

Review Notes – Consumer Choice

- Simple two good model
- Budget constraint
 - $p_1X_1 + p_2X_2 \leq M$
 - meaning? graphically?
- Budget Line
 - $p_1X_1 + p_2X_2 = M$
 - meaning? graphically?
 - intercepts of the BL?
 - slope of the BL?
 - what shifts the BL?
 - opportunity cost of the two goods?
- Preferences
 - define consumption bundle, preferred, and indifferent
 - rationality
 - completeness (what's that?)
 - transitivity (what's that?)
 - indifference curves
 - how are points on, and off, an indifference curve related?
 - two points on the same indifference curve?
 - a point above and a point on an indifference curve?
 - a point below and a point on an indifference curve?
 - what do they look like?
 - how many are there?
 - in which direction is the consumer better off?
 - can indifference curves cross?
 - what do different examples of indifference curves look like?
 - utility
 - what does utility measure?
 - what happens to utility as we move to a higher indifference curve?
 - assume individuals want to maximize utility given prices, income, and preferences
 - what is marginal utility?
 - What is the marginal rate of substitution?
- How do consumer's maximize their utility?
 - Know utility maximization both graphically and mathematically
 - Graphically – get on highest possible indifference curve
 - Mathematically – $MRS = -p_1/p_2$

- how do you derive a demand curve, graphically, from indifference curve analysis?
 - Composite Goods
 - What are they?
 - How are they used?
 - Changes in Income
 - What is the income consumption path?
 - What happens to D as income changes?
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- Price Changes
 - What is a price consumption curve?
 - Income and Substitution Effects
 - Do Demand curves always have a negative slope?
 - No – what's a giffen good?
 - How likely are giffen goods?
 - Substitution effect of a price change – as price increases then Q_D decreases and the reverse.
 - Income effect of a price change
 - As the price decreases, then like \$\$ increases, so change consumption of the good
 - If the good is normal then what happens?
 - If the good is inferior then what happens?
 - You should know how to show the substitution and income effects graphically in each of three situations.
 - Applications
 - Decision making is made on the margin – example used in class was excise/tax and then a rebate.
 - Important point = don't change relative prices unless you wish to change behavior
 - What is market Demand?
 - What is consumer surplus?
 - Net benefit of consumption = total benefit – total cost.
 - What is consumer surplus graphically using demand curve?
 - What is consumer surplus graphically using indifference curves and budget lines?
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