

Managerial Economics And Business Strategy 8th Edition Solution Manual Baye Prince

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Test Bank for Managerial Economics & Business Strategy, 8th edition by Michael Baye, Jeff Prince

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Chapter 4: The Theory of Individual Behavior Answers to Questions and Problems

1.

- a. The market rate of substitution is $-\frac{P_x}{P_y} = -\frac{15}{5} = -3$.
- b. See Figure 4-1.
- c. Increasing income to \$600 (by \$300) expands the budget set, as shown in Figure 4-1. Since the slope is unchanged, so is the market rate of substitution.

Budget Set

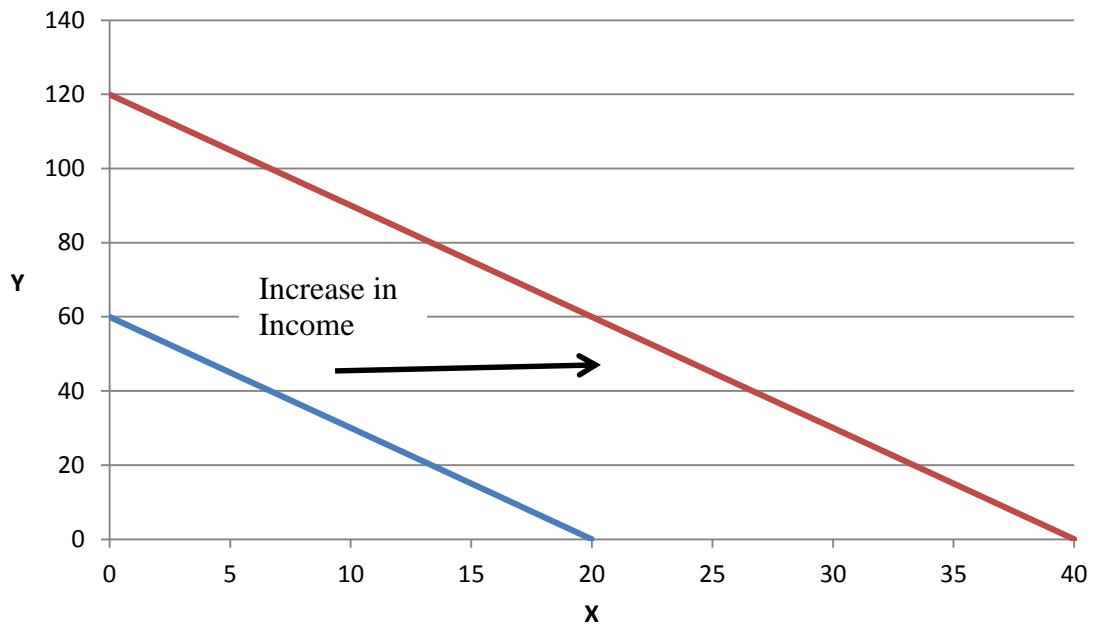


Figure 4-1

2.

- a. Since the slope of the line through point A is $-\frac{20}{20} = -1$ and the price of good X is \$5, it follows that $P_y = 5$.
- b. If the consumer spends all her income on good X she can purchase 20 units. Since these units cost \$5 each, her income must be \$100.
- c. At point A, the consumer spends $(\$5)(10) = \50 on good Y, which means that the remaining $\$100 - \$50 = \$50$ is being spent on good X. Since good X costs \$5 per unit, point A corresponds to 10 units of good X.
- d. The price of good Y decreased to \$2.50. The consumer achieves a higher level of satisfaction at point B.

3.

- a. The consumer's budget line is $\$600 = \$10X + \$40Y$. Rearranging terms and solving for Y results in $Y = 15 - 0.25X$.
- b. See in Figure 4-2.
- c. When the price of X increases to $\$20$, the budget line becomes $\$600 = \$20X + \$40Y$ which is equivalent to $Y = 15 - 0.5X$ (after rearranging and simplifying terms). This is shown in Figure 4-2. The market rate of substitution changes from $-\frac{P_x}{P_y} = -\frac{10}{40} = -0.25$ to $-\frac{P_x}{P_y} = -\frac{20}{40} = -0.5$.

Budget Set

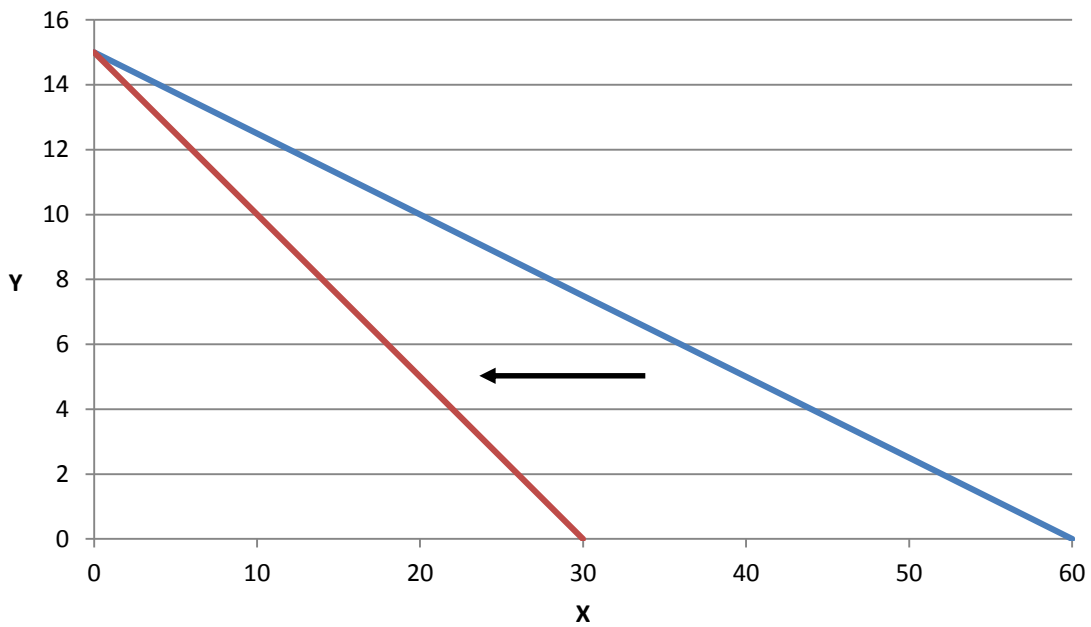


Figure 4-2

4. This is not always the case. For instance, if the consumer was initially consuming more of the inferior good than a gift certificate would purchase, then less of the inferior good will be consumed when given a gift certificate.
5. A half-price sale cuts the price of each and every unit in half. In contrast, a buy-one, get-one-free deal does not change the relative price of any units between 0 and 1 unit. Furthermore, it makes the price of units purchased between 1 and 2 units purchased zero.

6.

- a. $P_x = \$100, P_y = \200 and $M = \$400$
- b. $\frac{M}{P_y} = \frac{400}{200} = 2$ units.
- c. $\frac{M}{P_x} = \frac{400}{100} = 4$ units.
- d. 1 unit (since the \$100 gift certificate will purchase exactly one unit of good X).
- e. $\frac{M+\$100}{P_x} = \frac{500}{100} = 5$ units.
- f. D, B, C, A.
- g. Normal.

7.

- a. Consumption of good X will increase and consumption of good Y will decrease.
- b. Consumption of good X will increase and consumption of good Y will decrease.
- c. Nothing will happen to the consumption of either good.
- d. Consumption of good X will decrease and consumption of good Y will increase.

8.

All properties hold except *Property 4-3* (“Diminishing Marginal Rate of Substitution”) and *Property 4-2* (“More is Better”).

9.

- a. The initial budget set is depicted in Figure 4-3.

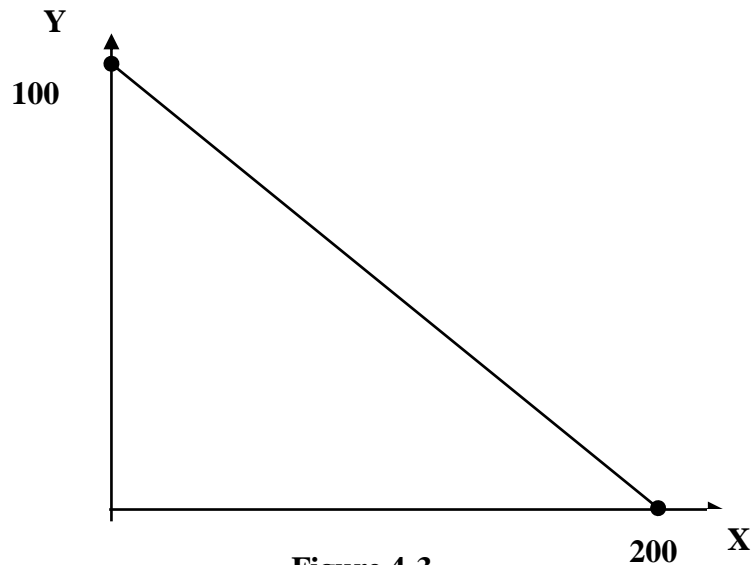


Figure 4-3

- b. Doubling all income and price leaves the budget set unchanged. The increase in income is sufficient to offset the price increases. The market rate of substitution is unchanged.

- c. The consumer's income is \$600, the price of X is \$3 per unit and the price of Y is \$6 per unit.
- 10.
- The worker's opportunity set in a given 24-hour period is $E = 360 - 15L$.
 - Since the worker is always willing to trade \$11 dollars of income for one hour of leisure, the worker's indifference curve does not exhibit diminishing marginal rate of substitution; the worker always trades between the two goods at the same rate. Since \$11 is less than \$15, the worker will choose to work 24 hours.
11. These preferences do not exhibit a diminishing marginal rate of substitution since consumers are always willing to substitute the same amount of store-brand sugar for an additional pound of producer-brand sugar. When store-brand sugar is \$1 per pound and producer-brand sugar is \$3 per pound, the consumer will purchase 24 pounds of store-label sugar and no producer-brand sugar. After the change, the consumer will purchase no store-label sugar and 8 pounds of producer-brand sugar.
12. See Figure 4-6. When there is no food stamp program, the market rate of substitution is -0.33 . The Food Stamp program leaves the market rate of substitution unchanged, and a consumer can purchase \$284 of food without spending her income. A dollar-for-dollar exchange of food stamps for money further expands a consumer's opportunity set, potentially making her better off.

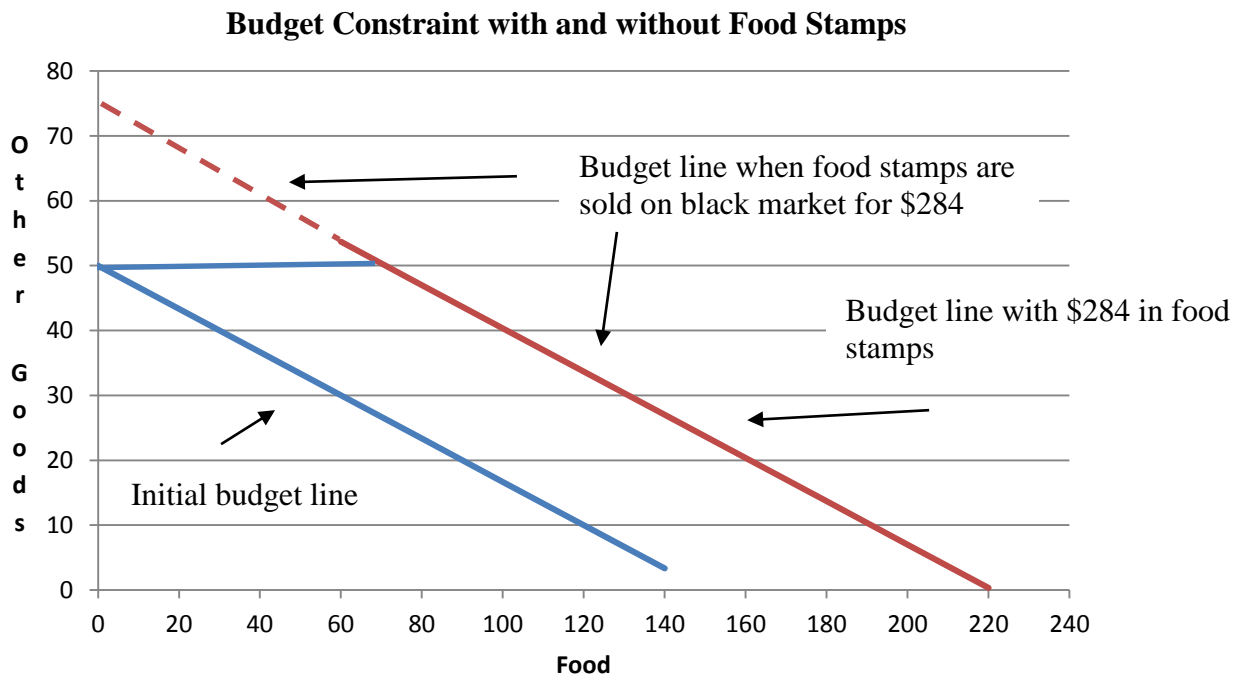


Figure 4-6

13. See Figure 4-7. The offer expands the consumer's budget set and allows her to purchase more tires.

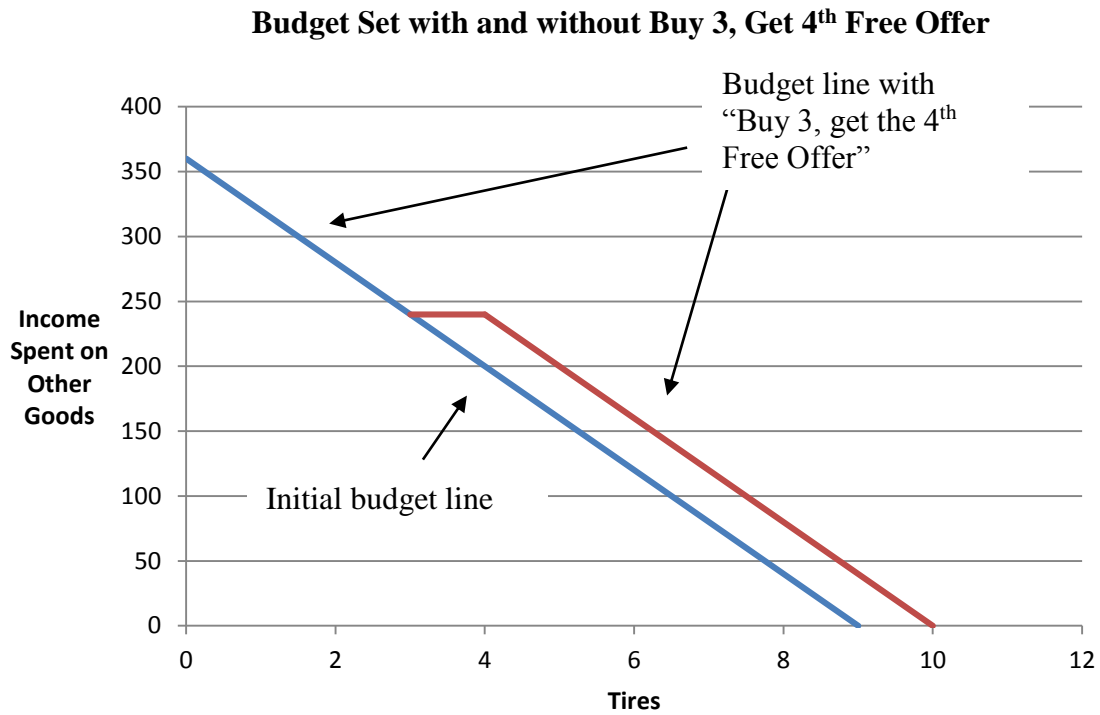


Figure 4-7

14. See Figure 4-8. The initial market rate of substitution is -0.5 . Since, after the price decrease, the $MRS = -1 \neq -0.67 = \frac{P_{EM}}{P_T}$ (where P_{EM} is the price of electronic media and P_T the price of travel) equilibrium has not been achieved. To reach equilibrium, the business should increase its use of electronic media and decrease travel.

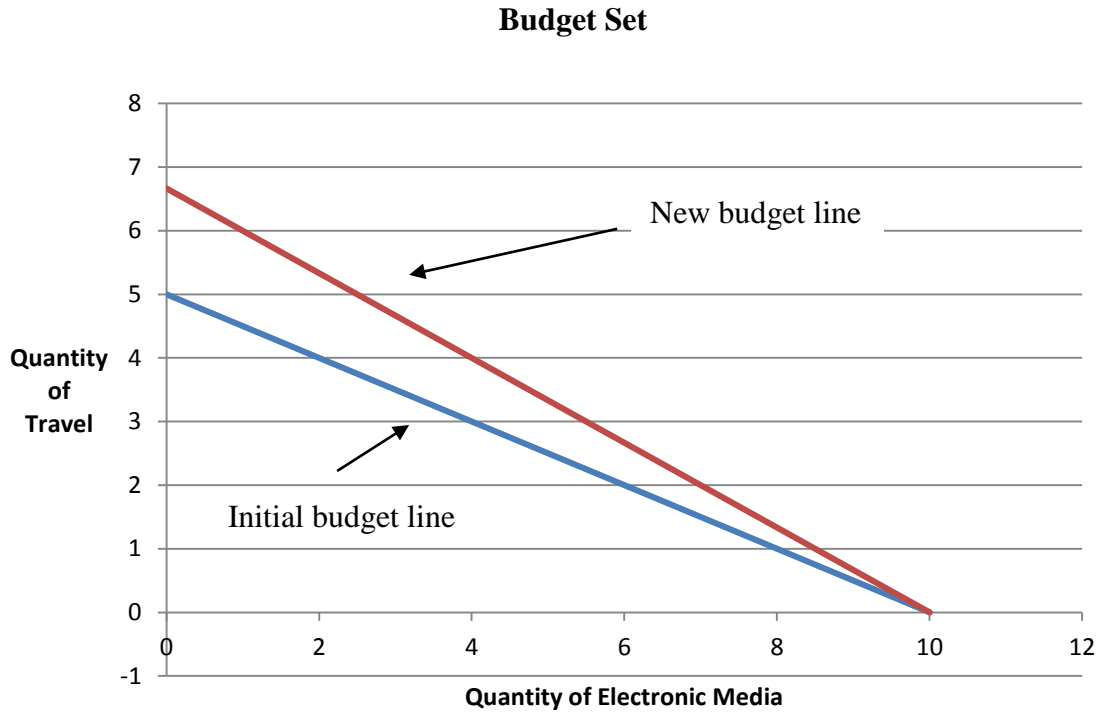


Figure 4-8

15. The impacts on the consumer's budget sets are illustrated in Figure 4-9. As is shown in the diagram, if the consumer has a strong preference for other goods (so that the preferred quantity of other goods is greater than 10 units), the cash is preferred even though it is taxed. Otherwise, the non-taxable, employer-sponsored health insurance program allows an employee to achieve a higher indifference curve.

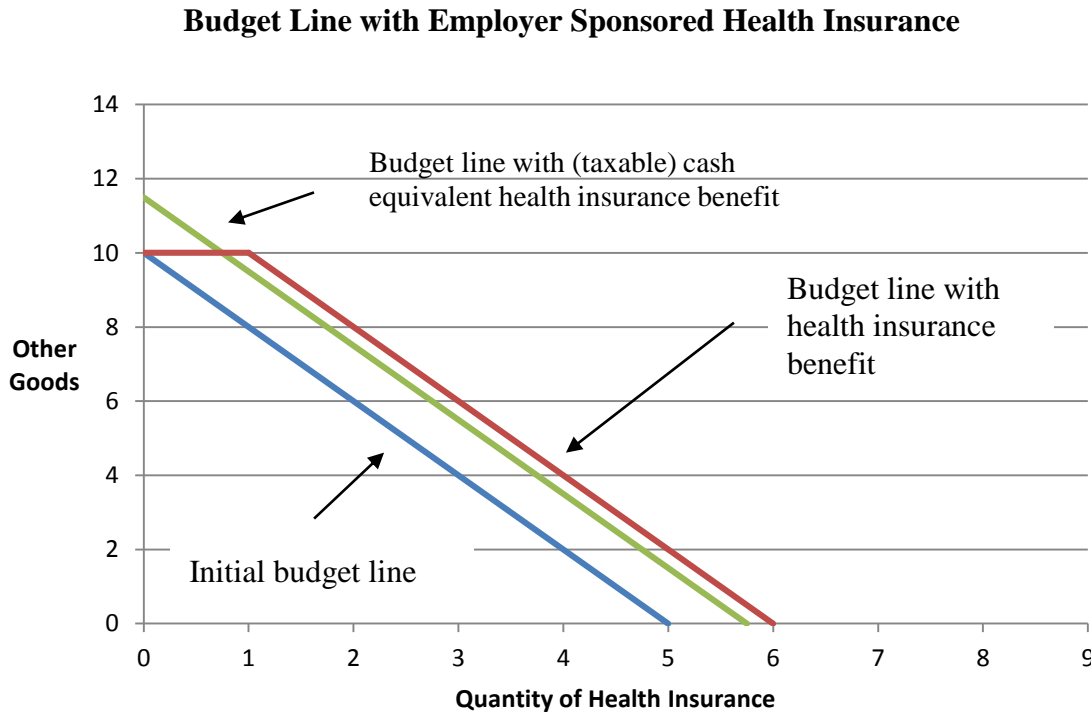


Figure 4-9

16. Under the existing plan, a worker that does not “goof off” produces 3 copiers per hour and thus is paid \$9 each hour. Under the new plan, each worker would be paid a flat wage of \$8 per hour. While it might appear on the surface that the company would save \$1 per hour in labor costs by switching plans, the flat wage would be a lousy idea. Under the current plan, workers get paid the \$9 only if they work hard during the hour and produce 3 machines that pass inspection. Under the new plan, workers would get paid \$8 an hour regardless of how many units they produce. Since your firm has no supervisors to monitor the workers, you should not favor the plan.

17. As shown in Figure 4-10, the budget line when more than 10 dozen bagels are purchased annually under the frequent buyer program is always greater than the budget line when the firm sells each dozen bagels at a 3 percent discount. However, the budget line for consumers who purchase fewer than 10 dozen bagels per year is greater under the 3 percent per dozen discount.

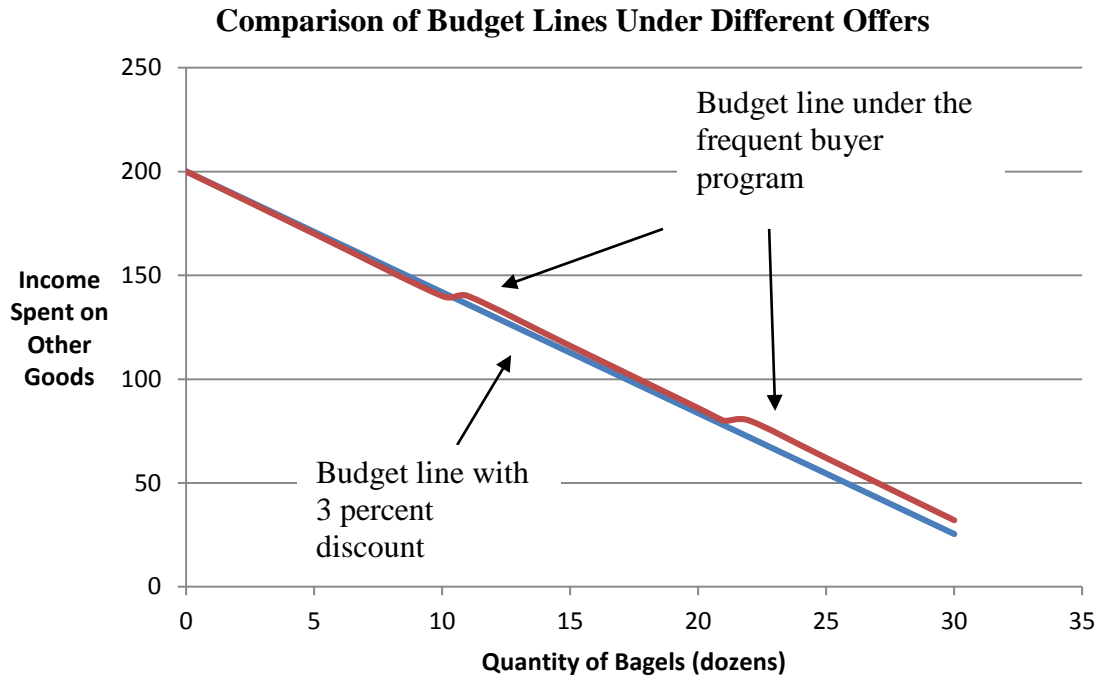


Figure 4-10

18. Yes. Since pizza is an inferior good, if the consumer is given \$50 in cash she will definitely spend it entirely on music downloads – just as she would if given a \$50 gift certificate for music downloads.

19. Figure 4-11 illustrates a consumer's budget line when a firm offers a "quantity discount." A consumer will never purchase exactly 8 bottles of wine, since at this kink in the opportunity set the consumer would always be better off by buying more or less wine.

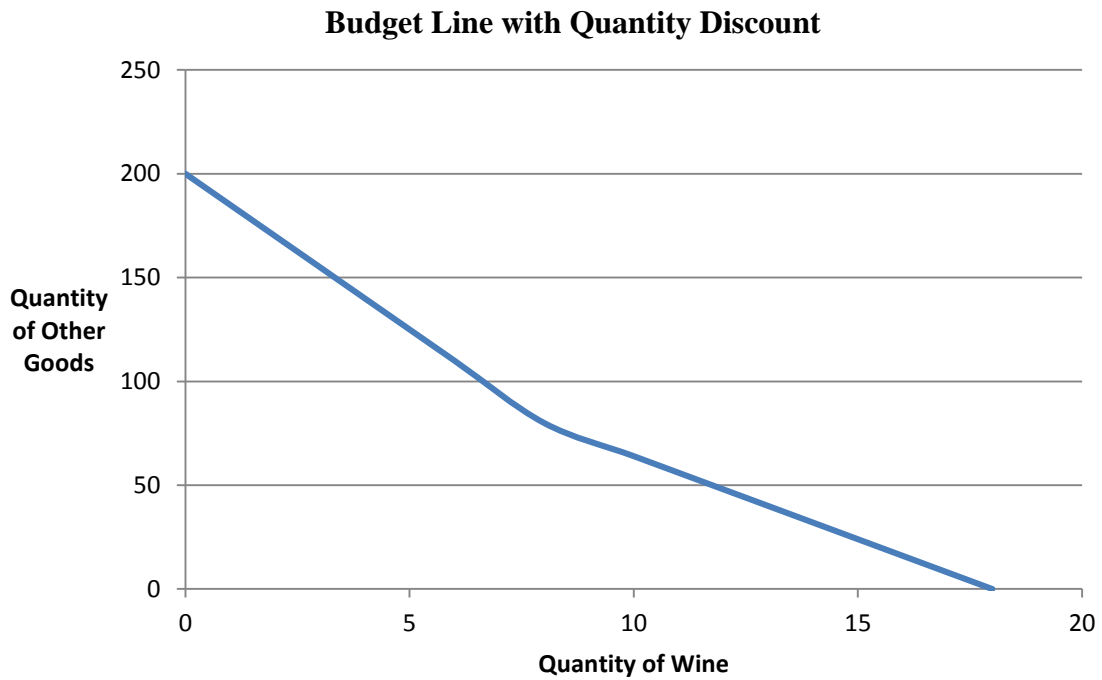


Figure 4-11

20. Figure 4-12 contains profit as a function of output. Output when managers are compensated based solely on output is 20 units and profits are zero. In contrast, when managers' compensation is based solely on profits, output is 10 units and profits are \$200. When managers' compensation is based on a combination of output and profit, output ranges between 10 and 20 units and profit will be between zero and \$200. The exact combination of output and profit depends on how these variables are weighted.

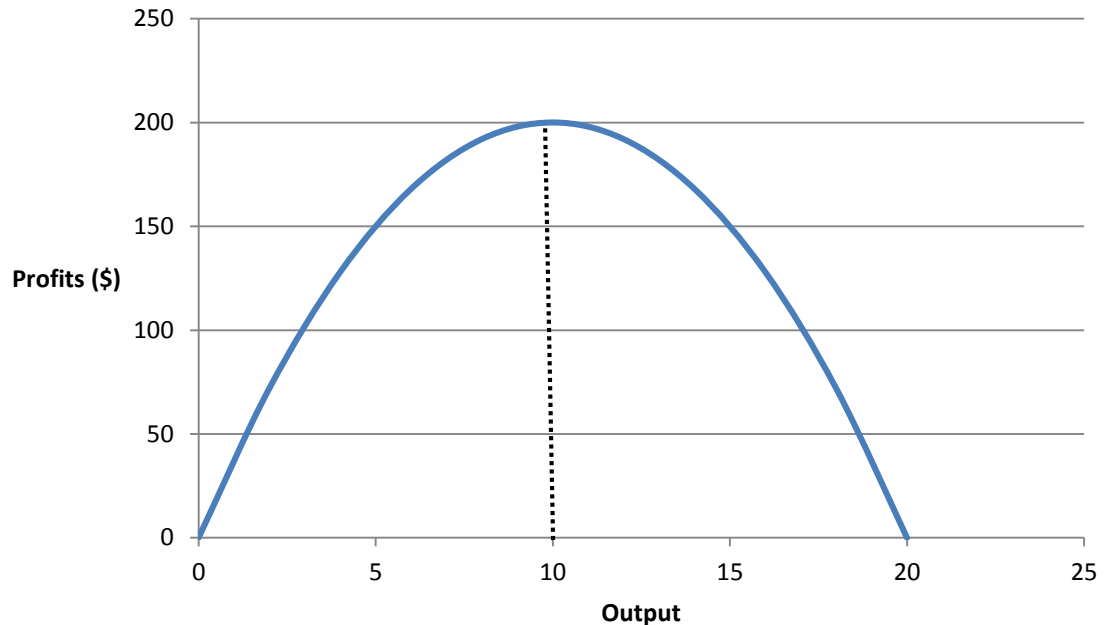


Figure 4-12

21. Figures 4-13a and 4-13b, respectively, illustrate Albert's and Sid's opportunity sets. Since there are 24 hours per day, at the new wage rate of \$22 per hour Albert will supply 14 hours of labor per day (24-10), and Sid will supply 10 hours of labor per day (24-14). This seemingly contradictory result is explained by decomposing the wage change into the substitution effect and income effect. The diminishing marginal rate of substitution between income and leisure implies that the substitution effect will increase the amount of leisure consumed by each worker (decrease the amount of labor supplied). Since after the wage change Albert is observed consuming less leisure (supplying more labor), the income effect dominates the substitution effect. In contrast, the substitution effect dominates the income effect for Sid; since Sid is observed consuming more leisure (supplying less labor) after the wage change.

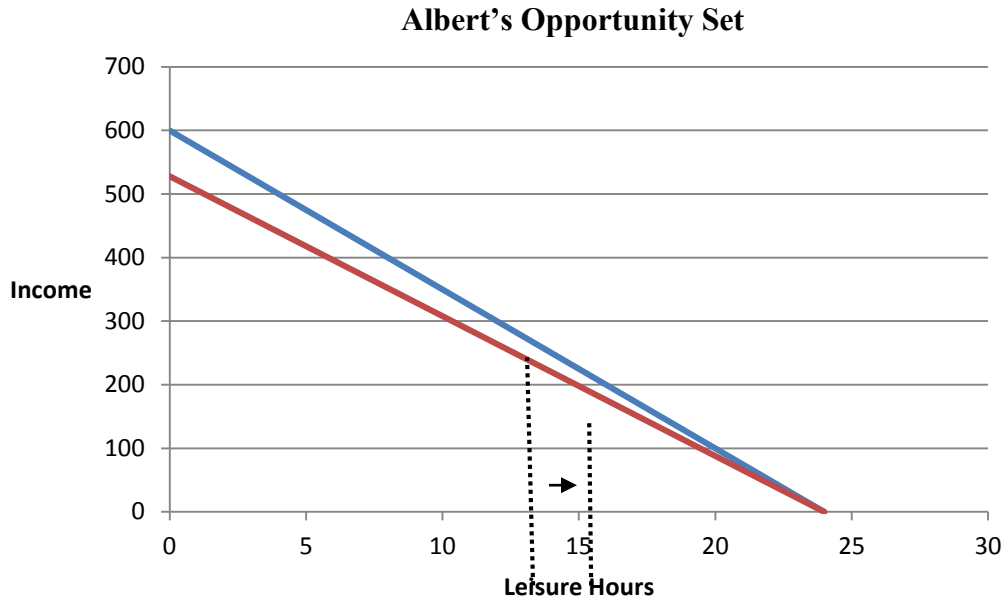


Figure 4-13a

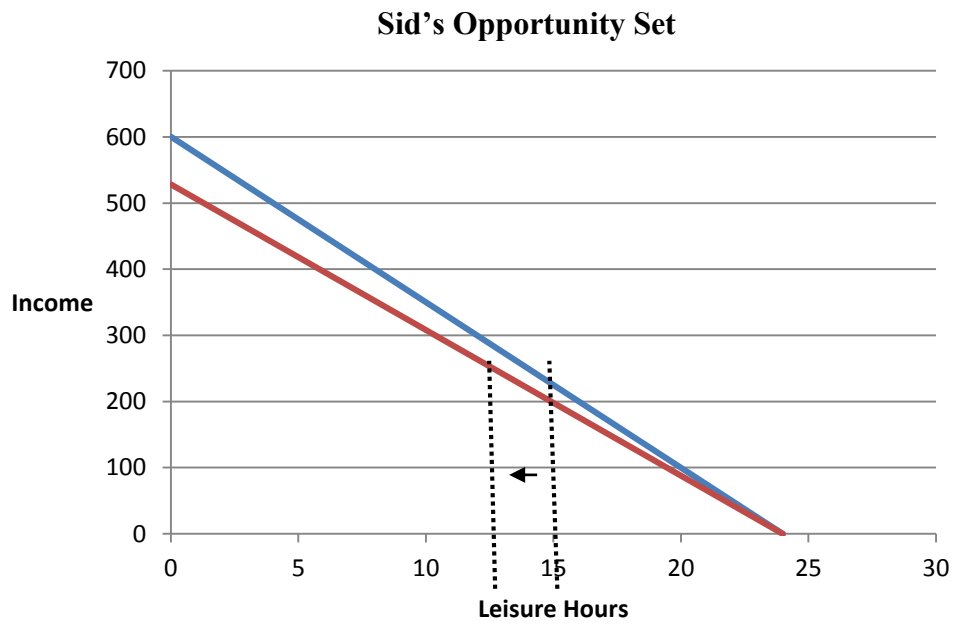
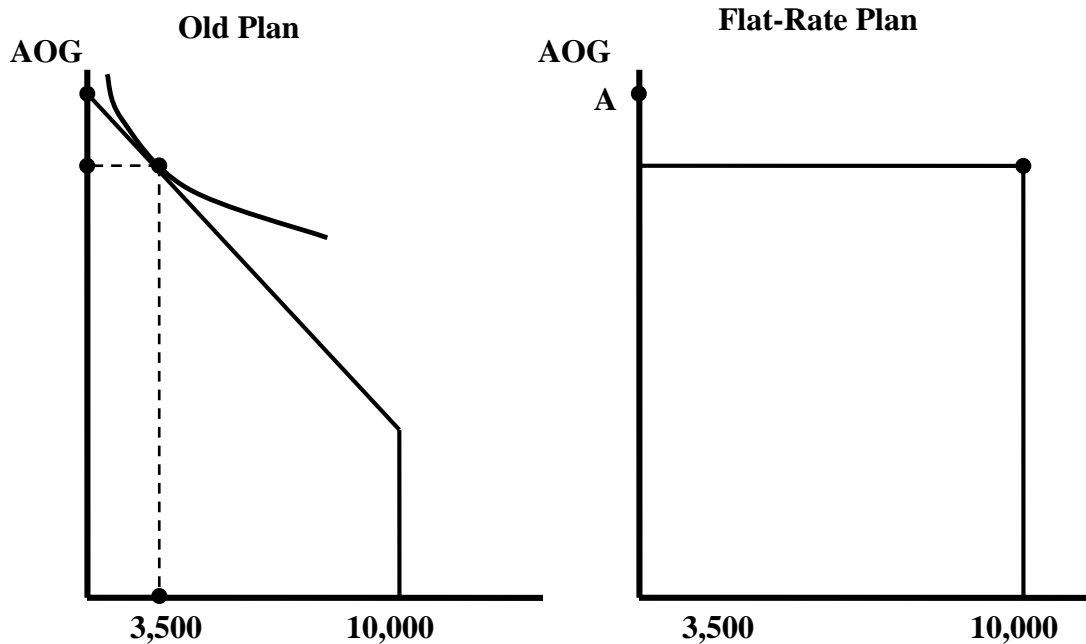


Figure 4-13b

22. Gift cards are not merely a fad. Retailers experience significant benefits from gift cards since they minimize product returns; independent of whether the good is normal or inferior. Gift cards can also benefit consumers. A gift card does not impact the amount purchased for one good (say the good on the Y axis), but shifts out the budget constraint for the other good (the good on the X axis) by the face value of the gift card. The expanded budget constraint permits the consumer to reach a higher indifference curve; resulting in greater utility.
- 23.



Under the Old Plan, consumers consumed 3,500 gigabytes of Internet traffic for £399.99. The budget line under the Flat-Rate Plan, however, is significantly different. Consumers can choose to now spend all their income on all other goods (AOG), represented by point A on the AOG axis, or consume the same amount of AOG as they did under the old plan along with any amount of Internet traffic up to the maximum volume in a month. Optimizing consumers will choose the corner solution represented by the same number of units of AOG as the Old Plan and 10,000 gigabytes of broadband Internet traffic. Thus, UK consumers are necessarily better off (assuming similar quality of service). The Internet service provider (ISP), however, gains no additional revenues and presumably must increase its network capacity. Therefore, the ISP may earn lower profit (ignoring other factors).

24. The movement from selling 9 bottles of Coke to 7 bottles of Coke, as shown in the graph, is the change in sales due to the substitution effect. We know this because it is determined by keeping the consumer on the same indifference curve, and comparing purchases at the two different prices. The price increase also has an income effect, since it effectively lowers the consumer's overall purchasing power. Since Coke is a normal good, this lowering of income results in lower sales. Adding this to the substitution effect means that sales will be less than 7.
25. As shown in the book, we can determine aggregate demand by summing up quantity demanded for each individual at every price. At a given price, P , quantity demanded by a female customer is $24 - 2*P$, and at that same price, quantity demanded by a male customer is $27 - P$. Summing gives us $24 - 2*P + 27 - P = 51 - 3P$. So, for any price P , the total demand is $51 - 3P$. If we call total demand Q^T , then we have the aggregate demand equation: $Q^T = 51 - 3P$. We often want to graph demand using the inverse demand function, and we can do that here. Solving the aggregate demand curve for P gives us: $P = 17 - (1/3)*Q^T$.

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