

Econ321 Test03 Fall 2004

Name _____

Student Number _____

True/False

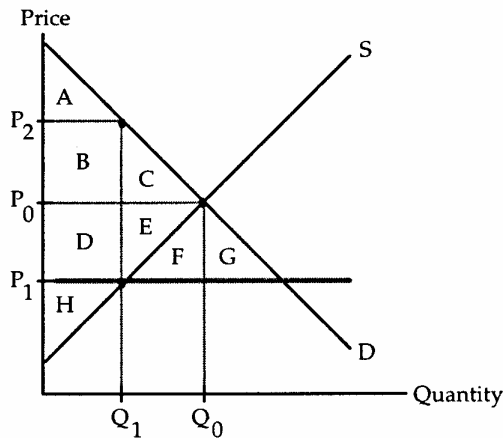
Indicate whether the sentence or statement is true or false. (3.5 points each)

- ___ 1. Producer's surplus is equal to total revenue minus consumer's surplus.
- ___ 2. A draft is better for society than a volunteer army because it is less costly than a volunteer army.
- ___ 3. A monopoly's supply curve is the portion of its marginal cost curve that lies above its average variable cost curve.
- ___ 4. The large increase in the price of oil and in the total revenues and profits of the US oil industry in the last two years are evidence that oil companies have monopoly power.
- ___ 5. A monopoly, like a competitive firm, will reduce its quantity supplied when an effective price ceiling is imposed.
- ___ 6. If a natural monopoly charged the competitive price (a price where the demand curve is intersected by the marginal cost curve), it would earn a negative profit.

Multiple Choice Identify the letter of the choice that best completes the statement or answers the question. (3.5 points each)

Price Ceiling

Questions 7 and 8 refer to the accompanying diagram which shows the effects of a price ceiling imposed in a perfectly competitive market. The initial price and quantity (before the price ceiling is imposed) are P_0 and Q_0 , respectively, and the price ceiling is imposed at the price P_1 . Assume that none of the potential deadweight loss can be avoided (i.e., the costs of “competing” or waiting to secure the price-controlled good rise to a level sufficient to equate quantity demanded and quantity supplied).

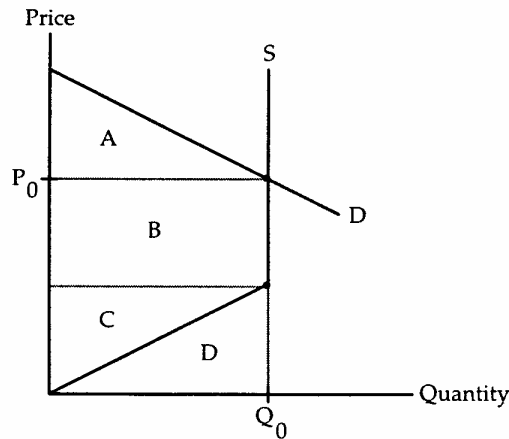


- ___ 7. Refer to Price Ceiling. Area B + D represents
 - a. the deadweight loss due to the price ceiling.
 - b. the fall in consumers' surplus caused by the imposition of the price ceiling.
 - c. the value of the time and resources spent by consumers to acquire the limited supply.
 - d. the post-ceiling profits earned by the producers of the good.
- ___ 8. Refer to Price Ceiling. The price ceiling creates a deadweight loss equal to
 - a. area A + H.
 - b. area B + C + D + E.
 - c. area B + D.
 - d. area C + E.
- ___ 9. Under competition, the price of a resource reveals
 - a. information about the past, but not future, uses of a resource.
 - b. the most valuable way to use the resource.
 - c. how much the resource is worth in the most valuable of its alternative uses.
 - d. the value of the labor needed to fully exploit the resource.
- ___ 10. According to Hayek, a social planner has no hope of matching the efficiency of a competitive pricing system because
 - a. no social planner can be completely benevolent in his actions.
 - b. a social planner cannot have access to the specialized knowledge of individuals.
 - c. the social planner will be unable to fully monitor the activities of his agents.
 - d. people are selfish and will not be actively altruistic to the social planner.

- _____ 11. A military draft is likely to be inefficient because
- it transfers wealth from those who are drafted to those who benefit from the army's services.
 - the wage rate paid to army personnel is set by the government, not by the market.
 - more people will be drafted than would have joined a volunteer army.
 - there is no guarantee that individuals with the lowest opportunity costs will be drafted.

Resource Supply/Demand

The following question (12) refers to the accompanying graph, which shows the supply and demand for a resource. The owner of the resource is receiving the price P_0 and is providing the quantity Q_0 .



- _____ 12. Refer to the Resource Supply/Demand diagram above. What does area D represent?
- The value that Q_0 units of the resource gives to demanders.
 - The revenue generated from selling Q_0 units of the resource.
 - The rent that resource owner earns from providing Q_0 units.
 - The minimum payment needed for the resource owner to supply Q_0 units.
- _____ 13. The significant difference between adverse selection problems and moral hazard problems is
- that adverse selection refers to bad luck, moral hazard refers to bad behaviors.
 - that adverse selection applies to markets for goods, moral hazard applies to markets for services.
 - only identifiable after an action has been taken.
 - that in adverse selection one group of people starts out at a higher risk, while in moral hazard problems, people incur additional risks.
- _____ 14. A simple monopoly will maximize its profit by producing the quantity where
- price and marginal cost are equal.
 - the demand curve crosses the average cost curve.
 - marginal cost reaches its minimum.
 - marginal revenue equals marginal cost.

- _____ 15. What can, in general, be said about a monopoly's supply curve?
- A monopoly's supply curve, like that for a competitive firm, coincides with its marginal cost curve.
 - A profit-maximizing monopoly will operate only on the elastic portion of its supply curve.
 - The monopoly's supply curve is more inelastic than if the firm were competitive.
 - A monopolist does not have a supply curve.
- _____ 16. A monopolist will always end up choosing to operate
- even if its profits are negative.
 - on the elastic portion of its demand curve.
 - until such time as a new competitor enters its market.
 - only if it can capture the entire consumer surplus.
- _____ 17. Suppose regulators impose a price ceiling on a monopoly. If the price ceiling is set below the monopoly price but above the competitive price, then the monopoly will
- reduce its output.
 - increase its production.
 - produce the same output at a lower price.
 - earn zero profit.
- _____ 18. When a firm with market power practices third-degree price discrimination, it charges the highest price to the group that
- has the most elastic demand.
 - has the most inelastic demand.
 - purchases the highest quantity.
 - purchases the lowest quantity.
- _____ 19. In third-degree price discrimination, the monopolist will choose quantities so that each market has the same
- price.
 - total revenue.
 - marginal revenue.
 - elasticity.
- _____ 20. When will setting a relatively high entry fee and a low competitive price be the best strategy for a two-part tariff monopolist?
- When the customers are nearly identical.
 - When the customers have inelastic demand for the product.
 - When the customers place a relatively low value on their time.
 - When the customers can be separated into a number of diverse groups.
- _____ 21. Suppose that an upstream manufacturer sells to a downstream retailer, who then resells a product to consumers. The upstream firm is a monopolist selling to the retailer, and the retailer is a monopolist selling to consumers. If the manufacturer and the retailer merged to form a single firm,
- The price charged to consumers would rise and overall profits (summing across manufacturing and retailing operations) would rise.
 - The price charged to consumers would rise and overall profits would fall.
 - The price charged to consumers would fall and overall profits would rise.
 - The price charged to consumers would fall and overall profits would fall.

- _____ 22. Which of the following statements does NOT correctly characterize monopolistic competition?
- a. In long run equilibrium, firms earn zero economic profit.
 - b. In long-run equilibrium, $P > MC$ for each firm.
 - c. In long-run equilibrium, each firm operates at the minimum point on its average cost curve.
 - d. Firms in the market sell differentiated products.

Analytical Questions

1. (13 points) Use a diagram to illustrate the profit maximizing price and quantity chosen by a monopolist. Your diagram should include the following curves: demand, marginal revenue, marginal cost, and average cost. Briefly explain the nature of the inefficiency of the monopoly outcome. Label axes and curves carefully.

2. (10 points) Suppose you are the monopoly owner of a movie theatre. You can allow people to enter the theatre at zero marginal cost, and you can provide popcorn at a constant marginal cost of \$0.50 per bag. You have two customers, Leksis and Trebe, who are identical twins. Leksis never buys popcorn under any circumstances. If you charge the monopoly price of \$1.00 per bag for popcorn, Trebe will buy 2 bags of popcorn and earn \$0.50 in consumer's surplus, and you will earn \$1.00 in profit from popcorn sales. If you charge the competitive price of \$0.50 per bag for popcorn, Trebe will buy 4 bags of popcorn and earn \$2.00 in consumer's surplus, and you will earn no profit from popcorn sales.
- (i) Suppose that Leksis is willing to pay up to \$8.00 to see the movie and Trebe is willing to pay up to \$5.00 to see the movie. How much should you charge for admission to the theatre and how much should you charge for popcorn?
 - (ii) Suppose that Leksis is willing to pay up to \$4.00 to see the movie and Trebe is willing to pay up to \$5.00 to see the movie. How much should you charge for admission to the theatre and how much should you charge for popcorn?

Briefly explain the logic behind your answers.