

EC111 Introduction to Economics: Class Exercises 3 (week 5)

1. A government wants to help people who are buying their own houses. It therefore offers to pay a subsidy of 25% of the price paid by buyers of houses. An economist says that this will not help house buyers because prices will rise by the amount of the subsidy. Is the economist correct? Why is it important to distinguish between the long run and the short run? If the scheme does help house buyers, who else will it help?

2. David consumes only peas and beans and has an income of £10. Beans are 20p per kg and peas 40p per kg.
 - (a) Draw David's budget line (with beans on the vertical axis) and find its slope.
 - (b) Suppose David's income falls to £5. Draw the new budget line.
 - (c) Suppose the price of peas falls to 20p per kg (income is still £5). Draw the new budget line.

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 - (a) Suppose we have the original situation in question (2) above. David decides to consume 30kg of beans. How many kg of peas does he consume?
 - (b) The price of peas then falls from 40p to 20p per kg. David decides to consume 30kg of beans. How many kg of peas does he now consume?
 - (c) With the price of peas now at 20p per kg, David tells us that he would have been just as well off as he was originally (under 2(a) above) if the price of peas was 20p and his income was £7.60, in which case he would buy 20kg of beans. Calculate the income and substitution effects on the quantity of peas of the fall in the price of peas in (b) above.
 - (d) Are either beans or peas an inferior good?

Key terms to review and understand:

Utility

Indifference curves

Marginal rate of substitution

Marginal utility

Budget line

Income effect

Substitution effect

Inferior good