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Ordinal Utility Theory

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Introduction

- According to ordinal school, a consumer is able to rank different combinations of the commodities in order of preference or indifference
- An indifference curve is the locus of points which show the different combinations of two commodities a consumer is indifferent about



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Indifference Curve

- 1-Indifference curves are downward sloping
- 2-Higher Indifference curve represents higher utility
- 3-Indifference curves are convex to the origin
- 4-Indifference curves can never intersect

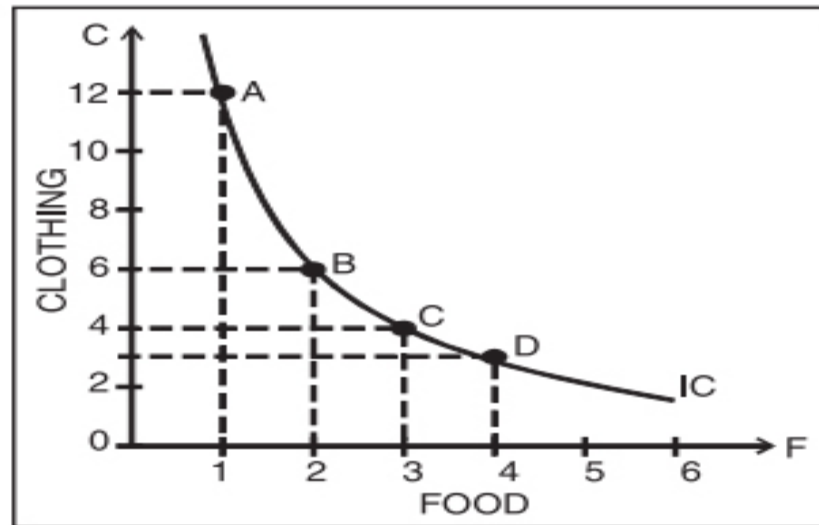


Fig. 1 : A Consumer's Indifference Curve



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Budget Constraint

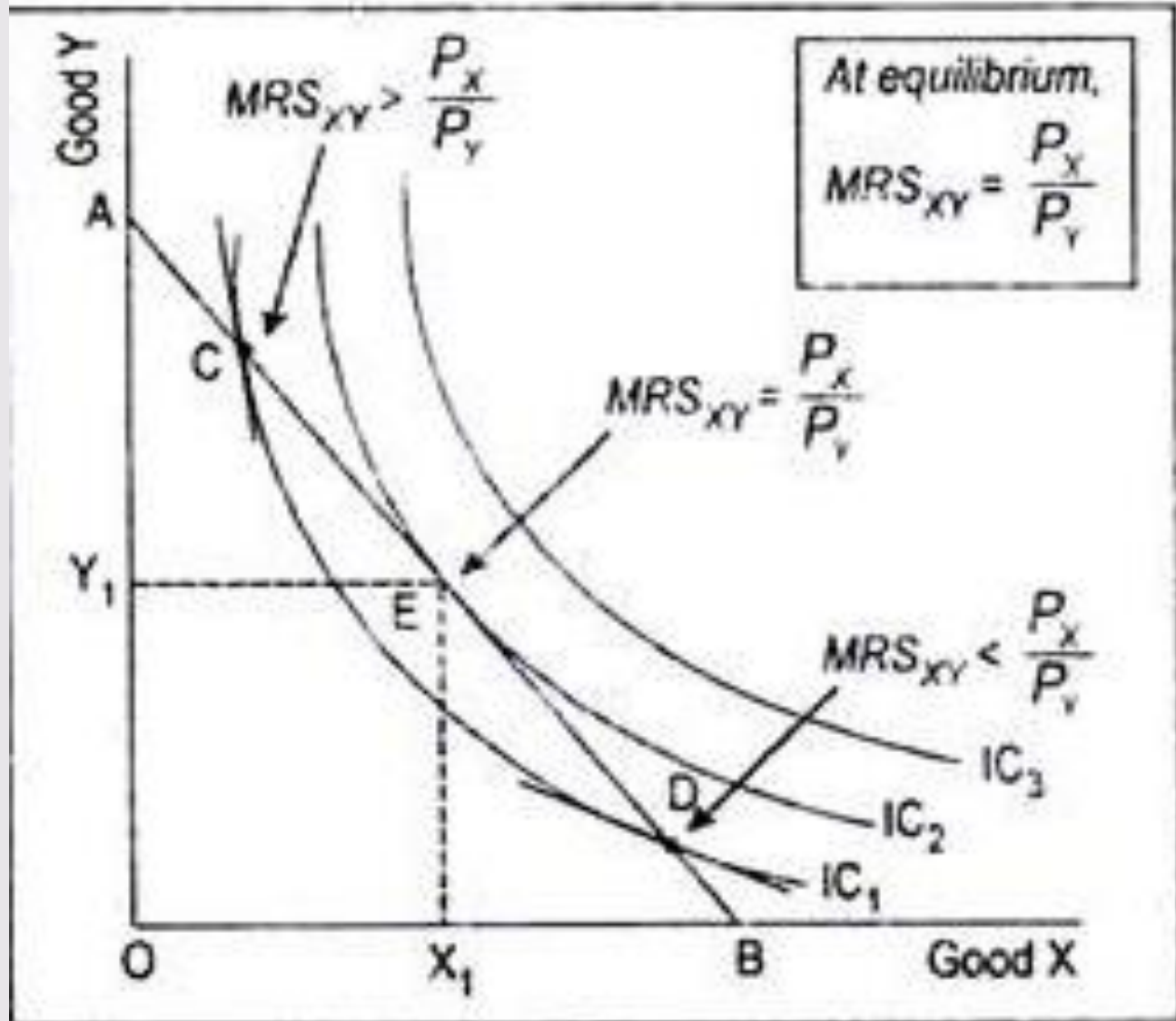
- The consumer faces two constraints-
 - 1-Income is limited
 - 2-He has to pay prices for the commodities

- Given the budget constraint, the consumer would be in equilibrium where the budget line is tangent to the highest possible IC



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Two important applications of indifference curves are frequently used to consider the effects of

(*a*) a change in money income and

(*b*) a change in the price of one of the two goods



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The Paradox of Value

More than two centuries ago, in *The Wealth of Nations*, Adam Smith posed the paradox of value:

“Nothing is more useful than water; but it will scarce purchase anything. A diamond, on the contrary, has scarce any value in use; but a very great quantity of other goods may frequently be had in exchange for it”



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Identify the reason of low price of water and very high price of diamond in line with demand and utility

Diamond-Water Paradox of Value



Water is more useful and is necessary for human life, yet diamonds are valued more highly.



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Happy Learning

