Ch. 21 The Theory of Consumer Choice

- Budget Constraint:
  - The limit on the consumption bundles that a consumer can afford

- The slope of the budget constraint equals the **relative** price of the good on the X axis.
  - A fall in income shifts the budget constraint down.
  - An increase in the price of one good pivots the budgetconstraint inward.

- Preferences and Indifference curve
  - **Indifference curve**: shows consumption bundles that give the consumer the same level of satisfaction
  - Consumer is indifferent between them.

- **Four Properties of Indifference Curves**
  - ① Indifference curves are downwardsloping.
  - ② Higher indifference curves are preferred to lower ones.
  - ③ Indifference curves cannot cross.
  - **④ Indifference curves are bowed inward.**

- **Marginal Rate of Substitution, MRS = Slope of indifference curve**
  - the rate at which a consumer is willing to trade one good for another.
  - MRS falls as you move down alongan indifference curve.
  - Perfect substitute vs. Perfect complements

- Extreme Cases
  - Perfect substitutes
  - Perfect complements
  - Close substitutes and close complements

- **Optimization**: What the consumer chooses
  - The optimum is the bundle Hurley most prefers out of all the bundles he can afford.
  - At the optimum, slope of the indifference curve equals slope of the budget constraint
  - **MRS = P_F / P_M**

- **Effects of an increase in income**
  - Normal goods
  - Inferior goods

- **Effects of a price change**
  - Income effects
  - Substitution effect

- **Application 1: Giffen goods**
- **Application 2: Wages and labor supply**
- **Application 3: Interest rates and saving**