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Theory of Utility- Classical

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Utility

- **Utility** denotes satisfaction. It refers to how consumers rank different goods and services
- Utility is a scientific construct that economists use to understand how rational consumers make decisions
- In the theory of demand, we assume that people maximize their utility, which means that they choose the bundle of consumption goods that they most prefer.



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Example: consuming the first unit of ice cream gives you a certain level of satisfaction or utility. Now imagine consuming a second unit.





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Law of Diminishing Marginal Utility

This law states that the amount of extra or marginal utility declines as a person consumes more and more of a good

Utility increases as consumption increases, However, as you consume more, total utility will grow at a slower rate

The law of diminishing marginal utility states that, as the amount of a good consumed increases, the marginal utility of that good tends to decline.

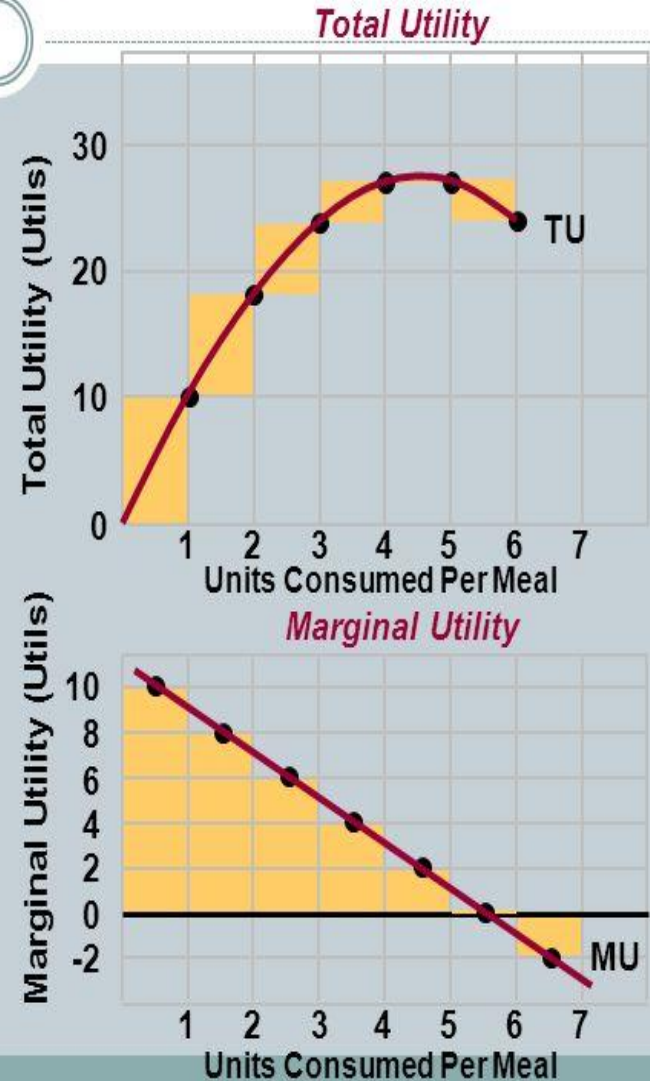


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Law of Diminishing Marginal Utility

(1) Tacos Consumed Per Meal	(2) Total Utility, Utils	(3) Marginal Utility, Utils
0	0	10
1	10	8
2	18	6
3	24	4
4	28	2
5	30	0
6	30	-2
7	28	





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Equimarginal Principle

- Each Consumer maximizes utility means most preferred bundle of goods is chosen from what is available
- Given certain income and market prices for goods **What would be a sensible rule for choosing the preference bundle of goods?**
- If good A costs twice as much as good B, then buy good A only when its marginal utility is at least twice as great as good B's marginal utility

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- This leads to the *equimarginal principle*
- **Equimarginal principle:** It states that a consumer will achieve maximum satisfaction or utility when the marginal utility of the last dollar spent on a good is exactly the same as the marginal utility of the last dollar spent on any other good.



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Why does this conditions hold?

- **If any one good gave more marginal utility per dollar?**
- I would increase my utility by taking money away from other goods and spending more on that good
- The law of diminishing marginal utility will occur
- Its marginal utility per dollar will come down to equality with that of other goods



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- The common marginal utility per dollar of all commodities in consumer equilibrium is called the *marginal utility of income*
- *The condition is*

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



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Use these concepts to state Why does demand curve slope downward?



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Leisure and the optimal allocation of time

- We can apply utility theory to the allocation of time as well as money
- The principles of consumer choice suggest that you will make the best use of your time when you equalize the marginal utilities of the last minute spent on each activity
- Suppose you want to maximize your knowledge in your courses but you have only a limited amount of time available. Should you study each subject for the same amount of time?



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Happy Learning

