Review Questions – I (covering material since Exam #1)

Explain the difference between Marshallian and Hicksian demand curves. Which can be measured empirically and why?

In a diagram showing consumer preferences for 2 goods (X and Y), show the income and pure substitution effects of a decrease in the price of Y.

Suppose that a proposed policy will decrease the price of water to households. In a market diagram, show the change in consumer surplus (CS) for this price reduction, the Equivalent Variation (EV) corresponding with the price change, and the Compensating Variation (CV) corresponding with the price change.

Zerbe and Dively, Chapter 5, Questions 1 and 2 (pp 90, 91)

Which do you think would be larger for an individual: the willingness to pay (WTP) to avoid a cost associated with a project (e.g. loss of home from construction of a reservoir), or willingness to accept (WTA) to actually suffer the cost (e.g. how much would the individual have to be compensated to be willing to lose his house)? Explain why these measures should be different, for the same individual.

Define the Kaldor and Hicks compensation tests. Why might these two tests be different for the same project?

What is the "tyranny of the status quo" with respect to consideration of CV and EV measures of policy options. Provide a numerical example of a combinations of CV and EV for two options which demonstrates the tyranny of the status quo.

Draw a diagram showing the effects of a negative externality (water pollution) in the production of batteries. Show the effects on producers, consumers, and water users (the external effects). Now suppose that the government is able to impose a tax on production of batteries just equal to the costs of the water pollution. How would this tax affect producers, consumers and water users. What would be the effect on the government budget?

Explain the difference between the concepts of "risk" and "uncertainty" as these terms are used in cost benefit analysis.

Explain why the assumption of diminishing marginal utility of income necessarily implies that that the individual is risk averse.

Boardman et al., Chapter 7, exercises 1, 2. (pp. 186-187).