Consumer Equilibrium

A2 Economics

Learning Outcomes

- What are consumers' economic objectives?
- Being subject to income constraint, how can consumers' maximize their utility?
- What are income and substitution effect of product price change?
- How is the slope of budget line defined?
- How is slope of indifference curves defined?
- What is the point of optimum allocation of individual's resources?

Consumption

- Consumption is defined as the process of buying goods and services to satisfy some need or want.
- Whenever consumers consume something that gives them some utility / satisfaction.
- Utility is the satisfaction that consumers derive from consumption of goods / services.

Consumer Equilibrium

- Since consumers' incomes are limited they need to smartly prioritize the things they want to spend their incomes on.
- Therefore consumers will prioritize their spending in terms of goods that yield them the highest level of satisfaction / utility.

Diminishing Marginal Utility

- Diminishing Marginal utility refers to the concept that each additional unit of good will provide lesser satisfaction to the consumer as compared to previous unit.

- For simplicity, economics assume that all products have diminishing marginal utility.

Consumer Equilibrium

- This model of consumer equilibrium will help us answer the question that how consumers decided about what products to buy and what products not to buy.

- Or more simply speaking how to allocate their incomes between different goods.

Budget Line

- The graphical depiction of an individual's consumption possibilities being subject to his/her fixed income and fixed prices for two different goods.
- Increase in consumers' income cause the budget line to shift outwards and vice versa.
- The budget line will shift outwards from the axis if the price of that good decreases and vice versa.

Indifference Curve

- The graphical depiction of all possible combinations of two different goods/services that yield same level of utility for a typical consumer and hence he/she is indifferent between the consumption of these points.

Indifference Curve

- Any indifference curve that lies to the right of another indifference curve yields higher utility for any consumer. Higher indifference curves provides more consumption possibilities that are unavailable at lower indifference curves.

Income and Substitution Effect of Price Change

- If one of the two goods become relatively cheaper then the relative price of these two goods change. The good whose price decreases becomes relatively cheaper.

- If consumption of the good that has become relatively cheaper increases then Substitution Effect of price change has taken place.

Income and Substitution Effect of Price Change

- If consumption of the good that has become relatively expensive is increased then Income Effect of price change has taken place.
- In a lot of cases of price change, both the changes take place. Like the total effect of price change consists of both substitution and income effect.

Budget Line and Indifference Curve

- Budget line is a straight downward sloping line that intersects both the axis.
- The gradient of budget line is equal to negative of Px/Py.
- The gradient of indifference curve is equal to negative of MUx/MUy.
- At the point where budget line is tangent to indifference curve, the gradient of the two lines is equal.

Optimum Allocation of Individual's Resources

- When we mathematically equate the values of two gradients for these two lines, we are able to solve for optimum values of units of good X and units of good Y that a typical consumer should consume to maximize his total utility given his budget constraint.