

Learning Objectives

Chapter 21

In this chapter you will

- See how a budget constraint represents the choices a consumer can afford
- Learn how indifference curves can be used to represent a consumer's preferences
- Analyse how a consumer's optimal choices are determined
- See how a consumer responds to changes in income and changes in prices
- Decompose the impact of a price change into an income effect and a substitution effect
- See how the demand curve is derived
- Apply the theory of consumer choice to three questions about household behaviour

You should be able to

- Draw a budget constraint on a graph if you are given the value of income and the prices of the goods
- Explain why indifference curves must slope downward if the two products considered are "goods"
- Show the point of optimal choice for the consumer on a graph
- Explain the relationship between the relative prices and the marginal rate of substitution between two goods at the consumer's optimum
- Shift the budget constraint when the price of a good increases
- Demonstrate the income and substitution effect on a graph using indifference curves and budget constraints
- Show why someone's labour-supply curve might be backward sloping