

# Chapter 21: Consumer Theory

Discussion section 4

November 2023

# Outline

Remember the core of microeconomics: we all face tradeoffs.

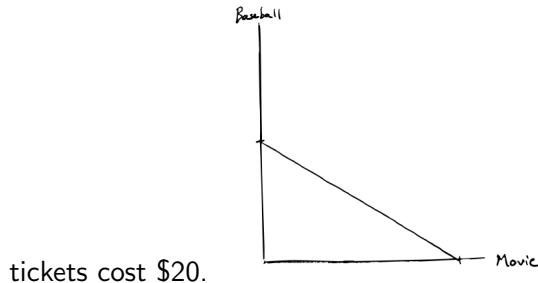
Consumers have to choose how to allocate limited resources to best satisfy their wants.

They will do so like good economists, by *thinking at the margin*.

# Budget constraint

Consider two goods: movie tickets and baseball tickets.

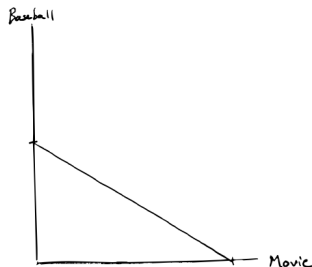
You have \$100 for your monthly entertainment budget. Movie tickets cost \$10, and baseball



# Budget constraint

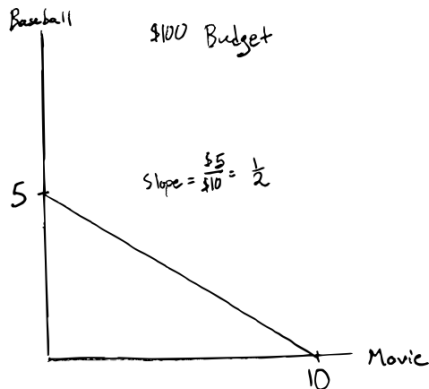
What are the intercepts on the budget constraint?

What is the slope? Does it depend on your budget?



# Budget constraint

Slope depends on relative price, position depends on total resources



# Indifference curves

How do we choose among all the different possible consumption points?

We will look at our *indifference curves*.

What does an indifference curve represent?

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What does an indifference curve represent?

*All the combinations of goods for which we are equally happy.*

# Principles for ICs

- Consumers always prefer more
- Downward sloping
- Do not cross
- Inwardly-bowed

Where does the inwardly-bowed shape come from?



# Extreme cases

Where does the inwardly-bowed shape come from?

The *marginal rate of substitution* (MRS)

Think about these principles in two extreme cases:

- Perfect substitutes
- Perfect complements

# Optimal choices

How can we combine these two tools to make an optimal choice?

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How can we find this?

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How can we find this?

Equate the *slope* of the BC to the MRS (slope of the IC)

Just what we saw in the free market equilibrium!

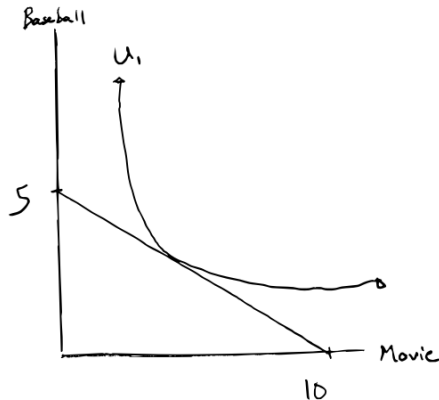
# Comparative statics

We know have a powerful tool for finding optimal choices of consumers

Can we use this to think about the effect of a change in price?

## Price increase

Suppose this is our budget constraint and optimal choice

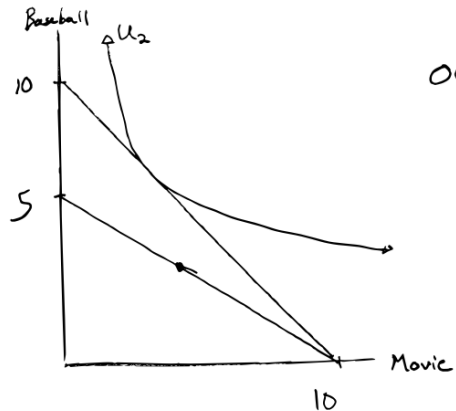


## Price increase

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# Price increase

Was the change unambiguous?

What effects are at play here?

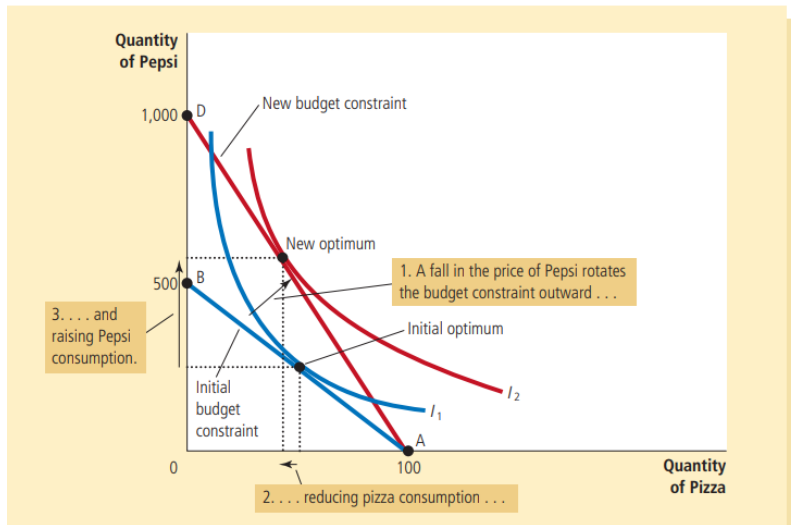
# Price increase

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- Income effect
- Substitution effect

# Income and substitution effects



# Wage increase

What is the tradeoff facing workers?

What do they balance in their budget constraint?

# Wage increase

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Workers balance consumption and leisure time.

What will happen when their wages go up?

# Wage increase

What will happen when workers' wages go up?

We will see the same two effects as before.

- Income: we are now wealthier, and so we may want to spend some of that wealth on more leisure time.
- Substitution: leisure is now relatively more expensive than consumption (why?), so we may want to increase consumption and decrease leisure.

# Wage increase

Net effect is *ambiguous* — but labor economists usually think that higher wages lead workers to work more hours.