

EXAM #1: Chapters 1, 2, and 21

Don't forget to review chapters 1 and 2 for the first exam.

CONSUMER THEORY (Chapter 21)

How do consumers decide what to buy in the market?

They maximize their utility (happiness) subject to their budget constraint.

A. Budget Constraint

Income, Price of good X, Price of good Y

Calculate slope of budget constraint (negative)

What happens to budget constraint when we change Income? P_X ? P_Y ?

B. Utility

Preferences—what people like

Indifference curve—graphical representation of utility

Slope of indifference curve

Properties of indifference curves

Higher curves are preferred to lower curves

Downward sloping

Do not cross

Bowed inward

Marginal Utility

Law of Diminishing Marginal Utility

Marginal Rate of Substitution

C. Consumer Optimization

At tangency point, slope of indifference curve = slope of budget constraint

Bang per buck – make sure you can do the math!

How do changes in income affect consumer choices?

Normal vs. inferior goods

How do changes in prices affect consumer choices?

Deriving a demand curve—all points on demand curve are optimal consumption points

[Remember to skip the sections discussing 1) indifference curves for goods that are perfect substitutes and perfect complements and 2) the income and substitution effects of a change in price.]