

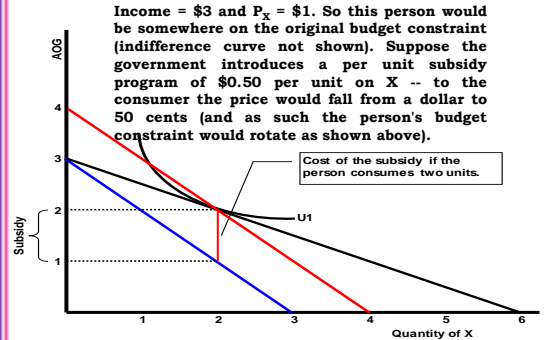
Chapter 5 Part A –Applications of Rational Choice and Demand Theories

Chapter 5 – Part A Applications of Rational Choice and Demand Theories

McGraw-Hill Irwin

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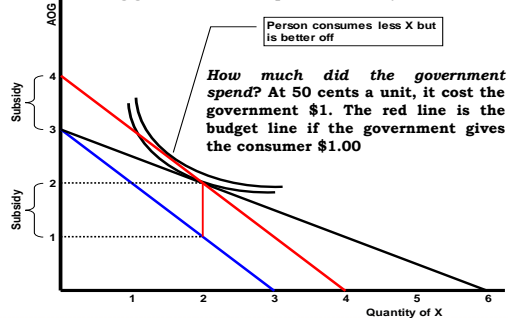
Flat Grants versus Subsidies



5-2

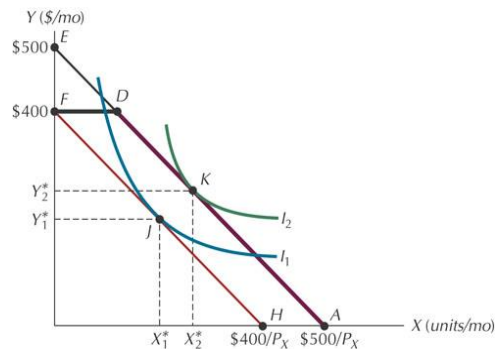
Flat Grants versus Subsidies

If you want to make people as well off as possible, then simply transfer unrestricted cash to them. If you are more interested in them consuming good X, then do a per unit subsidy.



5-3

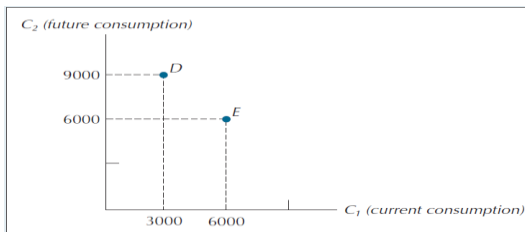
Food Stamp versus Cash Grant under a Voucher System



5-4

The Intertemporal Choice Model

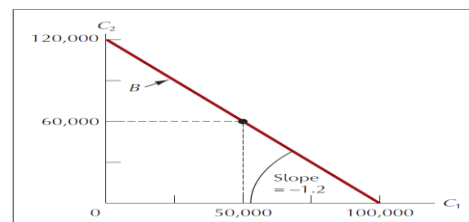
- How would rational consumers distribute their consumption over time?
- **Two time periods:** current and future.
- **Two alternatives (goods):** current consumption (C_1) versus future consumption (C_2).



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The Intertemporal Choice Model Budget Constraint

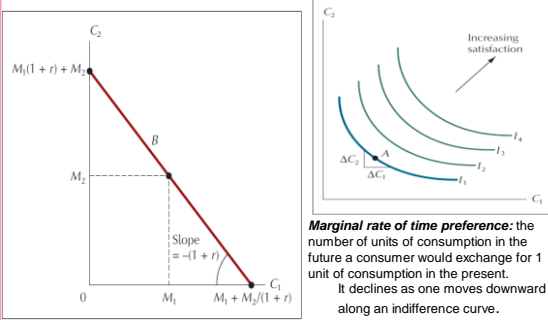
- **Present value:** the present value of a payment of X dollars T years from now is $X/(1+r)^T$, where r is the annual rate of interest.
- **Present value of lifetime income:** the horizontal intercept of the intertemporal budget constraint as the



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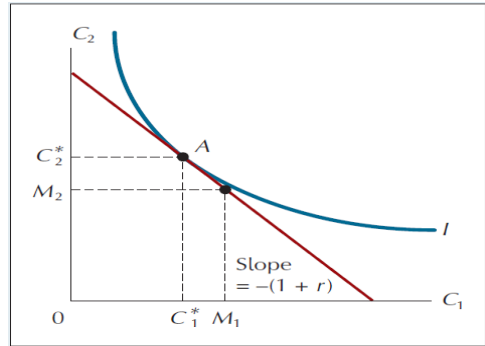
Chapter 5 Part A – Applications of Rational Choice and Demand Theories

Intertemporal Budget Constraint with Income in Both Periods, and Borrowing or Lending at the Rate r



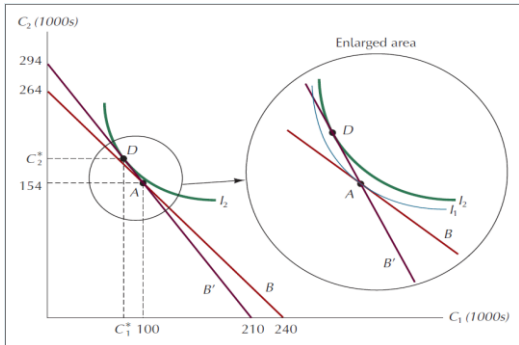
5-7

The Optimal Intertemporal Allocation



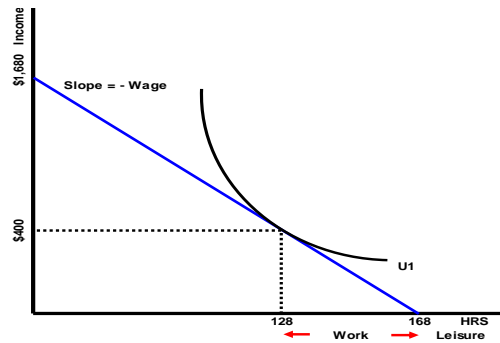
5-8

The Effect of a Rise in the Interest Rate



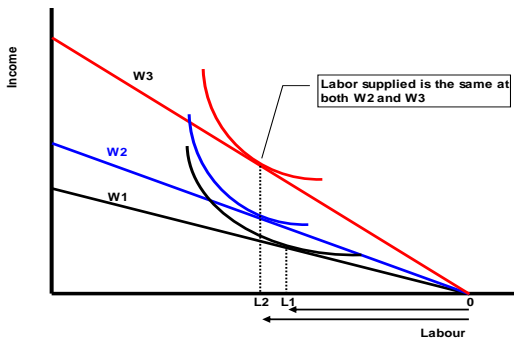
5-9

Labor - Leisure



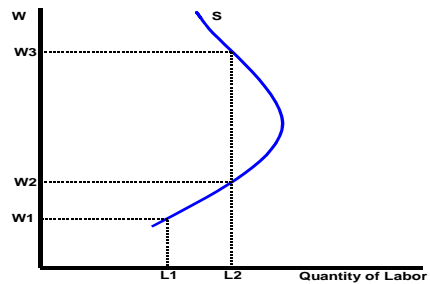
5-10

Labor - Leisure



5-11

Labor Supply Curve



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