

## 2

## Consumer Budgets: A Consumer's Economic Circumstances

This chapter is a relatively straightforward introduction of consumer budget constraints — with the idea of **opportunity costs** emphasized throughout.

### Notable Features and Comments

1. Consumer budgets are introduced as a depiction of the **economic circumstances** faced by a consumer — circumstances that are shaped by **prices** and **incomes** or **endowments**. We use the phrase *economic circumstances* frequently in the remainder of the text.
2. I distinguish between two kinds of budgets: **exogenous** and **endogenous**. By an *exogenous* budget, I mean a budget that arises from an exogenously given income level. By an *endogenous* budget, I mean a budget that arises from an *endowment*.
3. The section on *endogenous budgets* is saved for the end — Section 2.4. If you are not going into labor/leisure and intertemporal consumption choices (covered in Chapter 3) at this point, there is not much reason to emphasize it. But if you do (as I would recommend) develop leisure/consumption and intertemporal budgets simultaneously, introducing the idea of an *endowment* and carrying it through Chapter 3 makes sense.
4. Throughout, we emphasize that the slope of the budget is an *opportunity cost* — the opportunity cost of the good on the horizontal axis in terms of the good on the vertical.
5. The material on *kinked budgets* is not essential for most of the text and does not have to be covered in depth.
6. The idea of a **composite good**, however, is frequently used in the text and in exercises. It is a convenient tool — one that allows us to apply the 2-good model to less artificial sounding settings. We always place the composite good on the vertical axis and define it as “dollars of other consumption” –

with the price of the composite good therefore equal to 1. This then furthermore allows us to simply treat the slope of the budget as the opportunity cost of the good on the horizontal axis in terms of dollars.

7. The only potential confusion of introducing the idea of a composite good on the vertical axis is that, since it is denominated in dollars, students sometimes think of the vertical axis as representing “price” – an idea they carry with them from the depiction of demand curves in their Principles course. It is therefore important to emphasize that *price is a slope* — and the “dollars” on the vertical axis are simply consumption units of the composite good.
8. Even if instructors primarily focus on the intuitive A-portion of the chapters, many will want to illustrate the basic equation for a budget constraint. The powerpoint presentation for this chapter therefore allows instructors to jump to the B-portion development of the equation and back to the graphs.
9. In the B-Section, we illustrate not only how to mathematically represent the 2-good case but also how it is trivial to extend the mathematical representation to many goods. This is done in part to get students used to seeing a little bit of notation.
10. Finally, I introduce the students to **3-dimensional thinking** by illustrating a choice set with 3 goods. This is good practice to begin getting the students used to thinking that models are lower-dimensional simplifications of higher-dimensional reality — and that in creating models, we pick those aspects that are most relevant to the problem at hand.

## Where to Go From Here

Following this chapter, you may either proceed to Chapter 3 in order to apply the ideas of budget sets to *leisure/consumption* and *intertemporal settings*, or you can proceed to Chapter 4 and introduce the idea of *tastes*.

My recommendation would be to proceed with Chapter 3. The basic ideas are already developed, and applying them to new settings will both solidify those ideas and convey the general sense that the economic model we are developing applies to many settings.

One more note: End-of-chapter exercise 2.6 (in the domestic edition of the text) asks the students to build two budget sets that will then be directly used in Chapter 7 as we develop the idea of a substitution effect. Having students do this exercise now will make it a bit easier to cover the corresponding Chapter 7 section.