Review Sheet #1
Questions for Chapters 1-5

1. Why does it make sense to look at government spending as a percentage of GDP rather than the total level of spending? Has government spending as a percentage of GDP changed much since 1980? Is US government spending as a percentage of GDP higher or lower than the percentage in other developed countries?

2. What are the three largest categories of spending by the federal government? What are the three largest sources of revenue?

3. What is meant by the term Marginal Benefit (MB)? Explain how the height of the demand curve represents MB.

4. Explain how the MC of producing the last unit represents the value of the output that was sacrificed to produce the last unit. Explain how the height of the supply curve represents that value.

5. Given the graph below, explain why Q₁ and Q₂ are not efficient levels of output, but Q* is.

6. Define the term “deadweight loss.” In the graph above, if the level of output was Q₁, what area would represent the size of the deadweight loss?

7. If Q_D = 100 -2P and Q_S = 3P, what is the size of the deadweight loss if the quantity of the good is 10?

8. What is a natural monopoly? Would an unregulated natural monopoly produce an efficient quantity of a good? Explain why or why not.

9. How could adverse selection result in a failure in an insurance market?

10. What is an externality? What is the difference between a benefit (positive) and a (cost) negative externality?

11. In the absence of government intervention, will there be “too much” or “too little” production of a good with a negative externality. Explain your answer. What is the rule for the optimal level of production of the good?

12. Be able to graph an example of a negative externality. How is the loss in welfare from the externality represented graphically?

13. Assume that the demand for a good is equal to: Q = 20 – 2P, MPC = 2Q, and MEC = Q. What level of output will be produced with no correction for the externality? What is the optimal level of output? What is the deadweight loss if the externality is not corrected?

14. What is an inframarginal externality? Is it necessary to adjust for that type of externality? Explain.
15. What is the “theory of the second best”? What implications does it have for correcting for externalities?
16. What is the tragedy of the commons?
17. What is the Coase Theorem? Explain the role of transferable property rights in the theorem? Explain how can bargaining lead to an efficient outcome according to the theorem? Will the outcome be affected by how the bargaining rights are assigned? How will the size of the transaction costs affect whether this approach can be used? Explain.
18. What is command and control regulation? Be able to describe how a system of tradable pollution permits would work.
19. What are the advantages of using tradable pollution permits over a command and control approach?
20. Explain the difference between pure public goods and pure private goods. Include definitions of the terms nonrival and nonexclusionary in your answer.
21. How does the creation of the demand curve for a pure private good differ from the construction of the demand curve for a pure public good? Show graphically.
22. Assume there are two consumers with the following demand curves:
   \[ Q^A_d = 20 - P \]
   \[ Q^B_d = 40 - 2P \]
   Assume the consumers can always purchase the good for $16. If the good is a private good, what would the equilibrium price and quantity be? If the good were a public good, what is the optimal level of output (in this case assume the price paid equals the MB of the last unit and solve for MB as a function of Q)? Show both cases graphically.
23. What is the rule for the efficient level of production of a pure public good? Will an unregulated market produce this level of the good? Explain why or why not, and include a definition of the free rider effect in your answer.
24. If a user charge is imposed on a good that is nonrival but excludable, will the level of consumption of the good be optimal?
25. What are local public goods? Club goods?
26. What is meant by the term public choice? Give an example where decisions are made via public choice in a non governmental unit. What is government failure?
27. Explain the difference between single-peaked preferences and double-peaked preferences. Be able to explain how double-peaked preferences can result in cyclical majorities.
28. Be able to define the term tax price. Be able to show the most preferred political outcome for an individual graphically. How is the most preferred outcome selected?
29. What is the median voter theorem? When will the selection of the medium voter match the optimal level of output?
30. What is rational ignorance? Are you rationally ignorant about something?
31. What is a political externality? Give an example where you have been subject to a political externality.
32. What is the significance of Arrow’s Possibilities Theorem? What is transitivity? What is independence of irrelevant alternatives?
33. Be able to describe the characteristics of the Lindahl model, are there political externalities at the selected quantity of the public good? Why or why not? What are the problems with requiring unanimity in decision-making?
34. Why would majority-rule voting result in an outcome where political parties have similar platforms?
35. How can logrolling increase efficiency? Could it reduce efficiency?
36. Under what situations will special interest groups be most effective in pursuing their agenda? What is rent seeking?
37. What do bureaucrats maximize? How can the behavior of bureaucrats result in declines in social welfare?