

COMMERCE

GRADE XII – Mumbai Board

A.Y. 2020-21

ECONOMICS

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Important points to learn:

- 1) Meaning of Utility
- 2) Features of Utility
- 3) Types of Utility
- 4) Concepts of Utility – Total Utility and Marginal Utility
- 5) Relationship between Total Utility and Marginal Utility (with diagram)
- 6) Law of Diminishing Marginal Utility (DMU) with Assumptions and Exceptions
- 7) Criticism to the Law of DMU

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Please Note:

These notes are general guidelines only for reference, for the students of SRK/MBBI Junior College, Dahanu. ***For detailed notes, students should refer only the prescribed textbook of the Maharashtra State Bureau of Textbook Production and Curriculum Research. This study material is for learning purpose during lockdown.***

Introduction

Before understanding the meaning of Utility, let us understand the meaning of Wants.

WANTS

In simple words, Wants means Desires.

Economic Wants are desires that can be satisfied by consuming a good (product) or a service. Every individual tries to satisfy his wants with the available resources. However, human wants are unlimited. They are recurring in nature. Different people with different age group have different wants.

Wants are different from Needs!

NEEDS: Things that are required to live. Eg: Food, Clothing, Shelter, Education, etc.

WANTS: Things that add comfort and pleasure to your life. Eg: Car, Music System, etc.

Utility – Meaning

Utility is the capacity of a commodity to satisfy human wants. In other words, utility is the want satisfying power of a good.



Economic Utility refers to the value (pleasure or satisfaction) that a consumer experiences (derives) from consuming a particular good or service. Utility of a good or service is created by its availability at a particular time.

Utility is ‘the value’, the producers add to raw materials when they make them into a final product and offer them for sale to the public.

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Features of Utility

- 1) Relative Concept:** Utility is a relative (having relation) concept. It varies (changes) from time to time and place to place. Eg: Woollen clothes have greater utility in winter (seasonal i.e. time utility), Sand has greater utility near construction sites (i.e. place utility).
- 2) Subjective Concept:** Utility is a psychological concept. Utility differs from person to person. This because each person has different likes, dislikes, preferences, etc. Eg: Medicine has utility for a patient, but not for a healthy person.
- 3) Ethically Neutral Concept:** Utility has no ethical consideration. Utility is just about satisfying a want, irrespective of whether its good or bad. Eg: Knife is useful in kitchen to cut vegetables as well as useful to harm somebody.
- 4) Utility differs from Usefulness:** Utility and Usefulness, both are different concepts. Utility is want satisfying power whereas Usefulness is value-in-use of a commodity. Eg: Milk has both, utility and usefulness to a consumer while liquor has only utility and no usefulness and that to only for an addict.

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5) Utility differs from Pleasure: Utility is different from Pleasure. A commodity may possess utility but may not give pleasure. Eg: Injection has utility for a patient but it does not give pleasure to the patient.

6) Utility differs from Satisfaction: Utility is different from Satisfaction. Utility is a cause of consumption. Satisfaction is the end result of consumption. Eg: A thirsty person drinks a glass of water, since water has the capacity to satisfy thirst. Here, Utility of water is the cause of consumption. The satisfaction derived by the thirsty person is the end result of consumption.

7) Numerical measurement of Utility is not possible: Utility is an abstract concept. It cannot be measured cardinally (in numbers). Different thirsty people may have different quantities of water. Thus Utility can only be experienced. Utility can either be Positive, Zero or Negative.

For more points you can refer to prescribed textbook.

Types of Utility

- 1) Form Utility:** When Utility is created due to change in shape or structure or form of an existing material. Eg: Toys made from clay, furniture made from wood, etc.
- 2) Place Utility:** When Utility is created / increased due to a change in place. Eg: Woollen clothes have more utility at cold places. ***Transport creates place utility.***
- 3) Time Utility:** When the Utility of a commodity increases with a change in its time of utilisation. Eg: Demand for cold-drinks during summer, demand for blood during an emergency, etc. ***Warehousing creates time utility.***
- 4) Service Utility:** Service Utility arises when personal services are rendered by professionals. Eg: Services of doctors, lawyers, teachers, etc.
- 5) Knowledge Utility:** When a consumer acquires knowledge about a particular product. Eg: Utility of a computer increases when a person knows about its functions.
- 6) Possession Utility:** It arises when the ownership of goods is transferred from one person to another. Eg: Transfer of goods from seller to buyer.

Concepts of Utility: Total Utility and Marginal Utility

TOTAL UTILITY (TU):

Total utility is the utility (satisfaction) a consumer derives from the consumption of all units of particular goods and services. It measures the total satisfaction obtained from consumption of all the units of the commodity consumed.

Eg: If the consumption of 1st glass of water gives you a satisfaction of 10 utils and the 2nd one gives you satisfaction of 8 utils, then TU from two glasses of water will be $10 + 8 = 18$ utils.

TU can be calculated as $TU_n = U_1 + U_2 + U_3 + \dots + U_n$

where,

TU_n = Total Utility from n units (all units) of a given commodity

$U_1, U_2, U_3, \dots U_n$ = Utility from the 1st, 2nd, . . . n th Unit of consumption

n = Number of Units consumed

Utils = Unit of measuring Utility or Satisfaction.

Concepts of Utility: Total Utility and Marginal Utility

MARGINAL UTILITY (MU):

Marginal utility is the additional utility (satisfaction) a consumer derives from the consumption of an additional unit of particular goods and services. It measures the **addition made by the last unit** of a commodity consumed.

Eg: If the consumption of 1st glass of water gives you a satisfaction of 10 utils and the 2nd one gives you satisfaction of 8 utils, then the additional 8 utils of satisfaction derived from the consumption of the last unit is the MU.

MU can be calculated as $MU_n = TU_n - TU_{(n-1)}$

where,

TU_n = Marginal Utility from the n th units (last unit) of a given commodity

TU_{n-1} = TU from n units – 1 unit

n = Number of Units consumed

Utils = Unit of measuring Utility or Satisfaction.

Relationship between Total Utility and Marginal Utility

The relationship between TU and MU can be best explained with the help of a schedule (table) and a diagram.

Units of a Commodity	Total Utility (TU)	Marginal Utility (MU)
1	10	10
2	18	8
3	24	6
4	28	4
5	30	2
6	30	0
7	28	-2

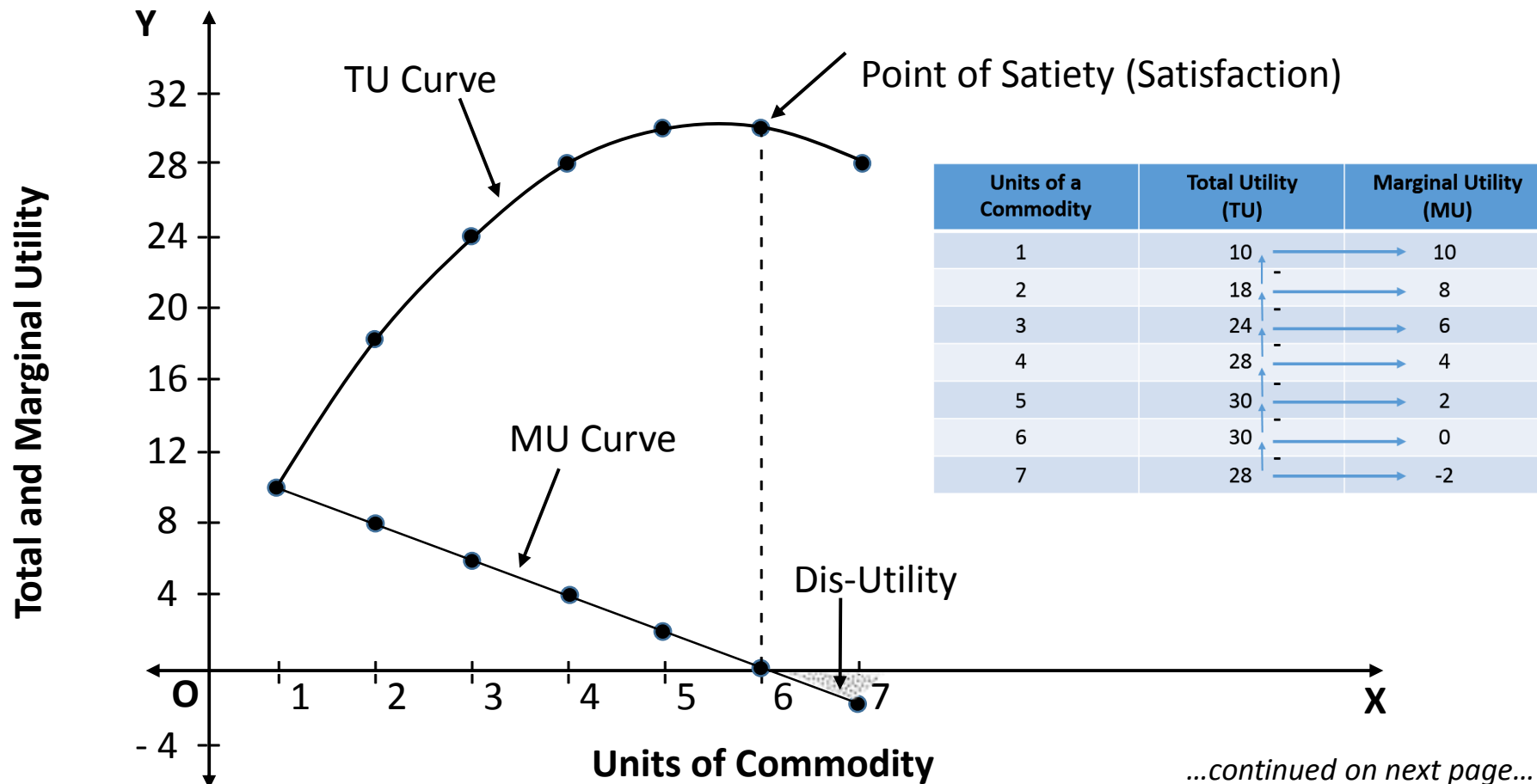
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Relationship between Total Utility and Marginal Utility

The relationship between TU and MU can be shown graphically as follows:



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Relationship between Total Utility and Marginal Utility

The relationship between TU and MU can be explained as follows:

X axis measure the units of the commodity consumed, and Y axis indicates the figures of TU and MU. The figure shows that the TU curve slopes upwards, whereas MU curve slopes downwards.

It can be noted that:

- 1) When the first unit of a commodity is consumed TU and MU are same. ($TU = MU$)
- 2) When the second unit is consumed, TU increases but at a diminishing rate, while MU goes on diminishing. ($TU \uparrow, MU \downarrow$)
- 3) With the consumption of 6th unit, TU becomes maximum whereas MU becomes zero. At this level maximum satisfaction is achieved. ($TU \text{ Max}, MU = 0$)
- 4) After this point, further consumption leads to fall in TU. However, MU becomes negative ($TU \downarrow, MU \text{ Negative}$)
- 5) Consumption beyond the point of satiety (satisfaction) leads to dissatisfaction.

TU may decline, but is **ALWAYS Positive**.

MU can be **Positive, Zero or Negative**.

Law of Diminishing Marginal Utility (DMU)

The Law of Diminishing Marginal Utility or DMU, was first proposed by Prof. Gossen. However, it was discussed in detail by Prof. Marshall in his book 'Principles of Economics', published in 1890.

The Law of DMU is universal in character. It is based on common consumer behaviour.

The Statement of the Law of DMU

According to Prof. Alfred Marshall, "Other things remaining constant, the additional benefit which a person derives from a given increase in his stock of a thing, diminishes with every increase in his stock that he already has".

In other words, the more of a thing you have, the less you want to have more of it.

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Assumptions of the Law of DMU

- 1) Rationality:** The behaviour of the consumer is assumed to be rational (logical) and that he tries to maximise his satisfaction.
- 2) Cardinal Measurement:** The law of DMU assumes that utility can be measured cardinally or numerically. Hence it is possible to know and compare the utility derived from each unit.
- 3) Homogeneity:** It is assumed that all units consumed are homogeneous, i.e. identical in shape, size, colour, taste, etc.
- 4) Continuity:** The law assumes that all the units of the commodity are consumed in quick succession without any break-in time.
- 5) Reasonability:** All the units of the commodity consumed are of reasonable size, i.e. they are neither too big nor too small.
- 6) Constancy:** It is assumed that all related factors i.e. income, taste, habit, etc remains constant.
- 7) Divisibility:** The commodity consumed should be divisible so that it can be consumed easily.
- 8) Single Want:** The law assumes that a given commodity can satisfy a single want of a person at a given point of time.

Exceptions to the Law of DMU

- 1) Hobbies:** The law does not hold true for hobbies like stamps, coins, art collection, music, etc. because every additional increase in the stock gives more pleasure. Here, MU keeps increasing.
- 2) Miser:** In case of a miser, every additional rupee gives him more and more satisfaction. MU of money increases with an increase in its stock. Here, assumption of rationality is ignored.
- 3) Addictions:** In case of drunkard, the level of intoxication increases with every additional unit of liquor consumed. This situation is similar for almost all addictions. So MU may increase.
- 4) Power:** When a person acquires power. His lust for more power increases. He desires to have more of it. This again ignores the assumption of rationality.
- 5) Money:** It is said that MU of ***Money never becomes Zero***. It increases when the stock of money increases. This is because money is a medium of exchange used to satisfy various wants.

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Criticisms to the Law of DMU

- 1) Unrealistic Assumptions:** The law of DMU is based upon various assumptions like homogeneity, continuity, rationality, etc. However, it is difficult to fulfill all these conditions at a point of time.
- 2) Cardinal Measurement:** The law assumes that the utility can be expressed cardinally so it can be added and compared. In reality the cardinal measurement is not possible because utility is a psychological concept.
- 3) Indivisible Goods:** The law is not applicable to indivisible and bulky goods like refrigerator, car, TV set, etc. which are normally purchased as a single unit.
- 4) Single Want:** The law is applicable to the satisfaction of a single want at a point of time. However, in reality human has to satisfy multiple wants at a point of time.

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