

Problem Set 1: Due Friday January 18 at the start of lecture.

Readings: Stiglitz and Walsh, Chapters 1-4.

1. For each of the following statements, explain which one of the five core concepts of trade-offs, incentives, exchange, information, and distribution is illustrated (some may illustrate more than one core concept):

- a) News of a case of mad cows disease in the U.S. causes beef prices to fall.
- b) Globalization reduces the demand for low skill workers in the United States.
- c) New environmental laws let firms trade their rights to emit pollution.
- d) Higher gas prices lead consumers to purchase more hybrids.
- e) State budget problems force the state to decide which programs to cut.

2. Stiglitz-Walsh, Chapter 2, page 64, Problem 4.

3. Stiglitz-Walsh, Chapter 3, page 89, Problems 3-4.

4. Assume Alfred has \$10,000, which he can either consume today or save and consume next year. If the interest rate is 10 percent, how much can he consume next year if he consumes nothing now? Suppose the interest rate falls to 5 percent. Now how much can he consume next year if he consumes nothing today? Use this example to discuss the income and substitution effects of the decrease in the interest rate.

5. Assume now that Alfred has no income this year, but next year will come into an inheritance of \$11,000. The bank is willing to lend money to Alfred at a 10 percent interest rate. How much can he borrow and spend today? How does your answer change if the interest rate charged by the bank falls to 5 percent? Use this example to discuss the income and substitution effects of the decrease in the interest rate; why do both effects work in the same direction?

7. Stiglitz-Walsh, Chapter 4, page 115, Problems 1-3.

Discussion questions for section during week 2: Stiglitz-Walsh, Chapter 2, page 64, problems 1, 2 and 5.

Discussion questions for section during week 3: Stiglitz-Walsh, Chapter 5, page 129, Review question 2, problem 2.