#1 Demonstrate how PCC with varying price Py, (Px and Income are fixed) can give us the price elasticity of Y to be equal to, less than, or greater than 1 in absolute value

#2

7. A college student has two options for meals: eating at the dining hall for $6 per meal, or eating a Cup O' Soup for $1.50 per meal. Her weekly food budget is $60.

    a. Draw the budget constraint showing the trade-off between dining-hall meals and Cups O' Soup. Assuming that she spends equal amounts on both goods, draw an indifference curve showing the optimum choice. Label the optimum as point A.

    b. Suppose the price of a Cup O' Soup now rises to $2. Using your diagram from part (a), show the consequences of this change in price. Assume that our student now spends only 30 percent of her income on dining-hall meals. Label the new optimum as point B.

    c. What happened to the quantity of Cups O' Soup consumed as a result of this price change? What does this result say about the income and substitution effects? Explain.

    d. Use points A and B to draw a demand curve for Cup O' Soup. What is this type of good called?

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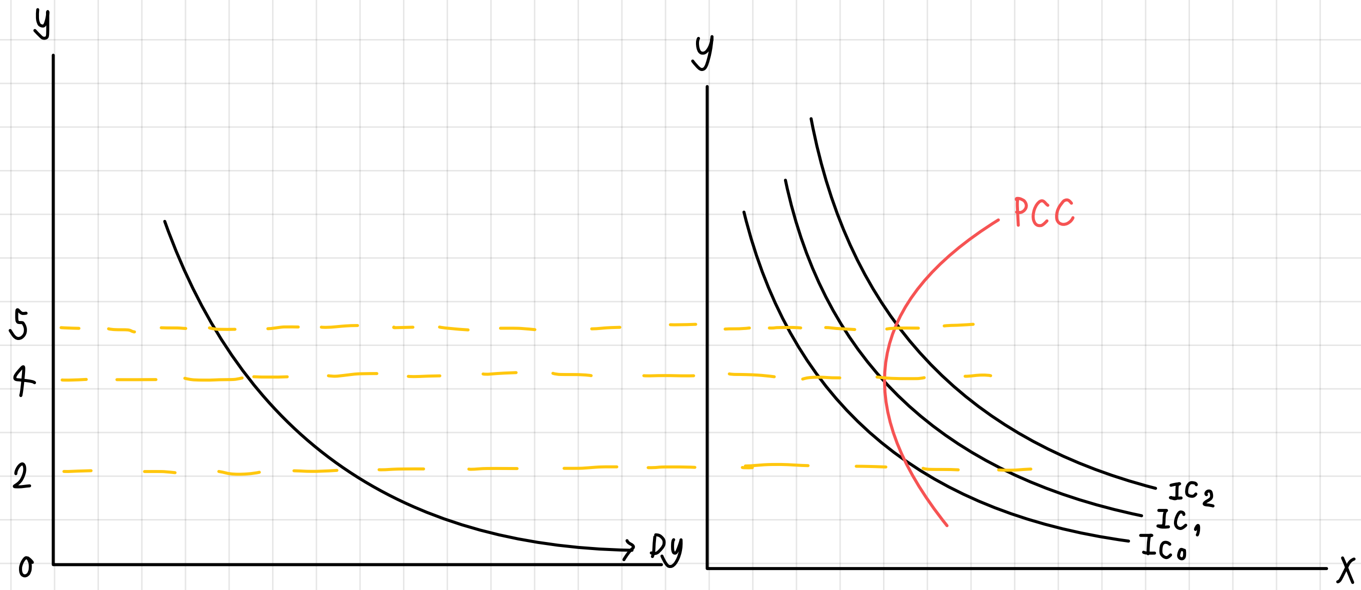

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This is a normal good since people want to buy more because of the increase in consumers' income. According to this type of good, the income & substitution effects will work in the same direction.

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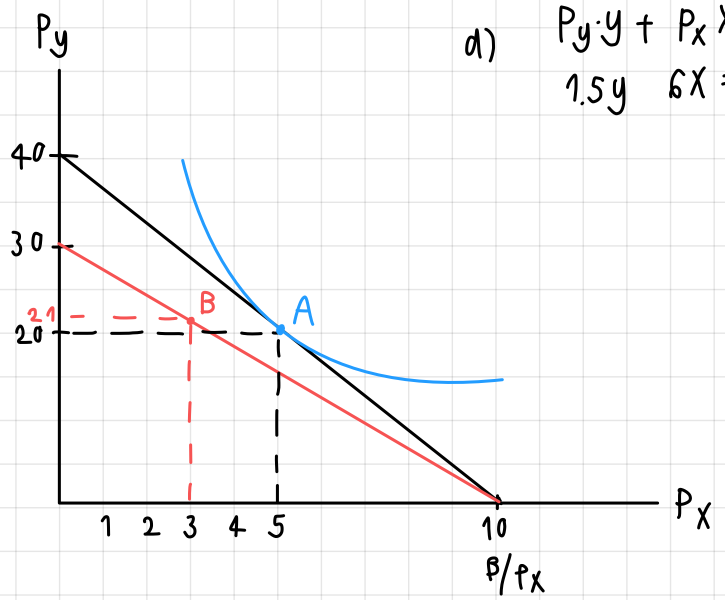


a) $P_y \cdot y + P_x X = B$

$1.5y \quad 6X = 60$

$30 = 1.5y \rightarrow y = 20$

$30 = 6X \rightarrow X = 5$

b) $2y + 6X = 60$

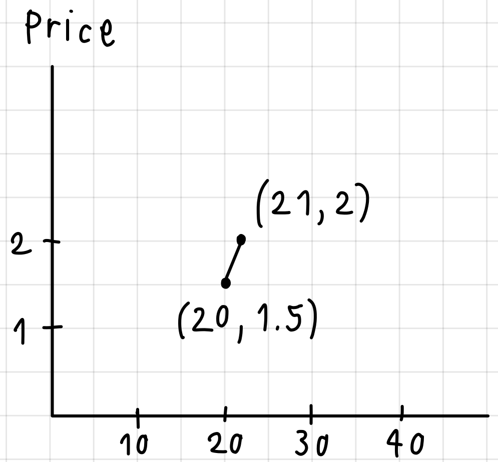
$60 \times 0.3 = \frac{60}{2}$

$2y + 18 = 60$

$y = 21$

c) H increases the consumption of meal at cups o'soup by 1 unit. (from 20 to 21). Because of income & substitution effect, in substitution effect states that an increase in price of good will encourage consumers to buy it more. The income effect effectively cuts disposable income & there will be lower demand for the good (Py increase) due to the fall in disposable income.

d)



H is called giffen good since the demand curve has positive slope.
(price ↑ → buy more)

Cup o' soup