Business Data Management

Professor G Venkatesh
Professor M Suresh Babu
Department of Humanities and Social Sciences
Indian Institute of Technology, Madras

Lecture

Utility and Prices: An Introduction

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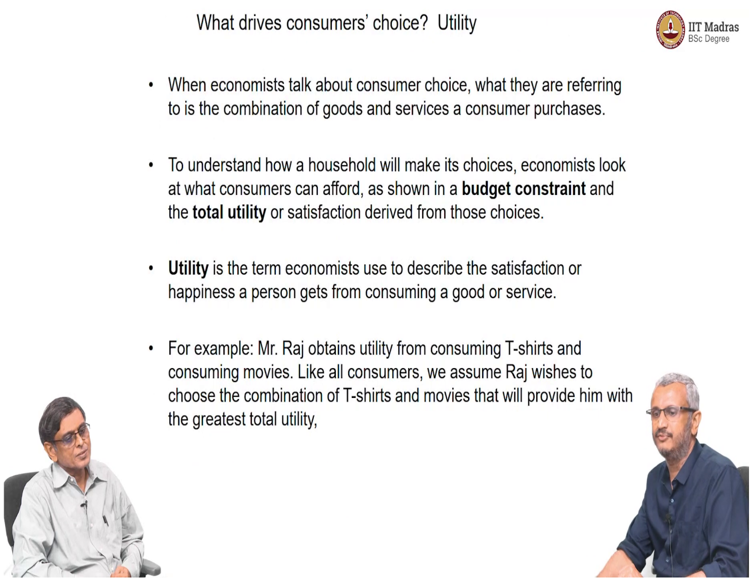

Professor. M Suresh Babu: That takes us to the concept of utility. What actually drives consumers' choice is utility. What is this utility thing? This utility thing is what is the kind of combination of goods and services that I should consume. Now, this utility is also linked to what I can actually afford. In our example, that person with a Rs. 15,000 salary can afford only certain things.

Professor. G Venkatesh: Right.

Professor. M Suresh Babu: The person with a 30,000 salary can afford different kinds of things. So that is.

Professor. G Venkatesh: So, Rs. 15,000 could not afford to buy a house with pride.

Professor. M Suresh Babu: Yeah. So, that is what we call the budget constraint. You have to operate within the budget constraint. And within that budget constraint, we have to derive certain total utilities from consumption and that drives consumers choice. Now, what is this utility then that we are talking about?

Professor. G Venkatesh: So, you are trying to get a kind of distilled or reduced decision making in every household to this factor now?

Professor. M Suresh Babu: Yes.

Professor. G Venkatesh: Income?

Professor. M Suresh Babu: Income and utility that we are deriving from that.

Professor. G Venkatesh: Those are the factors.

Professor. M Suresh Babu: Yeah. Now, we will, we will complicate it a little, because utility is also a function of the price.

Professor. G Venkatesh: Firstly, you said it will be subjective?

Professor. M Suresh Babu: Yeah, but it is also a function of the price.

Professor. G Venkatesh: It is also a function of the price.

Professor. M Suresh Babu: Yeah. Because sometimes, you know, you pay a high price and you do not derive so much of utility. For example, let us take, for example, a movie itself.

Professor. G Venkatesh: Yeah.

Professor. M Suresh Babu: You go and watch on the first day, the first show paying a premium ticket.

Professor. G Venkatesh: I do not enjoy it and I do not like going in the crowd. I want to go on a quiet day and watch a movie.

Professor. M Suresh Babu: Yeah.

Professor. G Venkatesh: So, but some people want to do that.

Professor. M Suresh Babu: Yeah so their utility is different. The price does not matter at all.

Professor. G Venkatesh: Price does not matter as they will pay any amount to get on the first day.

Professor. M Suresh Babu: So, we will complicate it by bringing price later on when we extend the model.

Professor. G Venkatesh: Right.

Professor. M Suresh Babu: Yeah. But for the time being, we will stick on to two things that is basically

Professor. G Venkatesh: Budget constraint.

Professor. M Suresh Babu: Budget constraint.

Professor. G Venkatesh: And utility.

Professor. M Suresh Babu: And utility. But it is a very simple example that we are putting. Mr. Raj, now would like to consume t shirts, and then watch movies. So, Raj actually wishes to have a combination of some t-shirts and some movies, but what is the combination that gives utility.

Professor. G Venkatesh: How many t-shirts or how costly is the t-shirt? So, you say, are you willing to pay Rs. 3000 for a t-shirt, you will say and I would rather pay only 1000 rupees get a t-shirt and go see a movie.

Professor. M Suresh Babu: Two movies or three movies and that is a trade off

Professor. G Venkatesh: Trade off.

Professor. M Suresh Babu: That we are talking.

Professor. G Venkatesh: I understand, yeah.

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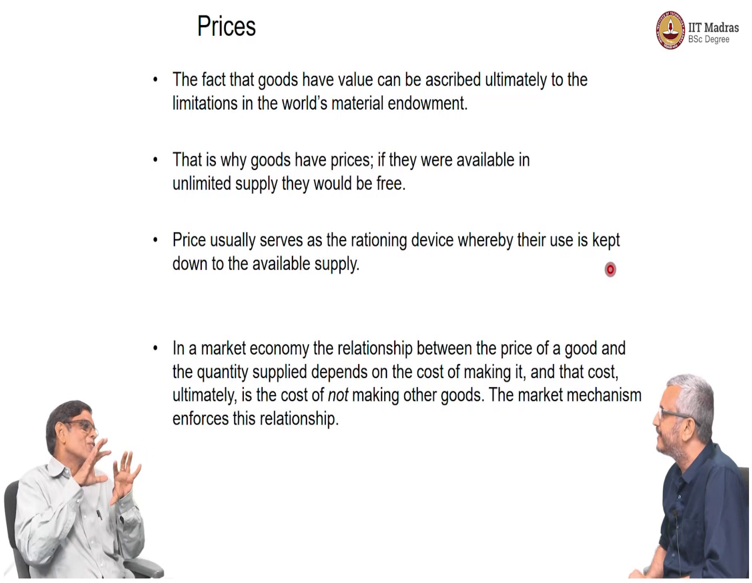

Professor. M Suresh Babu: Which means that we also need to bring some where the question of prices into this. And because goods have a value and once when goods have a value, ultimately it is

Professor. G Venkatesh: The market will find a price for it.

Professor. M Suresh Babu: Yeah. The prices have two rules to play. One we are actually conceiving of a system where material endowments are limited. So, if you get something free, then you know it will be unlimited consumption. So, the value of that will come down.

Professor. G Venkatesh: Oh, I see. So,

Professor. M Suresh Babu: Price then implicitly controls that value.

Professor. G Venkatesh: It controls the consumption.

Professor. M Suresh Babu: Yes. So that is a point about price. If they were available in unlimited supply, they would be free. So, prices then use as you are used as this

Professor. G Venkatesh: Allocation, it is a way of rationing.

Professor. M Suresh Babu: Device.

Professor. G Venkatesh: So, this resource movement whatever you said.

Professor. M Suresh Babu: Yeah

Professor. G Venkatesh: The price has a very similar role to play in allocating these resources in the correct way.

Professor. M Suresh Babu: Yeah.

Professor. G Venkatesh: By shifting it in terms of prices.

Professor. M Suresh Babu: Yes. So, that is why we have this usage in terms of, you know, getting prices right you need to get the right price or resource allocation, and prices could be skewed because of a variety of factors, etc.

Professor. G Venkatesh: Manipulation.

Professor. M Suresh Babu: Manipulation, when there are certain players in the market, who set high prices and things of that sort. So, that also is an important point to which we will come back . Generally in a market economy, the price of a good is also related to the cost of producing. So that cost of producing also has an inbuilt opportunity for all costs, because of those resources.

Professor. G Venkatesh: Could have been as .

Professor. M Suresh Babu: For something else. So, we need to understand this cost in a slightly nuanced manner and that we will see when we look at the production process in an economy. But we still have not come up with a theory of consumer behaviour. We have not been able to theorise as we saw some patterns. Now we need to formulate a theory. Why do we need a theory in that? We need a theory to look at demand, demand in terms of, demand at the individual level or a household level and demand for a market.