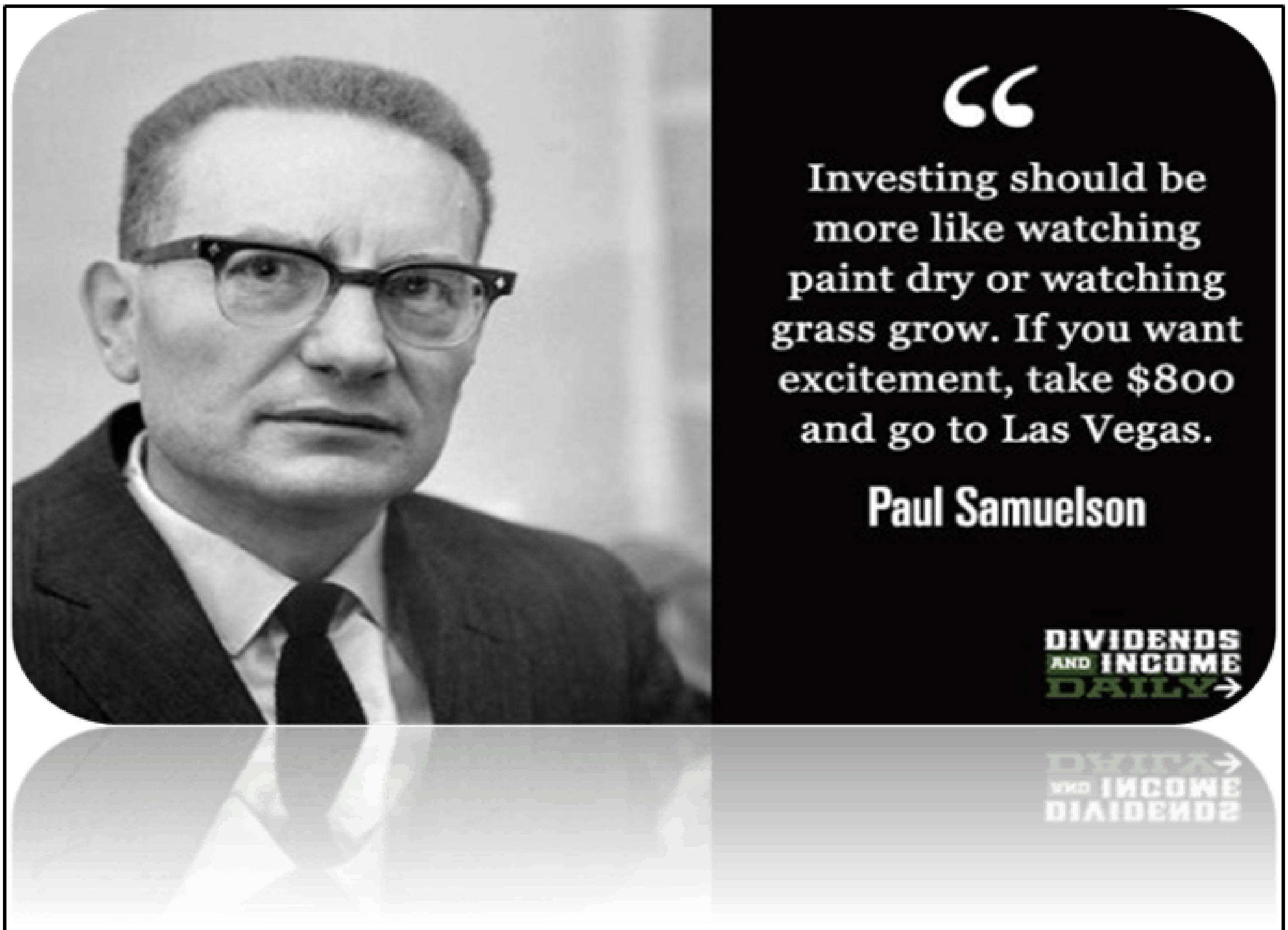
Revealed Preference Theory, Introduction and Graphical Representation



[Revealed Preference Theory: Theory of demand; Introduction and Graphical Representation (Economics) [https://www.youtube.com/watch?v=glQdqPmVEqg]](https://www.youtube.com/watch?v=glQdqPmVEqg)

Introduction

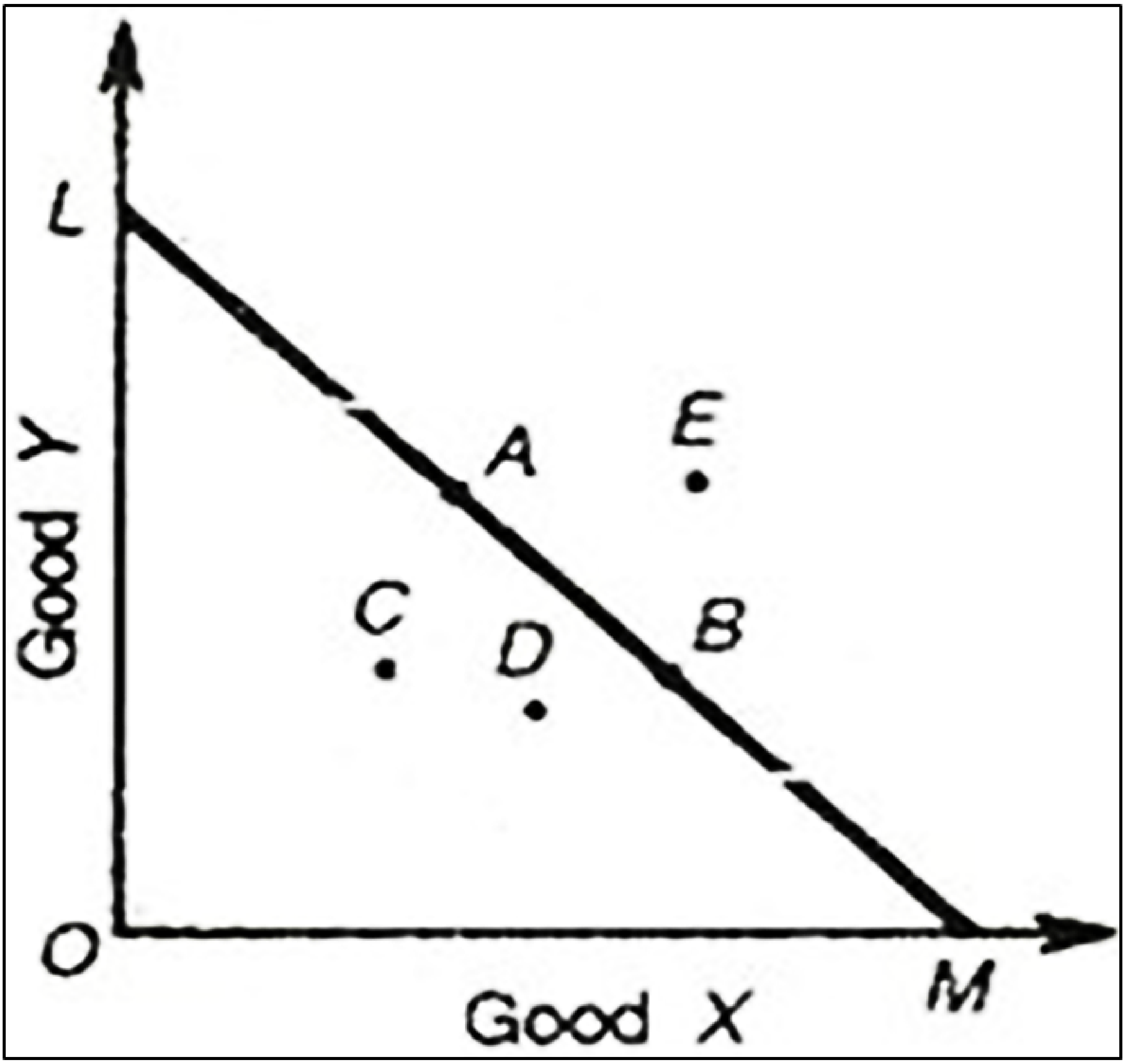
- Propounded by Paul Samuelson
- Ordinal utility analysis
- This theory analyses preference for a combination of goods on the basis of observed consumer behavior in the market.
- The demand theorem given by Samuelson, also known as the Fundamental theorem of consumption theory, states that a commodity that is known to have an increased demand when the income rises must have a decrease in demand when there is a rise in its price.

- In other words, when income elasticity of demand is positive, price elasticity of demand is negative.

Choice Reveals Preference

- This theory of demand is based on the revealed preference hypothesis which states that choice reveals preference.
- According to this theorem, a consumer buys a combination of goods because of two reasons:
    - Either the consumer likes the combination more than the other combinations even if it costs more,
    - Or the combination is cheaper than the other combinations.

Graphical Representation



Assumptions

- If a consumer chooses a combination, he reveals his preference for that combination.
- Tastes and preferences of the consumer are constant
- A consumer always prefers a combination with more goods than a combination with less goods.
- Only one combination is chosen at a given price-income line.
- Based on strong ordering.
- If A is preferred to B in one situation, combination B cannot be preferred to A in another situation. Therefore, the consumer is consistent in his behavior. This is called two-term consistency.
- If combination A is preferred to B, and B is preferred to C, then A is assumed to be preferred to C. This is known as transitivity or three-term consistency.
- The income elasticity of demand is positive, that is, when the income of the consumer rises, he demands more of the commodity and vice-versa.

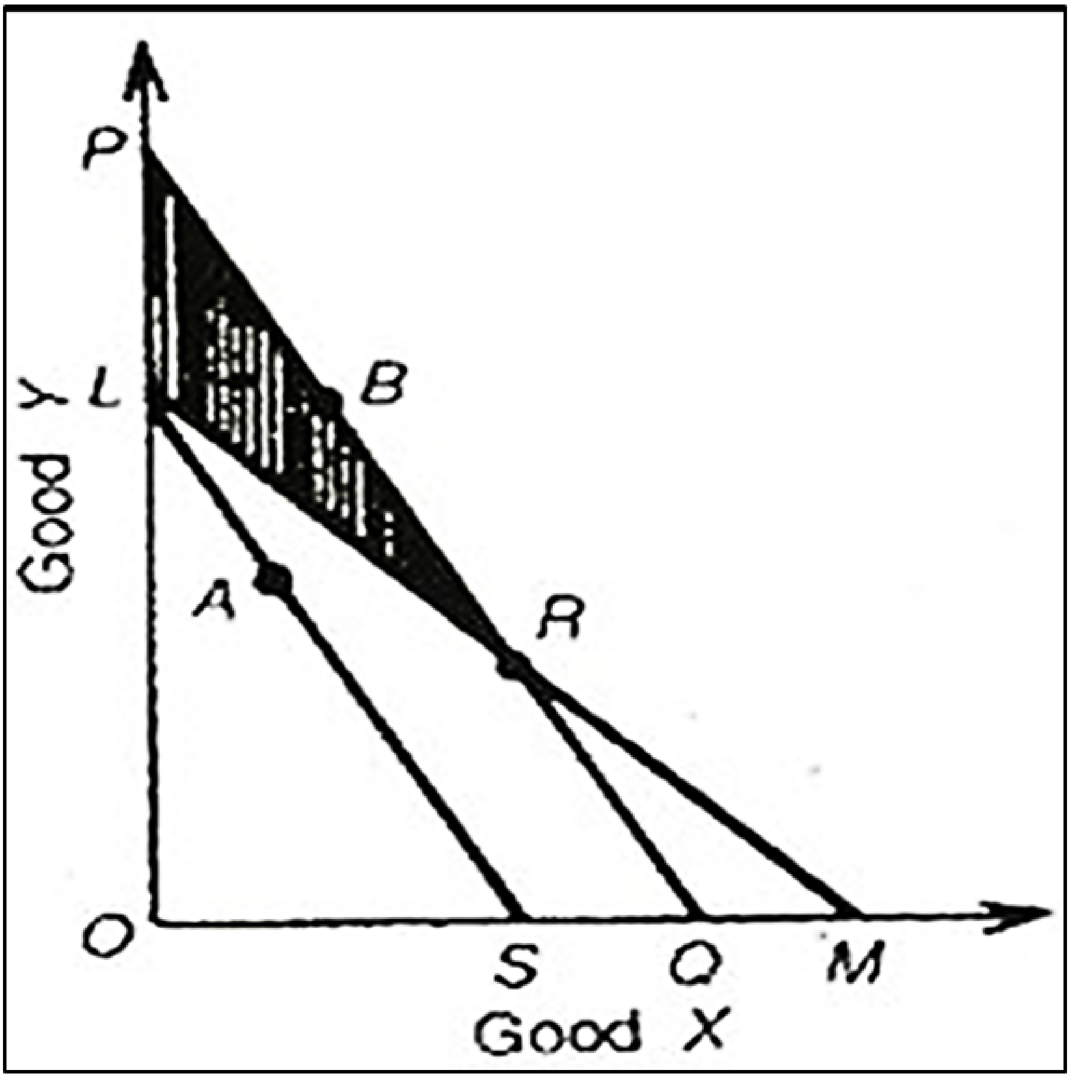
Demand Theorem in Case of Rise and Fall in Price

- We will now analyze the demand theorem in two cases:

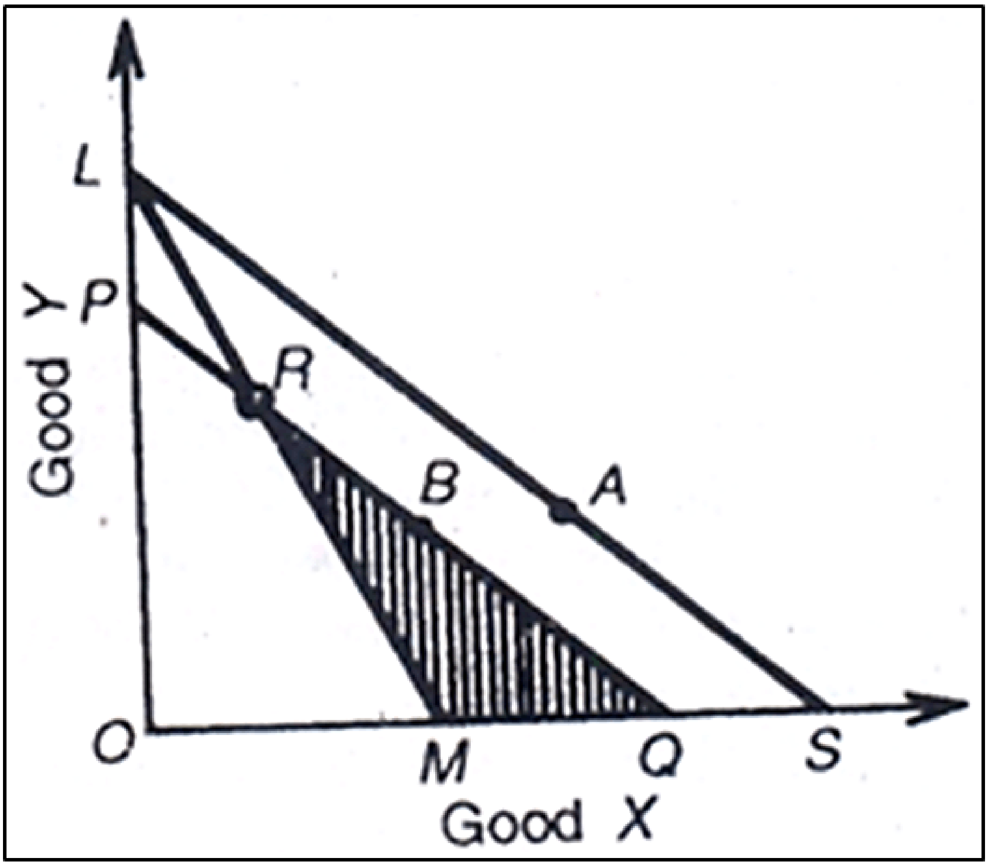
1. when price rises,
2. and when price falls.

- We will assume that there are two commodities, X and Y.

Rise in Price



Fall in Price



Mcqs

Q.1. Who propounded the revealed preference theory?

A. Milton Friedman

B. Paul Krugman

Paul Samuelson

D. Kenneth Arrow

Answer: C

Q.2. When income elasticity of demand is positive, the price elasticity of demand is:

A. Negative

B. Positive

C. Not correlated

D. None of the above

Answer: A

Q3. Which of the following is an assumption of the revealed preference theory?

A. A consumer will always choose a combination with less goods as opposed to a combination with more goods.

B. If a consumer chooses combination X in one situation, he may choose other combinations such as Y or Z in other situations.

C. If combination A is preferred to B and B is preferred to C, combination A is assumed to be preferred to C.

D. The income elasticity of demand is negative.

Answer: C

Q.4. . Revealed preference theory assumes

A. Weak ordering

B. Strong ordering

C. Constant ordering

D. Multiple ordering

Answer: B

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