

Place your name on the back of this sheet of paper and nowhere else. Staple your answers face up on the front of this sheet of paper. Failure to follow these directions will cost you 10 points. Your assignment will be typed, except graphs can be drawn by hand and mathematical equations can be done by hand. Failure to type it will cost you 10 points. If you use double-sided printing or print on the back of scrap paper, I will give you one additional point.

- 1) (15 points) What is the *principal-agent* problem? Explain why that causes some decisions made to be the wrong decision.
- 2) (20 points) Give an example of moral hazard. Explain how the firm in your example attempts to reduce the problem.
- 3) (20 points) What are public goods? Explain why market mechanisms cannot work. In other words, explain why firms cannot sell their product.
- 4) (15 points) Some of the outcomes we desire have a negative impact upon other outcomes. For example, moving more towards the “most desirable” income distribution will have a negative impact upon economic efficiency. Explain why that is the case.
- 5) (15 points) Suppose a country improves on the outcome of income distribution, but slides backwards on economic efficiency. Why is it hard to tell if the country’s economic system is improving or sliding backwards?
- 6) (15 points) Explain the difference between *static efficiency* and *dynamic efficiency*. Why do we want both?