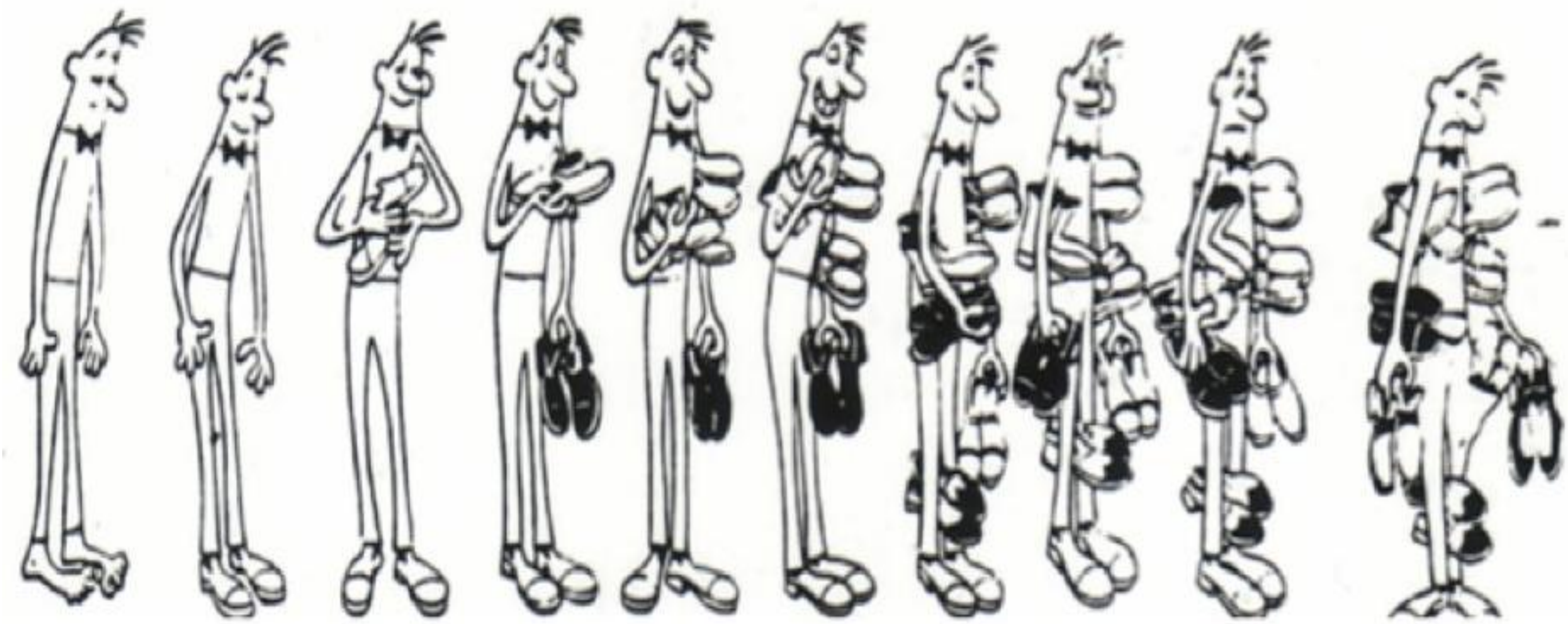
If it is important to you, you will find a way
If not, you will find an excuse.
Frank Banks

Test Yourself: Utility Theory

What does utility mean?



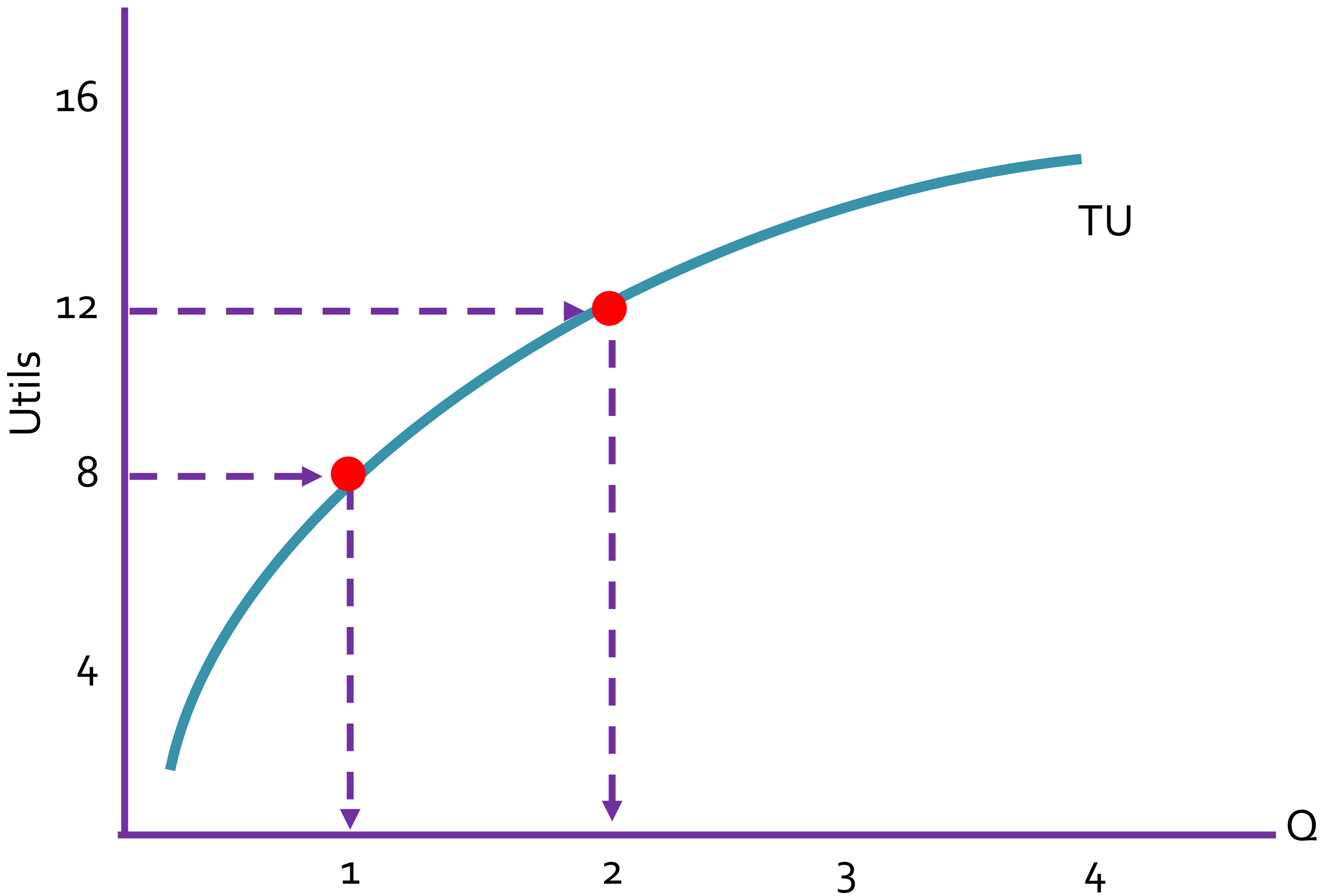
Utility is the satisfaction or pleasure that people receive from consuming a good or service.

What is total utility?

Total utility is the amount of satisfaction received from all the units of a good or service consumed.

Total utility is maximized when the marginal utility per dollar of each good is equal and the entire budget is spent.

Chart: Total Utility

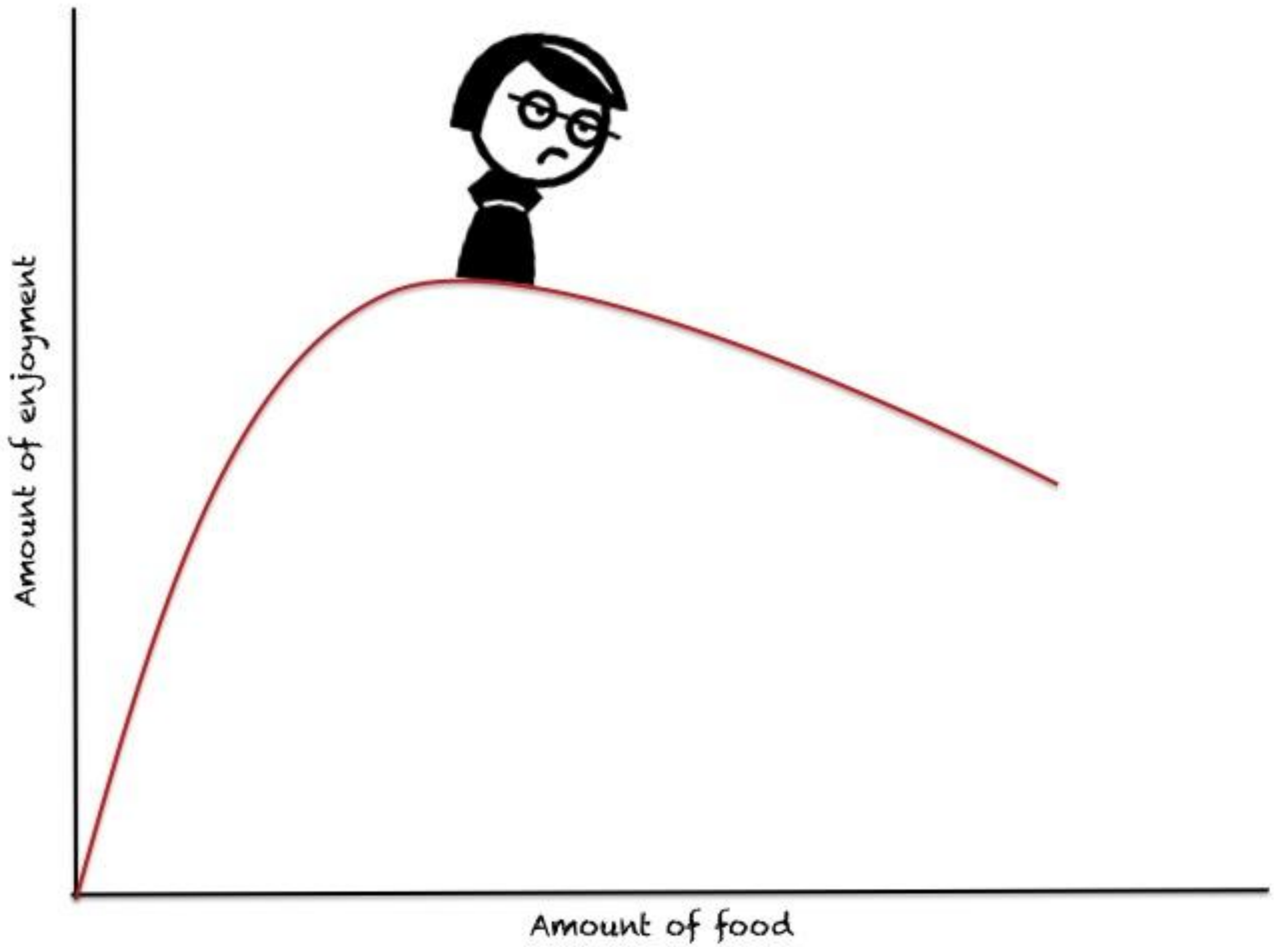


What is marginal utility?

Marginal utility is the change in total utility from one additional unit of a good or service.

Consumers make one choice over another depending on the marginal utility of the choices.

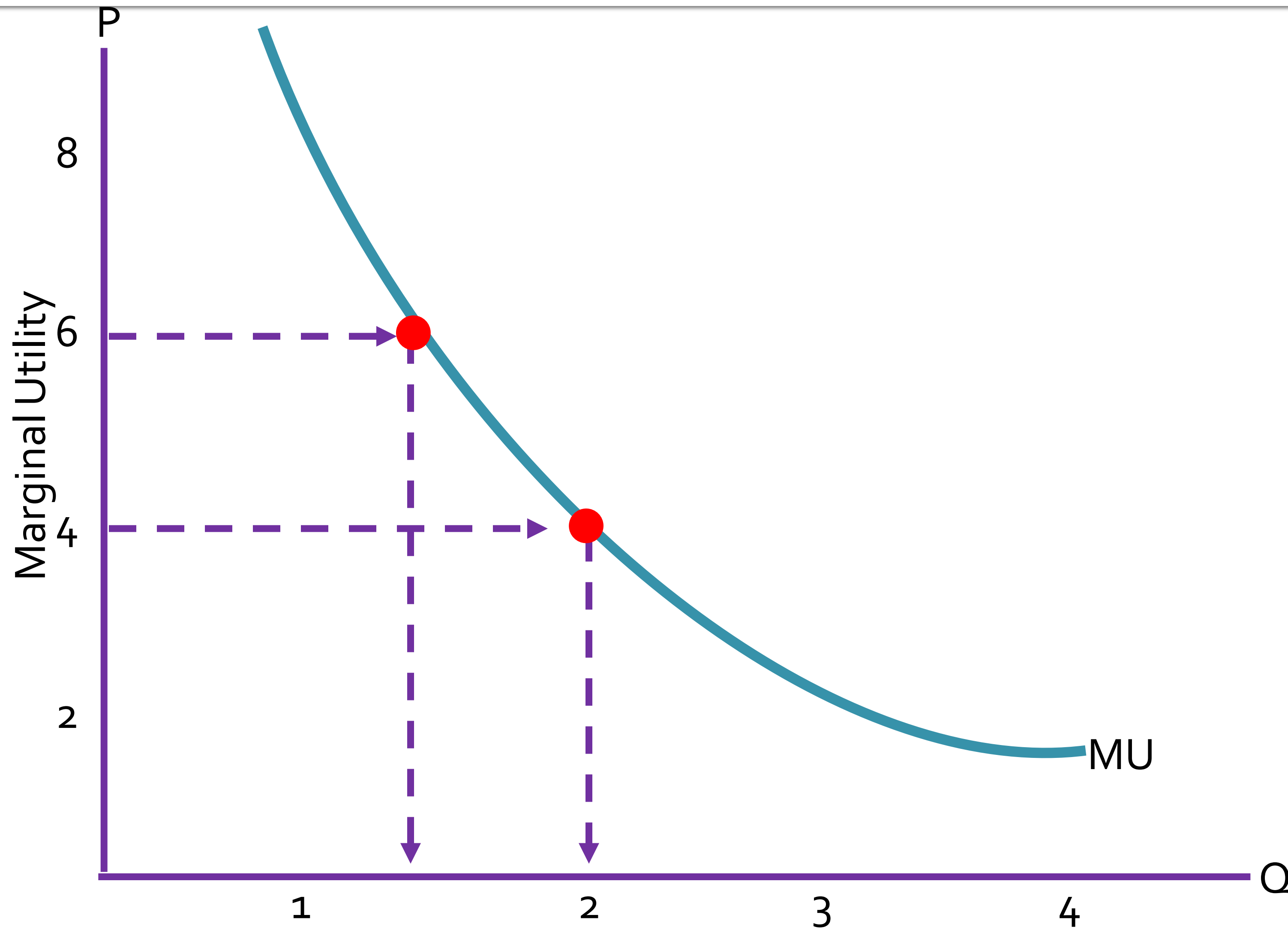
What is the law of diminishing marginal utility?



The law of diminishing marginal utility is the principle that the extra satisfaction of a good or service declines as people consume more in a given period.

Units	Total Utility	Marginal Utility
1	20	20- 0=20
2	38	38-20=18
3	54	54-38=16
4	68	68-54=14
5	78	78-68=10
6	82	82-78= 4
7	82	82-82= 0

Chart: Diminishing Marginal Utility



What is
consumer equilibrium?

Consumer equilibrium is a condition in which total utility cannot increase by spending more of a given budget on one good and spending less on another good.

$$\frac{\text{MU A}}{\text{price A}} = \frac{\text{MU B}}{\text{price B}} = \frac{\text{MU Z}}{\text{price Z}}$$

What are two alternative explanations of demand?

Two alternative explanations of demand are:

- the income effect – a change in the quantity demanded of a good or service caused by a change in real income (purchasing power). As prices decline, your real income increases, increasing your buying power, so you buy more units, *ceteris paribus*.
- the substitution effect – a change in the quantity demanded of a good or service caused by the change in its price relative to substitutes. If the price of Pepsi falls and the price of Coke remains unchanged, you will buy more Pepsi because it is less expensive than Coke.

What do the substitution and income effect explanations prove?

The substitution and income effect explanations prove the law of demand, that is, as the price of a good declines, consumers will buy more units of the good, and vice versa.

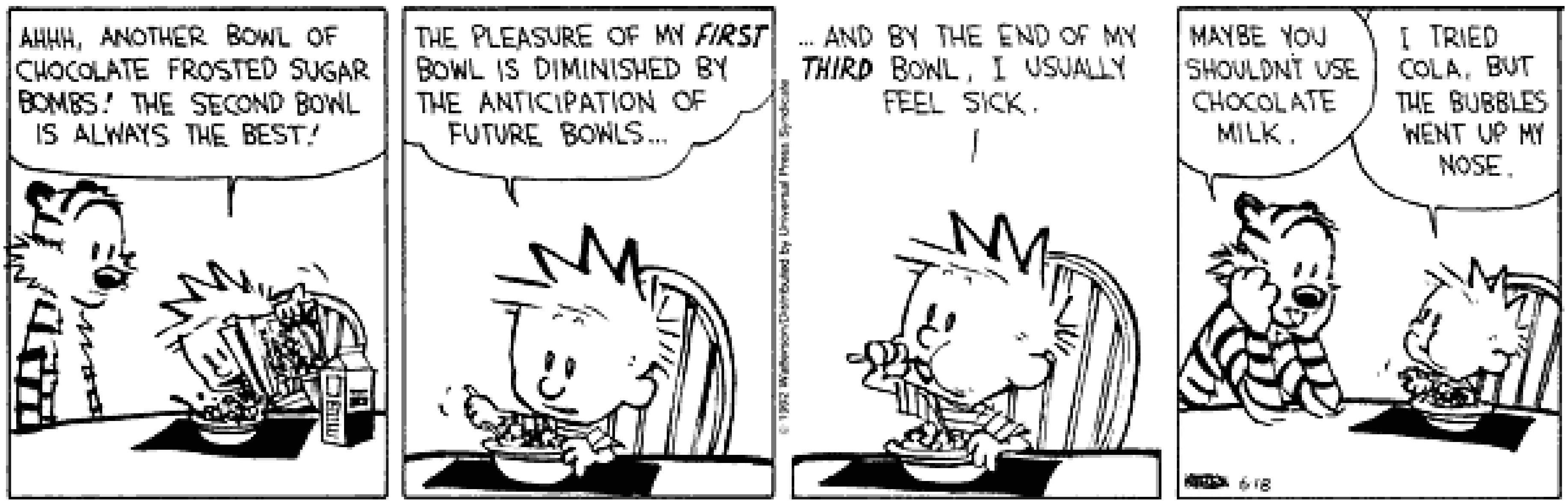
What is a normal good?

A normal good is a good that consumers will buy more of as their incomes increase.

What is an inferior good?

An inferior good is a good that consumers will buy less of as their incomes increase.

How did you do?! If you didn't do as well as you'd like, review the margin notes and presentations and test yourself again.



CONTINUED IN TEST YOURSELF: ELASTICITY