Lecture 9. Consumer Choice and Consumer Welfare

Register your clicker on Blackboard. Your exam score will be available by tonight. (It’s not so bad if your score isn’t good.)

Clicker Question
Consumer Choice

- How do consumers decide what to purchase?
  - Primarily a question of psychology.

- But economists traditionally have used models of “rational, self-interested consumers”:
  - The traditional models do not include the psychological factors that guide consumers,…
  - but traditional models have been useful for predicting consumer demand.

- Nowadays, many economists work in the field of *behavioral economics*, which incorporates economics and psychology. *(See required reading.)*

- Business schools teach *behavioral finance*.

Daniel Kahneman, a founder of *behavioral economics*, was awarded the Nobel Prize in 2002.
Classical Model of Consumer Choice

- **According to the classical model**, people consume in order to get **satisfaction** or **utility**.

- Different quantities of various goods and services provide different amounts of utility.

- Rational people want to purchase a combination of goods and services that will **maximize their utility**…

- …within the constraints (limits) imposed by their **income and wealth**.

- (Economists also use the **neoclassical model**, which is more abstract and may be misleading.)

Maximizing Utility

- Suppose a consumer has a fixed income that she can spend.

- If she wants to maximize her utility, then she must think “at the margin.”

- She will try to get the most utility from dollar after dollar.
• She will probably spend the first part of her income on basics: food and shelter.

• The next part of her income may be spent on comfort.

• If she has income remaining, she may purchase luxuries.

• The same idea applies to additional units of the same good.
  • The first units are applied to the most important uses.
  • Subsequent units increase comfort.
  • Additional units are often a luxury.
  • Still more, though, can make you worse off.
Emily’s Utility from Juice

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<th>Juice (Q)</th>
<th>Marginal Utility* (MU)</th>
<th>Total Utility (U)</th>
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<tr>
<td>0</td>
<td>60</td>
<td>60</td>
</tr>
<tr>
<td>1</td>
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<tr>
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<td>4</td>
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<td>160</td>
</tr>
<tr>
<td>5</td>
<td>-10</td>
<td>150</td>
</tr>
</tbody>
</table>

*Marginal Utility (MU) is the utility the consumer gets from a unit of consumption with preceding consumption taken into account.

Utility and Willingness to Pay

- The **marginal utility (MU)** that a consumer receives from a unit of a good is difficult to observe...
- because MU is a measure of satisfaction, a psychological state.
- However, consumers are **willing to pay** for a good because of the utility and welfare it creates.
- The **willingness to pay (WTP)**, which is the maximum amount a consumer is willing to pay for a good, is a monetary measure of utility and welfare.
- Economists like to use WTP, because we can observe payments and compute WTP from marketplace data.
- We will use WTP to discuss the relation between the demand curve and consumer welfare.
WTP Review

Suppose you are thinking of buying a good.

- If WTP = $60, you would not be willing to pay $61.
- But you are willing to pay $60 or less than $60.
- In particular, if the price of the good is only $12, you would be delighted to buy it.

Describing this situation, economists would say:

- Your *willingness to pay* = $60.
- The *price* = $12.
- Your *consumer surplus* = $48.

Clicker Question
Marginal Willingness to Pay

Suppose Emily is willing to pay the following for each plum:

- 1st: 12
- 2nd: 11
- 3rd: 10
- 4th: 8
- 5th: 4
- ...

These numbers are Emily’s marginal willingness to pay (MWTP) for plums.

Graph of Willingness to Pay

Does this curve look familiar?

- If the price were $12, how many plums would Emily buy?
- How many at $11?
- How many at $10?

It’s exactly the same curve as the demand curve!

If we know WTP, then we know demand.
The demand function and the WTP function are inverses.

- Utility creates the WTP, and WTP can be used to construct demand.

For the WTP curve...
- The plum # (horizontal axis) is the independent variable.
- The MWTP for that plum (vertical axis) is the dependent variable.

For the demand curve...
- The price (vertical axis) is the independent variable.
- The quantity of plums (horizontal axis) is the dependent variable.

The demand function and the WTP function are inverses.

WTP for several units

- How much is Emily willing to pay for a grocery bag with exactly 5 plums in it (if she begins with no plums)?

- We could find out by adding up her MWTP for each of the first five plums:
  - 1st: 12 +
  - 2nd: 11 +
  - 3rd: 10 +
  - 4th: 8 +
  - 5th: 4

  Total: 45
We can also see the WTP for 5 plums on the graph.

- 1st: 12 +
- 2nd: 11 +
- 3rd: 10 +
- 4th: 8 +
- 5th: 4 +

Total WTP for 5 units is approximately the area under the demand curve up to the 5th unit.

For divisible goods, the little yellow triangles would be filled in.

The same rule applies to any other number of units.

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**Consumer Surplus and Demand**

- Suppose the price is $P=$4.
  - Then Emily’s demand curve implies she will want to buy 5 plums.
  - Her WTP for 5 plums is $45.
  - But at $4 each, Emily will have to spend only $20 on plums.
  - The difference between the WTP and the expenditure, in this case $25, is the consumer surplus (CS) that Emily retains.
How accurate is WTP as a Measure of Utility and Consumer Welfare?

- Consumers buy things to obtain utility (satisfaction), which creates welfare.

- But consumers' WTP for goods may not always correspond to the utility the goods create.
  - Poor consumers may not be willing to pay as much as rich consumers for goods that give them the same utility.
  - Goods have unknown characteristics.
  - Utility depends on preferences* (or tastes), but people may not know their own preferences.
  - Consumers are sometimes willing to pay for goods that predictably lower their welfare.
  - Preferences change over time.

*Preferences describe what a person wants or desires, or what combinations of goods a person prefers to other combinations.
WTP may be inaccurate: *Examples*

- WTP may underestimate the utility of the poor:
  - Poor people may not be able to pay much for the goods that give them high utility.
  - If we want to see the WTP of the entire society by adding up the WTPs of individuals,…
  - …we may be placing too much weight on the rich.
  - For example, the WTP for expensive cars may exaggerate the utility those cars create.
  - And the WTP for cars of the poor may be too low.

- Goods have unknown characteristics, so WTP may not correspond to true utility.
  - Computers
  - Universities (from parents’ point of view)
More unknown characteristics

- Stereo Receiver, Model XRB81JK22V

- Super 88 (Asian supermarket).
  - Most Americans would have no idea of what these items are or how they would taste.

Utility depends on preferences (or tastes), but people may not know their own preferences.
Consumers are sometimes *willing to pay* for goods that predictably lower their welfare.

- Consumers may be self-destructive.
- Or they may yield to temptation.

Preferences and WTP change over time.

This means that WTP may reflect a consumer’s welfare in the short run, but not in the long run.
In spite of these problems, WTP and demand are often useful, for example, when…

- explaining how prices and incomes affect the choices that consumers make, and
- predicting prices and quantities transacted.

WTP and demand predict what people will do, even if they don’t accurately predict the welfare obtained.

Examples:

- How will an increase in the price of cigarettes affect teenage smoking? teenage drinking?
- How will an increase in the price of gasoline affect the kind of cars people buy?
End of File