



Consumer Equilibrium

MEGA LECTURE

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.

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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 P_x/P_y .
- The gradient of indifference curve is equal to negative of MU_x/MU_y .
- 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.