Chapter One:

1. Some people have argued that the US cannot afford a volunteer army in which wages are high enough to attract competent enlistees. Instead, they suggest paying lower wages and drafting the required number of recruits. Would such a policy change lower the accounting and economic costs to the US government from maintaining an army? Explain your answer.

   A draft would lower the accounting cost of maintaining an army but would not lower and probably increase economic cost. The economic cost of the draft is the reduced output elsewhere in the economy when people serve in the army instead of doing other jobs. With a volunteer army, the wages paid the soldiers equals the opportunity cost since the soldiers would not join unless their opportunity costs were covered. With a draft, the lower wages would often be less than the opportunity cost of the soldiers so the accounting costs would not reflect the economic costs. Further, some people would be drafted who would not have served under a volunteer army because their opportunities outside the military were better than the wage the army paid. Hence, the economic costs would be greater under a draft than a volunteer army.

2. Preparation time for the typical family meal has dwindled from two and a half hours in the early 1960s to 15 minutes today. Over the same time period, brown-bag lunches for school kids have yielded to prefabricated “meal kits.” For example, Oscar Meyer launched its packaged Lunchables in 1988 and by 2000 was making nearly $600 million in meal-kit profits. Using the concept of opportunity cost, explain these phenomena.

   As people’s time has become more valuable, the time devoted to meal preparation has decreased and households have increasingly switched to substitutes such as lunchables.

3. In 1997, the citizens of Tucson, AZ voted on whether the minimum wage within the city should be raised to $7 per hour. Explain how one would use positive and normative analysis to evaluate the desirability of this proposed policy.

   The first two steps would be taken in the realm of positive analysis: determining the qualitative and quantitative effects of the proposed policy. The third step would involve normative analysis: making a value judgment as to whether or not the policy was desirable.

Chapter Two:

1. A newspaper article points out that the price of economics textbooks is up 10% this year over last year, and yet the number of textbooks sold is higher this year. The article claims that these figures show that the law of demand does not apply to textbooks. Is there a flaw in this argument?

   answer in text

2. Suppose a freeze in Brazil damages Brazil’s coffee crop. Show the effects on a) the coffee market, b) the tea market, and c) the cream market.

   answer in text

3. Suppose that the price elasticity of demand for cigarettes is equal to 2.0. If the price elasticity of demand for Camel cigarettes is equal to 6.0, must there be at least some cigarette brands with an elasticity of less than 2.0?

   answer in text

4. In the antitrust case brought by the Justice Dept against Microsoft, explain why the cross-price elasticity of demand between rival operating systems such as Linux and Microsoft’s own MS-DOS system might have been of interest in determining Microsoft’s ability to control the prevailing price in the operating system market.
The cross price elasticity would indicate the extent to which systems such as Linux served as substitutes for Microsoft’s own operating system and thus would suggest the extent to which Microsoft had monopoly power in the operating system market.


Chapter Three:
1. Suppose Elton John says, “To me, Coke and Pepsi are both the same.” Draw several of Elton’s indifference curves relating Coke and Pepsi.

2. When we use the composite-good convention, what do we mean by composite good and how do we measure it? What is the slope of the budget line when a composite good is used? What is the slope of an indifference curve? Does the consumer equilibrium involve equality between MRS and the price ratio when a composite good is used?

Composition of the composite good is gauged by total outlays on all other goods other than the one represented on the horizontal axis. The slope of the budget line is given by the price of the good on the horizontal axis. The slope of an indifference curve, the MRS, shows how much the consumer is willing to reduce outlays on other goods to obtain one more unit of the good on the horizontal axis. At the optimal point for the consumer, the MRS equals the price of the good on the horizontal axis.

3. Is it possible for all goods a consumer buys to be normal? Is it possible for all goods a consumer buys to be inferior?

4. Marilyn spends her entirely monthly income of $600 on champagne (C) and perfume (F). The price of a bottle of champagne is $30 and the price of an ounce of perfume is $10. IF she consumes 12 bottles of champagne and 24 ounces of perfume, her MRS is 1C/1F. Is her choice optimal? Explain your answer with a diagram.

5. Can a “good” ever become a “bad” to a consumer? Explain.

Yes. For a definite period of time is possible for a consumer to not prefer consuming any more units of a good. For example, after consuming 5 pancakes, many people would consider a sixth pancake a “bad.” However, they may desire additional pancakes a few days later.

6. “If you are indifferent between two market baskets, then you would allow someone else to decide which basket you receive, even if that other person is your worst enemy.” Do you agree or disagree? Why?

Agree. If you are truly indifferent, then you don’t care which basket you receive. If that is really true, the there is no way the other peson can harm you by choosing either basket.

7. Draw a set of indifference curves relating two “bads” such as smog and garbage. What characteristics do these curves have?
These indifference curves are downward-sloping and concave to the origin, and utility increases as one moves toward the origin. If one gets less pollution, the person is better off, so he or she would have to receive more garbage in order to return to the original level of utility.

Chapter Four:
1. Explain how a bandwagon effect might speed up the rate at which DVD players are adapted by consumers. Do likewise for the case of cable television subscriptions.

   If DVD players and cable TV subscriptions are subject to a bandwagon effect, the market demand curve for these goods is more price elastic. As a result, any price decrease for such goods will lead to a faster adoption rate because individuals will be more likely to purchase the goods not just because of the lower price but also because the lower price encourages other individuals to make such a purchase.

2. When the price of gasoline in Italy is 5 lire per gallon, Fabio consumers 1,000 gallons per year. The price rises to 5.50 lire and, to offset the harm to Fabio, the Italian government gives him a cash transfer of 500 lire a year. Will Fabio be better or worse off after the price rise plus transfer? What will happen to his gasoline consumption?

   answer in text

3. Suppose that George Clooney is interested only in two goods: cigars and scotch. A). Employ indifference curve/budget line analysis to show a case where a decrease in the price of cigars leads to an increase in George’s scotch consumption. Does this imply that cigars and scotch are complements to George? Explain your answer, B). Repeat the preceding question but assume that a decrease in the price of cigars leads to a decrease in George’s scotch consumption. Does this mean that scotch is an inferior good in George’s case?

   look at book

4. Explain why a consumer’s well-being is not constant along a demand curve.

   answer in text

Chapter Five:
1. At the “All You Can Eat” brunch buffet offered by Chez Paul’s Cajun Restaurant, consumers pay a price of $15 and then can consume all they want. Show a consumer’s optimal consumption point with a budget line and indifference curve. Explain the shape of both curves.

   look at book [p. 132, 5.3]

2. How can the government reduce a consumer’s consumption of schooling by providing schooling at no cost? Explain in words and show in a diagram.

   answer in text [p. 128, 5.2]

3. In a two-year period, Anna has earnings of $6 million this year (year 1) and earnings of $10 million next year (year 2). She can borrow or lend at an interest rate of 25% per year. Suppose that Anna decides to borrow $1 million in year 1. Show Anna’s optimal consumption point in a diagram. Identify the amount borrowed in year 1, the amount repaid in year 2, consumption in year 1, and consumption in year 2.

   look at book [p. 135, 5.4]

4. Tony currently goes to the dentist twice a year at $50 per visit. His employer, the University of Arizona, subsidizes Tony’s purchases by paying half the cost of each dental visit in excess of one visit per year. (No subsidy is granted on the first visit) Show how this policy affects Tony’s budget line and his purchases of dental services. Identify in a diagram how much Tony spends on dental work and how much the University of Arizona spends in subsidizing his consumption.
5. Show the welfare cost (deadweight loss, excess burden) of an excise subsidy. What would it cost the government to give an equivalent lump-sum subsidy?
   answer in book (p 126)

6. College students often receive offers for credit cards even though they currently are not working. Why would banks send cards to students and why would students use them?
   It is expected that college students will earn income once they graduate and that their earnings will increase over time. Hence, the banks expect the borrowed money to be repaid over time. Similarly, the students can borrow against their expected future earnings in order to increase consumption while in school.

Chapter Six:
1. How is an equal distribution of goods shown in the Edgeworth box diagram? Is an equal distribution efficient?
2. What is meant by the term economic efficiency? Explain how voluntary exchange leads to an efficient solution.
3. After the Arab oil embargo in the early 1970s, the government set up a contingency plan that included rationing gasoline. Ration coupons were printed in case the plan was ever implemented. Some proposed that if the plan was implemented, consumers should be permitted to buy and sell coupons legally. Others disagreed and said that it should be illegal to buy and sell coupons. Which plan would be the most likely to be efficient? Why?
4. Tickets to the National Football League’s (NFL) championship game, the Super Bowl, are sold by the League at a below-market-clearing price. This policy produces a shortage. To allocate the relatively scarce tickets, the NFL typically employs a nonprice rationing scheme. For example, during a recent season, the League allowed all interested buyers to submit an application for up to two Super Bowl tickets. The NFL then conducted a lottery to determine which of the submitted applications would be honored. Explain why the nonprice rationing scheme employed by the NFL results in an inefficient distribution of goods. Can the NFL’s insistence that the state in which the Super Bowl is played prohibit ticket scalping by justified on efficiency or equity grounds? Explain. (Hint: ticket scalping involves the operation of a secondary market and the resale of tickets by original recipients to other interested consumers).