Consumer Behavior

2. The Role of Consumers in the Economic Theory

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2.1. Assumptions: The *Homo Economicus*

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2.1 Assumptions: The *Homo Economicus*

Homo economicus is the person looking to efficiently maximize his/her needs or desires. It describes humans as rational and self-interested beings, subjected to constraints, capable of making judgments, using perfect information, towards subjectively defined ends.

The rational economic actor desires to satisfy her/his needs, does not desire to work if it can be avoided, and is able to find ways of achieving targeted goals.

This concept assumes that;

People know what they want and their priorities.
People can judge the utility that consuming a good will bring.
People can place a value on the utility.
People seek to satisfy their own needs at the minimum cost.

People behave rationally when they,

Search for the cheapest product available
Buy what they need most
Seek to maximise utility with the scarce money available
Consider the opportunity cost of their decisions

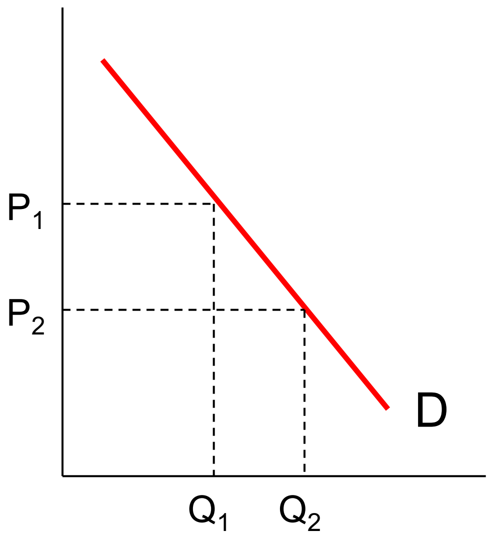
But don't behave rationally when they,

Make decisions that are not self-interested
Allow emotions to influence decisions
Follow others rather than thinking for ourselves
Make decisions without all the information they need

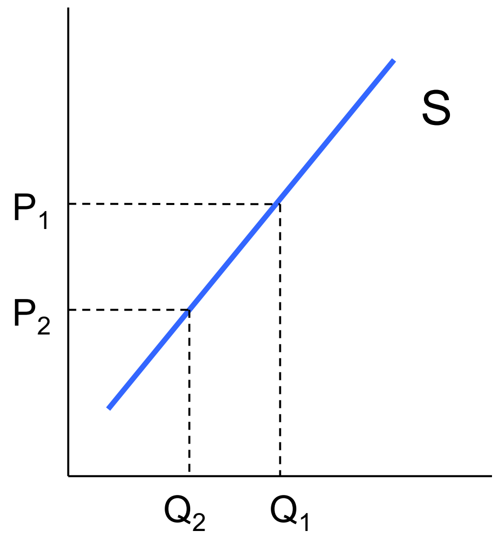
2.2 Elementary Theory of Supply and Demand

Consumers demand goods and services when they buy. The demand is the number of consumers willing to buy a product at a certain time for a certain price.

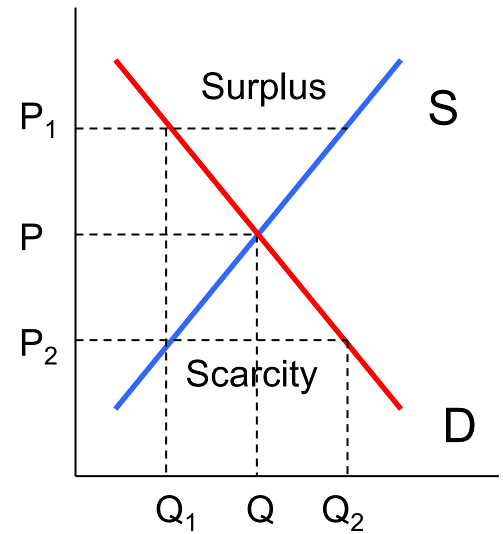
Supply and demand are closely connected. They cause prices to increase and decrease. When the supply is greater than the demand, prices go down. When the demand is greater than the supply, prices go up.



Demand: $Q_d = f(P_d)$



Supply: $Q_s = f(P_s)$



Equilibrium

Dynamics of equilibrium

When prices are high, consumers will purchase fewer of those products. Producers however, will be motivated to make more products to sell when prices are high and they can get more money from them.

Sometimes the supply is not available. Then the product is scarce. When scarcity occurs, the prices often increase. Then people must make decisions or choices. When this happens, they must often choose to buy less.

When prices are low, consumers purchase more of those products. More people can afford to buy them. Producers will then make fewer of these products to sell because they do not make much money from them, and the supply will decrease.

Price elasticity of demand

Measures consumers' price sensitivity.

Shows the responsiveness of the quantity demanded of a good or service to a change in its price. Gives the percentage change in quantity demanded in response to a one percent change in price.

$$e = \frac{Q_1 - Q_0 / Q_0}{P_1 - P_0 / P_0}$$

If $|e| > 1 \rightarrow$ Elastic demand

If $|e| = 1 \rightarrow$ Unit elastic

If $|e| < 1 \rightarrow$ Inelastic demand

2.3 The Theory of Utility

Needs, satisfaction and utility

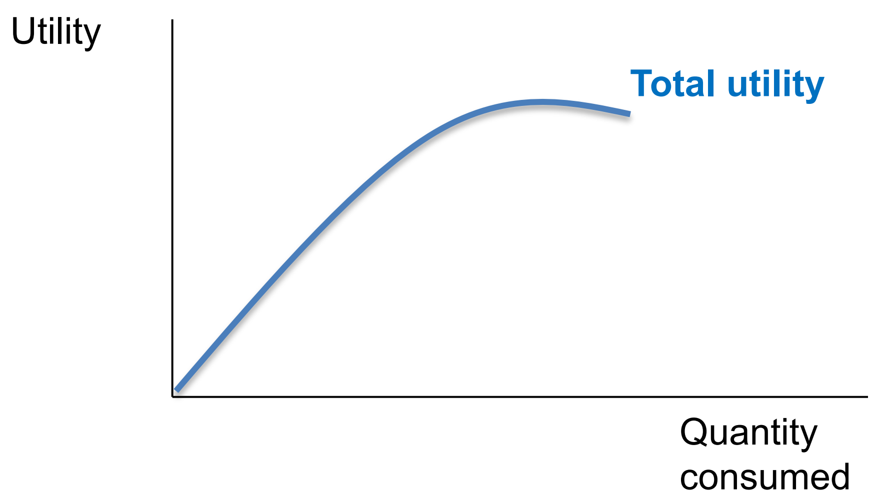
Consumers derive utility from the satisfaction of their needs by purchasing and using goods and services. Utility is the amount of satisfaction obtained when consuming products.

Although it is almost impossible to measure utility, it is usually possible to rank the alternatives in their order of preferences to the consumer.

If U(A) and U(B) are the utilities derived from products A and B
And A is preferred to B
then U(A) > U(B)

The utility function

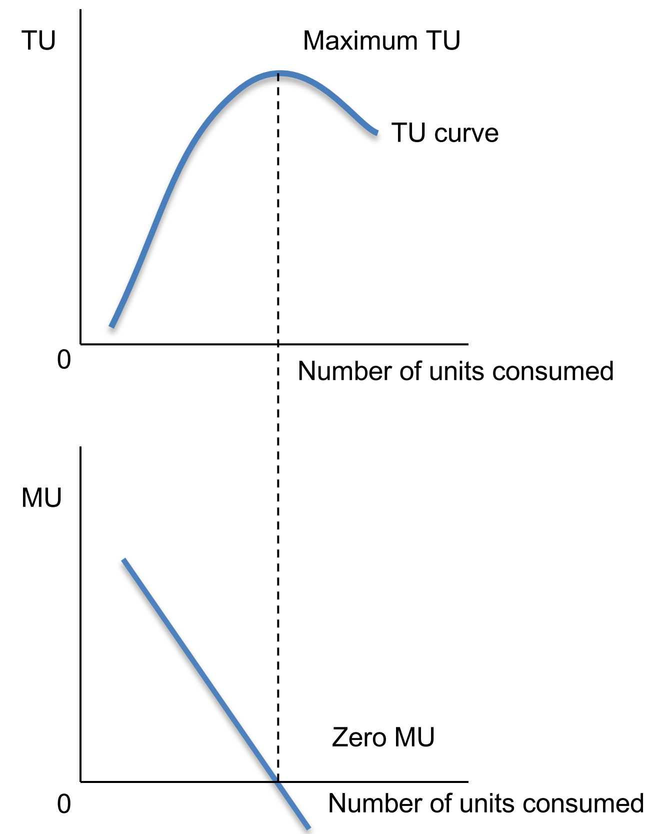
Assumes increasing utility is directly associated with increasing levels of consumption. The more you are able to consume, the more utility you derive. But there is a saturation point turning the slope downward.



Law of diminishing marginal utility

Marginal utility is the measure of relative satisfaction gained or lost from an increase or decrease in the consumption of a good or service.

As people consume more units of a specific product, the utility derived from the successive units goes on diminishing.

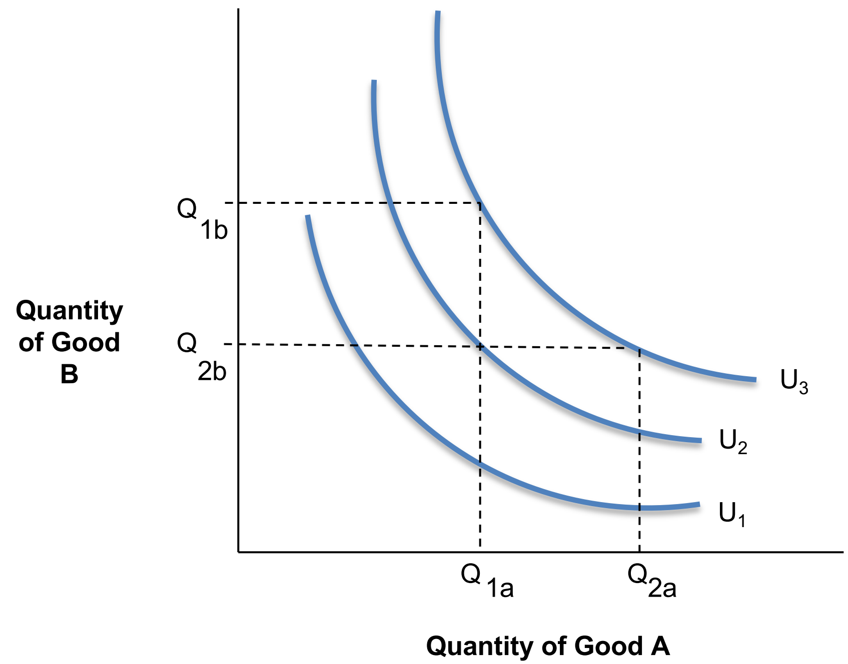


2.4 Indifference and choice

Indifference curve

This is a graphic representation of combinations of products resulting in the same utility for consumers.

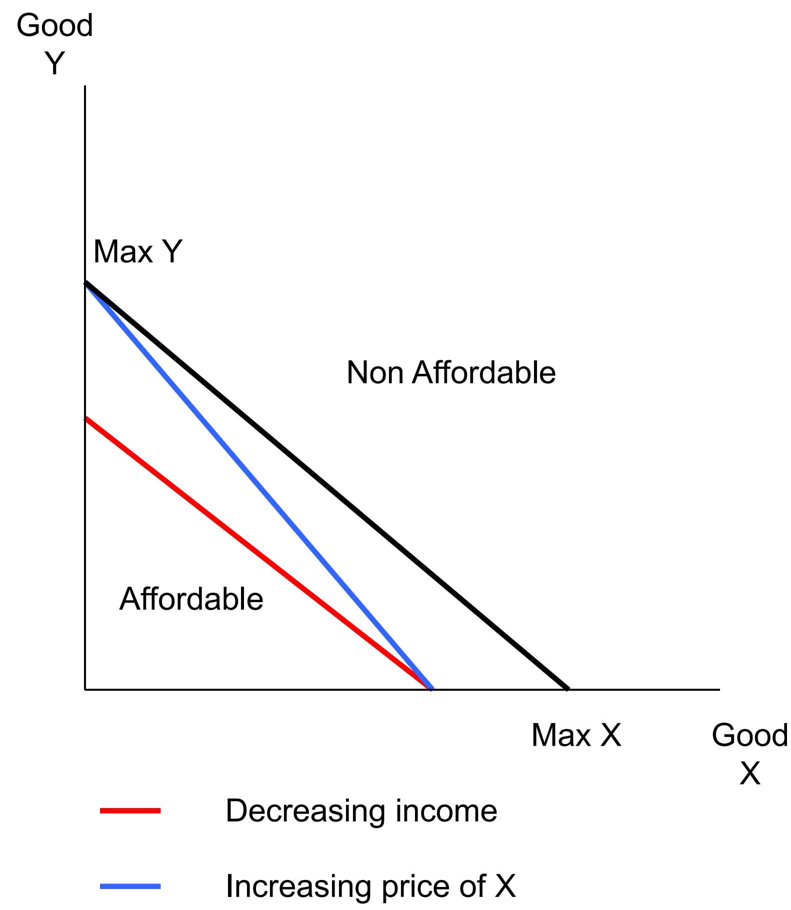
Assuming that more is better, upper curves will result in more utility, and will be preferred by consumers.



Balance constraint

This is a line representing the combinations of products a consumer will be able to purchase given current prices and income.

It changes as income and the prices of the goods change.



Individual choice

Point A, where the most preferred indifference curve is tangent to the budget constraint sets the best available combination of goods for the consumer.

Combinations in I4 are unaffordable.

Combinations in I2 are affordable, but result less satisfactory.