

Second Exam

Write all answers in your blue book and show all work there. Return your exam in your blue book.

21 pts.

1) Suppose that we have two goods, beer and pretzels. On Thursday, the price of beer doubles and our income increases just enough to hold utility constant.

a) Draw a well-labeled diagram that shows this situation.

On Friday, income is just sufficient to afford Wednesday's basket of goods.

b) Add a budget line to the part a diagram that depicts Friday's income. Label it clearly.

c) Would you choose Wednesday's basket on Friday? Why?

d) How does this example illustrate two ways of defining a substitution effect?

16 pts.

2) Marvelous Marvin Thornberry just spent \$130,000 for a new jungle quality mobile home. (His old one only cost \$65,000.) Subsequently, fuel cost doubles. Considering the payment on the vehicle and the fuel cost, his income is markedly decreased.

a) Based partly on the payments on his new vehicle, Marv thinks he should abandon the jungle trip, sell the vehicle and get a regular job. What do you suggest that he check before he decides?

b) If he persists with the jungle venture, how do you expect the miles that he drives to compare with the past? Why?

21 pts.

3) Suppose that our production function is  $Q = KL$  and  $P_L = 2$ .  $P_K = 3$  and that initially  $K = 10$ .

a) Find the  $MP_L$  and  $SRMC$  when  $L = 20$ .

b) Draw a well-labeled diagram of the  $SRMC$  curve.

c) Draw a well-labeled diagram of the  $SRTC$  curve.

d) Draw a diagram showing the general shapes (and relative positions) of the  $LRAC$  and the  $LRMC$  curves.

21 pts.

4) Use a well-labeled diagram to show the effect of an increase in demand on  $P$  and  $Q$  in the short run and the long run in an increasing cost competitive industry.

21 pts.

5) a) Use a well-labeled diagram to show how a subsidy could be used to eliminate excess supply in a industry with a price floor.

b) Would the subsidy eliminate the deadweight loss associated with the price floor? Explain.

I have neither given nor received unfair aid on this test nor am I aware of anyone else doing so.

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