Unit 1: Understanding Consumer Behaviour

The Foundation of Consumer Choice: A Review of Utility

- **What is Utility?** Utility refers to the satisfaction or happiness consumers get from consuming goods and services.
- **Cardinal vs. Ordinal Utility:** The sources contrast two approaches to understanding utility:
    - **Cardinal Utility:** This approach assumes that utility is measurable in absolute numbers, using units called "utils." While intuitive, this approach faces challenges in real-world application, as quantifying satisfaction in absolute terms is difficult.
    - **Ordinal Utility:** This approach, also known as indifference curve analysis, focuses on a consumer's ability to rank or order their preferences for different combinations of goods and services. This approach forms the basis for much of modern consumer theory.

Mapping Preferences: Indifference Curves and Their Properties

- **Indifference Curves (ICs):** An IC is a graphical representation of all combinations of two goods that provide a consumer with the same level of satisfaction or utility. The consumer is indifferent between any two points on the same IC.
- **Indifference Map:** An indifference map is a collection of indifference curves, each representing a different level of utility. ICs further from the origin represent higher levels of utility.
- **Key Properties of Indifference Curves:**
    - **Downward Sloping:** ICs slope downward because to maintain the same level of satisfaction, a consumer must reduce the consumption of one good if they increase the consumption of the other.
    - **Convex to the Origin:** This property reflects the diminishing marginal rate of substitution (MRS).
    - **Do Not Intersect:** If ICs intersected, it would violate the assumption of consumer rationality.
- **Marginal Rate of Substitution (MRS):** The MRS measures the rate at which a consumer is willing to give up one good in exchange for one more unit of another good while maintaining the same level of utility. It is represented by the slope of the indifference curve at a given point.
- **Diminishing MRS:** As a consumer consumes more of one good, they are generally willing to give up less and less of another good to obtain additional units of the first good.

Learnify

The Budget Constraint: Limiting Choices

- **Budget Line:** The budget line represents all possible combinations of two goods that a consumer can afford given their income and the prices of the goods. It is determined by the consumer's budget constraint.
- **Slope of the Budget Line:** The slope of the budget line is determined by the relative prices of the two goods. It represents the opportunity cost of consuming one good in terms of the other.

Consumer Equilibrium: Balancing Desires and Constraints

- **The Goal: Utility Maximization:** Consumers aim to maximize their satisfaction, given their budget constraint. This occurs where the consumer reaches the highest possible indifference curve while remaining within their budget line.
- **Conditions for Consumer Optimum:** The consumer reaches equilibrium, or the optimal consumption bundle, where:
    - The budget line is tangent to the indifference curve.
    - The MRS between the two goods is equal to the ratio of their prices.

Beyond Equilibrium: Analyzing Changes in Income and Prices

- **Income Consumption Curve (ICC):** The ICC traces the optimal consumption bundles for a consumer as their income changes, holding prices constant. For normal goods, the ICC slopes upward, indicating that as income rises, the consumer buys more of both goods.
- **Price Consumption Curve (PCC):** The PCC traces the optimal consumption bundles for a consumer as the price of one good changes, holding income and the price of the other good constant.
- **Deriving the Demand Curve:** Both the cardinal and ordinal approaches can be used to derive a consumer's demand curve for a good. The demand curve shows the quantity of a good a consumer is willing and able to buy at different prices.

.

Learnify