Intermediate Microeconomics - Budget Constraint (Ch2)

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2026 Spring

Consumption Theory

Components Market Equilibrium

- ▶ Demand side: **Consumer Theory**
- ▶ Supply side: Producer Theory
- ▶ Equilibrium

Consumer Theory

- ▶ Simple intuition: assumes that consumers choose the best (Ch3, preference) bundle of goods they can afford (Ch2).
- ▶ Budget Constraint: describes what a consumer can afford

Examples

Consuming books, spending time

- ▶ Say it takes Emily 2 hours to read one chapter of the math book,
  2 hour to read one chapter of *Microeconomics*,
  and 4 hours to read one chapter of *The Three-Body Problem*.
- ▶ For a day, she can only spend 12 hours reading books.

- ▶ Possible bundle of books Emily can read a day?
- ▶ What is her budget constraint for one day?

Examples

Consuming books, spending time

▶ Say it takes Emily 2 hours to read one chapter of the math book,
2 hour to read one chapter of *Microeconomics*,
and 4 hours to read one chapter of *The Three-Body Problem*.

▶ For a day, she can only spend 12 hours reading books.

▶ budget constraint:
2 (hours) * math (chapter) + 2 * MicroEcon + 4 * Novel ≤ 12 (hours)

Consuming Goods, Spending money

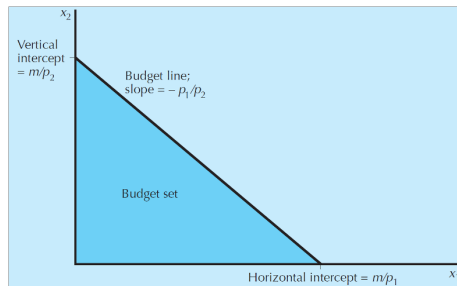### Basic Setting

▶ A consumption bundle $\mathcal{X}$: $(x_1, x_2, ..., x_n)$, where $x_i \geq 0$ is the **quantity** of good i

▶ Commodity prices $\mathcal{P}$: $p_1, p_2, ..., p_n$ (RMB)

▶ Suppose the consumer has an income of I (RMB)

▶ Budget constraint $\mathcal{P}\mathcal{X} \leq I$: $p_1 x_1 + p_2 x_2 + ... + p_n x_n \leq I$
The consumer can spend no more than her income

▶ Budget Set: bundles that satisfy budget constraint

▶ Budget Line: $\mathcal{P}\mathcal{X} = I$

To Illustrate the Budget Constraint
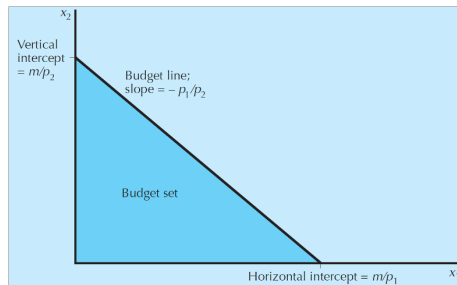
Consider two goods only

- ▶ Two goods: Good 1 with price p_1, and Good 2 with price p_2
- ▶ x_1: quantity of Good 1 (our focus)
- ▶ x_2: quantity of the composite good (anything else other than Good 1)
- ▶ m: income (RMB)
- ▶ Budget Constraint: $p_1 * x_1 + p_2 * x_2 \leq m$
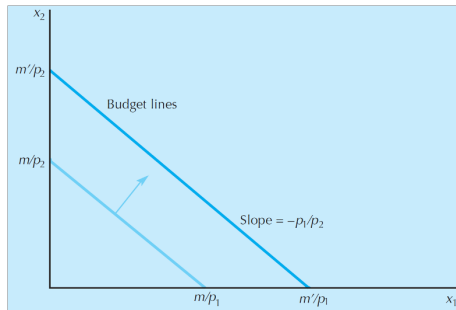 Budget Line: $p_1 * x_1 + p_2 * x_2 = m$

Slope of the Budget Constraint

Trade-off between x_1 and x_2

- x_1 increases $\Delta_1 > 0$ units, $p_1 * \Delta_1$ of money are needed
- x_2 should decreases, $\Delta_2 < 0$
- $\Delta_2 = -\frac{p_1 * \Delta_1}{p_2}$

- **The slope**: $= \frac{\Delta_2}{\Delta_1} = -\frac{p_1}{p_2}$
- **Opportunity cost of Good 1** $= \frac{p_1}{p_2}$: increasing one unit of x_1 requires decreasing x_2 by $\frac{p_1}{p_2}$ units
- **Relative price of Good 1**: $\frac{p_1}{p_2}$

How the Budget Line Changes

If income changes

- An increase (a) in income will result in a parallel shift outward of the budget line

  $\Rightarrow$ Budget Constraint:
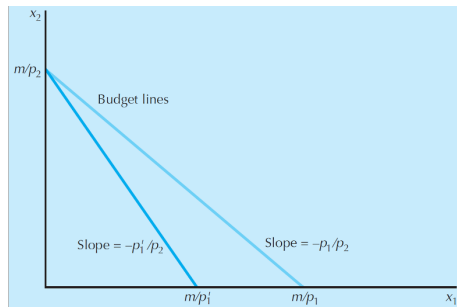 $p_1 * x_1 + p_2 * x_2 \leq m' = m + a$

- Similarly, a decrease (d) in income will cause a parallel shift inward

  $\Rightarrow$ Budget Constraint:
  $p_1 * x_1 + p_2 * x_2 \leq m - d$
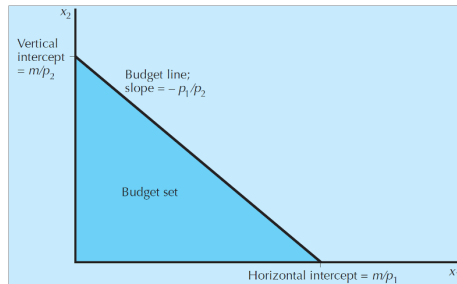
How the Budget Line Changes

If price changes

- An increase (a) in p_1, the budget line becomes steeper.

  $\Rightarrow$ Budget Constraint:
  $(p_1 + a) * x_1 + p_2 * x_2 \leq= m$

- Similarly, a decrease (d) in income will cause a parallel shift inward

  $\Rightarrow$ Budget Constraint:
  $(p_1 - d) * x_1 + p_2 * x_2 \leq m$

The Numeraire

If $p_2 = 1$

- x_2 is called as "**numeraire good**",
- p_2 is called as "**numeraire price**"

- **The slope**: $= \frac{\Delta_2}{\Delta_1} = -\frac{p_1}{p_2} = -p_1$
- **Opportunity cost of** $x_1 = \frac{p_1}{p_2}$: increasing one unit of x_1 requires decreasing x_2 by p_1 units
- **Relative price of** x_1: $\frac{p_1}{p_2} = p_1$

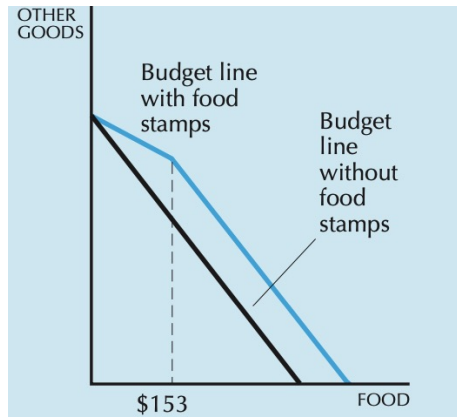# How to Encourage Food (x_1) Consumption?

US Food Stamp program

▶ The US government was trying to find a way to promote the expenditure on food for poor families in 1964.

To use Tax or Subside?

▶ **A quantity tax**: a per-unit tax

▶ **A value tax**: a percentage tax on the value (or expenditure) of a good, such as a sales tax, also known as "ad valorem tax"

▶ **A lump sum tax**: a unit tax on income

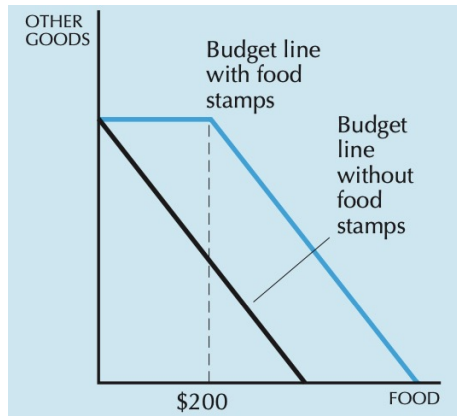▶ **Subsidies** can be thought of as negative taxes

Subsidies: Food Coupons

ad valorem subside: buy \$153 of food stamps for \$25

- x_1: dollar spent on food $\Rightarrow p_1 = 1$

- Relative price of x_1 when the consumption of food ≤ 153: $\frac{25}{153}$
- Relative price of x_1 when the consumption of food > 153: p_1

- Write the new budget constraint?

Subsidies: food coupons

$200 of food stamps for $0

- Relative price of x_1 when the consumption of food ≤ 200: $\frac{0}{200}$
- Relative price of x_1 when the consumption of food > 200: p_1

- Write the new budget constraint?
- Will people buy more food for sure? Why? (Quiz or PS)

Summary

What we have known

- ▶ Write the budget line equation, draw the budget line
- ▶ Know the budget set, the meaning of the slope (relative price, opportunity cost)
- ▶ Know how budget line moves with changing income, price, tax, or subsidy.

What's next

- ▶ Consumer Theory (**Ch3, Ch4**, Ch5, Ch6)