



THE BASIS OF CHOICE: UTILITY

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Basis of consumers' choice

- Consumers' make choices to make themselves as happy as possible
- Utility was thought of as a numeric measure of a person's happiness (Utils)
- Utility- The satisfaction, or reward, a product yields relative to the alternatives
 - Example- Consumption of liquor

Cardinal Utility

- How are we supposed to quantify the amount of utility associated with different choices?
- Some theories of utility that attach a significance to the magnitude of utility
- Basic problems are implicit in the concept of utility
 - It is impossible to measure utility
 - It is impossible to compare the utility of different people

Theories

- Diminishing Marginal Utility (Gossen's First Law)
- Equi-Marginal Utility (Gossen's Second Law)

Basic Concepts

- Marginal Utility (**MU**)- The additional satisfaction gained by the consumption or use of one more unit of output
- $MU_n = TU_n - TU_{n-1}$
- $MU = \frac{\Delta TU}{\Delta Q}$
- Total Utility (**TU**)- The total amount of satisfaction obtained from consumption of a good or service
- $TU = \sum MU$

Law of Diminishing Marginal Utility

- Statement- The more of any one good consumed in a given period, the less satisfaction (utility) generated by consuming each additional (marginal) unit of the same good

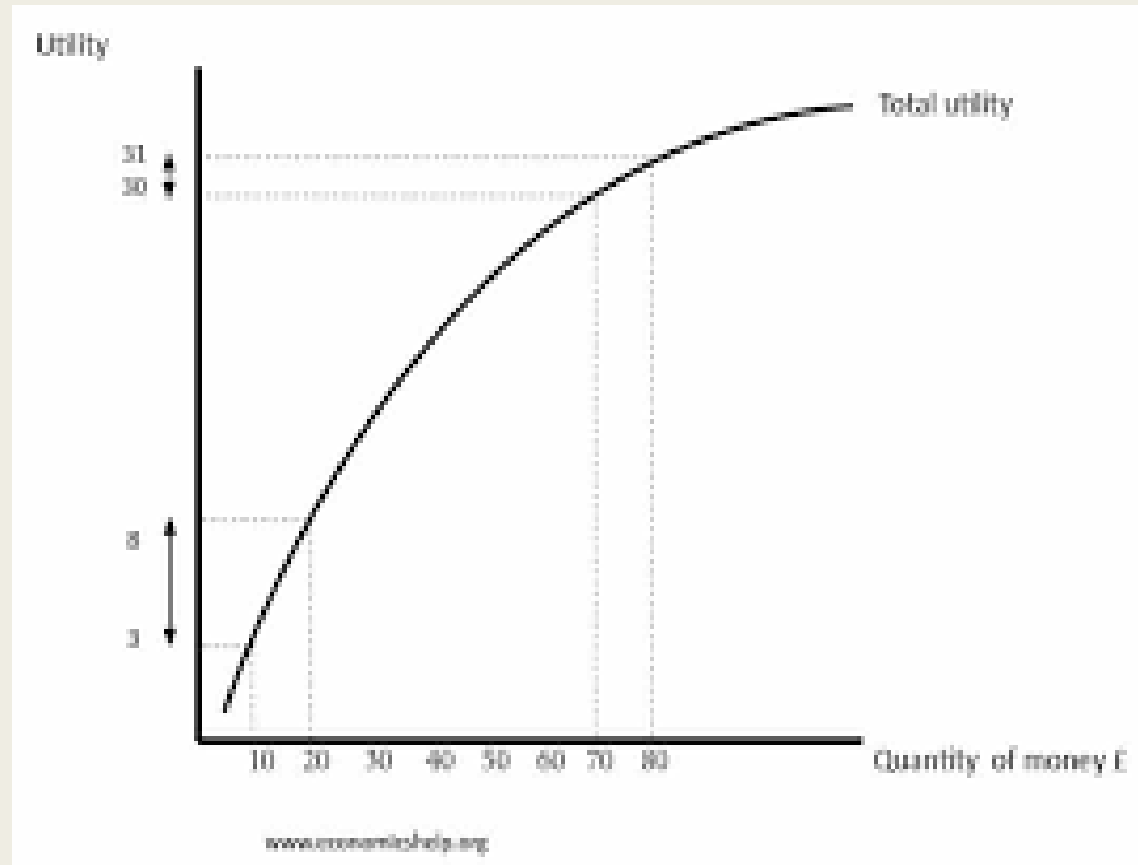
Assumptions

- Cardinal measurement of utility
- Monetary measurement of utility
- Reasonable quantity
- Continuous consumption
- Quality of goods remain constant
- Marginal utility of money remains constant
- Rational consumer
- Constant income and prices

Example

Units of Commodity	Total Utility	Marginal Utility
1	12	12
2	22	10
3	28	6
4	32	4
5	34	2
6	34	0
7	32	-2

Total Utility



Marginal Utility

Diminishing Marginal Utility

It states that the amount of satisfaction provided by the consumption of every additional unit of a good decrease as we increase the consumption of that good.

