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Quiz #2 Economics 222

Part I:

1. The

Part II: (25 points)

Everyone agrees that the Spring Brook River is ripe for development, but there are two competing projects:

Project A: This small scale recreational project has estimated net annual benefits of \$2,000,000 for evermore. It requires an initial investment by the government of \$20,000,000 which can be financed by issuing bonds at 5% per annum interest. What is the benefit cost ratio for this project:

Project B: This more ambitious hydro-electric project has net annual benefits of \$10,000,000, but it requires an initial investment by the government of \$150,000,000, which can also be financed by issuing 5% government bonds. What is the benefit cost ratio for this project?

Assuming the cost estimates are precise, which project do you recommend? Why?

Part III (50 points)

At least since Adam Smith, most economists have argued that the market mechanism works to allocate resources efficiently. In the absence of special circumstances, the government should not intervene but should let the market do its work.

Here are three important examples of intervention in the market by the United States government:

- #1. The government does intervene in the market for health care services with Medicare and Medicaid.
- #2. The government imposes substantial payroll taxes in order to finance Social Security Benefits in retirement.
- #3. The government provides special subsidies for student loans.

For *two* (only 2) of these three examples, explain the special characteristics of the market that are cited by those who support these government activities rather than allowing the markets to operate freely. Then evaluate the strength and weaknesses of these arguments and explain the case for privatization.

(Note: You are to write two separate essays.)