

Chapter 19 - The Logic of Consumer Choice

1. **Budget line** – a limit of consumption choices – want more of one thing, gotta give up some of another. Sorta like a household PPF
2. **The Budget Equation** – the equation of the budget line
3. **Real income** – household income expressed as a quantity of goods the household can afford to buy
4. **Relative price** – the price of one good divided by the price of another good. Instead of giving up \$10 for a CD, we have to give up 8 sodas for 1 CD. This is also the opportunity cost of the CD
5. A change in price changes the slope of the budget line – if the price falls by 50%, you can now afford twice as many. Relative prices change, but total income don't change.
6. A change in income shifts the budget line, either in or out. Total income changes, but relative prices do not change. Hence, slope remains the same
7. **Indifference curve** – a line that shows combinations of goods among which a consumer is indifferent. Below it is NOT preferred, and above it is preferred
8. **Family of curves** – anything on the upper curves is preferred to anything on the curve below it. This is known as a higher indifference curve
9. **Marginal Rate of Substitution** – The rate at which a person will give up good y (the good measured on the y axis) to get an addition unit of good x(the good measured on the x axis) and at the same time remain indifferent. This is the slope of the indifference curve at that point (think derivative)
10. **Diminishing marginal rate of substitution** – as we get more of one good, we don't value it as much. If at one point we're willing to give up 10 units of y for 1 unit of x, there's another point when we're only willing to give up 1 unit of x for a unit of y. Aka too much of a good thing is bad
11. **Degree of substitutability** – no matter how unrelated goods are, they're always somehow related
12. **Close/perfect substitutes** – indifference curves are straight lines – constant marginal rates of substitution
13. **Close/Perfect Complements** – indifference curves are L shaped – having two left shoes and a right or two right shoes and a left is the same. Also known as an infinite/0 marginal rate of substitution
14. **Ordinary goods** – curves w/ diminishing marginal rates of substitution
15. **Best attainable point** – on the highest indifference curve, on the budget line, and has a marginal rate of substitution between the two goods to be the relative price of the two goods
16. If the MRS is greater than or less than the relative price of the two goods, spending will change since we can get the same amount of satisfaction, yet have some unspent income
17. **Price effect** – Price effects changes the slope of the budget line, hence changing the best affordable point
18. **Income effect** – the income effect shifts the budget line, which changes the best affordable point
19. A change in price moves along the demand curve, a change in income shifts it (law of demand)
20. **Substitution Effect** – The effect of a change in price, then shifting the budget line to keep it on the same indifference curve as before. This basically says that if the price of a good falls, consumption of that good increases while the consumption of the other good decreases. The income shift is just to keep it on the same indifference curve so they can be compared
21. **Income Effect due to the Substitution Effect** – Since we shifted the budget line in the substitution effect, now we must shift it back. For normal goods, the income effect reinforces the substitution effect. For inferior goods, the income effect is negative. Hence, lower price doesn't always mean more quantity demanded, depending on the magnitudes of the income and substitution effects
22. **The substitution effect and income effects together form the price effect**
23. **Labor** – work
24. **Leisure** – everything else
25. **Income time budget line** – Set of indifference curves w/ income on the Y, leisure hours on the X. Slope is the hourly wage rate, which is also the opportunity cost of leisure
26. Depending on the hourly wage attainable, choose the best possible point, the slope is the hourly wage, and the intersection of the line through the 168 hour/week 0 point and the highest indifference curve is the optimum hours of work and leisure
27. **Labor supply curve** – As wages increase, hours increase, but past a certain point, they start decreasing. As wages increase, the opportunity cost of leisure increases, but since leisure is a normal good, as income increases, people demand more of it. In other words, there's both a substitution effect and an income effect. The substitution effect leans towards more work, while the income effect leans towards more leisure. Generally, in this case, the income effect outweighs the substitution effect