

**Homework Assignment 6. Due: Thursday, March 10.**

1. (2 points) In class we discussed two possible explanations of the fact that college graduates make substantially more than people with just high-school education – human capital theory and screening theory.
  - a. Briefly explain what each theory means.
  - b. Do you think that government should act differently (in terms of policies promoting education) depending on which effect dominates? Explain.
2. (3 points) Read the Policy Debate on Returns to College Education at: [http://www.swlearning.com/economics/policy\\_debates/return\\_to\\_ed.html](http://www.swlearning.com/economics/policy_debates/return_to_ed.html) (read only the main part; do not follow links unless you want to). Briefly summarize both sides of the debate.<sup>1</sup>
3. (1 point) Why is it possible to observe two persons with identical preferences and incomes, one of which buys insurance and the other one does not?
4. (4 points) Johnny is considering whether to buy health insurance. His utility is given by  $U(I)=I^{1/2}$ , where  $I$  is his yearly income equal to \$25,000. However, there is a 5% chance that he'll fall sick with a flu virus, which will cost him \$5000.
  - a. What is the expected utility of not buying any insurance?
  - b. What is the actuarially fair premium for the health insurance in this case?
  - c. Assuming that the premium is actuarially fair, what is the expected utility associated with buying full insurance (i.e. insuring all \$5000 of potential loss)? What is the expected utility associated with insuring only half of the loss (\$2,500)? Is Johnny going to choose full insurance or partial insurance?

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<sup>1</sup> Theodore Schultz, a Nobel-prize winning economist mentioned in this debate, was the head of the economics department at Iowa State.