CHAPTER

2

Principles for Analyzing Government

Multiple-Choice Questions

1. The market system is based upon _____.
   a. money
   b. voluntary exchange
   c. capitalism
   d. profits
   Difficulty: EASY
   Answer: b
   Section and/or page number: Principles for Analyzing Government, p. 25.

2. _____ a cornerstone of the market economy.
   a. Mutually beneficial exchange is
   b. A strong central bank
   c. Monopoly rents are
   d. Government regulation is
   Difficulty: Easy
   Answer: a
   Section and/or page number: Principles for Analyzing Government, p. 25.

3. The right of people to receive the value of their output as determined by the market _____.
   a. leads to people pursuing their own selfish ends, with little regard for others
   b. leads individuals to produce only goods that will appeal to the masses
   c. provides strong incentives to produce goods that will make themselves happy
   d. provides incentive to produce goods that others find valuable
   Difficulty: Moderate
   Answer: d
   Section and/or page number: The Market Economy, p. 26.

4. As long as the value of additional units of output exceed the opportunity cost of that output, _____.
   a. it will not be produced
   b. it likely will not be produced
   c. it will be produced
   d. it is likely to be produced
   Difficulty: Moderate
   Answer: c
   Section and/or page number: Economic Efficiency and the Competitive Market, p. 26

5. Which of the below statements is true?
   a. It is efficient to produce beyond the equilibrium output level as long as costs are low.
   b. The level of output that maximizes the value of an economy's output is found at the intersection of supply and demand in a competitive market.
   c. Production and exchange is beneficial as long as the demand curve lies below the supply curve.
   d. Mutually beneficial exchange is mostly harmful unless regulated.

   Difficulty: Medium
   Answer: b
   Section and/or page number: Economic Efficiency and the Competitive Market, p. 26

6. The subject matter of public economics falls into the two general categories of _____ and _____.
   a. public interest; private interest
   b. coercion action; individual liberty
   c. revenue generation; government spending
   d. civilian activities; military duties

   Difficulty: Moderate
   Answer: c
   Section and/or page number: The Role of Government, p. 28

7. Which of these is <u>not</u> a valid reason for government intervention into mutually beneficial exchange?
   a. The market system might not function at all without government protecting certain rights
   b. The market system produces an efficient outcome that the majority does not like
   c. The government might be able to undertake some activities more efficiently than the market outcome.
   d. The market allocation might be viewed as inequitable, so redistribution might be desired to achieve equity goals.

   Difficulty: Easy
   Answer: b
   Section and/or page number: The Role of Government, p. 29

8. The market system is able to allocate resources efficiently because individuals have the right to the output they produce and _____.
   a. freedom of the press
   b. freedom of speech
   c. freedom of movement
   d. freedom of exchange

   Difficulty: Easy
   Answer: d
   Section and/or page number: The Market System and Individual Rights, p. 29

9. If government did not individual rights, the efficiency of a market economy_____.
   a. would decline
   b. would be about the same
   c. would increase
   d. could possibly decline or possibly increase

   Difficulty: Easy
   Answer: a
   Section and/or page number: The Market System and Individual Rights, p. 29

10. Which of these is <u>not</u> true?
    a. Government uses its powers of coercion and force to collect taxes
    b. Government uses its powers of coercion and force to protect rights
    c. Government uses its powers of coercion and force to violate rights
    d. Government uses its powers of coercion and force only to improve the general welfare

    Difficulty: Moderate
    Answer: d
    Section and/or page number: The Government as Violator of Rights, p. 30.

11. Government institutions that protect the rights of individuals are ______.
    a. the executive, legislative, and judicial branches of government
    b. federal, state, and local governments
    c. federal agencies such as OSHA, FEC, and the FCC
    d. police, military branches, and the court system

    Difficulty: Moderate
    Answer: d
    Section and/or page number: The Government as Protector of Rights, p. 30

12. The idea that the public interest should be equated with those policies that produce the greatest good for the greatest number _____.
    a. is the utilitarian criterion
    b. is the Pareto optimality criterion
    c. is the Hobbesian criterion
    d. is a value free judgment

    Difficulty: Moderate
    Answer: a
    Section and/or page number: The Greatest Good for the Greatest Number, p. 31

13. Employing utilitarianism as a measure of the public interest _____.
    a. is inconsistent with the concept of a social welfare function
    b. attempts to minimize the problems associated with market failure
    c. attempts to maximize total utility in a society
    d. avoids comparing individual’s utilities

    Difficulty: Moderate
    Answer: c
    Section and/or page number: The Greatest Good for the Greatest Number, p. 31

14. Which of the following is <u>not</u> a drawback of utilitarianism?
    a. There exists no valid way to make interpersonal utility comparisons.
    b. Is incompatible with the Pareto criteria.
    c. It is not directly compatible with economic efficiency.
    d. It implies social arrangements that most people would find objectionable.

    Difficulty: Hard
    Answer: b
    Section and/or page number: Utilitarianism, p. 32

15. Utilitarianism is inconsistent with _____.
   a. the social welfare function
   b. cost-benefit analysis
   c. the Pareto criteria
   d. slavery

   Difficulty: Moderate
   Answer: c
   Section and/or page number: Utilitarianism, p. 32

16. The key difference between the Pareto optimality and Pareto superiority is that ______.
   a. Pareto optimality is incompatible with utilitarianism, while Pareto superiority is compatible
   b. Pareto superiority is superior to Pareto optimality
   c. Pareto optimality requires interpersonal utility calculations, while Pareto superiority does not
   d. Pareto optimality refers to a state of the world while Pareto superiority compares two states of the world

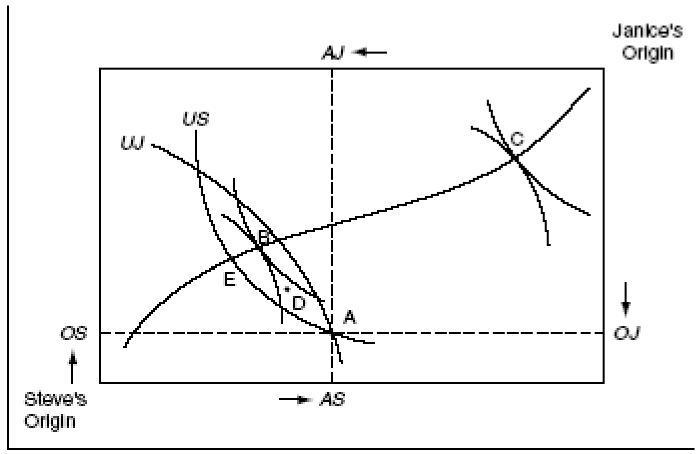
   Difficulty: Hard
   Answer: d
   Section and/or page number: The Pareto Criteria, p. 33

17. The Pareto superiority concept _____.
   a. is equivalent to utilitarianism
   b. is equivalent to equilibrium in a perfectly competitive market
   c. compares two different states of the world
   d. looks at a state of the world and judges its superiority

   Difficulty: Medium
   Answer: c
   Section and/or page number: The Pareto Criteria, p. 33

18. The Pareto optimality concept is _____.
   a. equivalent to the concept of economic efficiency
   b. equivalent to Pareto superiority
   c. equivalent to utilitarianism
   d. equivalent to cost-benefit analysis

   Difficulty: Moderate
   Answer: a
   Section and/or page number: The Pareto Criteria, p. 34



19. Using the above figure and the Pareto criteria to determine the public interest, would a move from point A to point C be in the public interest?
    a. yes
    b. no
    c. possible, depending upon other factors
    d. cannot say using the Pareto criteria

    Difficulty: Hard
    Answer: d
    Section and/or page number: The Pareto Criteria, p. 34

20. Pareto optimality and Pareto superiority _____.
    a. concern only monetary gains and losses
    b. compare utility gains with utility losses
    c. do not require interpersonal utility comparisons
    d. are equivalent to the concept of economic efficiency

    Difficulty: Hard
    Answer: c
    Section and/or page number: The Pareto Criteria, p. 35

21. When comparing public and private schools, the voluntary choice of going to a private school _____.
    a. is a Pareto optimal move
    b. is a Pareto superior move
    c. is neither Pareto optimal nor Pareto superior
    d. cannot be evaluated according to the Pareto criteria

    Difficulty: Hard
    Answer: b
    Section and/or page number: Market Exchange and the Pareto Criteria, p. 35

22. Which of the following is <u>not</u> a limitation of the Pareto criteria?
    a. Almost any policy change will make at least one person worse off.
    b. The status quo is lent legitimacy from being the starting point for evaluating social welfare.
    c. The criteria cannot tell us if a particular policy change will make all participants better off.
    d. The criteria do not allow for the ranking of all possible states of the world.

    Difficulty: Moderate
    Answer: c
    Section and/or page number: Limitations of the Pareto Criteria, p. 36

23. If the Pareto criteria are taken literally, _____ percent of United States residents must agree for a policy change to be a move towards efficiency.
   a. 25
   b. 50
   c. 75
   d. 100

   Difficulty: Easy
   Answer: d
   Section and/or page number: Limitations of the Pareto Criteria, p. 36

24. Outcomes are likely to be Pareto superior if they were _____.
   a. approved of by a unanimous vote
   b. enacted by a bureaucrat
   c. decreed by a judge
   d. enacted by bipartisan legislation

   Difficulty: Moderate
   Answer: a
   Section and/or page number: Limitations of the Pareto Criteria, p. 37

25. Which of the following would <u>not</u> satisfy the potential compensation criterion?
   a. The winners from a policy change could compensate the losers so everyone would be better off.
   b. The policy change was approved by a unanimous vote.
   c. The policy change was a Pareto superior move
   d. The policy change moved from a Pareto optimal position to a non-Pareto optimal position.

   Difficulty: Hard
   Answer: d
   Section and/or page number: Potential compensation, p. 37

   Which of these is an argument for using the potential compensation criterion?

26.
   a. If the winners can compensate the losers, no one is harmed by employing the criterion.
   b. The criterion does not employ interpersonal utility calculations.
   c. If employed over a large number of policy changes, everyone should enjoy a net gain in the long run.
   d. It is easy to determine the magnitude of the wins and losses.

   Difficulty: Hard
   Answer: c
   Section and/or page number: Potential Compensation, p. 38

27. Which of the following statements about the social welfare function is <u>not</u> true?
   a. It can be thought of as a set of indifference curves that depict the wealth of the entire society.
   b. It does not employ interpersonal utility comparisons.
   c. It is one possible method for evaluating the public interest/
   d. It allows for the rankings of possible outcomes.

   Difficulty: Moderate
   Answer: b
   Section and/or page number: The Social Welfare Function, p. 39

28. If compared against other criteria for evaluating the public interest, the social welfare function is most comparable to _____.
    a. utilitarianism
    b. the Pareto criteria
    c. the potential compensation criterion
    d. cost-benefit analysis

    Difficulty: Moderate
    Answer: a
    Section and/or page number: The Social Welfare Function, p. 39

29. Positive economic analysis _____.
    a. evaluates policy changes and determines whether it is a good idea
    b. seeks to understand the outcome of a policy change
    c. cannot be proven incorrect
    d. is a statement about "what ought to be"

    Difficulty: Easy
    Answer: b
    Section and/or page number: Positive and Normative Economics, p 40

30. Normative economic analysis _____.
    a. is concerned only with the facts
    b. is a statement about the relationship between a policy change an outcome
    c. judges the desirability of a policy change
    d. does not involve value judgments

    Difficulty: Easy
    Answer: c
    Section and/or page number: Positive and Normative Economics, p. 41

31. Which of the following is a normative economics statement?
    a. An increase in the minimum wage will reduce teenage employment.
    b. Increasing the minimum wage will result in more votes for progressive candidates.
    c. Raising the minimum wage would greatly increase labor costs in certain industries.
    d. Raising the minimum wage is a poor idea because living wage laws are better.

    Difficulty: Moderate
    Answer: d
    Section and/or page number: Positive and Normative Economics, p. 41

32. Which of the following statements about economic efficiency is **not** true?
    a. Economic efficiency is equivalent to Pareto optimality.
    b. Economic efficiency can be determined normatively.
    c. Economic efficiency is superior to equity.
    d. Economic efficiency can be evaluated positively.

    Difficulty: Easy
    Answer: c
    Section and/or page number: Equity and Efficiency, p. 43

33. Equity and efficiency _____. Thus, _____.
    a. are always consistent with each other; trade-offs between the two are necessary
    b. are never consistent with each other; trade-offs between the two are unnecessary
    c. might be consistent in certain situations; trade-offs between the two might be necessary
    d. might be consistent in certain situations, trade-offs between cannot be made

    Difficulty: Hard
    Answer: c
    Section and/or page number: Equity and Efficiency, p. 43

34. Normative analysis is very important to public finance because _____.
    a. public policy enacted by government is the result of voting by individuals
    b. positive analysis is full of value judgments
    c. we should be concerned with how the world works
    d. voluntary exchanges are economically efficient

    Difficulty: Easy
    Answer: a
    Section and/or page number: Conclusion, p 43

True or False

35. Production and exchange is beneficial as long as the demand curve lies below the supply curve.
    a. True
    b. False

    Difficulty: Easy
    Answer: b
    Section and/or page number: "Economic Efficiency and the Competitive Market," p. 27.

36. Coercion and force underlie government activity.
    a. True
    b. False

    Difficulty: Moderate
    Answer: a
    Section and/or page number: The Role of Government, p. 28

37. A government strong enough to protect individual rights is also strong enough to violate them.
    a. True
    b. False

    Difficulty: Moderate
    Answer: a
    Section and/or page number: The Government as a Violator of Rights, p. 30.

38. Using the utilitarian criterion, it is possible that slavery could be in the public interest.
    a. True
    b. False

    Difficulty: Moderate
    Answer: a
    Section and/or page number: Utilitarianism, p. 32.

39. Every market exchange is a Pareto superior move.
    a. True
    b. False
    Difficulty: Hard
    Answer: b
    Section and/or page number: Market Exchange and the Pareto Criteria, p. 35

40. If everyone agrees to a change, then the change will be a Pareto Superior move.
    a. True
    b. False
    Difficulty: Easy
    Answer: a
    Section and/or page number: Political Exchange and the Pareto Criteria, p. 36

41. When acting upon the potential compensation criterion, the winners must compensate the losers to the exchange.
    a. True
    b. False
    Difficulty: Hard
    Answer: b
    Section and/or page number: Potential Compensation, p. 37.

42. Cost-benefit analysis does not employ interpersonal utility calculations.
    a. True
    b. False
    Difficulty: Easy
    Answer: b
    Section and/or page number: Cost-Benefit Analysis, p. 40

43. While limited in their practical applications, the real value of the Pareto criteria is in allowing the public interest to be judged without making interpersonal utility calculations.
    a. True
    b. False
    Difficulty: Easy
    Answer: a
    Section and/or page number: Normative Analysis and the Public Interest, p. 41

44. The goal of equity is fundamentally a positive issue.
    a. True
    b. False
    Difficulty: Moderate
    Answer: b
    Section and/or page number: Equity and Efficiency, p. 42

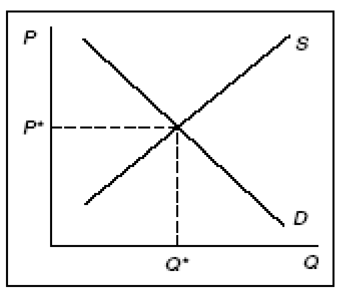
45. Public finance economists should only concern themselves with positive economic analysis.
    a. True
    b. False
    Difficulty: Easy
    Answer: b
    Section and/or page number: Conclusion, p. 43

Essay/Short Answer Questions

46. Compare and contrast Pareto optimality and Pareto superiority and provide a brief discussion of the advantages of the Pareto criteria in assessing the public interest.
Difficulty: Easy
Answer: Pareto optimality is the situation where nobody can be made better off without making someone else worse off, while a Pareto superior situation if at least one person is better off and nobody has lost anything. Pareto optimality applies to an individual situation, while Pareto superiority compares two separate states or situations. Compared to utilitarianism, the social welfare function, and cost-benefit analysis, the Pareto criteria do not require interpersonal utility comparisons, rendering them superior to the other criteria when attempting to determine economic efficiency and the public interest.
Section and/or page number: The Pareto Criteria, pp. 33-37.

47. Suppose that a particular policy would result in a $100 gain for Gwen but a $20 loss for Sabrina. Everyone else in the economy remains the same. Is this policy change in the public interest according to the potential compensation criterion? Explain and justify your answer.
Difficulty: Moderate
Answer: The potential compensation criterion states that if a proposed change benefits the winners by enough that they could use some of their gains to compensate the losers so that everyone could be made better off, than the proposed change is in the public interest. Using this criterion, the proposed policy would clearly be in the public interest, since Gwen could take some of her winnings to not only offset Sabrina's losses but also make Sabrina better off.
Section and/or page number: Potential Compensation, p. 37

48. Draw a demand and supply curve for a competitive product, making sure to clearly label the axis. Give a brief explanation for why the resulting equilibrium is economically efficient.
Difficulty: Easy
Answer:



The level of output that maximizes the value of output to the economy is Q*. If Q is less than Q*, the value of the output to consumers is greater than the opportunity cost to suppliers, implying that suppliers could supply more units where that consumers value above their opportunity cost. If Q is greater than Q*, the opportunity cost of the suppliers is greater than demanders are willing to pay, implying an inefficient use of resources. Thus, the output level where the opportunity cost of suppliers is equal to the price that demanders are willing to pay is the economically efficient level since this implies that no resources are being used inefficiently.
Section and/or page number: Economic Efficiency and the Competitive Market, p. 26

49. Briefly list and discuss in turn the three limitations of the Pareto criteria.
Difficulty: Moderate
Answer: The first limitation of the Pareto criteria is related to the fact that a Pareto improvement requires that no one be harmed. In a country as large and as complex as the United States, it will be nearly

impossible to find a public policy that will not harm at least one individual. If taken literally, the Pareto criteria therefore seem of little practical use. The second limitation is that it suffers from a status quo bias. Since the starting point of evaluation of any Pareto superior move is the current situation, the status quo is given favoritism over a proposed change if the proposed change is not a Pareto superior move. If the status quo was arrived at unfairly, it is troubling to not be able to label a move towards fairness as a move towards increasing social welfare.
Section and/or page number: Limitations of the Pareto Criteria, p. 36

50. What is cost-benefit analysis? Suppose that you were asked to do a cost benefit analysis of tearing down an elderly woman's ancestral home to provide space to expand a local high school. What difficulties might you encounter?
Difficulty: Hard
Answer: In cost-benefit analysis, a dollar value is placed on all the costs and benefits associated with a particular project. If the benefits of an action are greater than the costs of an action, it is in the public interest (according to the criterion). In the case above, the main difficulty would be in placing a dollar value on the woman's home as compared to the dollar value of the expanded school. Being here ancestral home, the woman probably places a high value on the house, probably much higher than market value. On the other hand, hundred s of students will gain enjoyment from the expanded school and it would be very easy to overstate their potential benefits since a small change in the enjoyment they each get from the expanded school will be multiplied across many individuals.
Section and/or page number: Cost-benefit Analysis, p 39