

Commerce 394: Government and Business

Sample Midterm Exam
(THIS AN ABBREVIATED EXAM)

Dr Steven Minns

Name: _____

Time: 70 minutes

Marks: 70

Part I. True/False (6 questions, 30 total marks, 1.5 marks per part). There can be more than one true/false/affirmative/correct 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 sacrificing an innocent life in order to save five lives.

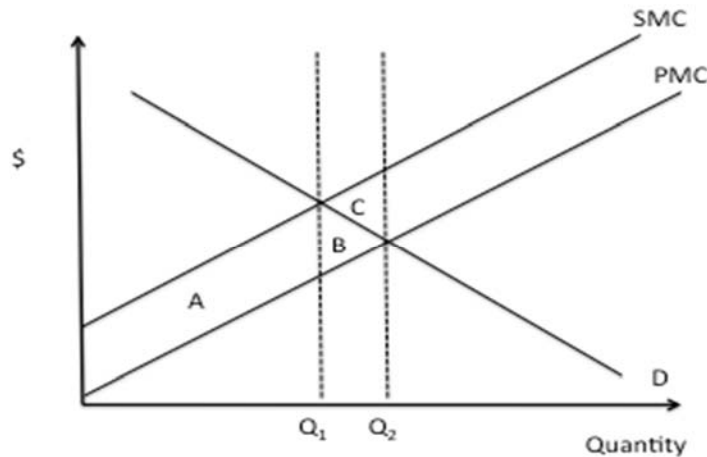
4. Which of the following would result in allocational efficiency?

- 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?

- Q_1 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.

Part II. True/False/Uncertain (5 questions, 8 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.

- Vancouver city government provision of bus transportation is best justified by the fact that bus transportation is a public good.
- A photo radar system generated only \$20 million in net revenues. The province paid \$35 million for equipment and start-up costs. Clearly the program was a failure.
- 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.
- In the late 1990s, the BC government provided a financial bailout of Skeena Celluse, a pulp mill located in Prince Rupert, a town located in a remote part of British Columbia. The bailout is justifiable from an economic efficiency point of view because the owners of the plant do not bear the full costs associated with the plant closure.

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

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: A cost-benefit analysis of the photo radar policy includes other considerations besides the program revenues and expenditures. One clear benefit would be a reduction in traffic-related fatalities/injuries. The benefit of fewer fatalities and injuries could be calculated and compared to the cost of the program.

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 bailout (subsidy) *may* be justified by positive externalities associated with the mill's operations (or the reduction in negative externalities associated with its closure). Its operations may keep workers off unemployment benefits, out of crime and benefit society overall. Most displaced workers, however, will eventually find work in economically viable enterprises. Although some justifications exist, it is very costly for government to subsidize a failing business. (Skeena Cellulose has since ceased operations.)