Econ 301 Intermediate Microeconomics
Chapter 2 group assignment 1
Suggested Solution

Consider the market for burritos in Ames, IA. Working together as a group, answer each of the following questions. Someone in your group should type up your answers on a laptop so that you can email me your answers during class. (Send them in a word document to themattsimpson@gmail.com)

1. What is everyone’s favorite burrito place in Ames? E.g. Chipotle, Fighting Burrito, Panchero’s, Mr. Burrito, and probably others. (Don’t spend too much time on this question!!)
   The correct answer is Chipotle. You guys should be ashamed.

2. Do you think burritos are an inferior, normal, or luxury good? Why?
   Most likely, burritos are an inferior good over some ranges of income and a normal good over others. Suppose you are really poor and you can’t even afford to eat burritos – all you can afford to eat is (cheap) ramen noodles. Suddenly your income doubles. Even if burritos aren’t your favorite thing to eat, you’re probably now willing to purchase one every now and then. So income increases, the quantity of burritos demanded increases. So burritos are a normal good here. (Think carefully about the calculus definition of income elasticity of demand – you could even argue burritos are a luxury good in this case).

   Now suppose everyone you’re middle class, but not super rich. You eat some number of burritos, but you probably would be 100% willing to cut a burrito or two out of your diet in exchange for eating lobster, or high quality steak, or whatever your favorite super expensive food is. Maybe you like caviar. So when your finally win the lottery and strike it rich, you purchase a little less burritos and a little more of your favorite high end foods – unless burritos are your favorite food I suppose. In this case, burritos are an inferior good since an increase in income corresponds do a decrease in the demand for burritos.

   In reality, most of the burrito market is probably in the range of income where it would take huge increases in their income before their demand for burritos would drop. So given current conditions and for not-too-large changes in income, burritos are a normal good. But it is possible to imagine an income change that turns burritos into an inferior good.

3. Think about what happens to the population of Ames during the summer. What does economic theory suggest should happen to the supply of burritos? Why? What actually happens to the supply of burritos? How could we modify our theory in order to make it more consistent with what actually happens?
   Two key things happen to Ames in the summer. First, a bunch of college students (and probably some professors) leave town. Second, high school students suddenly have a lot more free time. These are both relevant to the supply for burritos because high school and college students are the primary sources of cheap labor in Ames, and cheap labor is needed to construct those burritos! So the question is, does the supply of cheap labor increase or decrease? That depends on whether you think more labor is available from the high school students than is lost when the college students leave. Since the population of ISU students is so large, I suspect that more labor is lost than is gained. If that’s the case, then the price of cheap labor should go up, which makes producing those burritos more expensive. As a result, we should see the supply curve shift to the left. This should cause the price of burritos to increase.

   In reality, we don’t see this price increase happen during the summer. Why not? Probably the burrito restaurants don’t want to make their customers angry – for some reason, customers prefer constant prices rather than prices that bounce up and down as conditions change. If Panchero’s decides to start charging more for burritos during the summer (and perhaps less during the school year), then that might make customers angry and cause them to buy burritos from somewhere else permanently, which hurts Panchero’s in the long run.

   In order to make the theory consistent with reality, we just need to 1) take into account consumers’ preferences about constant prices, and 2) make sure that firms think about long run profit and not just short run profit.

   There’s another way to answer this question though — maybe prices are actually higher in the summer because during the school year, the burrito places are all running sales and handing out coupons (I don’t actually know if this is true, but it could be!). This would be a clever way to change prices without letting customers get angry about it.
4. Suppose that all of the restaurants that sell burgers in Ames cut the price of their burgers by 10%. How do you think this will affect the demand for burritos in Ames? Why?

_Burgers and burritos are most likely substitutes — when you buy one, you’re less likely to buy the other. So if the price of burgers goes down, the demand for burritos should shift to the left — Ames consumers will be less willing to buy burritos at any given price than before._

5. Do you think that the demand for burritos is elastic or inelastic? Why?

_The demand for burritos is probably elastic — there are lots of different food options available, and most people and burrito-philes, so if the price of burritos goes up, they’ll just buy some other cheap, hand held food._

6. One problem with thinking about the market for burritos is that we treat a Chipotle burrito and a Panchero’s burrito as the same thing, but clearly they’re not. How does this impact the own-price elasticity of demand for a single restaurant’s burritos (i.e. Chipotle’s burritos)? (Hint: if all burritos are the same, what happens if Chipotle raises the price of their burritos by $1? What happens if everyone’s burrito is different?)

_If all burritos are the exact same, then if one burrito seller raises their prices there is absolutely no reason to buy a burrito from them instead of a cheaper place, so demand for burritos must be very elastic. In reality, there are a ton of differences — taste, brand, location, options, etc. So the real life elasticity is probably not as high because some people would be willing to stomach a small price increase to still buy their preferred burrito because they think it tastes better, or because it’s closer, or they like the way the company sources the food, etc._

7. Can you think of any other problems we might have with assuming that all burritos are identical?

_One big potential problem is that we assume in the standard supply and demand model that no company has any market power — they’re basically forced to charge exactly the market price and don’t have any ability to raise their prices higher than the equilibrium price. This isn’t the case in reality because burritos are all different. As a result, they can raise their prices above the competitive equilibrium price and make somewhat higher profits. The effect probably isn’t very large for burritos because people don’t feel that strongly about their burrito preferences (and could also just by a cheeseburger instead), but this is a common problem with applying the standard perfect competition model to real world situations. Most real world markets exhibit “monopolistic competition” which is a sort of midway point between a monopoly and perfect competition. We’ll talk more about that later in the summer._