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The Theory of Consumer Choice

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- The theory of consumer choice addresses the following questions:
  - Do all demand curves slope downward?
  - How do wages affect labor supply?
  - How do interest rates affect household saving?

THE BUDGET CONSTRAINT: WHAT THE CONSUMER CAN AFFORD

- The *budget constraint* depicts the limit on the consumption “bundles” that a consumer can afford.
  - People consume less than they desire because their spending is constrained, or limited, by their income.

THE BUDGET CONSTRAINT: WHAT THE CONSUMER CAN AFFORD

- The budget constraint shows the various combinations of goods the consumer can afford given his or her income and the prices of the two goods.
- Suppose there are two goods, Pizza (x) and Pepsi (y).
- Let Income of consumer is 1000 dollars, price of Pizza is 10 dollars per unit and price of Pepsi is 2 dollars per unit.

- The Budget Constraint in this case is given by
- $10x+2y=1000$

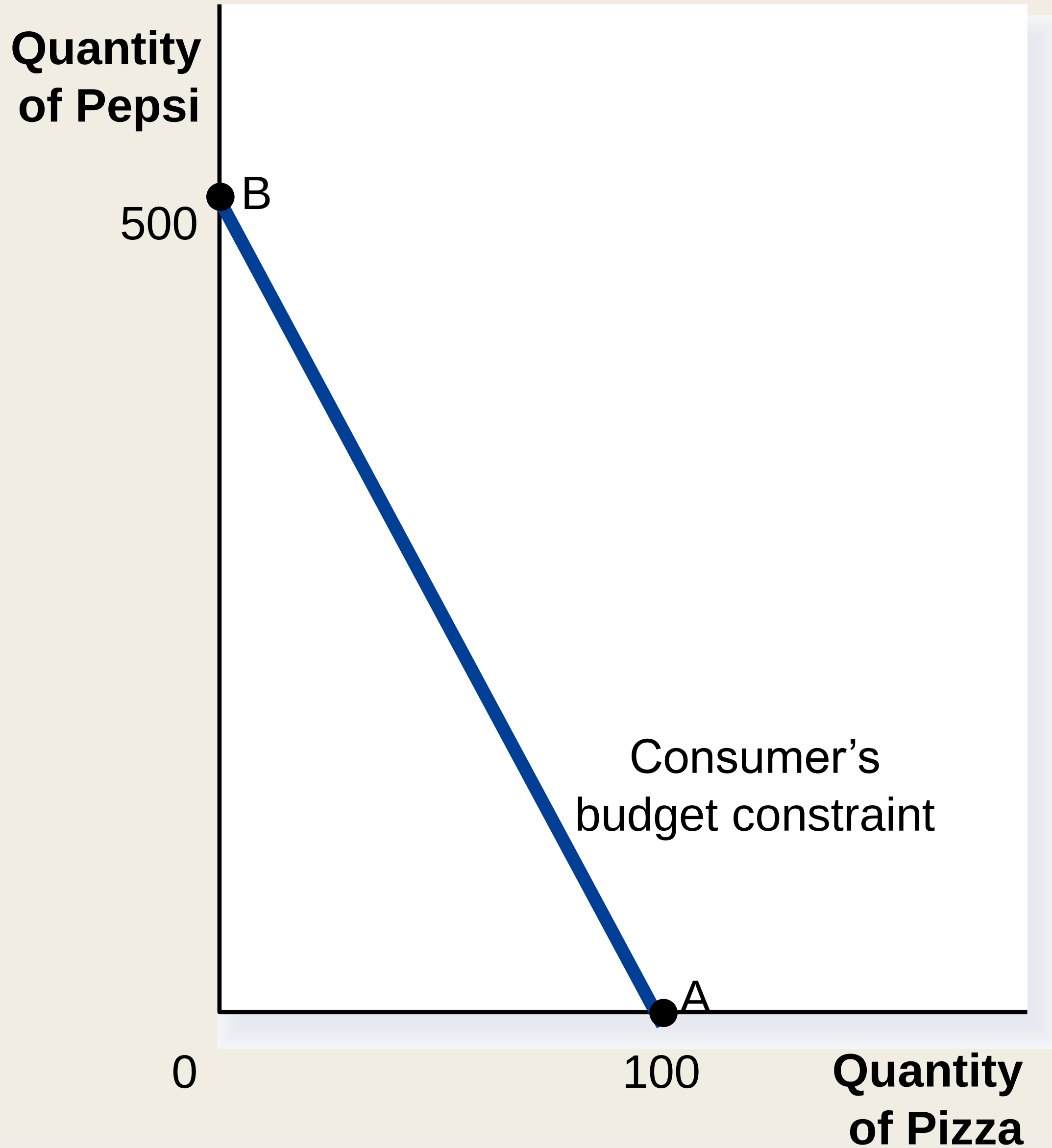
Figure 1 The Consumer's Budget Constraint: Let Pizza price is 10 dollars per unit, and Pepsi price is 2 dollars per unit

Pints of Pepsi	Number of Pizzas	Spending on Pepsi	Spending on Pizza	Total Spending
0	100	$ 0	$1,000	$1,000
50	90	100	900	1,000
100	80	200	800	1,000
150	70	300	700	1,000
200	60	400	600	1,000
250	50	500	500	1,000
300	40	600	400	1,000
350	30	700	300	1,000
400	20	800	200	1,000
450	10	900	100	1,000
500	0	1,000	0	1,000

THE BUDGET CONSTRAINT: WHAT THE CONSUMER CAN AFFORD

- The Consumer's Budget Constraint
  - Any point on the budget constraint line indicates the consumer's combination or trade-off between two goods.
  - For example, if the consumer buys no pizzas, he can afford 500 pints of Pepsi (point B). If he buys no Pepsi, he can afford 100 pizzas (point A).

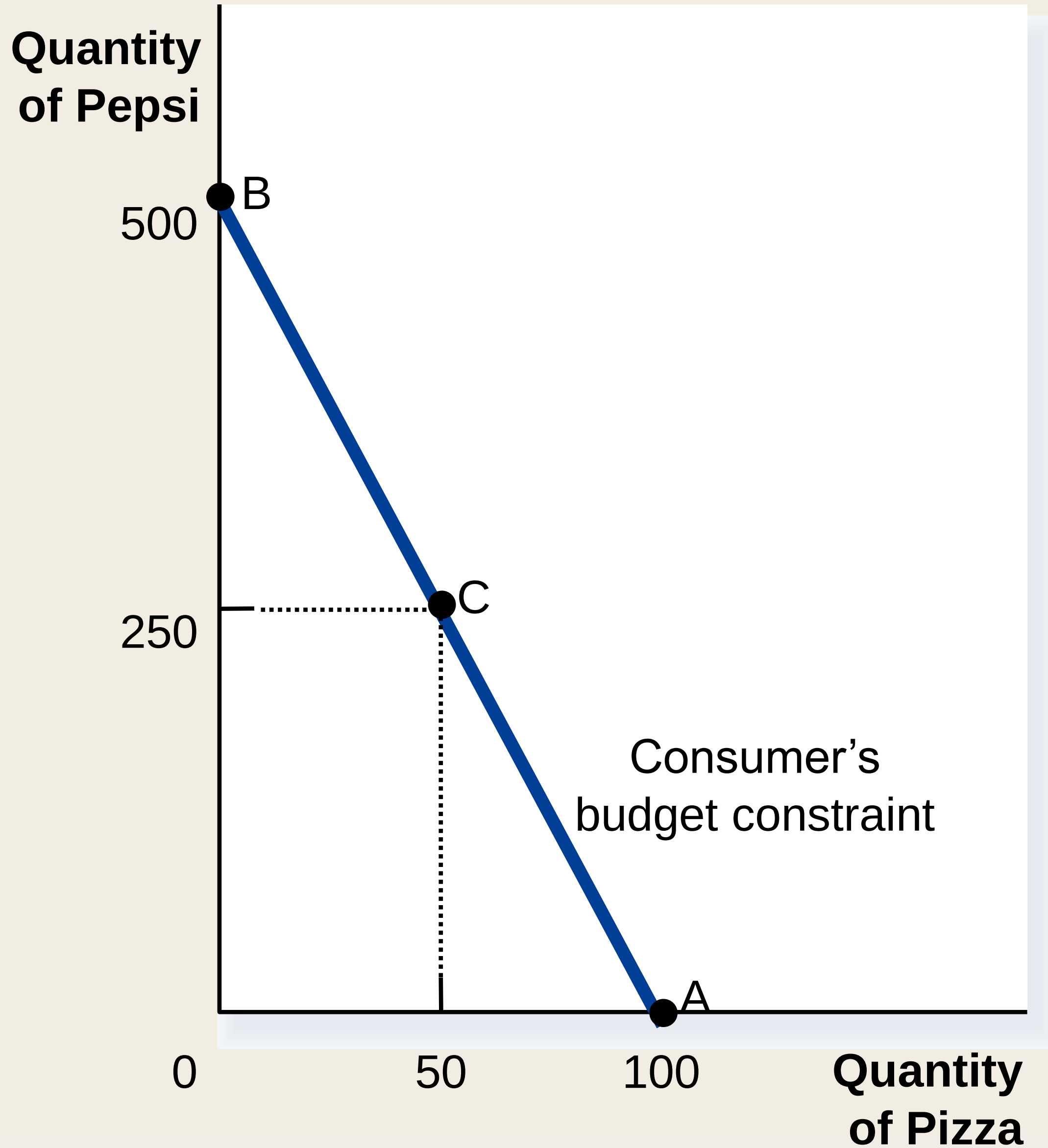
Figure 1 The Consumer's Budget Constraint



THE BUDGET CONSTRAINT: WHAT THE CONSUMER CAN AFFORD

- The Consumer’s Budget Constraint
  - Alternately, the consumer can buy 50 pizzas and 250 pints of Pepsi.

Figure 1 The Consumer's Budget Constraint



THE BUDGET CONSTRAINT: WHAT THE CONSUMER CAN AFFORD

- The *slope* of the budget constraint line equals the relative price of the two goods, that is, *the price of one good compared to the price of the other*.
- It measures the rate at which the consumer can trade one good for the other.

PREFERENCES: WHAT THE CONSUMER WANTS

- A consumer’s preference among consumption bundles may be illustrated with indifference curves.

Representing Preferences with Indifference Curves

- An *indifference curve* is a curve that shows consumption bundles that give the consumer the same level of satisfaction.

Figure 2 The Consumer's Preferences