The Consumer

At the end of this section a student will be able to:

- evaluate the economic role of consumers in an economy, explaining how positive and negative incentives influence consumer activity
- critique the assumption that consumers taking part in economic activity behave rationally

Role of Consumers in Society

- **To determine what goods and services are produced**
    - Consumers buy economic goods according to their individual demand. The total of all individual consumer demand is referred to as "aggregate demand".
- **Provide information about habits, trends and preferences**
    - Business research consumer patterns to try and meet their demands. When a business comes up with a new idea they must use information they can gather from their target consumers to see if it will be a success. The habits and preferences of consumers force businesses to adapt their offerings to meet actual consumers demand.
- **Pay for economic goods**
    - When consumers pay for goods this the supplier can use that money to create wealth, employ people and invest which can lead to economic growth.
        - Economic goods have the following characteristic:
            - **They give utility**
                - They must give **satisfaction** or be **beneficial** to the consumer or else consumer would not buy them
            - **They must be transferrable**
                - It must be possible to transfer the good to others. Eg physical fitness is not transferable therefore it is not an economic good. Beauty and sporting talent are other examples of goods that are **not** economic goods
            - **They must be scare and command a price**
                - If the good were not scarce in relation to demand for it then nobody would be willing to pay for it. For example air, sand at a beach are not economic goods

Assumptions Economists Make about Consumers

- **The consumer has a limited income.**
    - The consumer's income is not large enough to satisfy his/her needs and wants, therefore the consumer must choose between those goods he wishes to buy.
- **The consumer aims to gets maximum satisfaction / utility from that income an will act rationally**
    - A consumer will spend his/her limited income in such a way that he/she will achieve the most satisfaction / best value for money. He will obey the principle of Equi-Marginal Returns.
    - Eg: If the person sees an identical commodity priced differently in two adjoining shops they will but it at the lower price – this would be rational.

- **The consumer is subject to the law of diminishing marginal utility.**
    - As a consumer consumes additional units of a good his/her marginal utility for this good will eventually decline.

Consumer DO NOT always act rationally

The following factors may undermine a consumer's ability to act rationally:

- **Following a fashion trend**
    - Consumers may not spend their money in a way that maximises utility when following a fashion trend, or when intentionally trying to be different from the group.
- **The paradox of choice**
    - When faced with too much choice a consumer may make choices which does not maximise their utility.
- **Value Consciousness**
    - Consumers may make purchases based on their values (e.g. environmental reasons) therefore not maximising utility
- **Habitual Behaviour**
    - Due to brad loyalty or habit a consumer may make purchases that do not maximise their utility
- **Incomplete information**
    - Consumers may make poor decision due to incomplete or poor quality information.
- **Rule of thumb**
    - Consumer may use simple aids like buying the "middle priced" item even though they are not maximising their utility
- **Anchoring behaviour**
    - This happens when a consumer places too much emphasis on a particular piece of information which may lead to irrational behaviour.
- **Influence of Marketing**
    - Marketing tools can prompt us to make emotional purchases that are not rational.

Utility

Economists use the term **utility** to describe the satisfaction or enjoyment derived from the consumption of a good or service. If we assume that consumers act rationally, this means they will choose between different goods and services so as to maximize total satisfaction or total utility.

Consumers will take into consideration:

- How much satisfaction they get from buying and then consuming an extra unit of a good or service
- The price that they have to pay to make this purchase
- The satisfaction derived from consuming alternative products
- The prices of alternatives goods and services

Marginal Utility is the change in total utility or satisfaction resulting from the consumption of one more unit of a good.

No. of Sandwiches	*Total Utility*	*Marginal Utility*
1	*20*	-------
2	*65*	45
3	*135*	70

Note: By definition MU is the addition to total utility got from the consumption of an extra unit of a good. Therefore, the MU of the first item is not normally shown as there was no consumption of the goods before the first one.

Law of Diminishing Marginal Utility

- This law states that as a consumer consumes additional units of a good the marginal utility/ extra satisfaction derived from each additional unit consumed will eventually decline.

No. of Sandwiches	*Total Utility*	*Marginal Utility*
1	*20*	-------
2	*65*	45
3	*135*	70
4	*160*	35
5	*180*	20

In this example the LDMU sets in after the third sandwich is consumed or when the fourth sandwich is consumed as the marginal utility began to decrease.

Fill in the table below as a test:

Number of units consumed	**1**	**2**	**3**	**4**	**5**	**6**
Total Utility in units	**30**	**65**	**85**	**100**	**110**	**115**
Marginal Utility in units	**30**					

Complete the table and state the point after which diminishing utility sets in.

- **Assumptions underlying the LDMU**
  - **Applies after a certain point called the origin.**
    - The origin is the minimum quantity of the commodity which can be used effectively and until this stage has been reached, marginal utility may not diminish. Eg drinking a whole can of coke as opposed to taking a sip.
  - **It does not apply to Addictive goods.**
    - The consumer may gain increasing marginal utility by consuming each additional unit of an addictive good.

- **Time lapse between consumption of successive units. Sufficient time has not elapsed between the consumption of successive units.**
    - If a person eats a number of oranges, each additional orange consumed will give diminished marginal utility. However, if a person eats one on a Monday, one on a Thursday and one on Sunday, because of the time which has elapsed between the consumption of each extra orange marginal utility may not diminish.
- **'Other factors' affecting utility do not change.**
    - The law is based on the assumption that other factors which may affect a consumer's utility do not change including income levels, the nature of successive units of the commodity; and the consumer's taste for the commodity.

- **<u>Commodities/Goods that do not comply with the LDMU</u>**
    - **Medicine**
        - A person may get the same benefit from every dose. One's marginal utility may not decline as more doses are taken
    - **Addictive goods eg: alcohol or cigarettes**
        - The consumer's marginal utility will decline because each extra unit consumed brings the consumer constant/increasing marginal utility

<u>Principle of Equi-Marginal Returns (Law of Equi-Marginal Utility)</u>

- The laws states that a rational consumer who wants to maximise utility will allocate their limited income so that the ratio of marginal utility to price is the same for all goods consumed.
- Consider an example where a consumer has a choice between two goods A and B which have prices Pa and Pb respectively.
- Total Utility will be maximised when the utility derived from the last euro's worth of A is equal to the utility derived from the last euro's worth of B.
- Total utility maximised when:

$$\frac{\text{Marginal utility of good A}}{\text{Price of good A}} = \frac{\text{Marginal utility of good B}}{\text{Price of good B}}$$

Using the above solve the problem below:

In equilibrium a consumer buys 8 bars of chocolate at €1.00 each and 12 sandwiches at €4.00 each.
The marginal utility of the eighth bar of chocolate is 10 utils.
Using the Equi-Marginal Principle of Consumer Behaviour **calculate the marginal utility of the twelfth sandwich**.

Show all your workings.

Workings

Answer:

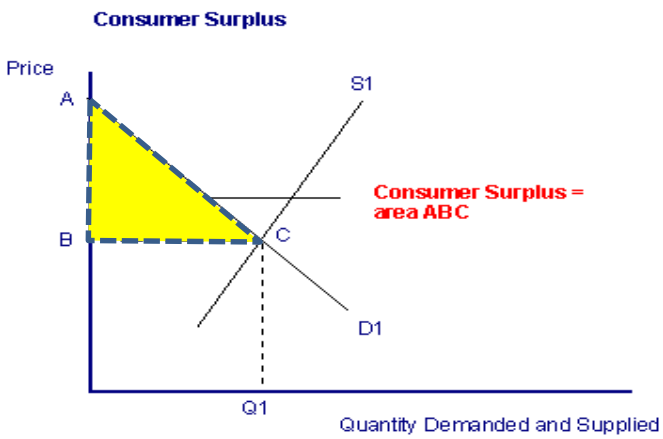
_____

Watch this

Consumer Surplus

Consumer surplus is the difference between what consumers are **willing to pay** for a good or service (indicated by the position of the demand curve) and what they **actually pay** (the market price).

The level of consumer surplus is shown by the area under the demand curve and above the ruling market price



Watch this up to 5min 20

Impact of Technology on Consumers

- **Easy access to more information**
  - With the advent of the internet/smartphones/price comparison websites consumer have access to much more information that allows them to make better decisions. Eg pricespy, tripadvisor, trivago, skyscanner
- **Consumers subjected to targeted advertising**
  - Businesses are always trying to gather data about their potential customers. This data allows them to determine consumer preference and target them with personalised ads in-line with their preferences. Eg – ads appearing on social media feeds based on previous browser searches
- **Less tied to buying in their geographical location**
  - E-commerce means that consumers can research and buy products from all over the world.

- **Consumers more exposed to international trends**
    - With the rise of social media and international influencers consumers can be exposed to more trends from across the globe
- **New payment methods available**
    - Consumers can use their phones to tap and go at pay points. Consumers could be more inclined to impulse buy as a result.

Influence on Consumer's choice - Incentives

Economic incentives are offered to encourage people to make certain choices or behave in a certain way. They usually involve money, but they can also involve goods and services.

Positive economic incentives leave you better off if you do what was asked of you. These incentives benefit you in some way. They reward you with money or some sort of financial gain such as a better price, a free item, or an upgraded item. Restaurants use coupons, buy-one, get-one deals, Kid's Eat Free Night, and other incentives to encourage people to **choose** their restaurant. Shops offer sales, discounts, buy-one, get-one free and other incentives to get customers to **choose** their shop. Airlines give frequent flier miles as incentives for people to **choose** to fly with them.

Negative incentives leave you worse off financially by making you pay money. These incentives cost you money. Fines, fees can be negative economic incentives. They are called negative because they are things you don't want to get. "Buy a TV license or face fine/jail time"

Incentives affect our daily lives in many ways. A famous example is the analogy that if you hold a carrot in front of a donkey–offering it an incentive to move forward–and also thwack its rump with a stick–offering a disincentive to stand still–then likely it will start walking forward. Parents typically offer both rewards and punishments to encourage good behaviour and discourage bad behaviour by their children.

In economics, incentives may involve either cultural norms, or financial rewards and punishments. Cultural norms may offer incentives by rewarding with social acclaim those who help the needy, or may offer disincentives (negative incentives) by punishing those who engage in theft. Financial incentives may involve offering financial prizes or financial fines for good or bad behaviour, or often just a change in a price that ends up with your having to spend more or less for what you want to sell or buy.

Incentives and disincentives (negative incentives) are not guarantees of behavioural changes. But, they tend to induce behavioural changes by choice rather than by force. Your parents can tell you that you are forbidden to text your friends after 8 p.m. and if you do it, they'll take away your phone for a month. Or, they can dock your pocket money by €1 per text message after 8 p.m. Both kinds of incentive structure may grate on you but it will likely change your behaviour at least a small bit.

The most common economic incentive is something we take for granted every day: **Prices are incentives.**

For example, a rise in the price of any good is an incentive for us to back off from buying it as much as we used to. Perhaps we'll buy a different good instead. So, for example, a rise in the price of butter creates an incentive to buy less butter. Maybe we'll buy margarine instead. Or maybe we'll use butter more sparingly and simply buy it less frequently. Or, if I'm a baker, maybe I won't change my use of butter directly, but I'll cut back on buying something else to be able to keep buying butter. No matter what, though, the change in the price of butter creates an incentive for me to change my behaviour–my economic behaviour.

And buyers are not the only ones affected by and with revised incentives in the fact of a price change. If I raise dairy cows and sell them for milk, a rise in the price of butter may give me an incentive to breed more cows or sell more raw milk to butter producers who are willing to pay more than they used to, what with the increased price of butter they are receiving. I may even have an incentive to change the seed I plant so as to encourage my cows to produce milk more conducive to butter production.

The moral is that every price change entails incentives for almost everyone in the economy. Though you may not think about it a lot, you probably make a lot of decisions every day that involve responding to your ever-changing personal incentives. Incentives matter, not only in your personal decisions but also across a whole economy, because often those incentives result in similar choices which accumulate across many individuals.

Taxes change prices. Thus, a change in tax rates affects incentives. Some economists argue that taxes should in fact be used with the express purpose of changing behaviour. For example, if a government decides it does not want its citizens to use plastic straws, it can do that by publicising the ill effects of plastic straw use, or by forbidding the use of plastic straws, or by taxing the use of plastic straws. Taxing the use of plastic straws, while it does not guarantee that there will be less use of plastic straws, does allow both buyers and sellers a degree of choice. Families with disabled children who need straws to drink at restaurants may still be able to find restaurants that offer paper straws. Restaurants that cater to traveling truck and car drivers who rely on straws to sip drinks while they drive can still decide what to do to serve their clientele.

Watch: Incentives explained

Consumer Sentiment Index

Consumer sentiment is an economic **indicator** that **measures** how optimistic consumers feel about their finances and the state of the economy. The index uses data collected by the ESRI for its monthly Consumer Survey. The monthly telephone survey collects information on people's views of the economic situation, the housing market and the savings environment. The data is used to track changes over time in people's views and experiences.

Link to KBC website