

RULES:

No notes or other source materials are permitted. All such items must remain on the floor.

You may use only: pens, pencils, rulers, erasers, calculators and watches. Calculators are not required, and calculators with alphanumeric memories are not permitted.

No looking, no copying, no cheating. All such behaviour will result in a zero score for the exam.

Write your NAME and SECTION NUMBER on the front page of your exam booklet.

The exam is worth 45 points—I suggest one minute per point and then move on. Every question is worth 5 points.

For every question, 1 to 3 sentences is appropriate. If you are clear enough, one sentence is typically sufficient.

Section 1: 15 points

On the Readings:

1. Luke Eric Peterson argues in his Globe and Mail editorial that “university graduates can look forward to a decade or more of debtor status before upgrading to the investor class”. Assuming this is true, is it a bad thing?
 - a. Debt used to finance an asset—in this case education—is not a bad thing, unless the return on the asset—in this case, the increased well-being and earnings resulting from the education—is insufficient to justify the cost. The appropriate time frame for debt repayment is the lifetime of the asset. If your education depreciates to valueless after a decade, then you should pay it off in a decade.
2. Nick Barr argues that future tax payments are an externality which make public investment in higher education a good idea. Identify one weakness in this argument (with a weakness of your weakness if you wish).
 - a. Possible weaknesses are: (1) future tax payments may not be as large as the current public investment; (2) the returns on education are largely private, that is, there is no benefit outside the person. Strengths are: (1) education may have externalities on the productivity of other people, thus raising *their* tax payments and incomes in the future; (2) since taxation is progressive, to the extent that the returns to education are risky, “repayment via taxation” is somewhat insured.
3. Landsburg argues that the claim “public debt hurts future generations” is a myth. Summarize his argument and whether or not you think his argument has merit. (Hint: think about how public debt and private bequests interact).
 - a. He argues that if public debt results from tax rates being ‘too low’, we all have more money in our pockets than we should, and we can just put this money in the bank and bequest it to our children. Then, when the debt has to be repaid, they can use this banked money. Weaknesses are: (1) some people don’t bequest due to bad luck, or don’t have children; (2) some of the next generation are immigrants, and so are children of outsiders; (3) some people *want* to exploit their children.

Section 2: 20 points

From the Study Questions:

4. Bill Watson and Paul Krugman both note that public debt is large. Why does Bill Watson propose reining in expenditure while Paul Krugman proposes raising taxes to deal with seemingly the same issue?
 - a. Their different proposals are rooted in different assessments of the ‘right’ size of government. Watson thinks government is ‘too large’, and therefore his answer to public debt is to cut expenditure so that deficits become surpluses. Krugman thinks that government is ‘too small’,

and therefore his answer to public debt is to raise taxes and not cut expenditures.

5. “It is crazy to borrow money to buy groceries.” Support this statement in the context of government financing. (Hint: think about the meaning of a structural deficit.)
 - a. The analogy to ‘groceries’ in the government context is those expenditures which are really not investments, that is, day-to-day expenditures that cannot and should not be avoided. These might include: infrastructure maintenance, health care, K-12 education and other things. If these things are financed with borrowing, since they recur every year, the borrowing must occur every year, which implies a structural deficit.

6. [Identify one] hidden information problem [which] might arise in K-12 education, and how government might solve/improve the situation?
 - a. Possible information problems include: (1) parents don’t know the quality of schools, but teachers and administrators do; (2) teachers don’t know the intelligence of children, but children do; or (3) children don’t know the competence of teachers, but teachers do. Possible solutions include: (1) schools may be rated according to standardized tests (with the bad effect that teachers teach to multiple-choice exams); (2) children could be rewarded for performance with something they value (candy, clothing coupons, less beating); (3) I don’t know for the last one.

7. “Governments should provide education for all for the sake of equality.” Support/refute this statement.
 - a. Equality may or may not be a good social goal, after all, it may dilute the incentives of people to work and try and so forth. To the extent that equalising education equalises opportunity across people, this criticism is weakened. Public education may not actually provide a lot of equality—in many US states, education is publicly provided, but highly heterogeneous due to financing rules. Public higher education may have an even greater problem on equalitarian grounds, since it is not attended by all people.

Section 3: 10 points

Explain why the following statements are wrong *or* why they are right.

8. “The federal government has been managed very well over the last decade—they have presided over 8 consecutive budget surpluses”.
 - a. A structural surplus does not imply good management. Structural balance (zero structural deficit) is a more reasonable goal. One might worry that: (1) governments have missed good things to invest in or spend on; (2) governments have missed opportunities to lower tax rates.

9. “Since students are enriched by post-secondary education, they should pay for it.”
 - a. The return to post-secondary education is on average positive and large, but it is fairly risky—everyone is not a winner. To the extent that students themselves get all the return to their education, one might argue that they should be called on to pay for it. However, one should worry that perhaps there are externalities on the productivity of others, both educated and not educated.