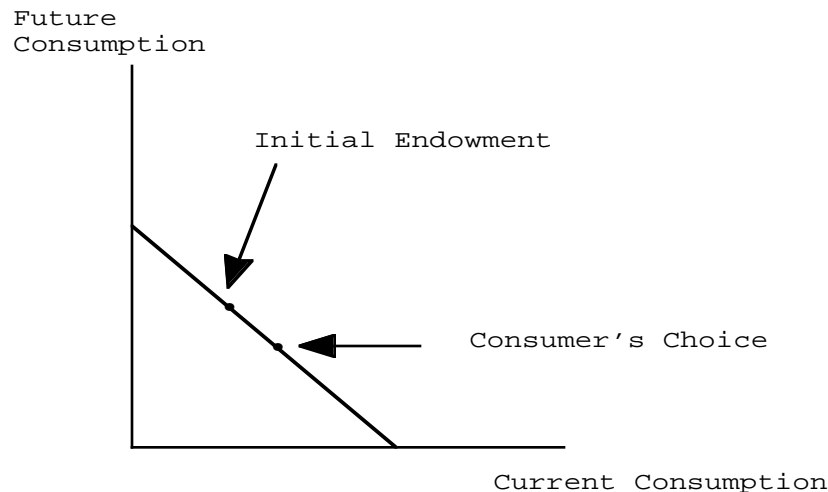


Midterm 2

Part I. Multiple Choice (50 Points): For each of the following choose the best answer.

Questions 1 and 2 refer to the following diagram.



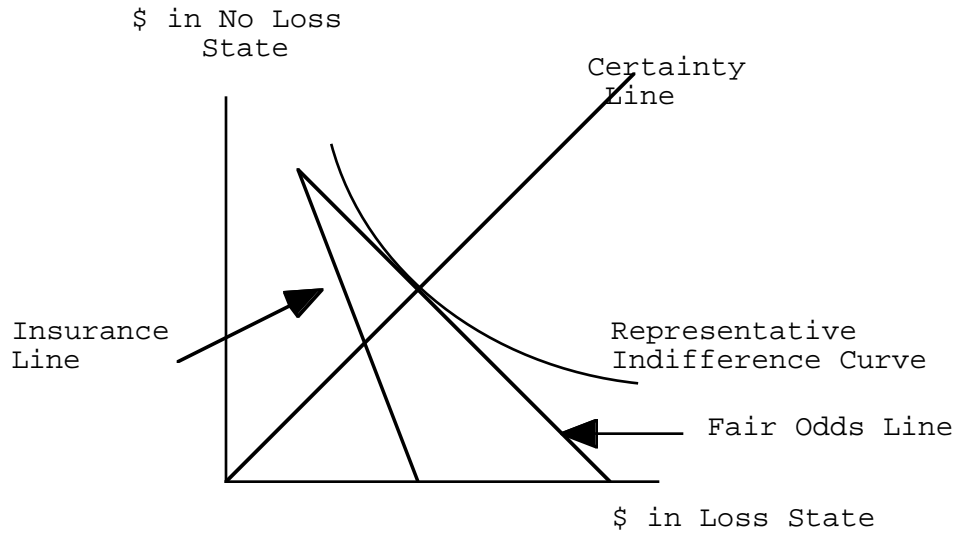
1. According to the diagram
 - a) The consumer is a saver.
 - b) The consumer is patient.
 - c) The consumer is a borrower.
 - d) The substitution effect outweighs the income effect.

2. If the interest rate were to rise
 - a) This consumer would be worse off.
 - b) This consumer would definitely increase current consumption.
 - c) This consumer would definitely decrease future consumption.
 - d) The consumer would be better off.

3. Suppose that in the short run the price of capital, the fixed input, rises. We should expect that
 - a) The firm will produce more output.
 - b) The firm will use more labor.
 - c) The firm's output will stay unchanged.
 - d) The firm will shut down.

4. Suppose that in the short run the price of capital, the fixed input, rises and the product market is perfectly competitive.
 - a) The product price will rise.
 - b) The product price will fall.
 - c) The product price will remain unchanged.
 - d) There will be entry.

Questions 5 - 7 refer to the following diagram.



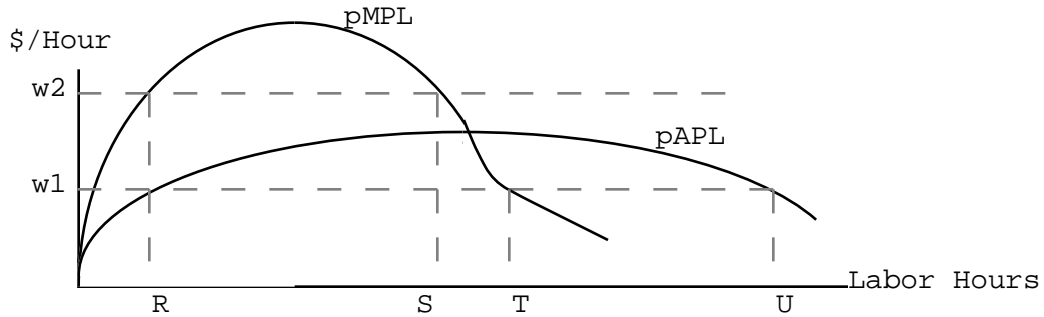
5. From the diagram, it must be that this individual
 - a) Is risk averse.
 - b) Is risk neutral.
 - c) Is risk seeking.
 - d) Prefers less money to more money.

6. This individual purchases insurance
 - a) Equal to the size of the loss.
 - b) So that all the risk is eliminated.
 - c) To transfer income from the loss state to the no-loss state.
 - d) Less than the size of the loss.

7. Suppose that along the insurance line the price of insurance is thirty cents per dollar of coverage. Then the probability of loss
 - a) Equals $7/10$.
 - b) Is greater than $7/10$.
 - c) Equals $3/10$.
 - d) Is less than $3/10$.

8. The primary explanation for increasing returns to scale is
 - a) Division of labor, i.e., assigning different workers to different tasks, when capital is held fixed.
 - b) Congestion effects among workers when capital is held fixed.
 - c) Indivisible inputs.
 - d) The increasingly hierarchical structure of the firm as its scale of operation increases.

Questions 9 and 10 refer to the following diagram.



9. Suppose the wage is given by w_1 . Then the firm's labor demand is given by

- a) Zero.
- b) R.
- c) T.
- d) U.

10. Suppose the wage is given by w_2 . Then the firm's labor demand is given by

- a) Zero.
- b) R.
- c) S.
- d) U.

Part II. Essay (25 Points): Answer the following in a paragraph or two. You need not write a lot of text, but make sure to answer the question.

Many people think that professional athletes are "overpaid." Would an economist think this? Regardless of whether you answer yes or no, justify your answer.

Part III. Problem (25 Points): Answer the following by supplying as many graphs as you deem appropriate. You should also include some text to explain what you're doing.

Suppose that in some industry the government imposes a tax of \$10 per unit output.

In the short run:

- a) What happens to marginal cost and average cost?
- b) What happens to the industry supply curve?
- c) What happens to the equilibrium product price? To the equilibrium amount purchased by buyers? Does the price go up by the amount of the tax?

In the long run (assume the industry is constant cost):

- a) What happens to marginal cost and average cost?
- b) What happens to the industry supply curve?
- c) What happens to the equilibrium product price? Does the price go up by the amount of the tax?