Youngberg

Econ 280—Bethany College

**Homework 04**

Answer all the following on a ***typed, stapled*** (if applicable)separate sheet of paper. You do not need to type equations and graphs. I charge 25 cents to staple your homework. Make sure that you justify your answers, use your own words, and show your work. All questions are equally weighted.

1. Using at least one example, define moral hazard. How is moral hazard different from adverse selection?
2. In many classes, it may seem like what you’re doing has no real world relevance even if these classes are required for your degree. While what you major in matters for your future earning potential (as we discussed), getting a degree in any major increases your earning potential even if you took many classes with little or no practical application. Why?
3. Consider Cathy Cornwall of Cathy’s Cleaning Crew, a company which commissions crews to clean for customers. Cathy wants to make sure her teams of cleaners do a thorough job at each domicile they visit without wasting any time (such as spending too much time at a home) or money (such as not using the strongest cleaning products for every mess since those products are most expensive but not always necessary). This is a very difficult balance to achieve since homes vary widely in the level of cleaning they need and the quality of cleaning is not easy to measure. Ideally, Cathy would be with a crew to make sure they achieve the right balance but Cathy has several crews—she can’t be everywhere at once—so she considers two different incentive structures to properly motivate her employees. Assume customers are assigned randomly to crews, thus everyone ends up with roughly the same number of very dirty homes, relatively dirty homes, etc. over the course of a month. (In other words, all crews should end up with the same amount of work.)

**Option 1.** For the crew which receives the best customer reviews (which are based on level of cleanliness and professionalism), Cathy will give each member a $1,000 bonus. This contest occurs each month.

**Option 2.** For every 5,000 square feet of living space (thus accomplished with many small homes, a few large ones, or a mix of both), each team member get a $50 bonus.

How does each option accomplish some of what Cathy wants? How does each option fail at accomplishing something else that Cathy wants?

1. As mentioned, law and economics concerns with structuring the law as to encourage economic efficiency. Select one of the ways contracts can be rendered unenforceable. How does that way of unenforceability encourage a more efficient society?
2. In *Drake v. Lerner Shops of Colorado, Inc.* (1960), a woman leaves a clothing store and, blinded by sunlight which happen to be quite bright that day and reflecting off a white building across the street at the just the right angle, fails to see an otherwise clear “Step Down” sign. She trips as a result and falls, fracturing a hip. She sues the store for damages. Using the Learned Hand formula, predict how the judge would rule on this case. Be sure to justify your answer by estimating values for each part of the formula. (In other words, what’s the expected cost of being blinded by the sun, causing a fall and an injury versus the cost of ensuring such an accident as stated never happens?)