Micro Economics

Theory of Consumer Behaviour

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PART-1

Consumer is an economic agent who consumes final goods or services for a consideration. Thus **Consumer behaviour** is the study of how individual customers, groups or organizations select, buy, use, and dispose ideas, goods, and services to satisfy their needs and wants. It refers to the actions of the consumers in the marketplace and the underlying motives for those actions.

Utility is want satisfying power of a commodity. There are two types:-

- **Total utility** is the total satisfaction derived from consumption of given quantity of a commodity at a given time. In other words, It is the sum total of marginal utility.
- **Marginal Utility** is the change in total utility resulting from the consumption of an additional unit of the commodity. In other words, it is the utility derived from each additional unit.

Law of Diminishing Marginal Utility: As consumer consumes more and more units of commodity the Marginal utility derived from each successive units go on declining. This is the basis of law of demand.

Consumer's Bundle is a quantitative combination of two goods which can be purchased by a consumer from his given income.

Law of Equi-Marginal utility- It states that when a consumer spends his income on different commodity he will attain equilibrium or maximize his satisfaction at that point where ratio between marginal utility and price of different commodities are equal and which in turn is equal to marginal utility of money.

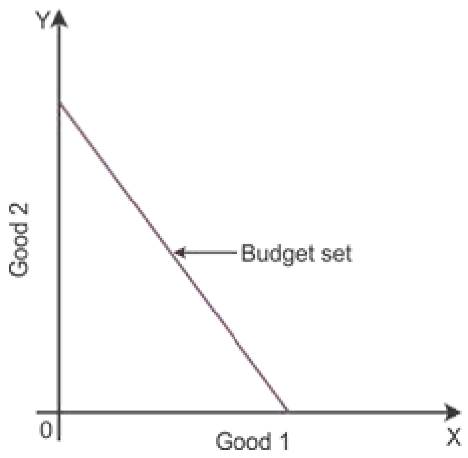
Budget set is quantitative combination of those bundles which a consumer can purchase from his given income at prevailing market prices. The group of all the bundles which the consumer is able to buy with his/her income at the prevailing prices in the market is called the budget set of a consumer. The budget set of a consumer is basically a collection of all bundles of goods and services which a consumer can purchase by using the available income.

Consumer Budget:- A budget constraint represents all the combinations of goods and services that a consumer may purchase given current prices within his or her given income. Consumer Budget states the real income or purchasing power of the consumer from which he can purchase certain quantitative bundles of two goods at given price. It means, a consumer can purchase only those combinations (bundles) of goods, which cost less than or equal to his income.

Budget Line: A graphical representation of all those bundles which cost the amount just equal to the consumer's money income gives us the budget line. The budget line represents two different combinations of goods which a consumer can purchase with the given income and prices of commodities.

For example;-

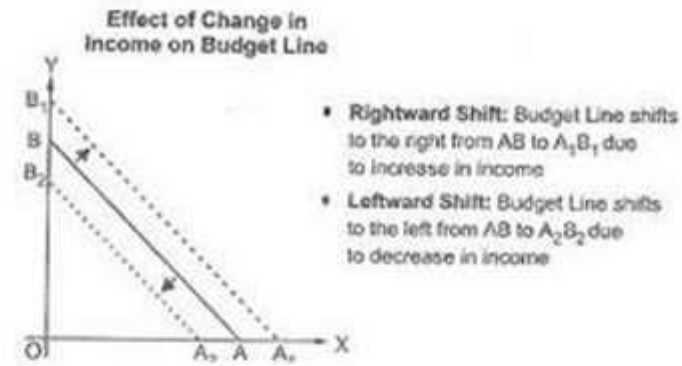
Q1 be the amount of Good 1, Q2 be the amount of Good 2, P1 be the price of Good 1, P2 be the price of Good 2, P1q1 = Total money spent on Good 1, P2q2 = Total money spent on Good 2. Therefore, the equation of the budget line will be p1q1 + p2q2 = X. The budget set can be shown in the below diagram:

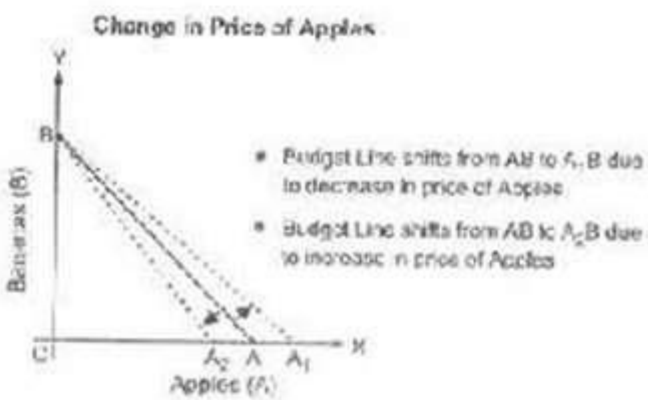


Budget line always slope downwards so that consumer can increase the consumption of Good 1 only by decreasing the consumption of Good 2. If consumers desire to have one additional unit of Good 1, then they can only have that additional unit if they manage to give up some quantity of other good. Consumers have limited income. They have to decide whether to spend on either Good 1 or Good 2.

Monotonic Preferences: Consumer's preferences are called monotonic when between any two bundles, one bundle has more of one good and no less of other good as it offers him a higher level of satisfaction.

Change in Budget Line: There can be parallel shift (leftwards or rightwards) due to change in income of the consumer and change in price of goods. A rise in income of the consumer shifts the budget line rightwards and vice-versa. In case of change in price of one good, there will be rotation in the budget line. Fall in price cause outward rotation due to rise in purchasing power and vice-versa.





Marginal Rate of Substitution (MRS) : It is the rate at which a consumer is willing to substitute (good Y/ good X) one good to obtain one more unit of the other good. Generally, It is the slope of indifference curve.

$$MRS = \frac{\text{Loss of Good Y}}{\text{Gain of Good X}} \text{ or } -\frac{\Delta Y}{\Delta X}$$