two is preferred to one

The more perfectly substitutable of two goods more their indifference curve to straight line and less quickly decreasing in mrs (Poor Substitute) - tight curve.



## Chapter 8

**Best affordable choice** - when marginal rate of substitution equals relative price of film & tea  
- on budget line, and an highest standard indifference curve

### Change in price

called the price effect changes indifference curve and budget line

### Change in income

"Income effect" shifts leftward, decrease demand curve

### Substitution effect + income effect

For a normal good, fall in price increase quantity bought  
- caused by sub and income

**Substitution effect**: the effect of a change in price on the quantity bought when customer (hypothetically) remain

- Price of film falls, film increase from 2 to 5  
cut in income (change) budget line (change) from 2 to 4  
more on indifference curve substitution

### Income effect

for a normal good income effect reinforces the substitution effect

**Inferior goods** - demand decreases when income rises

- Substitution effect of a fall in price increase quantity demanded but the negative income effect works in opposite direction



### Behavioural economics

- Studies the ways in which limits on the human brain's ability to compute and implement rational decisions influence economic behaviour.

### Bounded Rationality:

- Rationality that is limited by the computing power of human brain
- rule of thumb, views of others

### Bounded Willpower

- prevents us from making a decision that we know at the time of implementing the decision we will later regret.

### Bounded Self Interest:

- The limited self interest that results in sometimes surprising our own interest to help others

### Endowment effect:

- Tendency for people to value something more highly simply because they own it.

### Neuroeconomics:

- Study of activity of human brain when person makes economic decisions