

Commerce 394: Government and Business

Sample Midterm Exam

Name: \_\_\_\_\_

Time: 80 minutes

Marks: 85

**Part I. True/False (9 questions, 45 total marks, 1.5 marks per part). There can be more than one true/false part per question.**

**1. Which of the following is true?**

- a. The statement "Expo would not cost taxpayers a cent because any losses would be covered by the provincial lottery" illustrates a misunderstanding of opportunity cost.
- b. Setting output to the point where the total costs equals total revenues is an application of the marginalist principle.
- c. A reorganization of a manufacturing that allows the same amount of output to be produced with less inputs generates an increase in production efficiency.
- d. Adam Smith's views on the virtues of the private economy fails to take into account incentive effects.

**2. A policy change is said to cause a potential Pareto improvement when:**

- a. The sum of the benefits of the policy change exactly equals the sum of its costs.
- b. The sum of the benefits of the policy change outweigh the sum of its costs.
- c. More people are made better off than worse off by the policy change.
- d. The people made better off are able to compensate the losers and still be better off.

**3. Which of the following is true about utilitarianism?**

- a. Ethical actions are those that result in the greatest good for the majority of people.
- b. Potential Pareto improving actions are ethical.
- c. A utilitarian would advocate policies that increase total aggregate utility.

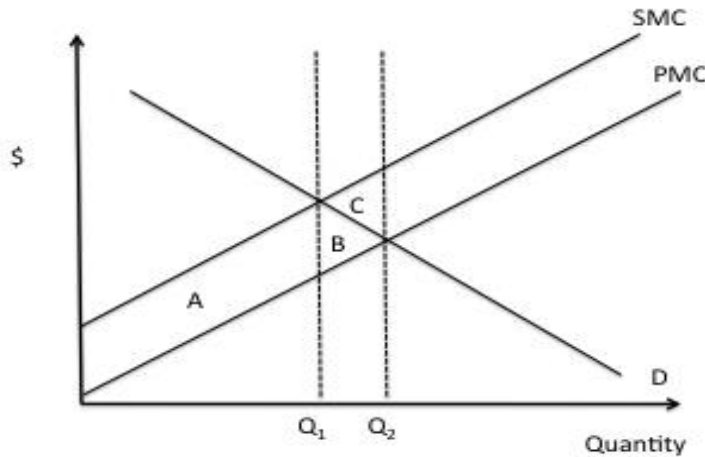
**4. Which of the following would result in allocational efficiency?**

- a. a monopolist that sets output such that  $p=mc$ .
- b. a monopolist that sets output such that  $mr=mc$ .
- c. a perfectly competitive firm that sets output such that  $p=mc$ .

**5. Lobbying by an industry (not subject to market failure) that results in government allowing the industry to restrict output level below the competitive level:**

- a. generates new wealth.
- b. is illegal in Canada.
- c. generates economic inefficiency.

6. Consider the following graph showing the private marginal costs (PMC), social marginal costs (SMC), and demand for an activity subject to negative externalities.



Which of the following is true?

- Q1 is the socially optimal level of output.
- Area B represents deadweight loss associated with the “uncorrected” negative externality.
- Area C represents deadweight loss associated with the “uncorrected” negative externality.

7. In the market for lemons:

- The presence of lemons leads to underpricing (i.e. the price offered is less than the true value) on the ‘good’ (i.e., non-lemon) goods
- Consumers rationally anticipate the presence of lemons, so there will be more ‘good’ (i.e., non-lemon) goods on the market
- A seller can develop a reputation to mitigate asymmetric information problems

8. To increase allocative efficiency government should:

- Fund a program more if, for that program, the  $MB > MC$
- Fund a program more if, for that program, the  $MSB > MSC$
- If it (government) is financially constrained, it should fund a program more if the  $MSB/\$$  of this program is higher than the  $MSB/\$$  of other programs
- If it (government) is financially constrained it should fund any new program exclusively by reduced spending on other programs or activities.

9. Examples of market failure that can happen in a free market economy include:

- Not enough public parks are provided by the market.
- A toy factory can emit too much pollution as it makes dolls for children.
- Not enough number of people take flu shots; taking a flu shot can benefit even those who do not take the flu shots by making them less exposed to flu virus.

## Part II. True/False/Uncertain (4 questions, 10 points each)

Determine whether the following statements are true, false, or uncertain and briefly explain your answer (4-5 sentences). Your answer should explain aspects of the statement that are correct (if any) and aspects of the statement that are false (if any). For some questions, I have included background information. In writing your answer you should assume that statements in italics are factually correct.

1. Vancouver city government provision of bus transportation is best justified by the fact that bus transportation is a public good.
2. Part of the social responsibility of corporations is to make donations to community or charities?
3. Voluntary exchanges must increase the welfare of each person participating in the exchange or else they would not agree to the transaction. Thus, from a utilitarian standpoint, all voluntary exchanges are ethical.
4. *BC has instituted a 'pay-for-performance' model in emergency rooms where hospitals are given baseline time targets, from arrival to discharge, for different categories of patients. If the hospital meets its targets, it gets a cash bonus, which can be used to buy equipment or improve facilities.* The new program will result in improved patient care in British Columbia.

## Answers

### Part I. True/False

1 a. T b. F c. T d. F

Notes: The marginalist principle implies output should be set at the point where  $mr=mc$ .  $p=mc$  in the case of perfect competition (short or long run).

Adam Smith's philosophy is predicated on individuals having the incentive to pursue profitable opportunities. He was an ethical egoist.

2 a. F b. T c. F d. T

3 a. F b. T c. T

Notes: Under utilitarianism, ethical actions are those that result in the greatest good for the *all* people – maximize the sum of all utility!

4 a. T b. F c. T

Notes: If a monopolist chose to set  $p=mc$  (perhaps fearing entry if it charged a higher price, or because it could also charge a fixed fee as in two-part tariffs, etc.), then output would be set at the point where the  $mc$  curve intersected with the demand curve and production would be at the efficient level.

5 a. F b. F c. T

6 a. T b. F c. T

7 a. T b. F c. T

8 a. F b. T c. T d. F

9 a. T b. T c. T

### Part II: Short answer

**1. False:** The definition of a public good is one that is non-exclusive and non-rival. Buses are not non-exclusive (you can be prevented from using a bus). It is generally (but not always) non-rival as my use of the bus usually does not prevent others from using a bus.

**2. Uncertain:** No, justified by Quote from Friedman “*There is one and only one social responsibility of business to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game*”. Pursuing social responsibilities other than profit maximization is a form of taxation without representation. However, yes justified by Arrow who emphasizes two types of market failure in the presence of which profit maximization fails to yield efficient results. 1) Negative externalities: pollution cause by the firm; 2) Asymmetric (imperfect) information: the firm knows more than the customer about the quality of the product.

In addition, Freeman indicates that managers have obligations to several groups in addition to shareholders (e.g. suppliers, customers, employees, community members, even social activists).

**3. False.** A voluntary transaction may not increase overall welfare in cases of third-party effects or imperfect information. If someone NOT participating in the exchange is harmed, then overall welfare may not be maximized. Information failures may make it impossible for consumers to make informed choices. If that is the case, consumers may engage in exchanges that turn out to reduce their welfare (and the welfare of society as a whole).

**4. Uncertain.** The program gives incentives to see/process more patients on time. This increases efficiency that creates resources that can be used to improve patient care. However, hospitals may start switching focus to monetary outcomes rather than patient care. For instance, by specifying procedures with monetary incentives even when they are not needed. These perverse incentives may result in reduced patient care (social benefit). There is also a cost associated with administering the program.