

Elements of Microeconomics

Hank Behaeghel

Johns Hopkins University

Week 9

Where Are We Going?

- So far, we have discussed market equilibrium, various policy implications, and we have explored consumer behavior a little with the concept of elasticity.
- Now we will be taking our studies of consumer behavior even further.
- Enter: **The Theory of Consumer Choice**

Key Concepts That Will Guide Us

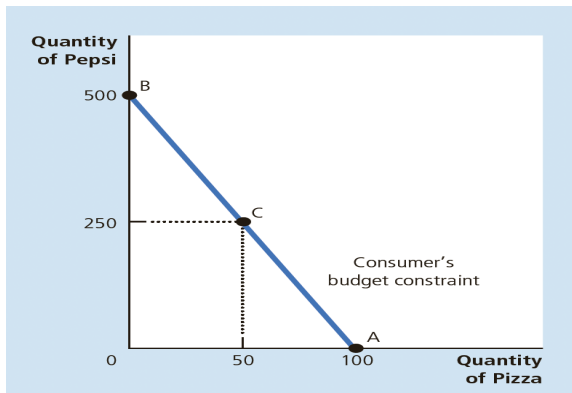
- This is where we clearly introduce some optimization into economics. What do I mean by this?
- Think about yourself for a moment. Everytime you want to buy something you're faced with a myriad of questions.
 - ▶ How much do I want this thing?
 - ▶ How much am I willing to spend? Can I even afford it?
 - ▶ Will it actually be worth having?
 - ▶ etc. etc.
- All of these questions really boil down to two main questions:
 - 1 **Can I afford it?**
 - 2 **Do I actually want it?**

Can I Afford it?

- Before you buy something you have to be able to afford it. The amount of disposable income depends on a host of factors.
- For the purposes of this class we will mainly focus on the trade off of two goods.
- We can model what we can afford using what is known as a **budget constraint**.

The Budget Constraint

- **Definition:** the limit on the consumption bundles that a consumer can afford.
- *So what does this actually mean?*
 - ▶ You cannot buy more things than you can afford. This is an obvious point but, its helpful for maximizing our utility.
 - ▶ I can have a certain amount of X and a certain amount of Y.



What Do I Want?

- In economics we use the term "utility" as a way to describe the benefit we gain from an item. You will study this more in terms to come.
- The want/value is encoded in this utility
- Utility is represented by our **indifference curve**.
- This curve is very important and has some fundamental properties.

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 - ④ IC are bowed inwards.
- The slope of the IC is the **marginal rate of substitution**.
 - ▶ **Definition:** the rate at which a consumer is willing to trade one good for another.

Practice Problems

Question 1

Carla buys Xbox (X) for \$10 each and Yoyo (Y) for \$4 each. She has an income of \$75. How many units of good X can Carla afford? Can Carla afford to buy 4 units of good X and 10 units of good Y? If Carla's income increases by 10%, what happens to the slope of the budget constraint? What is Carla's MRS_{XY} at the utility-maximizing point?