The Consumer

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.**
  - 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.
- **The consumer acts rationally.**
  - The consumer acts in that manner consistent with his preferences. If the person sees an identical commodity priced differently in two adjoining shops they will but it at the lower price.
- **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.

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.

Characteristics of Economic Goods

- **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

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.

- o **‘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>**
  - o **Medicine**
    - ▪ A person may get the same benefit from every dose. One's marginal utility may not decline as more doses are taken
  - o **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 Returns)</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 **<u>calculate the marginal utility of the twelfth sandwich</u>**.

Show all your workings.

Workings

Answer:

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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