

Theory of Consumer Behaviour

ECONOMICS – CLASS 3



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Utility theory

Utility Maximizing Choice

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Income, Substitution and Price Effects

Normal Goods, Inferior Goods and Giffen Goods

Consumption

“Consumption means the act of using goods and services to satisfy human wants during a given period of time”

If we had unlimited income we would satisfy unlimited wants: But income is limited!

- A. What should be buy amongst all the goods and services?
- B. How much to allocate to each good and service?

Two major Approaches

- Marginal Utility Analysis
- Indifference Curve Analysis

Marginal Utility Analysis

Economists use the term “UTILITY” to measure happiness of satisfaction.

Economics is amoral

The Law of Diminishing Marginal Utility

- Marginal Utility will not only tell me whether I am going to consume a good or service but also how much of it I will consume.

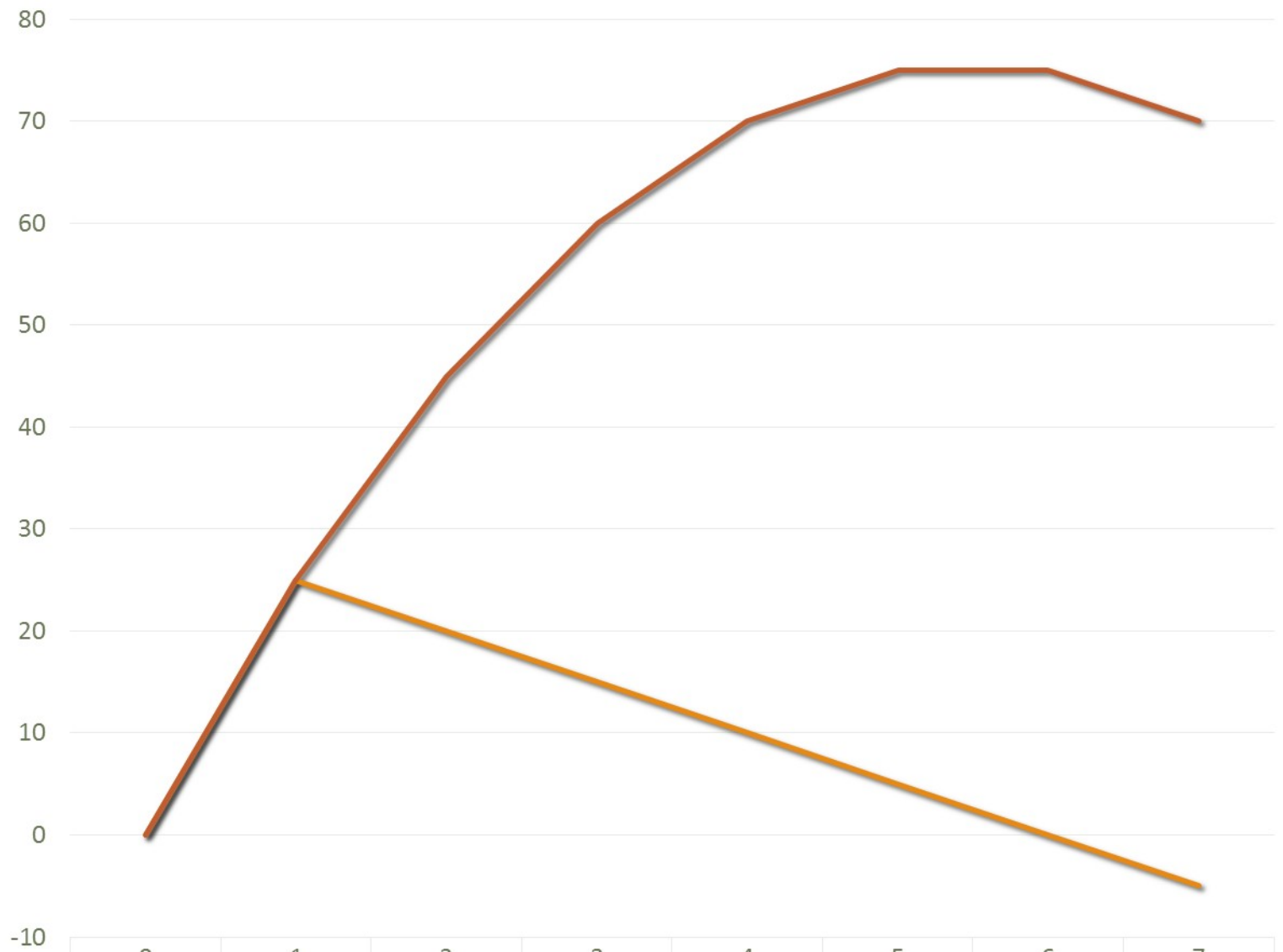
It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest.

[Adam Smith](#)

Total Utility and Marginal Utility

Qty Consumed	Marginal Utility	Total Utility
0	0	0
1	25	25
2	20	45
3	15	60
4	10	70
5	5	75
6	0	75
7	-5	70

Axis Title



Marginal Utility

Total Utility

0

1

2

3

4

5

6

7

0

25

20

15

10

5

0

-5

0

25

45

60

70

75

75

70

Economic Surplus

Consumer Surplus is the utility for consumers by being able to purchase a product for less than the highest price that they would be willing to pay.

Problem 1

Nelum purchases 4 chocolates for the price of Rs.15 per bar. She is willing to pay 25 for the bar 22 for the second 18 for the third and 15 for the 4th
How much consumer surplus is derived from the 4 bars?

Problem 2

Show graphically the change in consumer surplus resulting from a rise in product price.

Indifference Curve Analysis

Indifferent means you do not care.

Lets use Nelum again – Over the course of the year she likes 300 candy bars and 25 CD's

Budget constraints – This defines the opportunity set she can choose any point on or below the line.

Indifference Curves cannot cross!

Marginal Rate of Substitution

The technical term of the slope of the Indifference Curve is the Marginal Rate of Substitution.

It tells how much of one good one is willing to give up to get the second good.

If Nelum is willing to give up 15 candy bars for a 1 CD. Her marginal rate of substitution for candy bars to CDs is 1 to 15

Substitution Effect and Income Effect

The rise in quantity demanded due to a rise in purchasing power of real is called the income effect. (Price effect)

The fall of the price of a good will induce the consumer to purchase more of it and less of the other good this is called the substitution effect.

Normal Good – Are goods that we buy more of when the price falls

Inferior Good – We buy less when their price falls.

Thank You! See You Next Week!

