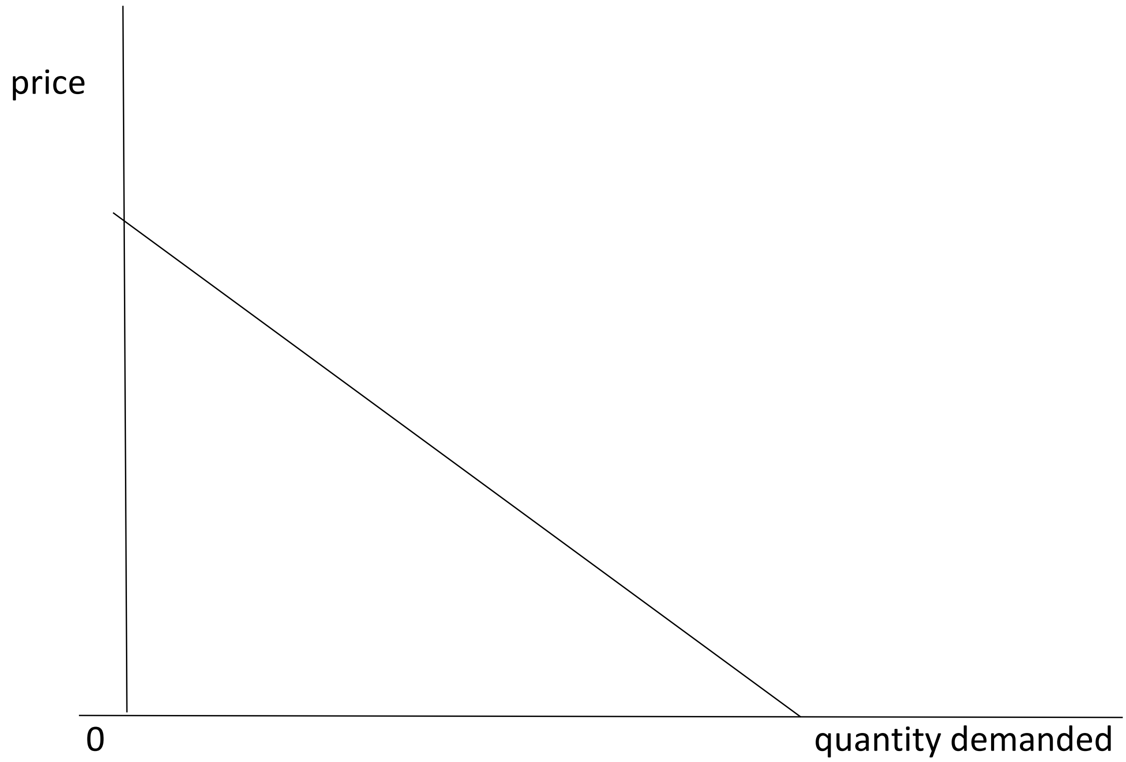
MOT1421
Economic Foundations
Week One

INTRODUCTION & THEORIES OF CONSUMER DEMAND
SELF-TEST

The self-assessment consists of 10 Questions.
Each Question has a weight of 1. Your maximum score therefore is 10.
A score of 6 means that you have successfully passed the test.

Question 1

Consider the following consumer demand curve for good A. Good A is a normal good.



The above consumer-demand curve has been drawn under the ceteris-paribus assumption. Explain what happens to this graph when consumer income rises.

Question 2

The representative consumer has the following utility function: $U = X \cdot \sqrt{Z}$; where *X* = the quantity of good *X*, and *Z* = the quantity of good *Z*. The prices of these goods are exogenously given: P_Z = 2 and P_X = Euro 4. The consumer budget is exogenously given and equals Euro 36. The consumption budget is completely used up.

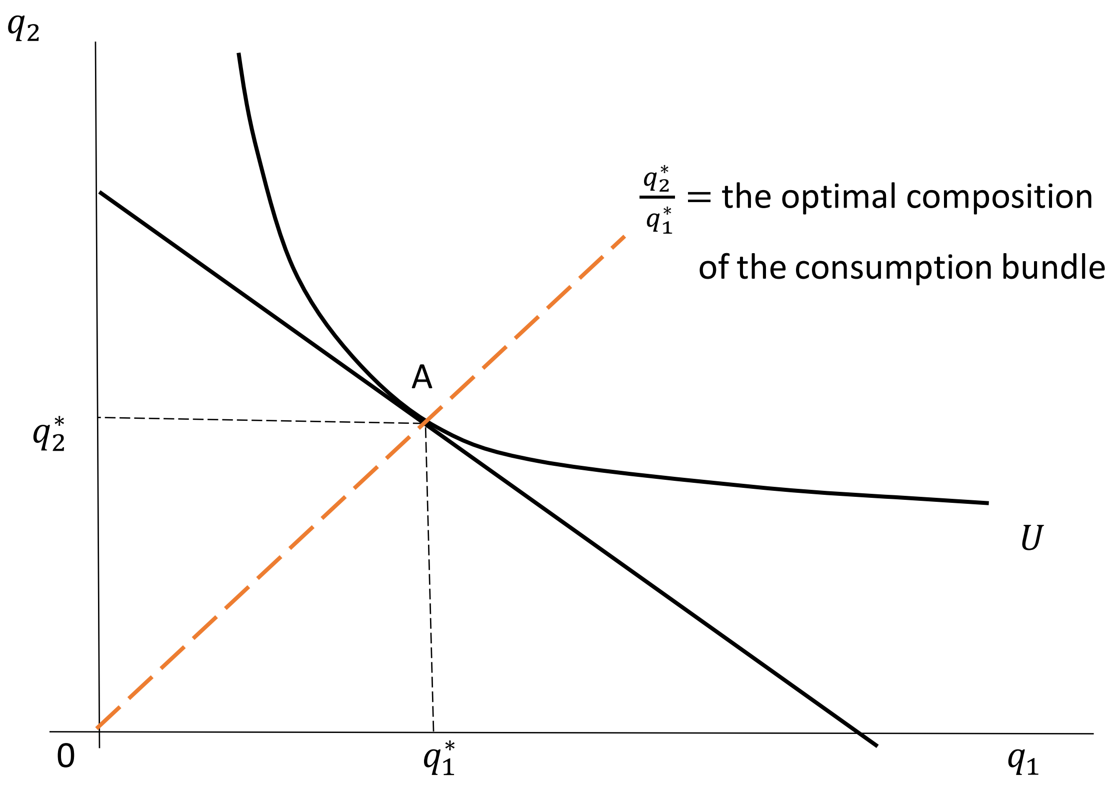
Identify the utility maximising consumption bundle of this consumer.

Question 3

Consider Figure A (below). Assume that the price of good 1 increases.

Figure A

Utility maximisation by the representative consumer



How does the optimal consumption choice by the representative consumer change? In your answer, identify (the signs of) the total effect, the substitution effect and the income effect.

Question 4

What do microeconomists mean by the 'bandwagon effect' in consumer demand theory?

Question 5

a. Suppose $e_Y = 0.75$. The income of the consumer falls by 3%. By how much does consumer demand change?
b. Suppose $e_P = -0.9$. The price of the service increases by 5%. How does consumer demand change?

Question 6

Consider the following consumer demand function (which is part of a complete Linear Expenditure System):

$$q_i = \gamma_i + \mu_i \times (\frac{Y}{P_i} - \sum_{i=1}^{n} P_i \times \gamma_i)$$

where $q_i =$ the quantity demanded of good *i*; $\gamma_i =$ fixed quantity demanded of good *i*; $\mu_i =$ the marginal budget share of good *i*; $Y =$ the income of the consumers; and $P_i =$ the price of good *i*. Note that the average budget share of good *i* is defined as: $\alpha_i = \frac{(P_i \times q_i)}{Y}$.

Derive the income elasticity of demand for good *i*.

Question 7

Explain the difference between a necessary good and a luxury good.

Question 8

Explain the difference between an inferior good and a Giffen good.

Question 9

Explain why consumers are not sovereign according to:

a. Thorstein Veblen.
b. John Kenneth Galbraith.

Question 10

Consider the following proposition:

“In neoclassical theory, consumers are not sovereign in a market of a monopoly.”

Explain why this proposition is wrong.

End of self-test Week 1