

2.1 First Model of the Macroeconomy: Consumer Behavior

References:
Williamson, Chs. 4.

Representative Consumer

- Rationale
- Two goods
- Consumption bundles

Representative Consumer: Preferences

- Three properties of preferences:
 1. More is preferred to less
 2. Likes diversity
 3. C and L are normal goods

Preferences, Utility function, and Indifference Curves

- Utility function
- What is an indifference curve?
- Properties of indifference curves (derived from properties of preferences).

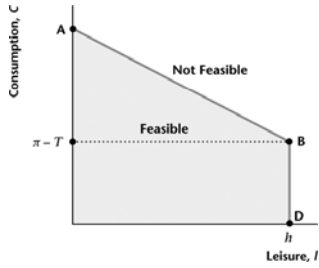
MRS(I,C), Marginal Rate of Substitution of I for C

- MRS(I,C) amount of C we would give up to get one additional unit of I (*at the margin*).
- Equal to (-1) times the slope of the indifference curve
- Properties:

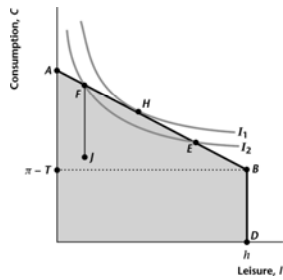
Consumer Choice

- Consumer's "problem" is to choose the best consumption bundle subject to constraints:
 - Time constraint
 - Budget constraint

Budget Set ($T < \pi$ case)



Consumer Optimization



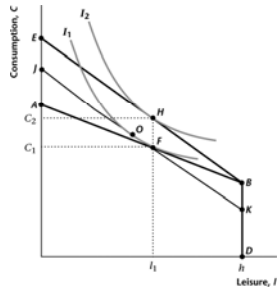
Income (or "Wealth") Effects: "What happens when non-wage income changes?"

- Change in non-wage income induces a "pure income (wealth) effect".
- Recall "both goods are normal" assumption...
- So what is the net effect of $\Delta(\pi - T) > 0$?

Increase in the real wage rate: Income and substitution effects confounded

- Key: w is
 1. wage earned on labor hours, but also
 2. Price of leisure relative to consumption!
- Increase in w increases $(w \cdot h + \pi - T)$
Then both goods normal, so...
- But w increases price of l relative to C , so...
- Conclusion: Consumption must rise, but leisure may rise or fall.

Increase in the real wage rate: Income and substitution effects



Labor Supply Curve

- $Ns(w) = h - l(w)$
- What is the effect of an increase in non-wage income?
(dividends or lump-sum taxes)
