Theory of Consumer Behaviour

Reference

Intermediate
Microeconomics
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Do now….

Imagine you are doing online shopping…

What would be in your shopping cart?

with Rs. 15K to spend…

- Economists assume that the consumer chooses the best bundle of goods they “can afford”.
  - How to describe what a consumer can afford?
  - Answer is…

The Consumer’s Budget Constraint

- Consumer can afford to purchase a bundle if its cost is less than her income :
- More formally, the bundle is affordable if:

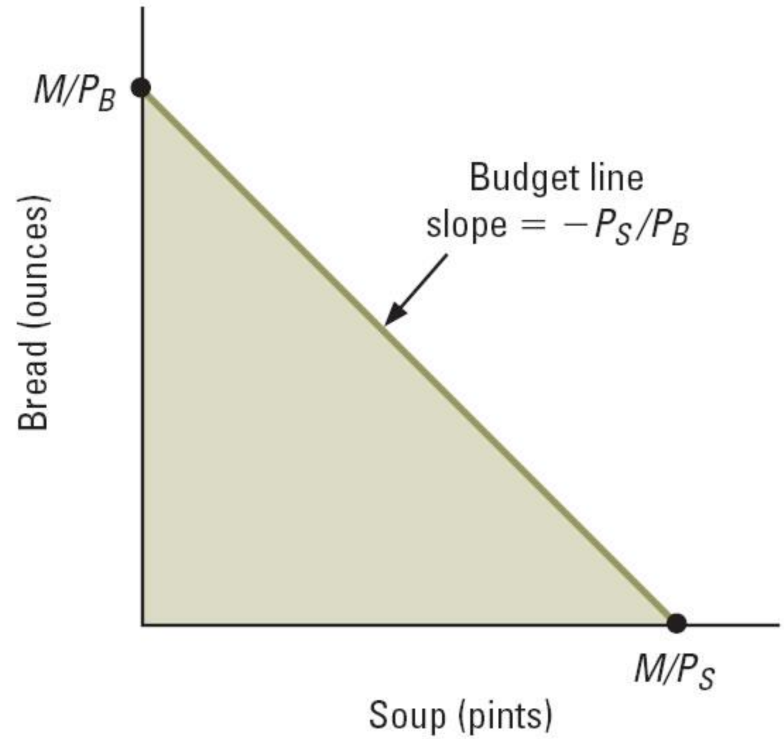
$$p_1 x_1 + p_2 x_2 \leq M$$

- And exhausts the consumer’s income if costs strictly equal income *(M)*
- This is the consumer’s ***budget constraint***

The Budget Constraint

- Equation of the budget line:

$$x_2 = \frac{M}{P_2} - \frac{P_1}{P_2} x_1$$



- Bundles in the shaded area are affordable but do not exhaust income
- Bundles on the budget line exhaust income

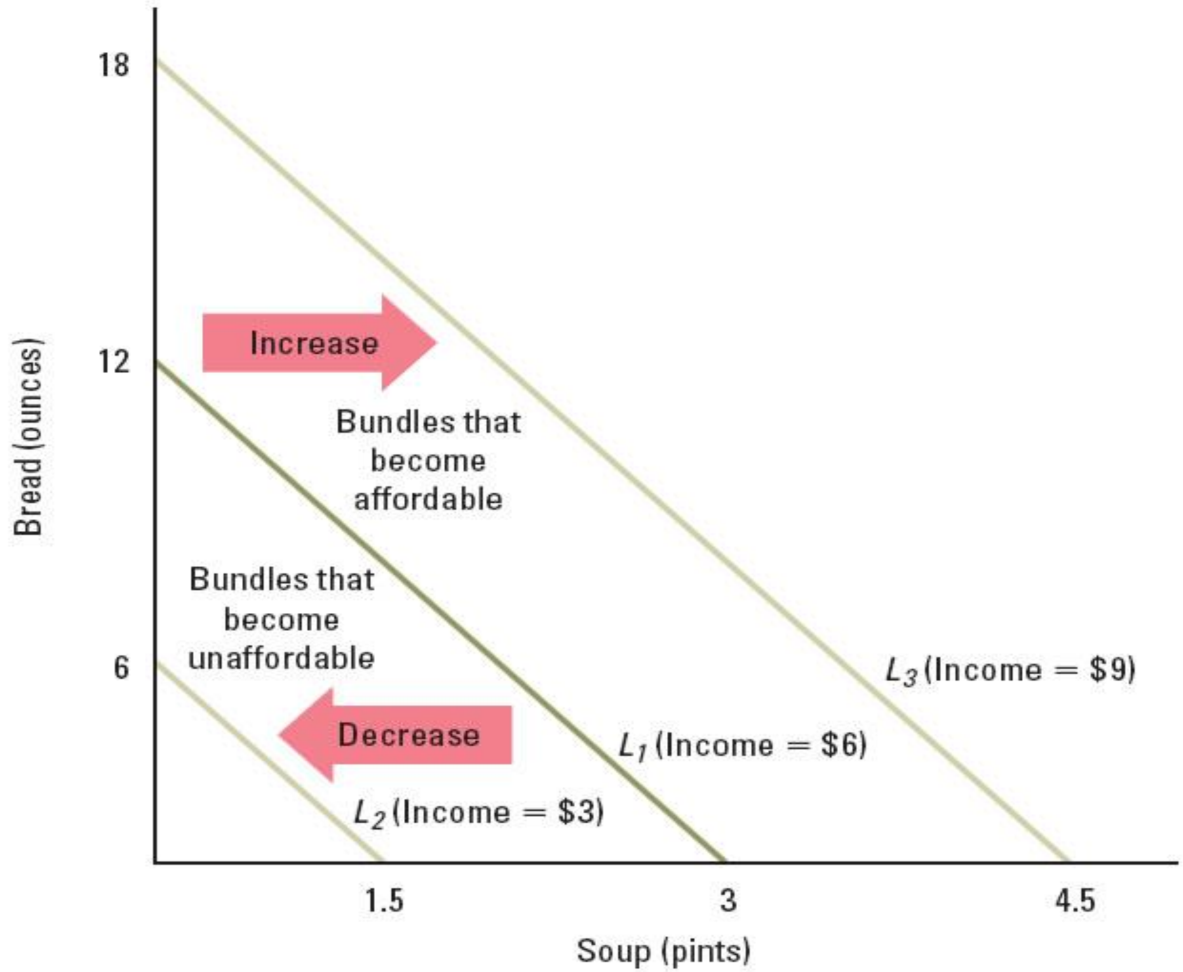
Properties of Budget Lines

- Budget line is the boundary that separates affordable bundles from all others
- Slope of budget line = $-P_X/P_Y$
- X-intercept is M/P_X; Y-intercept is M/P_Y
- Change in income shifts the line without changing its slope
- Change in the price of a good rotates the line
- Changing prices and income by the same proportion has no effect on the budget line

Changes in Budget Line

- Change in income alters intercepts of the budget line but does not change its slope
  - Reduction in income shifts budget line in
  - Increase in income shifts budget line out
- Change in price of a good pivots the budget line *at the intercept of the good with the unchanged price*
  - Outward for a price decrease
  - Inward for a price increase

Effects of Changes in Income on the Budget Line



Effects of a Change in the Price of Soup