3 ii All of these circumstances mean that the market price (the wage, the price of imports and competing domestic goods & services, petrol, and insurance) are not equal to the true cost of provision, the shadow price. Whereas a FA just uses the market price, a CBA should use the shadow price as a true measure of the cost of provision (the sacrifice necessary to obtain the good or service).

(a) As discussed in class, when there is involuntary unemployment, it is because there is a rigidity in the market, and the market wage > the shadow wage. (This is why CBA will favour labour-intensive projects when there is high unemployment.)

(b) As in the Lecture Notes, the tariff is a tax that drives a wedge between the cost of production and the higher market price. (There may be other dynamic effects as well.)

(c) If prices are kept artificially low then the shadow price > market price. There are ways of adjusting the market price to get the opportunity cost of supply = the shadow price.

(d) As in (c), the market premium < the true cost of provision. In calculating the NPV when insurance is bought, use the shadow price > market price.