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01

MICRO ECONOMICS

Market Structures, Competitive and Non-Competitive Equilibria and Their Efficiency Properties

Difficulty: Easy

PYQ practice

A natural monopoly occurs when :

- A. Average cost keeps on rising with increase in output over the relevant range of output.
- B. Average cost remains constant with increase in output over the relevant range of output.
- C. Average cost first decreases and then rises with increase in output over the relevant range of output.
- D. Average cost keeps on decreasing with increase in output over the relevant range of output.

EXPLANATION

Correct answer: D — Average cost keeps on decreasing with increase in output over the relevant range of output.

A natural monopoly has subadditive costs over the relevant market demand: one firm can supply total output more cheaply than several firms splitting that output. Continuously falling average cost over the relevant range is a sufficient pattern, so D is the intended answer. It is not a necessary definition; costs may remain subadditive over some outputs even after average cost begins to rise.

Why the other choices do not work

- **A:** Continuously rising average cost removes the cost advantage of a single large supplier.
- **B:** Constant average cost gives no strict cost saving from concentrating the same output in one firm.
- **C:** A U-shaped curve alone does not settle subadditivity. It can be compatible with natural monopoly over some demand ranges, but does not provide the clear sufficient condition in D.

Takeaway: Declining average cost is a familiar sufficient condition; subadditivity is the general cost criterion.

KEYWORDS

natural monopoly

declining average cost

economies of scale

market demand

02

MICRO ECONOMICS

Market Structures, Competitive and Non-Competitive Equilibria and Their Efficiency Properties

Difficulty: Easy

PYQ practice

Monopoly Power is explained by which of the following?

A. $\frac{(P-MC)}{P}$

B. $\frac{(P+MC)}{P}$

C. $\frac{(P-AC)}{P}$

D. $\frac{(P+AC)}{P}$

EXPLANATION

Correct answer: A — $\frac{(P-MC)}{P}$

The Lerner index measures monopoly power as the proportional markup of price over marginal cost: $L = (P - MC)/P$. It is zero under price-taking competition and rises with market power.

Why the other choices do not work

- **B:** Adding marginal cost to price is not a markup measure.
- **C:** Average cost can be above or below marginal cost and is not used in the Lerner index.
- **D:** The sum of price and average cost has no monopoly-power interpretation.

Takeaway: Monopoly power is captured by the price–marginal-cost markup relative to price.

KEYWORDS

lerner index

monopoly power

price cost margin

marginal cost

03

MICRO ECONOMICS

Market Structures, Competitive and Non-Competitive Equilibria and Their Efficiency Properties

Difficulty: Medium

PYQ practice

Suppose demand is $Q = 20/P$, the feasible price satisfies $P \leq 10$, and marginal cost is $MC = 1$. What profit-maximizing price and quantity will the firm choose?

A. $P = 20, Q = 4$ B. $P = 5, Q = 4$ C. $P = 10, Q = 2$ D. $P = 4, Q = 5$

EXPLANATION

Correct answer: C — $P = 10, Q = 2$

Demand is $Q = 20/P$, so profit with marginal cost 1 is $(P - 1)Q = (P - 1)(20/P) = 20 - 20/P$. This expression rises as P rises, because $20/P$ falls with P . Since the feasible price must satisfy $P \leq 10$, the profit-maximizing firm chooses the highest allowed price, $P = 10$. The corresponding quantity is $Q = 20/10 = 2$.

Why the other choices do not work

- **A:** $P = 20$ violates the price constraint.
- **B:** $P = 5$ is feasible but not profit-maximizing.
- **D:** $P = 4$ is also below the profit-maximizing cap.

Takeaway: When profit increases in price, the price ceiling binds.

KEYWORDS

unit elastic demand

profit maximization

price cap

binding constraint

04

MICRO ECONOMICS

Market Structures, Competitive and Non-Competitive Equilibria and Their Efficiency Properties

Difficulty: Medium

PYQ practice

Two steel firms receive price $p = 1$. $C_1(q_1) = q_1^2$ and $C_2(q_2, q_1) = (q_2 + 0.75q_1)^2$. Firm 2 incurs a short-run loss and can exit in the long run. What is firm 1's long-run profit π_1 ?

A. $\pi_1 = 0.025$ B. $\pi_1 = 0$ C. $\pi_1 = 0.25$ D. $\pi_1 = 0.125$

EXPLANATION

Correct answer: C — $\pi_1 = 0.25$

Firm 2 exits in the long run after incurring losses. The cost spillover runs from firm 1 to firm 2, not in the reverse direction, so firm 1's cost and profit functions are unchanged by that exit. Its profit remains $\pi_1 = q_1 - q_1^2$ because price is 1 and cost is q_1^2 . The first-order condition is $1 - 2q_1 = 0$, giving $q_1 = 1/2$. Profit is $1/2 - (1/2)^2 = 1/2 - 1/4 = 1/4 = 0.25$.

Why the other choices do not work

- **A:** Substituting the maximizing output $q_1 = 1/2$ gives $1/2 - 1/4 = 1/4$, so moving the decimal to 0.025 understates profit tenfold.
- **B:** After firm 2 exits, firm 1 still sells positive output and maximizes $q_1 - q_1^2$, which leaves profit $1/4$ rather than zero.
- **D:** At $q_1 = 1/2$, revenue is 0.5 and cost is 0.25; their difference is 0.25, not 0.125.

Takeaway: After exit, firm 1 earns the single-firm profit from $q - q^2$.

KEYWORDS

firm exit

long run equilibrium

residual firm profit

quadratic cost

05

MICRO ECONOMICS

Efficiency Criteria: Pareto-Optimality, Kaldor-Hicks and Wealth Maximization

Difficulty: Easy

PVQ practice

Welfare criterion based on compensation payments is known as :

- A. Dalton–Friedman Compensation Criterion
- B. Amartya Sen Compensation Criterion
- C. Pareto–Bains Compensation Criterion
- D. Kaldor–Hicks Compensation Criterion

EXPLANATION

Correct answer: D — Kaldor–Hicks Compensation Criterion

The Kaldor–Hicks criterion judges a change desirable when gainers could in principle compensate losers and still remain better off; actual payment is not required. It is therefore the compensation criterion among the listed choices.

Why the other choices do not work

- **A:** Dalton and Friedman do not name the standard compensation criterion.
- **B:** Sen's capability approach is not a compensation-test rule.
- **C:** Pareto improvement and Bain are not combined into the named criterion used here.

Takeaway: Potential compensation is the defining idea of Kaldor–Hicks efficiency.

KEYWORDS

kaldor hicks criterion

compensation principle

potential pareto improvement

welfare economics

06

MICRO ECONOMICS

Efficiency Criteria: Pareto-Optimality, Kaldor-Hicks and Wealth Maximization

Difficulty: Medium

PYQ practice

Find out the correct alternative – Scitovsky double criterion

- A. does not require the fulfilment of Kaldor – Hicks Welfare criterion test.
- B. requires only the fulfilment of reversal test
- C. does not require the fulfilment of reversal test
- D. requires the fulfilment of Kaldor – Hicks test and reversal test**

EXPLANATION**Correct answer: D – requires the fulfilment of Kaldor – Hicks test and reversal test**

The Scitovsky double criterion was designed to address the possibility that a change may pass a compensation test in one direction and also appear reversible under another test. Therefore it combines two requirements: the Kaldor-Hicks compensation criterion must be satisfied, and the reversal test must also be satisfied. The word double is the clue: both tests are needed, not just one of them.

Why the other choices do not work

- **A:** The double criterion begins with the Kaldor-Hicks compensation test, so dispensing with that test removes one of its two required parts.
- **B:** Passing the reversal test alone does not establish the forward Kaldor-Hicks improvement that Scitovsky also requires.
- **C:** Omitting the reversal test leaves the Scitovsky paradox unresolved, which is precisely why the second test was added.

Takeaway: Scitovsky double criterion = Kaldor-Hicks plus reversal test.**KEYWORDS**

scitovsky double criterion

kaldor hicks compensation test

reversal test

scitovsky paradox

07

MICRO ECONOMICS

Efficiency Criteria: Pareto-Optimality, Kaldor-Hicks and Wealth Maximization

Difficulty: Hard

Curated practice

Match List I with List II.

List I (Welfare criterion)	List II (Decision rule)
A. Pareto improvement	I. Gainers could compensate losers and still remain better off
B. Kaldor criterion	II. Winners under the reverse move cannot bribe the original gainers to prevent the move
C. Hicks criterion	III. At least one person gains and no person loses
D. Scitovsky double criterion	IV. The Kaldor test favours the move and the reverse move fails the compensation test

Choose the correct answer from the options given below:

A. A-I, B-III, C-IV, D-II

B. A-III, B-II, C-I, D-IV

C. A-IV, B-I, C-III, D-II

D. A-III, B-I, C-II, D-IV

EXPLANATION

Correct answer: D — A-III, B-I, C-II, D-IV

A Pareto improvement makes someone better off without making anyone worse off. Kaldor asks whether the gainers could compensate the losers and still retain a gain; actual payment is not required. Hicks asks whether the losers could compensate the gainers to prevent the change. Scitovsky addresses possible reversals by requiring the proposed move to pass the Kaldor test while the reverse move fails it.

Why the other choices do not work

- **A:** Potential compensation is the Kaldor idea, whereas Pareto does not permit uncompensated losers.
- **B:** It reverses Kaldor and Hicks: Kaldor starts with the gainers, Hicks with what the losers could offer to block the move.
- **C:** Scitovsky is a double compensation test, not the Pareto no-loser rule, and Hicks is not defined by Pareto improvement.

Takeaway: Track who hypothetically pays whom and whether the reverse move also passes; that separates the compensation tests.

KEYWORDS

pareto improvement

kaldor criterion

hicks criterion

scitovsky double criterion

compensation tests

08

MICRO ECONOMICS

Factor Pricing

Difficulty: Easy

PYQ practice

Which one of the following holds true at equilibrium level of demand for labour by a perfectly competitive firm?

A. $VMP_L < MRP_L$

B. $VMP_L = MRP_L$

C. $VMP_L > MRP_L$

D. $VMP_L + MRP_L = W^*$

EXPLANATION

Correct answer: B — $VMP_L = MRP_L$

Under perfect competition in the product market, marginal revenue equals price. Hence $MRP_L = MR \cdot MP_L = P \cdot MP_L = VMP_L$; at the hiring optimum both also equal the wage.

Why the other choices do not work

- **A:** VMP_L cannot be below MRP_L when $MR = P$.
- **C:** VMP_L cannot exceed MRP_L under the same equality.
- **D:** The hiring condition equates each marginal product value to the wage; it does not add the two magnitudes.

Takeaway: Perfect competition makes marginal revenue product and value of marginal product identical.

KEYWORDS

marginal revenue product

value of marginal product

labour demand

perfect competition

09

MICRO ECONOMICS

Factor Pricing

Difficulty: Medium

Curated practice

A firm hires labour competitively but sells output on a downward-sloping demand curve. Which relation holds at an interior profit maximum?

A. $w = VMP_L > MRP_L$

B. $w > MRP_L = VMP_L$

C. $w = MRP_L < VMP_L$

D. $w = MRP_L = VMP_L$

EXPLANATION

Correct answer: C — $w = MRP_L < VMP_L$

Competitive labor hiring makes the marginal factor cost equal to w , so the optimum satisfies $w = MRP_L$. Downward-sloping product demand implies $MR < P$, and therefore $MRP_L = MR MPL < P MPL = VMP_L$. Hence $w = MRP_L < VMP_L$.

Why the other choices do not work

- **A:** Wage equals MRP at the hiring margin, not the larger price-valued marginal product.
- **B:** MRP_L and VMP_L differ because marginal revenue is below price.
- **D:** All three coincide only when output is also sold competitively so that $MR = P$.

Takeaway: Output-market power creates a wedge between MRP and VMP even with competitive labor hiring.

KEYWORDS

marginal revenue product of labour

value of marginal product

competitive labour market

downward sloping product demand

wage condition

10

MICRO ECONOMICS

Factor Pricing

Difficulty: Medium

Curated practice

Quasi-rent refers to:

- A. A temporary short-run return to a specific factor whose supply cannot adjust immediately
- B. A permanent long-run rent earned only by land
- C. A rent collected by government from all factor owners
- D. The transfer earnings required to retain labour in its present use

EXPLANATION

Correct answer: A — A temporary short-run return to a specific factor whose supply cannot adjust immediately

Quasi-rent is the short-run excess return to a man-made or specialised factor whose supply cannot adjust quickly. Demand can temporarily raise its earnings above short-run variable or opportunity costs, but entry, replication or reallocation erodes that surplus in the long run.

Why the other choices do not work

- **B:** Rent from a naturally fixed supply of land may persist, whereas quasi-rent is temporary and can accrue to reproducible capital.
- **C:** Government collection is not part of the definition of quasi-rent.
- **D:** Transfer earnings are the opportunity cost of keeping a factor in its current use, not the temporary surplus earned by a short-run fixed factor.

Takeaway: Quasi-rent is temporary because the specific factor is fixed only in the short run.

KEYWORDS

quasi rent

short run specific factor

temporarily inelastic supply

surplus return

long run erosion

11

MICRO ECONOMICS

Game Theory - Non-Cooperative Games

Difficulty: Easy

PYQ practice

Which of the following games has no pure-strategy Nash equilibrium?

- A. BoS Game
- B. Stag Hunt Game
- C. Matching Pennies Game
- D. Prisoner's Dilemma

EXPLANATION

Correct answer: C — Matching Pennies Game

Matching pennies is the standard two-player zero-sum game with no pure-strategy Nash equilibrium. At every pure-strategy outcome, one of the players wants to change their action: the matcher wants the coins to match, while the mismatcher wants them not to match. Therefore no pure action pair is mutually stable. By contrast, Battle of the Sexes and Stag Hunt have pure coordination equilibria, and Prisoner's Dilemma has a pure dominant-strategy equilibrium.

Why the other choices do not work

- **A:** Battle of the Sexes has pure equilibria.
- **B:** Stag Hunt has pure equilibria.
- **D:** Prisoner's Dilemma has a pure equilibrium.

Takeaway: Matching pennies requires mixed strategies for equilibrium.

KEYWORDS

matching pennies

no pure nash equilibrium

zero sum game

mixed strategy equilibrium

12

MICRO ECONOMICS

Game Theory - Non-Cooperative Games

Difficulty: Easy

PYQ practice

When each player has chosen his or her optimal strategy given the strategy chosen by other player, the situation is referred to

as:

- A. Nash Equilibrium
- B. Wicksel's Equilibrium
- C. Prisoner's dilemma
- D. Co-operative Game

EXPLANATION

Correct answer: A — Nash Equilibrium

A Nash equilibrium occurs when each player is choosing the best available strategy given the strategies chosen by the other players. In that situation, no player can improve their payoff by changing strategy unilaterally.

Why the other choices do not work

- **B:** Wicksell's monetary equilibrium concerns the relation between the market and natural interest rates, not players' best responses.
- **C:** The prisoner's dilemma is a particular game that has a Nash equilibrium; it is not the general name for mutual best responses.
- **D:** Co-operative game refers to a game type, not this equilibrium condition.

Takeaway: Mutual best responses define Nash equilibrium.

KEYWORDS

nash equilibrium

mutual best responses

unilateral deviation

13

MICRO ECONOMICS

Game Theory - Non-Cooperative Games

Difficulty: Medium

PYQ practice

Which statements correctly characterize a Nash equilibrium?

- A. It must occur every time the game is played.
- B. It is a mutually consistent configuration that can persist as a strategic equilibrium.
- C. No player wishes to deviate unilaterally, given the other players' strategies.
- D. It is merely the first mover's best response.
- E. It must be a pair of dominated strategies.

A. A, B and C only

B. B and D only

C. B and C only

D. A, C and D only

EXPLANATION

Correct answer: C — B and C only

A Nash equilibrium is a strategy profile that can persist because each player's strategy is optimal given the strategies chosen by the others. That makes statement B correct. Statement C gives the standard no-unilateral-deviation condition, so it is also correct. Statement A is false because a Nash equilibrium is not guaranteed to occur every time a game is played. Statement D is too narrow, and statement E is false because equilibrium does not require dominated strategies.

Why the other choices do not work

- **A:** A Nash equilibrium describes mutual best responses, not an outcome that must be observed on every play of the game.
- **B:** A first mover's best response alone is insufficient; equilibrium requires every player's choice to be optimal against the others' choices.
- **D:** It combines the every-play misconception with the first-mover-only definition and drops the mutual-consistency condition in B.

Takeaway: Nash equilibrium means mutual best responses.

KEYWORDS

nash equilibrium

mutual best responses

unilateral deviation

strategic stability

14

MICRO ECONOMICS

Game Theory - Non-Cooperative Games

Difficulty: Hard

PYQ practice

Consider a Bertrand duopoly with a homogeneous product. Market demand is $y = y_1 + y_2 = 1 - p$. Each firm has cost $C_i(y_i) = \frac{1}{2}y_i$, $i = 1, 2$. Firms simultaneously quote prices in $[0, 1]$; the lower-price firm serves all demand, and equal-price firms split demand equally. What are the Nash-equilibrium price and quantities?

- A. $P_1 = P_2 = 1$. $Y_1 = Y_2 = Y/2$; is one of the Multiple Nash Equilibria
- B. $P_1 = P_2 = 1/2$. $Y_1 = Y_2 = Y/2$; is the Unique Nash Equilibrium
- C. $P_1 > P_2 = 1/2$. $Y_1 = 0$, $Y_2 = Y$; is one of the Multiple Nash Equilibria
- D. $P_1 < P_2 = 1/2$. $Y_1 = Y$, $Y_2 = 0$; is one of the Multiple Nash Equilibria

EXPLANATION

Correct answer: B — $P_1 = P_2 = 1/2$. $Y_1 = Y_2 = Y/2$; is the Unique Nash Equilibrium

Each firm has constant marginal cost $1/2$. In homogeneous-product Bertrand competition, any common price above marginal cost can be slightly undercut profitably, and any price below marginal cost is unprofitable. Therefore the unique Nash equilibrium has both firms charging marginal cost, $p_1 = p_2 = 1/2$. At equal prices, the firms split market demand, so $Y_1 = Y_2 = Y/2$.

Why the other choices do not work

- **A:** Price 1 is above marginal cost and can be undercut.
- **C:** Firm 2 earns zero at $P_2 = 1/2$ but can raise its price slightly while remaining below P_1 . It would still serve positive demand and now earn a positive margin.
- **D:** Firm 1 charges below its marginal cost of $1/2$ and makes a loss on every unit sold. Raising its price to $1/2$ eliminates that loss.

Takeaway: Homogeneous Bertrand equilibrium price equals marginal cost.

KEYWORDS

bertrand duopoly

homogeneous product

marginal cost pricing

unique nash equilibrium

15

MICRO ECONOMICS

Game Theory - Non-Cooperative Games

Difficulty: Hard

PYQ practice

Consider the following payoff matrix, with Player 1 choosing rows and Player 2 choosing columns.

Player 1 \ Player 2	B_1	B_2	B_3
A_1	(4, 2)	(2, 1)	(5, 0)
A_2	(3, 5)	(3, 2)	(3, 4)
A_3	(5, 2)	(4, 4)	(3, 1)

Which listed strategy–outcome pair is the Nash equilibrium?

A. (A_3, B_2) with outcome (4, 4)

B. (A_3, B_1) with outcome (5, 2)

C. (A_1, B_2) with outcome (2, 1)

D. (A_3, B_3) with outcome (3, 1)

EXPLANATION

Correct answer: A — (A_3, B_2) with outcome (4, 4)

Find best responses. For Player 1, the best row against B_1 is A_3 with payoff 5; against B_2 it is also A_3 with payoff 4; against B_3 it is A_1 with payoff 5. For Player 2, the best column against A_3 is B_2 with payoff 4. Thus (A_3, B_2) is a mutual best response and is the Nash equilibrium, with payoff (4, 4).

Why the other choices do not work

- **B:** At A_3 , Player 2 prefers B_2 to B_1 .
- **C:** At B_2 , Player 1 prefers A_3 .
- **D:** At A_3 , Player 2 does not prefer B_3 .

Takeaway: A Nash equilibrium is found where best responses intersect.

KEYWORDS

nash equilibrium

mutual best responses

payoff matrix

best response intersection

16

MICRO ECONOMICS

Game Theory - Non-Cooperative Games

Difficulty: Hard

Curated practice

Match List I with List II.

List I (Solution concept)	List II (Requirement)
A. Nash equilibrium	I. Strategies must be optimal after every history in every proper subgame
B. Subgame-perfect equilibrium	II. Each player's strategy is a best response to the strategies of the others
C. Trembling-hand perfect equilibrium	III. Strategies are optimal given beliefs about players' privately known types
D. Bayesian Nash equilibrium	IV. The equilibrium survives arbitrarily small probabilities of unintended moves

Choose the correct answer from the options given below:

A. A-II, B-I, C-IV, D-III

B. A-I, B-II, C-III, D-IV

C. A-II, B-IV, C-I, D-III

D. A-III, B-I, C-II, D-IV

EXPLANATION

Correct answer: A — A-II, B-I, C-IV, D-III

A Nash equilibrium is a profile of mutual best responses. Subgame perfection strengthens Nash equilibrium in dynamic games by requiring optimal play in every proper subgame, eliminating non-credible threats. Trembling-hand perfection asks whether the equilibrium remains optimal when every action has a small positive probability of being chosen by mistake. Bayesian Nash equilibrium applies best-response reasoning to strategies contingent on privately known types and beliefs.

Why the other choices do not work

- **B:** Sequential optimality is stronger than ordinary Nash and belongs to subgame perfection; tremble robustness is not Bayesian type dependence.
- **C:** Surviving small mistakes defines trembling-hand perfection, while optimality in every subgame defines subgame perfection.
- **D:** Private types belong to Bayesian games, not the basic Nash definition, and trembling-hand perfection requires more than mutual best responses.

Takeaway: Each refinement adds a discipline: credible continuation, robustness to mistakes, or consistency with private information.

KEYWORDS

nash equilibrium

subgame perfection

trembling hand perfection

bayesian nash equilibrium

equilibrium refinements

17

MICRO ECONOMICS

Decision Making under Uncertainty: Attitude towards Risk

Difficulty: Easy

PYQ practice

The condition of preferring a risky income to a certain income with the same expected value is referred as :

- A. Risk averse
- B. Risk loving
- C. Risk neutral
- D. Risk premium

EXPLANATION

Correct answer: B — Risk loving

A risk-loving person prefers a risky prospect to a certain income with the same expected value. The attraction is the risk itself, or the convexity of utility over income in the relevant range. A risk-averse person would choose the certain income instead. A risk-neutral person would be indifferent between the certain amount and the equal-expected-value gamble. A risk premium is the extra compensation needed to bear risk, not the name of this preference attitude.

Why the other choices do not work

- **A:** Risk aversion implies preferring certainty.
- **C:** Risk neutrality implies indifference.
- **D:** Risk premium is not a risk-attitude category.

Takeaway: Choosing the gamble over equal certainty means risk loving.

KEYWORDS

risk loving preferences

equal expected value

convex utility

risky prospect

18

MICRO ECONOMICS

Decision Making under Uncertainty: Attitude towards Risk

Difficulty: Hard

Curated practice

Match List I with List II.

List I (Contribution)	List II (Distinctive idea)
A. von Neumann-Morgenstern	I. Subjective probabilities and preferences over acts satisfying consistency axioms
B. Leonard Savage	II. Expected utility over objective lotteries
C. Arrow-Pratt	III. Reference dependence, loss aversion and probability weighting
D. Kahneman-Tversky	IV. Local measures of absolute and relative risk aversion based on utility curvature

Choose the correct answer from the options given below:

A. A-I, B-II, C-III, D-IV

B. A-II, B-I, C-IV, D-III

C. A-II, B-IV, C-I, D-III

D. A-III, B-I, C-II, D-IV

EXPLANATION

Correct answer: B — A-II, B-I, C-IV, D-III

Von Neumann and Morgenstern axiomatise expected utility over lotteries with objective probabilities. Savage derives subjective expected utility when probabilities are represented by the decision maker's beliefs over states. Arrow and Pratt measure local risk aversion through the curvature of utility. Kahneman and Tversky's prospect theory introduces a reference point, loss aversion, and non-linear probability weighting.

Why the other choices do not work

- **A:** Savage, not vNM, is the subjective-probability entry, while Arrow-Pratt and prospect theory are also interchanged.
- **C:** Arrow-Pratt supplies curvature measures; Savage supplies subjective expected utility.
- **D:** Prospect theory is Kahneman-Tversky, and vNM expected utility is not an Arrow-Pratt measure.

Takeaway: Objective risk, subjective uncertainty, utility curvature, and behavioural weighting are different analytical layers.

KEYWORDS

expected utility

subjective expected utility

arrow pratt risk aversion

prospect theory

decision under uncertainty

19

MICRO ECONOMICS

Asymmetric Information: Adverse Selection and Moral Hazard

Difficulty: Hard

Curated practice

Match List I with List II.

List I (Contribution)	List II (Information mechanism)
A. Akerlof	I. Education can separate worker types when acquiring it is less costly for high-productivity workers
B. Spence	II. Hidden borrower risk can make an interest-rate increase worsen the applicant pool and lead to credit rationing
C. Rothschild-Stiglitz	III. Quality uncertainty can drive high-quality used cars from the market
D. Stiglitz-Weiss	IV. Competitive insurance contracts may separate risk types through different premium-deductible combinations

Choose the correct answer from the options given below:

A. A-I, B-III, C-II, D-IV

B. A-III, B-IV, C-I, D-II

C. A-III, B-I, C-IV, D-II

D. A-II, B-I, C-III, D-IV

EXPLANATION

Correct answer: C — A-III, B-I, C-IV, D-II

Akerlof's lemons model shows how sellers' private knowledge of quality can unravel a used-car market. Spence explains education as a signal when its cost differs by worker productivity. Rothschild and Stiglitz analyse competitive insurance contracts that can separate risk types through premium and deductible choices. Stiglitz and Weiss show why banks may ration credit when higher interest rates worsen adverse selection or borrower incentives.

Why the other choices do not work

- **A:** Education signalling is Spence's mechanism, not Akerlof's, and the lemons result is not Spence's labour-market model.
- **B:** Separating insurance contracts belong to Rothschild-Stiglitz; Spence is the education-signalling contribution.
- **D:** Credit rationing is Stiglitz-Weiss, not Akerlof, and insurance separation is not their credit-market result.

Takeaway: The same information asymmetry produces different market responses—exit, signalling, screening, or rationing.

KEYWORDS

market for lemons

spence signalling

rothschild stiglitz insurance

stiglitz weiss credit rationing

adverse selection

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MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Easy

PYQ practice

For the CES production function $Q = [\alpha K^\rho + (1 - \alpha)L^\rho]^{1/\rho}$, the elasticity of substitution is $\sigma = 1/(1 - \rho)$. If $0 < \rho < 1$, then:

- A. $\sigma > 1$
- B. $0 < \sigma < 1$
- C. $\sigma = 0$
- D. $\sigma = 1$

EXPLANATION

Correct answer: A — $\sigma > 1$

The question gives the CES elasticity of substitution as $\sigma = 1/(1 - \rho)$. If $0 < \rho < 1$, then $1 - \rho$ is positive but less than 1. Dividing 1 by a positive number less than 1 gives a value greater than 1. Hence the elasticity of substitution exceeds unity. It is not between zero and one, not zero, and not exactly one.

Why the other choices do not work

- **B:** Because $1 - \rho$ lies between zero and one, its reciprocal must exceed one rather than remain below one.
- **C:** The denominator $1 - \rho$ is finite and strictly positive on the stated interval, so its reciprocal cannot equal zero.
- **D:** Unit elasticity requires $1/(1 - \rho) = 1$, which solves to $\rho = 0$ and lies outside the strict interval $0 < \rho < 1$.

Takeaway: Positive CES rho below one implies substitution elasticity above one.

KEYWORDS

ces production function

elasticity of substitution

ces rho parameter

substitution elasticity above one

21

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Easy

PYQ practice

The production function $Q = LK/(L + K)$ is:

- A. Homogeneous of degree 1
- B. Homogeneous of degree 0
- C. Homogeneous of degree $1/2$
- D. Homogeneous of degree 2

EXPLANATION

Correct answer: A — Homogeneous of degree 1

Check homogeneity by scaling both inputs by $t > 0$. Then $Q(tL, tK) = \frac{(tL)(tK)}{tL+tK} = \frac{t^2LK}{t(L+K)} = t \frac{LK}{L+K} = tQ(L, K)$. Since output is multiplied by t^1 when all inputs are multiplied by t , the production function is homogeneous of degree 1.

Why the other choices do not work

- **B:** Degree 0 would mean output is unchanged after scaling inputs.
- **C:** The scaling factor is t , not $t^{1/2}$.
- **D:** Degree 2 would require output to scale by t^2 .

Takeaway: Scaling both inputs reveals the homogeneity degree.

KEYWORDS

homogeneous production function

degree one homogeneity

constant returns to scale

input scaling test

22

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Easy

PYQ practice

If $Q = f(K, L)$ is homogeneous of degree one, which expression satisfies Euler's theorem?

A. $Q_K + Q_L = Q$

B. $KQ_K + LQ_L = Q$

C. $KQ_K + LQ_L > 1$

D. $Q_K + Q_L = 1$

EXPLANATION

Correct answer: B — $KQ_K + LQ_L = Q$

Euler's theorem says that if a differentiable function is homogeneous of degree r , then the sum of each variable multiplied by its partial derivative equals r times the function. For $Q = f(K, L)$ homogeneous of degree one, $r = 1$. Therefore $KQ_K + LQ_L = 1 \cdot Q = Q$. The inputs must weight their marginal products; simply adding marginal products is not Euler's expression.

Why the other choices do not work

- **A:** It omits the input multipliers K and L .
- **C:** Euler's theorem gives an equality, not this inequality.
- **D:** It omits input multipliers and uses 1 instead of Q .

Takeaway: Degree-one homogeneity means product exhaustion: $KQ_K + LQ_L = Q$.

KEYWORDS

euler theorem

degree one homogeneity

product exhaustion

factor marginal products

23

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Easy

PYQ practice

Which one of the following production functions exhibits decreasing returns to scale?

A. $AK^{1/4}\sqrt{L}$

B. $AK^\alpha L^{1-\alpha}$

C. $A(3K + 5L)$

D. $A\sqrt{KL^3}$

EXPLANATION

Correct answer: A — $AK^{1/4}\sqrt{L}$

For a Cobb-Douglas form, returns to scale depend on the sum of exponents. In $AK^{1/4}L^{1/2}$ the sum is $3/4 < 1$, so it has decreasing returns. The other homogeneous forms shown have degree one or two.

Why the other choices do not work

- **B:** The exponents sum to $\alpha + (1 - \alpha) = 1$, giving constant returns.
- **C:** A linear homogeneous function has degree one and constant returns.
- **D:** $A\sqrt{KL^3} = AK^{1/2}L^{3/2}$ has degree two and increasing returns.

Takeaway: A homogeneous production function has decreasing returns when its degree is below one.

KEYWORDS

returns to scale

cobb douglas production

homogeneous function

decreasing returns

24

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Medium

PYQ practice

Which one of the following is not true in case of producer's equilibrium?

- A. $MP_L/MP_K = w/r$
- B. $MRTS_{LK} = MP_L/MP_K = w/r$
- C. $MP_L/w = MP_K/r$
- D. $MRTS_{LK} = r/w$

EXPLANATION

Correct answer: D — $MRTS_{LK} = r/w$

At a cost-minimizing or output-maximizing producer equilibrium, the technical trade-off between labour and capital equals the market trade-off given by factor prices. With the notation in the options, $MRTS_{LK} = MP_L/MP_K = w/r$. This is also equivalent to $MP_L/w = MP_K/r$, equal marginal product per rupee. Option D gives r/w , the inverse of the required price ratio, so it is the statement that is not true.

Why the other choices do not work

- **A:** Cost minimization equates the marginal product ratio MP_L/MP_K to the factor-price ratio w/r , exactly as this option states.
- **B:** With $MRTS_{LK}$ defined as MP_L/MP_K , equality to w/r is the tangency condition and therefore is not the false statement.
- **C:** Cross-multiplying $MP_L/w = MP_K/r$ yields $MP_L/MP_K = w/r$, so it is algebraically the same producer-equilibrium rule.

Takeaway: Under this notation, producer equilibrium sets $MRTS_{LK} = w/r$.

KEYWORDS

producer equilibrium

mrts factor price ratio

equal marginal product per rupee

cost minimization

25

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Medium

PYQ practice

For a Cobb–Douglas production function with two inputs, $Q = AK^\alpha L^\beta$, where $A > 0, \alpha > 0$ and $\beta > 0$, the marginal products are:

- A. $MP_K = \alpha Q/K$
- B. $MP_K = \beta Q/K$
- C. $MP_L = \alpha Q/L$
- D. $MP_L = \beta Q/L$

Which of the above expressions are correct? Choose the correct answer from the options given below.

A. A and C only

B. A and D only

C. B and C only

D. B and D only

EXPLANATION

Correct answer: B — A and D only

Differentiating $Q = AK^\alpha L^\beta$ gives $MP_K = \partial Q/\partial K = \alpha Q/K$ and $MP_L = \partial Q/\partial L = \beta Q/L$. For positive input quantities, A and D are the general identities, valid for arbitrary positive exponents. If $\alpha = \beta$, the swapped coefficients in B and C also coincide numerically. The intended question concerns general derivative formulas, not a special equal-exponent parameter choice.

Why the other choices do not work

- **A:** For arbitrary exponents, the labour derivative uses β , not the capital exponent α appearing in statement C.
- **C:** Both coefficients are swapped relative to their inputs, so this pair is not generally valid; equality of the exponents is a special coincidence.
- **D:** The capital derivative in statement B uses the other input's exponent and fails as a general identity.

Takeaway: A Cobb–Douglas marginal product equals the relevant exponent times output divided by that input.

KEYWORDS

cobb douglas production

marginal product of capital

marginal product of labour

partial derivatives

26

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Hard

PYQ practice

A firm maximizes $Q = f(L, K)$ subject to $C = wL + rK$. Which conditions support an interior maximum?

- A. $Q_L/Q_K = w/r$
- B. $Q_{LL} > 0$ and $Q_{KK} > 0$
- C. $Q_{LL} < 0$ and $Q_{KK} > 0$
- D. $Q_{LL} < 0$ and $Q_{KK} < 0$
- E. $Q_{LL}Q_{KK} > (Q_{LK})^2$

A. A, B and E Only

B. A, D and E Only

C. A and E Only

D. A and B Only

EXPLANATION

Correct answer: B — A, D and E Only

Read “support” as asking for a sufficient package at a regular interior tangency, with positive input prices and a twice continuously differentiable production function. Tangency gives $Q_L/Q_K = w/r$, statement A. Negative own second derivatives (D), together with the positive determinant in E, make the Hessian negative definite. Every nonzero nearby direction then has negative second-order curvature, including feasible movements along the cost line. These conditions are sufficient for a strict local constrained maximum.

Full negative definiteness is stronger than necessary. At a constrained local maximum, the necessary second-order test only requires nonpositive curvature in feasible tangent directions. Here such directions satisfy $w dL + r dK = 0$. The function may have positive curvature in an infeasible direction without defeating the constrained maximum. Thus D and E are not necessary conditions at every constrained optimum.

Why the other choices do not work

- **A:** Positive own curvature together with E makes the Hessian positive definite, giving a local minimum at tangency instead.
- **C:** A positive determinant can accompany either positive or negative definiteness; A and E alone do not select the maximum case.
- **D:** Positive own second derivatives without a determinant or tangent-direction test do not supply a sufficient maximum condition.

Takeaway: Tangency and a negative-definite Hessian are sufficient here; constrained necessity concerns curvature along feasible directions.

KEYWORDS

producer tangency condition

marginal rate of technical substitution

concave production function

negative definite hessian

27

MICRO ECONOMICS

Theory of Production and Costs

Difficulty: Medium

Curated practice

For $Y = K^{0.5}L^{0.5}$, the rental price of capital is 10 and the wage is 5. What is the cost-minimizing capital-labour ratio $K : L$?

A. 2 : 1

B. 1 : 2

C. 1 : 1

D. 4 : 1

EXPLANATION

Correct answer: B — 1 : 2

Cost minimization requires $MPL/MPK = w/r$. For $K^{0.5}L^{0.5}$, $MPL/MPK = K/L$. Thus $K/L = w/r = 5/10 = 1/2$, giving $K : L = 1 : 2$.

Why the other choices do not work

- **A:** The ratio 2:1 reverses wage and rental price in the tangency condition.
- **C:** Equal input quantities would be optimal only if the two factor prices were equal.
- **D:** A 4:1 ratio moves even farther toward the relatively expensive capital input.

Takeaway: The symmetric technology uses more of the cheaper factor in inverse proportion to factor prices.

KEYWORDS

cobb douglas cost minimization

capital labour ratio

marginal rate of technical substitution

wage rental ratio

interior tangency

28

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

Curated practice

Market demand is $Q = 120 - 3P$ and market price is $P = 20$. Consider:

1. The choke price is 40.
2. Quantity demanded is 60.
3. Consumer surplus is 600.
4. Consumer surplus is represented by a triangle.

Which statements are correct?

- A. 1 and 2 only
- B. 1, 2 and 3 only
- C. 1, 2 and 4 only
- D. All of the above

EXPLANATION

Correct answer: D — All of the above

Setting $Q = 0$ in $Q = 120 - 3P$ gives the choke price $P = 40$, confirming statement 1. At $P = 20$, quantity is 60, and consumer surplus under the linear demand curve is the triangle $\frac{1}{2}(40 - 20)(60) = 600$. Thus statements 2, 3, and 4 also hold.

Why the other choices do not work

- **A:** Statements 1 and 2 are true, but this code omits the correct surplus value and its triangular geometry.
- **B:** The first three statements hold, but linear demand and the horizontal market-price line also bound a triangle, so statement 4 cannot be excluded.
- **C:** Statements 1, 2, and 4 are correct, but the same triangle has area 600, so statement 3 cannot be left out.

Takeaway: For linear demand, consumer surplus is one-half times the choke-price gap times quantity.

KEYWORDS

consumer surplus calculation

linear market demand

choke price

triangle area

quantity demanded

29

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Easy

PYQ practice

Which statement about indifference curves is not generally true?

- A. With convex preferences, indifference curves are convex to the origin.
- B. For perfect complements, indifference curves are right-angled.
- C. For perfect substitutes, indifference curves are downward-sloping straight lines.
- D. For any two normal goods, indifference curves must be straight lines.

EXPLANATION

Correct answer: D — For any two normal goods, indifference curves must be straight lines.

The question asks which statement is not generally true. Normal goods are defined by how demand responds to income, not by a requirement that indifference curves be straight lines. Straight-line indifference curves occur for perfect substitutes. Perfect complements have right-angled indifference curves, and convex preferences usually generate indifference curves convex to the origin. Therefore the statement that any two normal goods must have straight-line indifference curves is false.

Why the other choices do not work

- **A:** Convex preferences make averages weakly preferred to extremes, producing the usual indifference curves bowed toward the origin rather than compulsory straight lines.
- **B:** Perfect complements are consumed in fixed proportions, so additional units of only one good do not raise utility and the indifference curves have right-angle kinks.
- **C:** A constant substitution rate between perfect substitutes gives straight, downward-sloping indifference curves, unlike the claim made for arbitrary normal goods.

Takeaway: Normality is about income effects, not straight-line indifference curves.

KEYWORDS

indifference curve shape

normal goods

perfect substitutes

perfect complements

convex preferences

30

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Easy

PYQ practice

Indifference curves with horizontal and vertical arms, so that the marginal rate of substitution is respectively zero or infinite along those arms, describe:

- A. Perfect substitutes
- B. Normal goods
- C. Perfect complements
- D. Close but imperfect substitutes

EXPLANATION

Correct answer: C — Perfect complements

Perfect complements are consumed in fixed proportions, so their indifference curves are L-shaped or right-angled. Along the horizontal arm, extra units of the good on the horizontal axis do not raise utility unless the other good also increases, giving an MRS of zero. Along the vertical arm, the reverse shortage makes the MRS infinite. This is exactly the horizontal-and-vertical-arm description in the question.

Why the other choices do not work

- **A:** Perfect substitutes have straight-line indifference curves.
- **B:** Normal goods need not have L-shaped curves.
- **D:** Imperfect substitutes have smoother convex curves.

Takeaway: L-shaped indifference curves mean perfect complements.

KEYWORDS

perfect complements

L shaped indifference curves

fixed proportions

marginal rate of substitution

31

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

PYQ practice

A consumer has utility $U(q_1, q_2) = q_1 q_2$, faces prices $p_1 = 1$ and $p_2 = 2$, and has income $k > 0$. What is the interior Marshallian demand bundle?

A. $(q_1, q_2) = (k/2, k/2)$

B. $(q_1, q_2) = (k/4, k/6)$

C. $(q_1, q_2) = (k/2, k/4)$

D. $(q_1, q_2) = (k/2, k/3)$

EXPLANATION

Correct answer: C — $(q_1, q_2) = (k/2, k/4)$

For Cobb-Douglas utility $U = q_1 q_2$, the exponents are equal, so the consumer spends half of income on each good at an interior optimum. With $p_1 = 1$, $p_1 q_1 = k/2$ gives $q_1 = k/2$. With $p_2 = 2$, $p_2 q_2 = k/2$ gives $2q_2 = k/2$, so $q_2 = k/4$. The bundle also exhausts income: $k/2 + 2(k/4) = k$.

Why the other choices do not work

- **A:** The bundle costs $k/2 + 2(k/2) = 3k/2$, exceeding income and allocating twice as much expenditure to good 2 as to good 1.
- **B:** Expenditure is only $k/4$ on good 1 and $k/3$ on good 2, so the bundle neither splits income equally nor exhausts the budget.
- **D:** Choosing $q_2 = k/3$ makes spending $k/2 + 2k/3 = 7k/6$, which violates the budget; the half-income rule instead gives $q_2 = k/4$.

Takeaway: Equal-exponent Cobb-Douglas spends half the budget on each good.

KEYWORDS

cobb douglas utility

marshallian demand

equal expenditure shares

budget exhaustion

32

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

PYQ practice

The demand for good A is $Q_A = 100 - 2P_A + 0.2Y + 0.3P_B$. Find its income elasticity at $P_A = 6$, $Y = 500$, and $P_B = 10$, rounded to two decimal places.

- A. 0.06
- B. 0.02
- C. 0.52
- D. -0.06

EXPLANATION

Correct answer: C – 0.52

Income elasticity is $(\partial Q_A / \partial Y)(Y / Q_A)$. First compute demand at the given values: $Q_A = 100 - 2(6) + 0.2(500) + 0.3(10) = 100 - 12 + 100 + 3 = 191$. The income derivative is $\partial Q_A / \partial Y = 0.2$. Therefore income elasticity is $0.2 \times (500 / 191) = 100 / 191 \approx 0.5236$, which rounds to 0.52.

Why the other choices do not work

- **A:** The point-elasticity calculation is $0.2(500 / 191) = 100 / 191$; the proposed 0.06 cannot result from the stated income, quantity, and derivative.
- **B:** Using the demand slope alone or an incomplete scaling produces a small figure, but the required Y / Q_A factor raises the result to approximately 0.52.
- **D:** Since $\partial Q_A / \partial Y = 0.2 > 0$ and both Y and Q_A are positive, the income elasticity cannot carry a negative sign.

Takeaway: Point elasticity equals derivative times base variable over quantity.

KEYWORDS

income elasticity of demand

point elasticity

linear demand function

normal good

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MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

PYQ practice

The demand for good A is $Q_A = 100 - 2P_A + 0.2Y + 0.3P_B$. Find its cross-price elasticity with respect to P_B at $P_A = 6$, $Y = 500$, and $P_B = 10$, rounded to three decimal places.

- A. 0.060
- B. 0.016
- C. 0.520
- D. -0.060

EXPLANATION

Correct answer: B – 0.016

Cross-price elasticity with respect to P_B is $(\partial Q_A / \partial P_B)(P_B / Q_A)$. Evaluate demand first: at $P_A = 6$, $Y = 500$, and $P_B = 10$, the quantity is $Q_A = 191$. The derivative with respect to P_B is 0.3. Therefore the elasticity is $0.3 \times (10/191) = 3/191 \approx 0.0157$, which rounds to 0.016. The positive sign indicates that goods A and B are substitutes in this demand equation.

Why the other choices do not work

- **A:** Substitution into the cross-elasticity formula gives $0.3(10/191) = 3/191$, so 0.060 uses a scale inconsistent with the stated price and quantity.
- **C:** The value near 0.520 comes from $0.2(500/191)$, the income-elasticity calculation, rather than the cross-price derivative and P_B .
- **D:** The coefficient on P_B is +0.3, so a higher price of B raises demand for A and yields a positive cross-price elasticity, not a negative one.

Takeaway: Cross elasticity uses the other good's price coefficient and P_B/Q_A .

KEYWORDS

cross price elasticity

point elasticity

substitute goods

linear demand function

34

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

PYQ practice

For an interior optimum with differentiable, strictly convex and locally nonsatiated preferences, which statements are true?

A. Marginal utility per rupee is equal across the two goods. B. The marginal rate of substitution equals the price ratio. C. The consumer reaches the highest attainable indifference curve. D. The indifference curve is tangent to the budget line. E. The consumer is indifferent between every pair of bundles on the budget line.

A. A, C and E only

B. A, D and E only

C. A, B and D only

D. A, B, C and D only

EXPLANATION

Correct answer: D — A, B, C and D only

At an interior optimum with differentiable, strictly convex and locally nonsatiated preferences, the consumer exhausts the budget and reaches the highest attainable indifference curve. The tangency condition holds: the marginal rate of substitution equals the price ratio. Equivalently, marginal utility per rupee is equal across goods. Thus A, B, C and D are true. Statement E is false because bundles along the budget line generally lie on different indifference curves; only the chosen bundle is optimal.

Why the other choices do not work

- **A:** Bundles on a budget line generally deliver different utility, so E is false; this choice also loses the equivalent tangency conditions in B and D.
- **B:** It again treats every affordable boundary bundle as equally good and omits both the MRS–price–ratio condition and attainment of the highest feasible indifference curve.
- **C:** The tangency conditions identify the optimum, but local nonsatiation also means the chosen bundle reaches the highest attainable indifference curve stated in C.

Takeaway: Interior consumer optimum is a budget–line tangency with equal marginal utility per rupee.

KEYWORDS

consumer equilibrium

marginal utility per rupee

mrs price ratio

budget line tangency

highest attainable indifference curve

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MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

PYQ practice

For an own-price change, the income effect on a good opposes the substitution effect, but the substitution effect is larger in absolute value. The good is:

- A. Normal
- B. Inferior but not Giffen
- C. Giffen
- D. Impossible to classify

EXPLANATION

Correct answer: B — Inferior but not Giffen

For a normal good, the income effect and substitution effect of an own-price change reinforce each other. If the income effect opposes the substitution effect, the good is inferior. A Giffen good is a special inferior good where the income effect is larger than the substitution effect in absolute value, so the total effect moves in the abnormal direction. Here the substitution effect is larger, so the good is inferior but not Giffen.

Why the other choices do not work

- **A:** Normal goods do not have opposing income and substitution effects for own-price changes.
- **C:** Giffen requires the income effect to dominate.
- **D:** The information is enough to classify the good.

Takeaway: Inferior opposes; Giffen dominates.

KEYWORDS

inferior good

substitution effect

income effect

non giffen good

slutsky decomposition

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MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Medium

PYQ practice

Which statement is not generally true?

- A. The total effect of an own-price change can be decomposed into substitution and income effects.
- B. For every inferior good, the income effect is larger than the substitution effect in absolute value.
- C. At a strict differentiable corner optimum, the tangency equality $MRS_{xy} = P_x/P_y$ need not hold.
- D. For a normal good, the substitution and income effects of an own-price fall reinforce each other.

EXPLANATION

Correct answer: B — For every inferior good, the income effect is larger than the substitution effect in absolute value.

The question asks for the statement that is not generally true. Every own-price effect can be decomposed into substitution and income effects. For a normal good, a price fall makes both effects reinforce higher demand. At a corner optimum, tangency may fail. But not every inferior good is Giffen. Many inferior goods have an income effect that opposes substitution but is smaller in absolute value. Only a Giffen good has an income effect large enough to dominate.

Why the other choices do not work

- **A:** The Slutsky or Hicks decomposition separates an own-price response into substitution and income components, so this is a valid general accounting of the total effect.
- **C:** At a strict corner the consumer cannot make the marginal interior trade that produces $MRS_{xy} = P_x/P_y$, so equality need not hold.
- **D:** A fall in own price raises purchasing power and makes the good relatively cheaper; for a normal good both channels increase quantity demanded.

Takeaway: All Giffen goods are inferior, but not all inferior goods are Giffen.

KEYWORDS

inferior good

giffen good

income effect

substitution effect

corner solution

37

MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Hard

PYQ practice

Identify the correct statements.

A. If the price-consumption curve for good x is horizontal, with good x measured on the horizontal axis, demand for x has unit price elasticity. B. If $\log D = \alpha + \beta \log Y + \gamma \log P$, the elasticity of D with respect to P is γ . C. The stability condition in the simple Keynesian income-expenditure model is $0 < MPC < 1$. D. The total fixed-cost curve is a rectangular hyperbola.

A. A and C only

B. A, C and D only

C. A, B and C only

D. A, B, C and D

EXPLANATION

Correct answer: C — A, B and C only

If the price-consumption curve for good x is horizontal, spending on x remains constant as its price changes, so demand has unit price elasticity. In the log demand equation, the coefficient on $\log P$ is directly the elasticity with respect to price, so B is correct. The simple Keynesian income-expenditure model is stable when $0 < MPC < 1$, so C is correct. Statement D is false because total fixed cost is a horizontal line; average fixed cost is the rectangular hyperbola.

Why the other choices do not work

- **A:** In the log-linear demand equation, γ is directly the price elasticity, so excluding B makes this set incomplete.
- **B:** A rectangular hyperbola describes average fixed cost as output changes; total fixed cost remains a horizontal line.
- **D:** Adding D imports the same total-versus-average fixed-cost confusion into an otherwise complete set.

Takeaway: Total fixed cost is horizontal; average fixed cost is hyperbolic.

KEYWORDS

price consumption curve

unit price elasticity

log log demand

keynesian stability condition

total fixed cost

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MICRO ECONOMICS

Theory of Consumer Behaviour

Difficulty: Hard

PYQ practice

Which of the following conditions are required for the set of consumers to exhibit parallel, straight wealth expansion paths at any price vector P ?

- A. Preferences admit indirect utility functions of the Gorman form.
- B. Preferences are heterogeneous
- C. Wealth is equally distributed among all consumers.
- D. All consumers have identical preferences that are homothetic.
- E. All consumers have preferences that are quasilinear with respect to the same good.

A. A, B & C Only

B. A, D & E Only

C. B, C & D Only

D. A, B & D Only

EXPLANATION

Correct answer: B – A, D & E Only

Answer B follows when the statements are read as alternative sufficient routes to parallel, straight wealth-expansion paths, not as conditions that must all hold simultaneously. In the Gorman representation, indirect utility can be written $v_i(p, m_i) = a_i(p) + b(p)m_i$. Here m_i is consumer i 's wealth, p is the price vector, and the wealth coefficient $b(p)$ is common across consumers. Under the usual differentiability and interiority conditions, this gives demands linear in wealth with common slopes.

Identical homothetic preferences are one sufficient case: consumers choose the same proportions at given prices as wealth scales. Quasilinearity in a common good is another on the domain where its nonnegativity constraint does not bind, or where unrestricted numeraire holdings are permitted. At a zero-numeraire corner, income effects can change, so the claim is not global over all wealth levels without a domain qualification.

The word “required” is therefore imprecise: identical homotheticity and common-good quasilinearity are sufficient examples, not jointly necessary restrictions.

Why the other choices do not work

- **A:** Heterogeneity and equal wealth do not themselves impose common linear wealth responses.
- **C:** Equal distribution is a statement about current wealth, not the shape of demand as wealth changes; heterogeneity alone supplies no common slope.
- **D:** Heterogeneity may coexist with Gorman aggregation but does not guarantee it, and this set omits the qualified quasilinear example.

Takeaway: Common wealth-response slopes matter; sufficient preference classes and necessary restrictions must be distinguished.

KEYWORDS

gorman polar form

wealth expansion path

homothetic preferences

quasilinear preferences

demand aggregation

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MICRO ECONOMICS

General Equilibrium Analysis

Difficulty: Medium

PYQ practice

Given below are two statements : one is labelled as Assertion (A) and the other is labelled as Reason (R).

Assertion (A): When everyone trades in the competitive market place, all mutually beneficial trades are completed and the resulting equilibrium allocation of resources are economically efficient.

Reason (R): Even if a trade from an inefficient allocation makes everyone better off, the new allocation is not necessarily efficient.

In the light of the above statements, choose the most appropriate answer from the options given below :

A. Both (A) and (R) are correct and (R) is the correct explanation of (A)

B. Both (A) and (R) are correct but (R) is not the correct explanation of (A)

C. (A) is correct but (R) is not correct

D. (A) is not correct but (R) is correct

EXPLANATION

Correct answer: B – Both (A) and (R) are correct but (R) is not the correct explanation of (A)

Under the standard competitive-market assumptions, exhaustion of mutually beneficial trades yields a Pareto-efficient allocation. It is also true that one Pareto improvement from an inefficient point need not take the economy all the way to the efficiency frontier; that observation does not explain the competitive-equilibrium result.

Why the other choices do not work

- **A:** The reason is true but does not supply the theorem-based explanation for the assertion.
- **C:** The reason is not false: an improved allocation may still admit further Pareto improvements.
- **D:** The assertion is the standard first-welfare-theorem conclusion, so it is not false.

Takeaway: A Pareto improvement is not necessarily Pareto efficient, while a competitive equilibrium is efficient under the theorem's assumptions.

KEYWORDS

first welfare theorem

pareto efficiency

mutually beneficial trade

competitive equilibrium

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MICRO ECONOMICS

General Equilibrium Analysis

Difficulty: Hard

Curated practice

In a two-good exchange economy, let p be the price of good x relative to good y , and suppose that, in a neighbourhood of the positive equilibrium, aggregate excess demand for x is $z_x(p) = 8/p - 2p$. Under Walrasian tâtonnement, $\dot{p} = \lambda z_x(p)$ with $\lambda > 0$. Which statement correctly describes the positive equilibrium and its local stability?

- A. $p^* = 2$, and it is locally stable because $z'_x(2) < 0$
- B. $p^* = 2$, and it is unstable because $z'_x(2) < 0$
- C. $p^* = 4$, and it is locally stable because $z'_x(4) > 0$
- D. $p^* = 1/2$, and stability follows from Walras' law alone

EXPLANATION

Correct answer: A — $p^* = 2$, and it is locally stable because $z'_x(2) < 0$

Market clearing requires $8/p - 2p = 0$. Multiplying by positive p gives $8 - 2p^2 = 0$, hence $p^* = 2$. The slope is $z'_x(p) = -8/p^2 - 2$, so $z'_x(2) = -4$. With $\dot{p} = \lambda z_x(p)$ and $\lambda > 0$, a small price rise produces excess supply and a price fall, while a small price fall produces excess demand and a price rise.

Why the other choices do not work

- **B:** A negative slope generates corrective, not divergent, price movements under the stated adjustment rule.
- **C:** At $p = 4$, excess demand is $2 - 8 = -6$, so the market does not clear.
- **D:** At $p = 1/2$, excess demand is $16 - 1 = 15$; moreover, Walras' law is an accounting restriction, not a complete stability condition.

Takeaway: General-equilibrium existence and tâtonnement stability are separate checks: first solve excess demand equal to zero, then inspect the adjustment direction.

KEYWORDS

walrasian tâtonnement

aggregate excess demand

local stability

relative price equilibrium

walras law

Coverage at a glance.

40 questions · 48 practice minutes · No negative marking

Subject	Questions
Micro Economics	40

Answer key

1 · D	2 · A	3 · C	4 · C	5 · D	6 · D	7 · D	8 · B	9 · C	10 · A
11 · C	12 · A	13 · C	14 · B	15 · A	16 · A	17 · B	18 · B	19 · C	20 · A
21 · A	22 · B	23 · A	24 · D	25 · B	26 · B	27 · B	28 · D	29 · D	30 · C
31 · C	32 · C	33 · B	34 · D	35 · B	36 · B	37 · C	38 · B	39 · B	40 · A

Curated from reviewed PYQs and authored practice in the Xaptiq bank.

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Question counts in this practice resource, not predicted exam weightages.

Market Structures, Competitive and Non-Competitive Equilibria and Their Efficiency Properties	4	Efficiency Criteria: Pareto-Optimality, Kaldor-Hicks and Wealth Maximization	3
Factor Pricing	3	Game Theory – Non-Cooperative Games	6
Decision Making under Uncertainty: Attitude towards Risk	2	Asymmetric Information: Adverse Selection and Moral Hazard	1
Theory of Production and Costs	8	Theory of Consumer Behaviour	11
General Equilibrium Analysis	2		



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