Decision Making Relationships: Rational Consumer

by Sophia Tutorial

WHAT'S COVERED

This tutorial will identify the important decisions made by the rational consumer, through the process of weighing costs and benefits.

Our discussion breaks down as follows:

1. The Rational Consumer
2. Scarcity/Finite Resources
3. Opportunity Costs
4. Decision-Making and Utility
5. Cost/Benefit Analysis
6. Utility Maximization

1. The Rational Consumer

Since the focus of today's lesson is the **rational consumer**, let's begin by defining who that is.

The rational consumer is a consumer who considers choices based on factual information weighing opportunities and limited income or assets.

We will explore each part of that definition today, but let's start by discussing the idea of scarcity or finite resources.

TERM TO KNOW

Rational Consumer
A consumer who considers choices based on factual information weighing opportunities and limited income or assets

2. Scarcity/Finite Resources

Many people become stressed and overwhelmed by the sheer volume of decisions that they need to make every day.

Why do we have to make so many decisions? Well, it is because of an important economic concept called scarcity, which refers to something being limited and desirable.

Now, as consumers, we have unlimited wants. No matter how much money or material goods we have, we always want more. However, there is a limited, or finite, amount of stuff in the world to meet our unlimited wants.

So, what is limited in the world? For the average person, the following resources have a limited supply:

- Income
- Time
- Goods and services

Now, it may not seem like all goods and services are limited.

> EXAMPLE When you go to a grocery store in the United States, there seem to be limitless options. For instance, how many different kinds of yogurt could there possibly be? However, there is a limit, and a finite amount of it.

As mentioned, though, almost everything is limited or, in economics terms, scarce. A**finite resource**, then, is a fixed amount of supply that is irreplaceable and non-recoverable.

HINT

If something has a limit, it is a finite resource.

TERM TO KNOW

Finite Resource
A fixed amount of supply that is irreplaceable and non-recoverable

3. Opportunity Costs

So, what does this concept of scarcity or finite resources mean to us as consumers?

Well, it means that everything has a cost. Case in point, you will find this quote in almost any economics textbook:

"There is no such thing as a free lunch."

Basically, this means that nothing in this world is free--there is always a cost attached to it--which is a fundamental idea in economics, so it is important that we understand it.

Any time you see the word "cost" in this economics course, what it actually refers to is**opportunity costs**, which is the sacrifice made by choosing one value or opportunity over another due to limited resources.

HINT

Simply put, opportunity cost is either "the next best thing" or "what you give up."

IN CONTEXT

Here are several examples to illustrate opportunity cost. Consider the costs and benefits for each scenario.

Suppose you buy a pair of jeans for $120. What are you sacrificing or giving up? What is the next best thing you could do with that $120?

Or, if a student decides to go to a full-time, four-year college right out of high school, what are they giving up the opportunity to do? Most people think that the main cost of a college education is tuition, room, and board, but within the framework of economics, this isn't the case.

By going to college right out of high school, that student is potentially giving up the opportunity to get a full-time job, which is what we mean by opportunity cost.

Lastly, circling back to the "free lunch" quote from earlier, what if your company *does* offer you a free lunch, if, for instance, you listen to a particular seminar?

Again, is that really free? Remember, time is also a valuable resource.

Perhaps you wanted to have lunch with a friend and catch up, or even sit at your desk and have some time to yourself. In this case, you are giving up the opportunity to do something even though monetarily, your company is giving you a "free lunch."

Through the lens of economics, it's not free.

TERM TO KNOW

Opportunity Costs
The sacrifice made by choosing one value or opportunity over another due to limited resources

4. Decision-Making and Utility

So, how do we as consumers make decisions, now that we understand that there is a cost to every decision we make?

Well, we are going to consider something called**utility**, which is defined as the gratification received from consuming for buying a product or service.

HINT

Think of utility as goodness or satisfaction: what benefit are you getting out of this?

IN CONTEXT

Let's go back to the jeans example from above to illustrate the concept of utility.

Now, you might really want those $120 jeans and you know that you will get a lot of gratification from owning them.

Certainly, another pair of jeans will increase your utility--you'd be happier than if you hadn't bought them--but by how much?

The amount by which your utility increases will help you make your decision as to whether or not you buy the jeans.

It's not the same for every person, obviously. If you already have 50 pairs of jeans in your closet, you don't need them as badly as someone who, for instance, lost weight and now only owns one pair of jeans that fits.

Also, it depends on how much disposable income you have to spend on them. A millionaire might not even blink an eye at a $120 pair of jeans, but a person with an average income might think long and hard before spending that amount of money on a pair of jeans.

As you can see, not everyone makes the same decisions because each person's costs are quite different.

The bottom line is, what are you giving up by purchasing them? What you are giving up is your opportunity cost.

As a final note, if you occasionally have buyer's remorse and know that you will likely feel more guilt than enjoyment, you probably shouldn't buy them.

TERM TO KNOW

Utility
Gratification received from consuming a product or service

5. Cost/Benefit Analysis

Now, the notion of buyer's remorse leads us directly into the idea of a cost/benefit analysis. The basic premise is as follows, regarding a potential purchase:

If the benefit is greater than the cost, then a rational consumer purchases.

If the cost is greater than the benefit, then a rational consumer forgoes the purchase.

EXAMPLE Suppose if Person A buys the $120 pair of jeans, the opportunity cost for her is not going out to dinner this weekend.

For Person B, however, the opportunity cost of the $120 jeans is not being able to afford the birthday present for her daughter.

As you can see, these two situations present very different opportunity costs, and as a result, will lead to different decisions.

Person A might not mind skipping dinner out this one weekend, and the jeans will provide more utility for her because she will wear them all the time. Person B, on the other hand, will more than likely think that her daughter is more important that a pair of jeans.

6. Utility Maximization

Therefore, if we--as rational consumers--are always weighing costs with benefits, then we are seeking to maximize our utility.

Utility maximization means achieving the highest amount of satisfaction while spending the least amount of money.

Consider the chart below, which outlines the cost of the jeans, the utility or gratification received from purchasing the jeans, and the final decision whether or not to make the purchase.

Cost	Utility (Gratification)	Do I Buy?
$120	$80	NO
$60	$80	YES

Notice that when the utility of the jeans is $80, a rational consumer does not purchase the $120 jeans, because the cost is greater than any potential increase in utility. It simply doesn't justify the cost.

However, if there is a half price sale, for instance, and the jeans only cost $60, a rational consumer will purchase them. The utility didn't change; the jeans are still worth $80 to the consumer--they'll make the consumer $80 happier--but they only have to pay $60.

TERM TO KNOW

Utility Maximization
Achieving the highest amount of satisfaction while spending the least amount of money

SUMMARY

We began today's lesson by defining **the rational consumer**, a consumer who considers choices based on factual information weighing opportunities and limited income or assets. We learned that there are limited or **finite resources** in the world, so we have to make decisions because of that **scarcity** of resources. We learned that every decision involves giving up something, known as **opportunity cost**, and that in order to **make the best decision**, a rational consumer performs a **cost/benefit analysis** to **maximize utility**.

Source: Adapted from Sophia instructor Kate Eskra.

TERMS TO KNOW

Finite Resource
A fixed amount of supply that is irreplaceable and non-recoverable.

Opportunity Costs
The sacrifice made by choosing one value or opportunity over another due to limited resources.

Rational Consumer
A consumer who considers choices based on factual information weighing opportunities and limited income or assets.

Utility
Gratification received from consuming a product or service.

Utility Maximization
Achieving the highest amount of satisfaction while spending the least amount of money.