

Answer on Question #38924 – Economics - Microeconomics

The set of all affordable bundles is called the budget set. If all the money is spent on the first good, then m/p units can be purchased. Thus the bundle $(m/p, 0)$ is in the budget set. If all the money is spent on the second good, then m/q units can be purchased. Thus the bundle $(0, m/q)$ is in the budget set. The budget set consists of all those bundles with non-negative amounts of both goods that lie on or below the budget line, $px + qy = m$. One type of solution is a corner solution, at which the budget equation must hold, but the tangency condition need not hold. The optimal bundle is D, since none of the bundles above the indifference curve through D are affordable. The indifference curve through D is not tangent to the budget line, and the equality of marginal “bang for the buck” does not hold. Instead, $U_1(x^*, y^*)/p > U_2(x^*, y^*)/q$ with $(x^*, y^*) = (m/p, 0)$.

So, the right answer is D. The marginal rate of substitution is less than the ratio of prices at the optimal bundle.