

Final Exam ECON 104

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. Approximate calculations are fine—just write down your calculation. Be sure to carefully write down all assumptions that you use to answer the question.

Write your NAME and SECTION NUMBER (or Tutorial Leader) on the front page of your exam booklet. These are short-answer questions. Bullet points are fine.

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

Section I: Multiple Choice (2 points each, total of 10 points)

1. A. Saez, Slemrod and Giertz survey the many papers which estimate the elasticity of taxable income with respect to tax rates (ETI) and find that the ETI is probably between 0.12 and 0.25. Assume that the ETI is 0.2, and consider a 10 percentage point increase in the income tax rate. This would result in:
 - a. A 0.2 % decrease in the amount of taxable income reported to government;
 - b. A 2.0% decrease in the amount of taxable income reported to government;**
 - c. A 20% decrease in the amount of taxable income reported to government.
- B. A "Pareto Improvement" is
 - a. A situation in which it is impossible to make someone better off without making someone else worse off;
 - b. A change which makes someone better off without making someone else worse off; or**
 - c. A change which brings everyone closer to the same chance for success.
- C. The government sector as a fraction of GDP has grown over the past century. How much bigger that fraction now compared to 100 years ago?
 - a. About twice as big;
 - b. About 5 times as big; or
 - c. More than 10 times as big.**
- D. In the USA, public spending on health care as a fraction of GDP is
 - a. Less than half that of Canada;
 - b. About the same as that of Canada; or**
 - c. More than twice that of Canada.
- E. The "veil of ignorance" is a thought experiment in which one:
 - a. chooses what kind of society in which one wants to live without knowledge of what role they play (or of who they are) in that society;**
 - b. imagines the decision faced by an insurance provider who does not know the true risks of an insurance purchaser; or
 - c. has to decide whether or not to buy a product without knowing its quality or characteristics.

Short Answer (5 points each; 4-6 sentences is enough)

2. What is an externality? Give an example. How can the power of the state allow us to correct this externality? Why can't a firm solve this externality problem? (Note: use the same externality for all parts.)
 - a. 1 pt for correct definition. E.g., an effect (good or bad) on a person external to (not involved in) a transaction.
 - b. 1 pt for consistent example.
 - c. 2 pt for an example of a state solution.
 - d. 1 pt for what power the firm lacks.
3. What is a hidden action problem? Give an example. How can the power of the state allow us to correct this hidden action problem? Why can't a firm solve this hidden action problem? (Note: use the same hidden action problem for all parts.)
 - a. 1 pt for correct definition. E.g., action(s) controlled by one agent that affects the payoffs of another agent.
 - b. 1 pt for consistent example.
 - c. 2 pt for an example of a state solution.
 - d. 1 pt for what power the firm lacks.
4. Why should we have employment insurance? Why not just let people save up for their anticipated periods of unemployment?
 - a. 1 pt for identifying the risk: layoff (employment loss).
 - b. 2 points for identifying a hidden action or hidden knowledge problem that makes it hard to buy insurance from a private insurer.
 - c. 2 pts for an argument that individual saving will be inefficient. Best argument shows that there is a Pareto improvement via public insurance. But, sloppy arguments using economic reasoning are okay.
5. Why is K-12 education provided for everyone for free by government? Should it be? (Use tools developed in this course to answer this question. Be balanced and reasoned in your answer.)
 - a. 5 points for constructing an argument. They should be clear (though not necessarily explicit) about whether they are proposing a normative or positive argument (or both). Elements may include
 - b. positive: median voter wants it because the median voter cannot afford to borrow so much to educate children; other median voter style args; bureaucratic expansion; terrible schools don't get shut down, and new schools are being created all the time
 - c. normative: merit good; progressively redistributive (equal for all, but payment is unequal); social insurance (would have to specify what risk); externalities (illiteracy, innumeracy, uneducated/uninformed voters); equal opportunity (even starting point/playing field);
 - d. non-arguments include: (social) insurance arguments that don't specify a risk, or hidden action, or hidden knowledge; externalities left unspecified;
6. Does health insurance itself represent a form of government redistribution? Is it progressive redistribution?
 - a. They should use info from Krugman.

- b. It is progressively redistributive because use is almost even across wealth, but rich pay more in tax.
 - c. The point here is to bring in detail, and the more detail they can bring in their 5 sentences the better.
7. There is only one kind of tap water to buy in Vancouver. Is this social insurance? (Define social insurance and check to see if tap water is social insurance.)
- a. What is the risk? Is there evidence that private provision is absent or terrible? What is the hidden action or hidden knowledge?
 - b. My best answer is no. There is little risk in such a rainy place. You can buy private water that is safe. There is no appreciable hidden action or knowledge.
8. Why is there so much homelessness in Vancouver compared to 30 years ago? Is homelessness different from poverty? How so? What solutions are there to homelessness?
- a. 1 pt: Litany of supply reasons: low rental vs owned accommodation, due to condo acts; overbuilding on top of old rental structures in private sector; low public investment since 1980s.
 - b. 1 pt: Litany of demand reasons: Vancouver is nice, rich people want nice houses, not crappy rentals; welfare rates are so low that there is little incentive to provide rentals at those rates.
 - c. 1 pt: Lack of money is different from lack of shelter: you can suffer from one but not the other.
 - d. 2 pts: Solutions: build public housing (who should do it? Feds/provs?); change incentives for private builders to push them into rentals; examples are good here.
9. How does Statistics Canada measure poverty (that is, low income)? What can and/or should we do about poverty?
- a. 2 pts for definition: Low-income cutoffs (LICOs), specified for each household size/city size. Based on income levels at which households spend 'too much' (58.5%) on necessities (food, shelter, clothing).
 - b. 3 pts: Mention any of the redistributive programs or policies we discussed in the poverty lectures. Be specific about can vs. should.
10. What is the "New Deal"? What is the "Great Compression"? Why are they important? What can the occupy movement learn from the Great Compression?
- a. 3 pts: Straight out of Krugman: any reasonable definitions and explanations.
 - b. 2 pts: any reasonable argument connecting stuff from Krugman and/or their first part to policy lessons.
 - c. E.g.: Krugman is heavy on how unions influence public support for redistribution. So, policy recommendation might be: occupy guys should want to empower unions.
11. What are the consequences of the absence of a termination mechanism like bankruptcy in the government sector? Might the same problem be relevant in some private sector environments? If so, why, and give examples; if not, why not.
- a. 2 pts: define soft budget constraint and say why it matters.
 - b. 2 pts: either say it is irrelevant bc private firms can definitely go bankrupt if they suck enough, or say it is relevant because they might be bailed out in bad

circumstances; even better to say that if they're big they might face the latter, but if small, the former.

- c. 1 pt: are the example(s) relevant?
12. Suppose that there is a vaccine for a highly infectious disease. Should people be forced to take the vaccine? Why or why not? (Use tools developed in this course to answer this question. Be balanced and reasoned in your answer.)
- a. 2 points for figuring out the externality.
 - b. 2 points for identifying a correct govt intervention corresponding to the externality, e.g., mess with prices to raise the cost of not taking vaccine.
 - c. 1 pt for an economic argument for mandatory-ness rather than using a price. Could be: political economy (median voter) argument; difficulty of charging people who *don't* take the vaccine. Etc