

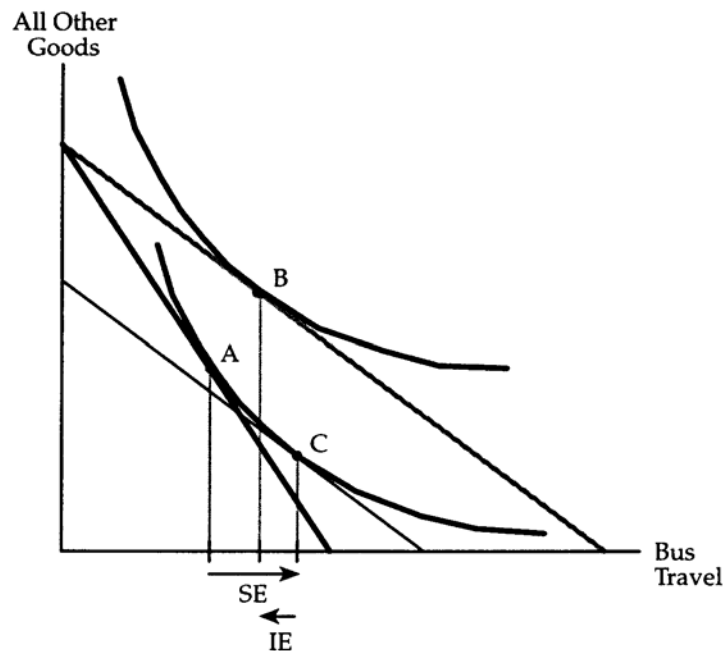
Econ 321 Test 1 Fall 2005
Answer Section

MULTIPLE CHOICE

1. D
2. D
3. B
4. C
5. A
6. A
7. C
8. B
9. C
10. C
11. B
12. B
13. C
14. C
15. B
16. C
17. B
18. B
19. D
20. C
21. A
22. A
23. C
24. C
25. D

ESSAY

1. When the prison sentences for all crimes are doubled, the "price" of criminal behavior is higher, and by the law of demand, the amount of criminal behavior will fall. Whether or not the prisons would become more overcrowded depends on whether the "demand" for criminal behavior is relatively flat or steep. If the demand for criminal behavior is relatively flat, then the doubling of prison sentences could sufficiently reduce the amount of criminal behavior so that less total prison time would be served. On the other hand, if the demand for criminal behavior is relatively steep, then the doubling of prison sentences would result in only a minor reduction in criminal behavior, an increase in the total prison time served, and worse overcrowding in prisons.
2.
 - (i) Bus travel is an inferior good, so the substitution and income effects must be in opposite directions. Since the demand curve for bus travel is downward sloping, the substitution effect must be larger than the income effect. This situation is shown in the accompanying diagram, where point A is the initial optimum and point B is the final optimum.



- (ii) Consider points C and B in the diagram. The parallel shift in the budget line shows a rise in income, but quantity demanded is falling from C to B. Therefore, income and quantity demanded are moving in opposite directions, so bus travel is an inferior good. The income elasticity of demand for inferior goods is negative.

3. After the price changes, Miguel could still purchase 4 pounds of cheese and 4 pounds of fruit, because this basket still costs \$48 under the new prices. Since Miguel chose not to continue purchasing this basket and instead chose to purchase a new basket, we can conclude that he must prefer having 2 pounds of cheese and 6 pounds of fruit to having 4 pounds of each good. Therefore, the price changes have made Miguel better off.

Alternatively, one can use a Laspeyres price index to show that Miguel is better off. In this situation, a Laspeyres price index would report no change in the cost of living (since 4 pounds of each good costs \$48 both before and after the price changes), so Miguel is better off since a Laspeyres price index makes price changes seem worse for consumers than they really are.

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