

Econ 30010  
**Intermediate Microeconomic Theory**

**Consumer Behavior Summary and Outline**

Three factors influence what products and how much of each product a person consumes: the unit cost of acquiring each of the products, how much the consumer can afford to spend, and personal taste and preferences. In modern economies, the first two factors are usually referred to as prices and income. In primitive societies, costs might have been measured by the time and energy demands of hunting or gathering while affordability might have been defined in terms of hours of daylight or caloric intake. In either case, to properly account for how individuals respond to a changes in acquisition costs or available resources or to changes in social policies (regulations, taxes, tribal customs), it is necessary to understand how individuals use all three types of information in making choices.

In order to understand the role of tastes and preferences, we first need to develop a way to model or describe the relevant economic information about tastes and preferences. We call this approach *utility theory*. Utility theory helps tell us what people like and how much more they like one item relative to another. Ultimately, the acquisitions a person makes depends upon the extent to which that person's resources restricts the ability of that person to satisfy his or her wants, needs, and/or desires. By assuming that each person make decisions to maximize some personal notion of well-being (which can include or ignore what happens to others), we can develop a theory that tells us how individuals respond to changes in prices and income.

**Outline**

I. Utility Theory - A way to analytically talk about tastes and preferences. (Chapter 3)

II. The Role of Prices and Income - Describing the set of affordable purchases. (Chapter 4)

III. Utility Maximization - By assuming that people make decisions with an objective in mind, we can develop a theory that integrates preference information with price and income information. (Chapter 4)

IV. Demand - The solution to the consumer's utility maximization problem gives us demand information. (Chapter 5)

IV. Income and Substitution Effects - A price change affects choice behavior in two ways. First, it causes people to buy more of the goods that have become relatively less expensive and less of the goods that have become relatively more expensive. This response is called the substitution effect. Second, a price change indirectly alters a person's purchasing power or real income, that is, the amount utility the person can afford. A person's response to a change in purchasing power is called the income effect. Understanding how the substitution and income effects work helps us better understand the complex responses consumers have to price changes and motivates a number of sophisticated marketing and policy strategies. (Chapter 5)

***Key Concepts and Ideas.***

- Consumer preferences for goods and services generally exhibit diminishing marginal rates of substitution: The more a consumer has of one good the less of other goods the consumer is willing to give up.
- A consumer can maximize utility subject to a budget constraint by making purchases where the last dollar spent on each commodity increases utility by the same amount.
- ***Real income*** refers to the benefit a consumer gets from his or her nominal income. Nominal income is the amount of money he or she has.

- All price changes generate an income effect and a substitution effect. For normal goods, price changes that increase real income create an income effect that increases consumption. The opposite is true for inferior goods. The substitution effect always works by increasing the consumption of the good that has become relatively cheaper.

***Important Skills.***

- Graphing a consumer's budget set (linear and non-linear prices) and indifference curves.
- Calculating a consumer's utility maximizing bundle and being able to explain the economic relevance of the equations used in the solution.
- Deriving individual demand from the utility maximization problem.
- Adding up individual demand curves to get the market demand curve.
- Decomposing any price change into an income effect and a substitution effect.